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# M&A AND CORPORATE GOVERNANCE CONFERENCE 2017

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# M&A AND CORPORATE GOVERNANCE CONFERENCE 2017

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March 29, 2017

## **M&A REPORT - TRANSACTIONS WITH NON-CONFLICTED CONTROLLING STOCKHOLDERS AND OBTAINING THE "FULLY INFORMED, UNCOERCED VOTE" OF DISINTERESTED STOCKHOLDERS**

To Our Clients and Friends:

On March 7, 2017, the Delaware Chancery Court granted a motion to dismiss in *In re Columbia Pipeline Group, Inc. Shareholder Litigation*, which capped a line of cases starting with *Corwin v. KKR Financial Holdings LLC* and continued with *In re Volcano Corporation Shareholder Litigation* that clarified that the business judgment rule applies to tender offers and to mergers that are approved by a "fully informed, uncoerced vote" of disinterested stockholders in which the merger counterparty is a non-controlling stockholder or a non-conflicted controlling stockholder.<sup>[1]</sup> Read together, these cases provide a roadmap for practitioners to limit post-closing stockholder litigation involving transactions with such stockholders by providing adequate disclosure of the negotiation process, the relationship between the company and its financial advisor and the analysis undergirding any fairness opinion. Here, we will outline the following key questions that directors, financial advisors and practitioners should consider in order to maximize the chance that approval of a transaction will be subject to the protection of the business judgment rule:

1. *Is the transaction with a stockholder that is (a) a "controller" and (b) "conflicted"? If not, then the approval of the transaction by a "fully informed, uncoerced vote" of disinterested stockholders will cleanse the transaction and the business judgment rule will apply.*
2. *If the transaction counterparty is not a "controller" or is a controller that is not "conflicted" and the shareholders vote to approve the transaction, then what determines whether such vote was "fully informed"? In general, stockholders must be provided material information pertaining to the transaction, which information is not misleading or omits material facts. Examples of subsidiary issues relating to the materiality standard for disclosure follow below:*
  - a. *Have the material facts pertaining to the negotiation of the transaction been disclosed?*
  - b. *Has the relationship between the company and its financial advisor been described?*
  - c. *If a fairness opinion is presented in the proxy, have the "key inputs" to the analysis undergirding the fairness opinion been sufficiently disclosed?*

*(1) Is the transaction with a stockholder that is (a) a "controller" and (b) "conflicted"?*

Standing at the center of the analysis under Delaware law of whether one party to a transaction is a "controller" is whether such party could exercise control over the board of directors of the other party to

the transaction. The *Corwin* line of cases distinguishes between this narrow formulation of control and contractual or other commercial relationships between the parties to a transaction that may merely confer rights in favor of one party with respect to the other party.

In *Corwin*, the company at issue merged with an entity that held 1% of the common stock of the company, but the company and the other entity were parties to a management agreement pursuant to which the company delegated responsibility for its day-to-day operations to the other entity, including providing employees and office space and administering other back-office functions. The Delaware Supreme Court endorsed the analysis of the Delaware Chancery Court, which noted that, while the entity "managed the day-to-day operations of [the company]," the management contract did not demonstrate that the other entity "controlled the [company] board--which is the operative question under Delaware law--such that the directors of [the company] could not freely exercise their judgment in determining whether or not to approve and recommend to the stockholders a merger with [the entity]."[2] Further, the Delaware Supreme Court explained that the entity "had no right to appoint any directors, and had no contractual right to veto any board action" of the company and that the company had "real assets" and an "independent board" that could choose its own course of action and otherwise could act without the other entity's consent.[3]

Standing on the other side of the ledger, as noted in *Larkin v. Shah*,[4] is the test for control set forth in *In re Cysive, Inc. Shareholders Litigation*. In *Cysive*, the court found that a company's founder, chairman and chief executive officer who held 35% of the company's outstanding stock was a controller because he wielded control over two immediate family members and stockholders whom he had installed as officers and directors, which gave him "day-to-day managerial supremacy" and the ability to effectively control a total of 40% of the common stock to his own benefit.[5] A more recent Delaware Chancery Court opinion summarized *Cysive* and found that, in the absence of a "significant showing" similar to that made in *Cysive*, "the courts have been reluctant to apply the label of controlling stockholder . . . to large, but minority, blockholders." [6]

The analysis does not end simply with control, however, for purposes of whether a transaction constitutes a "conflicted transaction" and, as such, merits the application of the entire fairness standard. Such transactions arise when the controller stands on both sides of a deal (as when, for instance, a parent acquires a subsidiary), as well as when the controller "derived a personal financial benefit to the exclusion of, and detriment to, the minority stockholders." [7] If a controller is merely selling its shares and receiving the same consideration as the minority shareholders, then the controller's and the minority shareholders' interests are not in conflict and the entire fairness standard is not applied. For example, the Delaware Chancery Court found that the entire fairness standard did not apply in *In re Merge Healthcare Inc.*, in which a putatively-controlling 26% stockholder sought to sell its shares to obtain liquidity and, as such, was "fully aligned with the stockholders' interest to obtain the highest price possible." [8] Further, Delaware courts have reacted skeptically to allegations that a controlling stockholder seeking liquidity for its shares had accelerated the sale process to such an extent that it became a "fire sale" and resulted in a diminution of consideration paid to all shareholders. These theories rely on the counterintuitive notion that in such cases a controller will not seek to maximize its own consideration. The courts have reacted by indicating that such theories will be substantiated only if the plaintiffs make specific allegations describing a unique liquidity need.

*(2) If the transaction counterparty is not a "controller" or is a controller that is not "conflicted" and the shareholders vote to approve the transaction, then what determines whether such vote was "fully informed"?*

For a stockholder vote to be "fully informed," the corresponding proxy statement must contain "material information" pertaining to the "integrity or financial fairness of the transaction" and not contain "materially misleading disclosure and omissions." By the same token, "'fully informed' does not mean infinitely informed" and, as such, "[r]edundant facts, insignificant details, or reasonable assumptions need not be disclosed. Nor must information be disclosed simply because a plaintiff alleges it would be helpful or interesting."<sup>[10]</sup> Rather, information is material if "from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the total mix of information made available."<sup>[11]</sup> Claims pertaining to the adequacy of disclosure to stockholders arise in the context of both pre-closing disclosure claims, heard on a motion for preliminary injunctive relief, post-closing disclosure claims alleging a breach of fiduciary duty by the board of directors.<sup>[12]</sup> A discussion of various manifestations of this standard in both contexts follows below.

*(a) Have the material facts pertaining to the negotiation of the transaction been disclosed?*

Regarding disclosure of the negotiation process, the proxy must include disclosure of "all of the objective facts regarding" the interests of the company's board of directors and the stockholder at issue, the negotiation process and any "troubling facts regarding director behavior . . . that would have been material to a voting stockholder."<sup>[13]</sup> Notably, in emphasizing the importance of disclosing "objective facts," a proxy statement need not include, for instance, how certain directors or officers were selected to lead a negotiation, as "asking 'why' does not state a meritorious disclosure claim."

The standard requiring only disclosure of material objective facts serves as a useful lens through which to understand how particular events in a negotiation should be conveyed. For instance, in *Corwin*, the plaintiffs alleged an inadequacy in the proxy disclosure as to the whether certain allegedly non-independent directors played a role in negotiating the transaction at issue. The court responded by noting the detail with which the directors' role was explained in the proxy and concluded that the gravamen of the plaintiffs' complaint was that the proxy did not explain why the directors at issue spearheaded the negotiations, and that merely asking this question is insufficient to raise a claim.<sup>[14]</sup> Similarly, in *In re Solera Holdings, Inc. Stockholder Litigation*, the plaintiffs alleged that a proxy statement did not provide sufficient detail regarding a supposed shift in compensation strategy for the company's senior officers away from long-term performance and towards consummating a transaction. However, the proxy statement did include detailed factual disclosure about the nature of the cash and stock awards granted to management, including the milestones for obtaining such awards. As such, the court found no deficiency because all the relevant facts pertaining to management's compensation were provided, and the absence of one potential explanation for the shift was insufficient to merit a disclosure claim.<sup>[15]</sup>

A frequently litigated issue is whether and to what extent the details of other offers that a company may have received constitutes "material information" that necessitates disclosure. The touchstone of whether other offers should be disclosed generally is whether the company had determined that negotiations with a potential counterparty had merit. For instance, in *City of Miami v. Comstock*, the plaintiffs alleged

deficiencies in a proxy statement that referenced in passing an acquisition proposal from a third party that the special committee determined, based on the advice of its legal counsel and financial advisor, was not reasonably likely to lead to a superior proposal. The plaintiffs claimed that the proxy statement should have contained the financial terms of the third party's proposal and statements to the effect that the special committee's financial advisor did not analyze certain forecasts and synergy projections relating to the bid of the third party. The court rejected these arguments on the premise that they recast the plaintiffs' substantive disagreement with the special committee's decision as a disclosure claim and held that Delaware law "does not require disclosing details about offers that directors conclude are not worth pursuing." Rather, disclosure that adheres to the objective facts of a negotiation without speculating as to a particular party's motivation is sufficient.<sup>[16]</sup> Even where a company does view a competing bid in the first instance as having merit, the good-faith determination that such bid could not, following negotiation, be improved so as to constitute a superior proposal will correspondingly obviate the need to provide detailed disclosure on such bid, as explained in *In re OM Group, Inc. Stockholders Litigation*.<sup>[17]</sup>

*(b) Has the relationship between the company and its financial advisor been adequately described?*

For a stockholder vote to be considered "fully informed," a proxy must contain "full disclosure of investment banker compensation and potential conflicts"<sup>[18]</sup> that permits stockholders to "understand what factors might influence the financial advisor's analytical efforts."<sup>[19]</sup>

The Delaware Chancery Court's decision in *OM Group* provides helpful instruction on this point. The plaintiffs challenged the adequacy of a proxy that disclosed the amount of the payment to be made to the investment bank providing the fairness opinion by the company. The disclosure made clear that such payment was contingent upon the consummation of the merger and indicated that the investment bank had previously received over €40 million in fees from the company's merger counterparty for a variety of investment and commercial banking services over the prior three-year period. The proxy further indicated that the company's board knew that the investment bank had received "significant fees," but that the board did not know the amount when it engaged such bank.

The plaintiffs alleged that the proxy was inadequate because it did not disclose the fact that the company's board initially considered retaining the investment bank on a fixed-fee basis before switching to a contingency fee structure and because it did not make clear that the board did not know the amount of the fees previously received by the investment bank from the merger counterparty. As to the first point, the court found that such internal deliberations constituted non-material "play-by-play" information and cited approvingly an earlier holding that a "board's underlying reasons for acting" are generally not deemed material. As to the second point, the court emphasized that the information would not have added to the total mix of information available to stockholders and noted, in a footnote, that such disclosure might have exposed the board to a potential claim for a breach of the duty of care. Yet, in such circumstances, the court noted that a "board is not required to engage in 'self-flagellation' and draw legal conclusions implicating itself in a breach of fiduciary from surrounding facts and circumstances prior to a formal adjudication of the matter."<sup>[20]</sup> More recently, in *Columbia Pipeline Group*, in refuting the plaintiffs' argument that a proxy statement failed to disclose that directors stood to benefit personally from engineering a spinoff (notwithstanding that the proxy did disclose certain change-of-control

benefits to which such directors would be entitled in the event of such a transaction), the court observed, "When a proxy statement describes the facts that create differing incentives for fiduciaries, it need not explain how those differing incentives could produce a self-interested outcome."<sup>[21]</sup>

Correspondingly, *Volcano* involved a transaction in which the company's investment bank had previously helped finance the company through the purchase of certain warrants. Upon the consummation of the contemplated transaction, the company would be obligated to pay the investment bank a spread based upon the value of those warrants. The proxy disclosed that the investment bank had received the warrants and that the value of the warrants would decline over time, which would incentivize the investment bank to consummate the transaction as soon as possible; however, the plaintiffs alleged a deficiency in that the proxy failed to describe the "exponential" rate at which the warrants would decay, which would presumably accentuate the investment bank's incentive. Nonetheless, the court rejected this argument in part because disclosure of the objective fact that the warrants would decline in value was sufficient to illustrate the incentive that the investment bank had in working to consummate the transaction, and adding detail about the rate at which the warrants would decline in value would only marginally improve the stockholders' understanding of the incentives at work.<sup>[22]</sup>

*(c) Have the "key inputs" to the fairness opinion been sufficiently disclosed?*

In presenting the analysis underlying a fairness opinion, "the valuation methods used to arrive at that opinion as well as the key inputs and range of ultimate values generated by those analyses must also be fairly disclosed."<sup>[23]</sup> As such, "a disclosure that does not include all financial data needed to make an independent determination of fair value is not *per se* misleading or omitting a material fact."<sup>[24]</sup>

The Delaware Chancery Court's recent decision in *Merge Healthcare* provides a useful gloss on this standard. The proxy statement at issue contained a fairness opinion with a discounted cash flow analysis of the company, indicated that the net present value of net operating losses was included in such analysis and stated the discount rate applied to such net operating losses. The Plaintiffs alleged that the board failed to disclose the standalone net present value of the company's net operating losses because such net present value comprised a material portion of the valuation of the company. The court rejected this argument on the premise that the proxy already included "key inputs," which it listed as revenue, gross profit, EBITDA, EBIT, net income, earnings per share and unlevered free cash flows, and further concluded that the addition of information pertaining to the net operating losses would not "alter the total mix of information available to the stockholders given the fair summary of [the financial advisor's] work already contained in the Proxy."<sup>[25]</sup>

\* \* \*

In recent months, *Corwin* and its progeny have been adopted or cited favorably by several non-Delaware courts.<sup>[26]</sup> As such, directors, financial advisors and practitioners across jurisdictions would be well-served in understanding the path set forth by the Delaware courts towards ensuring that disinterested stockholders approve transactions through a "fully informed, uncoerced vote."



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- [1] See *In re Columbia Pipeline Grp., Inc. S'holder Litig.*, C.A. No. 12152-VCL (Del. Ch. filed Mar. 7, 2017); *In re Volcano Corp. S'holder Litig.*, 143 A.3d 727 (Del. Ch. 2016), *aff'd*, No. 372, 2016, 2017 WL 563187 (Del. Sup. Ct. Feb. 9, 2017) (Strine, C.J.); *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015), *aff'g*, *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980 (Del. Ch. 2014); see, e.g., *In re Merge Healthcare, Inc.*, Consol. C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017); *In re Solera Holdings, Inc. S'holder Litig.*, C.A. No. 11524-CB, 2017 WL 57839 (Del. Ch. Jan. 5, 2017); *In re OM Grp., Inc. S'holders Litig.*, Consol. C.A. No. 11216-VCS, 2016 WL 5929951 (Del. Ch. Oct. 12, 2016); *Larkin v. Shah*, C.A. No. 10918-VCS, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016); *City of Miami Gen. Emps. & Sanitation Emps. Ret. Trust v. Comstock*, C.A. No. 9980-CB, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016).
- [2] *KKR Fin. Holdings*, 101 A.3d at 991-95; accord *Corwin*, 125 A.3d at 306-08.
- [3] *Corwin*, 125 A.3d at 307-09 & n.7.
- [4] *Larkin*, 2016 WL 4485447, at \*14.
- [5] *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 551-52 (Del. Ch. 2003).
- [6] *In re Crimson Exploration Inc. S'holder Litig.*, C.A. No. 8541-VCP, 2014 WL 5449419, at \*11-12 (Del. Ch. Oct. 24, 2014).
- [7] *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1034 (Del. Ch. 2012) (internal quotations marks omitted); see *Larkin*, 2016 WL 4485447, at \*8 & nn. 45-46.
- [8] *Merge Healthcare*, 2017 WL 395981, at \*8.
- [9] *Synthes*, 50 A.3d at 1035-36; accord *Larkin*, 2016 WL 4485447, at \*16 & n.96.
- [10] *Merge Healthcare*, 2017 WL 395981, at \*9.
- [11] *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884, 899 (Del. Ch. 2016) (internal quotation marks omitted).
- [12] See, e.g., *Nguyen v. Barrett*, C.A. No. 11511-VCG, 2016 WL 5404095, at \*3 (Del. Ch. Sept. 28, 2016).
- [13] *Corwin*, 125 A.3d at 312 & n.27.
- [14] *KKR Fin. Holdings*, 101 A.3d at 1000-01 (internal quotation marks omitted).
- [15] *Solera Holdings*, 2017 WL 57839, at \*11-12.
- [16] *City of Miami*, 2016 WL 4464156, at \*14-15.

- [17] *OM Grp.*, 2016 WL 5929951, at \*12-14.
- [18] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 832 (Del. Ch. 2011).
- [19] *David P. Simonetti Rollover IRA v. Margolis*, C.A. No. 3694-VCN, 2008 WL 5048692, at \*8 (Del. Ch. June 27, 2008).
- [20] *OM Grp.*, 2016 WL 5929951 at \*16-17 & nn. 92, 95 (internal quotation marks omitted).
- [21] *Columbia Pipeline Grp.*, slip op. at 6.
- [22] *Volcano Corp.*, 143 A.3d at 749.
- [23] *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 203-04 (Del. Ch. 2007).
- [24] *Nguyen v. Barrett*, C.A. No. 11511-VCG, 2015 WL 5882709, at \*4 (Del. Ch. Oct. 8, 2015).
- [25] *Merge Healthcare*, 2017 WL 395981, at \*12.
- [26] *See, e.g., In re Xtreme Power Inc.*, 563 B.R. 614, 633 (Bankr. W.D. Tex. 2016); *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 12-CV-2652 (RJS), 2017 WL 82391, at \*7 (S.D.N.Y. Jan. 6, 2017); *Quinn v. Knight*, C.A. No. 3:16-cv-610, 2016 WL 6471462, at \*3 (E.D. Va. Nov. 1, 2016); *MAZ Partners LP v. Shear*, C.A. No. 11-11049-PBS, 2016 WL 4574640, at \*7 (D. Mass. Sept. 1, 2016).



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## **NEW YORK AND DELAWARE PART WAYS ON M&A "DISCLOSURE-ONLY" SETTLEMENTS**

To Our Clients and Friends:

On January 22, 2016, the Delaware Court of Chancery signaled the demise of "disclosure-only" settlements in M&A stockholder lawsuits with its decision in *In re Trulia, Inc. Stockholder Litigation*.<sup>[1]</sup> Arguing that the "optimal means by which disclosure claims in deal litigation" should be through adjudication rather than the settlement process, the Chancery Court cautioned that it would "continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the 'give' and 'get'" of disclosure-only settlements. The Chancery Court offered its "hope and trust that [its] sister courts will reach the same conclusion if confronted with the same issue."

On February 2, 2017, in *Gordon v. Verizon Communications, Inc.*, the Appellate Division for the First Department in New York announced a different approach in reversing a lower court's rejection of a "disclosure-only" settlement.<sup>[2]</sup> The *Gordon* litigation arose from a putative class action relating to Vodafone Group plc's sale of its 45% minority stake in Cellco Partnership, Inc. ("Cellco") to Verizon Communications, Inc. ("Verizon") for \$130 billion in stock and cash. The plaintiffs alleged that Verizon's board of directors had breached its fiduciary duties to Verizon's shareholders by causing Verizon to overpay for Cellco stock and that Verizon had failed to disclose material information in its preliminary proxy statement concerning the transaction. The parties reached an agreement to settle the action pursuant to which Verizon agreed (a) to provide its shareholders with additional disclosures in its definitive proxy statement, (b) to obtain a fairness opinion from an independent financial advisor if Verizon entered into certain material transactions during the subsequent three years and (c) not to oppose the fee and expense application of plaintiffs' counsel up to a cap. Following a hearing, the lower court declined to approve the settlement, finding that the incremental disclosures "individually and collectively fail[ed] to materially enhance the shareholders' knowledge about the merger" and "provide[d] no legally cognizable benefit to the shareholder class" and, as such, was not "fair, adequate, reasonable and in the best interests of the class members."

The First Department reversed the lower court's decision and entered an order approving the settlement. The Court initially applied the five-factor test for evaluating a settlement of merger litigation announced previously in *In re Colt Industry Shareholders Litigation*: (i) the likelihood of success on the merits, (ii) the extent of support from the parties for the proposed settlement, (iii) the judgment and experience level of the plaintiffs' counsel, (iv) the presence of bargaining in good faith and (v) the "nature of the issues of law and fact" (that is, whether the process for negotiating a settlement agreement itself would be appropriate for the resolution of the plaintiffs' claims). The Court found that the proposed settlement satisfied these five factors.

The Court then proceeded to explain that the "need to curtail excesses not only on the part of corporate management, but also on the part of overzealous litigating shareholders and their counsel" necessitated the introduction of two new factors to evaluate proposed litigation settlements: (a) "whether the proposed settlement is in the best interests of the putative settlement class as a whole" and (b) "whether the settlement is in the best interest of the corporation." In considering the first factor, the Court found that certain of the incremental disclosures required by the settlement agreement, such as disclosing the identities of the financial advisors that valued the interest in Cellco as well as providing further detail on the financial advisors' valuation methods, were "of some benefit to the shareholders." The Court ascribed particular weight to the requirement that Verizon obtain a fairness opinion from an independent financial advisor for certain future transactions because the "prospective corporate governance reform provided a benefit to Verizon shareholders in mandating an independent valuation, without restricting the flexibility of directors in making a pricing determination." As to the second factor, the Court noted that the "lack of a monetary or quantifiable benefit to the corporation does not necessarily preclude" a finding that the settlement is in the best interest of the corporation. The Court then concluded that the settlement benefited the corporation because it allowed Verizon to provide input into the additional disclosures to be made to shareholders while allowing Verizon to avoid incurring the additional expenses of a trial.

The *Gordon* decision has several significant implications for deal litigation in New York that both companies and practitioners should consider:

*First*, the *Gordon* decision has received attention for suggesting that New York is more receptive than Delaware to disclosure-only M&A settlements. However, practitioners should not ignore the Court's focus on the settlement agreement's requirement that Verizon retain an independent financial advisor in the future in connection with certain material transactions, which the Court described as a "corporate governance reform in place to safeguard the valuation of corporate assets" that "constitutes a sufficient benefit to the putative class of shareholders as a whole to warrant approval of the proposed settlement." While the Court acknowledged that requirements of this nature should not unduly restrict the "flexibility of directors in making a pricing determination," the use of similar covenants in settlements of M&A litigation may make them more palatable to New York courts irrespective of the incremental disclosure requirements.

*Second*, the *Gordon* Court responded to concerns about the breadth of the release granted in the settlement agreement--an issue identified in the *Trulia* decision as a reason to be skeptical of disclosure-only settlements--by noting that (i) all shareholders had the right to seek exclusion from the settlement to the extent necessary to preserve their monetary claims, (ii) only two shareholders (out of more than two million) appeared at the fairness hearing held by the lower court and (iii) ultimately none of the shareholders objected to the settlement. On this basis, the Court found that "none of the shareholders was divested of his or her rights." This suggests that New York courts may consider the factual record in respect of the conduct of the shareholders to determine whether the scope of the release is appropriate in a given litigation settlement.

*Third*, it is worth noting that New York law continues to evolve and bears watching in this arena. A separate concurring opinion emphasized that none of the parties had addressed the adequacy of the five-factor *Colt* test in gauging settlement agreements and cited to opinions of the New York Court of Appeals

that declined to address matters not briefed by the parties. In addition, other New York courts have expressed skepticism of disclosure-only settlements in terms that echo those used in *Trulia*.<sup>[3]</sup> As such, whether other judicial departments and/or the New York Court of Appeals will adopt the expanded test set forth by the First Department in *Gordon* remains to be seen.

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[1] 129 A.3d 884 (Del. Ch. 2016). See our discussion of *Trulia* here.

[2] No. 653084/13, 2017 WL 442871 (N.Y. App. Div. Feb. 2, 2017).

[3] See, e.g., *In re Allied Healthcare S'holder Litig.*, 43 Misc.3d 1210(A), 2015 WL 6499467, at \*3 (N.Y. Sup. Ct. Oct. 23, 2015); *City Trading Fund v. Nye*, 46 Misc.3d 1206(A), 2015 WL 93894, at \*14 (N.Y. Sup. Ct. Jan. 7, 2015), *rev'd on other grounds*, 144 A.D.3d 595 (N.Y. App. Div. 2016).



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June 3, 2016

## **DELAWARE COURT OF CHANCERY AWARDS 28% PRICE INCREASE TO STOCKHOLDERS WHO DISSENTED FROM 2013 MANAGEMENT-LED BUYOUT OF DELL INC.**

To Our Clients and Friends:

On May 31, 2016, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued his much-anticipated merits opinion in *In re: Appraisal of Dell Inc.*, C.A. No. 9322-VCL, a statutory appraisal action arising from the 2013 management-led buyout of Dell Inc. In the opinion, Vice Chancellor Laster determined that Dell Inc.'s fair value as of the date of the transaction was \$17.62 per share--approximately 28% higher than the \$13.75 per share transaction price approved by Dell Inc.'s stockholders. In contrast to several recent appraisal decisions by the Court of Chancery, Vice Chancellor Laster declined to give significant weight to the transaction price in his determination of Dell Inc.'s fair value.

Although Vice Chancellor Laster recognized that the transaction price can be a relevant factor when determining fair value, he determined that, under the facts of this case, "a combination of factors undercut the relationship between the [transaction price] and fair value, undermining the persuasiveness of the former as evidence of the latter." These factors included, in the Court's view, (i) the use of a leveraged buyout pricing model to determine the transaction price, "which had the effect in this case of undervaluing the Company," (ii) the evidence of a "valuation gap" between the trading price of Dell Inc.'s stock and the Company's operative reality, "driven by the market's short-term focus," and (iii) the lack of meaningful competition among bidders before the merger agreement was signed.

Vice Chancellor Laster further noted that, although Dell Inc. conducted a go-shop after the merger agreement was signed, it was not sufficient to ensure that the transaction price provided fair value. In particular, Vice Chancellor Laster observed that although the go-shop generated two higher indications of interest for the Company, it ultimately resulted in only a 2% price increase for Dell Inc.'s stockholders. Additionally, Dell's large size--approximately 25 times larger than any other "jumped" deal--made a topping bid unlikely. Finally, the Court expressed its view that Michael Dell's superior knowledge of and unique value to the Company created information asymmetries and other potential impediments to competing bidders.

In view of these factors, Vice Chancellor Laster concluded that Dell Inc. "did not establish that the outcome of the sale process offers the most reliable evidence of the Company's value as a going-concern." The market data was sufficient, however, "to exclude the possibility, advocated by the petitioners' expert, that the Merger undervalued the company by \$23 billion." Accordingly, based on the results of a discounted cash flow analysis, Vice Chancellor Laster determined that Dell Inc.'s fair

value was \$17.62 per share, or approximately \$31 billion. For comparison, the \$13.75 per share transaction price valued Dell Inc. at approximately \$25 billion. The petitioners' expert opined that Dell Inc. was worth approximately \$48 billion.

This decision should not be read as a rejection of judicial consideration of--or even deference to--the transaction price in appraisal proceedings. Indeed, Vice Chancellor Laster acknowledged that the Court of Chancery repeatedly "has found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak." However, Vice Chancellor Laster went to great lengths to distinguish the Dell Inc. transaction from those in which the Court of Chancery deferred to the deal price in subsequent appraisal proceedings. In the Court's view, distinguishing factors included the transaction's status as a management-led buyout, rather than an arm's-length, third-party merger; the Special Committee's decision not to contact any potential strategic bidders; and the size of the transaction.

This decision has conflicting implications for the growing appraisal arbitrage trend. On one hand, the decision will probably further encourage appraisal arbitrage in the context of management-led buyouts, which are more likely to involve the circumstances Vice Chancellor Laster concluded undercut the reliability of the transaction price as an indicator of fair value. On the other hand, the decision should serve as a warning to appraisal petitioners who--as Vice Chancellor Laster recognized in his opinion--frequently submit expert testimony that the subject company is worth more than double the transaction price. Vice Chancellor Laster agreed with Dell Inc. that it was "counterintuitive and illogical--to the point of being incredible--to think that another party would not have topped [the buyout group] if the Company was actually worth" \$28.61 per share, the valuation petitioners' expert advanced. Rather, where a transaction results from a credible process free from any fiduciary breaches, the evidence likely will not support a valuation gap of the magnitude typically proffered by petitioners in appraisal proceedings.

The decision has implications for dealmakers, as well. In view of Vice Chancellor Laster's conclusion that the use of a leveraged buyout pricing model to determine the transaction price "had the effect of undervaluing the company," boards, special committees, and their advisors faced with bids from financial sponsors should take care to consider multiple valuation methodologies and determine the fairness of the proposed transaction independent of any leveraged buyout analysis. Additionally, the decision serves as a reminder that go-shops will not necessarily provide a sufficient market check to justify deference to the transaction price in a subsequent appraisal proceeding. Even though Vice Chancellor Laster noted that Dell Inc.'s go-shop was "relatively open" and "flexible," he nonetheless concluded that other factors precluded a finding that the go-shop "in fact generated a price that persuasively established the Company's fair value."





*The following Gibson Dunn lawyers assisted in preparing this client update: Stephen Glover, Eduardo Gallardo, Meryl Young, Adam Offenhartz, Aric Wu and Colin Davis.*

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## Deal Litigation After ‘Trulia’

By **Paul J. Collins** and  
**Michael J. Kahn**

By now, virtually every lawyer who litigates merger cases knows that the “disclosure-only settlement” is either dead or at least on life support in Delaware following several recent decisions rejecting such settlements, including *In re Trulia Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016), *In re Aruba Networks Stockholder Litigation*, C.A. No. 10765-VCL, transcript op. (Del. Ch. Oct. 9, 2015), and *Acevedo v. Aeroflex Holding*, C.A. No. 9730-VCL, slip. op. (Del. Ch. July 8, 2015). And few would say, given the ubiquity with which merger cases have been pursued in recent years, that the “deal tax” that most such settlements represented will be missed. There are, however, likely to be several consequences, both intended and otherwise, that leave the typical defendants in merger litigation subject to the same “perverse incentives” that the Delaware Court of Chancery is attempting to eradicate.

In *Trulia*, Chancellor Andre G. Bouchard declined to approve a disclosure-only settlement of litigation challenging Zillow Inc.’s 2015 stock-for-stock acquisition of Trulia Inc., finding based on the limited record that the defendants’ “give” in the form of supplemental disclosures to the parties’ joint proxy statement was inadequate to



*Paul J. Collins and Michael J. Kahn*

support the “get” of broad releases from the proposed settlement class of “any claims arising under federal, state, statutory, regulatory, common law, or other law or rule’ held by any member of the proposed class relating in any conceivable way to the transaction.”

Following a lengthy discussion of the parties’ incentives in settling merger cases on a disclosure-only basis, and the courts’ frequently limited ability to review the fairness of the terms of such settlements to absent class members, Bouchard noted that, absent a settlement, there are two options to resolve disclosure claims: litigating a motion for preliminary injunctive

relief and supplementing disclosures voluntarily followed by a potential mootness fee application by plaintiffs’ lawyers. In either case, defendants would not obtain a release and “to the extent fiduciary duty claims challenging the sales process remain in the case, they may be amenable to dismissal” on a Rule 12 motion. Although the court did not rule out the viability of disclosure-only settlements given an appropriate record—and the court approved such a settlement in *In re BTU International*, C.A. No. 10310-CB, transcript op. (Del. Ch. Feb. 18, 2016), just weeks after *Trulia*—Bouchard warned that “practitioners should expect that

disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process.”

The court’s new rubric has several practical implications, not all of which may have been anticipated. First, by requiring only “plainly material” supplemental disclosures as a price for obtaining a release, plaintiffs may pass on some marginal cases—but they might also bring more cases (and certainly the marginal ones) in jurisdictions where the settlement standard is lower and the hurdle to dismissal on a pleading motion is higher. Indeed, although the number of merger cases filed in Delaware is down since the court began applying greater scrutiny to disclosure settlements, there is evidence that at least some of those cases are being brought elsewhere.

Anticipating this, Bouchard, in *Trulia*, noted that Delaware companies have the option to adopt bylaws requiring such suits to be filed in Delaware. That option may not always be attractive, however, given that ISS or other proxy advisory firms are not entirely on board with exclusive forum bylaws and ISS, in particular, has stated that it will evaluate such bylaws—and the boards that adopt them—on a case-by-case basis. Moreover, it is not clear that a target’s board will view litigation in Delaware as an attractive option given the hostility

to disclosure settlements; for some target companies and their boards, the prospect of being sued outside Delaware may be a feature rather than a bug. Likewise, it is not yet clear that companies that adopt exclusive forum bylaws will choose to enforce them if, in the context of a merger transaction, a disclosure-only settlement remains an option outside Delaware. Chief Justice Leo E. Strine Jr. of the Delaware Supreme Court recently noted that Delaware judges are likely to “take a dim view” of companies that choose to waive their rights in this circumstance, but at least some companies are doing precisely that to obtain the certainty associated with settlement.

Second, Bouchard, in *Trulia*, noted that the court may apply greater scrutiny to disclosure claims when plaintiffs seek expedited discovery in advance of a stockholder vote and “screen out frivolous cases.” If the court denies expedited discovery based on the perceived merits of the plaintiffs’ claims, the plaintiffs may attempt to obtain the same information through a Section 220 inspection demand. Indeed, in the context of derivative suits, the Court of Chancery has strongly encouraged, if not required, stockholders to pursue their inspection rights prior to filing a complaint.

Finally, the court’s views on disclosure settlements may result in more, not less, merger litigation at least in some types of cases. To the extent that disclosure claims remain untested until after a transaction closes, plaintiffs still may assert disclosure claims post-closing that might easily have been resolved

earlier, in “quasi-appraisal” actions—that is, in class actions in which plaintiffs allege they were denied an effective appraisal remedy because they did not have information sufficient to make an informed appraisal decision. As a result, litigants may pursue disclosure settlements in which releases are narrowed to prevent further disclosure-related claims, including quasi-appraisal claims, while preserving unexculpated fiduciary breach and aiding and abetting claims, such as those at issue in *In re Rural/Metro Stockholders Litigation*, 102 A.3d 205 (Del. Ch. 2014), *RBC Capital Markets v. Jervis*, 129 A.3d 816 (Del. 2015), and *In re Jefferies Group Stockholders Litigation*, C.A. No. 8015-CB, order (Del. Ch. Mar. 26, 2015), and other recent cases.

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April 12, 2017

## **DELAWARE CHANCERY COURT FINDS STOCKHOLDER VOTE TO BE COERCED AND NOT FULLY INFORMED IN *IN RE SABA SOFTWARE, INC. STOCKHOLDER LITIGATION***

To Our Clients and Friends:

In a series of decisions that began with *Corwin v. KKR Financial Holdings LLC*, it is now clear under Delaware law that boards of directors will receive the protection of the business judgment rule "when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders."<sup>[1]</sup> On March 31, 2017, in *In re Saba Software, Inc. Stockholder Litigation*, the Delaware Chancery Court determined, for the first time, that a transaction did not satisfy the *Corwin* standard.<sup>[2]</sup> Although *Saba* addresses unique facts, the opinion provides useful guidance on the required level of disclosure to ensure that the "fully informed" prong under *Corwin* is satisfied, as well as on how Delaware courts analyze the "coerciveness" of a transaction.

*Saba* arose from the acquisition in 2015 of Saba Software, Inc. ("Saba") by affiliates of Vector Capital Management, L.P. ("Vector") in an all-cash merger (the "Merger"). Prior to the Merger, the SEC had filed a complaint accusing Saba of overstating its pretax earnings from 2008 to 2012. After the fraud was uncovered, Saba offered assurances that it would restate its earnings (the "Restatement"), but repeatedly missed deadlines to do so. In June 2013, Nasdaq delisted Saba's common stock, which began trading over-the-counter. In September 2014, Saba and the SEC reached a settlement pursuant to which Saba was required to complete the Restatement by February 2015. Saba announced that it would complete the Restatement on time, but later concluded that it would miss the deadline. In November 2014, the Saba board of directors formed an *ad hoc* committee (the "Committee") to consider strategic alternatives for the company, including a sale. In December 2014, Saba announced that it would miss the SEC's deadline for the Restatement. In February 2015, when Saba formally missed the deadline, the SEC issued an order to deregister Saba stock, which rendered the stock illiquid.

Saba signed a merger agreement with Vector in early March 2015. In seeking stockholder approval of the Merger, Saba distributed a proxy statement to its stockholders (the "Proxy Statement"), which stated, among other things, that Saba intended to complete the Restatement by August 2015, and included valuations of the company based on this and other timelines. Because Saba's stock was deregistered, Saba was not required to submit its Proxy Statement or financial statements to the SEC for review, which allowed it to accelerate the stockholder vote. Three weeks after the Proxy Statement was distributed, Saba's stockholders voted to approve the Merger. Following the closing of the Merger, a former Saba stockholder filed a complaint alleging that the members of Saba's board of directors breached their fiduciary duties, and were aided and abetted by Vector. The defendants moved to dismiss the post-closing complaint.

The Court denied the motion to dismiss in part on the grounds that the stockholder vote was neither "fully informed" nor "uncoerced" under *Corwin* and, as such, the Merger was subject to enhanced scrutiny under *Revlon*. The Court found that the Proxy Statement contained two material omissions of fact. First, the Proxy Statement failed to describe the circumstances surrounding Saba's failure to complete the Restatement, which led to the deregistration of Saba's stock. The Court distinguished this from a typical claim in which a proxy statement provides the facts surrounding a board's decision without explaining its underlying rationale; in considering such claims, Delaware courts have previously held that Delaware law "does not require management to discuss the panoply of possible alternatives to the course of action it is proposing" on the premise that stockholders "entrust management with evaluating the alternatives and deciding which fundamental changes to propose."<sup>[3]</sup> By contrast, in omitting the reasons for Saba's failure to complete the Restatement, the Proxy Statement did not allegedly omit a "purposeful decision of the Board" but rather a "factual development that spurred the sale process and, if not likely correctible, would materially affect the standalone value of Saba going forward."<sup>[4]</sup> Even though the Proxy Statement described the consequences of deregistration and provided estimates of the value of the company based on possible dates by when the Restatement would be completed, the Court determined that the company's history of failing to meet Restatement deadlines meant that the stockholders could not meaningfully assess the credibility of those valuations.

Second, the Court found that the Proxy Statement omitted material facts relating to the Committee's consideration of the company's strategic options in December 2014 once it had become clear that Saba would miss the Restatement deadline and have its stock deregistered. Noting that details concerning alternative courses of action ordinarily need not be disclosed, the Court nonetheless found that the company's realization that it would miss the Restatement deadline "caused a fundamental change to the nature and value of the stockholder's equity stake in Saba." Further, this realization "dramatically affected the environment in which the Board conducted the sales process" and so necessitated disclosure to stockholders regarding whether Saba was viable as a going concern if the Merger were not approved.

In addition, the Court found that the stockholder vote was coerced, which the Court framed as "whether the stockholders have been permitted to exercise their franchise free of undue external pressure created by the fiduciary [*i.e.*, in this case, the board of directors] that distracts them from the merits of the decision under consideration."<sup>[5]</sup> Here, the Court found that the Proxy Statement only gave stockholders a "Hobson's choice" between proceeding with the Merger or holding onto their stock, but without the information that would permit stockholders "to assess whether the choice of rejecting the Merger and staying the course made any sense." As such, the stockholders had "no practical alternative" but to vote for the Merger. Notably, the Court found that coercion does not require identifying some "affirmative action" by the board of directors that would have caused the stockholders who rejected the Merger to be placed in a "worse position than they occupied before the vote"; rather, coercion can exist when a board of directors permits "situationally coercive factors" to force the stockholders to vote a particular way.

It is important to highlight that *Saba* reaffirmed that the *Corwin* standard remains alive and well and will only be overcome based on unusual facts--indeed, the holding in *Saba* is consistent with the Delaware Supreme Court's original admonition in *Corwin* that "if troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked."<sup>[6]</sup> In this regard, the *Saba* Court's examination of whether the stockholder vote was

coerced is coterminous in many respects with its consideration of whether the Proxy Statement omitted material facts. The gravamen of the Court's analysis was the absence of information in the Proxy Statement that would permit stockholders to assess whether the Restatement would be completed and, as such, whether the company's stock could begin to trade freely again. In other words, stockholders were "coerced" not because of their "Hobson's choice" to either accept cash or retain their illiquid stock, but rather because the Proxy Statement omitted certain material facts necessary for the stockholders to reach any credible conclusions regarding the value of their stock.<sup>[7]</sup>

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[1] *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 306 (Del. 2015). See our recent discussion of *Corwin* [here](#).

[2] *In re Saba Software, Inc. S'holder Litig.*, C.A. No. 10697-VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017).

[3] *In re 3Com S'holders Litig.*, C.A. No. 5067-CC, 2009 WL 5173804, at \*6 (Del. Ch. Dec. 18, 2009) (internal quotation marks and citations omitted).

[4] *Saba Software*, 2017 WL 1201108, at \*12.

[5] *Id.* at \*16.

[6] *Corwin*, 125 A.3d at 312.

[7] As the *Corwin* standard requires that stockholders voting to approve a transaction must be both "fully informed" and "uncoerced," it is unclear why the *Saba* Court reached the coercion issue after finding that the stockholder vote was not fully informed. Future Delaware courts may need to assess whether the "coercion" inquiry is derivative of or independent from the "fully informed" analysis in transactions in which the *Corwin* standard is applied. *Cf. Solomon v. Armstrong*, 747 A.2d 1098, 1131 (Del. Ch. 1999) ("All disclosure of material information may cause shareholders to vote in a particular way, and so is, in some general sense, 'coercive.' Considering the legal imperative that all shareholders be armed with all material information, it cannot be that the mere potential to influence a shareholder's vote renders disclosed information actionable."), *aff'd*, 746 A.3d 277 (Del. 2000).



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## DETERMINING THE LIKELY STANDARD OF REVIEW APPLICABLE TO BOARD DECISIONS IN DELAWARE M&A TRANSACTIONS (APRIL 2017 UPDATE)

To Our Clients and Friends:

M&A practitioners are well aware of the several standards of review applied by Delaware courts in evaluating whether directors have complied with their fiduciary duties in the context of M&A transactions. Because the standard applied will often have a significant effect on the outcome of such evaluation, establishing processes to secure a more favorable standard of review is a significant part of Delaware M&A practice. The chart below identifies fact patterns common to Delaware M&A and provides a preliminary assessment of the likely standard of review applicable to transactions fitting such fact patterns. However, because the Delaware courts evaluate each transaction in light of the transaction's particular set of facts and circumstances, and due to the evolving nature of the law in this area, this chart should not be treated as a definitive statement of the standard of review applicable to any particular transaction.

No.	Facts	Likely Standard of Review <sup>[2]</sup>
1.	Fully independent and disinterested <sup>[3]</sup> board of directors; no controlling stockholder <sup>[4]</sup>	Business judgment <sup>[5]</sup>
2.	Majority of board is independent and disinterested; no controlling stockholder	Business judgment <sup>[6]</sup>
3.	Board is evenly split between directors who are independent and disinterested and directors who are not independent and disinterested; no controlling stockholder	Entire fairness <sup>[7]</sup> Business judgment if transaction is approved by a properly functioning special committee <sup>[8]</sup> or a fully-informed, uncoerced stockholder vote <sup>[9]</sup>



No.	Facts	Likely Standard of Review <sup>[2]</sup>
4.	Majority of board is not independent and disinterested; no controlling stockholder	Entire fairness <sup>[10]</sup> Business judgment if transaction is approved by a properly functioning special committee <sup>[11]</sup> or a fully-informed, uncoerced stockholder vote <sup>[12]</sup>
5.	None of the board members is independent and disinterested; no controlling stockholder	Entire fairness <sup>[13]</sup> Business judgment if transaction is approved by a fully-informed, uncoerced stockholder vote <sup>[14]</sup>
6.	Transaction with a controlling stockholder where majority of the board is independent and disinterested	Entire fairness, but <u>either</u> (a) a properly functioning special committee <u>or</u> (b) approval of a majority of the minority will shift the burden of proof to the plaintiff <sup>[15]</sup> Business judgment if <u>both</u> (a) a properly functioning special committee <u>and</u> (b) approval of a majority of the minority <sup>[16]</sup>
7.	Transaction with a controlling stockholder where a majority of the board is <u>not</u> independent and disinterested	Entire fairness, but <u>either</u> (a) a properly functioning special committee <u>or</u> (b) approval of a majority of the minority will shift the burden of proof to the plaintiff <sup>[17]</sup> Business judgment if <u>both</u> (a) a properly functioning special committee <u>and</u> (b) approval of a majority of the minority <sup>[18]</sup>
8.	Controlling stockholder; majority of the board is independent and disinterested with respect to the controlling stockholder; controlling stockholder is <u>not</u> the counterparty in the transaction; and controlling stockholder is treated the same as other stockholders	Business judgment <sup>[19]</sup>

No.	Facts	Likely Standard of Review <sup>[2]</sup>
9.	Controlling stockholder; majority of the board is <u>not</u> independent and disinterested with respect to the controlling stockholder; controlling stockholder is <u>not</u> the counterparty in the transaction; and controlling stockholder is treated the same as other stockholders	Business judgment <sup>[20]</sup>
10.	Controlling stockholder; majority of the board is independent and disinterested with respect to the controlling stockholder; controlling stockholder is <u>not</u> the counterparty in the transaction; and controlling stockholder receives different treatment in the transaction than other stockholders	Entire fairness, but <u>either</u> (a) a properly functioning special committee <sup>[21]</sup> <u>or</u> (b) approval of a majority of the minority will shift the burden of proof to the plaintiff <sup>[22]</sup>  Business judgment if <u>both</u> (a) a properly functioning special committee <u>and</u> (b) approval a of majority of the minority <sup>[23]</sup>
11.	Controlling stockholder; majority of the board is <u>not</u> independent and disinterested with respect to the controlling stockholder; controlling stockholder is <u>not</u> the counterparty in the transaction; and controlling stockholder receives different treatment in the transaction than other stockholders	Entire fairness, but <u>either</u> (a) a properly functioning special committee <sup>[24]</sup> <u>or</u> (b) approval of a majority of the minority will shift the burden of proof to the plaintiff <sup>[25]</sup>  Business judgment if <u>both</u> (a) a properly functioning special committee <u>and</u> (b) approval of a majority of the minority <sup>[26]</sup>

[1] This report updates our report, "Determining the Likely Standard of Review Applicable to Board Decisions in Delaware M&A Transactions," as originally published on November 18, 2014 and updated on February 8, 2016.

[2] Assumes duty of care is discharged. In addition to the standards of review identified in this chart, a transaction is subject to enhanced judicial scrutiny under *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) "when a company embarks on a transaction -- on its own initiative or in response to an unsolicited offer -- that will result in a change of control." *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009). However, under the so-called *Corwin* doctrine, if a transaction (other than a transaction in which a controlling stockholder extracts personal benefits) has been ratified by a vote of a "fully informed, uncoerced majority of the disinterested stockholders," it will

be subject to business judgment review even if *Revlon* would otherwise apply. *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 305–06 (Del. 2015); *see also, e.g., In re Saba Software, Inc. S'holder Litig.*, No. 10697-VCS, slip op. at 20–21 (Del. Ch. Mar. 31, 2017) (explaining the *Corwin* doctrine).

[3] "Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984), *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d. 244, 254 (Del. 2000). "Such extraneous considerations or influences may exist when the challenged director is controlled by another." *Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002). Thus, a "lack of independence can be shown when a plaintiff pleads facts that establish that the directors are beholden to [the controlling person] or so under [that person's] influence that [the directors'] discretion would be sterilized." *Id.* (first alteration in original) (internal quotation marks omitted). Disinterestedness means that "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Id.* at 23.

[4] A stockholder is a controlling stockholder under Delaware law where the stockholder (1) owns more than 50% of the voting power of a corporation or (2) exercises control over the business affairs of the corporation. *Kahn v. Lynch Commc'ns Sys. (Kahn I)*, 638 A.2d 1110, 1113–14 (Del. 1994). When evaluating whether a stockholder exercises the requisite control, Delaware courts will evaluate whether the stockholder controlled the board "such that the directors . . . could not freely exercise their judgment" with respect to a transaction. *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 993 (Del. Ch. 2014); *see also In re Crimson Exploration Inc. S'holder Litig.*, No. 8541-VCP, 2014 WL 5449419, at \*10–\*12 (Del. Ch. Oct. 24, 2014) (analyzing Delaware case law concerning controlling stockholders).

[5] *See In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 36 (Del. Ch. 2013) (explaining that the business judgment rule applies to decisions by board members who are "disinterested and independent").

[6] The business judgment rule is generally the applicable standard of review where a majority of the board is disinterested and independent. *See Cinerama, Inc. v. Technicolor*, 663 A.2d 1156, 1170 (Del. 1995). Nonetheless, a transaction must be "approved by a majority consisting of the disinterested directors" in order for the business judgment rule to apply. *See Aronson v. Lewis*, 473 A.2d at 812, *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d. at 254; *see also In re Trados Inc.*, 73 A.3d at 44 ("To obtain review under the entire fairness test, the stockholder plaintiff must prove that there were not enough independent and disinterested individuals among the directors making the challenged decision to comprise a board majority. . . . To determine whether directors approving the transaction comprised a disinterested and independent board majority, the court conducts a director-by-director analysis."); *Chaffin v. GNI Group, Inc.*, No. 16211-NC, 1999 WL 721569, at \*5–\*6 (Del. Ch. Sept. 3, 1999) (holding that where a board had three independent and disinterested members and two interested members, and the board approved a merger by a vote of 4-1, with one of the independent and disinterested directors voting against the merger, the merger approval "was one vote short of the required disinterested majority").

[7] "A board that is evenly divided between conflicted and non-conflicted members is not considered independent and disinterested." *Gentile v. Rossette*, No. 20213-VCN, 2010 WL 2171613, at \*7 n.36 (Del. Ch. May 28, 2010); *see also* *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1046 n.8 (Del. 2004). "[T]he business judgment rule has no application" to a merger transaction that is "not approved by a majority consisting of the disinterested directors," *Aronson v. Lewis*, 473 A.2d at 812, *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d. at 254, and where the business judgment rule has been "rebut[ted]" this "lead[s] to the application of the entire fairness standard," *In re Crimson Exploration Inc.*, 2014 WL 5449419, at \*20.

[8] The relevant law is not entirely clear, but the better reasoned view appears to be that a properly functioning special committee brings the business judgment rule to bear. *See In re W. Nat'l S'holder Litig.*, No. 15927, 2000 WL 710192, at \*26 (Del. Ch. May 22, 2000) (explaining that the "[t]he use of an independent special committee, bargaining at arm's length with a controlling shareholder, to shift the burden of proving entire fairness is well noted . . . . The policy rationale requiring some variant of entire fairness review, to my mind, substantially, if not entirely, abates if the transaction in question involves a large though not controlling shareholder. In other words, because the absence of a controlling shareholder removes the prospect of retaliation, the business judgment rule should apply to an independent special committee's good faith and fully informed recommendation."); *see also In re PNB Holding Co. S'holders Litig.*, No. 28-N, 2006 WL 2403999, at \*14 n.69 (Del Ch. Aug. 18, 2006) (then-Vice Chancellor Strine explaining that the business judgment rule would apply if a properly functioning special committee had "negotiated and approved the transaction"). There is, however, some other precedent that could be read to suggest that a properly functioning special committee does no more than shift the burden of the proof to the plaintiff, *see In re Tele-Comm's, Inc. S'holders Litig.*, No. 16470, 2005 WL 3642727, at \*8 (Del. Ch. Dec. 21, 2005), although the better reading of this precedent may be that it involved a controlling stockholder, *see In re John Q. Hammons Hotels Inc. S'holder Litig.*, No. 758-CC, 2009 WL 3165613, at \*11 (Del. Ch. Oct. 2, 2009) (interpreting *In re Tele-Comm's* as having involved a controlling stockholder). In any event, the Delaware Supreme Court has not definitively resolved the question of which standard of review applies when a special committee approves a transaction and there is no controlling stockholder.

[9] *See Corwin*, 125 A.3d 304 (holding that, in the absence of a controlling stockholder, an uncoerced, informed stockholder vote causes the application of the business judgment standard of review even where enhanced scrutiny would otherwise apply); *see also* Vice Chancellor J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 Wm. Mitchell L. Rev. 1443 (2014) (providing substantial discussion of the interplay between stockholder approval and the standard of review prior to the decision in *Corwin*). Note, however, that the failure to disclose all material information to stockholders can prevent a stockholder vote from being fully informed, and would thus prevent the vote from "ratifying" the transaction. *See Chen v. Howard-Anderson*, 87 A.3d 648, 669 (Del. Ch. 2014) (noting that, even if defendants had argued that the stockholder vote ratified the challenged transaction, "disclosure deficiencies" would undermine the vote and render the ratification ineffective); *In re Saba Software, Inc.*, No. 10697-VCS, slip op. at 21–23 (concluding that material omissions from a proxy statement "undermined the stockholder approval").

[10] See *In re Trados Inc.*, 73 A.3d at 45 (holding that entire fairness was the applicable standard of review in scrutinizing a board's approval of a merger where "the plaintiff proved at trial that six of the seven . . . directors were not disinterested and independent"); *In re Tele-Comm's, Inc.*, 2009 WL 3165613, at \*6–\*8 (explaining that an "entire fairness analysis" is required whenever "evidence in the record suggests that a majority of the board of directors were interested in the transaction" and providing several examples).

[11] See note 8, *supra*.

[12] See note 9, *supra*.

[13] See *In re PNB Holding Co.*, 2006 WL 2403999, at \*12–\*15 (concluding that all of the members of the board were interested and that entire fairness was the standard of review, recognizing that stockholder approval for the merger was accordingly "the only basis for the defendants to escape entire fairness review," but ultimately concluding that "[b]ecause a majority of the minority did not vote for the Merger, the directors cannot look to our law's cleansing mechanism of ratification to avoid entire fairness review").

[14] See note 9, *supra*.

[15] See *Kahn I*, 638 A.2d at 1117 (the "standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . . However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof . . . to the challenging shareholder-plaintiff.>").

[16] The detailed requirements for the business judgment review to apply to a controlling-stockholder transaction are set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) as follows: "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *Id.* at 645.

[17] *Kahn I*, 638 A.2d at 1117.

[18] See note 16, *supra*.

[19] See *In re Synthes, Inc. S'holder Litigation*, 50 A.3d 1022, 1046 (Del. Ch. 2012) (applying business judgment review despite pled facts that a majority of the board was not independent with respect to the controlling stockholder because the controlling stockholder "received equal treatment in the Merger").

[20] "Entire fairness is not triggered solely because a company has a controlling stockholder. The controller also must engage in a conflicted transaction." *In re Crimson Exploration Inc.*, 2014 WL

5449419, at \*12. A conflicted transaction exists if the controlling stockholder is the counterparty to, or otherwise "stands on both sides of," the transaction. *Gamco Asset Mgmt. Inc. v. iHeartMedia Inc.*, No. 12312-VCS, 2016 WL 6892802, at \*15 (Del. Ch. Nov. 23, 2016). A conflicted transaction also exists if the controlling stockholder receives different treatment or "competes with the common stockholders for consideration" in the transaction. *Id.* In some cases, such as when a controlling stockholder receives disparate consideration, it is relatively simple to conclude that the controlling stockholder was not treated the same as other stockholders. See *In re Delphi Fin. Grp. S'holder Litig.*, No. 7144-VCG, 2012 WL 729232, at \*3 (Del. Ch. Mar. 6, 2012) (controlling stockholder negotiated a substantial premium for his shares); *In re Tele-Commc'ns, Inc.*, 2005 WL 3642727, at \*6–\*8 (controlling stockholder received more valuable high-vote stock). In other cases, however, where the controlling stockholder receives a unique benefit (other than disparate consideration) or a continuing stake in the acquiring entity, the question is more complex. Compare *New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, No. 5334-VCN, 2011 WL 4825888, at \*9–\*11 (Del. Ch. Sept. 30, 2011) (controlling stockholder received "desperately needed liquidity"), and *In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 WL 3165613, at \*1 (controlling stockholder received "an array of private benefits" including a continuing stake in the acquiring entity), with *Larkin v. Shah*, No. 10918-VCS, 2016 WL 4485447, at \*15 (Del. Ch. Aug. 25, 2016) (rejecting plaintiffs' assertion that a venture capital firm's desire to exit its investment was a hurried attempt to sell the company and extract a unique benefit).

[21] See *In re John Q. Hammons Hotels Inc. S'holder Litig.*, No. 758-CC, 2011 WL 227634, at \*2 (Del. Ch. Jan. 14, 2011) ("[P]laintiffs bear the ultimate burden to show the transaction was unfair given the undisputed evidence that the transaction was approved by an independent and disinterested special committee of directors.").

[22] Although we have not identified any Delaware cases explicitly addressing the effect on the standard of review of approval by a majority of the minority stockholders in this factual scenario, it would be reasonable to conclude that the reasoning of *Kahn I*, 638 A.2d 1110, would apply.

[23] See *In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2009 WL 3165613, at \*12 (in transaction where controlling stockholder receives different consideration than minority stockholders, "business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders").

[24] *In re Tele-Commc'ns, Inc.*, 2005 WL 3642727, at \*8 (explaining that because of the directors' interested status "[t]he initial burden of proof rests upon the director defendants to demonstrate . . . fairness," but further explaining that "[r]atification by a majority of disinterested directors, generally serving on a special committee, can have the effect of shifting the burden onto the plaintiff shareholders to demonstrate that the transaction in question was unfair. In order to shift the burden, defendants must establish that the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length.").

[25] See note 22, *supra*.

[26] See note 23, *supra*.



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# Appraising the “Merger Price” Appraisal Rule\*

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## Abstract

This paper develops an analytic framework combining agency costs, auction design and shareholder voting to study how best to measure “fair value” for dissenting shareholders in post-merger appraisal proceedings. Our inquiry spotlights an approach recently embraced by some courts benchmarking fair value against the merger price itself. We show that as a general matter, the “Merger Price” (MP) rule tends to depress both acquisition prices and target shareholders’ expected welfare relative to both the optimal appraisal policy and several other plausible alternatives. In fact, we demonstrate that the MP rule is strategically equivalent to *nullifying* appraisal rights altogether. Although the MP rule may be warranted in certain circumstances, our analysis suggests that such conditions are unlikely to be widespread and, consequently, the rule should be employed with caution. Our results are robust to settings where courts commit errors in applying conventional valuation metrics (such as discounted cash flow analysis), and the analysis helps explain why conventional approaches generate outcomes that skew well above the deal price—an equilibrium phenomenon that is an artifact of strategic behavior (and not an institutional deficiency, as some assert). Finally, our analysis facilitates a better understanding of the efficiency implications of recent reforms allowing “medium-form” mergers, as well as an assortment of (colorfully named) contractual terms, such as blow provisions, drag-alongs, and “naked no-vote” fees.

JEL Classification: D44; D82; G34; K22

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## Introduction

Within mergers and acquisitions law, the appraisal remedy affords target-company shareholders an option of eschewing the terms of an acquisition in favor of receiving a judicially determined cash valuation for their shares. All states provide this statutory option in some form for many—though not all—transactions.<sup>1</sup> In eligible cases, appraisal gives dissenting shareholders a potentially powerful tool to counter deal terms that they believe to be inadequate or under-compensatory. Although public company targets have historically faced appraisal actions only rarely, the procedure has grown appreciably more popular and prevalent in recent years, even as the number of appraisal eligible public company deals has remained steady.<sup>2</sup>

Appraisal proceedings are far less popular, by contrast, among judges who preside over them. A particularly vexing challenge facing courts in such matters is the task of distilling metaphorical mountains of financial and technical data into a singular equitable determination of “fair value.”<sup>3</sup> The judge usually cannot dodge this responsibility on procedural grounds, cannot hand off the job to a jury, and cannot take refuge in traditional jurisprudential heuristics—such as evidentiary burdens of proof. Rather, the typical appraisal proceeding allocates the burden of proof on both the plaintiff and the defendant and requires the court to deliver a single number at the end of the process. Testimony in such proceedings typically adds little solace, dominated by prolix technical reports from litigant-retained experts whose valuation opinions can diverge by a factor of two or more. Especially for judges who are ill at ease with the intricacies of asset pricing, fair valuation can be a formidable beast to wrangle.<sup>4</sup>

In several recent appraisal cases,<sup>5</sup> the Delaware Chancery Court has deployed a jurisprudential *verónica*<sup>6</sup> of sorts—invoking a doctrine that sidesteps this valuation

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<sup>1</sup> Delaware’s statute limits appraisal to certain statutory merger transactions (excluding asset or stock sales). For public company targets, Delaware further limits appraisal to deals involving mandatory non-public-stock (including cash) consideration as well squeeze-outs. See DGCL §262(b). In contrast, several other states utilize the Revised Model Business Corporations Act (RMBCA) approach, where appraisal is triggered by a greater variety of events (including mergers, share exchanges, asset sales and charter amendments). However, the RMBCA withholds appraisal rights from nearly all public company targets—including cash deals—granting dissenters’ rights only for interested-party contexts. RMBCA §§13.01-02.

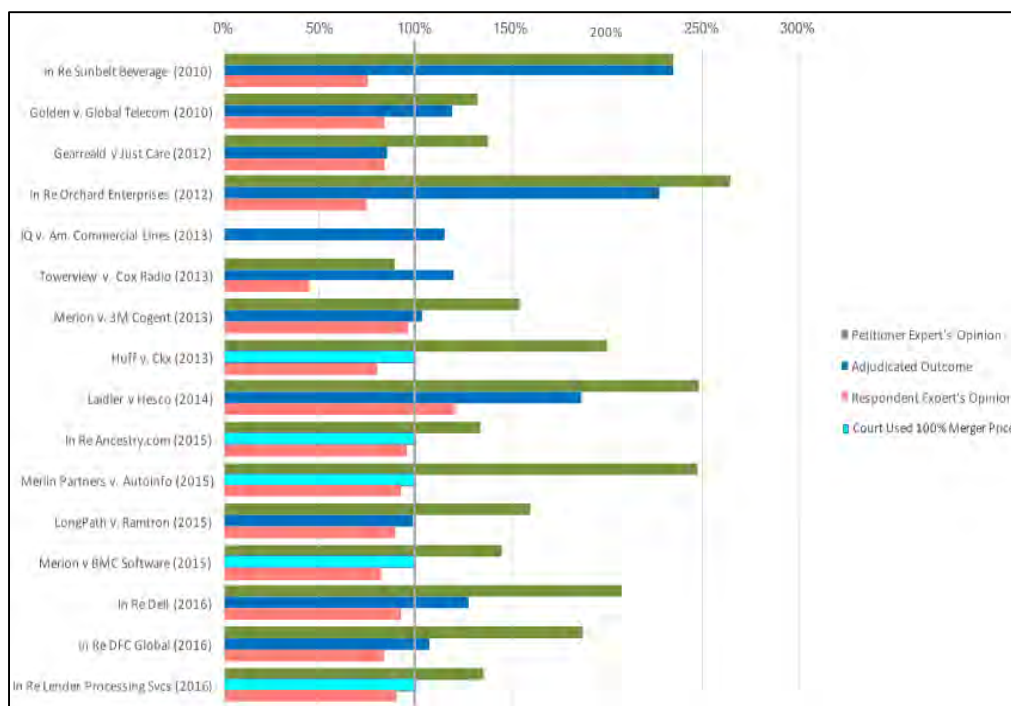
<sup>2</sup> See, e.g., Jiang et al (2017); Korsmo and Myers (2015 and 2016), documenting the recent rise of appraisal actions, which grew from affecting 5% of eligible deals in the early 2000s to 20-25% by 2016, along with a roughly six-fold increase in aggregate monetary claims over the same period. Sophisticated institutional shareholders (including hedge funds) appear to be playing an important role in this recent upsurge.

<sup>3</sup> See, e.g., DGCL §262(h) (requiring the Court to determine the “fair value” of the shares “exclusive of any element of value arising from the accomplishment of expectation of the merger or consolidation”).

<sup>4</sup> See, e.g., *In re Appraisal of Ancestry.com*, 2015 WL 399726, at 2 (“this task is made particularly difficult for the bench judge, not simply because his training may not provide a background well-suited to the process, but also because of the way the statute is constructed....[I]n reality, the ‘burden’ falls on the judge to determine fair value, using all relevant factors”).

<sup>5</sup> See, e.g., *Merion Capital v. Lender Processing Services, C.A. No. 9320-VCL* (Del. Ch. Dec. 16, 2016); *Dunmire v. Farmers & Merchants Bancorp, C.A. No. 10589-CB* (Del. Ch. 2016); *Merion Capital v. BMC Software, C.A. No. 8900-VCG* (2015); *Huff Fund Inv. P’ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013); *In re Appraisal of Ancestry.com*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *LongPath Capital LLC v. Ramtron International Corp.*, C.A. No. 8094-VCP (Del. Ch. June 30, 2015); *Merlin Partners*

challenge substantially (if not altogether). Specifically, the Court has proven increasingly willing to use *the merger price itself* as evidence (and indeed *the decisive* piece of evidence) of fair value. The “Merger Price” (MP) rule began to make regular appearances in appraisal decisions towards the end of 2013 and has been a regular since (See Figure 1 below). As applied thus far, the rule seems most likely to be invoked in settings where the transaction resulted from an arm’s length transaction, free from the taint of self-interest.<sup>7</sup> Several advocates and at least some academic commentators have sought to regularize this practice, arguing that courts should defer “entirely” to the merger price when it is the product of a reasonable and disinterested process.<sup>8</sup>



**Figure 1:** Fair-Value Assessments in DE Appraisals (2010-2016)

The concept underlying the MP rule is easy enough to articulate: it posits that “The Market” delivers the best indication of fair value,<sup>9</sup> so long as the deal price is a

LP v. AutoInfo Inc., C.A. No. 8509-VCN (Del. Ch. Apr. 30, 2015); The Union Illinois 1995 Investment Limited Partnership v. Union Financial Group, Ltd., 847 A.2d 340 (Del. Ch. 2004).

<sup>6</sup> See, e.g., Angela Tung, “Them’s Bullfighting Words.” The Week (March 25, 2015); “Jose Tomas a la Verónica en Sevilla” (available at <https://youtu.be/NZD4N7plZnQ>).

<sup>7</sup> See, e.g., CKx, supra note 5, at 15. In 2010, the Delaware Supreme Court rejected the argument that the MP rule should be used categorically in such cases, but also held that the merger price was a permissible consideration in determining fair value. Golden Telecom Inc. v. Global GT LP, 11 A.3d 214 (Del. 2010).

<sup>8</sup> See, e.g., Bainbridge et al., Brief of Corporate Law and Finance Professors as *Amici* in Support of Reversal, DFC Global Corp. v. Muirfield Value Partners et al. (Del. Sup. Court, Dec. 29, 2016); Appellants Opening Brief, DFC Global Corp. v. Muirfield Value Partners et al., No. 518, 2016 On Appeal from the Del. Court of Chancery, Consolidated C.A. No. 10107-CB (Del. Sup. Court, Dec. 13, 2016).

<sup>9</sup> See, e.g., See, e.g., Merion Capital LP v. BMC Software, Inc., 2015 WL 6164771, at \*14–16, \*18 (Del. Ch. Oct. 21, 2015); LongPath Capital, LLC v. Ramtron Int’l Corp., 2015 WL 4540443, at \*20–24 (Del. Ch. June 30, 2015).

product of arm's-length negotiations between a willing buyer and willing seller. In other words, the MP rule is a natural corollary to the (seemingly intuitive) economic intuition that a negotiated, disinterested deal provides adequate pricing protection to target shareholders, and that in such cases market price is a better bellwether of value than a judge's often arbitrary, error-prone, and inaccurate accounting.

Sounds simple enough, right?

Not so fast. This paper demonstrates that the intuition underlying the MP rule—while sound in some respects—is far more fragile than it first appears. Specifically, we show that the rule is defensible on economic grounds only in relatively narrow set of circumstances that can be demanding, in practice, to meet; and in any event, such circumstances may be difficult to diagnose *without* the court going much of the way to value the firm using more conventional measures. Consequently, if the primary benefit of the MP approach is judicial cost savings, the approach can be self-defeating.

Our argument highlights a critical flaw in the logic that purportedly animates the MP rule: the presumption that “The Market” operates separately and independently from its underlying legal environment. On first principles alone, *this presumption is generally false*: market outcomes and laws governing markets are fundamentally intertwined. Markets—particularly robust ones—amalgamate and reflect participants' expectations about the future, related to earnings, costs, new business opportunities, and the like. But markets also reflect market participants' expectations about the legal environment in which they operate.<sup>10</sup> Change that environment, and expectations change; change expectations, and market prices soon follow. It is a fundamental economic misconception, therefore, to presume that a market price—even one produced by a seemingly robust market—is some autonomous oracle of worth, untethered to expectations related to (and affected by) law.

While the interdependency of market price and legal environment is hardly novel,<sup>11</sup> it carries particular bite in the appraisal context: for a court's approach to assessing fair value affects not only what dissenting shareholders receive *ex post*, but also how the merger is priced and approved (or not) *ex ante*. Indeed, the outside option of seeking appraisal after a merger can functionally alter shareholders' receptivity to an announced deal, effectively committing them to a “reserve price” of sorts for the sale, at an amount tied to the anticipated appraisal remedy. Under plausible conditions, this *de facto* reserve price can protect shareholders' interests more ably than either a shareholder approval requirement, or reliance on managerial incentives to design—and then commit to—a profit maximizing auction.<sup>12</sup> Sophisticated buyers, moreover, anticipate this effect, and may well modify their bids in response, adjusting them upward to meet (or get close to) the appraisal reserve price, secure shareholder approval, and preempt widespread

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<sup>10</sup> See, e.g., Cornell (1990).

<sup>11</sup> For more on the circularity that ensues when market price is used to determine a legal outcome—even as the anticipated legal outcome simultaneously determines market price—see Talley (2006).

<sup>12</sup> See, e.g., Milgrom (1987) and Grant et al. (2006) for a discussion of the practical difficulties sellers face in committing to a reserve price without a third party enforcement mechanism.

appraisal litigation. To the extent that appraisal value is pegged against independent factors (and *not* the merger price), a plausibly designed appraisal remedy can enhance value for *all* shareholders—even those who do not seek appraisal.

Under the MP rule, by contrast, this reserve-price effect collapses under its own weight. Indeed, the MP rule dictates that the value of shareholders' appraisal right floats up and down mechanically with the winning bid, regardless of the bid's evident adequacy under objective measures. Opting for appraisal, therefore, can never yield a dissenter any upside over the terms of the merger (and will introduce a downside in the form of legal costs). In turn, prospective buyers need not fear that the winning bid will prove inadequate relative to the outside appraisal option: for *the winning bid is the outside option*. Put simply, the MP rule functionally nullifies the appraisal right, and whatever value enhancing implications the reserve-price effect portends. So long as there exists some plausible alternative appraisal remedy that enhances shareholders' welfare *ex ante*—even if modestly—the MP rule cannot be optimal.

To demonstrate our claims, we study a framework incorporating several features of the corporate M&A environment, including agency costs, shareholder voting, and post-transaction appraisal rights. Using this framework, we compare equilibria under “conventional” appraisal valuation approaches (where the valuation criteria are independent of the transaction price<sup>13</sup>) to the MP rule (where appraisal value is pegged to the winning bid). We show that, for any number of bidders, the MP rule *never* generates a higher price than plausible conventional approaches, and more typically leads to strictly lower prices and reduced shareholder welfare. Our argument, moreover, is robust to the introduction of substantial statistical “noise” in appraisal outcomes, due, for example, to judicial error. Although we identify circumstances where the MP rule could be optimal (albeit non-uniquely), such conditions appear difficult to satisfy in practice. Our analysis therefore counsels that the MP rule should be deployed—if at all—with caution.

Our inquiry also informs several ongoing debates regarding appraisal litigation. For example, we predict that under conventional valuation criteria, shareholders are likely to seek appraisal only for deals offering relatively low premiums. And, in those instances where appraisal is sought, fair-value assessments will tend overwhelmingly to be skewed *well above* the deal price. Both predictions appear to have solid empirical support.<sup>14</sup> And yet, several proponents of the MP point to the upwards skew of appraisal awards as evidence of institutional dysfunction. Our analysis casts significant doubt on such conclusions: the upward skew we predict is a simple artifact of rational, strategic decision making. (When target shareholders expect the appraisal valuation to be *lower* than the merger consideration, they will simply decline to seek appraisal.) In fact, one

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<sup>13</sup> Discounted Cash Flow (DCF) is the dominant “conventional” practice today, but all other methods that are independent of merger price also qualify, such as the comparable-companies approach and even the Delaware “block” method. See Allen (2002).

<sup>14</sup> See, e.g., Jiang et al. (2016); Korsmo and Myers (2015 and 2016).

would expect a similar upward skew *regardless* of whether the appraised value is set too high, too low, or just right by objective criteria.<sup>15</sup>

The analysis additionally illuminates the strategic and efficiency implications of several other institutional devices that bear indirectly on appraisal. For example, a popular deal structure for public-company targets in Delaware—and one where appraisal is typically available—involves a negotiated tender offer followed by an involuntary squeeze-out merger of non-tendering shareholders. Such two-step deals historically required at least 90-percent of target’s shareholders to tender into the first stage.<sup>16</sup> In 2013, however, Delaware amended its statutes to allow an alternative “medium-form” merger, in which first step need secure only a 50-percent threshold before an accelerated squeeze out can commence.<sup>17</sup> A central result of our analysis (Proposition 7) is that the MP rule can become optimal (non-uniquely) when the merger is conditioned on a strong super-majority approval of shareholders. This insight suggests that courts might similarly condition their appraisal approach on the strength of the shareholder mandate presented: for instance, traditional two-step deals requiring 90 percent support could receive the MP rule, while “medium-form” deals requiring only 50 percent would fall under more conventional approaches (such as DCF).

Our analysis also sheds light on several appraisal-related contractual provisions. For example, “drag-along” terms oblige shareholders to vote in favor of a merger when a sufficient fraction of shareholders favors the acquisition. “Naked no vote” terms require the target to pay a termination fee to the buyer should the deal be vetoed by shareholders. “Blow” provisions condition the buyer’s duty to close a merger on a maximal threshold of shareholders seeking appraisal (typically in the 10-20% range). Each of these devices plays multiple roles in our model of (a) reallocating surplus between the winning bidder, supporting shareholders and dissenting shareholders; (b) distorting the incentives of shareholders to oppose the merger; and (c) changing the characteristics of an optimal auction design. Our analysis suggests that drag-alongs and naked no-vote provisions tend to dampen deal prices and target shareholder welfare, negating many of the beneficial attributes of appraisal. Blow provisions, in contrast, have more complex effects: although a blow clearly rations appraisal’s availability to a relatively select fraction of target shareholders, it simultaneously mandates an implicit supermajority condition for the deal’s consummation. As noted above, such supermajority conditions can often substitute for an optimal appraisal rule, pushing merger prices and shareholder welfare upwards and (potentially) justifying the MP rule. Although we comment briefly on each of these effects below, our analytic framework provides a promising platform from which to analyze these contractual institutions in more granular detail in the future.

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<sup>15</sup> Moreover, our argument is also robust to adjustments that strip out buyer-specific “synergies” from fair value, per DGCL §262(h). Even here, the MP rule continues to be weakly inferior to the conventional approach—particularly so when the target’s fair going-concern value reflects the present discounted value of the target’s growth opportunities (as many believe it should). See part IIC, *infra*.

<sup>16</sup> See DGCL §253. Falling short of 90% in the first stage did not derail the deal, but rendered it impossible (absent a top-up) to execute the squeeze-out stage quickly.

<sup>17</sup> See DGCL §251(h).

Several important caveats to our core argument warrant elaboration before proceeding. First, although the price- and welfare-dampening attributes of the MP rule hold for auctions of any size, the magnitudes of these effects attenuate as the number of bidders grows. (In the limit, as the bidder population grows arbitrarily large, the discount from the MP rule approaches zero.) Consequently, when the number of bidders is *endogenous* to the seller's efforts to shop the deal, a court's appraisal rule can represent a promising incentive device. For example, if the MP rule were available only after large and robust auctions, the seller's deal team may have a much stronger incentive *ex ante* to recruit numerous bidders. In such settings, shareholder welfare may well be higher when (a) several bidders participate but the MP rule nullifies appraisal rights, than when (b) relatively fewer bidders bid in the shadow of a bona fide appraisal right. Thus, were the MP rule strictly limited to "many-bidder" settings, its downside would be relatively modest (and its upside promising).<sup>18</sup>

Second, as noted above, a standard criticism of conventional approaches to fair value (such as DCF valuation) is that they are prone to measurement error when utilized by judges who are not financially sophisticated. (See, e.g., Subramanian (2017).) Our analysis easily accommodates—and sheds considerable doubt—on this such arguments. In fact, virtually all our arguments remain intact even when appraisal proceedings are subject to (potentially severe) judicial inaccuracy, so long as courts remain unbiased overall in their approach. The reason is simple: much of the reserve-price benefit of appraisal inures to shareholders by enhancing buyers' willingness to pay higher premiums *ex ante*, so as to win affirmative votes and avoid appraisal. In the presence of judicial error, both the buyer's and shareholders' calculi change, replacing a *known* appraisal value with its *predicted/expected* value. But so long as error-prone courts remain unbiased overall, the substitution of expected values will have only marginal effects, and bidding and dissenting behaviors remain largely unchanged.

Third, it is important to recognize that appraisal is one of *several* alternative mechanisms that introduce an implicit reserve price in a company auction. Another is shareholder voting. Our analysis engages this possibility explicitly, demonstrating that the required approval of target shareholders implicitly provides an alternative reserve price: if the "pivotal" (usually the median) shareholder views the merger price as insufficiently attractive relative to her valuation, the transaction will not be approved and the acquisition will fail. The standard requirement of a target shareholder vote, therefore, already provides a type of reserve price pegged at the pivotal voter's valuation. That said, our model shows that shareholder voting need not always substitute for a meaningful appraisal doctrine in at least two respects. First, voting outcomes are pegged against the preferences of the *pivotal* voter, whose preferences need not coincide with the overall (or average) firm value. And second, voting can be an inherently unpredictable check on the sale process, since it can generate multiple equilibria that introduce

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<sup>18</sup> As noted above, however, there has been a recent push by courts and commentators to expand the doctrine beyond these bounds, according the merger price substantial (or even exclusive) weight even when the deal is the product of bilateral one-on-one negotiations. See text accompanying notes 9-10, *supra*.

coordination problems for shareholders.<sup>19</sup> Appraisal rights, in contrast, pose no such challenges.

Relatedly, the potential for multiple equilibria in voting outcomes can have distributional consequences for target shareholders contemplating appraisal. Although we show that conventional appraisal approaches generally dominate the MP rule for *all* shareholders, the benefits of appraisal need not always be evenly distributed. In some equilibria, the rising tide of appraisal lifts all boats, enhancing the payoffs of every shareholder *pro-rata*. In other equilibria, however, the optimal appraisal award will tend to be more generous than the equilibrium merger price, forcing target shareholders to divide into two groups: (i) those who seek (the more lucrative) appraisal; and (ii) those who remain part of the majority voting to support the deal (disqualifying them from appraisal). Ironically, shareholders tend to fare better collectively when they cannot easily coordinate as to who fall into groups (i) and (ii). With greater concentration of ownership among sophisticated hedge funds and institutional investors, however, coordination becomes easier, a fact that may often leave retail investors with the short end of the appraisal stick.<sup>20</sup>

Finally, we focus here on an *economic* account of appraisal, assessing how different valuation approaches fare in enhancing target shareholder welfare (or in some cases, social efficiency<sup>21</sup>). For this approach to have practical traction, one must also presuppose (a) that economic considerations “matter” for appraisal jurisprudence, and (b) that the judicial outcome is not overdetermined by other factors (such as rigid precedent, statutory inflexibility or historical path dependence). As to the first presupposition, no one today seriously challenges the utility of economics in clarifying unsettled issues of corporate law (even if disagreement remains about what *other* considerations deserve equal billing). Indeed, many commentators argue that appraisal law *in particular* should embrace the tenets of financial economics as a central normative commitment.<sup>22</sup> As to the second presupposition, it seems unlikely that non-economic factors pre-ordain the outcome of most modern appraisal cases. Although appraisal statutes certainly contain some hard-and-fast imperatives, they are conspicuous both in what they leave unattended (e.g., how to compute fair value) and in their uniquely tortured linguistic indeterminacy.<sup>23</sup> The common law interpretations that have sprung up around appraisal rights, moreover, appear analogously pliant: in the last half century alone, courts have invented (and then reinvented) major components of appraisal time and again, seemingly undaunted by inelastic precedent or statutory compulsion. These dalliances include prescribing—*inter alia*—what approaches are permissible for fair valuation;<sup>24</sup> what elements of value

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<sup>19</sup> Indeed, as we show below, shareholder voting can introduce multiple equilibria that cannot always be eliminated, even with standard “refinement” assumptions. See Section II(D), *infra*.

<sup>20</sup> Even here, however, retail investors still fare better than under the MP rule. See Section III(A), *infra*.

<sup>21</sup> While we focus on maximizing target shareholder value, our framework can also take on broader aims (such as maximizing the sum of the target shareholders’ and buyers’ payoffs). See Section III(A), *infra*.

<sup>22</sup> See, e.g., Hamermesh & Wachter (2007) at 47-48; Allen (2003) at 552-3.

<sup>23</sup> See, e.g., Thompson (1995), at 30 (characterizing § 262(b) as embodying “the kind of double negative that should make any legislator’s grammar teacher cringe”).

<sup>24</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (embracing DCF approaches as a preferred – but not mandatory – alternative to the legacy “block” method of valuation).

comprise excludable “merger synergies” in an appraisal;<sup>25</sup> whether to adjust fair value for implicit minority discounts;<sup>26</sup> whether mixed cash/stock deals trigger appraisal rights;<sup>27</sup> whether beneficial owners purchasing after the record date are eligible to seek appraisal;<sup>28</sup> and whether late-purchasing owners must demonstrate that their specific shares were not voted in favor of the merger.<sup>29</sup> Even the underlying *policy rationale* for appraisal appears to be a contingent product of apocryphal provenance and peripatetic evolution<sup>30</sup>—one that appears to be unfolding even still. If anything, the role of post-merger appraisal has grown *more* crucial as alternative avenues for challenging mergers have progressively narrowed.<sup>31</sup> If the recent surge in appraisal activity heralds a “transformation” that invites us to re-imagine appraisal’s normative commitments—as several now assert<sup>32</sup>—then economic analysis clearly warrants a seat at the table.

The remainder of this paper proceeds as follows. Section I presents a brief overview of related scholarship. Section II lays out the fundamental framework we study, combining auction design, shareholder governance, agency costs, and appraisal. Section III derives equilibria of the model for various appraisal rules. We show that voting and appraisal can interact in significant ways, with appraisal plausibly inducing strategic voting among shareholders. We also derive our central result that the MP rule is usually undesirable for target shareholders. Section IV considers a variety of extensions to our core model, including characterizing an optimal valuation measure for fair value. There we show that while the MP rule might, under the right circumstances, be one of many other optimal regimes, those circumstances seem implausible in most circumstances. The last section concludes.<sup>33</sup>

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<sup>25</sup> *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 n.8. (Del. 1988).

<sup>26</sup> *Cavalier Oil Corp. v. Harnett*, Nos. 7959, 1988 WL 15816, at \*22-23 (Del. Ch. Feb. 2, 1988), *aff’d*, 564 A.2d 1137 (Del. 1989) (disallowing the implicit minority discount in a DCF valuation). See also *Hamermesh & Wachter* (2007).

<sup>27</sup> *La. Mun. Police Ees’ Ret. System v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007).

<sup>28</sup> *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at \*1 (Del. Ch. May 2, 2007).

<sup>29</sup> See, e.g., *In re Appraisal of Ancestry.com*, *supra* note 5; *In re Appraisal of Transkaryotic Therapies, Inc.*, No. Civ.A. 1554-CC, 2007 WL 1378345, at \*1 (Del. Ch. May 2, 2007).

<sup>30</sup> It is commonly thought that appraisal statutes were originally intended as compensation for the elimination of unanimity voting rules for acquisitions in the early 1900s. See, e.g., Thompson (1995) at 3-4. The “fit” between the timing of appraisal’s introduction and the elimination of unanimity mandates, however, casts doubt on that narrative. See, *id.* at 14-15. Moreover, this standard account seems inconsistent with the heterogeneity in statutes – both across jurisdictions and over time. Levmore & Kanda (1985) at 431-2. In any event, modern practice suggests significant heterogeneity in cases deploying appraisal. Thompson (1995), for example, analyzes data from 1984-1994, finding numerous circumstances where appraisal is sought, ranging from close corporations (13.1%) to public-company minority freeze-outs (35.7%) to cash acquisitions of widely-held public targets (25.0%).

<sup>31</sup> See, e.g., *In re Trulia Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016); *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014); *Singh v. Attenborough*, 137 A.3d 151 (2016); *In Re Volcano Stockholder Litigation*, 143 A.3d 727 (2016).

<sup>32</sup> See, e.g., *Korsmo & Myers* (2016), at 2, 55-56.

<sup>33</sup> Part A of the Technical Appendix briefly reviews the basics of auction theory and optimal auction design, focusing particularly on optimal reserve price. Part B contains all the relevant proofs.



## I. Related Scholarship

This section briefly reviews three relevant lines of scholarship in relation to mergers: (1) auction design, (2) shareholder voting, and (3) appraisal rights. As far as we know, ours is the first paper to interrelate all three dimensions. While auction-related scholarship is vast, its application to merger transactions using auction theory is somewhat less extensive. Fishman (1988) shows why a buyer may be better off with a high, “preemptive” bid when information acquisition is costly, since such a preemptive bid can credibly signal to other (potential) bidders that the bidder has a high valuation for (and is more likely to acquire) the target. Cramton and Schwartz (1991) analyze two important auction frameworks: private independent values or pure common values among the bidders. They argue that the perceived legal requirement on the target company to run an auction is better suited for the latter scenario than the former. This is because, under a purely common value setting, the target can be sold to any buyer without any efficiency valuation loss. Bulow and Klemperer (1996) demonstrate why a target company, attempting to maximize its return for the shareholders, will be better off running (1) an auction with no reserve price but with one more bidder than (2) an auction with reserve price but with one less bidder. The paper thereby shows the importance of inducing more bidder participation, the idea that this paper builds on. More recently, Che and Lewis (2007) examine the role of break-up fees and lock-ups in takeover contests and show that, when bidding is costly, break-up fees are generally more desirable because lock-ups tend to favor one bidder at the expense of another.

There also is a small number of academic studies that examine the effect of shareholder voting on corporate decision-making. Harris and Raviv (1988) examine different types of voting rules in the context where an incumbent and a rival compete to control a firm. They argue that simple, one-share-one-vote regime may be optimal because the rule does not create a bias in favor of either the incumbent or the rival. Stulz (1988) analyzes the effect of managerial control over voting rights on the probability and on the size of a possible tender offer. He shows that, in the context where shareholders attach different valuations over the company, as the manager controls more voting rights, the probability of a tender offer falls but the tender offer premium rises (due partly to an upward-sloping supply curve). Bhattacharya (1997) examines shareholder voting issues in a proxy contest, where a dissent has to bear a cost to communicate its type (“good” or “bad”) to or “lobby” the pivotal shareholder. The paper shows that as the communication cost falls, more proxy fights will ensue when the loss from electing a “bad” dissident is larger than the gain from choosing a “good” dissident. Recently, Becht, Polo, and Rossi (2016) empirically examine the value of shareholder voting by looking at the effect on price from UK’s imposition of mandatory shareholder vote in certain types of transactions. The paper finds that the shareholders generally gain from the imposition of mandatory shareholder voting.

The third line of relevant scholarship, mostly by legal academics, deals with appraisal. Kanda and Levmore (1985) review the various theories associated with the appraisal remedy and argue that the appraisal remedy can be thought of as an additional check against the (potential) agency problem. This idea plays an important role in this

paper, too, since we argue that the manager’s incentive in selling the company will often diverge from the shareholders’ incentive. Thompson (1995) emphasizes the important role played by the appraisal remedy in giving minority shareholders an exit right. This is because, without appraisal, the majority can indefinitely retain the minority investment in an enterprise. Hamermesh and Wachter (2005) show how the existing Delaware case law has produced uncertainty in the concept of “fair value” especially when attempting to estimate the present value of future cash flows. Mahoney & Weinstein (1999) compare merger premia in appraisal-eligible and appraisal-ineligible cases, finding little evidence that appraisal eligibility predicts different premia. Korsmo and Myers (2015 & 2016) document the recent rise of appraisal litigation and argue that appraisal plays a salutary role in mergers and acquisitions by playing proxies for deals that may hurt target shareholders. Finally, Jiang, Li, Mei, and Thomas (2016) present an empirical investigation of appraisal remedy and show that appraisal is more likely to be exercised when there is a perception of conflicts-of-interest and when the premium offered is low. The latter result, in particular, is consistent with our theoretical findings.

## II. The Setup

We analyze the sale of a corporate entity (“target”) involving three groups of strategic, risk-neutral players: incumbent target shareholders, an agent (or “manager”), and a group of potential buyers (all described in greater detail below). Our game has four periods (indexed by  $t \in \{0,1,2,3\}$ ) with no time discounting. At  $t = 0$ , corporate governance and dissenters’ rights are fixed, and the agent establishes an auction process. At  $t = 1$ , bidders privately observe their respective valuations of the target and bid on the company in pursuant to the auction process. At  $t = 2$ , incumbent shareholders vote whether to accept the winning bid. Should a sufficient fraction vote in favor, the transaction closes and all shareholders (including dissenters) relinquish their shares.<sup>34</sup> At  $t = 3$ , dissenting shareholders may be allowed to choose between (a) accepting the merger consideration, or (b) receiving a judicially determined “fair value” through an appraisal proceeding. We will analyze and compare several alternative approaches for determining fair value (including the MP rule).

The target has a single class of fully-distributed (voting) stock, held by a large, diffuse group of  $2T + 1$  shareholders (with  $T \in \mathbb{N}$  and  $T \gg 0$ ), and each shareholder owning a single share of the company. For expositional simplicity, in what follows we will typically describe the shareholder population as a continuum with mass 1, each holding a  $d\gamma \approx \frac{1}{2T+1}$  fractional ownership share of the company. Nevertheless, all equilibria described below constitute equilibria of the finite-player game for an arbitrarily large  $T$ . Each shareholder places a differential valuation on the firm as a going concern, indexed through her “type”  $\gamma \in [\underline{v}, \bar{v}]$  with  $0 \leq \underline{v} < \bar{v} < \infty$ , representing the shareholder’s willingness to accept. Differential valuations may be due to myriad factors, such as distinct tax positions, liquidity preferences, divergent beliefs, and so forth.

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<sup>34</sup> Since—unlike tender offers—dissenters *must* relinquish their shares, holdouts (a la Grossman & Hart 1980) are not as problematic in our model. We assume a single-step transaction for cash, but both assumptions are easily relaxed.

Shareholder type  $\gamma$  values the entire firm at  $\gamma$ , and thus her fractional ownership stake at  $\gamma \cdot d\gamma$ . Shareholder types are distributed according to a commonly-known cumulative distribution function  $H(\gamma): [\underline{v}, \bar{v}] \rightarrow [0,1]$ , with associated density function  $h(\gamma) > 0$ , assumed continuously differentiable for all  $\gamma \in [\underline{v}, \bar{v}]$ .<sup>35</sup>

Shareholders' differential willingness to accept naturally causes disagreement about the relative attractiveness of buyout bids. To appreciate the effects of this disagreement, it will help to distinguish between three shareholder types. First, consider the *marginal* shareholder, whose willingness to accept is lowest among all existing shareholders (at  $\gamma = \underline{v}$ ) and is thus the most willing to sell. The marginal shareholder is also functionally the price maker, and her value reflects the market clearing price for shares in the absence of a material prospect of a merger.

Second, consider the *representative* shareholder with type  $\mu \in (\underline{v}, \bar{v})$ , whose willingness to accept is the mean among target shareholders. Aggregating across all shareholders on  $[\underline{v}, \bar{v}]$ ,  $\mu$  is given by:

$$\mu = E(\gamma) \equiv \int_{\underline{v}}^{\bar{v}} \gamma h(\gamma) d\gamma \in (\underline{v}, \bar{v}).$$

Note that while the representative shareholder values her own shares at  $\mu \cdot d\gamma$ , her value of the firm at a whole ( $\mu$ ) captures the aggregated value that target shareholders cumulatively place on their shares.

Third and finally, let  $\rho \in (\underline{v}, \bar{v})$  denote the *pivotal shareholder*, who provides the swing vote in approving a merger. The pivotal shareholder's valuation will typically turn on the threshold of shareholder approval needed to consummate the merger, which we will denote by the parameter  $\alpha \in [1/2, 1)$ . By construction, conditional on offer price  $b$ , all shareholders with  $\gamma \leq b$  support selling at that price while shareholders with  $\gamma > b$  oppose the sale. If shareholders vote sincerely (a condition we interrogate below), obtaining shareholder approval requires offering a sufficiently high price  $b$  such that  $H(b) \geq \alpha$ . Consequently, with sincere voting the shareholder with valuation  $\rho$  satisfying the condition  $\alpha = H(\rho)$  is the unique pivotal shareholder.<sup>36</sup> While our framework allows the approval threshold  $\alpha$  to be set at any level, we will periodically highlight the 50% point coinciding with the median shareholder ( $\alpha = 1/2$ ).<sup>37</sup>

<sup>35</sup> A special case of our framework involves identically-valuing shareholders, so that  $\underline{v} = \bar{v}$ . That said, the assumption of differential shareholder valuations is intuitive and familiar. See, e.g., Stulz (1988) (tax basis differences among shareholders generating different reservation values); Brunnermeier, Simsek, and Xiong (2014) (players holding divergent beliefs that are common knowledge but do not converge).

<sup>36</sup> The assumptions on  $h(\cdot)$  guarantee that the relationship mapping from  $\alpha$  and  $\rho$  is unique. That said, as we show below, the pivotal voter need not always be unique with insincere voting.

<sup>37</sup> Corporate law typically fixes a default at  $\alpha = 0.5$ . See, e.g., DGCL §251(c). There are exceptions, however. In traditional two-step acquisitions (prior to enactment of DGCL § 251(h)), the effective threshold in the first step was 90% (i.e.,  $\alpha = 0.9$ ; see DGCL § 253). Also, under Delaware's anti-takeover statute (DGCL § 203), an "interested" stockholder who acquires 15% or more a target's cannot take control within three years unless it either obtains 85% of the outstanding stock at the time of first purchase or it

Because of shareholder heterogeneity, the marginal, representative, and pivotal shareholders are generally distinct. Indeed, under our distributional assumptions, both  $\mu > \underline{v}$  and  $\rho > \underline{v}$ , and thus the marginal shareholder ( $\underline{v}$ ) must always be the lowest valuing of the three. The ordering of  $\mu$  and  $\rho$ , however, is indeterminate and hinges on relevant vote threshold ( $\alpha$ ) and the attributes of  $h(\cdot)$ . As an example, if  $[\underline{v}, \bar{v}] = [0, 1]$  and  $\gamma$  is uniformly distributed, with  $\alpha = 1/2$ , we get  $\mu = \rho = 1/2$  and the representative and pivotal shareholders coincide.

The agent plays a simple but important role at the target firm. She is entrusted with designing the auction process (at  $t = 0$ ) that may culminate in a successful acquisition bid. From an institutional perspective, we amalgamate the target's managerial team along with other actors who assist with the auction (such as financial advisers, legal advisers and investment bankers). In the baseline model, we assume that the agent's chief design role is to establish ground rules for bidding—which we model as setting a “reserve price”  $r \geq 0$  that establishes the minimum opening bid.<sup>38</sup> Importantly, the agent-manager's payoff does not necessarily align with that of shareholders, reflecting a fundamental agency cost problem. Specifically, we assume the agent receives a payoff of  $M > 0$  if and only if the firm is sold (regardless of price), and zero otherwise. Viewed ex ante, the manager's payoff as a function of the reserve price is  $M \cdot \Pr\{\text{Sale}|r\}$ . This payoff structure is meant to represent one type of agency cost frequently associated with company auctions, in which the deal team is overly incentivized to close a deal at a low price.<sup>39</sup>

Turning finally to potential buyers, we suppose that  $N \geq 1$  bidders have been recruited to participate in the auction. We assume  $N$  to be exogenous at this stage. We will later discuss the role the manager can play in recruiting bidders (increasing  $N$ ). Each bidder  $i \in \{1, \dots, N\}$  costlessly observes its private valuation of the target, denoted by  $v_i$ . To fix ideas, our baseline analysis considers an independent private values (IPV) auction,<sup>40</sup> where  $v_i$  is independently and identically distributed on support  $[0, \infty)$

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procures a  $2/3$  vote of disinterested shareholders. This functionally sets  $\alpha = \min\{0.85, \frac{x+2}{3}\}$ , where  $x \geq 0.15$  denotes the block shareholder's initial fractional purchase.

<sup>38</sup> There may be other auction-related tasks for the agent, such as recruiting bidders to participate. In fact, we analyze an extension below of the case where the agent both sets a reservation price  $r$  and expends non-pecuniary effort cost to recruit each successive bidder to the table. We discuss this in the extension section.

<sup>39</sup> This assumption is stronger than we require. All our results go through if the agent places positive weight on the payoff stated in the text *alongside* expected target-shareholder value.  $M$  thus can be construed as any *additional* non-shareholder-motivated incentive that the manager has to sell the company. (It can also incorporate any golden parachute payment that the manager may claim.) Nevertheless, it captures a key intuition that for many selling firms, target management may simply be too quick to sell. See, e.g., *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985) (retiring CEO sold the target too cheaply and with inadequate diligence). Other participants, such as investment banks in “stapled finance” deals, similarly receive substantial external compensation only if a deal closes. See, e.g., *RBC Capital Markets v. Jervis*, 129 A.3d 816 (Del. 2015) (financial advisor induced board to accept an inadequate deal for which it had buy-side financing prospects). There are no doubt instances where managers are instead too *reluctant* to sell the company. In those cases, questions of post-acquisition appraisal tend to be of little consequence.

<sup>40</sup> In the extension section, we discuss how our analysis extends to both common value (CV) and correlated private-value (CPV) auction settings.

according to a commonly-known cumulative distribution function  $F(v)$ , with associated density function of  $f(v) > 0 \forall v \in [0, \infty)$ . Similar to  $h(\cdot)$ , we assume that  $f(\cdot)$  is continuously differentiable. We also make the standard regularity assumption that  $\frac{1-F(v)}{f(v)}$  is monotone non-increasing in  $v$ . Buyers are assumed to maximize their expected payoff in the auction. As with shareholders, we will frequently offer examples in which buyer types are uniformly distributed on  $[0,1]$ .

For the purposes of analyzing the auction, it will be useful to define several order statistics associated with buyer valuations. Let  $v_{(j)}$  denote the  $j$ 'th order statistic on the  $N$  various realizations of  $v_i$ 's, where we define  $v_{(1)}$  as the lowest realization and  $v_{(N)}$  as the highest realization. One order statistic that will play a useful role is  $v_{(N-1)}$ , corresponding to the second highest realization among  $v_i$ 's. In a generic second-price (Vickrey) or English auction, the winning buyer's bid will be equal to the second highest realization, conditional on the winning buyer having the highest realization. (This condition, however, will not always hold in our model when appraisal introduces the prospect of two-tier pricing.)

**III. Equilibrium Analysis**

Having laid out the basics of the model, we now present the main equilibrium results, for a variety of combinations of dissenters' rights target shareholders may enjoy. Because our game involves a sequential extensive form game with some privately informed players (including both the buyers and the shareholders), Perfect Bayesian Equilibrium (PBE) is an appropriate solution concept. We use this concept throughout in what follows, referring to it simply as an *equilibrium*.

It is important to remain mindful that both appraisal and shareholder approval provide potential checks on price adequacy. Consequently, to understand the effect of appraisal rights, one must first appreciate the interaction between appraisal rights and voting rights. We therefore proceed to analyze four distinct cases, as pictured by Table 1 below.

	<i>No SH Approval Right</i>	<i>SH Approval Required</i>
<i>No SH Appraisal Right</i>	A	B
<i>SH May Seek Appraisal</i>	C	D

**Table 1: Combinations of Shareholder Approval and Appraisal Rights**

Our equilibrium analysis will work through each combination from the above table progressively: (A) a "benchmark" case where neither shareholder appraisal nor approval are possible; (B) the case where shareholders vote whether to approve a merger, but no appraisal is possible; (C) the case where individual shareholders can seek appraisal but no shareholder vote is allowed; and finally (D) the case where both shareholder approval and shareholder appraisal are available and interact with one another. As it will turn out, the equilibria will generally turn on which combinations of dissenters' rights are in play. (We will be more explicit about this as we proceed.) In working through cases

(C) and (D), we will also assess different valuation metrics for determining fair value, comparing the MP rule to other plausible candidates that do not use the merger price as an input.

### A. Benchmark Case: Pure Auction with No Shareholder Voting and No Appraisal Remedy

Consider first the benchmark case where shareholders have no voice whatsoever, and everything is left to the agent-manager to design, implement and close the sale. While simple, this benchmark case underscores the potential problem posed by agency costs in executing the sale.

As assumed above,  $N \geq 1$  bidders participate in the auction. We assume the auction to be an ascending-bid (English) auction, in which a commonly observed bid opens at a reserve price  $r \geq 0$ , and continuously rises until the earliest moment where a single bidder remains active, and she immediately wins and pays the prevailing price (stopped bid). If there are no active bidders at the opening price, then no sale occurs. (As is well known, this structure is revenue equivalent to a second-price, Vickrey mechanism in which all bidders submit sealed bids of their willingness to pay—including the seller, who bids the reserve price—and the highest bidder wins the auction paying the second highest bid or the reserve price.)<sup>41</sup>

The equilibrium of the auction game is well known in the literature. (We provide a refresher of key results in the Appendix.) Truth telling by bidders is a dominant strategy in equilibrium, and thus each buyer stays in the auction until the bid surpasses his valuation  $v_i$ . (See Myerson (1981), Milgrom and Weber (1982), and Ausubel and Cramton (2004)). The probability of a sale for a fixed  $N \geq 1$  number of bidders and reservation price  $r \geq 0$  is equal to the probability that at least one bidder's valuation exceeds the reserve price:

$$\Pr\{\text{Sale}|N, r\} = 1 - F(r)^N$$

Note that this is increasing in  $N$ , but decreasing in  $r$ . Given  $N$  and  $r$ , the selling shareholders' corresponding expected aggregate payoff is (see Appendix):

$$Nr[1 - F(r)]F(r)^{N-1} + N(N - 1) \int_r^\infty [1 - F(y)]F(y)^{N-2}y dF(y) + F(r)^N \mu$$

An important question that will animate much of our discussion concerns the “optimal” reserve price  $r^* \in [\underline{v}, \bar{v}]$  that maximizes the shareholders' expected aggregate payoff. A well-known (and somewhat surprising) result from the literature is that for

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<sup>41</sup> In fact, in the unaffiliated and private value setting, all four standard auctions, first-bid, second-bid, English, and Dutch, produce the same revenue for the seller. This is known as the revenue equivalence principle. See Milgrom and Weber (1982) and Krishna (2002) at 29-36.

owner's valuation  $\mu$ ,  $r^*$  is independent of the number of bidders, and is characterized by the following relationship:

$$r^* = \mu + \frac{1 - F(r^*)}{f(r^*)}$$

Note that since  $f(\cdot) < \infty$ ,  $r^* \in (\mu, \infty)$ . Thus, the shareholders optimally set a reserve price that exceeds their aggregate (average) valuation. The condition above is closely related to the monopoly pricing problem, in which the seller determines price by balancing the chance of no sale against the hope of a higher winning bid (Bulow and Klemperer (1996)). If the shareholders could choose their own reserve price, then  $r^*$  would be a logical choice (a point we return to in the next section). However, it is the *agent* who controls the auction process. Recall that the agent's expected payoff is:

$$M \cdot \Pr\{\text{Sale}|N, r\} = M \cdot (1 - F(r))^N$$

This payoff is strictly decreasing in  $r$ , since increasing the reservation price enhances the chance that no bidder is willing to post the opening minimum bid. This observation immediately spawns the following proposition (all proofs are in the Appendix):

**Proposition 1.** *When neither shareholder approval nor appraisal are available, there is a unique equilibrium in which the agent sets the reserve price at  $r_m = 0 < \mu < r^*$ , and all bidders actively participate. An acquisition always occurs in equilibrium, yielding an expected payoff to target shareholders equal to:*

$$E(v_{(N-1)}) = N(N-1) \int_0^\infty [1 - F(y)]F(y)^{N-2} dF(y)$$

*This payoff can be less than the marginal, pivotal, and representative shareholders' respective status quo values, and is strictly so lower for  $N$  sufficiently small.*

The intuition behind Proposition 1 is straightforward. If shareholders have no voice in monitoring the sale process, then the manager is free to maximize her own utility by designing an auction that maximizes the probability of a sale. This task is uniquely accomplished with a minimal reserve price of zero ( $r = 0$ ), ensuring that a transaction always occurs, albeit at a depressed price relative to what would obtain in an optimally designed auction. Not only could target shareholders do better, but they might be *affirmatively harmed* by it, depending on the number of bidders and the underlying distribution of  $H(\cdot)$  relative to  $F(\cdot)$ . (For example, if there is only a single bidder, the shareholders receive expected payoff of  $0 < \underline{v} \leq \min\{\mu, \rho\}$ .<sup>42</sup>)

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<sup>42</sup> When the manager must expend effort to recruit bidders, the  $N = 1$  case may be a real possibility, since the manager can secure a sale after finding only one bidder. In the extension section, we discuss the possibility where  $N$  will be endogenously determined through the manager's effort.

## B. Shareholder Approval but No Appraisal Remedy

Now consider the case where shareholders can vote to approve (or veto) a sale to the winning bidder, but appraisal rights remain unavailable. (We assume that failure to procure a sufficiently high fraction  $\alpha \equiv H(\rho)$  of affirmative votes ends the game, with shareholders consuming their status quo payoff and all others receiving nothing.) Just as before, the manager begins by designing the auction (through announcing  $r \geq 0$ ); and just as before, the  $N \geq 1$  bidders will have an incentive to bid truthfully, dropping out only when the bid exceeds their individual valuations. Nevertheless, the requirement of shareholder approval adds an important wrinkle. Now, the winning bid must also be acceptable to the pivotal voter, who values at  $\rho$ .

As is well known in the political science literature, voting models with many players generically have multiple (and possibly infinitely many) equilibria. The usual culprit is indifference: for any posited equilibrium where a clear winner emerges, no single player's vote is "pivotal" in determining the outcome. Knowing this, each voter finds herself indifferent about how to cast her vote—so much so that she is willing to vote for outcomes she disfavors. This multiplicity issue clearly carries over to our setting, which assumes a large number of diffuse shareholders. Accordingly, for each winning bid  $b$ , our voting game stage has infinitely many Nash equilibria, in which shareholders can either approve or veto a proposed merger, regardless of their preferences and regardless of the price offered. Although a standard refinement helps to eliminate all but the most intuitive of these equilibria, the multiplicity problem warrants explicit recognition here, since it bears on questions of institutional design. Shareholder voting *may* be a capable institutional elixir to treat managerial agency costs, but this check is only as good as one's faith that the voting equilibria that ensue are "well behaved" and predictable. In many settings, such faith may be misplaced.

That said, we deploy a version of standard equilibrium refinement that makes intuitive sense here and permits us to narrow the set of equilibria substantially. The refinement involves the *elimination of weakly dominated strategies*. (See, e.g., Duggan (2003) and Patty et. al. (2009).) Informally, a strategy is a weakly dominated strategy if some alternative strategy always makes the player at least as well off regardless of others' actions, and in at least one situation that strategy makes the player strictly better off. More formally, this refinement disallows any posited equilibrium strategy  $\hat{\sigma}_\gamma$  for any player  $\gamma$  if there exists an alternative strategy  $\tilde{\sigma}_\gamma \neq \hat{\sigma}_\gamma$  that fares at least as well for player  $\gamma$  across every possible permutation of opponents' (potentially mixed) strategy profiles  $\sigma_{-\gamma} \in \Sigma^{-\gamma}$ , and does strictly better for player  $\gamma$  in at least one such permutation. In our framework, the weak dominance refinement is sufficient to generate sincere voting when the candidate set is truly binary, and in such cases will generate a unique equilibrium.<sup>43</sup> In what follows, we will refer to the set of limiting-case equilibria that remain after removal of weakly dominated strategies as *weakly undominated equilibria*.

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<sup>43</sup> When voting and appraisal are combined, however, the candidate set grows richer and multiple equilibria are possible. (We also make a *simplifying* assumption below that when a sincere voter is indifferent between the merger and the status quo, she supports the merger. This assumption is easily relaxed.)



Under the above refinement, the preferences of the pivotal shareholder with valuation  $\gamma = \rho$  begin to loom large. In particular, if the highest bid falls short of  $\rho$ , then the pivot and all those with types  $\gamma \geq \rho$  will disfavor it, vote against the merger, and no transaction will be consummated. Only bids that offer at least the pivotal shareholder's value are feasible. Effectively, then, shareholder approval introduces *de facto* reserve price at the pivotal shareholder's value, effectively eclipsing the agent's preferred strategy (Proposition 1) of setting  $r = 0$ . With the voting constraint, the agent's payoff remains strictly decreasing in  $r > \rho$ , but she is indifferent over all  $r \leq \rho$ , since the *de facto* reserve set by the vote imposes a sharper bound. Because there is by assumption no appraisal remedy, conditional on there being an approved merger, all shareholders will be cashed out for the same consideration.

Consequently, two qualitative outcomes are possible. First, all buyers' valuations fall below  $\rho$ , in which case no sale takes place. Second, there is at least one bidder for whom  $v_i \geq \rho$ , in which case a sale will occur at a price of  $\min\{\rho, v_{(N-1)}\}$ . This logic immediately generates the following Proposition.

**Proposition 2.** *When a fraction of shareholders of at least  $\alpha \in [1/2, 1)$  is required to approve a merger but appraisal is unavailable, there is a unique set of outcome-equivalent, weakly undominated equilibria in which shareholders vote sincerely and approve the merger if and only if the winning bid is at least equal to  $\rho$ . The agent sets a reserve price of  $r_m \leq \rho$ , and only bidders with valuations of at least  $\rho$  actively participate. The equilibrium probability of a sale is  $1 - F(\rho)^N < 1$ , and the expected equilibrium payoff to target shareholders is equal to:*

$$N\rho[1 - F(\rho)]F(\rho)^{N-1} + N(N-1) \int_{\rho}^{\infty} [1 - F(y)]F(y)^{N-2}y dF(y) + F(\rho)^N\mu$$

*The equilibrium payoff must exceed the shareholders' payoff in the absence of approval (Proposition 1) if  $\rho \leq r^*$ , and exceeds the status quo value of  $\mu$  whenever  $\mu \leq \rho \leq r^*$ .*

Although the discussion above treats  $\rho$  as fixed by policy (e.g., enshrined in the jurisdiction's merger statute), there may be ample room for tailoring. For example, the target's charter might contain a "supermajority" provision, conditioning fundamental changes on a supererogatory level of shareholder support, even as high as  $\rho = r^* \Leftrightarrow \alpha = H(r^*)$ , so that even without appraisal, shareholder approval alone might support an optimal reserve price. Alternatively, the terms of the merger transaction itself may specify a voting threshold. For example, traditional two-step squeeze out mergers require that either a 90-percent mandate of target shareholders assent to a first step tender offer before the remainder are squeezed out. Alternatively, the deal may explicitly condition closing on receiving a supermajority of "yes" votes and/or a no more than a maximal

threshold of dissenters. Such provisions are not uncommon in negotiated acquisitions.<sup>44</sup> That said, it would often be up to the agent and bidders to opt into the structures described above; and both groups have plausible incentives to keep the reserve price low (see discussion above). It is, of course, possible that the prospect of other forms of shareholder challenge (alleging, for instance, *Revlon* claims or breach of fiduciary duty) may imperil the deal unless it is sufficiently “sanitized” by subjecting the proposal to a super-majority vote by the shareholders. (We return to these possibilities in the extension section.)

Consider the following numerical illustration of Proposition 2. Suppose both the target shareholders’ and the bidders’ reservation values are uniformly distributed on  $[0,1]$  with  $f(\cdot) = h(\cdot) = 1$ . Under the simple majority voting requirement ( $\alpha = 1/2$ ), we know that  $\rho = \mu = 1/2$ . With respect to the bidders,  $v_{(N-1)}$  follows a beta distribution with parameters of  $N - 1$  and  $2$ :  $v_{(N-1)} \sim B(N - 1, 2)$  and  $G(y) = \frac{B(y, N-1, 2)}{B(N-1, 2)}$ . The unconditional expected value of  $v_{(N-1)}$  is given by:

$$E(v_{(N-1)}) = \frac{N - 1}{N + 1}$$

From before, the seller’s expected profit is given by:

$$N \cdot E_v\{m(v; r)\} + F(r)^N v_0 = N \cdot \left( \frac{1}{4} \cdot G(1/2) + \frac{1}{2} \int_r^1 y \cdot g(y) dy \right) + \frac{1}{2}^{N+1}$$

In this case, the target corporation with the reservation value of  $\mu = 1/2$  would maximize expected shareholder payoff by setting the reserve at  $r^* = 3/4$ , which is independent of the number of bidders. Alternatively, suppose the merger were subject to a 75% ( $\alpha = 0.75$ ) supermajority requirement. Here, even if no additional reserve were set, the voting requirement substitutes for it, and target shareholders maximize their expected return from the auction with no added help.

### C. Appraisal with No Shareholder Approval

Now consider the case where an appraisal option is available to shareholders, but there is no shareholder vote to approve. While seemingly fanciful, this scenario can sometimes occur in practice, such as in the context of acquisitions of controlled firms or squeeze outs.<sup>45</sup> (It is, in any event, an instructive case to consider on a technical level before combining appraisal with shareholder voting.)

<sup>44</sup> In fact, a related provision, known as a “blow” provision, has a similar effect, allowing the buyer to back out if more than a critical mass of shareholders seek appraisal. We discuss blow provisions in the extension section.

<sup>45</sup> See, e.g., DGCL §253 (“short-form” merger). The charter can also take away the voting rights to certain class (but not all classes) of shareholders, such as the class of non-voting preferred stock.

Without a shareholder vote, the outcome of the auction fully determines whether a sale occurs, subject to the terms laid out by the agent-manager. Should the highest bid exceed the manager's stated reserve price  $r$ , the highest bidder purchases the company at a price of  $\min\{r, v_{(N-1)}\}$ . However, once a winner and a price are determined, all shareholders may choose<sup>46</sup> between (a) taking the merger consideration and (b) petitioning the court to determine the "fair value" of their shares, which we denote as  $\phi$ . We assume this amount is paid by the successful buyer in lieu of the merger consideration to all petitioning, dissenting shareholders, while the non-petitioning (approving) shareholders are cashed (squeezed) out on the terms of the merger.

A key question in determining the equilibrium in this case is the approach undertaken by the court to assess fair value. Our analysis compares two regimes: (1) the MP rule, where,  $\phi$  is pegged at the winning auction bid, floating up and down with the merger price; and (2) a conventional rule, where,  $\phi$  is fixed ex ante, and its terms are independent of the realized bids in the auction. We analyze each rule, in turn, below.

### 1. The Merger Price (MP) Rule

First consider the effects of the MP rule, so that the appraisal value is pegged to the merger price such that  $\phi = \min\{r, v_{(N-1)}\}$ , moving mechanically up and down with the winning auction price. Against this backdrop, consider a shareholder of type  $\gamma$  who is choosing between accepting the terms of a merger at a winning bid of  $b = \min\{r, v_{(N-1)}\}$  or seeking a judicial appraisal and receiving the same amount  $\phi = b$ . This shareholder gains nothing from seeking appraisal over simply accepting the merger terms. And in fact, from the winning buyer's perspective there is no difference either: the consideration—and the consequences—are identical regardless of the shareholders' strategy.

The strategic role that the MP rule serves in equilibrium is significant: because the MP rule provides no natural "outside option" to the merger price, it is not a meaningful constraint on reserve prices, thereby leaving such choices completely up to the agent. The resulting strategic landscape, then, is identical to the benchmark case (from subsection A), where there was neither appraisal nor approval: The agent-manager favors the lowest reserve to which she can credibly commit ( $r = 0$ ), since her payoff is strictly decreasing in  $r$ ; the following result immediately emerges:

**Proposition 3.** *When appraisal is available at an amount pegged to the merger price, and there is no shareholder approval, the unique equilibrium is identical to the case where neither appraisal nor approval were permitted (Proposition 1). The manager-agent sets the reserve price at  $r_m = 0$ , all bidders actively participate, and a merger always occurs in equilibrium. The parties' expected payoffs are the same as in Proposition 1.*

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<sup>46</sup> Formally, appraisal is available only to shareholders who did not vote in favor of the merger. See DGCL §262(a). That is true by construction here, since no vote occurs. It also holds in various types of short form mergers.

Proposition 3 embodies an important intuition that merits emphasis. At least when viewed in isolation, the MP rule is tantamount to *eliminating the appraisal remedy altogether*, and with it whatever price protection that it might be able to support under alternative forms of measurement. We proceed to address such alternatives now.

## 2. The Conventional Rule

Now consider a “Conventional” rule in which the appraisal is pegged at some independently determined fixed value  $\phi$ , which is computed by the court. We assume for the moment that  $\phi$  is fixed *ex ante*, and commonly observed by all the players. (We consider the case where  $\phi$  is subject to noise, due to judicial error, later.) Beyond requiring that it be untethered to the winning bid price  $b$ , for now we remain agnostic about *exactly* how  $\phi$  is computed. That said, several possibilities suggest themselves. First, fair value might be pegged against the valuation of the representative incumbent shareholder, so that  $\phi = \mu \equiv E(\gamma)$ . Such a measure has some intuitive appeal, since it represents an aggregated measure of the target’s going-concern value to its incumbent owners, excluding buyer synergies (as the statute instructs<sup>47</sup>). Alternatively,  $\phi$  might be pegged to the minimal reserve price a representative shareholder with value  $\mu$  would demand in an auction with an arbitrary number of bidders. Recall that regardless of  $N$ , a seller with valuation  $\mu$  maximizes its expected return by fixing the reserve price such that  $r^* = \mu + \frac{1-F(r^*)}{f(r^*)}$ , below which no sale would occur. This measure also has some intuitive appeal, since a well-managed sales process would never sell to any buyer for less than this price. Moreover, this measure does not reflect deal synergies from *any specific buyer*, and one could thus defend it as being consistent with statutory command.<sup>48</sup>

Consider a shareholder of type  $\gamma$  who is choosing between accepting the terms of a merger, or seeking a judicial appraisal and receiving price  $\phi$ , as described above. Regardless of the shareholder’s type, it is clear that she would favor appraisal in all cases where the merger price falls below  $\phi$ , and favors the merger terms otherwise. Similar to shareholder voting, the Conventional rule imposes a *de facto* reserve price  $\phi$ , and the agent’s stated reserve is relevant only if  $r > \phi$ . The core conclusions from Proposition 2 follow, but with  $\phi$  replacing  $\rho$ : the auction will produce either no sale or a sale at a price equal to  $\min\{\phi, v_{(N-1)}\}$ . The following proposition immediately follows.

**Proposition 4.** *When appraisal is available under the Conventional rule in the amount  $\phi$  but there is no shareholder approval, there is a unique set of outcome-equivalent equilibria in which manager sets the reserve price at  $r_m \leq \phi$ , and only bidders with*

<sup>47</sup> See, e.g., DGCL §262(h) (requiring the Court to determine the “fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation”).

<sup>48</sup> As discussed above, current appraisal valuation practice outside of the MP rule tends to focus on DCF and/or comparable companies models. Either of these approaches is arguably consistent with several alternative conceptualizations of  $\phi$ , including those articulated above.

valuations of at least  $\phi$  actively participate. The probability of a sale is  $1 - F(\phi)^N < 1$  in equilibrium, and the expected equilibrium payoff to target shareholders equal to

$$N\phi[1 - F(\phi)]F(\phi)^{N-1} + N(N - 1) \int_{\phi}^{\infty} [1 - F(y)]F(y)^{N-2}y dF(y) + F(\phi)^N\mu$$

which is maximized by setting  $\phi = r^*$ . Expected shareholder welfare is strictly greater than the benchmark case (Proposition 1) for all  $\phi \in (0, r^*]$ , strictly greater than the status quo value of  $\mu$  whenever  $\phi \in (\mu, r^*]$ , and strictly greater than under shareholder approval alone (Proposition 2) when  $\phi \in (\min\{\rho, r^*\}, \max\{\rho, r^*\})$ .

Note that the main result is very close to that of Proposition 2, other than the replacement of  $\rho$  with  $\phi$ .<sup>49</sup> The size of the shareholders' payoff in the appraisal only case depends critically on how  $\phi$  and  $\rho$  are set. Note that if the court is free (and sufficiently competent) to choose  $\phi$  near  $r^*$ , then target shareholders likely fare better when limited to appraisal only (Proposition 4) than when limited to approval-only (Proposition 2). On the other hand, if the voting rule induces the pivotal voter  $\rho$  to be near  $r^*$ , the opposite can hold, and an approval-only regime can dominate.

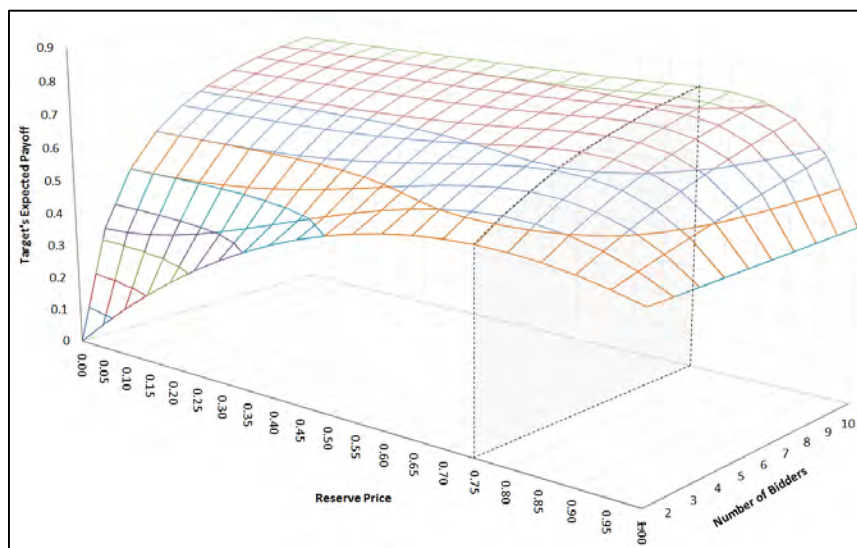
### 3. Comparison of MP and Conventional Rules

With the above results in hand, we can offer a preliminary assessment of how the MP rule stacks up against plausible Conventional rules within the appraisal-only regime. (We hold in abeyance—until the next section—how adding shareholder voting affects things.) It is easy to see that this doctrinal battle of the bands is not especially flattering for the MP rule. As Proposition 3 demonstrates, the MP rule leaves target shareholders in the same position as if they had no dissenters' rights whatsoever. In contrast, the most plausible candidates for Conventional appraisal remedies do strictly better than the MP rule. In fact, *even if a court were wildly incompetent*, unable to discern with sufficient accuracy any of those plausible measures, it could still enhance target shareholder welfare beyond what the MP rule promises simply by fixing fair value at a trivially low level (such as  $1\phi$ ). Doing so would at least marginally bolster the reserve price beyond zero (the price that the MP rule implicitly advertises).

That said, it is important to recognize that while the MP rule is unambiguously shareholder-welfare reducing for all  $N$ , its disadvantages attenuate as competition grows. To see this, see Figure 2, which plots the expected welfare of target shareholders, as a function of the reserve price (horizontal axis) and the number of bidders (depth axis). The figure assumes that the uniform distribution on the unit interval governs both the target shareholders' and the buyers' valuations. Note the hyperplane cutting through the figure at the point where the reserve price is equal to  $r = 0.75$ , which is the optimal reserve price for shareholders in the case. The MP rule effectively reduces this reserve price to zero, represented by the far-left wall of the graph. As demonstrated above, the

<sup>49</sup> In addition, the equilibrium in Proposition 4 does not depend on restricting the strategy space with weakly undominated criterion, since there is no voting.

MP rule represents a significant hit to target shareholder payoffs when the number of bidders is somewhat small (e.g., in the low single digits). However, as the number of bidders increases (moving away on the depth axis), the penalty visited by the MP rule shrinks substantially. While the MP rule is still unambiguously worse than the optimal reserve price, its advantage dissipates considerably with more competitive bidding.<sup>50</sup>



**Figure 2:** Target Shareholders' Expected Payoff as a Function of Reserve Price (Horizontal Axis) & Number of Bidders (Depth Axis).

The intuition behind this example extends the general case too; it is straightforward to show that the marginal value of increasing  $r$  above zero attenuates quickly in  $N$ , and that this marginal return eventually becomes zero when  $N$  grows arbitrarily large.<sup>51</sup> Thus, in the case of appraisal with no voting, the adoption of the MP rule over plausible alternatives—while always suboptimal for shareholders in a *qualitative* sense—visits a somewhat limited discount on them in a *quantitative* sense with competitive bidding. We revisit this point below.

#### D. Shareholder Approval Combined with Appraisal

Finally, we consider the hybrid case where both shareholder approval is required and appraisal is available to dissenters. Perhaps unsurprisingly, this is the most interesting and complex case, since we must consider *not only* the effects of both options in isolation, but also their interaction. Such interaction is, in fact, a virtual certainty: voting and appraisal are designed to interact structurally on each other in two related respects. First, under most states' laws (including Delaware's), target shareholders are ineligible to seek appraisal if they previously voted in favor of the merger.<sup>52</sup> In the

<sup>50</sup> Bulow and Klemperer (1996) demonstrates this effect more generally, showing that the value of a reserve price can be swamped by the value of adding another bidder.

<sup>51</sup> For a formal proof of this claim, see Lemma A.1 in the Appendix.

<sup>52</sup> See, e.g., DGCL §262(a) (appraisal available to shareholder who "neither voted in favor of the merger or consolidation nor consented thereto in writing").

context of our model (which assumes away abstention), this implies that shareholders must vote against the merger to be eligible. Second, shareholders who vote against the merger receive a true option—they may select whether to take the merger consideration or seek appraisal. Thus, voting in favor of a merger extinguishes real option for the target shareholder, while voting against preserves it.<sup>53</sup>

Accordingly, now each shareholder’s strategy consists of two elements: (1) determining whether to vote in favor of or against the merger; and (2) if the shareholder has voted against a shareholder-approved merger, determining whether to accept its terms or seek appraisal. Unlike the case of pure approval, the combination of these factors can support equilibria with strategic (insincere) voting by shareholders who support the merger yet nonetheless demur, hoping to preserve eligibility to seek appraisal. To analyze this interaction, we once again proceed sequentially, starting with the “Merger Price” rule, and then moving on to several plausible “Conventional” rules.

### 1. The Merger Price (MP) Rule

As in the previous subsection, MP rule is simple to analyze. Just as before, the appraised fair value floats mechanically up and down along the with the merger price, so that  $\phi = \min\{r, v_{(N-1)}\}$ . And, just as before, no shareholder ever gains from seeking appraisal, implying that appraisal rights do not affect how any shareholder votes. In this case, the game devolves into the pure approval rights case, similar to that studied above. This reasoning immediately implies the following:

**Proposition 5.** *When shareholders must approve the winning bid and appraisal is subject to the MP rule, there is a unique set of outcome-equivalent, weakly undominated equilibria identical to that characterized in Proposition 2.*

The result is not surprising. In the pure approval regime studied above, an underlying assumption was that dissenting shareholders would still receive the same consideration assenters. This is functionally identical to obtaining appraisal at an amount mechanically pegged to the merger price (the winning bid). Furthermore, given that the buyer only needs to induce the pivotal voter to vote in favor of the bid, the *de facto* minimum bid is once again equal to  $\rho$ . Note that when  $\rho < \mu$ , it is possible for a buyer to acquire the company for less than its incumbent shareholders value it. In any event, it remains the case that even in the presence of shareholder approval rights, the MP rule functions largely to negate the effect of the appraisal remedy, leaving shareholder voting as the sole source of reserve price protection for target shareholders.

### 2. The Conventional Approach

Now consider a variety of Conventional valuation approaches, in which the court fixes fair value pegged at some  $\phi$  untethered to the merger price. (We need not rehash

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<sup>53</sup> See, e.g., DGCL §262(e) (allowing dissenting shareholder, who previously notified the corporation its intent to exercise the appraisal remedy, to withdraw and accept the merger consideration within 60 days of the completion of the merger).

here the foregoing discussion about how various measures of  $\phi$  might be justified, but we return to this discussion later.) In this case, most strategic interaction hinges on the size of the anticipated fair value ( $\phi$ ) relative to the pivotal voter's value of the firm ( $\rho$ ). We therefore analyze the two possible orderings in sequence.

i. Case A:  $\phi < \rho$

Suppose first that the anticipated appraisal value is strictly less than the pivotal shareholder's assessment. In this case, appraisal is unattractive relative does little to alter the pivotal shareholder's behavior, since it offers less than her going concern valuation. As before, this shareholder, moreover, would oppose any winning bid offering less than  $\rho$ , but would support any bid exceeding her valuation (so that  $b \geq \rho$ ). Ultimately, then, in this region, the appraisal remedy is insufficiently lucrative to affect the pivotal voter's behavior from the approval-only case, as reflected in the following Lemma.

**Lemma 6A.** *If shareholder approval and appraisal are both available, and the appraisal remedy is pegged at  $\phi < \rho$ , there is a unique set of outcome-equivalent, weakly undominated equilibria identical to that characterized in Proposition 2.*

ii. Case B:  $\phi \geq \rho$

Now consider the more interesting case where the fair value equals or exceeds the pivotal shareholder's type. In this case, a successful merger can result in an appraised fair value that the pivotal shareholder would find attractive relative to the status quo. Whether (and how) the shareholder responds to this incentive, in turn, depends on the value of the winning bid/merger proposal,  $b$ .

On one end of the spectrum, suppose  $b$  were even higher than the appraisal value (i.e.,  $b \geq \phi$ ); in this case, no shareholder would ever favor appraisal since the terms of the merger dominate, and a strong majority of shareholders support (and would vote for) the merger. Here, then, the appraisal option does no added work, and the merger is supported by a strong majority, all voting sincerely. The merger always succeeds.

At the other end of the spectrum, suppose the bid is relatively low (i.e.,  $b < \rho \leq \phi$ ). Here, the pivotal shareholder has divided interests: appraisal looks extremely attractive, while the merger price is unattractive (since  $b$  is below her status quo payoff). The pivotal shareholder's most preferred option would be to see merger consummated over her "no" vote and then to seek appraisal, and if that route were unavailing, she would want the merger to fail. Either way, her optimal strategy is clear: she finds it weakly dominant to cast her vote against the merger. Similar reasoning also applies to all shareholders who have a higher valuation than the pivot. Consequently, the merger always fails.

**Lemma 6B.1.** *When  $\rho \leq \phi \leq b$  and  $r \leq b$ , the unique weakly undominated equilibrium of the voting continuation game prescribes sincere voting and approval of the merger.*



*When  $b < \rho \leq \phi$  and  $r \leq b$ , the unique weakly undominated equilibrium prescribes sincere voting and rejection of the merger.*

Summing up so far, when  $b$  is outside the (presumed non-empty) interval  $[\rho, \phi)$ , the equilibrium outcome is relatively straightforward. The most interesting case is when the winning bid resides in the Goldiloxian middle ground where  $\rho \leq b < \phi$ . Here, the type  $\rho$  shareholder is attracted to the winning bid, but she is *even more* attracted to the lucrative appraisal value. Thus, this shareholder would most prefer that the transaction be consummated, and then to seek appraisal. However, her next most preferred strategy would be for the merger to be approved and to receive the winning bid  $b$ . Her least preferred strategy is the outright rejection of the merger. And herein lies the rub: for the type  $\rho$  shareholder has countervailing motives: in order to retain eligibility for her *most* preferred outcome (appraisal), she must vote insincerely for her *least* preferred outcome (rejection). Such an appraisal-preserving negative vote would be acceptable to the pivotal shareholder *if* she could count on other shareholders to carry the requisite majority ( $\alpha \equiv H(\rho)$ ) to override her vote. But alas, all shareholders with valuations on the interval  $[\underline{v}, b]$  are performing the same strategic calculus, hoping that others will vote to support the merger so that they will be able to seek appraisal. For this group of shareholders, weak dominance no longer does any work in refining possible equilibria. A collective action problem ensues, and much depends on whether (and how) merger-supporting shareholders coordinate on a voting equilibrium that determines who can seek appraisal, and who must “take one for the team” to approve the deal.

It should therefore not be surprising that there are multiple equilibria in this case. Confining attention to pure-strategy equilibria,<sup>54</sup> two distinct classes of equilibria emerge in this case, which turn on whether shareholders can solve their coordination problem. They are summarized in the following Lemma.

**Lemma 6B.2.** *When  $\rho \leq b < \phi$ , there are two classes of weakly undominated equilibria in pure strategies of the voting continuation game:*

- (A) *In the first (“uncoordinated”) equilibrium, a coalition of shareholder types  $Z_1 \subset [\underline{v}, b]$  comprising a strictly less than  $\alpha$ -fraction of shareholders vote to approve the merger, and all others vote against. All voting against seek appraisal. The merger never succeeds.*
- (B) *In the second (“coordinated”) equilibrium, a coalition of shareholder types  $Z_2 \subseteq [\underline{v}, b]$  comprising an exact  $\alpha$ -fraction of shareholders vote to approve the merger, and all others vote against. All those voting against seek appraisal. The merger always succeeds.*

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<sup>54</sup> Although we cannot generically exclude mixed strategy equilibria, weak dominance excludes all equilibria in which players on  $(b, \bar{v}]$  vote for the merger with positive probability. Moreover, of the remaining shareholders on  $[\underline{v}, b]$ , there exist no symmetric mixed strategy equilibria prescribing vote in favor of the merger with probability  $p \in (0,1)$ . See the Appendix for details.

As Lemma 6B.2 illustrates, the appraisal interacts non-trivially with shareholders' voting incentives. When the merger price is attractive to the type- $\rho$  shareholder but the anticipated appraisal value is even more tempting, equilibrium turns on whether shareholders on the interval  $\gamma \in [0, b]$  who are in the same boat can cobble together a coalition of "yes" votes to support the merger. If they cannot coordinate (as in the first equilibrium), the bid is rejected, even though a majority of all shareholders would have preferred it. When they succeed in coordinating (as in the second equilibrium), the merger wins by a hair's breadth, and the "no" voters (many of whom vote insincerely) seek appraisal at a higher expected price.

Note that in the second, "coordinated" equilibrium, the prospective buyers' bidding strategy must adapt as well. No longer is it optimal to bid truthfully (as is usually the case in Vickrey or English auctions). Rather, the winning buyer must anticipate the possibility of having to pay two different prices: the bid amount to the "have-nots" (the  $\alpha = H(\rho)$  fraction voting in favor and receiving  $b$ ), and a premium price to the "haves" (the  $(1 - \alpha)$  fraction voting against and receiving appraisal of  $\phi > b$ ). The buyer's total outlay therefore may exceed her bid of  $b$ , and will instead be equal to  $\max\{b, \alpha b + (1 - \alpha)\phi\}$ . Consequently, buyers must prepare to adjust their bidding behavior to account for the anticipated "tax" they pay the dissenters for winning bids in the interval between  $\rho$  and  $\phi$ . (Indeed, truthful revelation is no longer incentive compatible for buyers in this intermediate range.) Analysis of the foregoing lemmas yields the following central result.

**Proposition 6.** *When shareholders vote on the winning bid and Conventional appraisal is available, equilibrium turns on the relative sizes of  $\rho$  and  $\phi$ :*

- (A) *When  $\phi < \rho$ , all weakly undominated equilibria are identical to Propositions 2 and 5. The agent sets the reserve price no higher than the pivotal shareholder's valuation ( $r_m \leq \rho$ ), and all bidders with valuation  $\gamma \geq \rho$  participate. Winning bids are approved and no dissenters seek appraisal.*
- (B) *When  $\phi \geq \rho$ , there are two outcome-equivalent classes of weakly undominated equilibria in pure strategies.*
  - (1) *In the first, the equilibria are identical to Propositions 4. The agent sets the reserve price no higher than the appraisal value ( $r_m \leq \phi$ ), and all bidders with valuation  $\gamma \geq \phi$  participate. Winning bids are approved and no dissenters seek appraisal.*
  - (2) *In the second, the agent sets the reserve price at no higher than the type- $\rho$  shareholder's valuation ( $r_m \geq \rho$ ), and bidders with valuation  $\gamma \geq \alpha\rho + (1 - \alpha)\phi$  participate. Winning bids of at least  $\phi$  are approved and no dissenters seek appraisal; while winning bids on  $[\rho, \phi)$  are approved by a bare  $\alpha$ -fraction of the shareholders, and all dissenters seek appraisal.*

Although Proposition 6 is somewhat involved, its intuitive content is simple. The appraisal rule “matters” only if it is not overshadowed by the alternative check of shareholder approval. When  $\phi < \rho$ , the appraisal option is insufficiently potent to matter, since the required vote on the merger already ensures a *de facto* reserve price of  $\rho$ . Here, there is no difference between the MP Rule and a Conventional rule, since both are overshadowed by shareholder approval.

Once the appraisal value exceeds the pivotal valuation ( $\phi \geq \rho$ ), equilibrium behavior changes significantly, pushing the *de facto* reserve price above  $\rho$ . How far above turns on which class of equilibrium emerges. In the “non-coordinated” equilibrium (B)(1), shareholders’ collective action problem causes them to reject any bid below  $\phi$ , which then becomes the effective reserve price for the auction. When the “coordinated” equilibrium (B)(2) obtains, voting and appraisal interact. Those seeking appraisal must rely on sufficiently many affirmative voters to approve the deal and make appraisal possible, and all shareholders voting to approve the merger effectively become pivotal. Bidders’ thus expect to pay a two-part price consisting of the winning bid (to an  $\alpha$ -fraction of shareholders) and the appraisal value (to the remaining  $1 - \alpha$ ). The end result from bidders’ perspective is to replicate the expected payoffs of an ascending auction with *de facto* reserve price equal to  $\alpha\rho + (1 - \alpha)\phi$ .

Several aspects of the equilibria described in Proposition 6 warrant attention. First, our model predicts appraisal will be far from ubiquitous. When it occurs in equilibrium, it will be systematically pursued only in those circumstances where (a) the anticipated appraisal award exceeds the pivotal voter’s type  $\phi > \rho$ ; (b) the “coordinated” equilibrium obtains; and (c) the winning bid lies somewhere between  $\rho$  and  $\phi$ . In no other cases are appraisal proceedings an equilibrium phenomenon in our model.

Second, when appraisal proceedings are observed in equilibrium, *fair-value assessments should systematically exceed the merger price*. This ordering holds regardless of whether  $\phi$  is set “too high” or “too low” as measured against some normative benchmark. It is simply a byproduct of equilibrium behavior: strategic litigants will not pursue appraisal (and may not even approve a merger) if the appraisal option is less attractive than the winning bid. Consequently, one should be extremely skeptical about the argument (put forth by several commentators) that the appraisal system is “broken” because appraisal awards typically exceed the merger price.<sup>55</sup> Such evidence may well demonstrate that parties are acting rationally; but it is hardly a symptom of institutional dysfunction warranting the broad embrace of the MP rule.<sup>56</sup>

Finally, for any fixed  $\phi \leq r^*$ , the expected revenue from the “coordinated” equilibrium (B)(1) is *strictly less* than its counterpart in the “non-coordinated” equilibrium (B)(2). In effect, target shareholders’ collective ability to coordinate can ultimately *hurt* them in the aggregate, by allowing bidders to rely on a type of judicially-mediated price discrimination, paying a lucrative appraisal value to dissenters but a more modest bid to all others. In fact, the recent emergence of sophisticated hedge funds (such

<sup>55</sup> See, e.g., Bainbridge (2012) and Hamermesh and Wachter (2005).

<sup>56</sup> Accord Bomba et al. (2014) (asserting similar conclusions from several practitioners’ standpoints).

as Marion Capital and Elliot Associates) pursuing appraisal might signify a transition of sorts from uncoordinated to the coordinated equilibria, in which uncoordinated shareholders must more frequently carry the burden of merger approval (with no appraisal rights) while strategic and coordinated investors reap the greater benefits of dissenting. That said, this outcome does not in itself justify the adoption of the MP rule. Indeed, a comparison of Propositions 5 and 6 reveals that regardless of the equilibrium that emerges, *target shareholders are uniformly better off* under a Conventional approach than the MP rule (at least so long as  $\phi \leq r^*$ ).<sup>57</sup>

#### IV. Applications and Extensions

Our equilibrium analysis complete, we are now in a position to discuss applications of and extensions to appraisal policy and related issues. We begin by considering the design of an “optimal” appraisal rule (bearing in mind the possibility of judicial error), followed by a brief discussion of several other possible extensions.

##### A. Optimal Appraisal Policy in (Possibly) Error-Prone Courts

Our first application relates to a core motivation in this paper: assessing the conditions under which the MP rule (or something else) would be an “optimal” judicial policy. For present purposes, we define “optimality” as the appraisal approach that maximizes the expected net payoff that target shareholders as a whole expect in equilibrium.<sup>58</sup> Analysis of the previous sections yields the following proposition:

**Proposition 7.** *The optimal appraisal rule  $\phi^*$  is characterized as follows:*

(A) *If  $\rho > r^*$ , then  $\phi^*$  includes both the merger price and any fixed  $\phi \leq \rho$ ;*

(B) *If  $\rho \leq r^*$ , then:*

(1)  *$\phi^* = r^*$  if the “uncoordinated” equilibrium in Proposition 6(B)(1) obtains;*

(2)  *$\phi^* = \left(\frac{r^* - \alpha\rho}{1 - \alpha}\right) > r^*$  if the “coordinated” equilibrium in Proposition 6(B)(2) obtains.*

<sup>57</sup> In fact, as we show in the next section, the optimal judicial response to the increased frequency of the coordinated equilibrium may be (ironically) to *increase* the award even further.

<sup>58</sup> Although this design question need not reflect the statutory language in the appraisal statute, it is worth noting that Delaware judges have significant equitable discretion to assess fair. Under current law, the Chancery Court need not follow any prescribed procedure other than the general rules of court. But, the statute requires the court to set the fair value amount “exclusive of any element of value arising from the accomplishment or expectation of the merger.” DGCL §262(h). And even though the statutory formulation specifically excludes the inclusion of buyer “synergies” in fair value, the practical meaning of that limitation is hotly contested. See, e.g., *Merion Capital v. BMC Software*, C.A. No. 8900-VCG, at 46 (Del. Ch. October 21, 2015) (likening the exclusion of synergies to the value of the deal that accrues to the buyer with a patent on the bow when it purchases an arrow company).

Proposition 7 provides a key result from this paper. It states, among other things, that the MP rule *may* be one of many optimal rules in certain circumstances, but only when the pivotal shareholder's valuation,  $\rho = H^{-1}(\alpha)$ , exceeds the optimal reserve price in the auction,  $r^*$ , which recall is characterized by:

$$r^* = \frac{1 - F(r^*)}{f(r^*)} + \mu$$

In all other circumstances, the MP rule is unambiguously suboptimal.

The condition that  $\rho > r^*$  can be difficult to satisfy, particularly when the voting rule requires a bare majority (so that  $\alpha = 0.5$ ), and it generally requires a significant rightward skew in the distribution of incumbent shareholders' valuations relative to bidders'. For example, consider the case where both buyers' and shareholders' valuations are on the unit interval, with buyers' valuations distributed uniformly, so that  $r^* = \frac{1+\mu}{2}$ . In order for  $\rho > r^*$  to hold, the median shareholder's valuation would have to be more than midway between the representative shareholder value (of  $\mu$ ) and the maximal shareholder value (of 1). While there exist distributions that satisfy this condition, most conventional ones do not. (For example, if target shareholders were also uniformly distributed, then this condition would fail miserably, since  $\rho = 1/2 = \mu < r^* = 3/4$ .) Moreover, even in those cases where the median shareholder is so heavily skewed upwards as to satisfy this condition, it would imply that most target shareholders have extremely high valuations relative to possible buyers, calling into question whether conditions are ripe for a profitable merger to begin with.

If, in contrast, a *supermajority* of shareholders were required to approve the merger, it becomes easier to satisfy the condition in Proposition 7. To take one example, recall that two-step mergers in Delaware traditionally required at least 90% of the target shareholders to tender their shares into a first step tender offer before the squeeze-out step was permitted.<sup>59</sup> This is tantamount to setting  $\rho = H^{-1}(0.9)$ . Proposition 7 tells us that when a merger requires supermajority assent such as this, either by compulsion or by the pursuit of a certain deal structure, the pivotal voter may exceed the optimal reserve price, and it would be optimal to relax appraisal standards, possibly by adopting the MP rule rather than the Conventional rule.

When  $\rho \leq r^*$ , on the other hand, the MP rule is generally suboptimal, and instead the optimal appraisal value is a fixed value, either at  $r^*$  (in the case of the non-coordinated equilibrium from Proposition 6) or at  $\frac{r^* - \alpha\rho}{1 - \alpha}$  (in the case of the coordinated equilibrium from Proposition 6). The former case is intuitive, since it simply fixes the appraisal value at the optimal reserve price for the representative seller. The latter case is more interesting and provocative, since it suggests that the optimal appraisal value should be set *even higher than the optimal reservation price*  $r^*$ . The reason for this additional

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<sup>59</sup> See DGCL §253. As noted above, the Delaware legislature recently promulgated DGCL §251(h), allowing a buyer to commence with a squeeze out contingent on a bare 50% of the target shareholders tendering into the first step tender offer.

premium is that in the coordinated equilibrium, the buyer pays two distinct prices to affirmative voters and appraisal petitioners, and the maximizing value for  $\phi^*$  must be calibrated so that the buyer's minimum expected price is  $r^*$ . For example, when buyers and shareholders are uniformly distributed and the voting threshold is 50%, it is optimal for the court to fix  $\phi^* = r^* = 3/4$  in the uncoordinated case, but in the coordinated equilibrium it should set  $\phi^* = 1$ , pegging the appraisal value at the highest valuation among the shareholders. (In equilibrium, the winning buyer will pay a “sticker price” of 0.5 to a bare majority of shareholders voting yes, and an appraisal value of 1.0 to the remainder who seek appraisal, averaging out to a total outlay of 0.75.)

Significantly, Proposition 7's insights are largely robust to environments where valuation assessments are inexact and/or prone to considerable statistical noise, possibly due to judicial error. This observation is not insignificant, since the perceived imprecision of conventional appraisal approaches such as DCF as applied by (putatively) inexpert judges is often cited as a key rationale for using the merger price (See, e.g., Subramanian (2017)). Our framework easily accommodates—and casts significant doubt on—such arguments. To see why, suppose in attempting to implement a target valuation amount  $\phi$ , the court was prone to err, so that the *realized* appraisal value in litigation is  $\phi' = \phi + \varepsilon$ , where  $\varepsilon$  represents an independently (independent from  $\phi$ ) distributed noise with zero mean and positive variance. In this setting, both bidders and shareholders would predicate their strategies *not* on  $\phi'$ , but on the *expected value*<sup>60</sup> of  $\phi'$ . But because  $E(\phi') = \phi$ , all the results from Proposition 7 continue to go through, and the error term would have little net effect (so long as the noise component remains unobservable until the case is decided<sup>61</sup>).

It is important to note that this brief discussion presumes an “optimal” appraisal rule to be one that maximizes target shareholders' *ex ante* expected net payoff. While this assumption is natural within the context of corporate and M&A law, some judges could harbor objectives that coincide with a broader measure of social welfare.<sup>62</sup> If we also adapt our analysis to embrace such capacious desiderata, it would have implications for several of our results, as well as whether courts should grant shareholders the freedom to set reserve price in the first place. Indeed, as discussed above, the optimal reserve price in an English auction is closely related to a monopolist's profit maximizing pricing condition, balancing the chance of failing to make an efficient sale on the margin against the reward of a higher price on the infra-margin. Were we to incorporate both buyers' and sellers' expected welfare in the definition of optimality, it would be optimal to set the

<sup>60</sup> While this argument presumes risk neutrality, little changes with risk aversion, since the judicial noise affects *both* the buyer and dissenters, giving them a strong incentive to settle at close to expected value.

<sup>61</sup> A caveat worth noting is that the option-like nature of appraisal could introduce *bias* if information about judicial error is observed *after* signing but *before* dissenters must commit to seek appraisal. Dissenters would then effectively own a valuable call option over valuation risk (written by the buyer), and it would be appropriate to *reduce* the optimal appraisal award by the value of that option. (A similar adjustment would be warranted for a variety of other sources of bias.) Net of such adjustment, however, the core results in Proposition 7 remain intact.

<sup>62</sup> One plausible reading of the statute, for example, might constrain a judge to award no more than the status quo value of the target as measured by the representative agent,  $\mu$ . As we discuss below, such a measure may also be an optimal one more generally in the case of common-value auctions.

reserve price at  $r^* = \mu$ , so that the company always ends up in the hands of the highest valuing owner (be that the incumbent shareholders or the highest bidding buyer). The key steps of our earlier analysis would go forward for this case in more or less the same way, but with the significant caveat that now we would have  $r^* = \mu$ . That alteration, in turn, would expand the circumstances under which the MP rule could be optimal (though not uniquely so), by slackening the conditions in which  $\rho \geq r^* \equiv \mu$ .

## B. Other Extensions

There are several other extensions and applications of the basic analysis that are worth serious consideration, and we list several of them here (along with conjectures about how they would affect our analysis). The first concerns equilibrium selection. Proposition 6 (including the Lemmas leading up the Proposition) is silent on the question of equilibrium selection. Yet this question is clearly important, in particular for the buyers with valuations between  $\alpha\rho + (1 - \alpha)\phi$  and  $\phi$ , who may need to decide whether to participate in the auction or stay away. One possible way of confronting this issue is to identify situations where shareholders are likely to be able to solve their coordination problem over voting and seeking appraisal. Here, a plausible predictor is ownership concentration in the firm. Though we have largely assumed that the target stock is completely dispersed, this may be overly simplistic. For many publicly traded companies, even those with multitudes of beneficial owners of stock, there are a relatively modest number of institutional shareholders holding relatively large fractions of the outstanding stock on behalf of these owners. In that setting, the bare majority equilibrium (as laid out in Lemma 6B.2(B)) may be much easier support, compared to a setting where the shares are completely dispersed and the shareholders are wholly unorganized.

Several other extensions to our model are also policy relevant and worth exploring. The multiple equilibria described in Propositions 6 and 7, for example, may pose challenges when the judge cannot predict *ex ante* which equilibrium will materialize. To deal with this uncertainty, at least in theory, the appraisal remedy might be contingent on the realized equilibrium: *i.e.*, the judge may be able to “learn” which equilibrium is in play by observing the deal structure and/or voting outcomes before deciding on the appraisal rule. For instance, when the merger agreement sets the threshold ( $\rho$ ) relatively high, there may be little need for an appraisal remedy that pushes that *de facto* reserve price even higher (*i.e.*,  $\phi > \rho$ ). In such cases, it might be better for the court to adopt the Market Price (MP) rule, or put some evidentiary weight on the merger price as corroborative of “fair value,” so as to eliminate possible distortion that could be caused by the Conventional approach. This intuition suggests that judges might the MP rule when the appraisal follows a two-step merger involving a 90% squeeze out condition than a 50% condition. Alternatively, if the shareholder vote was a close call, the judge could infer a coordinated equilibrium has obtained and set the “fair value” under the appraisal at  $\phi^* = \frac{r^* - \alpha\rho}{1 - \alpha}$ . On the other hand, if the merger is approved overwhelmingly, the judge could infer that it was the uncoordinated equilibrium, and sets the appraisal value equal to  $\phi^* = r^*$ . An attractive feature about such a contingent

appraisal system is that it awards more compensation to the dissenting shareholders when the merger seems more “controversial.”

We might also extend the analysis by introducing judges as strategic players. Doing so might provide insights about the creeping judicial embrace of the MP rule as a type of collective action problem. Recall from the introduction that at least some of the judicial preference for the MP rule appears predicated on the technical difficulties courts face in divining independent financial valuations from whole cloth. In the eyes of an individual judge, the end product may not be worth the effort. Indeed, assuming buyers/agents had largely expected courts to utilize an optimal conventional appraisal rule, the deals they produce are likely to look *especially* protective of shareholder interests, dampening a judge’s incentive to invest in an arduous fairness calculation when market price is clearly reliable. When that judge rationally defects from the conventional rule, however, it visits an externality on others, since future buyers/agents will design their auction against a prospect of an incrementally diluted appraisal rule—an actuarial hybrid of the MP rule and the conventional rule. Although each defection is rational for the individual judge, the collective effect can be to cause excessive judicial use of the MP rule.

Our analysis may also be amenable to studying a variety of different contractual mechanisms that respond to appraisal risk. From the buyer’s perspective, appraisal introduces a type of transactional “tax.” Not surprisingly, some buyers try to reduce or eliminate such surprises through a variety of contractual terms. One often-observed contractual clause—known as a “blow” provision—allows the buyer to walk away from the deal if a sufficient fraction of target shareholders exercise the appraisal remedy. Especially if the bare majority equilibrium is anticipated (as in Proposition 6), the buyer may have a strong incentive to adopt a “blow” provision so as to protect itself against a cascade of dissenters (who may be demanding cash compensation substantially higher than the merger consideration). A blow provision that is set at, say 20%, will allow the winning bidder to avoid such an outcome. At the same time, blow provisions also implicitly condition the deal on a supermajority vote to consummate the deal (80% in this case, assuming no abstentions). This side effect may ultimately benefit target shareholders, since it requires the buyer to increase its bid to be attractive to a larger majority of shareholders. Other contractual mechanisms include “drag-along” provisions (which require shareholders to vote in favor of the merger under certain conditions and lose appraisal), and “naked no vote” fees, which require the target to pay the buyer a termination fee in the event of a negative vote by shareholders. Viewed in terms of our model, these latter two provisions tend to coordinate shareholders by making no votes costly or ineffectual. All else held constant, they would tend to dilute bids and shareholder welfare.

Still another line of extension concerns the auction environment and the attributes of buyers. Our analysis has focused on the tractable setting of independent, private valuations (IPV) among the bidders. In many merger settings, however, this assumption may be too restrictive, and one can extend our analysis to allow various types of correlation among bidder valuations: either with correlated private valuations (CPV) or



common valuations (CV). Doing so can affect our analysis in several ways. Most notably, the optimal reserve price in the IPV setting is relatively aggressive, largely because buyers' valuations are assumed uncorrelated. With correlated values (CV or CPV), the optimal reserve price will tend to (possibly monotonically) decline towards  $\mu$ .<sup>63</sup> Even in such settings, the traditional appraisal remedy can still play an important role when the pivotal shareholder's valuation falls below the average valuation:  $\rho < \mu$ . By setting  $\phi = \mu$ , the court can avoid the possibility of the target firm being sold to a buyer with inefficiently low valuation ( $\rho \leq v_i < \mu$ ). On the other hand, when the pivotal shareholder's valuation is (at least weakly) higher than the average valuation,  $\rho \geq \mu$ , with correlated value, the MP rule might be an efficient response since the rule effectively negates the reserve price created by appraisal.

Finally, we have assumed throughout that the number of bidders ( $N$ ) is exogenous and fixed *a priori*. Here too, we might enrich the model in realistic ways by allowing the agent-manger also to recruit new bidders into the auction (albeit at some non-pecuniary cost of effort). Such an extension would not only add richness into the auction model but also into the principal-agent setup. For example, suppose it costs the agent an effort cost of  $k$  to attract each new bidder into the auction. In that setting, an optimal appraisal rule may depend on the number of bidders and in an interesting way:  $\phi^* = \phi(N)$  where  $\phi(N)$  declines as  $N$  increases. Under this structure, the agent would have an incentive to heat up the bidding through recruiting buyers, and the court would reward her efforts by progressively reducing the effective reserve price. One version of this mechanism would be for the court to (progressively) revert to the MP rule once the agent-manager has recruited a sufficient number of buyers. One possibility to adopt a cut-off rule, where the court reverts to the MP rule when the number of bidders is sufficiently high:  $\phi^* = MP$  when  $N \geq N^* > 1$  and  $\phi^* = \phi$  otherwise. Another possibility is to assign differential weights on the merger price and the traditional appraisal valuation, depending on the number of bidders and let the weight on the MP rule grow as the number of bidders gets larger:  $\phi^* = q(N) \cdot MP + (1 - q(N)) \cdot \phi$  where  $q(N) \in [0,1]$  and  $q'(N) \geq 0$ . Such contingent rules could function as an incentive device for the deal team.

## Conclusion

This paper has developed an analytic framework (combining auction design, agency costs, and shareholder voting) to shed light on how best to measure the "fair value" of a target company's shares in a post-merger appraisal proceeding. Appraisal is an important mechanism not only in protecting the dissenting minority shareholders' rights but also in affecting the *ex ante* merger negotiation and shareholder approval process by imposing a price floor for the possible benefit of all target shareholders. The topic has also received heightened attention recently due to the rise of so-called "appraisal arbitrage" litigation that some institutional investors have strategically

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<sup>63</sup> If the seller does not have any information that could affect the buyer's valuations, as the number of bidders grows, it may no longer be optimal to set a reserve price above the seller's valuation ( $\mu$  in our model). See Levin & Smith (1996) at 1279 (showing that the optimal reserve price in a correlated values auction converges to the seller's true value as the number of bidders grows arbitrarily large); and Krishna (2002) at 121—124 (failure of the "exclusion principle").

deployed. Due partly to concerns about speculative petition activity as well as the mounting challenge generating independent valuations, the Delaware Chancery Court has become more amenable of late of using the merger price itself as an important piece of evidence (or even the sole evidence) in determining “fair value” when certain conditions are met. An evaluation of the MP rule on *ex ante* behavior has been the principal focus of the paper.

Our analysis has several novel implications. Most fundamentally, as a general matter, the MP rule tends to depress both acquisition prices and target shareholders’ expected payoff compared to both the optimal appraisal rule and the most plausible interpretations of the conventional approach that determine the “fair value” independent of the merger price. At the same time, our analysis has also suggested specific conditions under which the MP rule may be (at least weakly) optimal, such as when the deal is structurally dependent on super-majority shareholder approval (such as traditional short-term squeeze outs), and as an incentive device to encourage a deal team to recruit a healthy number of interested buyers. These situations square reasonably well with what appear (to us) to be the several contours of the MP rule as it is developed thus far by courts. That said, it remains the case that a special situation would be needed to justify the MP rule over any number of possible conventional approaches. Consequently, if it is to be used at all, the MP rule should be deployed with some caution.

Finally, our analysis sheds light on a host of other interesting debates that surround post-acquisition appraisal. It helps explain, for example, why a healthy majority of litigated appraisal cases using conventional fair value measures result in valuation assessments exceeding the deal price, an equilibrium phenomenon predicted by our analysis and a simple artifact of rational, strategic behavior (not necessarily an institutional deficiency, as some have suggested). In addition, our analysis facilitates a better understanding of the strategic and efficiency implications of recent reforms allowing “medium-form” mergers, as well as various appraisal-related practices, such as blow provisions, drag-alongs, and “naked no-vote” fees.

## Appendix A: A Brief Review of Second Price Auctions with Private Values and Reserve Prices

Because some of the analysis in the text draws on auction theory, we review some of the basics here. For more detail, see the classic treatments by Myerson (1981), Milgrom and Weber (1982) and Bulow and Klemperer (1996) for details. Suppose the seller (target corporation) derives his own (reservation) value from the auctioned object of  $v_0 \geq 0$ . Recall that in a second price (Vickrey) auction with independent private valuations (IPV) assumptions, each bidder will reveal (bid) her true valuation ( $b_i = v_i$ ), and thus we can confine ourselves to direct revelation mechanisms. Similarly, in an English auction, where there is a commonly observed ascending bid, it is each bidder's dominant strategy to stay in the auction until the ascending bid surpasses his or her valuation.

For each buyer-bidder  $i$ , let the random variable  $y$  represent the maximum of all remaining buyer's valuations, conditional on bidder  $i$  having the highest valuation. That is,  $y = \max\{v_1, \dots, v_{i-1}, v_{i+1}, \dots, v_N\}$ . Under the distributional assumptions above, it is easy to derive the conditional distribution function on  $y$ , which we denote as  $G(y)$ , is given by:

$$G(y) = F(y)^{N-1}$$

The density function is, then, given by:

$$g(y) = (N - 1)F(y)^{N-2}f(y)$$

If there is no reservation price ( $r$ ), then given the symmetry of the problem, each bidder with valuation  $v$  will expect to pay the following amount in the auction:

$$m(v) = \int_0^v y \cdot g(y) dy$$

In contrast, suppose a minimum reservation price of  $r \geq v$  is introduced, so that the winning bidder must make a bid larger than or equal to  $r$ . With the reservation price, the bidder expects to pay nothing if  $v < r$ , since she will not meet the minimum reservation price. In contrast, when  $v \geq r$ , the bidder of type  $v$  will expect to pay:

$$m(v; r) = r \cdot G(r) + \int_r^v y \cdot g(y) dy$$

The first expression represents the possibility that only the winning bidder has the valuation above the reservation price, in which case the winner will simply pay the reservation price.

The seller, of course, does not know the value of the bidder. But the seller can compute the expected payment of the bidder:

$$\begin{aligned} E_v\{m(v; r, N)\} &= \int_r^\infty \left( r \cdot G(r) + \int_r^v y \cdot g(y) dy \right) f(v) dv \\ &= r \cdot G(r) \cdot [1 - F(r)] + \int_r^\infty [1 - F(y)] \cdot y \cdot g(y) dy \end{aligned}$$

(The second line requires changing the order of integration in the second term; it's a standard calculation but it is a bit tedious.) Consequently, the total payoff for the seller consists of the sum of the expected payments from each buyer plus the seller's own valuation the asset is retained. This payoff therefore is given by:

$$\begin{aligned} \Pi_s(v_0; r, N) &= N \cdot E_v\{m(v; r, N)\} + F(r)^N v_0 \\ &= N \cdot \left( r \cdot G(r) \cdot [1 - F(r)] + \int_r^\infty [1 - F(y)] \cdot y \cdot g(y) dy \right) + F(r)^N v_0 \end{aligned}$$

As an example, when there is no reserve price ( $r = 0$ ) and the seller's reservation value is zero, the seller's payoff simplifies considerably to be:

$$\Pi_s(v_0; 0, N) = N \cdot \int_0^\infty [1 - F(y)] \cdot y \cdot g(y) dy$$

What is the optimal reservation price ( $r$ ) for a seller with reservation value of  $v_0 \geq 0$ ? When we take the derivative of the seller's payoff respect to  $r$ , after some simplifications, we get:

$$\frac{\partial \Pi_s(v_0; r, N)}{\partial r} = N \cdot \left[ 1 - (r - v_0) \frac{f(r)}{1 - F(r)} \right] (1 - F(r)) \cdot F(r)^{N-1}$$

Note that this term is increasing in  $r$  when  $r=0$ , and thus for finite  $N$ , there is value to increasing the reserve price above zero.

Note that the second derivative is strictly negative for all interior  $r$ , so the interior root of the above equation must be a unique maximum. This unique maximum occurs at when the expression in the square brackets is zero, or:

$$r^* = \frac{1 - F(r^*)}{f(r^*)} + v_0$$

Note also that the optimal value of  $r$  is clearly greater than the seller's valuation  $v_0$ . In the case of a uniform distribution of buyers, where  $f(v) = 1$  and  $F(v) = v$ , the above condition simplifies to:

$$r^* = \frac{1 + v_0}{2}$$

That is, the seller takes the average of her valuation and the top buyer valuation (of 1). In the context of our acquisition example, then, in the uniform [0,1] case, the marginal shareholder would prefer a reserve price of  $r^* = 1/2$ , and both the pivotal and representative shareholders would favor a reserve price of  $r^* = 3/4$ .

It is interesting to note that the optimal reserve price does not hinge on the number of buyers in the auction. The maximized value for the shareholder is thus:

$$\Pi_s(v_0; r^*, N) = N \cdot \left[ 1 - (r - v_0) \frac{f(r)}{1 - F(r)} \right] (1 - F(r)) \cdot G(r)$$

From the above derivations, a simple but helpful lemma follows:

**Lemma A.1:** *As  $N$  increases beyond  $N = 1$ , the marginal value of setting the reserve price  $r$  decreases for all values of  $r$ . In the limit, as  $N$  grows arbitrarily large, the marginal value of adjusting  $r$  approaches zero.*

**Proof of Lemma A.1:** First, note that for all  $r$  and  $N > 1$ ,

$$\frac{\partial^2 \Pi_s(v_0; r, N)}{\partial r \partial N} = \left[ 1 - (r - v_0) \frac{f(r)}{1 - F(r)} \right] (1 - F(r)) \cdot F(r)^{N-1} (1 + N \cdot \ln(F(r))) < 0$$

which is negative for  $r < r^*$  and strictly positive for all  $r > r^*$ . Thus, the marginal benefit of moving  $r$  towards its optimal level attenuates as  $N$  grows beyond  $N = 1$ . A simple application of L'Hopital's rule to the above expression confirms that

$$\lim_{N \rightarrow \infty} \frac{\partial^2 \Pi_s(v_0; r, N)}{\partial r \partial N} = 0$$

and thus in the limit a large number of bidders fully attenuates the value to the seller of setting  $r > 0$ . ■

## Appendix B: Proofs

**Proof of Proposition 1.** The proof basically follows the analysis from Appendix A. Recall that the probability of sale, given by  $\Pr\{Sale|N, r\} = 1 - F(r)^N$ , strictly decreases as  $r$  increases. Therefore, the agent-manager, who wants to maximize  $M \cdot \Pr\{Sale|N, r\} = M \cdot (1 - F(r)^N)$ , will set  $r = 0$ .

To prove the last sentence of the Proposition, from Appendix A, we know that when  $r = 0$ , the expected sale price is given by:

$$E(v_{(N-1)}) = N(N-1) \int_r^\infty [1 - F(y)] F(y)^{N-2} dF(y)$$

When  $N = 1$ , we get  $E(v_{(N-1)}) = 0 < \underline{v} < \mu$ . ■

**Proof of Proposition 2:** Consider the effect of eliminating weakly dominated strategies for each shareholder type  $\gamma$ . Recall that the continuous framework presented in the text approximates for the limiting case of a finite-voter game,  $\Gamma(H, b, \alpha; T)$ , in which there are  $2T + 1$  shareholders (with  $T \in \mathbb{N}$  and  $T \gg 0$ ), each holding a fractional ownership claim equal to  $\frac{1}{2T+1} \approx d\gamma$ . Suppose, then, that in this finite game each shareholder has valuation  $\underline{v} = \gamma_0 < \gamma_1 < \dots < \gamma_i < \dots < \gamma_{2T+1} = \bar{v}$ , and that the winning bid is  $b \in [0, \infty)$ , so that the per share price of  $b \cdot d\gamma$ . The merger requires a critical fraction  $\alpha \in [1/2, 1)$  of shareholder votes to pass. For any fixed  $T$ , this is equivalent to requiring at least  $T_\alpha \geq \alpha \cdot (2T + 1)$  affirmative votes to pass. The payoff shareholder of type  $j$  gets from the status quo is  $\gamma_j \cdot d\gamma$ , while the payoff the shareholder gets from an accepted bid is  $b \cdot d\gamma$ .

There are multiple Nash equilibria in this game, including those where the bid wins (or loses) by more than one vote, so that no voter considers herself “pivotal” for the outcome. The weak dominance refinement restricts attention to those equilibria in which voters are not playing a weakly dominated strategy, defined as in the text. Here, for each player of type  $\gamma_j$ , weak dominance requires that the probability of voting in favor of the deal is zero whenever  $\gamma_j$  favors the status quo:

$$\gamma_j \cdot d\gamma > b \cdot d\gamma \Leftrightarrow \gamma_j > b$$

and similarly, the probability of voting to approve the deal is 1 when  $\gamma_j < b$ . In the special case where (at most) one type of shareholder is indifferent between the status quo and the bid (so that  $\gamma_i = b$ ), we assume without loss of generality the shareholder votes for the merger with probability 1. (Relaxing this assumption has little effect on our ultimate results, but is computationally more tedious). Given these assumptions, we also can identify the pivotal voter. We define the pivotal voter as the shareholder who has valuation  $\gamma_j$  such that:

$$H(\gamma_{j-1}) < \alpha \leq H(\gamma_j) \Leftrightarrow \gamma_{j-1} < H^{-1}(\alpha) \leq \gamma_j$$

We use the notation  $\gamma^*(\alpha)$  to denote the valuation of the pivotal voter. The following Lemma immediately follows from the foregoing analysis:

**Lemma 2A:** *Under Assumptions 1 and 2, there exists a unique equilibrium of  $\Gamma(H, b, \alpha; T)$  for all  $b$  and  $T$ . All shareholders for whom  $\gamma_j \leq b$  vote in favor of the merger, while all those for whom  $\gamma_j > b$  vote against. The merger is approved if and only if  $b \geq \gamma^*(\alpha)$ .*

Finally, we consider the limiting behavior of  $\Gamma(H, b, \alpha; T)$  as  $T \rightarrow \infty$ . Observe that  $\lim_{T \rightarrow \infty} H(\gamma^*(\alpha)) = \alpha$ , and thus  $\lim_{T \rightarrow \infty} \gamma^*(\alpha) = \rho$ . This immediately implies the following:

**Lemma 2B:** *Under Assumptions 1 and 2, the limiting case equilibrium of  $\Gamma(H, b, \alpha; T)$  as  $T \rightarrow \infty$  is unique for all  $b$ . All shareholders for whom  $\gamma \leq b$  vote in favor of the merger, while all those for whom  $\gamma > b$  vote against. The merger is approved if and only if  $b \geq \rho \equiv H^{-1}(\alpha)$ .*

This completes the proof. ■

**Proof of Proposition 3.** Let  $b$  denote the winning bid and let the appraisal price  $\phi(b)$  reflect the MP rule, so that  $\phi(b) = b$ . Conditional on the merger taking place, all shareholders are indifferent between accepting the terms of the merger or seeking appraisal. Regardless of their decision, they receive  $b$ , and again (without loss of generality) we will assume that indifferent shareholders opt to take the terms of the merger. Appraisal rights under the MP thereby have no bearing on the agent's decision choice of a reserve price. And, since the agent's payoff is strictly decreasing in  $r$ , the manager once again sets  $r_m = 0$ . Facing a zero reserve price, all bidders participate. As with Proposition 1, the firm will be sold with probability one at price equal to  $v_{(N-1)}$ . ■

**Proof of Proposition 4.** Suppose that the agent agrees to a merger at price  $b$ . With no shareholder voting, the merger is sure to occur. For each shareholder, the strategy choice boils down to choosing between taking the merger consideration  $b$  or seeking appraisal at a "fair value" equal to  $\phi$ .

Suppose first that the winning bid is such that  $b < \phi$ . Conditional on there being a merger, for all shareholders, the dominant strategy is to seek appraisal and receive  $\phi$ . If the winning bid is such that  $b > \phi$ , on the other hand, the strictly dominant strategy for all shareholders is to eschew appraisal and receive  $b$ . If the winning bid is such that  $b = \phi$ , conditional on there being a merger, all shareholders are indifferent between accepting the merger terms or seeking appraisal. We will assume once again that the shareholder will accept the merger consideration.

Given the shareholders' strategies, for each bidder, if she wins the auction with a bid of  $b < \phi$ , the bidder will must nonetheless pay  $\phi$  instead of  $b$  for the company. On the other hand, if she wins the auction with a bid of  $b \geq \phi$ , she will pay  $b$  for the company.

Consequently, any bidder whose valuation is such that  $v < \phi$  will immediately drop out. On the other hand, if her valuation is (weakly) higher than  $\phi$ , she will stay in the auction until the ascending bid reaches her valuation. This is equivalent to an auction in which the reserve price is set at  $r_m = \phi$ .

In equilibrium, if  $v_{(N)} < \phi$ , which occurs with probability  $F(\phi)^N$ , the firm will not be sold. On the other hand, if  $v_{(N)} \geq \phi$ , which occurs with probability  $1 - F(\phi)^N$ , the firm will be sold at merger price equal to  $\max\{\phi, v_{(N-1)}\}$ . The ordering of shareholder welfare follows naturally from the definition of  $r^*$ . ■

**Proof of Proposition 5.** Suppose  $\phi < \rho$ . We will divide the proof into three cases: (1)  $b < \phi < \rho$ ; (2)  $\phi \leq b < \rho$ ; and (3)  $\phi < \rho \leq b$ .

Case 1: suppose that the winning bid is such that  $b < \phi < \rho$ . Consider shareholder type  $\gamma \in (\phi, 1]$ , and three distinct scenarios: (1) merger takes place regardless of the shareholder's vote; (2) merger fails regardless of the shareholder's vote; and (3) the shareholder's vote is outcome determinative. In the first scenario, the shareholder's dominant strategy is to vote against the merger and exercise appraisal (since  $b < \phi$ ). In the second, the shareholder is indifferent among strategies. In the third, the shareholder's dominant strategy is to vote against the merger to prevent it from occurring. Hence, for all shareholders with  $\gamma \in (\phi, 1]$ , the weakly dominant strategy is to vote sincerely against the merger and seek appraisal. The merger thus fails. Conditional on the merger failing, the other shareholders' votes become irrelevant. (Weak dominance does not, in contrast, constrain the strategies of shareholders with values less than  $\phi$ , and thus there is not a unique undominated equilibrium for these voters. However, their votes are never sufficient to tip the balance on the merger.)

Case 2: suppose now that  $\phi \leq b < \rho$ . Because  $b \geq \phi$ , no dissenting shareholders will seek appraisal. Consider shareholder type  $\gamma \in (b, 1]$ , and the three possibilities. If merger will take place regardless of the shareholder's vote, the shareholder is indifferent about her vote. If merger does not take place regardless of the shareholder's vote, the shareholder is also indifferent among different strategies. If the shareholder's vote is outcome determinative, the shareholder's dominant strategy is to vote against the merger, since  $\gamma > b$ . The shareholder's weakly dominant strategy, therefore, is to vote against the merger and seek no appraisal in case the merger takes place. The bid does not get enough votes from the shareholders, and the merger fails.

Case 3: suppose  $\phi < \rho \leq b$ . Once again, since  $b \geq \phi$ , no dissenting shareholder will exercise appraisal. Consider shareholder type  $\gamma \in [0, \rho]$ . If the merger were to take place regardless of the shareholder's vote, the shareholder is indifferent about her vote. If the merger were not to take place regardless of the shareholder's vote, the shareholder is indifferent among different strategies. Finally, if the shareholder's vote is outcome determinative, the dominant strategy is to vote for the merger to receive  $b \geq \gamma$ . The weakly dominant strategy for the shareholder with type  $\gamma \in [0, \rho]$  is therefore to vote for the merger; the merger thus succeeds. All shareholders receive the consideration of  $b$  and no one exercises the appraisal remedy. ■



**Proof of Lemma 6A.** Suppose  $\phi < \rho$ . We will divide the proof into three cases: (1)  $b < \phi < \rho$ ; (2)  $\phi \leq b < \rho$ ; and (3)  $\phi < \rho \leq b$ .

Case 1: suppose that the winning bid is such that  $b < \phi < \rho$ . Consider shareholder type  $\gamma \in (\phi, 1]$ . Consider three scenarios: (1) merger takes place regardless of the shareholder's vote; (2) merger fails regardless of the shareholder's vote; and (3) the shareholder's vote is outcome determinative. In the first scenario, the shareholder's dominant strategy is to vote against the merger and exercise appraisal. In the second, the shareholder is indifferent across different strategies. In the third, the shareholder's dominant strategy is to vote against the merger and seek appraisal. Hence, for all shareholders with  $\gamma \in (\phi, 1]$ , the weakly dominant strategy is to vote against the merger and seek appraisal. The merger fails. Conditional on the merger failing, the other shareholders' votes become irrelevant.

Case 2: suppose  $\phi \leq b < \rho$ . Because  $b \geq \phi$ , no dissenting shareholders will seek appraisal. Consider shareholder type  $\gamma \in (b, 1]$ , and the three possibilities. If merger takes place regardless of the shareholder's vote, the dominant strategy for the shareholder is to vote against and not exercise appraisal. If merger does not take place regardless of the shareholder's vote, the shareholder is indifferent among different strategies. If the shareholder's vote is outcome determinative, the shareholder's dominant strategy is to vote against the merger, since  $\gamma > b$ . The shareholder's weakly dominant strategy, therefore, is to vote against the merger and seek no appraisal in case the merger takes place. The bid does not get enough votes from the shareholders and the merger fails.

Case 3: suppose  $\phi < \rho \leq b$ . Again, since  $b \geq \phi$ , no dissenting shareholder will exercise appraisal. Consider shareholder type  $\gamma \in [0, \rho]$ . If the merger were to take place regardless of the shareholder's vote, the dominant strategy is for the shareholder to vote for the merger. If the merger were not to take place regardless of the shareholder's vote, the shareholder is indifferent among different strategies. Finally, if the shareholder's vote is outcome determinative, the dominant strategy is to vote for the merger to receive  $b \geq \gamma$ . The weakly dominant strategy for the shareholder with type  $\gamma \in [0, \rho]$  is to vote for the merger and the merger will succeed. All shareholders receive the consideration of  $b$  and no one exercises the appraisal remedy. ■

**Proof of Lemma 6B.1.** Suppose  $\rho \leq \phi$ . Consider two separate cases: (1)  $b < \rho \leq \phi$  and (2)  $\rho \leq \phi \leq b$ .

Case 1:  $b < \rho \leq \phi$ . Because  $b < \phi$ , all dissenting shareholders will seek appraisal. Consider shareholder type  $\gamma \in (b, 1]$ . If the merger were to pass regardless of the shareholder's vote, the dominant strategy is for the shareholder to vote against the merger and seek appraisal. If the merger were to fail, the shareholder is indifferent across strategies. Finally, if the shareholder is pivotal, the dominant strategy is to vote against the merger since  $\gamma > b$ . The weakly dominant strategy for the shareholders is to vote against the merger and seek appraisal remedy. Merger will fail since  $b < \rho$ .

Case 2:  $\rho \leq \phi \leq b$ . Since  $\phi \leq b$ , no dissenting shareholder will seek appraisal. Consider shareholder type  $\gamma \in [0, b]$ . First, if the merger were to take place regardless of that shareholder's vote, the dominant strategy is for the shareholder to vote for the merger. Second, if the merger is to fail regardless of the shareholder's vote, the shareholder is indifferent among different strategies. Third, if the shareholder's vote is outcome determinative, the dominant strategy is to vote for the merger. Hence, the weakly dominant strategy for the shareholder is to vote for the merger. Since  $\rho \leq b$ , merger succeeds and all shareholders receive the merger consideration. ■

**Proof of Lemma 6B.2.** Suppose that  $\rho \leq b < \phi$ , so that the bid price is attractive to the pivotal shareholder, but the appraisal value is even more attractive. Whenever a merger is conjectured certain to occur, all shareholders would prefer to vote against and seek appraisal. That outcome is clearly not attainable, since 50% of the shareholders must vote for it. Thus, any equilibria involving the approval of the merger can never have more than a bare majority supporting the sale—thereby making every affirmative vote pivotal. The key question is how the account of “no” votes is allocated among the shareholders in this case.

Consider first the group of shareholders for whom  $\gamma > \phi$ , and thus are not in favor of the merger even with the appraisal option. For these shareholders, it is weakly dominant to vote against the merger regardless of their continuation strategy, since they do not want the deal to go through (even if they are pivotal), and they would rather receive the appraisal if it does occur. A similar (but slightly more nuanced) form of reasoning applies to shareholders for whom  $\gamma \in (b, \phi]$ ; these types have valuations exceeding the bid  $b$  but less than the appraisal value  $\phi$ . They would most prefer to see the merger approved, but seek appraisal—which requires them to vote against. If that is not possible, their next best favored outcome is that the merger is not approved, in which case they could enjoy their status quo payoffs—which also prescribes voting against. Their least preferred scenario is to vote for a merger where they vote in favor. Thus, this group will vote against the merger as well. We thus know that all shareholders with  $\gamma > b$  will vote sincerely against the merger.

Now consider the set of shareholders for whom  $\gamma \leq b$ , which consists of the union of shareholders for whom  $\gamma \in (\rho, b]$  as well as those for whom  $\gamma \in [0, \rho]$ . Both groups have the same set of payoffs here: both would support the merger on its own terms, since it offers more than their valuation. But at the same time, both groups would prefer to seek appraisal if they knew the deal would carry an affirmative vote of shareholders. This poses a significant coordination problem. If there were ever an equilibrium where all of these shareholders voted for the merger, then all would have a strict incentive to defect and vote against in order to perfect appraisal rights. Indeed, there cannot be an equilibrium involving approval unless votes in favor marshal a bare minimum 50% vote. There are infinite ways to marshal this vote, but in all of them, the relatively low-valuing shareholders (for whom  $\gamma \leq b$ ) must coordinate on a way to ration their strategic no votes so as to preserve the approval of the merger, assuming all others vote against. In contrast, there are an arbitrarily large number of equilibria in which these

low-valuing shareholders overwhelmingly vote no. Both types of equilibria are robust to the elimination of weakly dominated strategies. ■

Although not explicitly included in Lemma 6B.2, it is also possible to show that there exists no mixed strategy equilibrium, where all shareholders use vote in favor of the merger with a strictly positive, but less than one, probability, when  $\rho \leq b < \phi$ . We demonstrate this point with the following lemma.

**Lemma 6B.3:** *When  $\rho \leq b < \phi$ , there does not exist a mixed strategy equilibrium, where all shareholders vote for the merger with probability  $p(\gamma) \in (0,1)$  in the continuation game.*

**Proof:** The proof is by contradiction. Consider the discrete-voter version of the game (with  $2T + 1$  shareholder-voters), and suppose there exists a mixed strategy such that all shareholders vote in favor of the merger with probability  $p(\gamma) \in (0,1)$ . Define  $X \in \{0,1, \dots, 2T + 1\}$  as the number of shareholders voting in favor. In case  $(\gamma) = p \in (0,1) \forall \gamma$ ,  $X$  will have a binomial distribution:  $X \sim B(2T + 1, p)$ ; and, as  $T \rightarrow \infty$ , the distribution of  $X$  will asymptotically approach a normal distribution:  $X \sim N(p(2T + 1), p(1 - p)(2T + 1))$ .

Now, consider a shareholder  $i$  with valuation  $\gamma_i$ . Her expected payoff from voting in favor of the merger (and losing the appraisal eligibility) consists of a probability-weighted sum of  $b$  and  $\gamma_i$ :

$$Pr \left\{ \frac{X+1}{2T+1} \geq \alpha \right\} \cdot b + \left( 1 - Pr \left\{ \frac{X+1}{2T+1} \geq \alpha \right\} \right) \cdot \gamma_i$$

By contrast, by voting against (and preserving appraisal eligibility), the shareholder expects:

$$Pr \left\{ \frac{X}{2T} \geq \alpha \right\} \cdot \phi + \left( 1 - Pr \left\{ \frac{X}{2T} \geq \alpha \right\} \right) \cdot \gamma_i$$

A mixed strategy equilibrium requires that shareholders are indifferent between supporting and opposing the merger, which thus requires equality of the two expressions above. This condition reduces to:

$$Pr \left\{ \frac{X+1}{2T+1} \geq \alpha \right\} \cdot b - Pr \left\{ \frac{X}{2T} \geq \alpha \right\} \cdot \phi = \left[ \left( 1 - Pr \left\{ \frac{X}{2T} \geq \alpha \right\} \right) - \left( 1 - Pr \left\{ \frac{X+1}{2T+1} \geq \alpha \right\} \right) \right] \cdot \gamma_i$$

As  $T \rightarrow \infty$ ,  $Pr \left\{ \frac{X+1}{2T+1} \geq \alpha \right\} \rightarrow Pr \left\{ \frac{X}{2T} \geq \alpha \right\} > 0$ , so that the left hand side becomes strictly negative (since  $b < \phi$ ), while the right hand side converges to zero, thereby violating the equality. ■

**Proof of Proposition 6.** Part (A) follows from Lemma 6A where  $\rho$  becomes the de facto reserve price. The manager maximizes her expected return by setting  $r = \rho$ . Part (B)(1) follows from Lemmas 6B.1 and 6B.2. ■

**Proof of Proposition 7.** Recall first, from Part II.A, that  $r^* > \mu$ . When  $\rho > r^*$ , because the pivotal shareholder's valuation exceeds the optimal reserve price, per Propositions 5 and 6, setting  $\phi > \rho$  will only reduce the target shareholders' expected return. Hence, the optimal appraisal rule is to either use the MP rule or to set  $\phi \leq \rho$ .

When  $\rho \leq r^*$ , voting threshold is insufficiently high to maximize the target shareholders' return. The optimal appraisal rule depends on the type of equilibrium obtained. Per Proposition 6(B)(1), in the uncoordinated equilibrium,  $\phi$  becomes the de facto reserve price. The optimal appraisal rule, therefore, is to set  $\phi = r^*$ . In the coordinated equilibrium, per Proposition 6(B)(2), with  $\rho = H^{-1}(\alpha)$ ,  $\alpha$  fraction of the shareholders receive  $b$  while the remaining shareholders ( $1 - \alpha$  fraction) get  $\phi$ . The expected payment by the winning bidder is  $\alpha b + (1 - \alpha)\phi$ . The minimum winning bid is equal to  $\rho$ , in which case the buyer's expected payment is  $\alpha\rho + (1 - \alpha)\phi$ . To create the de facto reserve price of  $r^*$ , the court needs to set  $\phi$  such that  $\alpha\rho + (1 - \alpha)\phi = r^*$  or, equivalently,  $\phi = \frac{r^* - \alpha\rho}{1 - \alpha}$ , subject to the constraint of  $\frac{r^* - \alpha\rho}{1 - \alpha} \leq 1$ . The optimal appraisal rule, therefore, is:  $\phi = \min \left\{ 1, \frac{r^* - \alpha\rho}{1 - \alpha} \right\}$ . ■

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# Antitrust Merger Clearance Getting Your Deal Through - Strategies for Increasing Deal Certainty

April 4, 2017

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# Status of U.S. Antitrust Agencies

- Antitrust Division, U.S. Department of Justice
  - Makan Delrahim, nominated as Assistant Attorney General for the Antitrust Division
  - Acting AAG, Brent Snyder, the Deputy Assistant Attorney General for Criminal Enforcement
- Federal Trade Commission
  - Two sitting Commissioners
    - Acting Chairman Maureen Ohlhausen (Republican)
    - Commissioner Terrell McSweeney (Democrat)
  - President has not yet selected a permanent FTC chair or nominated commissioners for three vacancies



# Assessing Antitrust Deal Risk

- Practical to reliably predict antitrust agencies' views about a transaction
- Antitrust agencies have used largely consistent standards for the last 20 years
- Agencies challenge 3-to-2s, 2-to-1s, and some 4-to-3s, which produce firms with high market shares (*e.g.*, 40%+), with likelihood of price increases
  - Complaining customers and entry barriers increase antitrust risk
- Agencies have predictable strategies for merger reviews in many sectors, such as pharmaceuticals, energy, retail, and health care



# Strategy 1: Up-Front Assessment/Planning

- Collect documents and data that antitrust agencies always request
- Conduct up-front analysis that tracks agencies' analytical paradigms
- For transactions likely to receive regulatory scrutiny:
  - Calculate “shares” of potential “markets”
  - Gather key facts about competitors
  - For “concentrated” markets, collect information that demonstrates that “shares” are not representative of real world market conditions
  - Collect information needed to demonstrate transaction's efficiencies
- Bottom line: *Early investment in information collection and analyses can produce reliable antitrust risk assessments and reduce the likelihood of lengthy investigations*



## Strategy 2: Prepare Advocacy Presentations

- When there are antitrust risks, prepare and make robust presentations that address the key issues
  - Agencies value early engagement
  - Element of surprise is almost always overrated and often counterproductive
- *Take advantage of antitrust agencies' desire to avoid devoting substantial resources to investigations that do not produce an enforcement action*
- For transactions that require multiple filings, have a global strategy that accounts for the exchange of information among competition agencies
  - Arguments should be analytically consistent, while accounting for individual jurisdiction dynamics



## Strategy 3: Document/Customer Management

- Use antitrust compliance training to reduce the risk of creating damaging documents
  - “Hot” documents produced early in the process can significantly increase deal risk and lengthen investigations
- Have a proactive customer outreach strategy ready to put in place immediately upon the announcement of the deal
  - Complaining customers dramatically increase the odds of lengthy antitrust investigations
  - Conversely, neutral or supportive customers can cause agencies to shut down “close call” investigations



## Strategy 4: Time/Clock Management

- Avoid second requests/Phase II investigations through strategies that give agencies extra time in early phases of investigations
- In U.S., when antitrust considerations warrant and business considerations permit, consider:
  - Engaging with the DOJ/FTC *before submitting HSR filings*
  - Pulling and re-filing the HSR to give provide an additional 30 days before second request decision
- In EC and other jurisdictions, use pre-filing period to engage in proactive advocacy
- Use a global time management strategy for transactions that require multiple filings
  - *E.g.*, stagger the pre-notification filings when warranted



# Strategy 5: Account for New Realities of DOJ/FTC Second Request Investigation/Litigation Strategies

- If you receive a DOJ/FTC second request, consider responding and certifying compliance rapidly
- Negotiate "timing agreement" that gives the parties the flexibility to "put the agencies on the clock"
  - Virtually no examples of prolonged investigations benefitting the parties
- Prepare for and defend investigation depositions as if they are trial depositions
  - Agencies take depositions to "lock in" witnesses/obtain transcripts for cross examination at trial
- For transactions with substantial U.S. antitrust risk, prepare for possibility of litigation from the outset
  - Don't let the agencies get ahead of the parties





## Strategy 6: Proactive Assessment of Remedies

- Account for agencies' demanding standards for evaluating and approving remedies
  - Agencies are very concerned that remedies will fail – *i.e.*, not preserve pre-merger market structure and competition
- Offer "robust" remedy that fully addresses the agencies' competitive concerns
  - Agencies react negatively to "low-ball" offers
- When warranted, consider offering a remedy early in the investigative process, rather than risk producing damaging information and a prolonged investigation
- Poorly planned remedy strategies can significantly increase the time required to complete the review process



# Overview of EU regime for merger control

- Both the EU itself and 27 countries within the EU have merger control regimes
- EU has “one-stop-shop” merger system – review by European Commission (EC) deprives Member States of jurisdiction to review deals for competition concerns
  - “One-stop-shop” also applies to Norway, Lichtenstein and Iceland
- Referral system allows deals to be reallocated either back to Member State(s) or upwards to the EC in certain situations
- Mandatory notification system – qualifying deals cannot be completed without EC’s prior approval
  - Failure to notify/implementation without clearance punishable by a fine of up to 10% of aggregate turnover of parties

# Criteria for falling within EC jurisdiction

- Thresholds for whether a merger qualifies for EC review are based on mechanistic “turnover” criteria:
  - combined worldwide turnover exceeds EUR 5000 million; and
  - EU-wide turnover of each of at least two of the parties exceeds EUR 250 million; unless
  - each of the parties achieves more than two-thirds of its aggregate EU-wide turnover within one and the same Member State.
- Additional threshold to give EC jurisdiction over deals involving parties with lower turnover who achieve a certain level of turnover in three Member States:
  - combined worldwide turnover exceeds EUR 2.5 billion; and
  - in each of at least three Member States, combined turnover exceeds EUR 100 million; and
  - in those three Member States, aggregate turnover of each of at least two parties exceeds EUR 25 million; unless
  - each of the parties achieves more than two-thirds of its aggregate EU-wide turnover within one and the same Member State.



# Overview of the EC merger review process

- Two-phase review process – both phases carried out within the EC
  - Same case team with additional members and involvement of Chief Economist team and Hearing Officer
  - Phase II concerns set out in formal SO with possibility for oral hearing
- Strict deadlines
  - 25 working days for Phase I
    - Phase I deadline extended to 35 working days if parties offer remedies
  - 90 working days for Phase II
    - Phase II deadline extended to 105 working days if remedies offered
  - Possible further extension of up to 20 working days

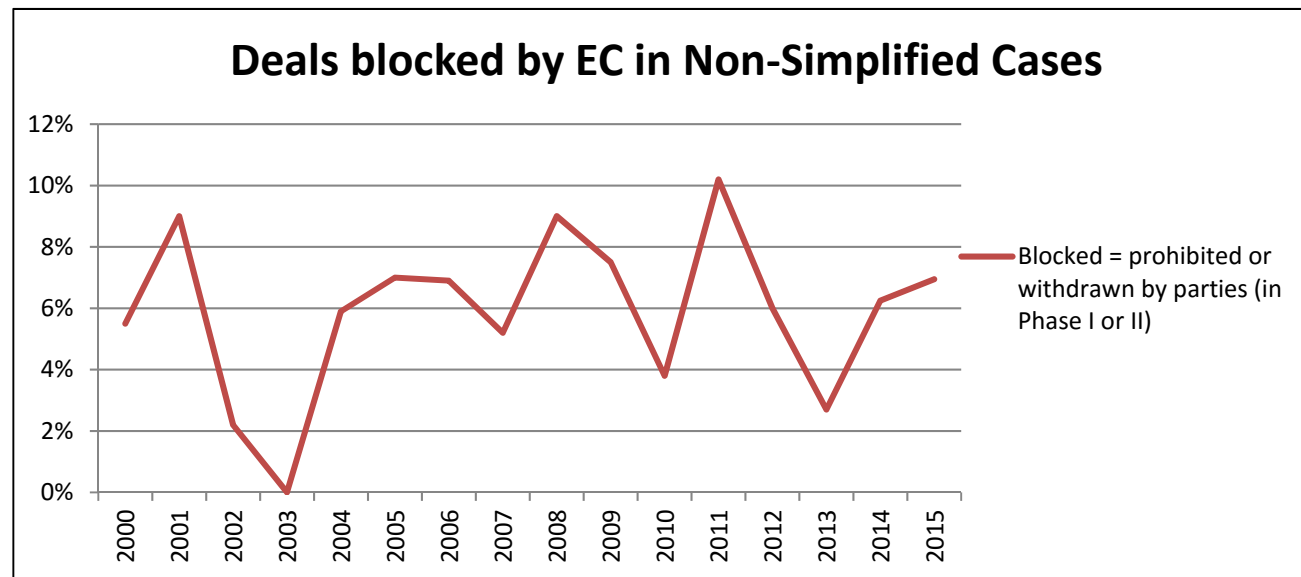


# Overview of the EC merger review process (cont.)

- Process can be lengthy
  - “Pre-notification” discussions as a matter of course
    - EC requires detailed information on all “plausible” “affected markets”
  - Notification (Form CO) requires considerable detail
  - But “simplified procedure” available (at EC’s discretion) for some transactions
- Judicial oversight of EC’s merger decisions is not a full-merits review
  - EU courts give deference to EC’s view/interpretation of facts – wide “margin of appreciation” in relation to assessments of economic nature
  - Internal peer review panels and chief economist set up to provide degree of discipline on process

# EU merger control in practice – statistics (I)\*

- EC is far less likely to prohibit deals than is often feared
- Since 1990, EC has cleared over 5,500 deals and blocked only 25
- Blockage rate of reviewed deals that do not qualify for simplified procedure is low



\*Source data: EU yearly statistics on (i) notifications and (ii) number of decisions per decision-type; percentages are approximate because year of notification may not be the same as year of decision. I updated all the tables in the presentation.

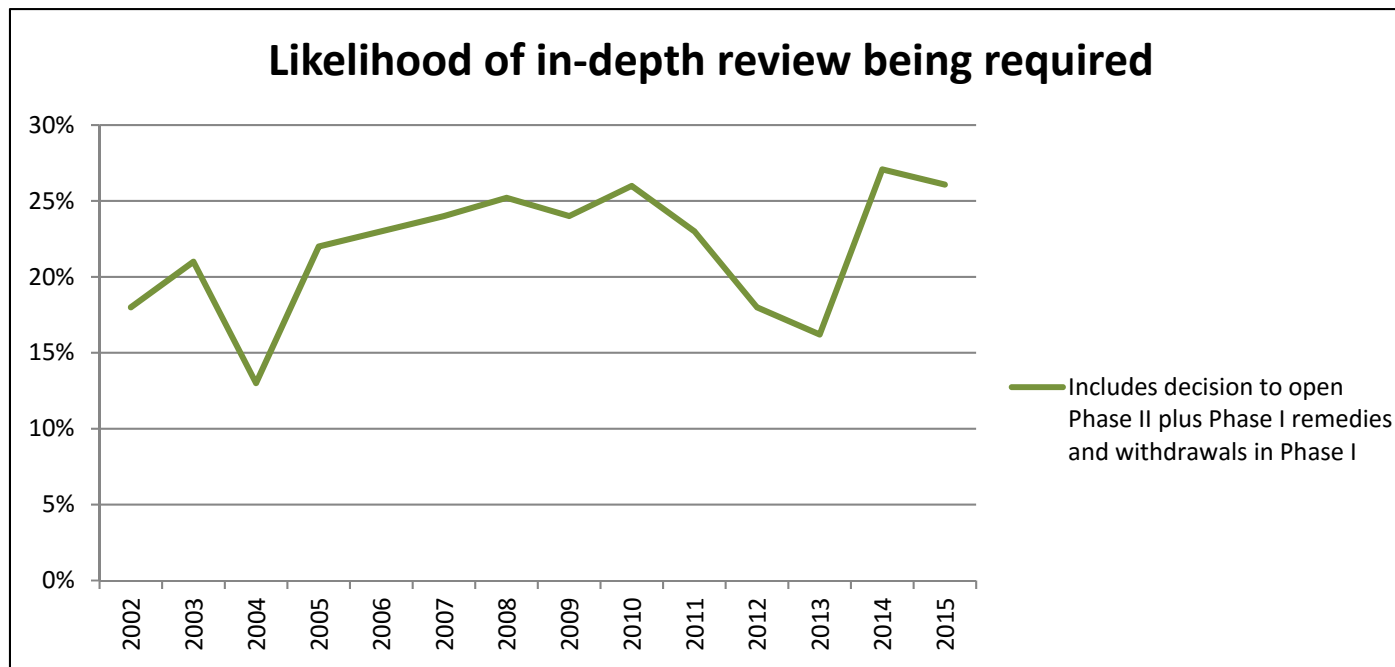


# Recent prohibition decisions

- *Hutchison 3G/Telefonica UK* (May 2016): Proposed combination of “O2” and “Three” mobile networks in UK would have created new number 1 player
  - Three-to-two merger would lead to higher prices and less choice
  - Would hamper development of mobile network infrastructure (merged entity would have been part of both network sharing arrangements)
  - Would reduce number of operators willing to host virtual mobile network operators
- *Deutsche Börse/LSE* (March 2017): Two largest European stock exchange operators
  - Would have led to *de facto* monopoly in clearing fixed income instruments
  - Downstream impact on markets for settlement, custody and collateral management

## EU merger control in practice – statistics (II)\*

- Although not a big deal “blocker,” EC is cautious in merger review
- Significant percentage of deals that do not qualify for simplified procedure require either in-depth review or clear remedies in Phase I to avoid Phase II

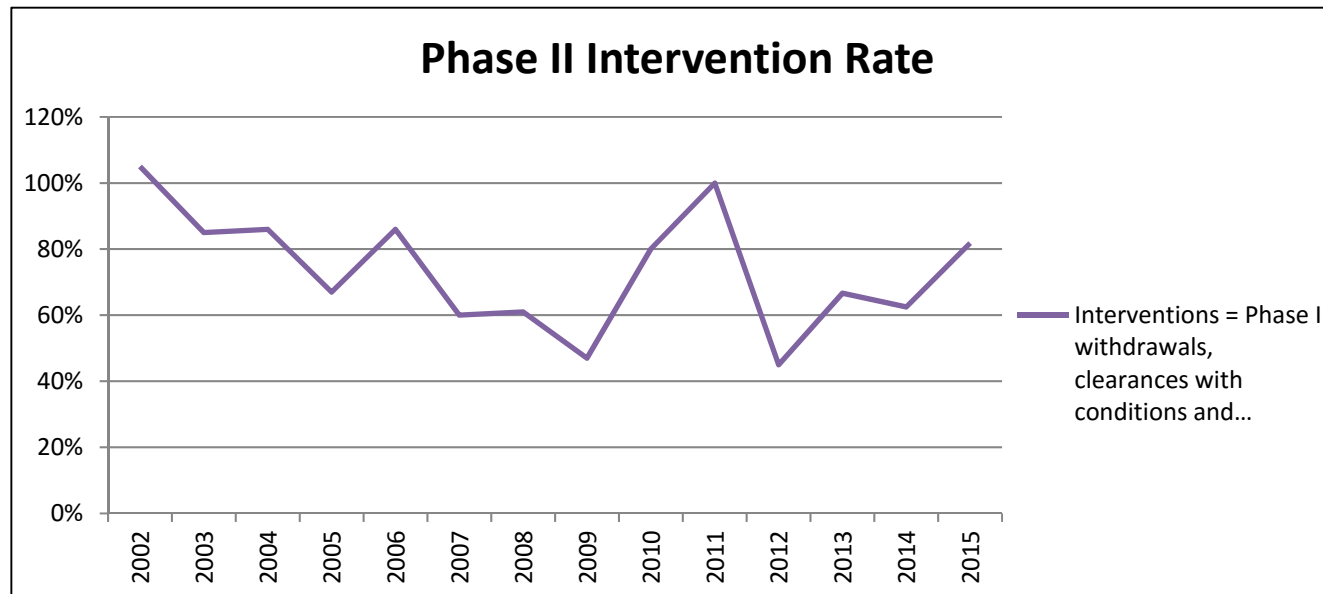


\*Source data: EU yearly statistics on (i) notifications and (ii) number of decisions per decision-type; percentages are approximate because year of notification may not be the same as year of decision.



# EU merger control in practice – statistics (III)\*

- Deals that go into Phase II are highly likely to require remedies to avoid prohibition



\*Source data: EU yearly statistics on (i) notifications and (ii) number of decisions per decision-type; percentages are approximate because year of notification may not be the same as year of decision.



# EU merger control in practice – characteristics

- EC more cautious on vertical and conglomerate mergers than US
- Some deals inevitably come in for close scrutiny; “red flag” deals where:
  - Parties have combined market shares over 35%;
  - Parties are close competitors;
  - Active complainants or national authorities are opposed to the deal; and
  - The deal is high-profile
- EC will carefully review deals in network/regulated industries and innovation
  - Telecoms, financial services, life sciences, energy
  - EC has rejected recent referral requests from MS to examine telecoms deals – citing EC expertise and experience
- No indication that extra-scrutiny placed on US or “foreign” mergers



# EU merger control in practice – developments

- EC more concerned about innovation than US
  - Traditional focus on market-to-pipeline and pipeline-to-pipeline overlaps, with a time horizon of approximately two-to-three years
  - Now EC assessment covering earlier states in pipeline as well; *e.g.*, not only Stage III in pharmaceutical clinical trials but also Stage I and/or II



# Getting your deal through the EU faster

- If your deal meets the EU thresholds, start work on the filing as soon as possible
  - Many companies prioritize the US, although EU clearance often takes much longer
- EU process is data- and information-heavy even for non-problematic deals
- Notification form must be completed before formal filing is permitted – can run to hundreds (sometimes thousands) of pages
- Require provision of detailed market information on every plausible affected market
- Is possible to debate market definition and narrow down scope of information provided if deals looks like Phase I clearance
  - If prima facie problematic, EC less likely to agree scope reduction
- Expect multiple RFIs from EC and prepare to respond in-depth



# Getting your deal through the EU faster

- Internal documents becoming increasingly important, so take compliance steps
- Great weight given to customer view
- Proactive customer outreach strategy equally important in EU
- Unlike US, competitor views are also important – consider proactively addressing likely competitor concerns in submissions
- Need to explain rationale of deal
- In vast majority of cases, collaborative approach is much more effective than confrontational with EC
- EC process puts time pressure on case team, and working “with” the staff can make significant difference to process
- Litigation rarely an option in deal for parties and not a credible threat given “discretion” to EC
- Avoid Phase II if at all possible
- Consider staying in pre-notification longer to give EC extra time to get comfortable in early phases of investigations
- For “red flag” deals, think about remedies early

# Case Study: Merger of Marriott and Starwood

- Largest M&A transaction in the history of the hotel industry, creating the world's largest hotel company
- The companies operate or franchise more than 5,700 properties and 1.1 million rooms, across 30 brands, in more than 110 countries worldwide
- Merger agreement signed on November 16, 2015; transaction closed on September 23, 2016





# Challenges

- Competitive overlaps in thousands of local markets around the world
- Pre-merger filings required in 15 jurisdictions on 5 continents representing over 40 countries
- High-profile, consumer-facing deal
- Limited recent history of antitrust merger reviews in the hotel industry
- Publicly available sources of competitive data are incomplete and/or unreliable for many parts of the world
- Aggressive timeline: Obtain merger approvals on a global basis for a complex deal with thousands of competitive overlaps in less than a year



# Getting the Deal Done: Secured Unconditional Clearance on a Global Basis within 10 months

- India – Jan. 15, 2016
- Canada – Feb. 19, 2016
- US – Feb. 29, 2016
- Taiwan – March 14, 2016
- Colombia – March 15, 2016
- S. Africa – March 16, 2016
- Pakistan – April 1, 2016
- Turkey – April 20, 2016
- Japan – April 22, 2016
- Chile – May 9, 2016
- S. Korea – June 7, 2016
- EU – June 27, 2016
- Saudi Arabia – June 27, 2016
- Mexico – July 1, 2016
- China – Sept. 20, 2016





# Keys to Getting the Deal Done

- Cohesive global team
  - Leadership team with global perspective to manage filings
    - Understand local issues in context of global mission
- From the outset, develop themes and facts that will work on a global basis
  - Top-down analytical approach: Start globally, then address local issues within a cohesive global approach
  - Analytical approach must be consistent across jurisdictions
    - Understand that regulators will talk to one another
- Develop and follow global regulatory timeline



# Keys to Getting the Deal Done (cont.)

- Push the process forward
  - Be proactive, forthcoming, and nimble
  - Be responsive and be an advocate
- Examples:
  - 75-day engagement with FTC during initial waiting period
    - Day 1: Produce market data, key strategic and deal documents, and meeting between FTC Staff and senior executive
    - Respond quickly to information requests and provide numerous additional presentations throughout the waiting period
  - Five-month engagement with European Commission leading to Phase I clearance



# Gibson Dunn Transactions

- **St. Jude Medical/Abbott Laboratories.** Global antitrust counsel to St. Jude in its \$25 billion merger with Abbott Laboratories, which closed in eight months, following the negotiation of divestiture agreements with the FTC, the European Commission, MOFCOM, and the KFTC.
- **LinkedIn/Microsoft.** Global antitrust counsel to LinkedIn Corporation in obtaining clearance for its acquisition by Microsoft Corporation. Gibson Dunn obtained antitrust clearance for the \$26 billion transaction in the United States and the European Commission in less than six months.
- **Marriott/Starwood.** Global antitrust counsel for Marriott International in its \$13.6 billion acquisition of Starwood Hotels & Resorts. Gibson Dunn obtained unconditional clearance in 15 jurisdictions, including in the United States, the European Commission, and China, in ten months.
- **Luminant/NextEra.** U.S. antitrust counsel to Luminant in its \$1.6 billion acquisition of generating assets from NextEra. Gibson Dunn obtained unconditional clearance in five months.



## Gibson Dunn Transactions (cont.)

- **Southern Company/Kinder Morgan.** U.S. antitrust and regulatory counsel to Southern Company in its \$2 billion joint venture with Kinder Morgan. Gibson Dunn obtained unconditional clearance in two months.
- **Southern Company/AGL Resources.** U.S. antitrust and regulatory counsel to Southern Company in its \$12 billion acquisition of AGL Resources, an electric and gas utility company. Gibson Dunn obtained unconditional clearance in three months.
- **Intel/Altera.** Global antitrust counsel for Intel Corporation in its \$16.7 billion acquisition of Altera Corporation. Gibson Dunn obtained unconditional clearance in four months.
- **Norbord/Ainsworth.** Global antitrust counsel to Norbord in its \$650 million acquisition of Ainsworth. Gibson Dunn obtained unconditional clearance in five months, following a DOJ second request investigation.



## Gibson Dunn Transactions (cont.)

- **Gala Coral Group/Ladbrokes.** European antitrust counsel to Gala Coral Group Limited in its \$3.4 billion merger with Ladbrokes to create Ladbrokes Coral, the largest betting and gaming company in the UK. Gibson Dunn was able to obtain clearance with a small number of divestitures.
- **Schlumberger/Cameron.** Global antitrust counsel to Schlumberger in its \$14.8 billion acquisition of Cameron International. Gibson Dunn obtained unconditional clearance in seven months.
- **Tenet Healthcare/United Surgical Partners International.** U.S. antitrust counsel to Tenet Healthcare for the creation of a joint venture with the owners of United Surgical Partners International. The joint venture created the world's largest chain of ambulatory surgery centers. Gibson Dunn secured clearance for the transaction in sixty days.
- **Tenet Healthcare/Emanuel Medical Center.** U.S. antitrust counsel to Tenet Healthcare in its acquisition of Emanuel Medical Center. Gibson Dunn obtained unconditional clearance for the transaction in six months, following an FTC second request investigation.

# Today's Gibson Dunn Panelists



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# Upcoming Gibson Dunn Webcasts



# Upcoming Gibson Dunn Webcasts

- April 18, 2017, 11:00 am – 12:30 pm EDT
  - The New French Anti-Corruption Law (“Sapin II”) within the Global Compliance Landscape
- May 2\*, 2017, 12:30 pm – 1:30 pm EDT (\*pending confirmation)
  - Hot Topics in Securities and Governance
- May 10, 2017, 12:00 pm – 1:00 pm EDT
  - Labor & Employment Developments in the Trump Administration





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- March 30, 2017
  - Congressional Investigations: Where is the 115<sup>th</sup> Congress Heading?
- March 16, 2017
  - Identifying and Combatting Fraud and Other Misconduct in Transactions and Litigation
- February 8, 2017
  - Tectonic Shifts in the Landscape of Economic Sanctions: Will the Pace of Change in 2016 Continue?
- January 25, 2017
  - 13<sup>th</sup> Annual Webcast: Challenges in Compliance and Corporate Governance

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December 6, 2016

## ANTITRUST IN THE TRUMP ADMINISTRATION

To Our Clients and Friends:

It is too early to predict with confidence the direction that antitrust policy will take in the Trump Administration, because the President-elect has not yet announced who will lead the Antitrust Division of the Department of Justice ("DOJ") or the Federal Trade Commission ("FTC"). But President-elect Trump's selection of Senator Jeff Sessions for Attorney General and an antitrust transition team consisting of former Antitrust Division Deputy Assistant Attorney General David Higbee, former FTC Commissioner Joshua Wright, and Alex Pollock of the R Street Institute suggest that some changes to the level and types of federal antitrust enforcement are likely to occur.

We think antitrust enforcement and policy in the Trump Administration may roughly track the approaches of recent Republican administrations. While the Trump Administration is the product of a different political environment, it appears that Mr. Trump, like recent past Republican presidents, will focus on reducing economic regulation while at the same time maintaining competitive markets. Combined, these objectives will likely produce the same or higher level of criminal cartel enforcement and potentially a modest reduction in the number of enforcement *challenges* to mergers, although whether the number of merger *investigations* declines will likely depend heavily on the level of M&A activity. The Trump Administration may also devote fewer resources to civil, non-merger matters and move those resources to cartel investigations.

The Trump Administration could affect FTC merger enforcement in particular by securing passage of the Standard Merger and Acquisition Reviews Through Equal Rules (SMARTER) Act of 2015,<sup>[1]</sup> commonly referred to as the "Smarter Act." The bill, which former Commissioner Wright and sitting Republican FTC Commissioner Maureen Ohlhausen have generally supported, would align the FTC's and DOJ's preliminary injunction standards by applying the common law standard--long-since used by the DOJ--to FTC merger challenges as well. It would also substantially limit the FTC's ability to challenge mergers by using its administrative adjudicative authority (often referred to as "Part III" proceedings). The Democratic FTC Commissioners and the Obama Administration strongly oppose the bill.

In addition, the Trump antitrust team may reduce the number of investigations of non-merger conduct. However, Mr. Trump's comments expressing antitrust concerns with respect to some companies suggest the possibility of conduct investigations in particular industries.

Finally, the Trump Administration may support amendments to the Hart-Scott-Rodino ("HSR") statute to reduce filing requirements for private equity companies and other entities that acquire minority shares in companies.<sup>[2]</sup> Commissioner Wright has supported reducing HSR filing requirements for minority stock acquisitions that are unlikely to result in a reduction in competition.<sup>[3]</sup>

## 1. Prospects for Current DOJ and FTC Cases

It is important to note at the outset that there is no indication that the Obama Administration will back off from ongoing antitrust investigations or prosecutions in its last two months. Current Antitrust Division Acting Assistant Attorney General Renata Hesse recently said that the "transition isn't likely to affect the timeline of any pending matters . . . nor does the election of [President-elect] Trump change anything about how current officials view those cases."<sup>[4]</sup>

The DOJ is currently in trial for its challenges to Anthem's attempt to purchase Cigna and Aetna's attempt to purchase Humana. Additionally, on November 16, the week after the election, the DOJ sued to block EnergySolutions' acquisition of Waste Control Specialists. Also ongoing are the DOJ's litigation challenge to Deere & Company's attempted acquisition of Precision Planting and its lawsuit against DirecTV and parent AT&T, which alleges that DirecTV unlawfully exchanged competitively sensitive information with Cox, Charter, and AT&T during the companies' negotiations for the right to telecast the Dodgers Channel.

The FTC similarly has significant ongoing litigation matters, including its challenge to Advocate Health Care Network's attempt to merge with NorthShore University HealthSystem. The Court of Appeals for the Seventh Circuit recently reversed a ruling for the merging parties by the district court and remanded the case for further proceedings. The Commission is also still reviewing several large mergers, including the Walgreens-Rite Aid transaction.

It is conceptually possible that the Trump Administration could materially alter the course of these cases. For example, the Administration could decide to settle some of the matters prior to trial or the issuance of a court decision. However, with the exception of the Bush Administration's rapid settlement of the *Microsoft* case in 2001, new Administrations tend not to change course on pending enforcement actions even when there is a change of party.

## 2. Process of Appointing and Selecting a New Leadership Team

All signs point to the Trump Administration moving rapidly to fill out its leadership team, including at the antitrust agencies. But putting in place the new leadership at the DOJ and the FTC will likely occur in stages and take at least several months. At the DOJ, the new Assistant Attorney General ("AAG") for the Antitrust Division requires confirmation by the Senate. Even though the Republicans control the Senate, confirmation will likely take until at least early spring because cabinet-level positions and other more senior positions are typically taken up first by the Senate. In the meantime, it is probable that Deputy AAG for Criminal Enforcement Brent Snyder would serve as Acting AAG starting on January 20. (The Deputy AAG for Criminal Enforcement is the highest career official at the Antitrust Division.) When the Obama Administration took office, Gibson Dunn Partner Scott Hammond, who at the time was the Criminal Enforcement Deputy AAG, served as the Acting AAG.

Alternatively, immediately upon taking office, the Trump Administration could appoint someone as the Principal Deputy Assistant Attorney General for the Antitrust Division ("Principal Deputy") who could serve as Acting AAG. The Principal Deputy position does not require Senate confirmation.

At the FTC, the transition process could move faster than at the DOJ. Immediately upon taking office, President Trump could appoint the sole Republican currently serving on the Commission, Maureen Ohlhausen, as the FTC's Chairwoman. (The President has the authority to appoint the FTC's Chair from among the sitting Commissioners.) If the President intends for Commissioner Ohlhausen to serve as the FTC's Chair at least through the end of her term, which expires in September 2018, she then would likely move quickly to fill the key leadership positions at the FTC: the Directors of the Bureaus of Competition, Consumer Protection, and Economics; and the position of General Counsel. None of these positions require Senate Confirmation.

In addition, there currently are two vacant Commissioner slots at the FTC, and the term of the current Chairwoman, Edith Ramirez, has already expired. Accordingly, President Trump will have at least three Commissioner slots to fill, all of which require Senate confirmation. The President will fill two of these seats with Republicans and Chairwoman Ramirez's seat with a Democrat. Not more than three of the five Commissioners may be members of the same political party. It is possible that the President will decide to select one of the new Republican Commissioners as Chairman or Chairwoman once confirmed, in which case Commissioner Ohlhausen is unlikely to select new Bureau Directors or the General Counsel.

### **3. Cartels**

The DOJ has exclusive jurisdiction to bring criminal actions against cartel conduct such as price fixing and bid rigging. For the past two decades, there has been strong bipartisan support for aggressive prosecutions of cartels, with substantial prison sentences for individuals and large fines for corporations convicted of cartel conduct. We do not expect this policy to change. Both Republican and Democratic antitrust enforcers agree that such conduct is particularly harmful to competition and consumers. When Mr. Higbee served at the DOJ during the Bush Administration, both he and then-AAG R. Hewitt Pate placed significant emphasis on cartel enforcement.<sup>[5]</sup> Moreover, while serving on the Judiciary Committee, Senator Sessions supported legislation to strengthen the Antitrust Division's "leniency program," which is designed to incentivize companies to report cartels to the Division. The Trump Administration may even allocate more resources to cartel enforcement, particularly if it decides to reduce civil enforcement actions against mergers and other types of non-cartel conduct. In addition, if the Administration is successful in increasing infrastructure spending, there may be an upswing in bid-rigging cases.

### **4. Mergers**

Both the DOJ and the FTC investigate mergers. We expect that the leaders of the agencies in the Trump Administration will generally continue to challenge transactions in highly concentrated markets, meaning transactions that combine the only two, or two of only three, strong competitors in a market. Challenges to such transactions are more likely to occur if there are substantial barriers to entry in the market.

In the healthcare sector, we expect the FTC to continue to aggressively investigate hospital mergers. The FTC's current hospital merger enforcement strategy was developed and put in place by former FTC

Chairman Tim Muris in the first term of the last Bush Administration. Commissioner Wright is a strong supporter of using the antitrust laws to protect competition in the healthcare sector. He wrote approvingly in the November 14, 2016 *New York Times* that "the Federal Trade Commission has successfully challenged proposed mergers with convincing economic evidence that greater concentration would lead to increases in price and reduced quality of service."<sup>[6]</sup>

However, there could be a modest reduction in the number of overall transactions that the agencies challenge, because the Trump Administration could use a somewhat higher evidentiary "bar" for deciding whether to try to block a merger in court or require divestitures. While he was at the FTC, Commissioner Wright dissented from the Commission's decision to challenge or require remedies in a number of mergers, such as the FTC's divestiture orders in the *Reynolds American/Lorillard* and *Nielsen/Arbitron* transactions, because he thought there was insufficient evidence that the transactions would reduce competition.

For the same reason, there may be fewer challenges to transactions about which the primary concern is a decrease in innovation or "potential" competition. The Obama Administration challenged several mergers in the technology and pharmaceutical sectors on these grounds. However, the evidence that such transactions will produce anticompetitive effects is generally more speculative than it is for deals where the parties are engaging in substantial head-to-head price competition at the time of the merger.

The antitrust agencies in the Trump Administration may also rely less on market shares and more on economic analysis when deciding whether to challenge a transaction. Commissioner Wright has frequently written that the antitrust agencies should base enforcement decisions on economic theories that are subject to market testing and analyses of empirical data. He has critiqued reliance on market shares as an indication of pricing power. In his November 14 *Times* article, Commissioner Wright wrote that "a high level of concentration in an industry simply does not mean the industry lacks competition. Concentration and competition are distinct concepts. . . . The new anti-merger fervor is based upon the presumption that they are never a good deal for consumers because more consolidation always leads to higher prices, and never leads to cost savings or product improvements that benefit consumers. Both are demonstrably false."<sup>[7]</sup>

If the Trump Administration does in fact give market shares less weight, it will likely provide opportunities for merging parties to obtain merger clearances for strategic transactions by using economic analyses and direct evidence of how a market actually performs during investigations.

The most uncertain question is how the Administration will treat large "vertical" and "complementary" mergers, where the parties do not engage in material direct competition but some companies or individuals are nonetheless concerned that the transaction will in some sense give the combined companies too much power or reduce the level of innovation. The Obama Administration Antitrust Division blocked several such transactions, such as the *Comcast/Time Warner Cable* and *Applied Materials/Tokyo Electron* deals. During the campaign, Donald Trump vowed to block the AT&T/Time Warner transaction on the ground that it would create an excessive concentration of power, but we expect that the Antitrust Division will make decisions on this and other vertical deals based on a factual analysis applying traditional antitrust principles.

The Republican-controlled Congress may also reintroduce and pass the Smarter Act. The U.S. House of Representatives passed the legislation on March 23, 2016, but the Senate never acted on it due to opposition by Democratic Senators and the White House. The purpose of the bill is to standardize the procedures used by the DOJ and the FTC when challenging transactions and the requirements that both agencies must satisfy to obtain a preliminary injunction.

Currently, when the DOJ challenges a transaction, it must litigate in federal district court and satisfy the common law standard, which includes demonstrating that it is likely to succeed at a trial on the merits, in order to obtain a preliminary injunction. In contrast, the FTC may choose to use its administrative adjudicative process (rather than litigating in federal court) to block a transaction. In addition, the FTC's authority to seek a preliminary injunction of a transaction comes from Section 13(b) of the FTC Act, whereas the DOJ's authority derives from the Clayton Act. Several courts have recently held that Section 13(b) permits a preliminary injunction if the FTC shows that it would serve the "public interest," which is arguably a lower standard than the DOJ faces.<sup>[8]</sup>

Thus, the FTC has two advantages vis-à-vis the parties involved in a transaction that the DOJ does not have: the ability to continue to challenge a transaction in its own administrative court even after a federal court denies an injunction and a lower preliminary injunction standard. The Smarter Act would neutralize these advantages by prohibiting the FTC from using its administrative proceedings to challenge *unconsummated* transactions and standardize the preliminary injunction standards for the agencies.

## 5. Non-Merger Civil Investigations

Both the DOJ and the FTC have jurisdiction to investigate non-merger conduct that they believe reduces competition. In the Obama Administration, the two agencies brought several cases challenging such conduct, two of which were in the healthcare sector.<sup>[9]</sup>

Because such cases are very fact-specific, it is difficult to predict whether and how the Trump Administration will decide any particular matter. Generally, Republican administrations have devoted fewer resources at the DOJ to these matters, particularly to cases involving unilateral conduct, preferring to devote more bandwidth to challenging cartel behavior and mergers for which there is powerful evidence that the transaction will reduce competition.

That said, there has been strong bipartisan support at the FTC for the Commission's challenges to agreements between brand and generic pharmaceutical companies that the FTC believes have delayed entry of generic drugs. The strategy for challenging these cases was also put in place by former Chairman Muris. And in 2002, Senator Sessions commented in favor of legislation that was designed to close loopholes in the Hatch-Waxman Act that let brand drug manufacturers keep generic rivals off the market. Accordingly, we expect the FTC to continue to aggressively investigate what the Commission terms "pay-for-delay" agreements between brand and generic pharmaceutical companies and the DOJ to support such cases if they reach the Supreme Court.

The leadership team at the FTC during the last Bush Administration also brought a number of civil conduct cases designed to attack the use of state regulatory systems to reduce competition,<sup>[10]</sup> as well

as the activities concerning standard-setting organizations that allowed IP holders to create "lock-in" effects with respect to particular patents.[11]

We suspect that the Antitrust Division in the Trump Administration is not likely to bring an enforcement action when there is not clear evidence of a reduction in competition. Moreover, the ability of the Trump Administration (or any administration) to litigate antitrust cases that are not focused on traditional antitrust standards is limited given the likelihood of continuity of the current Supreme Court balance. In recent years, the Court has gradually incorporated key principles of the Chicago School antitrust jurisprudence, most notably that the conduct at issue must produce actual anticompetitive effects to violate the antitrust laws. Gibson Dunn's antitrust and appellate groups have played significant roles in these cases, including *Leegin*.<sup>[12]</sup>

## **6. Changes to the HSR Statute**

The Trump Administration may formally or informally expand the scope of the investment-only exemption from the HSR Act reporting requirement. The exemption excludes from the Act's notice and waiting requirements "acquisitions, solely for the purpose of investment, of voting securities, if, as a result of such acquisition, the securities acquired or held do not exceed 10 per centum of the outstanding voting securities of the issuer."<sup>[13]</sup>

The Obama Administration's appointees at the FTC worked to narrow the scope of the exemption. For example, in August 2015 the Commission charged Third Point with violating the HSR statute for failing to observe the filing and waiting requirements of the HSR Act before purchasing shares in Yahoo. The FTC alleged that the investment-only exemption did not apply because Third Point communicated with third parties to determine their interest in becoming the CEO or a board candidate of Yahoo. (Third Point acquired less than six percent of Yahoo's stock.) Notably, Commissioner Ohlhausen and then-Commissioner Wright dissented from the Commission's decision. They wrote that the majority's interpretation of the investment-only exemption was "likely to chill valuable shareholder advocacy while subjecting transactions that are highly unlikely to raise substantive antitrust concerns to the notice and waiting requirements of the HSR Act."<sup>[14]</sup>

HSR practitioners and the financial services sector have long argued, unsuccessfully, for expanding the scope of the investment-only exemption to, at a minimum, apply to acquisitions by officers and directors of voting securities of the companies for which they serve. We think there is a strong possibility that the Trump antitrust team at the DOJ and FTC will agree to some expansion of the exemption.

## **7. U.S. Relationships with Foreign Antitrust Enforcement Officials**

The Trump Administration could both privately and publicly advocate against the European Commission ("EC") and other foreign competition agencies taking enforcement actions against U.S. companies when the Administration disagrees with the analysis underlying the enforcement. In the 1990s, Senator Sessions wrote a letter to then-Attorney General Janet Reno expressing concern that the Antitrust Division was assisting the EC's investigation of Microsoft. And in the second Bush Administration, U.S. antitrust officials were critical of several enforcement actions taken by the EC against U.S. firms, which



they believed were not targeted at reductions in competition but instead designed to protect European competitors.

However, we do expect the Trump Administration to continue the Obama Administration's efforts to use bilateral meetings and international fora (such as the Organization for Economic Cooperation and Development and the International Competition Network) to try to persuade other competition agencies to increase the procedural fairness and transparency of their processes. We also expect the administration to encourage cooperation that reduces the costs on parties in responding to multi-jurisdiction merger investigations.

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[1] Standard Merger and Acquisition Reviews Through Equal Rules (SMARTER) Act of 2015, H.R. 2745 (June 12, 2015).

[2] In 1988, the DOJ and FTC charged Mr. Trump with failing to report under the HSR Act the acquisition of stock in two gaming companies. Mr. Trump is not alone in being fined for violating the HSR Act reporting requirements. Other prominent individuals and companies that have been fined for HSR Act violations include Barry Diller, John C. Malone, and William H. Gates ([https://www.ftc.gov/system/files/attachments/hsr-resources/enforcement\\_actions\\_final\\_updated\\_aug\\_2016.pdf](https://www.ftc.gov/system/files/attachments/hsr-resources/enforcement_actions_final_updated_aug_2016.pdf)). Many violations of the HSR Act, generally first offenses, do not result in fines; in fiscal year 2015 alone, 39 post-consummation "corrective" HSR filings were made (<https://www.ftc.gov/system/files/documents/reports/federal-trade-commission-bureau-competition-department-justice-antitrust-division-hart-scott-rodino/160801hsrreport.pdf>).

[3] President-elect Trump has personally been involved in two other antitrust lawsuits. In the early 1980s, Mr. Trump was a successful plaintiff in the USFL's antitrust suit against the NFL, although the USFL dissolved shortly thereafter. And in the late 1980s and early 1990s, Mr. Trump successfully defended charges that he attempted to monopolize casino gambling in sections of Atlantic City. It is difficult to gauge whether these cases will affect the Trump Administration's antitrust policies.

[4] Leah Nylen, *Pending matters won't be affected by Trump transition, DOJ's Hesse says*, mLex (Nov. 17, 2016).

[5] See R. Hewitt Pate, International Anti-Cartel Enforcement, Before the 2004 ICN Cartels Workshop, Sydney, Australia (Nov. 21, 2004) ("[W]e at the U.S. Justice Department see antitrust enforcement as a three-part hierarchy. At the top of this hierarchy is enforcement against cartels, conduct that is devoid of any efficiency justification and inflicts tremendous harm on our economy."), available at <https://www.justice.gov/atr/speech/international-anti-cartel-enforcement>.

[6] Joshua Wright, *Concentration in an Industry Does Not Mean It Lacks Competition*, New York Times (Nov. 14, 2016), available at <http://www.nytimes.com/roomfordebate/2016/11/14/should-the-government-bring-back-trust-busting>.

- [7] *Id.*
- [8] *See, e.g., FTC v. Whole Foods*, 548 F.3d 1028, 347-48 (D.C. Cir. 2008).
- [9] *See United States v. United Regional Health Care System of Wichita Falls, Texas*, No. 7:11-cv-0030 (N.D. Tex. 2011); *United States v. Blue Cross Blue Shield of Michigan*, No. 2:10-cv-15155 (D. Mich 2010).
- [10] *See, e.g., In re Ky. Household Goods Carriers Ass'n Inc.*, 139 F.T.C. 404 (2005) (finding Kentucky's high-level review of the reasons for movers' rate increases did not constitute sufficient supervision to immunize the Association from the antitrust laws).
- [11] *See, e.g., In re Rambus Inc.*, 2007 WL 431522 (FTC 2007) (finding that Rambus engaged in anticompetitive acts to deceive a standard-setting organization); *In re Union Oil Co. of Calif.*, 140 F.T.C. 123 (2005) (ordering that Unocal not enforce certain patent rights).
- [12] *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).
- [13] 15 U.S.C. § 18a(c)(9); Section 801.1(i)(1) of the HSR Rules, 16 C.F.R. § 801.1(i)(1).
- [14] Dissenting Statement of Commissioners Maureen K. Ohlhausen and Joshua D. Wright, *In the Matter of Third Point*, FTC No. 121-0019 (Aug. 24, 2015).



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## 2016 ANTITRUST MERGER ENFORCEMENT UPDATE AND OUTLOOK

To Our Clients and Friends:

Since our last update in March 2015, we have witnessed increasing volumes of M&A activity and a corresponding level of global competition law enforcement. Antitrust and competition enforcers around the world continued to devote substantial resources to policing mergers at a time when transactional activity is accelerating across a wide range of industries.

Nowhere is this trend more pronounced than in the United States. In April of last year, the Antitrust Division of the U.S. Department of Justice, supported by the Federal Communications Commission, successfully opposed Comcast's \$45 billion acquisition of Time Warner Cable. Two months later, the Federal Trade Commission persuaded a court to enjoin Sysco's \$8.2 billion takeover of rival distributor US Foods, despite the parties' substantial remedy offer. And in recent weeks, Halliburton abandoned its \$35 billion bid to buy Baker Hughes and the Federal Trade Commission won its high-profile court challenge to Staples' attempted acquisition of Office Depot. Both agencies are also expected to make decisions in the coming months involving a series of healthcare-sector mergers. The FTC is investigating (and in some cases challenging) a number of significant transactions involving hospitals, pharmaceuticals, and retail pharmacies, while the DOJ is tasked with reviewing several large health insurer transactions.

A number of factors are driving the high level of antitrust enforcement in the United States:

- HSR filing volumes have recovered from the slowdown resulting from the 2008 financial crisis, and are now approaching the same level as a decade ago.
- The agencies have enhanced their litigation capabilities.
- The agencies are continuing to press more aggressive, less traditional theories of harm (*e.g.*, potential competition and innovation).
- The agencies have been less willing to accept what they view as weak or risky remedy proposals, leading them to challenge mergers that in past years may have ended in a settlement.

As the Obama Administration reaches its final months, it is clear that the President's 2008 campaign promise to increase merger enforcement has become a reality. As we reported in 2010, the agencies issued the first revision of the U.S. Horizontal Merger Guidelines in nearly two decades, which was aimed at strengthening the government's hand in challenging mergers, particularly in high-technology sectors. Over the past five years, the agencies have successfully pursued challenges of high-profile deals based on many of the principles articulated in the 2010 Guidelines, most notably its reduced

emphasis on market definition and greater focus on proving "direct effects." Time will tell how far-reaching and lasting the agencies' efforts will be.

Merger enforcement is also on the rise outside the U.S. The European Commission initiated 11 in-depth (Phase II) investigations of mergers in 2015, the highest annual total since 2007. The percentage of all EC merger filings that triggered a Phase II has more than doubled over the past five years. In addition to blocking large mergers such as the \$15 billion takeover of mobile phone operator O2 by CK Hutchison, the EC has demonstrated its willingness to demand and impose substantial remedies.

## **Gibson Dunn's Antitrust and Competition Law Practice**

Gibson Dunn's Antitrust and Competition Law Practice Group has extensive experience successfully representing clients in a broad range of industries in antitrust investigations conducted by enforcement agencies in the U.S., Europe, and other jurisdictions worldwide. In 2015 and 2016 alone, Gibson Dunn's antitrust and competition lawyers represented AT&T in its \$48 billion acquisition of DirecTV, Williams in its \$33 billion proposed merger with Energy Transfer, Intel in its \$16.7 billion acquisition of Altera, Schlumberger in its \$14.8 billion acquisition of Cameron, Southern Power in its \$8 billion acquisition of AGL Resources, Marriott in its \$13.6 billion proposed acquisition of Starwood, St. Jude in its \$25 billion sale to Abbott, Tenet Healthcare in its \$2 billion acquisition of United Surgical Partners International, and Hewlett-Packard in its \$3 billion acquisition of Aruba Networks.

Our worldwide Antitrust Practice Group numbers over 100 lawyers located throughout the United States and Europe. In addition, the Antitrust Group works closely with attorneys in Gibson Dunn's other practice groups to provide efficient service for our clients.

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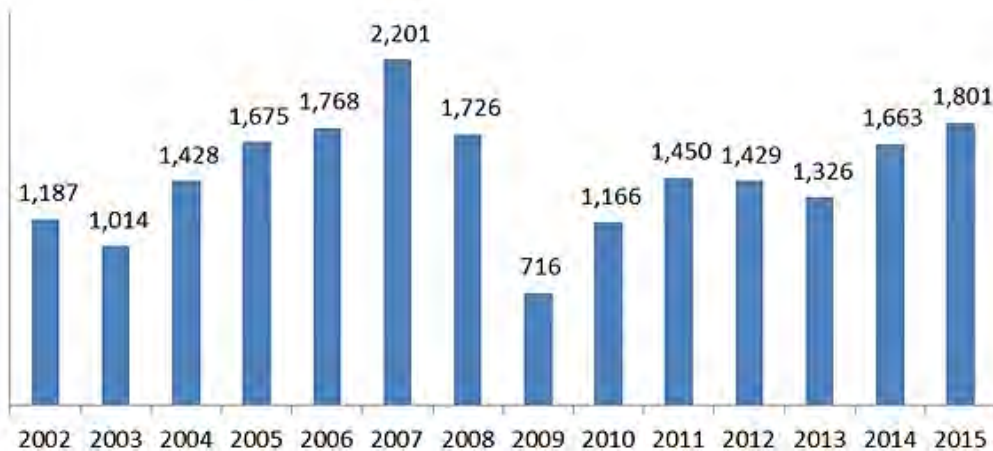
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## **HSR VOLUME INCREASES AS HIGH ENFORCEMENT LEVELS PERSIST**

The well-publicized uptick in global M&A activity in 2014 was borne out in a 25% increase in the number of transactions reported under the Hart-Scott-Rodino ("HSR") Act in FY 2014 over FY 2013 and another 8% increase in FY 2015 over FY 2014. Based on activity in the first half of FY 2016, it appears that total FY 2016 HSR transaction volume will be even higher than in FY 2015, perhaps approaching the extraordinary level of HSR activity in FY 2007.

## HSR Act-Reportable Transactions FY 2002–2015



Of course, the number of HSR filings is a useful measure of overall US M&A activity, but because a small percentage of these filings trigger formal second request investigations (less than 5% historically), such figures provide little insight into the agencies' enforcement workload. The rate at which the agencies investigate transactions and seek enforcement shows merger enforcement continues to be a priority. The percentage of HSR Act-reportable transactions subject to a second request was slightly lower (3.2% in FY 2014) than in previous years; however, because of the higher number of transactions reported, the actual number of second requests issued was higher in FY 2014 (51) than in FY 2013 (47).

## Percentage of HSR Act Transactions Resulting in a Second Request FY 2002–2014





Enforcement rates (reflecting transactions that are either challenged in court, abandoned due to antitrust concerns, or subject to remedies) under the Obama Administration continue to be on the higher end of the historic range. Between FY 2006 and FY 2008, the agencies brought an average of 34 merger enforcement actions per year. By contrast, between FY 2010 and FY 2012, the agencies averaged 41 challenges annually, even though M&A volume was considerably lower than it is today. However, despite a number of high-profile challenges and increased overall M&A activity, the FTC and DOJ actually brought fewer merger enforcement cases in each of the most recent three years where data is publicly available: The agencies challenged 44, 38, and 33 mergers in FY 2012, FY 2013, and FY 2014, respectively.

## **THE DEPARTMENT OF JUSTICE**

In 2015, the Antitrust Division of the Department of Justice ("DOJ") continued to aggressively investigate and challenge mergers in many sectors of the economy. The DOJ caused three deals—Halliburton/Baker Hughes, GE/Electrolux and National CineMedia/Screenvision—to collapse after filing court challenges, and caused the parties to five other transactions to abandon or modify their deals, including Applied Materials/Tokyo Electron and Comcast/Time Warner Cable. The DOJ's decisions to oppose the Applied Materials and Comcast transactions were particularly notable because the parties to both deals arguably had relatively few directly competing lines of business. In its review of these two transactions, the DOJ focused on "conglomerate" market power and "innovation" issues, respectively, both of which are more commonly associated with reviews by the European Commission. These enforcement actions signal that DOJ may closely investigate any transaction that produces a large firm in a high-profile industry, even if there is not a clear cut traditional basis to conclude that it is likely to reduce competition.

The DOJ has also devoted substantial resources to investigating and challenging non-merger transactions. In November, the DOJ filed a lawsuit to stop United's lease of slots from Delta at Newark Airport, alleging that United's planned acquisition of 24 slots at Newark would increase United's already dominant position at the airport, and would strengthen a barrier that diminishes the ability of other airlines to challenge United at the location. United announced that it would abandon the acquisition in April, citing the FAA's decision to eliminate slot controls at Newark.

### **Stability in DOJ's Leadership**

Heading into the final year of the Obama Administration, DOJ's Front Office will continue to have a very experienced team. Assistant Attorney General Bill Baer will become the Department's Associate Attorney General, which supervises the Antitrust Division. Renata Hesse is now serving as the Division's Acting AAG, with David Gelfand and Sonia Pfaffenroth as the two Civil DAAGs. Underscoring that litigation readiness remains a key objective of the DOJ, Baer quickly replaced the Director of Litigation, Mark Ryan, with Eric Mahr when Ryan returned to private practice in May 2015.

## DOJ Lawsuits and Threats to Litigate Caused Parties to Abandon Mergers

Throughout the year, the DOJ proactively used its ability to litigate to force parties into abandoning deals. This track record reflects that the DOJ is highly confident that it has the litigation team in place to win in court. Parties involved in transactions that raise material antitrust issues cannot count on any hesitancy by DOJ's leadership to file a lawsuit.

***Halliburton-Baker Hughes:*** On April 6, 2016, the DOJ filed a complaint against Halliburton and Baker Hughes alleging that their proposed merger would violate Section 7 of the Clayton Act by combining two of the three largest oilfield services providers in the world. In announcing the complaint, AAG Baer remarked that the "transaction is unprecedented in the breadth and scope of competitive overlaps and antitrust issues it presents." DOJ alleged that the transaction would harm competition in at least 23 separate relevant markets involving a wide range of products and services used to drill and prepare oil and gas wells for production. In addition, the DOJ's complaint highlighted the inadequacies of the parties' divestiture packages, further underscoring the agencies' tougher stance on remedies. Three weeks after the complaint was filed, the parties abandoned the transaction, ending the litigation and triggering a \$3.5 Billion reverse-break-fee payment from Halliburton to Baker Hughes.

***GE/Electrolux:*** In July 2015, the DOJ challenged Electrolux's proposed \$33 billion acquisition of GE's appliance business in federal court, alleging that the transaction would reduce the number of providers of value-segment, major home appliances to homebuilders from three to two. Competitors such as Samsung and LG sold higher-end appliances but the DOJ alleged the parties were the primary suppliers of mid-range appliances. GE abandoned the transaction once it was contractually allowed to do so at the end of trial, before the court ruled on the injunction.

***National CineMedia's/Screenvision:*** In March 2015, National CineMedia walked away from its efforts to acquire Screenvision shortly before the scheduled trial. The DOJ had filed a lawsuit alleging that a merger between the only two significant cinema advertising networks in the United States would deprive movie theatres of options and risk raising ticket prices to consumers. According to the complaint, the companies had a combined 88% share of all movie theatre screens in the United States through long-term, exclusive contracts.

In the face of a DOJ that continues to succeed through litigation, 2015 saw the parties to five other mergers abandon or modify their transactions when confronted with concerns by the DOJ. Of particular significance are several transactions in which the DOJ was prepared to rely on "innovation" and "conglomerate" theories of anticompetitive effects in the Applied Materials and Comcast matters, respectively.

***Applied Materials/Tokyo Electron:*** In April, eighteen months after proposing a merger, the two semiconductor manufacturers abandoned the transaction after the DOJ raised concerns about a loss of innovation for "next-generation semiconductors." Significantly, in its press release after the parties abandoned the deal, the DOJ did not focus on a reduction in head-to-head competition between the parties, but on the *development* of new types of semiconductor manufacturing equipment. The CFO of

Applied Materials in statements following the collapse of the deal underscored that the transaction ran into obstacles when the DOJ began looking at the products in development and general technology innovation.

***Comcast/Time Warner Cable:*** In April, after 14 months of review, Comcast and Time Warner Cable abandoned their merger plans when faced with opposition from the DOJ and the Federal Communications Commission ("FCC"). Both reviewing agencies opposed the transaction notwithstanding that there appeared to be little local head-to-head competition between the parties. Instead, both the DOJ and FCC noted concerns that the transaction would "make Comcast an unavoidable gatekeeper for Internet-based services that rely on a broadband connection to reach consumers." The DOJ's approach shows that it may not be constrained by conventional merger theories when investigating transactions that will produce a company with a large footprint in a particular sector.

***Chicken of the Sea/Bumble Bee:*** In the Chicken of the Sea/Bumble Bee merger, the DOJ alleged that the companies were the second- and third-largest sellers of shelf-stable seafood products. The DOJ also raised concerns that the market was "not functioning competitively today and further consolidation would only make things worse." Faced with opposition based on traditional structural concerns, the parties abandoned the merger in December.

***Entercom Communications Corp./Lincoln Financial Media Company:*** The DOJ also kept up its enforcement efforts in older industries. In July 2015, the DOJ challenged a transaction between Entercom Communications Corp. and Lincoln Financial Media Company. The parties entered into a consent decree which required them to divest three radio stations in Denver. Despite the substantial changes that have occurred in the media and advertising sectors, the DOJ continued to define the product market as "English-language broadcast radio stations." As the media landscape continues to evolve, with Internet and social media outlets commanding an increasing share of advertising dollars, the DOJ may ultimately need to reevaluate this approach but for now, the DOJ's policy is to take an aggressive stance of defining media markets by format type.

***Tribune Publishing Co./Freedom Communications, Inc.:*** The newspaper industry also received close DOJ scrutiny. In March 2016, the DOJ challenged Tribune Publishing Co.'s ("Tribune") purchase of Freedom Communications, Inc. ("Freedom"). Tribune owns the *Los Angeles Times*, while Freedom owned the *Orange County Register* and the *Riverside County Press-Enterprise*, the two other newspapers with significant circulation in Orange and Riverside counties that sell alongside Tribune's *Los Angeles Times*. Freedom was in bankruptcy and its auction on March 16, 2016 resulted in Tribune winning. The DOJ alleged that the acquisition would create a monopoly by combining the two largest English-language local daily newspapers in the market, thereby increasing subscription prices, raising advertising rates and reducing the incentive to invest in the newspapers. Following the DOJ's lawsuit, a California bankruptcy judge approved the sale of Freedom to another buyer. The lawsuit reflects that the DOJ continues to review transactions that are too small to trigger an HSR filing or occur through bankruptcy.

## **DOJ Finds No Competitive Issues in Expedia/Orbitz and AT&T/DirecTV Transactions**

Notwithstanding its aggressive enforcement posture, the DOJ's leadership demonstrated that they will decisively close investigations, without asking for remedies, when the parties persuasively demonstrate that the transaction is not anticompetitive. Most notable, following a six-month investigation, the DOJ decided to close its investigation into the Expedia/Orbitz transaction. The DOJ based its decision in part on its conclusion that "the online travel business is rapidly evolving" with new entry such as TripAdvisor's Instant Booking service and Google's Hotel and Flight Finder, both of which had booking functionality.

The DOJ also declined to challenge AT&T's acquisition of DirecTV, concluding that the transaction did not pose a risk to competition. The FCC did require that AT&T commit to continue to build out broadband assets and not discriminate against content providers.

## **United's Lease of Slots from Delta at Newark Airport Abandoned Following DOJ Challenge and FAA Ruling**

In addition to the expected continuation of an aggressive review of mergers, the DOJ in 2016 will continue to challenge asset acquisitions as well as mergers. In November 2015, the DOJ filed a civil antitrust lawsuit seeking to block United Continental Holdings Inc.'s \$14 million lease of slots from Delta Air Lines. Both United and Delta operate out of Newark Liberty International Airport with United already controlling 73 percent of the slots. United sought to lease an additional 24 takeoff and landing slots from Delta. The DOJ alleged that the lease was an acquisition and would strengthen United's "monopoly position" and result in higher fares to the 35 million annual passengers traveling through Newark. The airlines abandoned their transaction before the court ruled on their motion to dismiss the DOJ's complaint, citing an FAA ruling lifting takeoff restrictions at Newark.

## **THE FEDERAL TRADE COMMISSION**

The last twelve months have been a veritable high water mark for FTC merger enforcement activity. The agency scored two high-profile litigation wins by securing injunctions blocking Staples' \$6.8 billion bid for Office Depot and Sysco's \$8.2 billion proposed acquisition of rival US Foods. In addition to requiring remedies in over 15 matters during the last year, the FTC initiated litigation to block five transactions, roughly doubling the agency's recent historical average of approximately two-to-three merger litigations per year.

Not all of the FTC's merger litigation efforts have succeeded. In particular, as discussed below, the FTC lost a significant preliminary injunction proceeding in federal court involving a merger between alleged potential competitors, and another federal court denied the FTC's efforts to enjoin a hospital merger in central Pennsylvania. Time will tell how this might influence the FTC's willingness to challenge potential competition and hospital cases going forward, but statements from the FTC officials suggest that the agency will continue to bring lawsuits where it concludes that enforcement is warranted.

Notably, several large transactions that raise interesting antitrust issues are currently pending before the agency, including Walgreens' proposed \$17 billion purchase of Rite Aid, 'Teva Pharmaceuticals' \$40.5 billion acquisition of Allergan's generic drugs portfolio, and Sherwin-Williams \$8.9 billion proposed acquisition of Valspar. The agency's actions--or inactions--in these matters will provide further insights into the agency's future direction.

### **And Then There Were Three**

Although the Commission's Democratic majority will very likely persist through the election cycle, Commissioner Wright resigned on August 17, 2015, to return to the faculty of the George Mason law school and Commissioner Brill announced her resignation on March 22, 2016, to enter private practice. The President has not nominated a candidate for either position and, given the current acrimony between the President and Congress regarding appointments, both seats may remain empty for some time.

Other staffing changes at the Commission include the departure of the Commission's General Counsel, Jonathan Nuechterlein, to private practice; the addition of Professor Ginger Zhe of the University of Maryland to the Bureau of Economics as the Bureau's Director; and the addition of Lorrie Faith Cranor, a Professor of Computer Science and Engineering and Public Policy at Carnegie Mellon University, to replace Ashkan Soltani as Chief Technologist. While notable, these staffing changes are unlikely to materially alter the agency's enforcement decisions.

### **Déjà Vu – FTC Blocks Staples's Proposed Acquisition of Office Depot (Again)**

On May 10, 2016, following a year-long investigation and two weeks of trial, the FTC secured an injunction in federal court blocking Staples's proposed acquisition of rival Office Depot. This is the third time the FTC has weighed in on a major office supply superstore transaction, and marks the second time it has prevented Staples from acquiring Office Depot. Nearly two decades ago, in 1997, the Commission obtained an injunction from the same court blocking this very same deal. In the 1997 case, the Commission's focus was on sales of disposable office supplies (e.g., Post-it notes, paper, and pens) to retail store consumers. Sixteen years later, in November 2013, the FTC cleared a merger of Office Depot and OfficeMax, which was then the third-largest operator of retail office supply stores in the United States. In clearing that transaction, the FTC issued a closing statement noting that the "current competitive dynamics are very different" than they were in 1997. In addition to concluding that office supply chains face "significant competition" for retail customers, the Commission explained that "[a] substantial body of evidence indicates that the merger is unlikely to substantially lessen competition or harm large [business] contract customers."

Notwithstanding its 2013 closing statement, the Commission elected to challenge the Staples/Office Depot transaction after rejecting the parties' offers to divest assets and customer contracts to a third party. Unlike its 1997 challenge, the agency's case focused not on retail sales of office supplies to individual consumers, but rather on sales to large corporations. Specifically, the agency alleged that the relevant market "is the sale and distribution of consumable office supplies to large business-to-business ["B-to-B"] customers in the United States." The agency's economist, Dr. Carl Shapiro,

estimated that Staples and Office Depot combined accounted for nearly 80% of consumable office supply sales to Fortune 100 companies.

In a 75-page opinion, Judge Sullivan explained that the FTC had met its burden of "showing that the merger would result in 'undue concentration' in the relevant market of the sale and distribution of consumable office supplies to large B-to-B customers in the United States." In addition to accepting the FTC's relevant market definition, Judge Sullivan noted that "Amazon Business' lack of demonstrated ability to compete for [B-to-B contracts] and the structural and institutional challenges of its marketplace model" mean that it "will not be in a position to compete . . . on par with the proposed merged entity within three years," and "it would be sheer speculation . . . for the Court to conclude otherwise."

The outcome of this case was far from preordained, given the FTC's 2013 Office Depot/OfficeMax closing statement, but reflects several emerging trends in U.S. merger enforcement. First, as discussed above, the agencies are increasingly skeptical of remedy proposals, particularly in large transactions where there is extensive pre-merger competition and overlap between the parties. *Staples* is yet another high-profile instance where the agency chose to litigate rather than agree to a substantial divestiture package. Second, the agencies are gaining confidence in defining national markets in which large players vie for business from customers that require services across multiple distribution facilities throughout the country. The DOJ relied on a similar market definition theory in its 2010 challenge of AT&T's proposed acquisition of T-Mobile, and the FTC used it in its litigation against Sysco/US Foods (discussed below). Finally, the agencies are increasingly relying on evidence of head-to-head competition to support not only competitive effects, but also their proposed market definition. The Commission's expert argued that evidence of competitive rivalry between Staples and Office Depot for large corporate customers supported the contention that these customers formed a distinct relevant market.

## **FTC Obtains Injunction Blocking Sysco's Proposed Acquisition of US Foods**

In June 2015, Sysco and US Foods abandoned their proposed merger after the FTC won a preliminary injunction enjoining the transaction in federal district court. The case was the FTC's signature victory of 2015, and is noteworthy because it came outside of the healthcare sector, the focus of virtually all recent FTC competition-law litigation successes, merger or otherwise. Another impressive aspect of this win was that the FTC prevailed by alleging the merger would lessen competition in a market where the merging parties faced many (albeit differentiated) competitors.

In the litigation, the FTC contended--and the court agreed--that the relevant product market was broadline food product distribution, a market that excluded distributors who focused only on certain categories of food (or food-related products) or served only narrow geographic areas. The court found that the product market must be defined in a way that grasps the reality that large government agencies, healthcare systems, industrial catering companies, and restaurant chains conduct a very substantial portion of their business with the broadliners, who offer special services unavailable from others. The court also concluded that the sheer scale of certain national customers means they are categorically different from regional customers who only receive goods from a small set of distribution centers.

## **FTC Loses Preliminary Injunction Case Premised on a Potential Competition Theory**

But the FTC's fortunes changed several months later in September 2015, when the Northern District of Ohio denied the FTC's motion for a preliminary injunction to block Steris Corporation's ("Steris") proposed acquisition of Synergy Health plc ("Synergy"). The \$1.9 billion merger combined the second- and third-largest medical product sterilization companies in the world.

The FTC's *Complaint* asserted an actual potential competition theory, under which the agency claimed that the merger would eliminate future rivalry between the two companies. Both Steris and Synergy provide contract sterilization services for companies that need to ensure their products (e.g., medical devices) are free of unwanted microorganisms before they reach customers. According to the FTC, gamma radiation is currently considered the only feasible method of sterilizing large volumes of dense and heterogeneously packaged products, and Steris is one of only two companies providing such services in the United States. The FTC further alleged that, prior to the proposed merger, Synergy was implementing a strategy to open new plants in the United States that would offer X-ray sterilization services, which would provide a competitive alternative to Steris's dominant gamma radiation offering.

In evaluating its actual potential competition claim, the court accepted the FTC's underlying legal theory – *i.e.*, that a merger could be blocked on the ground that one party would enter and compete against the other absent the transaction. But at the preliminary injunction hearing the court focused on the evidence the FTC proffered in support of its claim that Synergy was likely to enter the US market by building one or more X-ray facilities within a reasonable period of time. The court concluded that the FTC failed to meet its evidentiary burden on this point. It concluded that, absent the deal, Synergy was unlikely to enter the market in any reasonable timeframe because the evidence demonstrated that it had failed to obtain customer commitments for its X-ray sterilization services, and that Synergy had failed to lower its capital costs to levels that would enable it to compete effectively. Following the court's decision to deny the injunction, the Commission announced that it did not intend to appeal and was dropping the suit.

We do not expect the loss to portend the end of the Commission's interest in pursuing cases premised on "potential competition" theories. Bureau of Competition Director Feinstein delivered a major policy speech outlining the FTC's commitment to potential competition cases in September 2014 and the agency has an established history of pursuing remedies premised on competition that will occur only in the future, some of which were successful (e.g., the Commission's successful defense of its *Polypore* decision in the Eleventh Circuit). However, *Steris* reflects the reality that potential competition cases inherently place a high evidentiary burden on the agency because it must prove future, rather than current, rivalry. Commissioner Ohlhausen recently commented that the *Steris* decision may reflect that the courts have a "different appetite than does the Commission" when it comes to forecasting future competitive dynamics.

## **FTC Enforcement in the Healthcare Provider Sector Reaches Unprecedented Levels**

After pressing "pause" on merger enforcement in the healthcare provider sector after suffering a string of eight FTC and DOJ losses in hospital merger cases in the late 1990s, the FTC has now fully

rebooted its efforts in this large and important sector. After successfully challenging the consummated acquisition of Highland Park Hospital by Evanston Northwestern Hospital in 2008, an action that resulted in relatively limited behavioral remedies, the FTC has aggressively policed hospital mergers on a prospective basis.

Indeed, since the FTC issued its decision in Evanston eight years ago, the agency is five-for-six, posting an impressive .833 batting average, in litigating hospital merger challenges. During the final two months of 2015, the FTC initiated *three* additional hospital merger challenges, two of which are currently pending in the courts. On May 10, 2016, the court in the third case involving two hospitals in Pennsylvania, denied the FTC's motion for an injunction—the agency's lone hospital-matter loss since the agency issued its decision in the *Evanston* case. This unprecedented level of enforcement reflects the agency's commitment to policing combinations among healthcare providers.

- *In the Matter of Cabell Huntington Hospital*: The FTC moved to block the merger of two hospital systems located approximately three miles apart in Huntington, West Virginia. According to the FTC's complaint, the combination would create a near monopoly for general acute care inpatient hospital services and outpatient surgical services in the surrounding four-county area, with a market share above 75%. The FTC also stated that the procompetitive benefits of the merger were speculative, not merger-specific, and insufficient to outweigh the likely competitive harm resulting from the acquisition. However, on March 20, 2016, West Virginia governor Earl Ray Tomblin signed into law a bill that ostensibly exempts hospitals and other healthcare providers subject to state regulation from antitrust scrutiny. How the law will alter the course of the FTC's challenge remains to be seen.
- *In the Matter of The Penn State Hershey Medical Center/PinnacleHealth System*: Moving in cooperation with the Pennsylvania Attorney General, the FTC filed a complaint in federal district court to stop the proposed merger of two nonprofit hospital systems serving Harrisburg, Pennsylvania, and the surrounding area. The FTC alleged that the combined entity would have nearly 64% market share, and that the merger would likely lead to increased healthcare costs and diminished quality of care for more than 500,000 residents in the area. However, the court denied the FTC's injunction, finding that the FTC's purported four-county "Harrisburg Area" market was too narrow and improperly excluded 19 competing hospitals located within a 65 minute drive of Harrisburg. Moreover, the two largest insurers in Harrisburg, accounting for nearly 80% of the hospitals' commercial patients, had executed contracts that would prevent the merging hospitals from raising prices for at least the next five years. The court was also persuaded by the parties' claim that the merger would allow them to utilize capacity more efficiently and to avoid unnecessary capital expenditures. The FTC has appealed the decision to the Third Circuit, and briefing regarding a stay of the district court's opinion is ongoing.
- *In the Matter of Advocate Health Care Network*: The FTC challenged the proposed merger of NorthShore University HealthSystem and Advocate Health Care Network, which would create the largest hospital system in the North Shore area of Chicago. According to the FTC, the combined entity would operate a majority of hospitals in the area, and control more than 50% of the general acute care inpatient hospital services.



In both *Hershey* and *Cabell Huntington*, the merging hospitals contracted with their largest payors to freeze rates at pre-merger levels for five and ten years, respectively. The court in *Hershey* concluded that the hospitals' long-term agreements foreclosed the possibility of anticompetitive post-merger price increases. The FTC, according to the court, was "essentially asking the Court [to] prevent this merger based on a prediction of what might happen to . . . rates in 5 years." In response, Chairwoman Ramirez voiced her "very serious" concerns with using such agreements as a means of deflecting antitrust attack. She described such strategies as "akin to conduct remedies" that fail to address the longer-term anticompetitive effects of horizontal mergers, including future reductions in innovation and quality. It remains to be seen whether long term price contracts will be more broadly accepted as a safeguard against the anticompetitive effects of mergers as the FTC pursues its appeal of the *Hershey* decision and awaits the outcome of *Cabell Huntington*. If this practice gains favor in the courts, it will have significant implications for merger remedies both in and outside the health care context.

Of these three challenges, the *Advocate/NorthShore* matter may turn out to be the most significant precedent. Unlike the FTC's other recent hospital merger challenges, the area served by Advocate and NorthShore is not an isolated city (or town) surrounded by a rural area. Rather, the hospitals serve the suburbs north of downtown Chicago. The FTC alleged that the relevant market excluded hospitals located in downtown Chicago and to the west of the city. The court's reaction to the FTC's alleged geographic market may create an important benchmark for geographic market definition in healthcare provider markets in large metropolitan areas. In addition, unlike other recent FTC hospital challenges, the combined shares of Advocate and NorthShore (and market concentration) are relatively close to the thresholds specified in the *Horizontal Merger Guidelines* needed to establish a presumption of anticompetitive harm (*i.e.*, a post-merger HHI greater than 2,500 and an increase in HHI of 200 or more). Thus, even if the court accepts the FTC's geographic market, the court may give less weight to the presumption of harm associated with concentration thresholds, and correspondingly more weight to other evidence, including the parties' efficiency justifications.

A notable trend in the FTC's enforcement program in the healthcare provider sector is the extension of its enforcement beyond hospitals to include ambulatory surgery centers (ASCs), physician groups, and other low-acuity healthcare providers. Although the FTC had previously pursued merger enforcement cases involving dialysis clinics and laboratory services (and continues to do so, as evidenced by the remedy it required in approving U.S. Renal Care, Inc.'s acquisition of DSI Renal), the agency had not previously targeted low-acuity medical services offered by local providers. The FTC's current position, however, appears to be that any transaction involving healthcare providers--no matter how small or "local"--that results in concentration levels in excess of the thresholds specified in the *Horizontal Merger Guidelines* merits scrutiny.

## **The FTC Continues to Resolve Competitive Issues Raised by Pharmaceutical and Medical Device Transactions Through Negotiated Remedies**

During the last year, which witnessed a number of very large pharmaceutical transactions, the FTC has stayed the course in the pharmaceutical and medical device sector. In particular, the FTC maintained its approach to analyzing deals involving drugs and medical devices based on whether the transactions involve therapies that are substitute treatments for patient conditions.

Most notably, the FTC's investigations of several blockbuster pharma deals--including Shire PLC's \$32 billion proposed merger with Baxalta' and Teva Pharmaceuticals' \$40.5 billion acquisition of Allergan's generic drugs portfolio--remain ongoing. Commentators anticipate the FTC requiring as much as \$600 million in divestitures to clear the Teva/Allergan deal.

In November 2015, the FTC cleared Pfizer's \$16 billion acquisition of Hospira, Inc. after the parties agreed to divest assets related to four generic drugs. The FTC's required divestitures related to two alleged product markets where the parties were two of three (acetylcysteine inhalation solution) or two of four (clindamycin phosphate injection) current sellers. The FTC also required divestitures of two products based on concerns that future (*i.e.*, potential) competition would be harmed. Specifically, with regard to injectable voriconazole, Pfizer currently marketed a branded version and was expected to obtain and launch FDA approval for a generic version in May 2016. With regard to injectable melphalan hydrochloride, a drug used in conjunction with various chemotherapy treatments, the parties were the only companies with generic versions in late-stage development.

The FTC also required Endo International and Par Pharmaceuticals to divest generic drugs for treating ulcers and thyroid ailments as part of their \$8 billion merger. Endo and Par were the two foremost producers of the generic ulcer medication; and the merger would have reduced the number of competitors from four to three for the thyroid medication in question.

The FTC cleared Mylan N.V.'s acquisition of Perrigo Company plc in November 2015 after the parties agreed to divest four generic pharmaceuticals in which they already competed, as well as three other generic medications for which the Commission deemed the parties future competitors.

In keeping with the potential-competition theme in this space, the Commission required a remedy in Impax Laboratories Inc.'s \$700 million deal for CorePharma, LLC: the parties agreed to divest assets related to two different generic pharmaceuticals. In one, pilocarpine, the Commission alleged that the parties were the only two likely new entrants absent the proposed merger. Impax currently produces the other generic medication in question, ursodiol, and CorePharma is one of relatively few likely future entrants in a market that has suffered from supply shortages recently.

In June 2015, the FTC required Zimmer Holdings to divest overlapping products as a condition of clearing its \$13 billion acquisition of Biomet Inc. First, the parties divested knee implant and elbow implant products. In these markets, the FTC alleged that the transaction would have reduced the number of current competitors from three to two. Second, the Commission required divestiture of bone cement assets, after finding that the deal would have reduced the number of competitors in the relevant market from four to three.

Most recently, in February of this year the Commission required divestitures in two other mergers of marketers of generic drugs. Lupin Ltd. will be allowed to close its \$850 million acquisition of Gavis Pharmaceuticals LLC after agreeing to divest a pair of generic pharmaceuticals. The FTC alleged that the deal would have reduced the number of generic options from four to three for antibacterial drug doxycycline monohydrate, and that the parties were likely future competitors in the market for a generic ulcerative colitis medication called mesalamine. The Commission showed that no merger is

too small to attract antitrust scrutiny when it mandated that Hikma Pharmaceuticals PLC divest five generic drugs to remedy allegations its \$5 million acquisition of Ben Venue Laboratories would be anticompetitive. The five drugs in question treat a range of maladies, such as infections, hypertension, ulcers, and psychiatric and neurological disorders.

Notably, the Commission voted unanimously in each of these cases, reflecting the consensus within the agency regarding market definition and competition effects analysis in the pharmaceutical and medical device sectors.

## **The FTC Continues Vigorous Enforcement in Energy, Infrastructure, and Other Industries**

***Oil & Gas*** – In March 2015, the FTC announced that it had obtained a settlement in its challenge to the proposed \$107 million acquisition of Mid Pac Petroleum, LLC by Texas-based energy company Par Petroleum Corporation. In its Administrative Complaint, the FTC alleged that the proposed merger would reduce competition and lead to higher prices for bulk supply of Hawaii-grade gasoline blendstock. Under the final consent order, Par Petroleum was required to terminate its storage and throughput rights at a key gasoline terminal in Hawaii.

Just before the New Year, the FTC announced that ArcLight Energy agreed to divest its stake in four petroleum product terminals in Pennsylvania. ArcLight had purchased the Gulf Oil Limited Partnership from Cumberland Farms, which the FTC deemed anticompetitive.

In addition, the FTC's investigation of the proposed acquisition of Williams Companies, Inc. by Energy Transfer Equity, L.P. ("ETE") remains ongoing. According to ETE, the combined company will be one of the five largest global energy companies. The FTC issued a Second Request in December 2015.

***Infrastructure:*** In May 2015, the FTC announced that cement manufacturers Holcim Ltd. and Lafarge S.A. agreed to divest plants, terminals, and a quarry to settle FTC charges that their proposed \$25 billion merger creating the world's largest cement manufacturer would likely harm competition in the United States. According to the FTC's Complaint, the merger would have harmed competition in 12 markets where the two companies either were the only significant suppliers of cement or were two of, at most, four significant suppliers in the market.

***Automotive:*** Also in May 2015, the FTC reached a settlement requiring two of the world's largest auto parts suppliers, ZF Friedrichshafen AG and TRW Automotive Holdings Corp., to divest TRW's linkage and suspension business in North America and Europe as part of their proposed \$12.4 billion merger. The merging companies were two of only three North American suppliers of heavy vehicle tie rods.

***Tobacco:*** To resolve a closely watched transaction, tobacco companies Reynolds American Inc. and Lorillard Inc., the second- and third-largest US cigarette makers, agreed to divest four brands of cigarettes as part of their \$27.4 billion merger. The May 2015 order required Reynolds to divest the four brands to Imperial Tobacco Group, a tobacco manufacturer with a significant international

presence but a comparatively smaller presence in the United States. Significantly, the parties had proposed the divestiture to the FTC very early in its investigation, and negotiated with Imperial prior to announcing their deal. This strategy proved to be effective, although the FTC's prolonged investigation underscores the reality that early remedy proposals do not necessarily result in expedited clearance.

**Retail:** Following up on what we reported on the dollar store industry last year, in January 2015, Family Dollar shareholders approved Dollar Tree's \$8.5 billion takeover bid and rejected a \$9.1 billion bid from Dollar General, reasoning that the FTC would require divestiture of thousands of stores in a merger with Dollar General but only around 300 stores in a merger with Dollar Tree. Following shareholder approval, the FTC identified 330 stores in local markets across 35 states where competition would be lost if the acquisition went forward as proposed. On July 2, 2015, Dollar Tree agreed to sell the 330 Family Dollar stores to a private equity firm.

The Commission is also currently reviewing Walgreens' proposed \$17 billion purchase of Rite Aid. Walgreens and Rite Aid are the largest and third-largest retail pharmacy operators, respectively, in the United States. There are a variety of product markets the Commission will examine during its review, including local retail pharmacy markets, the market for the distribution of drugs billed by insurance companies, and other markets that may exist on a regional or national scale.

**Electronics:** In November, NXP Semiconductors N.V. agreed to sell its RF power amplifier assets to settle FTC charges that its proposed \$11.8 billion acquisition of Freescale Semiconductor Ltd. is anticompetitive. The companies were two of only three major worldwide suppliers of RF power amplifiers--semiconductors that amplify radio signals used to transmit information between electronic devices such as cellular base stations and mobile phones.

**Packaging:** The FTC issued Second Requests to fully evaluate Ball Corporation's proposed \$7.8 billion acquisition of Rexam PLC in April 2015. Rexam and Ball Corp. are two of only three major aluminum can manufacturers in the US market. The merger was recently approved by the Administrative Council for Economic Defense, Brazil's competition authority, with limited conditions and divestitures. Recent reports indicate that the EU is also likely to approve the deal following some additional recent concessions from Ball Corp. Neither Ball nor the FTC has issued a public statement regarding resolution of the FTC's investigation.

**Industrial Gases:** In the FTC's most recent merger remedy in May 2016, Air Liquide and Airgas obtained clearance for their \$13.4 billion merger after agreeing to divest commercial gas production and distribution facilities that pertain to seven different commodities in numerous geographic markets. The FTC emphasized that the markets for these particular products – such as oxygen gas and dry ice – are already concentrated and that the barriers to new entry are high. In sum, the parties agreed to divest 18 Air Liquide facilities and seven Airgas facilities across the country.

## **Both the DOJ and the FTC Require Increasingly Demanding Remedies**

The leadership at both the DOJ and FTC have made it clear that they will require robust remedies to resolve any competitive concerns from mergers and acquisitions. In a speech in February 2015,

Assistant Attorney General Bill Baer explained that the Division had filed complaints against the AB InBev/Grupo Model and the USAir/American Airlines mergers because the parties had failed to put forward remedies that the DOJ believed would preserve competition in the industries at issue. Baer explained that in both cases, the DOJ was only willing to settle the cases after the parties had offered substantially greater remedies than they had prior to DOJ's initiating the lawsuits.

Both agencies have continued to reject remedy packages that they view as inadequate, even when it means litigation. In each of the major litigations discussed above – *Sysco*, *Staples*, and *Halliburton* – the merging parties offered to divest substantial portions of their businesses before the agency filed its complaint. The agencies rejected these packages as insufficient to ensure that the level of post-merger competition (including innovation competition) would remain robust. As AAG Baer remarked at a press conference announcing the *Halliburton* complaint:

Halliburton wants the United States to agree to the most complicated array of piecemeal divestitures and entanglements that I have ever seen. Halliburton's various proposals – and those have been a moving target – involve selling a grab bag of assets in certain product lines. . . . At the end of the day, Halliburton's purported settlement would eliminate a formidable rival – Baker Hughes – and replace it with a smaller, weaker rival that is not the equivalent of Baker Hughes today.

These and other comments by agency leaders underscore the stricter scrutiny remedy proposals have received in recent years, particularly where the divestiture package (i) spans multiple business lines, (ii) is national or global in scope, (iii) requires that the merged firm provide extensive long-term support services, (iv) does not identify a buyer or includes a buyer with inadequate scale and resources, and (v) requires the agency to devote substantial resources over many years to supervise.

The DOJ also demonstrated that in certain cases it would require the parties to consummated mergers to disgorge what DOJ views as unlawful profits from an anticompetitive transaction. In March 2015, the DOJ and the New York State Attorney General settled the long-running investigation into *Twin America*, the joint venture between Coach USA Inc. and City Sights LLC, created in 2009. The lawsuit, which was filed in 2012, centered on hop-on, hop-off bus tours in New York City. The DOJ and NY AG alleged that *Twin America* had a monopoly over the hop-on, hop-off bus tour market in New York City and that the transaction had enabled *Twin America* to raise ticket prices by 10%. The settlement required the parties to divest all of City Sight's Manhattan bus stop authorizations and disgorge \$7.5 million in profits from the joint venture.

We noted in last year's Update that the FTC had announced a second merger remedy retrospective, following on the heels of the Commission's similar 1999 study. That effort has undergone the notice and comment process and is now underway. The Commission is gathering data from various parties--both voluntarily and by the use of compulsory process--and we expect the study to be released in late 2016 or 2017. We believe that the study is an integral component of a broader FTC effort to obtain more robust (and correspondingly onerous) merger remedies, including by requiring parties to divest more assets, provide more substantial transition services, and take various other steps to ensure that buyers are positioned to succeed in selling (or developing) the divestiture product(s).

## **The DOJ and the FTC Hold the Line on Merger Reporting Requirements**

The agencies have continued to prosecute parties who failed to file the proper HSR notifications, regardless of whether the underlying transaction raised substantive antitrust issues. In April, DOJ filed a lawsuit against ValueAct seeking fines of at least \$19 million – a record for an HSR Act violation – for failing to file before acquiring shares of Halliburton and Baker Hughes. As detailed above, Halliburton and Baker Hughes abandoned their proposed merger following a separate antitrust lawsuit from the DOJ. ValueAct allegedly purchased shares in both companies "with the intent to influence the companies' business decisions as the merger unfolded," and as a consequence its purchases did not qualify for the "investment-only" exemption to HSR's notification requirements. This lawsuit follows a string of cases brought by the DOJ and FTC in recent years against activist investors that are alleged to have improperly claimed the investment-only exemption.

In September 2015, the DOJ fined Leucadia National Corp. \$240,000 for violating the premerger notification rules by improperly relying on the institutional investor exemption when it acquired shares in KCG Holdings, Inc. in July 2013. Similarly, in October 2015, the DOJ fined Len Blavatnik \$656,000 for violating the premerger notification rules when he acquired shares in TangoMe, Inc. in August 2014. Mr. Blavatnik purchased shares that brought his stake above the reporting threshold and failed to report the transaction. The multi-year gaps between the violation and DOJ prosecution underscores that the DOJ will seek penalties for failures to comply with the HSR Act whenever it learns about the violation.

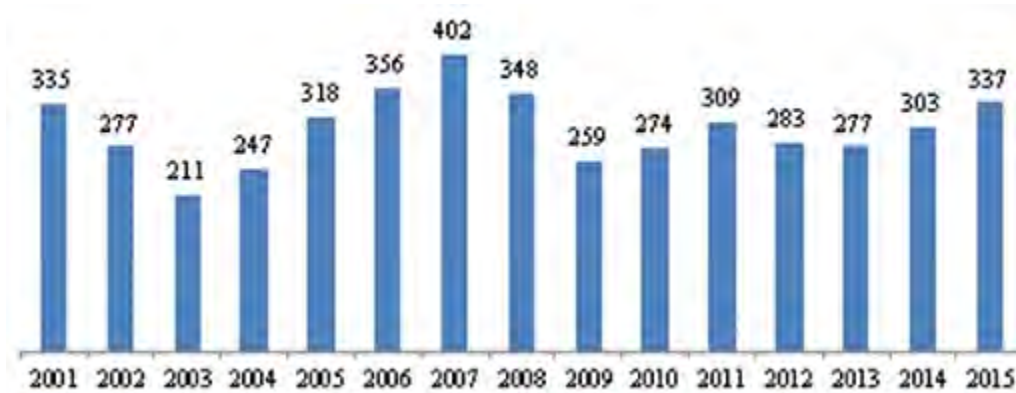
The Commission made a point of enforcing the reporting requirements of the Hart-Scott-Rodino Act, securing nearly \$900,000 in fines for two separate alleged violations. A year after fining Berkshire Hathaway nearly \$900,000, the Commission fined a holding company \$240,000 for failing to report a new investment--its second HSR violation since 2007. In October 2015, famed investor Len Blavatnik and his company paid a \$656,000 fine for a similar violation, which came on the heels of a prior violation in 2010. These actions, which both involved unintentional violations of the HSR Act's reporting requirements, reflect the seriousness with which the FTC polices its review process even where the transaction at issue does not pose antitrust concerns.

## **THE EUROPEAN UNION**

### **Increasing Number of Notifications and Tendency to Initiate In-Depth ("Phase II") Investigations**

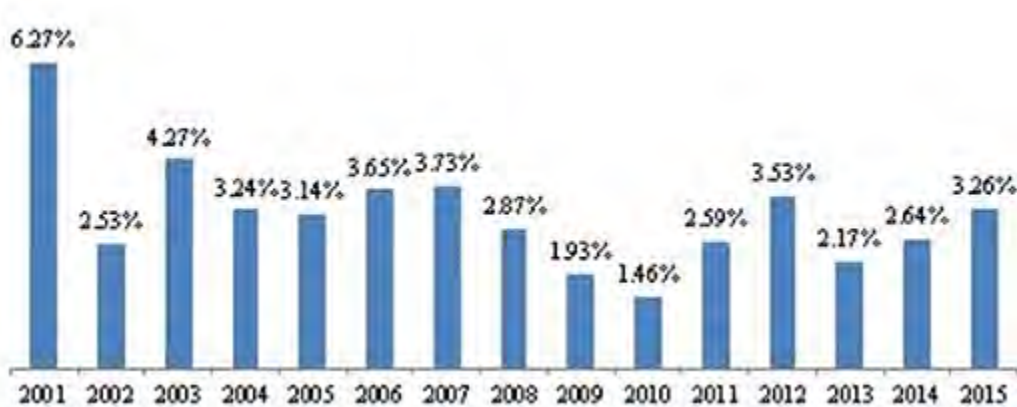
Shortly after the financial crisis brought an end to the last merger wave, there was an apparent decline in the number of mergers notified to the European Commission (with the number of notified transactions falling from 402 in 2007 to 259 in 2009). However, as of Q3 and Q4 of 2014, M&A activity in the EU has reached very high levels again, with the number of notified transactions growing from 277 in 2013 to 303 in 2014 and up to 337 in 2015. Consistent with this trend, 62 notifications had already been filed in 2016 by the end of the month of February.

## Mergers Notified at EU Level 2001-2015



The trend towards greater scrutiny of notified transactions, which arguably commenced in 2011, has continued apace throughout the year in 2015. Over the course of 2015, the Commission has initiated 11 in-depth (Phase II) investigations, which reflects a record high since the year 2007. Over the past five years, the rate at which M&A transactions have triggered an in-depth investigation has more than doubled, from 1.46% in 2010 to 3.26% in 2015. Despite this increasing level of scrutiny, Competition Commissioner Vestager has yet to block her first merger, although notifying parties have decided to terminate their proposed mergers in at least two high-profile situations.

## Percentage of Reported Transactions Resulting in Phase II Investigation



The appetite for mergers in the telecommunications industry in the EU remained undiminished over the course of 2015, even in the face of what appears to be a hardening of approach by the Commission to the review of mergers in the sector. There has also been an increasing amount of activity in the oil exploration industry recently, largely in response to the dramatically changed economic circumstances in which the sector finds itself. Finally, there is a continued interest in consolidation in the pharmaceutical sector, with the *Zimmer/Biomed* and *GlaxoSmithKline/Novartis* transactions being the main examples in 2015.

The Commission has continued its established preference for the use of structural remedies and the identification of up-front buyers as the basis for addressing identified theories of harm flowing from notified mergers (as reported in our [2015 Antitrust Merger Enforcement Update and Outlook](#)), with the divestiture of viable businesses to a suitable purchaser remaining the preferred remedy.

The Commission's desire to review high profile mergers was given even greater impetus when, on 10 March 2016, Commissioner Vestager signaled her Directorate's intention to consider the review of mergers by reference to the value of the deal, rather than simply on the basis of its traditional annual revenue thresholds test.

## **In Depth (Phase II) Investigations in 2015 / 2016**

### *Phase II Clearances*

#### **2015**

The Commission cleared eight proposed transactions in 2015 after in-depth (Phase II) investigations, only one of which was cleared without any conditions attached. In the first two months of 2016, the Commission has cleared another four notified concentrations that were subject to Phase II investigations, with one being cleared unconditionally. Merger activity in the electronic communications sector escalated even further in 2015, and is subject to a separate discussion below.

After an in-depth investigation, the Commission cleared unconditionally the proposed acquisition of US corporation **Dresser-Rand** by Germany's **Siemens**. Both companies supply a range of turbo compressors as well as their "drivers", which take different forms, such as aero-derivative gas turbines ("ADGT"), industrial gas turbines ("IGT"), steam turbines and electric motors. The combination of a compressor with a driver (which creates a "turbo compressor train") is widely used for various applications in the oil and gas industry. The Commission initially had concerns that the transaction would lead to less product variety and to higher prices by reducing the number of significant suppliers of ADGT-driven turbo compressor trains from three to two. In addition, the parties' competitors for the supply of small steam turbines had a limited presence and might not pose a significant competitive constraint on the merged entity.

The Commission's investigation revealed that, as regards ADGT-driven compressor trains, the activities of Dresser-Rand and Siemens were largely complementary, as they focused on different oil and gas applications. This was demonstrated by the fact that they were found to have bid rarely against each other in tender bids. In addition, the ADGT-driven compressor trains were found to be largely substitutable with light IGT-driven compressor trains, where the parties faced strong competition from entities such as Solar and GE. With regard to small steam turbines, the investigation again demonstrated that the two companies were not close competitors, given that their activities were largely complementary and they faced strong competition from other major suppliers. Moreover, not only were a number of smaller competitors already active in the small steam turbine market which were capable of expanding their production, but additional producers could also enter the market.



The acquisition of **Biomet** by **Zimmer Holdings** (both orthopedic implant producers for knees and elbows from the United States) was cleared subject to commitments. The Commission was concerned that the merger would lead to less innovation and choice (in what was in effect a 5-to-4 merger), as well as to price increases, since the transaction would combine two leading orthopedic implants manufacturers which collectively had significant market power in a large number of EEA countries. By contrast, the size of other competitors on the relevant affected markets was small and there were relatively high entry barriers.

To address these concerns, Zimmer offered an extensive remedy package, whereby it would divest: (i) its knee and elbow businesses across the EEA; and (ii) Biomet's knee business in Denmark and Sweden. These divestures were to be accompanied by corresponding instrumentation, improvements and pipeline projects. The parties would also divest IP rights, know-how and customer contracts, as well as committing to supply the businesses' product lines on reasonable conditions for a transitional period. Moreover, the purchaser of the Biomet knee business was to be granted an EEA-wide licence to the rights and know-how used to manufacture and sell exact copies of the knee implant. The companies also committed not to implement the transaction before one or more suitable purchasers were found.

The Commission approved the joint venture between two of the world's leading coffee manufacturers - **DEMB** of The Netherlands and **Mondel  z** of the US – subject to commitments. Concerns were expressed that the transaction, as initially notified, would have led to price increases in roast and ground coffee products, as well as in filter pads. The transaction would combine all material assets of DEMB and the coffee business of Mondel  z. The joint venture would therefore be active across all coffee formats, including filter pads, discs and capsules for different single-serve coffee machines. Concerns were raised in relation to markets where the transaction would bring together consumer brands which competed closely against each another, as the remaining companies on the market would not be able to exert sufficient competitive pressure on the joint venture to avoid price increases.

To address these concerns, the parties offered to divest the Carte Noire business, together with manufacturing plants in France, and the Merrild business in Denmark and Latvia, as well as to license for the purpose of re-branding the Senseo brand so as to remove concerns in Austria. The Commission was also initially concerned that the joint venture could lead to higher prices and less innovation by bringing together the parties' single-serve system of capsules and pods, as they could influence the price paid for single-serve coffee machines. However the in-depth investigation revealed these concerns were unfounded once the divestures were implemented.

The Commission approved a joint venture for online music licensing between three collective rights management organisations ("CMOs"): Britain's **PRSfM**, Sweden's **STIM**, and Germany's **GEMA**, subject to commitments. CMOs manage the copyright of authors, performers and writers of musical works and grant licences on their behalf. There were concerns that the creation of the joint venture would render more difficult the task of other collecting societies to offer copyright administration services, by raising barriers to entry and expansion in the market. This was because the joint venture could bundle different types of copyright administration services and make it difficult for customers of

its database to port their data to a competitor. Moreover, it might require its customers not to source their copyright administration services from any other third party. This would result in higher prices and worse commercial conditions for digital service providers ("DSPs"), resulting ultimately in less choice and higher prices for European consumers of digital music.

To address the Commission's concerns, the parties committed not to use the joint venture's control over performing rights to force their customers to purchase copyright administration services from it. In addition, the joint venture would offer key copyright administration services to other collecting societies on terms that are fair, reasonable and non-discriminatory when compared to the terms offered to the parent companies, as well as allowing collecting societies to terminate their contracts at any time (thereby allowing them to switch to other database providers). Finally, the joint venture committed not to enter into exclusive contracts with its customers for copyright administration services other than in relation to database services. The Commission considers that these commitments will ensure that the market for copyright administration services provided to CMOs and "option 3" publishers remains contestable, as they will remove PRSfM's ability to use its performing rights to force CMOs or option 3 publishers to use the services of the joint venture and they will also enable CMOs to switch from the joint venture to another CMO that offers copyright administration services.

In July 2015, the Commission approved the acquisition of **Archer Daniels Midland** ("ADM") Chocolate by **Cargill**, subject to conditions. The Commission opened a Phase II investigation in February 2015, focusing on competition in industrial chocolate markets. Both companies supply industrial chocolate, as well as fat-based coatings and fillings and are important suppliers of industrial chocolate to customers based around their plants in Germany. The Commission considered that the transaction would reduce competition, as the number of main competitors would be reduced from three to two, with smaller competitors not being able to exert a sufficient competitive constraint on the parties. The Commission also stated that the market structure is different in the areas around the parties' plants in Belgium, France and the United Kingdom (the parties' combined market share in these countries is smaller and Barry Callebaut is a much more important competitor). With regard to the cocoa market, which the Commission considered to be a related market as cocoa is used as a raw material for industrial chocolate, the Commission concluded that Cargill's position in cocoa markets was not significant and there were sufficient alternative suppliers. Cargill offered commitments according to which it would divest ADM's industrial chocolate plant in Mannheim to a suitable purchaser, as this plant is one of the largest ADM plants in Europe and its only industrial chocolate plant in Germany. The commitment thus ensures that an important alternative supplier will remain available.

In September 2015, following an in-depth review by the Commission, approval was granted for **GE's** acquisition of **Alstom**, subject to the divestiture of key elements of Alstom's heavy-duty gas turbines business. Both companies are active in the market for heavy-duty gas turbines, which are mainly used in gas-fired power plants. The Commission expressed concern that the transaction would eliminate competition between GE and Alstom in that market, and identified the parties as two of four competitors (*i.e.*, GE, Mitsubishi Hitachi Power Systems (MHPS), Siemens, and Alstom). The parties offered commitments in order to address the EC's concerns, focusing mainly on the divestiture of: (i) Alstom's heavy-duty gas turbine technology for the GT 26 and GT 36 turbines, existing upgrades and

pipeline technology for future upgrades, excluding essentially only the technology for Alstom's older GT 13 model in relation to which the Commission had no competition concerns; (ii) Alstom's key personnel (R&D engineers); (iii) two test facilities for the GT 26 and GT 36 turbine models in Switzerland; and (iv) Alstom's PSM servicing business based in Florida. GE proposed that Ansaldo, an Italian competitor in the heavy gas turbine market, be the purchaser for the assets. According to GE, Ansaldo already had the know-how and a factory for gas turbines and other power plants components (as steam turbines and generators) that are often sold together with heavy-duty gas turbines. The Commission concluded that the commitment would allow the purchaser to replicate Alstom's previous role in the market, thus maintaining effective competition. Given the global reach of the parties' activities, the Commission cooperated with the competition authorities of a number of countries, such as the DOJ in the US, along with the respective competition agencies of Canada, China, Brazil, South Africa and Israel.

## 2016

In July 2015, the Commission opened an in-depth investigation into the proposed acquisition of **TNT Express** by **FedEx**. The companies are two of the four global "integrators" said to be active in the European small package delivery sector. Integrators are companies that control a comprehensive air and road delivery network in many parts of the world (including the EEA) capable of offering a broad portfolio of small package delivery services. The Commission was concerned that, on a number of European markets for international express and regular small package deliveries (for destinations within and outside the EEA), the merged entity would face insufficient competitive constraints from the remaining integrators (namely, UPS and DHL), which might eventually result in higher prices.

After an in-depth investigation, the transaction was authorised unconditionally, because FedEx and TNT were deemed to be not particularly close competitors and because the merged entity would continue to face sufficient competition from its rivals in all the relevant markets concerned. The investigation concluded that, within the EEA, FedEx still exerts a weaker competitive constraint on other integrators due to the lack of density and scale of its European network and that, outside the EEA, TNT is not a strong competitor to the other integrators. These conclusions were said to be supported by a Price Concentration Analysis, which was supposedly conducted in terms consistent with the Commission's approach in the UPS/TNT case that was discussed in our 2014 Antitrust Merger Enforcement Update and Outlook. In addition, the Commission took into account merger-specific efficiencies put forth by the parties. The transaction was thus authorised unconditionally on 8 January, 2016.

In January 2016, the Commission cleared the acquisition of the UK-based beverage can manufacturer **Rexam** by the US-based **Ball**. Rexam is a UK-based company that is also active worldwide in beverage can manufacture. Ball is a US-based company active worldwide in the production and supply of metal packaging for beverages, food and household products and in the design, development and manufacture of aerospace systems. Rexam and Ball are, respectively, the largest and second-largest beverage can manufacturers, with both entities owning the most extensive network of plants across the EEA. The Commission opened an in-depth investigation in July 2015, due to its initial concerns that the proposed transaction might reduce competition in the beverage can and aluminum

bottle manufacturing industry in the EEA. The Commission considered that the remaining two suppliers (Can-Pack and Crown) would not pose a sufficient competitive constraint on the merged entity. In addition, the Commission has found that the industry is characterised by high barriers to entry, primarily because of economies of scale. In order to address the Commission's concerns, Ball committed to the divestiture of ten plants manufacturing can bodies and two plants making can ends to a suitable purchaser, thereby ensuring that an important alternative supplier would constrain the merged entity. The divestiture consists of most of Ball's Metal Beverage Packaging activities in Europe and two of Rexam's can-body plants. The business to be divested will have a total manufacturing capacity in the EEA of over 18 billion cans.

In September 2015, the Commission opened an in-depth investigation into the acquisition of office supplies distributor **Office Depot** by its competitor **Staples**, both from the US. Both parties are active in the distribution of office products via a number of sales channels and are two of the three largest suppliers of office products for business customers in Europe. The Commission's preliminary investigation indicated potential competition concerns that could lead to price increases and less choice in the market for the supply of office products to business customers through international contracts in the EEA, as well as in the market for the supply of office products to business customers through national contracts in the Netherlands and Sweden. According to the Commission, its Phase II investigation confirmed that the proposed transaction would have critically reduced competition in an already highly concentrated market. The Commission also found that barriers to enter the office supplies contract market were high. In February 2016, the Commission authorised the transaction conditional upon: (i) the divestiture of the whole of Office Depot's contract distribution business in the EEA and Switzerland; and (ii) the divestiture of Office Depot's entire business operations in Sweden. These commitments were deemed sufficient to remove in their entirety the problematic overlaps between the merging companies, with the clearance being made conditional upon the Commission approving the divestitures to a suitable purchaser.

## **Withdrawn Transactions**

In September 2015, the Commission opened an in-depth investigation to assess whether the proposed acquisition by **Mondi** of two industrial packaging plants owned by **Walki** raised competition concerns. Mondi and Walki are two leading suppliers of wrapping materials in the EEA. According to the Commission, the proposed acquisition could result in less choice and higher prices for consumers of wrapping materials, as it entailed the removal of a key competitor, with the remaining competitors being arguably unable to exert a sufficient competitive constraint. For this reason, Mondi and Walki started discussions with the European Commission in order to craft remedies that would eliminate competition concerns. However, as by December 2015, no workable solution had been found by the parties, with Mondi deciding to withdraw its notification and to terminate the acquisition agreement.

In January 2016, a Phase II investigation was opened in the proposed acquisition of oilfield service supplier **Baker Hughes** by rival **Halliburton**. The merging parties supply a broad range of services for the drilling and production of oil and gas wells. Three months later, as discussed above, the parties abandoned the transaction in the wake of a lawsuit filed by the U.S. DOJ. The Commission's statement following the termination of the merger noted that the merger "raised competition concerns on a very

large number of markets relating to oilfield services . . . in the EEA." At the time it was abandoned, the merger also faced opposition from the authorities in Brazil and Australia.

Refer also to the *TeliaSonera/Telenor* case below.

## Ongoing Investigations

As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, the Commission opened an in-depth investigation into the proposed acquisition of a majority stake (66%) in the Greek gas transmission system, DESFA, by the State Oil Company of Azerbaijan Republic ("SOCAR") in November 2014. SOCAR operates and performs activities which include the production of natural gas and the upstream wholesale sale of gas in Greece. The entity being acquired, DESFA, owns and directs the only high-pressure gas transmission pipeline in Greece, including its only existing Liquefied natural gas ("LNG") terminal, while mainly transporting gas through its network and not over the network facilities of competitors. As a result of SOCAR's minority shareholdings in various gas pipelines, concerns have arisen as to whether the transaction might allow the merged entity to hinder the access of SOCAR's competitors to the Greek gas transmission network (*i.e.*, seeking to reduce competition on the upstream wholesale gas market) by strategically limiting investments in future expansions of import capacity, including an expansion of the LNG Terminal and the interconnection of the TAP pipeline (which has recently received EU State aid approval) with DESFA's network. In addition, the merged entity could restrict inflows of gas into Greece by managing the gas transmission network in a discriminatory manner which favours SOCAR's supplies over those of its competitors.

The Commission has concluded that the transposed Greek national regulatory framework would be unlikely under the circumstances to prevent the identified potential harm from occurring, thereby eliminating the ability of actual or potential competitors from competing effectively. The procedural clock for review was stopped in January 2015 and has not been resumed since that time. It is speculated that SOCAR will have to propose remedies to allow the proposed takeover to be approved by the Commission, although additional complications will have inevitably arisen in relation to SOCAR's potential controlling interest in an EU energy operator, given its non-EU origins.

In February 2016, the Commission opened an in-depth Phase II investigation into the proposed acquisition of Arianespace by Airbus Safran Launchers ("ASL"). Arianespace is the global leader for launches of commercial satellites to geostationary transfer orbits. It has a *de facto* monopoly in the European markets for institutional launches and is entrusted by the European Space Agency ("ESA") with the commercial exploitation of the two ESA-funded launchers, Ariane and Vega. ASL is a 50/50 joint venture between Airbus and Safran. Airbus is one of the leading global manufacturers of satellites, sub-systems for launchers and satellite operations for telecommunications and Earth observation satellites, while Safran is active in the provision of aerospace propulsion, aircraft equipment and defence and security.

According to the Commission, the transaction might lead the merged entity to discriminate on price against satellite manufacturers competing with Airbus, thereby reducing the incentives of Airbus' rivals to innovate and invest in satellite manufacturing. As regards the launch services market, post-merger

ASL might give priority to launch services connected to Ariane launchers, since ASL produces this launcher. The Commission is also concerned by the fact that the merged entity might procure payload adapters and dispensers exclusively from Airbus and ASL, irrespective of the price and quantity offered by competitors leading to potentially higher prices and less research and development in these services markets. The Commission has decision deadline of 10 August 2016.

## **Other High-Profile EU Investigations in 2015**

The Commission has approved, unconditionally or subject to commitments, several high-profile transactions notified in 2015, without opening an in-depth Phase II investigation.

The Commission granted conditional clearance to two acquisitions made by **GlaxoSmithKline plc** ("GSK") over the course of a three-part inter-related deal between **GSK** and **Novartis AG** ("Novartis"). GSK and Novartis are active worldwide in the research, manufacturing and supply of pharmaceuticals, vaccines and consumer health products. First, the Commission cleared the acquisition of sole control by GSK of Novartis' global human vaccines business (excluding influenza vaccines), as well as creation of a new entity combining the consumer health activities of GSK and Novartis under the sole control of GSK. In a separate Decision, the Commission approved the acquisition of GSK's oncology business by Novartis.

The market investigation showed that the first transaction would have eliminated an important competitor to GSK for the supply of several vaccines and consumer health products, which might have led to price increases for European consumers, given that GSK and Novartis were the only suppliers of vaccines for bacterial meningitis in the EEA (*i.e.*, the creation of a monopoly). In addition, GSK and Novartis were competing suppliers of bivalent vaccines for diphtheria and tetanus in Germany and Italy, where the remaining players would be unable to sufficiently constrain the merged entity. As regards consumer health activities, the Commission concluded that the proposed transaction would have combined key branded products, such as those relating to smoking cessation aids, cold sore management products, cold and flu products, as well as pain management products, which might have led to price increases for consumers. In addition, the second transaction would have reduced competition and innovation for certain cancer treatment products after eliminating GSK as a competitor. In order to address the Commission's concerns in the latter case, the parties committed to divesting assets in their vaccines and consumer health businesses, as well as to grant licences and enter into distribution agreements. As regards cancer treatment products, clearance was made conditional upon certain divestiture commitments being made, along with the relinquishment of licences for certain cancer treatments.

In May 2015, the Commission approved the acquisition of sole control of **Eurostar International Limited** ("Eurostar") by **SNCF MOBILITES** ("SNCF"), the French rail operator. Since 2010, Eurostar has operated as a full-function joint venture controlled jointly by SNCF and the UK Government. Clearance was made conditional upon compliance with commitments providing for fair access of new entrants to: (i) standard and cross-Channel areas and services, such as ticket offices; (ii) maintenance centers in France, the UK and Belgium currently managed by SNCF, Eurostar and SNCB (the Belgian national railway) for services such as overnight storage, servicing and cleaning of trains;

and (iii) access to train paths that are currently being used by Eurostar at peak times. These commitments would supposedly reduce barriers to entry for new operators offering international rail passenger transport services on the London-Paris and London-Brussels routes.

The Commission cleared the transaction between **Royal Dutch Shell** ("Shell") and **BG Group** ("BG") despite initial competitive concerns that, post-merger, Shell would benefit from market power in: (i) oil and gas exploration; (ii) the liquefaction of gas; and (iii) the wholesale supply of liquefied natural gas ("LNG"). The Commission's investigation showed that Shell would be faced with a number of strong competitors that would remain active in the identified markets after the merger. It was therefore concluded that the takeover would not allow Shell to influence prices and that these markets would remain competitive post-merger. Moreover, the merged entity would be unlikely to prevent competitors from accessing some of Shell's LNG liquefaction facilities used to supply LNG into the EEA or from its natural gas transportation and processing infrastructure in the North Sea. This was mainly due to significant additional liquefaction capacity being built and coming on-stream post-merger with significant spare oil and gas transport and processing capacity already existing in the North Sea region.

Further to close cooperation with the US Federal Trade Commission, the European Commission approved the proposed acquisition of data storage manufacturer **SanDisk** by rival **Western Digital** after concluding that the takeover would not adversely affect competition in Europe. The investigation showed that, despite the merged entity's relatively high combined share in the market for enterprise space for flash memory storage solutions, strong established players such as Intel, Toshiba, Micron and Samsung would continue to exert competitive pressure on the merged entity. The Commission also investigated the vertical link between SanDisk's activities in the production of flash memory and the downstream markets for which flash memory was an essential input, concluding that the merged entity would be unable to foreclose competitors from access to flash memory and that competing producers of flash memory would still have a sufficient customer base to address, given SanDisk's limited market share and the presence of several established competitors upstream.

In January 2016, the Commission approved the acquisition of **Cameron** by **Schlumberger**. Schlumberger provides services supplying technology, information solutions and integrated project management for oil and gas customers, as well as oilfield products, while Cameron provides drilling systems and topside process systems used on oil, gas and process platforms above sea level. According to the Commission, the proposed acquisition would not raise competition concerns, as there were limited overlaps between the companies' activities. Moreover, even where horizontal overlaps were identified, the incremental changes in market shares brought about by the transaction were negligible. OneSubsea, a JV formed in 2013 between Cameron and Schlumberger and granted clearance in its own right by the Commission, was active in the supply of products and services for subsea oil and sea production. Cameron's stake in the OneSubsea JV was also part of the transaction, but raised no additional vertical issues beyond those already addressed by the Commission in its initial review of the JV in 2015.

## **European Commission Policy and Procedural Reforms**

With the aim of intervening to the least extent possible while efficiently maintaining the competitive structure of markets, the Commission adopted a White Paper towards the achievement of more effective merger control in July 2014. The White Paper contains proposals that would allow the Commission to better deal with non-controlling minority shareholdings which may affect competition, as well as making referral procedures simpler and faster. On the basis of comments received during the public consultation for the White Paper, Commission policy along a range of policy fronts is emerging.

### *Possible Changes in the Merger Thresholds*

In March 2016, the EU Commissioner for Competition Margrethe Vestager remarked that changes might take place with regard to the "simplified procedure" for deals that are unlikely to raise competition concerns. The Commissioner considers that because a successful merger control has to be very selective, mergers that are "very unlikely" to restrain competition should face less burdensome reviews before the European Commission.

The Commissioner however stated that, after extensive consideration, DG Competition has decided to carry out further studies with respect to extension of the existing merger control regime to acquisitions of minority shareholdings. This implies that for the moment, no such procedural changes are to be proposed; however, upon collection of compelling evidence that such system could run smoothly at the European level (and not only at a national level), steps in that direction might be taken in the future.

With respect to potential changes of the notification thresholds, Vestager clarified that it may be necessary to take into account criteria other than turnover in order to judge the size and impact of a deal. For instance, Facebook's \$19 billion acquisition of WhatsApp was outside the scope of EU Merger Regulation on the grounds of WhatsApp's revenues at the time being under the notification threshold. This example illustrates that what incentivises companies to merge might also be assets, a customer base or even a set of data. In the pharmaceutical sector, it might be a new drug that's been developed but not yet approved for sale, or simply the ability to innovate. A merger involving this sort of company could clearly affect competition, even though its turnover might not be high enough to meet the notification thresholds.

### *Geographic Markets*

A recent study conducted for the Commission has sought to address some of the criticism that has arisen that the Commission's approach towards the adoption of geographic market definitions may be too narrow. Since a transaction is less likely to give rise to concerns in a wider geographic market, given that the merging parties' shares are likely to be lower, the adoption of such narrow geographic market definitions tends to have the effect of amplifying competition concerns beyond what may be strictly necessary. Given that many companies today operate on a global scale and compete with a variety of suppliers in different parts of the world, it is felt that a more expansive approach to geographic market definition should be taken.



In 2015, only 30% of all geographic markets were defined by the Commission as national in scope. In the retail telecommunications sector, however, the Commission has always defined the market as national, despite the mobile network operators operating on a pan-European or even on a global level. The Commission has consistently held that this is due not only to regulatory requirements and spectrum allocations at a national level, but also due to consumer preferences which affect the way mobile operators compete on the market. In *Orange/Jazztel*, for instance, the Commission concluded that the relevant geographic market was national, whereas it left the precise delineation of the relevant product market open as it considered the proposed commitments addressed its concerns adequately, regardless of the product market definition.

Moreover, in *Zimmer/Biomet*, the Commission also concluded that the geographic markets for orthopaedic medical devices were national in scope, notably due to the fact that market structures differed from country to country (in light, for example, of different public reimbursement systems and hospital purchasing behaviour), but also due to the importance of local/national sales forces.

The Commission has, *inter alia*, repeatedly held that regulation plays a significant role in market definitions, especially in liberalised sectors. The creation of a digital single market, for example, which is one of the priorities of the Juncker Commission and which intends to break down national barriers through telecommunications regulation, copyright and data protection and in the management of radio spectrum, could therefore have significant impact on how market definitions are approached in the future.

In *Cargill/ADM*, the Commission carried out a market reconstruction in addition to the performance of its classic market definition exercise, as regards the question of the extent to which competition was national, regional or EEA-wide, depending largely on the characteristics of the product. By obtaining transaction-level data, the Commission reconstructed the market and rejected the notifying party's argument that the relevant geographic market was EEA-wide. Interestingly, the Commission did not reach a final conclusion in that regard, but merely stated that the transaction resulted in a significant impediment to effective competition both on national markets, as well as geographic markets delineated based on identified catchment areas, while ultimately leaving open the relevant geographic market definition.

By contrast, where the products or services are purchased by customers on a global scale, such as information technology products, natural resources and mining or avionics, the Commission has identified global markets. Indeed, the number of Decisions which defined EEA or even wider geographic markets shifted from 48% in 2004 to 61% by 2013. For instance, when *Western Digital*, a manufacturer of hard disk drivers for use in computers, acquired the competing business *Hitachi* back in 2011, the Commission identified a global market. Given that customers, in particular computer manufacturers, source hard disk drivers on a global basis, the prices for hard disk drivers are broadly similar on the different continents, and customer needs do not vary significantly between regions.

## Merger Activity in the Telecommunications Sector

The Commission's approach towards telecommunications sector mergers has reached a critical stage, reflecting increasing concerns with mergers that result in less than four network-based players in the mobile sector, and possibly even in the fixed sector. These concerns have been expressed in the application of the "Substantial Lessening of Effective Competition" test for so-called "gap" cases, as opposed to its legal predecessor (the creation or strengthening of a 'Dominant Position' test), which seeks to address the range of competition concerns that might arise from the loss of competition between parties identified as "close" competitors.

In December 2014, a Phase II investigation was opened into the proposed acquisition of **Jazztel plc** by **Orange, S.A.** The Commission believed that the proposed transaction would reduce the number of nationwide providers of fixed telecommunications services in Spain from four to three. While the merged entity would not hold a dominant position, there were concerns that the proposed transaction could lead to a significant loss of competitive pressure for fixed Internet access services and fixed-mobile multi-play or converged offers. The Commission's Statement of Objections concluded that: (i) the merged entity would have had fewer incentives to compete aggressively against the remaining operators; (ii) the major competitors (Telefónica and Vodafone) would have been unlikely to replace the competitive pressure formerly exercised by Orange and Jazztel because they would also have benefited from the reduced pricing pressure; (iii) new entrants would be faced with significant difficulties due to the high investments required to enter the retail markets involving fixed Internet access services; and (iv) end consumers would have no countervailing buyer power.

Following the in-depth investigation and commitments submitted by the parties designed to remove the Commission's perceived need to promote viable network-based entry, the Commission approved the transaction in May 2015. In doing so, it took into account the fact that Orange and Jazztel's offers for the provision of mobile telecommunication services were complementary in nature and could lead to efficiencies which would benefit consumers. Although these efficiencies reduced the anticompetitive effects of the transaction, the Commission concluded that the loss of competition caused by the merger would still remain significant. The commitments submitted by Orange were based on *two* different technologies: (i) an optical fibre network, according to which Orange committed to divest an independent high speed Fibre-To-The-Home ("FTTH") network (including wholesale access to its mobile network, including 4G services covering 13 urban districts located in five of the largest Spanish cities); and (ii) a copper network. The new player would be able to compete aggressively against Orange and Jazztel; Orange was committed to granting the purchaser of the FTTH network wholesale access to Jazztel's national ADSL network for up to eight years, for an unlimited number of subscribers, while allowing the purchaser of the assets to compete immediately over 78% of Spanish territory.

On 24 February 2015, after the opening of a Phase II investigation on 22 September 2014, the Commission authorised **Liberty Global's** acquisition of the Belgian media company **De Vijver Media NV** ("De Vijver"), subject to commitments. The Commission's initial concerns were that, post-transaction, De Vijver would refuse to license its channels (Vier and Vijf) to TV distributors competing with Telenet (a cable company controlled by Liberty Global). It was concluded that TV

distributors in Belgium (both in Flanders and Brussels) must have Vier and Vijf in their offer in order to compete with Telenet. It would be profitable for Telenet and De Vijver to withhold popular channels from competitors such as Belgacom and TV Vlaanderen. As a result of not having access to these popular regional channels, the latter and the former would find it harder to attract and retain customers without those channels, while new entrants such as Mobistar would not be able to enter the market at all (*i.e.*, resulting in less competition in the TV distribution market that could possibly lead to higher prices and less innovation for consumers).

In addition, the Commission's investigation revealed that Telenet could disadvantage the channels and programmes of Medialaan and VRT discreetly (*e.g.*, by displaying their video-on-demand content less prominently than that of De Vijver). The commitments offered by the parties to remove these concerns included: (i) access to Vier and Vijf; (ii) licensing to new basic pay TV channels launched in the future; and (iii) licensing to distributors with linked services such as "catch-up TV" and "PVR" (Personal Video Recorder). The commitments had to be provided under fair, reasonable and non-discriminatory terms (FRAND) to any interested TV distributor in Belgium, as well as being in place for seven years. In the eyes of the Commission, these commitments ensured that Telenet's competitors are able to offer Vier and Vijf to their subscribers at no competitive disadvantage *vis-à-vis* Telenet.

On 5 October 2015, the Commission opened an in-depth investigation into the proposed acquisition of **BASE** by **Liberty Global** in Belgium. This transaction had *two* features: (1) it would combine one of the largest mobile network operators in Belgium (BASE) with the largest Mobile Virtual Network Operator ("MVNO") (Telenet, a subsidiary of Liberty Global); and (2) it would also combine a strong player in fixed-line telecommunications with a strong mobile network operator. The Commission was concerned that the merger would thereby: (i) reduce competition in the retail mobile telephony market in Belgium by removing an important independent competitive force; (ii) would likely reduce the incentives for BASE to offer access to its network to other MVNOs; and (iii) the post-merged entity would have the ability to foreclose competitors through the bundling of both its fixed and mobile services. After the Commission's in-depth investigation, it found that BASE competed "aggressively" on the Belgian retail mobile market and had challenged other price-competitive operators. Telenet was recognised to be an effective MVNO competitor, as it had contributed towards major price reductions in Belgium.

In the mobile market, the Commission concluded that the post-merger entity would be able to significantly reduce competition, with a risk of higher prices and less choice and innovation for Belgian mobile consumers. By contrast, with regard to the bundling of fixed and mobile services, Liberty Global's ability to exclude competitors from the market was limited, as Telenet already offered both fixed and mobile offerings (*i.e.*, the merger produced no change to the market structure). There were also no incentives to limit MVNO wholesale access on the network of both BASE and Liberty Global. To resolve the Commission's competition concerns, Liberty Global submitted commitments: (i) to sell BASE's share in Mobile Vikings (MVNO using BASE's network) to Belgian broadcaster Medialaan; and (ii) to transfer part of BASE's customer base to Medialaan. Liberty Global also concluded an agreement with Medialaan, giving it access to BASE's mobile network on the condition that it would allow Medialaan to compete effectively. As a result of the commitments, the Commission conditionally approved the transaction on 4 February 2016.

Danish operators **TeliaSonera** and **Telenor** announced on 8 April 2015, a proposed joint venture which sought to combine the parties' respective telecommunications activities in Denmark, leading to the largest market player/network operator, and thereby reducing the total number of Mobile Network Operators ("MNOs") from four to three. The joint venture would result in the post-merged entity having a 40% market share, reflected in 3.5 million mobile subscribers. The Commission was initially concerned that the merger would: (i) reduce the merged entity's and its competitors' incentives to compete, leading to higher prices, a loss of innovative offers and lower quality on the Danish retail mobile telecommunications market; (ii) reduce the number of MNOs able to offer wholesale services (thus reducing the choice of alternative host networks, and weakening the negotiating position of wholesale customers); and (iii) result in a highly concentrated market structure with two of the largest and symmetric operators active at both retail and wholesale levels (*i.e.*, leading to possible co-ordination).

In August 2015, both parties offered concessions and there was a general belief that the proposed commitments would resolve the Commission's competition concerns. The first proposal provided that the parties would make available a limited amount of spectrum for the roll-out of a self-standing mobile network, and provide wholesale access to their own joint network. The second set of proposed commitments would have enabled a new (fourth) market entrant to accumulate as much as 40% of TeliaSonera/Telenor's joint mobile infrastructure unit (to divest an ownership stake in their shared mobile network to a new entrant with a right to use a corresponding share of the network capacity). Such a 40% ownership solution would have been "groundbreaking" and a significant hardening of the approach adopted by the Commission in relation to earlier mergers in the mobile sector. However, the Commission was not satisfied as the commitment did not guarantee the entry of a fourth MNO in Denmark. Competition Commissioner Margrethe Vestager stated that "... *[b]ased on the commission's in-depth analysis and evidence gathered, we are convinced that the significant competition concerns required an equally significant remedy. This means the creation of a fourth mobile network operator. What the parties offered was not sufficient to avoid harm to competition in Danish mobile markets*". As a result, on 11 September 2015, TeliaSonera and Telenor informed the Commission that they had withdrawn their notification. It is a sign of a more circumspect stance on consolidation in the mobile sector by the Commission.

On 25 February 2015, the Commission received a notification for the proposed acquisition of **PT Portugal** by **Altice**. Altice operates via two subsidiaries in Portugal, namely, Cabovisão and ONI: (i) Cabovisão provides pay TV, fixed Internet access and fixed telephony services essentially to residential customers; and (ii) ONI provides services to business customers, including fixed telecommunication services, particularly voice, data and Internet access services, as well as IT services. PT Portugal was the former Portuguese telecommunications/multimedia incumbent, offering fixed, mobile voice and data services (to both residential and business customers); broadband Internet access services; and pay TV services to residential customers.

The Commission had initial concerns that the post-merger entity would have faced insufficient competitive constraints for the provision of fixed telecommunications, thereby leading to higher prices. There were significant horizontal overlaps with regard to PT Portugal's activities in the residential and business sectors, arguably dampening competition in the provision of retail

communications services (both stand-alone retail offers and multiple-play bundles). Post-merger, PT Portugal's dominance would arguably extend from 50% to 100% in at least 18 districts in Portugal through the offering of double- and triple-play service bundles. Moreover, it was considered likely that the merged entity would focus its commercial efforts on the accelerated upselling of triple-play customers to higher-value quadruple-play service offers. The retail pay TV market, fixed Internet services market, and various relevant wholesale markets, were also considered to be national in scope, with the possibility being left open by the Commission that certain markets might be sub-regional in their geographic scope. On 20 April 2015, the Commission approved the proposed transaction on the condition that Altice divest its current Portuguese businesses ONI and Cabovisão. The structural commitments completely remove the overlap between the activities of Altice and PT Portugal within Portugal, thereby satisfying the initial competition concerns identified by the Commission.

On 11 September 2015, **Hutchison** notified the Commission of its acquisition of **Telefónica UK**. The combination of Telefónica UK and Hutchison would create the largest MNO in the UK with more than 31 million subscribers (or about 41% of the market), followed by EE with 32% and Vodafone with 24%. Thus, the number of major UK mobile operators would be lowered from five to three in a short period of time (following the BT/EE approval by the CMA in the UK in 2015). The Competition and Markets Authority ("CMA") made a referral request to review the proposed transaction, however, the Commission rejected its application and highlighted that it was best placed to review the proposed transaction. On 30 October 2015, the Commission announced that it would be carrying out an in-depth investigation into the proposed acquisition, as it had underlying concerns that the transaction could lead to higher prices, less choice and reduced innovation for customers of mobile telecommunications services in the UK. A combined Telefónica UK and Hutchison would have a concentrated amount of lower-frequency spectrum, but would have none of the higher frequency spectrum that is needed to satisfy consumers' increasing demands for data-rich applications.

The Commission expressed the following *three* concerns arising from the merger: (i) given the fact that Telefónica UK and Hutchinson's "Three UK" currently compete against each other in the retail mobile telecommunications market in the UK, the merger could remove or limit incentives on them to exercise significant competitive pressure on the remaining market competitors (leading to higher prices, lower investment, *etc.*); (ii) there would be a reduction in the number of MNOs that are effectively willing to host MVNOs, with prospective/current MVNOs having less choice between host networks and weaker negotiating power to obtain favourable wholesale access terms; and (iii) a reduction in the number of MNOs could lead to coordinated behaviour, thereby leading to price increases on both the retail and wholesale markets. On 11 May 2016, the Commission blocked the proposed acquisition the parties had failed to propose sufficient remedies to deal with Commission's competition concerns. The remedies proposed by Hutchison failed to address adequately the serious concerns raised by the takeover, insofar as they would not have been able to prevent the likely negative impact on prices, quality of service and network innovation in the UK mobile sector as a result of the takeover. Commissioner Margrethe Vestager, in charge of EU competition policy, expressed that: "*We want the mobile telecoms sector to be competitive, so that consumers can enjoy innovative mobile services at fair prices and high network quality. The goal of EU merger control is to ensure that tie-ups do not weaken competition at the expense of consumers and businesses. Allowing Hutchison to takeover O2 at the terms they proposed would have been bad for UK consumers and bad for the UK*"

*mobile sector. We had strong concerns that consumers would have had less choice finding a mobile package that suits their needs and paid more than without the deal. It would also have hampered innovation and the development of network infrastructure in the UK, which is a serious concern especially for fast moving markets. The remedies offered by Hutchison were not sufficient to prevent this".*

## **Appeals to the Courts of the European Union**

Appeals before the European Courts in merger cases have a mixed history of success. In 2015, the protracted litigation derived from a merger Decision of 2004 came to an end as regards the selection of an appropriate purchaser of divested assets, while a number of other cases have raised interesting challenges to the Commission's fundamental methodology in arriving at robust conclusions on the substance of merger reviews.

On 28 January 2016, the European Court of Justice upheld the General Court's Judgment confirming the Commission Decision to approve the purchaser for the Vivendi assets sold off as one of the elements of a remedy package relating to the acquisition by **Lagardère** of **Vivendi Universal Publishing** ("VUP"). As discussed in our 2015 Antitrust Merger Enforcement Update and Outlook, the Commission authorised the concentration in 2004, on the condition that a suitable buyer would be found for VUP's assets. Among several interested undertakings, including Éditions Odile Jacob, Lagardère accepted the offer of Wendel Investments, which was in turn approved by the Commission. Odile Jacob appealed the Decision of the Commission to award the divested assets to Wendel. The General Court, while confirming that the Commission was entitled to authorise the acquisition by Lagardère, annulled the Decision approving the purchaser, on grounds that the Decision was based on a Report of a Trustee who did not satisfy the required condition of independence. This finding was upheld on appeal by the Court of Justice in 2012. Following the General Court Judgment, the Commission again consented to Lagardère's request to approve Wendel as a purchaser of the assets, with retroactive effect as from 30 July 2004. Odile Jacob then brought another action for the annulment of that Decision before the General Court, which was rejected in September 2014, after which it has brought yet another new action before the Court of Justice.

In March 2015, the General Court confirmed the Commission's Decision by which it had prohibited the proposed merger between **Deutsche Börse** and **NYSE Euronext**. Through this merger, the parties aimed to create a new company (HoldCo) under Dutch law that was to acquire, by way of public tender offer, all of the outstanding shares issued by Deutsche Börse, in exchange for its own shares. Following the offer being acted upon, a newly formed company, incorporated under US law, and wholly owned by HoldCo, was to merge with NYSE to become a wholly owned subsidiary of HoldCo. In February 2012, the Commission considered that the merger was incompatible with the internal market as it would have led to a single vertical structure, conducting the trading and clearing of more than 90% of the global transactions of European exchange-traded derivatives. The General Court rejected each of the arguments put forward by Deutsche Börse, concluding that the Commission had not made errors of assessment when considering that exchange-traded derivatives ("ETDs") and over-the-counter derivatives ("OTC derivatives") constituted two separate product markets. Second,

the General Court concluded that no efficiencies would be generated by the merger that were capable of overriding the restrictions of competition generated by it.

As mentioned in the 2014 Merger Review, in January 2013, the Commission issued a Press Release announcing the prohibition of the merger of **UPS** and **TNT Express**, based on the level of concentration in the markets for small parcel delivery services and for international express services. The Commission explained that the remedies UPS had offered, including divestitures and the granting of access to a new competitor to UPS's air network for a period of five years, were insufficient to address the Commission's concerns. In the Commission's view, UPS was not able to secure the signing of a binding agreement before the end of Phase II and the Commission expressed concerns regarding the candidates' ability to stimulate competition post-transaction. On 5 April 2013, UPS appealed the Commission's Decision on a range of grounds, including: (i) UPS's right of defence was infringed, as the Commission had modified the econometric model submitted by UPS without explaining the modifications made or without hearing UPS on those modifications; (ii) the Commission had assigned zero weight to efficiencies, which it had accepted in principle; (iii) the "price-concentration analysis" made by the Commission, which explored the relationship between prices and the number of players on the markets at issue, was wrong; and (iv) the Commission had erred in assessing whether buyer power existed.

In January 2015, the Court of Justice published its preliminary ruling regarding the request in the proceeding between **T-Mobile Austria** ("T-Mobile") and the **Telekom-Control-Kommission** ("TCK") concerning the latter's refusal to grant T-Mobile "interested party" status in the procedure authorising the modification of the ownership structure resulting from the acquisition of Orange Austria Telecommunication GmbH ("Orange") by Hutchison 3G Austria GmbH (now Hutchison Drei Austria GmbH ("Hutchison")), and the possibility of bringing an appeal against the Decision adopted by the TCK at the end of that procedure. The proceedings arose out of the Commission's 2012 merger authorisation, subject to the parties' commitment to divest radio spectrum in the Austrian mobile telephony market through an auction held by the Austrian Regulatory Authority that granted the right to use the divested radio spectrum to Al Telekom Austria. In this context, T-Mobile challenged the Regulator's Decision before the Administrative Court, which referred the matter to the Court of Justice in order to clarify whether Directive 2002/20/EC (regarding the rights of use for radio frequencies and numbers) and Directive 2002/21/EC (regarding the right of appeal against a decision of a National Regulatory Authority) conferred upon a competitor legal standing to challenge the outcome of spectrum transfer authorisation procedures. The Court of Justice concluded that T-Mobile, as a direct competitor on the electronic communications services market with the parties to the transaction for the transfer of frequencies, must, by definition, be regarded as being a party "affected" by the Decision, since the transfer modifies the respective shares of radio frequencies granted to those undertakings and therefore must have an impact on T-Mobile's position on the market.

In September 2015, **KPN N.V.** ("KPN"), a Dutch fixed and mobile telecommunications company, brought an action before the General Court seeking to annul the Commission's Decision in which it approved the acquisition by Liberty Global plc ("Liberty Global") of Ziggo NV ("Ziggo"), subject to conditions. (See discussion in Section V above). According to KPN, the Commission had committed a manifest error in the assessment of the vertical effects on the market for Premium Pay TV sports

channels, especially given the role played by the largest individual shareholder in Liberty Global in other media companies.

In June 2015, **1&1 Telecom** and **Airdata**, third party German Internet providers, appealed the Commission's Decision by which it had authorised the acquisition of Dutch telecommunications operator KPN's German mobile telecommunications business, "E-Plus" by Telefónica Deutschland, subject to conditions. Telefónica and E-Plus were both MNOs which provided mobile telecommunications services to end consumers, in Germany and in related markets (such as the wholesale of network access and call origination). The Commission originally had concerns that the transaction would weaken the position of MVNOs and Service Providers to the detriment of consumers, as it would bring together the third and fourth largest MNOs in Germany. Telefónica submitted commitments based on three components, namely, MVNO entry using 30% of the merged entity's network capacity, radio spectrum divestiture and the extension of existing wholesale access arrangements. 1&1 Telecom and Airdata claim that the Commission has committed errors of law and assessment when it analysed the vertical effects of the transaction, as the commitments offered by Telefónica were unlikely to be sufficient to allow the acquirer of the divested assets to compete effectively with the merged entity in a manner which addressed the theory of harm expressed by the Commission. 1&1 Telecom has also brought a separate action in relation to the Self-Commitment Letter.

## **Merger Control in EU Member States**

### ***United Kingdom***

It is the first full year since the Competition and Markets Authority ("CMA") became fully operational. As of 1 April 2015, there has been a change made to the maximum penalty amounts for the failure to comply with merger control rules. While these penalties are capped at 5% of the worldwide turnover of the entity concerned, the CMA can also impose fines on parties that do not, intentionally or without reasonable excuse, comply with investigatory requirements.

Over the course of 2015, a major Phase II case was decided in the telecommunications sector, involving **BT Group plc** and **EE Limited**, which are respectively the largest suppliers in the UK of fixed telecommunications services and broadband services, on the one hand, and mobile telecommunications services, on the other. BT provides many fixed services to other communications providers, including the provision of network (backhaul) services (to connect their radio masts to their core network) to mobile communications providers such as EE, O2, Three and Vodafone, while also providing Global Telecommunications Services on a worldwide basis. By contrast, EE is the leading mobile network operator in the UK, with 31 million customers overall (24.5 million of which are direct mobile customers), while also providing wholesale mobile access services to other MNOs and providing fixed voice, broadband and pay TV services to retail customers in the UK (where it has 834,000 fixed broadband customers). EE also has the largest national 4G customer base of any operator in Europe. As a result, the post-merger entity would be able to offer "quad-play" services, whereby fixed-line phones, broadband, mobile and TV would be sold in one package. Rivals warned



that the EE deal would give BT an estimated 40% of the UK retail telecommunications market and could result in the wholesale foreclosure of smaller competitors.

As a result of the CMA's initial findings as regards the provision of fibre mobile broadband services to MNOs and the provision of wholesale access and call organisation services, the CMA referred BT's proposed acquisition of EE for an in-depth Phase II investigation in June 2015. The merger was ultimately cleared unconditionally by the CMA on 15 January 2016. Rivals of BT criticised the unconditional approval and expressed the view that the CMA had failed to analyse concerns that the merged entity would be able to abuse its dominance in supplying backhaul services and in providing wholesale lines and capacity to place them at a disadvantage. The issue was heavily debated after a report published on 23 January 2016 entitled "Broadband", which raised concerns as to whether Openreach should have been divested for the merger to be accepted. Currently, the UK's National Regulatory Authority Ofcom, is investigating whether or not to compel BT to divest Openreach, *i.e.*, thereby rendering it structurally separate to BT, because of its alleged lack of investment in Internet infrastructure.

A notable UK Supreme Court case in the UK concerns jurisdictional issues that arose in the *Eurotunnel/SeaFrance/SCOP* merger. In 2012, **Groupe Eurotunnel SA** ("Eurotunnel") and **Société Coopérative De Production SeaFrance SA** sought to acquire SeaFrance SA ("SeaFrance"), which went into liquidation in 2011. The CMA's predecessor, the Competition Commission ("CC"), prohibited the acquisition on the ground that, post-merger, there would be likely price rises for both passengers and freight customers. The dispute concerned whether the acquisition actually gave rise to a merger situation. The issue arose as to whether the CC had jurisdiction to review the merger, given that assets per se were not being transferred as part of a business concern.

After a series of appeals, the Supreme Court ultimately upheld the CAT's finding that the CMA had exercised jurisdiction correctly over the transaction. The Supreme Court stated that the identification of "economic continuity" is necessary when identifying whether the transaction involves a collection of assets or an "enterprise" under the Enterprise Act of 2002: "*it depends on whether at the time of the acquisition one can still say that economically the whole is greater than the sum of its parts*". The Supreme Court also expressed that it is necessary to identify whether: (i) the acquirer of the assets is gaining "*more than he might have acquired by going into the market and buying factors of production*"; and (ii) this advantage is owed "*to the fact that the assets were previously employed in the 'activities' of the target enterprise*".

## *Spain*

Key developments in Spain in 2015 included important precedents for "gun-jumping" by notifying parties in two cases and the crafting of remedies to remove vertical foreclosure concerns in a key merger involving the provision of pay TV services.

In October 2015, the CNMC imposed a fine of 106,500 euros on **Grifols S.A.** ("Grifols") for its failure to comply with the obligation to notify its acquisition of certain assets of **Novartis International AG** ("Novartis"), resulting in a serious infringement of Article 9.1 of the Spanish Competition Law

15/2007, which establishes an obligation to notify any transaction where market shares exceed 50%. Grifols had closed the transaction by which it had acquired Novartis's transfusion diagnostics business in January 2014 and then notified the deal on 10 March 2015. In April 2015, the CNMC initiated proceedings against Grifols for "gun-jumping". When calculating the fine, the CNMC took into account that: (i) the market share of Grifols after the acquisition was in the range of 52.2%; (ii) its failure to notify was not due to an error, as it had previously notified acquisitions of other companies, thus being aware of the obligation to notify; (iii) Grifols maintained this irregular situation for one year and three months; and (iv) this transaction did not represent a threat to competition. Grifols can now appeal before the Spanish High Court.

In May 2015, the CNMC also initiated proceedings against Masmovil Ibercom – a telecommunications operator – for its failure to notify its acquisition of **Xtra Telecom, Tecnologías Integrales and The Phone House Movil**. Despite having decided to authorise the acquisition in Phase I in February 2015, the CNMC reminded the parties that the authorisation had been granted without prejudice to the possible responsibilities derived from the infringement of Article 9.1 of the Spanish Competition Law 15/2007. The CNMC has six months to notify its Decision in this regard.

In April 2015, the CNMC authorised the acquisition of sole control of **DTS** – active in the pay television market – by **Telefónica**, through its acquisition of 56% of the share capital of Prisa, which was added to the 44% of the share capital already held by Telefónica. The CNMC initiated Phase II proceedings in November 2014 and, in February 2015, after having submitted five different versions of its proposal of commitments, Telefónica submitted a final version, which was accepted by the CNMC and classified in three different groups: (i) commitments relating to the pay television market in Spain; (ii) commitments relating to the wholesale commercialisation of individual audiovisual content and television channels markets in Spain; and (iii) wholesale commitments relating to Telefónica's Internet access network in Spain. As regards access to its Internet network, this commitment was made by reference to the necessary capacity and quality conditions required to sustain the provision of OTT pay television services to fixed and mobile broadband clients, lasting for a period of five years.

## *Belgium*

On 15 March 2016, Belgium's Competition Authority granted a conditional clearance to the merger of the Netherlands-based supermarket operator **Royal Ahold** and Belgium-based **Delhaize Group**. The deal stands out as one of a few transactions that have been cleared by the Belgian Competition Authority subject to remedies. The European Commission handed the review of the deal over to the National Authority in October 2015, stating that the transaction might significantly affect competition in regions of Belgium. Delhaize and Royal Ahold operate 800 and 40 supermarkets respectively in Belgium, whereas their activities do not overlap in any other European jurisdiction. In its referral Decision, the European Commission noted that the merging parties would control more than 60% of supermarket food sales in a number of local areas in Belgium, while adding that both supermarkets would still face strong competition from France's Carrefour and from discount retailers Colruyt, Aldi and Lidl. In addition to retail food distribution, the Commission has expressed concerns as regards the national wholesale level, where the merging parties would achieve a combined market share of 20-

30%. In order to address competition concerns, the merging parties offered to divest eight Royal Ahold shops, five Delhaize shops and several other shops that had not yet opened.

Having secured competition clearances in Belgium, Serbia and Montenegro, the deal is still under review in the US, where the merging parties make approximately 60% of their worldwide sales. The FTC opened an in-depth investigation in November 2015, given the strong presence of both parties on the East Coast.

## *The Netherlands*

In the course of 2015, the Dutch Competition Authority (*Autoriteit Consument en Markt*, "ACM") conducted two in-depth (Phase II) merger investigations.

On 11 February 2015, the ACM conditionally approved the acquisition of **Mecom Group plc** ("Mecom") by **De Persgroep Publishing NV** ("De Persgroep") following an in-depth investigation. The acquisition created a nationwide publisher, which publishes national and regional daily newspapers and distributes papers and magazines. De Persgroep already owned several national and regional publications, a radio station, and a diverse range of online media. Mecom's subsidiary Wegener mainly publishes regional daily newspapers. The ACM investigated the impact of the transaction on advertisers, on printers, and on distributors, and concluded that commitments were required to ensure sufficient competition in the distribution of newspapers and magazines. The ACM observed that the media landscape is changing rapidly, and faces a declining number of newspaper readers, an increasing shift towards the provision of services over the Internet, as well as changing advertising options. The ACM concluded that *consumers* would not be harmed, and would have sufficient choices post-transaction. With regard to *advertisers*, the ACM concluded that the two parties largely attract different kinds of advertisers in light of their different geographic coverage (nationwide for De Persgroep and regional for Mecom). As such, the parties were not considered to be "close competitors", and the transaction would not raise any concerns for advertisers, who in any event would have sufficient choice among various providers of advertising space post-transaction.

On the other hand, the ACM found that the transaction did raise some concerns regarding *distribution*. In particular, following the transaction, De Persgroep would cover distribution of daily newspapers in almost 66% of the Netherlands (given that the publisher with the most subscribers typically takes on the distribution of all daily newspapers in the entire area in order to keep distribution costs low for all). In light of the concerns raised by the ACM, De Persgroep offered commitments to ensure that other publishers would not become too dependent on the distribution network of the combined entity. De Persgroep committed itself to maintaining current agreements with the distribution arm of Telegraaf Media Group for the next 10 years, and to the guarantee of the distribution of all daily newspapers at reasonable conditions.

On 7 December 2015, the ACM approved the merger between **Stichting Exploitatie Nederlandse Staatslotery** ("State Lottery") and **Stichting de Nationale Sporttotalisator** ("Lotto"), after an in-depth investigation. Chris Fonteijn, President of the ACM, stated that: "*[i]t appears that the State Lottery and Lotto in practice barely compete with each other, amongst others because of the strong*

*regulation of games of chance. Our investigation shows that this merger only has a limited effect on the market for games of chance".* The two largest gaming organisations would remain in the market for lotteries post-transaction: the new combination State Lottery – Lotto (which markets the state lottery, Miljoenenspel, Loot, Eurojackpot, Lucky Day, Toto and scratch tickets), and Goede Doelenloterij (with among others Postcode lottery and Vriendenloterij). Both organisations would hold approximately half of the current market for games of chance. All these lottery games have their own target group of players, and the ACM's investigation demonstrated that few consumers switch between different types of lottery game.

The ACM also noted that online games of chance were likely to be legalised in 2017, and investigated what the competitive position would be on this market. The ACM concluded that there are powerful competing foreign players in this market, and that it did not see a risk of the creation of a dominant position by State Lottery – Lotto on the (online) games of chance market. Finally, the ACM took into account that the Netherlands has strict regulatory rules for games of chance. The government will, for example, grant one single licence for each kind of lottery, which prevents too many lotteries from fighting over the favour of the same players.

## ***France***

Over the course of 2015, the French Competition Authority, "Autorité de la concurrence" (the "Autorité"), was notified of numerous mergers in a variety of sectors.

As regards the food distribution sector, on 24 February 2015, the *Autorité* cleared the acquisition of poultry slaughterer and seller **Glou Sanders** by **LDC**. Both companies are active across the whole value chain for the sale of poultry, ranging from its collection for slaughter to the marketing of fresh meat and poultry processed products. Further to an assessment of the transaction, the *Autorité* was satisfied that it would not lead to competition concerns. As regards the market for the collection of live poultry intended for slaughter, the *Autorité* found that the transaction only led to overlaps in the region of Brittany, where the combined market shares remained nevertheless moderate. In the market for the sale of fresh meat and poultry-processed products, the *Autorité* noted that, despite its high market share, the merged entity would face countervailing buying power from the distribution chains where poultry products are sold (*i.e.*, mass retail distribution chains, as well as Terrena Gastronome, Maïsador/FSO/Delpeyrat and Ronsard). The *Autorité* also took into account the growing importance of imports in the French poultry sector.

More recently, **Groupe Auchan** and **Groupement Systeme U** notified their proposed alliance to the Autorité on December 30, 2015. Groupe Auchan and Groupement Systeme U are important players in the retail sector, being primarily involved in food distribution. In terms of size, they are supposedly the fifth and sixth operators in food distribution and have an overlapping presence in approximately 400 areas. Although the transaction does not amount to a concentration in the strict sense of EU merger control rules, the European Commission agreed to refer the case to the Autorité, which will assess the operation under French merger control rules. In addition to analysing the effects of the alliance in the retail markets and areas where the parties have overlapping presence, the Autorité will

also assess the impact of the operation on competition in the upstream markets for the supply and sourcing of food and other products for mass distribution.

In the energy sector, on May 18, 2015 the *Autorité* authorised, subject to commitments, the purchase of **Totalgaz**, a subsidiary of the Total Group, by **UGI Bordeaux Holding France** ("UGI"), which is owned by competitor Antargaz. The *Autorité*'s Decision brings to an end the procedure under French merger control rules, which was initiated further to a referral conceded by the European Commission. Antargaz and Totalgaz are both present in the French markets for the sale of bottled liquefied petroleum gas ("LPG"), fuel LPG and LPG sold in mini-bulk (for filling private tanks), as well as in intermediate and large-bulk (for filling professional tanks) forms. The *Autorité* found that the merger would strengthen significantly Antargaz's national presence in the intermediate and large-bulk LPG markets, since the merged entity would own the main supply infrastructures such as sea import depots and the refineries. As far as the mini-bulk LPG markets were concerned, the post-merger entity would hold particularly high market shares in 11 local areas. Clearance by the *Autorité* was made conditional upon UGI's commitment to divest part of its shareholding in a number of depots. Furthermore, UGI also committed to reducing its supply contracts with the Total Group refineries to one year, thereby freeing up the amounts of LPG produced by the Total Group for other operators.

Finally, in the medical devices sector, on 18 September 2015 the *Autorité* authorised, subject to commitments, the acquisition of **Audika** by **William Demant**. William Demant is one of the main manufacturers of hearing aid products in Europe, and is also involved in distribution activities through its minority stake in the networks of the Audilab and Auditis companies (which have respectively 108 and 11 hearing centers in France). The target, Audika, is a major player in the retail sale of hearing aid products, with 476 hearing centers in France. After the market investigation, the *Autorité* considered that the transaction was likely to harm competition in 12 local markets for the retail distribution of hearing aid products. To address these concerns, William Demant committed to divesting 11 hearing centres (one of these divestments addressing overlaps in two different local markets). The *Autorité* did not consider that the transaction would harm competition through vertical effects, since there was no risk of foreclosure of competitors in the hearing aids product market.

## *Germany*

Due to the relatively low turnover thresholds and the wide definition of a "concentration" under German merger control rules, which includes minority shareholdings, the *Bundeskartellamt* ("BKartA") usually receives at least around 1,000 merger filings per year. Only a small number of these are usually subject to an in-depth investigation in Phase II and an even smaller number of mergers are prohibited. In 2014, for example, the BKartA received 1,188 merger control notifications, only 22 of which were closely examined in Phase II proceedings, with only one merger being prohibited and another being cleared subject to conditions.

BKartA has not yet published statistics for 2015 but, according to its website, seven Phase II decisions were adopted in 2015. In five of those cases the BKartA cleared unconditionally the concentration, whereas in one case (a merger between wholesalers of auto spare parts; B9 – 48/15 – *Wessels & Müller*

SE / Trost Auto Service Technik SE) it granted clearance subject to conditions, while another merger (the €1.8 billion Edeka/Kaiser's Tengelmann deal; Case B 2 – 96/14) was prohibited.

The Edeka/Kaiser's Tengelmann merger concerned the acquisition of 451 Kaiser's Tengelmann food retail outlets by rival Edeka. The BKartA held that the elimination of Kaiser's Tengelmann as an independent retail company and the acquisition of its outlet network by Edeka would have considerably worsened competition conditions on a large number of already highly concentrated regional markets and municipal districts in greater Berlin, Munich, Upper Bavaria and North Rhine-Westphalia. The BKartA furthermore concluded that the leading group of retailers, consisting of Edeka, Rewe and the Schwarz group (with Kaufland and Lidl), would have further increased their market lead over their competitors in the procurement of branded products in particular, because the manufacturers would have lost one of the remaining alternative sales outlets outside this group.

Edeka and Kaiser's Tengelmann offered to give up a total of approximately 100 outlets in Berlin and Bavaria in two separate steps. However, the BKartA held that, in their choice of outlets, the parties did not satisfy the criteria and conditions established by the BKartA for offering sustainable commitments. The BKartA held that the parties offered to sell those outlets to third parties which would not have had the effect of reducing Edeka's critical market share or which Edeka could have easily acquired in any event without the need for the merger. The BKartA found that some outlets which were closed, or on the verge of closure, were offered for sale to third parties as part of the commitments. Ultimately, the BKartA held that the commitments did not address how the prohibition criterion of a "*significant impediment to effective competition (SIEC)*" could be overcome and hence decided to prohibit the merger.

The parties have applied to the Federal Minister for Economic Affairs and Energy for a Ministerial authorisation. They have also filed an appeal against parts of the prohibition decision with the Düsseldorf Higher Regional Court.

Under German law, the Economics Minister can allow a merger to proceed if the restraint of competition found by the BKartA is outweighed by advantages to the economy as a whole resulting from the concentration, or if the concentration is justified by an overriding public interest. Since 1974, there have been only 21 applications for a Ministerial authorisation, resulting in three unconditional authorisations and five conditional authorisations.

On 17 March 2016, Economics Minister Sigmar Gabriel granted the Ministerial authorisation subject to conditions, *e.g.*, that Edeka will have to maintain at least 95% of the 16,000 employees in the acquired outlets and that it will not divest any Kaiser's Tengelmann outlets for a period of five years. Rivals and other participants to the proceedings can appeal the authorisation within one month. As a result of the ministerial authorization, the chairman of Germany's Monopolies Commission ("*Monopolkommission*"), Professor Daniel Zimmer (director of the Centre for Advanced Studies in Law and Economics at the University of Bonn), resigned from his post. The Monopolies Commission is an independent expert committee, which advises the German government and legislature in the areas of competition policy-making, competition law, and regulation. The Monopolies Commission in its non-binding assessment unanimously recommended to not grant the

ministerial authorization because the alleged public interest concerns would not outweigh the deal's anticompetitive effects. In addition, Rewe, a rival of the merging parties, announced that it will appeal the ministerial authorization before court.

## *Italy*

During the course of the past year, the Italian Competition Authority (*L'Autorità Garante Della Concorrenza e Del Mercato* (the "AGCM")) has approved several Phase II merger investigations pursuant to Article 16(4) of Law 287/90, often imposing structural remedies. These include:

- ***Giochi Preziosi / Bimbo Store***: On 15 July 2015, the AGCM conditionally approved Giochi Preziosi S.p.A.'s acquisition of sole control of Bimbo Store S.p.A., as well as the subsequent creation of a NewCo by Giochi Preziosi and Artsana S.p.A, comprised of the retail operations of Giochi Preziosi, Bimbo Store and Prénatal. Remedies were offered to address the AGCM's competition concerns in the retail markets for a range of neonatal products, as well as products for expectant mothers and children, in 16 distinct geographic areas. Among other things, the parties agreed to cease control over certain stores within a specified period of time, so that these stores would become independent and be in position to exert actual or potential competitive pressure on the merged entity.
- ***Società Elettrica Altotesina/Azienda Energetica***: The AGCM also conditionally approved a merger between the two biggest energy companies in Alto Adige (South Tirol) through a NewCo structure. The parties were active in the production, distribution and sale of electricity and natural gas and in the management of district heating plants. The NewCo will be jointly controlled by the Province of Bolzano and the Municipalities of Bolzano and Merano.
- ***Libero / Seat Pagine Gialle***: On 11 November 2015, the AGCM approved, subject to conditions Libero's acquisition of sole control over Seat-Pagine. The concentration concerned the markets for directory assistance, online advertising, direct marketing services and the provision of web services. Because the parties were the two principal operators in the provision of directory assistance services, structural remedies were offered to address competition concerns in this market.

The AGCM is also currently reviewing a high profile merger between two close competitors, **Mondadori** and **RCS Libri**, and has concerns that the concentration might create or strengthen a dominant position in the publishing sector, in particular, in ebooks and fiction and non-fiction publications. According to the AGCM, the five key players represent around 60% of the publishing sector in Italy. The AGCM considers that the sector is already concentrated and that the businesses of bigger players (including the merging parties) are characterised by varying degrees of vertical integration (whereas SMEs tend not to be integrated at all).

In 2016, the AGCM raised the turnover thresholds for the notification of concentrations, effective as from 14 March 2016. The thresholds are adjusted annually to take into account increases in the GDP deflator index. Section 16(1) of Law No. 287/90 now requires the prior notification of all mergers and acquisitions where both of the following conditions have been fulfilled, namely: (1) aggregate turnover

in Italy of all undertakings involved in the concentration exceeds €495 million (previously €492 million); and (2) aggregate turnover in Italy of the target company involved in the concentration exceeds €50 million (previously €49 million).

## **BRAZIL**

### **Brazil's Merger Control Reform: Three Years Later**

In May 2015, the Brazilian Administrative Council of Economic Defense ("*Conselho Administrativo de Defesa Econômica*," or "CADE") celebrated the third anniversary of the entry into force of the Brazilian Competition Act (Law 12,529 of November 30, 2011). As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, the new Law introduced the following changes to Brazilian merger control:

1. Consolidating powers for merger review under a single authority (CADE).
2. Establishing a pre-merger review system with suspensory effect (*i.e.*, a mandatory waiting period).
3. Implementing other changes with the objective of streamlining the review of "simple" cases.

Under the prior regime, three separate agencies were responsible for the application of the Brazilian merger control rules. Now, a single institution, CADE, consisting of the Administrative Tribunal (the "*Tribunal Administrativo*," or "Tribunal") and the Superintendence ("*Superintendência-Geral*"), is in charge of merger analysis. The Superintendence investigates cases before referring them to the Tribunal for decision. The Secretariat, previously assigned to the Ministry of Justice and scrutinizing only antitrust behavioral cases, is now a part of CADE's Superintendence and also deals with merger control.

In 2015, 404 transactions were reported to CADE, just 19 fewer than in 2014 but significantly less than the 626 transactions notified in 2012. This decrease is likely the result of the slowdown in the Brazilian economy. According to statistics from the World Bank, Brazil's GDP grew by 3% in 2013 and by 0.1% in 2014. According to the IMF's World Economic Outlook Report from October 2015, Brazil's GDP is projected to decrease by 3% in 2015 and 1 % in 2016. According to the report, business and consumer confidence in Brazil continues to retreat in large part because of deteriorating political conditions; overall investment is declining rapidly.

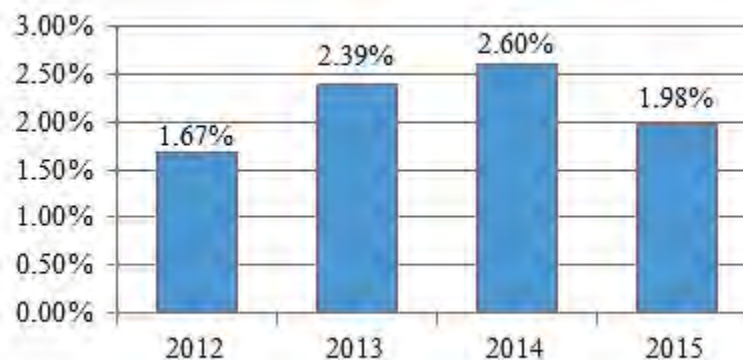


## Mergers Reported to CADE 2012-2015



As in other jurisdictions, only a small fraction of transactions reported to CADE are subject to an in-depth investigation. In 2015, the Superintendence referred eight transactions to CADE's Tribunal for an in-depth assessment, *i.e.*, 1.98% of all the transactions. This reflected a slightly lower rate than in 2014 and 2013 (approx. 2.60 % and 2.39 %, of all the transactions, respectively), but is significantly lower than the proportion of transactions reported under HSR subject to a Second Request.

## Percentage of Reported Transactions Resulting in an In-depth Assessment 2012-2015



On June 2, 2015, a plenary session of Brazil's Federal Senate confirmed the appointment of four new Commissioners and a new General Superintendent at CADE. The new appointees were designated for these positions by the President of the Republic, Ms. Dilma Rousseff, at the end of April. The Federal Senate referred the names to the Presidency of the Republic to proceed with their formal designation. The Brazilian competition bar has been widely reported to welcome the new appointments.

The Senate approved the appointment of João Paulo de Resende, Paulo Burnier da Silveira, Alexandre Cordeiro de Macedo and Cristiane Alkmin Junqueira Schmidt as Commissioners of CADE's decision-making body, the Tribunal. The Tribunal is composed of seven Commissioners, including its President, each appointed for a term of four years. Its decisions are taken by majority vote.

Prior to his appointment, Mr. Burnier da Silveira led CADE's international unit since 2011. Mr. Paulo de Resende headed a unit in charge of public-private partnerships at the Brazilian Ministry for Planning since 2012. Mr. Cordeiro de Macedo served as executive secretary of the Ministry of Cities and as an auditor at the Office of the Comptroller General. Ms. Alkim Junqueira Schmidt was an economist for Itaú, an asset management company. She holds a Ph.D. in Economics from the Postgraduate School of Economics of the Fundação Getúlio Vargas and worked in different positions at the Secretariat of Economic Affairs of the Ministry of Finance from 2000 to 2003, including the position of Deputy Secretary.

Eduardo Frade Rodrigues was confirmed by the Senate as CADE's General Superintendent for a term of two years. The General Superintendence, which is CADE's investigative arm, is led by a General Superintendent and two Deputy Superintendents. Since June 2014, Mr. Frade Rodrigues has been the Acting General Superintendent of CADE, where he had previously worked as Deputy Superintendent (2012-2014) and as an advisor to CADE's Commissioners (2007-2011).

In a joint interview of Mr. Frade Rodrigues and Mr. Vinicius Marques de Carvalho, the President of CADE, Brazil's top two antitrust enforcers hinted that the new appointments were unlikely to dramatically change Brazil's enforcement.

## **High Profile CADE Merger Decisions in 2015**

### ***CADE Issues Eight Prohibitions Since the Entry into Force of the Brazilian Competition Act***

On September 3, 2015, CADE blocked the acquisition of Condor Pincéis Ltda. by Tigre S/A – Tubos e Conexões. The reporting Commissioner Márcio de Carvalho Oliveria Júnior, followed CADE's General Superintendence opinion that, according to the evidence in the file, the merger would lead to significant competition concerns in certain markets for paint brushes, brushes, paint rollers and other painting accessories, including high concentration, enhanced barriers to entry and low rivalry in some markets. More specifically, according to CADE, as a result of the proposed transaction, Tigre would control more than 70% of the paint brush market. In order to remedy these competition concerns, the companies had suggested the signature of a Merger Control Agreement (in Portuguese, "ACC"), which was negotiated by the Reporting Commissioner's Office, but they could not reach an agreement with CADE's Tribunal.

This is the eighth transaction blocked by CADE since the new Brazilian Competition Act came into force in late 2011. As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, in 2014, CADE blocked one transaction, the acquisition of Solvay Indupa by Braskem S/A. As reported in our 2014 Antitrust Merger Enforcement Update and Outlook, in 2013 CADE blocked three proposed acquisitions: *first*, the acquisition by the steel manufacturer Armco Staco S.A. of Mangels Industrial, S/A.'s guard rails and galvanized steel divisions. Guard rails are a type of barrier used on

streets, avenues, and highways to protect vehicles. Galvanization is the fire treatment given to steel structures used to manufacture guard rails. *Second*, CADE blocked the proposed acquisition by Brasil Foods S/A, the second largest food company in Brazil, of the pork production and slaughter assets of Doux Frangosul S/A, a poultry and pork producer. And, *third*, the proposed acquisition, by Unimed Franca, a health services cooperative, of the control over Hospital Regional de Franca, in São Paulo, and its healthcare plan "Regional Saúde."

### ***Other Noteworthy Transactions***

According to CADE's own statistics, CADE was very active in 2015, imposing a variety of structural and behavioral remedies in seven transactions decided in 2015. These include the imposition of remedies on global transactions involving non-Brazilian companies, such as GlaxoSmithKline PLC, Novartis AG and Rexam PLC.

***Gun-Jumping Enforcement.*** On January 20, 2015, CADE imposed a fine amounting to BRL 30 million (USD 8 million) on Cisco Systems Inc. and Technicolor S/A for gun-jumping. According to CADE, the parties had closed a global transaction for the takeover of a wholly owned subsidiary of Cisco Systems Inc., based in the USA, by Technicolor S/A, based in France, before the conclusion of CADE's final analysis was released.

As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, in November 2014, CADE had decided that the acquisition of Brasfrigo Alimentos Ltda (a company which operated in the market for canned vegetables) by Goiás Verde Alimentos Ltda had been closed before receiving the mandatory authorization from CADE. On April 22, 2015, CADE imposed a fine on both parties of BRL 3 million (USD 0.8 million) for gun-jumping. The fine was the result of an agreement between CADE and the parties. The agreement also provides that Goiás Verde must refrain from using the Jurema brand within the Brazilian territory for two years.

On June 24, 2015, the companies GNL Gemini Comercialização e Logística de Gás Ltda. – GásLocal and Companhia de Gás de Minas Gerais – Gasmig agreed, before the Tribunal, to pay BRL 90,000 (USD 24,500) for engaging in gun-jumping. CADE was of the view that the agreement signed between the companies in order to regulate the general conditions for LNG supply to Gasmig by GásLocal amounted to gun-jumping. The quantity of the pecuniary contribution to be paid by GásLocal and Gasmig was agreed between CADE and the Parties.

On September 21, 2015, CADE ordered the notification of two transactions, namely: (i) Banco Carrefour acquiring Itaú Unibanco; and (ii) TAM Linhas Aéreas S/A codeshare contracts with Total Linhas Aéreas S/A and Trip Linhas Aéreas S/A. CADE concluded that the two transactions should have been notified as they met the relevant criteria (incidentally, under the previous Brazilian Competition Act, namely Law 8.884/94, which was in force at the time both the transactions were carried out). No fines appear to have been imposed as a result of these failures to notify.

Together with the fines for gun-jumping imposed by CADE in 2014 and 2013 (and reported in our 2015 Antitrust Merger Enforcement Update and Outlook and 2014 Antitrust Merger Enforcement

Update and Outlook, respectively), these decisions stress CADE's commitment to enforce its merger control regulations.

***Remedies in Foreign-to-Foreign Transactions.*** On February 25, 2015, CADE approved the proposed joint venture between GlaxoSmithKline PLC ("GSK") and Novartis AG. Post-merger GSK will own 63.5% and Novartis 35.5% of the joint venture's shares. According to Reporting Commissioner Márcio de Oliveira Júnior, the transaction would give rise to high concentration in relation to smoking-related drugs. To mitigate these competition concerns, the companies and CADE signed a Merger Control Agreement stipulating that GSK commits to divest a package of assets related to its main antismoking product (sold in the form of tablets and patches). The divestitures also include intangible assets, such as intellectual property rights, licenses and contracts. In addition, the parties committed to adopt various measures guaranteeing that unlawful information exchanges between the joint venture and Novartis will not occur during the period of existence of the joint venture.

On December 9, 2015 CADE approved, the acquisition of Rexam PLC by the Ball Corporation. According to reporting Commissioner Gilvandro Araújo, the transaction would create a tie-up of the two biggest producers of metal cans for beverages in Brazil. In the post-merger scenario, the market shares of both companies would be significant across all of the regions in Brazil. In order to address these concerns, the transaction's approval was conditioned to:

- the divestiture of plants and tangible and intangible assets related to them.
- the transfer of current contracts related to the unities to be sold to the plants' eventual buyer. Furthermore, Ball and Rexam will have to sign contracts for can ends supply with the assets buyer. The Merger Control Agreement also establishes that the identity of the buyer is subject to approval by CADE's Tribunal. The transaction was subsequently authorised by the European Commission on January 15, 2016, also subject to divestitures.

***Access Remedies.*** As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, on February 12, 2015, CADE authorized the acquisition of America Latina Logística – ALL by Rumo Logística a Operadora Multimodal S/A. According to CADE, the transaction would allow one of the country's largest sugar exporters to take control over a major railroad company. The new company, in addition to being controlled by a major player that uses the railroad for its own transportation of sugar and fuel, will control the entire export supply chain of dry bulk through the Port of Santos. To reduce the possibility of market foreclosure, CADE conditioned its approval, among others, on the new company: (i) guaranteeing access by Rumo's competitors to its terminals in the Port of Santos; (ii) offering long-term contracts to certain railway users; and (iii) applying objective parameters for pricing the services provided to competitors.

***Imposition of Remedies Arguably Unrelated to the Competition Concerns Identified During the Merger Review.*** On March 25, 2015, CADE approved two mergers involving the Spanish telecommunications group Telefónica S/A. Telefónica controls Vivo do Brasil and operates in the markets for fixed and mobile telephony, broadband internet, and pay TV.

- The *first* transaction consisted of the proposed acquisition by Telefónica Brasil of GVT Participações S/A, (formerly belonging to the Vivendi Group). Although CADE was of the view that Telefónica and GVT's activities were complementary in most of Brazil, according to CADE, the transaction would have resulted in a significant increase in the concentration in some municipalities of the state of São Paulo. However, after a market study and a consultation with the National Telecommunications Agency, ANATEL, the possibility of the transaction leading to price increases was considered unlikely. However, Telefónica Brasil and GVT agreed, upon the signature of the Merger Control Agreement, to adopt measures to effectively ensure the supply, quality and competitive prices on fixed telephony markets, broadband internet and pay TV.
- The *second* transaction consisted of the division of Telco S.p.A., a holding company with interest in Telecom Italia, of which Telefónica and the Italian companies Assecuriazioni Generali S.p.A., Intesa Sanpaolo S.p.A., and Mediobanca S.p.A. are shareholders. In order to mitigate the competition concerns arising from the spin-off of Telco, the agreement with Telefónica also establishes that post-merger it must divest 6.5% of the voting shares it holds in Telecom Italia. In addition, until Telefónica divests its direct stake in Telecom Italia, its political rights in the company will be suspended (the deadline for the divestment is confidential).

Finally, in the Merger Control Agreement, both Telefónica and Vivendi, also a minority shareholder of Telefônica Brazil, committed to refrain from sharing, directly or indirectly, confidential, strategic and competitively sensitive information between any of the companies or between those responsible for the management and representation of the companies of the Telefónica Group, Vivendi and Telecom Italia.

***Extra-territorial application of the remedial powers of CADE.*** As reported in our 2015 Antitrust Merger Enforcement Update and Outlook, on January 29, 2015, CADE authorized the acquisition of Veyance Technologies Inc. by Continental Aktiengesellschaft subject to divestitures, some of which in Mexico. The companies manufacture auto parts, rubber products, hoses and industrial equipment, among other products. According to CADE, the transaction represents a merger between the market leader and the third player in the markets for heavyweight steel conveyor belts and air springs. To address the competition concerns, the parties committed to divest the following assets of Veyance: (i) a plant located in San Luis Potosi, in Mexico, which produces air springs, and (ii) a factory in São Paulo, which produces heavyweight steel conveyor belts.

### ***Other Noteworthy Transactions Subject to Remedies***

On November 25, 2015, CADE approved the proposed merger involving Dabi Atlante S/S Indústrias Médico-Odontológicas and Gnatus Equipamentos Médico-Odontológicas Ltda. According to CADE, both companies are market leaders in the provision of dental products in Brazil. More specifically, CADE identified competition problems in the following product markets: vacuum pumps; clinical or dental sets; intraoral x-ray; manual instruments; and prophylaxis equipment. The transaction was approved subject to a combination of structural and behavioural remedies including:

- the divestiture of the brand "Gnatus" in favor of an economic entity meeting certain requirements to become a rival of the post-transaction entity.
- the termination of certain exclusivity clauses in relation to the distribution of the products and the supply of technical assistance services.

According to Reporting Commissioner Paulo Burnier, the proposed remedies will be able to restore competition in the sector of dental products in Brazil.

### *Ongoing High-Profile Transactions*

On March 23, 2015, CADE's Superintendence issued an opinion in which it referred to the Tribunal of the acquisition of the totality of equity shares of Genix Indústria Farmacêutica by Capsugel Brasil. After the analysis of the information provided by the parties, competitors and clients, the Superintendence verified that Capsugel and Genix are the main suppliers of hard capsules to the pharmaceutical industry and to the Brazilian manipulation pharmacies' market. In addition, the Superintendence is of the view that there is a high concentration in the sector and there is only one competitor in the Brazilian market that produces hard capsules.

On December 7, 2015, the Superintendence referred to CADE's Tribunal the proposed merger regarding the acquisition of Baker Hughes by Halliburton. The transaction refers to a worldwide operation, notified, according to CADE's press release, in different jurisdictions, such as the United States, the European Union, China, Russia and Australia.

Also according to the Superintendence, the transaction may result in price increases in several markets related to the companies' activities, particularly since, according to the Superintendence, the industry features high barriers to entry and there would be a situation of lower competition in the post-merger scenario. The initial deadline for a decision in Brazil is 240 days after notification. However, this can be extended for an additional 90 days.

On January 25, 2016, CADE's Superintendence published a decision, submitted to The Tribunal concerning the proposed joint venture between Itaú Unibanco S/A and MasterCard Brasil Solucoes de Pagamento Ltda. The proposed joint venture proposed to launch a new credit and debit card brand in Brazil. Itaú Unibanco operates in the market for (i) credit and debit card issuance and (ii) merchant acquirer – through Bede, a certifier controlled by Lau. According to the Superintendence, the proposed transaction would involve the vertical integration between the joint venture and the markets for issuance and merchant acquirer. CADE's Superintendence found that the proposed joint venture could lead to discriminating strategies against competing merchant acquirers, which could possibly make behavioural and access remedies necessary. After the Superintendence's analyses, the case will be submitted directly to the Tribunal.

According to publicly available information, on February 19, 2016, the United Parcel Service filed an appeal of a merger between its parcel delivery rivals FedEx and TNT Express, two weeks after CADE cleared the USD 4.8 billion deal. In its appeal to CADE's tribunal yesterday, UPS apparently claimed that the deal would eliminate competition and give the post-merger company a dominant position in

parcel delivery services – especially in the Brazilian market for international express deliveries of small packages. CADE's superintendent-general had recommended to the Tribunal to unconditionally clear the deal on 2 February, concluding there were no anticompetitive effects in any of the parcel delivery markets.

## **Policy Reforms in Brazil**

On May 25, 2015, CADE, adopted a document entitled *Guidelines for Analysis of Previous Consummation of Merger Transactions* during the Tribunal's public hearing on 20 May 2015. The document is divided into three sections. The *first* section provides a definition for gun-jumping and specifies the actions which can lead to it. The *second* section sets forth specific guidelines for companies as a means of avoiding the risks of this practice, such as clean teams and parlor rooms. The *third* section concludes with the penalties that can be applied to the parties in case of noncompliance with the established rules.

Among the actions which can lead to gun-jumping, the guidelines include the pre-closing exchange of sensitive information, price fixation between competitors, and interference on the acquired companies' decisions and other actions that take place before and during the transaction. In regards to the penalties, the practice of gun-jumping entails fines ranging from BRL 60,000 (USD 16,631) to BRL 60 million (USD 1,633,010).



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## Non-Voting Shares Make Their Public Debut and Generate Some Governance Concerns, but How Will Courts View the Structure When First Presented?

3/12/2017 | Posted by James Moloney; Elizabeth Ising; Peter Wardle; Stewart McDowell  
Topic: Corporate Governance ; Securities Regulation

On March 1, 2017, Snap Inc. (“Snap” or the “Company”) – owner of the popular social media platform Snapchat – priced its highly anticipated initial public offering (“IPO”). With 200 million shares sold at \$17 per share, the IPO raised approximately \$3.4 billion for the Company. On their first trading day, Snap shares opened at \$22.41 per share and peaked as high as \$28.84 the following day. As of March 10, shares closed at \$22.07, above its initial offering price, but below its opening trading price. As the largest IPO of any U.S.-based company since Facebook’s public offering in 2012, many investors’ primary focus here has been on the complete lack of voting privileges associated with the shares sold in the IPO.

As described in [Snap’s IPO prospectus](#), the Company has three classes of shares: Class A common stock, the publicly traded shares; Class B common stock, reserved for early investors and executives; and Class C common stock, owned solely by the company’s co-founders Evan Spiegel and Bobby Murphy. Class A shares are not entitled to vote, while Class B and Class C shares are each entitled to one and ten votes, respectively, and vote together as a single class. Given this structure, even before shares were sold in the IPO, 88.5 percent of the voting power of the Company remained concentrated in its two founders. Furthermore, Class B shares lose voting privileges when sold or transferred, and Spiegel’s and Murphy’s control of the Company through their Class C shares will not diminish even if either or both leave Snap.

Attempting to preserve control through non-traditional voting structures is not a new concept for companies, especially technology companies. Many technology companies have dual class structures, in which founders and other early-round investors hold higher vote shares (typically ten votes per share) and others hold low vote shares (typically one vote per share). In the last several years, a number of companies including Alphabet, Google’s parent company, Facebook, Zillow and Under Armour have introduced non-voting shares into their capital structures in order to delay the loss of voting control of their founder(s). Snap, however, is the first to issue only non-voting shares to the public in an IPO.

There has been a fair amount of criticism of Snap’s move to publicly offer shares that do not include voting rights. Kurt Schacht, the Chair of the Securities and Exchange Commission’s Investor Advisory Committee, [described](#) the structure as “a significant concern” and a “troubling development from the perspective of investor protection and corporate governance” if it were to spur a new trend for tech companies going public. Just prior to Snap’s IPO, top fund managers including BlackRock, Vanguard, and T. Rowe Price [urged companies](#) to allocate voting rights to shareholders “in proportion to their economic interest.” The Council of Institutional Investors (“CII”) sent [a letter](#) to Snap urging its board to adopt a single-class voting structure and is now leading an [initiative](#) to exclude Snap (and

any other company that sells non-voting shares to investors) from market indices managed by S&P, Dow Jones and MSCI Inc. In a March 9, 2017 CII Governance Alert, CII noted that it “also plans to renew its 2012 request to the NYSE and Nasdaq to bar listings of companies with multiple share classes with unequal voting rights. At a minimum . . . the exchanges should set standards for regulating dual-class companies, such as reasonable sunset provisions for multiple share classes.”

SEC Commissioner Kara Stein, a Democrat, [said that](#) regulators need to “critically assess” the IPO regime following the Snap IPO, noting that “[t]he current structure is premised on taking investor capital while giving that investor the rights that help hold a company’s management accountable [for] the use of the capital.” How the SEC will proceed going forward will depend largely on the views of Jay Clayton, President Trump’s appointee to head the Commission. His views on this issue may become public during his confirmation hearings before the Senate Banking Committee, currently scheduled for March 23.

Absent, however, from the current discussion regarding the corporate governance issues raised by Snap’s capital structure is the potential impact of non-voting shares on future transactions and the judicial scrutiny that may follow. Snap’s non-voting shares draw into question situations where a shareholder vote may be necessary. The NYSE, NASDAQ, and other self-regulating organizations have rules requiring the submission of certain transactions to a shareholder vote, such as a change of control transactions or certain issuances of more than 19.9 percent of the Company’s outstanding shares. With most shareholders lacking any voting rights altogether, how Snap and other companies that may follow in their wake can cleanse such transactions via disinterested shareholder approval remains an open question.

Additionally, when reviewing disputed business transactions in the context of damages, courts will generally apply one of two basic standards of review: business judgment or entire fairness. The well-known business judgment rule typically applies to arms’-length transactions, creates a rebuttable presumption in favor of the corporation and protects directors from after-the-fact second-guessing in litigation proceedings. Entire fairness, on the other hand, may apply to those transactions involving interested directors, officers, or controlling shareholders. The standard is more exacting in that it places the burden on the corporation to show that a challenged transaction is entirely fair to its shareholders both in terms of process and price. Enhanced scrutiny may also apply in the context of an injunction, if shareholders seek to prevent consummation of a transaction.

In its IPO prospectus, Snap explained that its co-founders Spiegel and Murphy “have the ability to control the outcome of all matters submitted to our shareholders for approval, including the election, removal, and replacement of directors and any merger, consolidation, or sale of all or substantially all of our assets” – the very transactions that will often trigger litigation where the courts must determine the appropriate standard of review. While the presence of non-voting shares does not itself preclude a review under the business judgment standard, it seems one practical effect of Snap’s voting structure is that it may serve to hamper the company’s ability to seek shareholder ratification from disinterested shareholders or other procedural safeguards (*e.g.*, obtaining a “sterilized vote” – from a majority-of-the-minority) that could otherwise help shield the directors’ actions from heightened judicial scrutiny.

This rather novel structure incorporating non-voting stock in an IPO will certainly raise some interesting issues for the courts to consider (when first presented), and it's only a matter of

time before that happens!

Thanks to Sean Sullivan and Alon Sachar, corporate associates in Gibson Dunn's San Francisco office, for all their hard work and effort in drafting this blog.

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## SEC Brings Enforcement Action for Deficient Disclosure of Financial Advisors' Fee Arrangements

2/17/2017 | Posted by James Moloney  
Topic: M&A ; Securities Regulation

On February 14, 2017, the U.S. Securities and Exchange Commission (the "SEC") announced the settlement of an enforcement action against CVR Energy, Inc. ("CVR" or the "Company"). The SEC brought action against the Company for its failure to disclose adequately the material terms of its fee arrangements with two investment banks in connection with the financial advisory services each bank provided to CVR during the pendency of a hostile tender offer launched by an activist. See *CVR Energy, Inc.*, Exchange Act Release No. 80039 (February 14, 2017).

Notwithstanding the fact that the banks failed to help CVR avoid a takeover by the activist or produce a higher offer price, they collected approximately \$36 million in success fees based on the expansive definition of the term "success" set forth in their engagement letters with the Company. The engagement letters (negotiated with the assistance of CVR's outside counsel), provided the banks would receive an increased fee in the event the company were sold, *regardless* of whether: (i) the final sale price was deemed adequate by CVR's board, (ii) the banks succeeded in defending against the activist's bid, or (iii) the banks were successful in causing the activist to raise its bid for the Company.

According to the SEC's order, CVR violated Section 14(d)(4) and Rule 14d-9 thereunder which require an issuer to summarize the material terms of the compensation arrangements with its financial advisor when disclosing a solicitation or recommendation on Schedule 14D-9 in response to a tender offer. CVR's Schedule 14D-9 (prepared by CVR's outside counsel), indicated the banks' fee arrangements were "customary." The SEC's order found CVR's disclosure of customary compensation inadequate under the circumstances noting that it failed to inform CVR shareholders of the potential conflicts of interest arising from the structure of the fee arrangements.

This enforcement action comes on the heels of [recent guidance](#) published by the SEC that addresses the appropriate level of disclosure relating to a financial advisor's fee arrangements in Schedule 14D-9 filings. On November 18, 2016, the Staff in the Office of Mergers & Acquisitions in the Division of Corporate Finance (the "Staff") at the SEC released new Compliance and Disclosure Interpretations ("C&DIs") outlining the Staff's view of what is appropriate to disclose when summarizing compensation arrangements with financial advisors retained to assist in responding to a registered tender offer. The C&DIs make clear that "a summary of all material terms" in a Schedule 14D-9 is required. Even though an advisor may disclaim making a recommendation to or solicitation of shareholders, where the issuer's board or independent committee retains a financial advisor to advise with respect to a tender offer and the analysis is discussed in the issuer's Schedule 14D-9, a summary of material terms is required. In such case, the act of retaining the advisor and discussing the engagement in the Schedule 14D-9 is viewed as sufficient to bring the terms of the advisor's engagement within the scope of the line item disclosure requirement.

The C&DIs serve as a good reminder to issuers (and their counsel) that boilerplate disclosures with respect to an advisor's compensation can be deemed inadequate by the Staff. Specifically, issuers can expect the Staff to challenge vague or general statements in Schedule 14D-9s indicating that an advisor will receive "customary compensation." While acknowledging that the appropriate level of disclosure will depend on the facts and circumstances, the Staff noted the summary should be sufficiently detailed to allow an investor to make an informed decision regarding the merits of a solicitation or recommendation, as well as the objectivity of the financial advisors' analyses or conclusions.

The SEC order in the CVR case advances this point one step further and raises the stakes for including generic or boilerplate disclosure. Thus, going forward companies confronted with a potential takeover (as well as their counsel), should take great care when negotiating the terms of engagement letters with financial

advisors. The terms should be tailored to the circumstances, including any carve-outs (where appropriate) from the payment of success fees in hostile bids, such that the interests of a company's financial advisor are aligned with the interests of shareholders. Moreover, those involved in drafting and approving the disclosure in Schedule 14D-9 statements should ensure the filing contains the appropriate level of disclosure on compensation arrangements with advisors, particularly where such arrangements present a potential for conflicts of interest.

Special thanks to Eduardo Gallardo, Jason Mehar and Jason Park who assisted with the drafting of this post.

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## Public Statement

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# Reconsideration of Pay Ratio Rule Implementation

## Acting Chairman Michael S. Piwowar

**Feb. 6, 2017**

The Commission adopted the pay ratio disclosure rule in August 2015 to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rule requires a public company to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer.

Based on comments received during the rulemaking process, the Commission delayed compliance for companies until their first fiscal year beginning on or after January 1, 2017. Issuers are now actively engaged in the implementation and testing of systems and controls designed to collect and process the information necessary for compliance. However, it is my understanding that some issuers have begun to encounter unanticipated compliance difficulties that may hinder them in meeting the reporting deadline.

In order to better understand the nature of these difficulties, I am seeking public input on any unexpected challenges that issuers have experienced as they prepare for compliance with the rule and whether relief is needed. I welcome and encourage the [submission of detailed comments](#), and request that any comments be submitted within the next 45 days.

I have also directed the staff to reconsider the implementation of the rule based on any comments submitted and to determine as promptly as possible whether additional guidance or relief may be appropriate.

I understand that issuers need to be informed of any further Commission or staff action as soon as possible in order to plan and adjust their implementation processes accordingly. I encourage commenters and the staff to expedite their review in light of these unique circumstances.

### Comments Received

## Acting SEC Chair Piowar Directs Staff to Reconsider Conflict Minerals Rule

2/1/2017 | Posted by James Moloney; Lori Zyskowski

Topic: Corporate Governance ; Dodd Frank ; Securities Regulation

On January 31, 2017, the SEC's Acting Chairman, Michael Piowar, issued a public statement (available [here](#)) that he has directed the Commission's Staff to reconsider whether the Staff's prior guidance on conflict minerals disclosures (previously published in April 2014 and available [here](#)) is still appropriate and evaluate whether additional relief may be appropriate.

By way of background, the SEC's conflict minerals disclosure rules – Exchange Act Rule 13p-1 and Form SD – were challenged shortly after adoption. Ultimately, the Court of Appeals for the D.C. Circuit in [National Association of Manufacturer's et al. v. SEC et al.](#) held that certain of the disclosures required by the SEC's conflict minerals rule violated the First Amendment. Specifically, the Court of Appeals held that Section 13(p) and Rule 13p-1 (the "Rule") "violate the First Amendment to the extent the statute and rule require regulated entities to report to the Commission and state on their website that any of their products have not been found to be 'DRC conflict free.'"

Shortly thereafter, the Corporation Finance Division Director at the time, Keith Higgins, issued a public statement providing guidance that companies will be afforded some flexibility in how they describe products in their Conflict Minerals Reports. The guidance explained that companies are not required to affirmatively describe their products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict indeterminable." However, if a company voluntarily elects to describe any of its products as "DRC conflict free", then the company would be permitted to do so provided it had obtained an independent private sector audit (IPSA) as otherwise required.

Piowar goes on in his statement to provide several general observations regarding the current state of affairs surrounding the Rule. Specifically, Piowar notes that the litigation relating to the Rule is ongoing, the Staff's prior guidance in this area remains in effect, and the temporary transition period relating to the Rule has expired. Specifically, the reporting period beginning January 1, 2017, will be the first reporting period in which *all* (emphasis added) issuers subject to the Rule's disclosure requirements, including smaller reporting companies, are unable to take advantage of the transition period afforded to companies when the Rule was first adopted. Lastly, Piowar solicits public comment on all aspects of the Rule and related guidance, which can be submitted directly through a link on the public statement page (available [here](#)).

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## Proxy Access a' la Private Ordering? Not So Fast!

*By Jim Moloney & Lauren Assaf of Gibson, Dunn & Crutcher LLP<sup>1</sup>*

The American Bar Association's Proxy Statements and Business Combinations Subcommittee met on Friday, November 18, 2016, as part of the Business Law Section's Fall Meeting in Washington, D.C. Speakers at the Subcommittee meeting included Securities and Exchange Commission ("SEC") Associate Director (Legal) of the Division of Corporation Finance Michele Anderson, SEC's Office of Mergers & Acquisitions ("OM&A") Chief Ted Yu and Special Counsel Tiffany Posil, with Weil, Gotshal, & Manges LLP partner Jim Griffin and counsel Adé Heyliger serving as moderators.

### Universal Ballot

Michele Anderson and Tiffany Posil opened the panel with a discussion of the SEC's recent universal proxy card rule proposals.<sup>2</sup> Both worked on drafting the proposed rules along with Christina Chalk, Senior Special Counsel in OM&A. Ms. Anderson and Ms. Posil explained that the Staff sought to create a management- and shareholder-neutral framework that would allow shareholders to use proxy voting systems in a way that mirrored the experience of voting in person at an annual shareholder meeting: in sum, the rules as proposed were designed to allow shareholders to vote by proxy for a mix of management and shareholder nominees all on one ballot (proxy card).

As proposed, the framework is mandatory in order to mitigate shareholder confusion and logistical issues, reduce the likelihood that parties could use universal proxies as tactical tools, and limit application of the rules to real election contests alone (*i.e.*, those solicitations where both sides seek to elect their own director nominees). The Staff also highlighted its keen interest in receiving comments on the proposed 60-day advance notice deadline for shareholders to submit the names of their nominees and related information to management,<sup>3</sup> and the requirement that shareholders solicit at least a majority of the voting power of shares outstanding and entitled to vote on the election of directors.<sup>4</sup>

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<sup>1</sup> © 2016 Gibson, Dunn & Crutcher LLP. James J. Moloney is Co-Chair of Gibson, Dunn & Crutcher LLP's Securities Regulation and Corporate Governance Practice Group and a Corporate Partner in the firm's Orange County Office. Lauren Assaf is a Corporate Associate in Gibson Dunn's Orange County Office.

<sup>2</sup> Universal Proxy, 81 Fed. Reg. 79,122 (proposed Nov. 10, 2016) (to be codified at 17 C.F.R. pt. 240). See also *SEC Proposes New Universal Proxy Card Rules for Contested Elections*, GIBSON DUNN (Nov. 1, 2016), <http://gibsondunn.com/publications/documents/SEC-Proposes-New-Universal-Proxy-Card-Rules-for-Contested-Elections.pdf>.

<sup>3</sup> See Universal Proxy, 81 Fed. Reg. at 79,131, 79,135-37.

<sup>4</sup> *Id.* at 79,138-39.

## **“Affiliates” in Going Private Deals**

Ted Yu then went on to address the Staff’s longstanding interpretive position as to who is deemed an “affiliate” in connection with the application of Rule 13e-3 to “going private” transactions. Mr. Yu noted that the term “affiliate” is defined in Rule 12b-2 as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.”

Citing to several recent going private transactions (without naming the parties involved), Mr. Yu explained that counsel for several companies recently argued their position to the Staff that a shareholder under the common control of the target and the acquirer should not be deemed an affiliate when certain procedural safeguards are imposed (e.g., walling-off or ring-fencing the particular person, shareholder, or entity under common control from any transaction-related negotiations). Mr. Yu indicated that the Staff had recently rejected such arguments by counsel, recommending that a two-part analysis be conducted instead: first, a determination of whether a person is in fact an affiliate of the issuer, and second, whether the relevant party or parties are engaged in a transaction having a Rule 13e-3 “going private” effect.

Mr. Yu went on to caution the audience against raising certain categorical arguments; for example, that a party cannot be an affiliate if another holder has a significantly greater beneficial ownership position, or that a party with less than a majority (*i.e.*, 49% ownership stake) is not an affiliate. In both cases, Mr. Yu noted that such arguments, alone, are not generally persuasive to the Staff. Instead, Mr. Yu suggested that companies focus on the facts and circumstances of the underlying transaction and analyze whether the potential affiliate has the power to control the target’s management or policies.

## **Proxy Access & Private Ordering**

Lastly, Ms. Anderson and Mr. Yu discussed some interesting issues that have come up in connection with “private ordering” proxy access bylaws that were adopted in the wake of Rule 14a-11. The SEC’s approach to proxy access, as embodied in Rule 14a-11,<sup>5</sup> sought to allow shareholders or groups of shareholders possessing an aggregate of at least 3% of the voting power of a company’s securities for at least three years, to request inclusion of the shareholders’ director nominees in the company’s proxy materials disseminated to shareholders. The D.C. Circuit struck down the rule down in July 2011.<sup>6</sup>

Nonetheless, companies began to adopt their own “proxy access” bylaw provisions that essentially mirrored the requirements in Rule 14a-11 in what is commonly known today as “private ordering” proxy access. On November 10, 2016, GAMCO Investors, Inc. (“GAMCO”) became the first shareholder to exercise its right to nominate directors under a private ordering proxy access bylaw provision at National Fuel Gas Company.<sup>7</sup>

Now that a private ordering proxy access bylaw has been exercised, Mr. Yu observed several interesting practical issues in this case of first impression. Notably, the exemptions from Section 13(d) reporting and the proxy solicitation rules that were adopted as part of Rule 14a-11 went away when the rule was vacated. As such, some fundamental questions have arisen, including: how can shareholders seeking to rely on a proxy access bylaw be comfortable they are not engaged in a proxy solicitation in violation of the proxy rules should they do more than simply disclose the bare bones information permitted in the company’s proxy statement and that required in the shareholder’s Schedule 14N? And what, if any, proxy

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<sup>5</sup> Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. (to be codified at 17 C.F.R. pts. 200, 232, 240, 249)).

<sup>6</sup> Bus. Roundtable v. SEC (*Business Roundtable II*), 647 F.3d 1144 (D.C. Cir. 2011).

<sup>7</sup> Nat’l Fuel Gas Co., Notice of Submission of a Nominee or Nominees in Accordance with Procedures Set Forth Under Applicable State or Foreign Law, or the Registrant’s Governing Documents (Schedule 14N) (Nov. 10, 2016) (filed by GAMCO Asset Mgmt. Inc. and Gabelli Funds, LLC); see generally James McRitchie, *GAMCO Invokes Proxy Access at National Fuel Gas, CORP. GOVERNANCE* (Nov. 10, 2016), <http://www.corpgov.net/2016/11/gamco-invokes-proxy-access-national-fuel-gas/>; N. Peter Rasmussen, *First Investor Takes Proxy Access Out For A Spin; Tea Leaves Muddled on “Fix It” Proposals*, BLOOMBERG BNA (Nov. 14, 2016), <http://www.bna.com/first-investor-takes-b57982082713/>. National Fuel Gas Company subsequently rejected GAMCO’s proposed nomination on the grounds that GAMCO’s nomination did not satisfy the company’s bylaw provision. Specifically, the company said GAMCO was seeking to change or influence control of the issuer, citing the shareholder’s beneficial ownership reporting on Schedule 13D, and the prior submission of proposals seeking a spin-off transaction. Several days after the company’s rejection, GAMCO withdrew its proposed nomination(s). See Kristyn Hyland, *First Proxy Access Nominee? Not So Fast Says National Fuel Gas Co.*, BLOOMBERG BNA (Nov. 28, 2016), <https://www.bna.com/first-proxy-access-b73014447718/>; Samantha Mergenthaler, *Bakrow Withdraws His NFG Board Nomination*, INTELLIGIZE (Nov. 30, 2016), <http://www.intelligize.com/blog/bakrow-withdraws-nfg-board-nomination/>.

solicitation exemptions may be available to such persons seeking to go one step further in articulating the reasons that shareholders should vote for their nominees, as opposed to management's nominees?

Ms. Anderson and Mr. Yu briefly reviewed some options including reliance on the "10-person-or-less" exemption in Rule 14a-2(b)(2) and the so-called "soapbox" exemption found in Rule 14a-1(1)(2)(iv) where a shareholder can state how it intends to vote (and the reasons therefor) by means of speeches in public forums, press releases, broadcast media, newspapers, magazines, or other similar publications that are disseminated on a regular basis. The Staff went on to note that the exemption in Rule 14a-12 is conditioned on the eventual filing of a definitive proxy statement. As such, Rule 14a-12 would not be available for the more extensive soliciting activities that one might want to engage in as part of a proxy access campaign.

The Staff also discussed the absence of any clear exemption from Section 13(d) beneficial ownership reporting obligations, noting that the relevant exemptions from 13(d) were similarly lost when Rule 14a-11 was vacated. Thus, if two or more shareholders come together in order to nominate directors under a private ordering proxy access bylaw, a Section 13(d) group may be formed as a result. Moreover, when shareholders with 5% or more (in the aggregate) seek to nominate directors under a proxy access bylaw, they would no longer be eligible to report their beneficial ownership on Schedule 13G (as previously permitted by Rule 14a-11), but instead would need to disclose their ownership on the more onerous Schedule 13D.

In the wake of GAMCO's initial lead in this area, we will likely see other shareholders attempt to nominate and elect their own director nominees in the upcoming 2017 proxy season using proxy access bylaws. In doing so, the issues highlighted by the Staff, notably the lack of any express exemptions from Section 13(d) and the proxy rules, will only become more prominent going forward. These issues will of course need to be resolved, either through advanced legal planning—which may include seeking guidance from the Staff (through no-action or exemptive relief)—or perhaps, given the current political climate, in *after-the-fact* litigation.

Either way, the discussion at the recent ABA subcommittee meeting highlights the Staff's concerns and the need for careful analysis when shareholders seek to utilize proxy access bylaws to nominate and elect their director nominees to a public board. Mr. Yu invited shareholders and issuers alike to call OM&A when faced with these and other issues, so that they may discuss with the Staff in advance their plans and approach to soliciting activities pursuant to a proxy access bylaw.

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# Statement on the Commission's Conflict Minerals Rule

## Acting Chairman Michael S. Piwowar

**January 31, 2017**

In April 2014, the Court of Appeals for the D.C. Circuit held that a portion of the disclosure required by the Commission's Conflict Minerals Rule violated the First Amendment. Shortly thereafter, the then-Director of the Division of Corporation Finance issued guidance regarding compliance with the Rule in light of the court's decision and the Commission issued an order staying the effect of the compliance date for those portions of the rule found to be unconstitutional. The case was subsequently remanded to the district court for further consideration. The litigation remains ongoing and the staff's guidance remains in effect.

In the interim, the temporary transition period provided for in the Rule has expired. And the reporting period beginning January 1, 2017, is the first reporting period for which no issuer falls within the terms of that transition period. In light of this, as well as the unexpected duration of the litigation, I am directing the staff to consider whether the 2014 guidance is still appropriate and whether any additional relief is appropriate in the interim.

I welcome and encourage interested parties to [submit detailed comments](#), and request that they be submitted within the next 45 days.

### *More information*

- [Additional statement from Acting Chairman Piwowar](#)
- [Commission order issuing stay](#)
- [2014 Statement on the Effect of Court of Appeals Decision on the Conflict Minerals Rule](#)

### **Comments Received**

## Public Statement

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# Reconsideration of Conflict Minerals Rule Implementation

## Acting Chairman Michael S. Piwowar

Jan. 31, 2017

Today, I directed the staff to reconsider whether the 2014 guidance on the conflict minerals rule is still appropriate and whether any additional relief is appropriate.

Since May 2014, the Commission has partially stayed compliance with the rule, after the U.S. Court of Appeals for the D.C. Circuit found that the rule violated the First Amendment. This partial stay has done little to stem the tide of unintended consequences washing over the Democratic Republic of the Congo and surrounding areas.

While visiting Africa last year, I heard first-hand from the people affected by this misguided rule. The disclosure requirements have caused a *de facto* boycott of minerals from portions of Africa, with effects far beyond the Congo-adjacent region. Legitimate mining operators are facing such onerous costs to comply with the rule that they are being put out of business. It is also unclear that the rule has in fact resulted in any reduction in the power and control of armed gangs or eased the human suffering of many innocent men, women, and children in the Congo and surrounding areas. Moreover, the withdrawal from the region may undermine U.S. national security interests by creating a vacuum filled by those with less benign interests.

Given these facts on the ground, I believe that it is essential to hear from interested persons on all aspects of the rule and guidance.

A comment page regarding reconsideration of the conflict minerals rule and guidance has been created — [submit detailed comments](#).

\* \* \*

More Information:

- [Statement of Acting Chairman Piwowar on the Commission's Conflict Minerals Rule](#)

### Comments Received

## SEC Staff Grants No-Action Request Concurring with Exclusion of Shareholder Proposal On Virtual-Only Annual Meetings

1/4/2017 | Posted by Lori Zyskowski; Elizabeth Ising; Ronald Mueller

Topic: [Shareholder Proposals](#) ; [Proxy Statements and Annual Meetings](#) ; [Corporate Governance](#)

In recent years, an increasing number of companies have opted to hold annual shareholder meetings exclusively online. These annual meetings are commonly referred to as “virtual-only annual meetings”. In a decision critical for companies that currently hold or are contemplating switching to virtual-only annual meetings, the staff of the Securities and Exchange Commission (the “SEC Staff”) recently issued a no-action letter permitting a company to exclude a shareholder proposal that objected to virtual-only annual meetings. Specifically, the shareholder proposal requested that the company’s board adopt a policy to initiate or restore in-person annual meetings. The SEC Staff concurred that the proposal could be excluded under Rule 14a-8(i)(7) on the grounds that the decision whether to hold in-person annual meetings is related to the company’s ordinary business operations because the proposal “relates to the determination of whether to hold annual meetings in person.” The SEC Staff’s decision is not yet available on the SEC’s website.

The proposal in question was submitted to HP Inc. (“HP”) by John Chevedden and Bart Naylor. HP has been holding its annual meetings solely online since 2015. Previously, in a [no-action letter](#) dated December 9, 2016, the SEC Staff permitted Hewlett Packard Enterprise (which also adopted a virtual-only annual meeting format when it became a stand-alone publicly traded company) to exclude the same proposal based on procedural grounds without addressing the Rule 14a-8(i)(7) arguments (which Hewlett Packard Enterprise also included in its no-action request). By concurring with arguments made by Gibson Dunn on HP’s behalf, the SEC Staff confirmed that this proposal is also excludable under Rule 14a-8(i)(7).

In permitting HP to exclude the proposal, the SEC Staff reaffirmed its position on this subject from more than 14 years ago. Specifically, in *EMC Corp.* (avail. Mar. 7, 2002), the Staff concurred in the exclusion under Rule 14a-8(i)(7) of a proposal “request[ing] that EMC Corporation adopt a corporate governance policy affirming the continuation of in-person annual meetings, adjust its corporate practices policies [sic] accordingly, and make this policy available publicly to investors” on the basis that the proposal “relat[ed] to EMC’s ordinary business operations (i.e., the determination whether to continue to hold annual meetings in-person).”

Companies that currently hold and are considering holding virtual-only annual meetings should take comfort in this decision from the SEC Staff – whether to go virtual properly remains within the purview of the company’s board of directors. Given the potential cost savings and flexibility that can be achieved from holding virtual-only annual meetings, we expect that more companies will choose to hold virtual-only annual meetings in the near future. Importantly, as discussed in detail in our client memo, [“Planning for your Annual Shareholder Meeting: Selected Considerations for a Virtual-Only Meeting”](#), before deciding to change to a virtual-only annual meeting format, companies should consult their governing documents and the laws of their state of incorporation. In addition, in spite of HP’s successful no-action request, companies may also wish to proactively discuss the proposed change with key shareholders and explain the rationale behind holding shareholder meetings exclusively online.

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November 14, 2016

## **FINANCIAL REGULATORY REFORM UNDER A TRUMP PRESIDENCY: WHAT WE KNOW AND WHAT TO EXPECT**

To Our Clients and Friends:

President-elect Donald J. Trump campaigned for sweeping regulatory reforms in order to encourage economic growth. Although a cornerstone of his campaign was built around deregulation, many of the details of the President-elect's plans remain unknown. This Client Alert discusses what the upcoming Trump years might entail for the financial services industry and the derivatives markets. Currently, much of the landscape is unclear, because, although the general election was marked by negative sentiments towards both Wall Street and the regulatory agencies that supervise its activities, few specific policy proposals articulated what reform would entail.

### **I. What We Know**

#### **A. Congressional proposals for CFTC reforms**

Since the enactment of Dodd-Frank in 2010, Republican members of Congress have introduced legislative proposals to amend many of its provisions. Although the President-elect has remained largely silent on specific regulatory reform measures, recent proposed legislation in Congress seeking to reform derivatives markets and market regulators may provide a template for future reform efforts.

Within the derivatives space, Congress has, to date, enacted few changes to Dodd-Frank. One, repealing the so-called "swaps push-out" rule, was included very late in the consideration of a must-pass appropriations bill.<sup>[1]</sup> Two others--creating new exceptions from certain clearing and margin requirements--were passed for commercial end-users. This past summer, U.S. Representative Jeb Hensarling (R-Texas), Chairman of the House Committee on Financial Services, introduced H.R. 5983, The Financial CHOICE Act of 2016 (the Financial CHOICE Act), which would repeal a multitude of Dodd-Frank provisions and introduce numerous Commodity Futures Trading Commission (CFTC) reforms.<sup>[2]</sup>

In particular, these reforms would include: introducing enhanced procedures governing the issuance of no-action relief, guidance and interpretive rules; introducing a technology plan and internal risk controls; limiting the duration under which the CFTC or staff may issue subpoenas; and mandating that the CFTC issue a comprehensive cross-border compliance rule in accordance with formal notice and comment rulemaking procedures. Notably, the Financial CHOICE Act also reflects Congress's increased attention to agencies' cost-benefit analyses, and would both impose heightened cost-benefit requirements and provide for direct appellate review of rulemakings for challenges to the application of those heightened standards.

## **B. A moratorium on rulemaking**

President-elect Trump has vowed to "issue a temporary moratorium on new agency regulations that are not compelled by Congress or public safety."<sup>[3]</sup> As part of this moratorium, the President-elect has called for a systematic review of federal regulation, whereby he would ask "every federal agency to prepare a list of all of the regulations they impose on Americans which are not necessary."<sup>[4]</sup> Since it is very early in the transition, it is unclear at this time what regulations will be a part of the moratorium.<sup>[5]</sup> We would anticipate that the transition team for the independent financial regulatory agencies led by former Republican Securities and Exchange Commissioner Paul Atkins would gather and present information relating to a moratorium to the financial regulatory agencies.

## **C. An intent to reform Dodd-Frank**

The President-elect has stated that his presidency will "be working to dismantle the Dodd-Frank Act and replace it with new policies to encourage economic growth and job creation."<sup>[6]</sup> In particular, the President-elect has stated that "under Dodd-Frank, the regulators are running the banks. The bankers are petrified of the regulators. And the problem is that the banks aren't loaning money to people who will create jobs."<sup>[7]</sup> Moreover, it appears that the Trump transition team is considering, among others, Representative Hensarling as a possible candidate for Secretary of the Treasury.<sup>[8]</sup>

In addition, the 2016 Republican platform stated support for a "21st Century" Glass-Steagall Act, which would separate the investment and commercial activities of banks. Although the President-elect has not explicitly stated his desire to "break up the banks" in order to address the Too Big To Fail issue and has previously said publicly that he disagreed with the idea, certain campaign speeches indicated his agreement with the Republican platform on the "21st Century" Glass-Steagall concept.<sup>[9]</sup>

Some members of Congress have also pushed for regulatory relief for financial institutions that focus on community lending by calling for an increase to the regulatory thresholds for certain aspects of Dodd-Frank compliance. In particular, U.S. Senator Mike Crapo, who will chair the Senate Banking Committee in the 115th Congress, has consistently expressed his support for raising the threshold for heightened prudential regulatory standards to \$100 billion in assets, which would benefit community and mid-sized regional banks. Similar sentiment was expressed in 2014 by Federal Reserve Governor Daniel Tarullo, when he stated that Dodd-Frank testing and planning provisions "do not seem . . . to be necessary" for banks with between \$50 billion and \$100 billion in total assets.<sup>[10]</sup>

## **D. A change in the scope and power of the Federal Reserve**

President-elect Trump has also made it clear of his intent to rein in the powers of the Federal Reserve. As part of an anticipated overhaul of Dodd-Frank, the President-elect has explicitly noted the need to hold the Federal Reserve accountable; in particular, the need for a congressional audit of its activities. In addition, the President-elect has expressed his intent to replace Chair Yellen, but her term runs until February 3, 2018, and it is not at all clear who would be her successor. Further, it is unclear as to whether Vice Chair Fischer would continue to serve as Vice Chair under the Trump presidency after his term ends June 12, 2018. Although terms as Chair and Vice Chair are limited to four years, both Yellen and



Fischer would continue to serve as members of the Board of Governors until January 31, 2024 and January 31, 2020, respectively.[11]

## **E. Economic advisors and transition team**

During his campaign, President-elect Trump sought the advice of several financial executives, including Steven Mnuchin, a former Goldman Sachs executive who founded hedge fund Dune Capital Management, John Paulson, a well-known hedge fund manager, and Stephen Feinberg, CEO of private-equity firm Cerberus Capital Management. As President-elect Trump transitions into office, David Malpass, who served under the Reagan administration, is leading the transition strategy for the Treasury Department, while Paul Atkins (discussed above) will lead the transition of independent financial regulatory agencies. It is believed that Mr. Mnuchin is another potential candidate for U.S. Treasury Secretary.

## **II. What to Expect**

In the coming years, we expect a shift in the way financial institutions are regulated, and how such institutions interact with their corporate end-users. In particular, we will likely see a Congress that, while emboldened, is unable to repeal or substantially alter Dodd-Frank, but may be able to pass bipartisan amendments to the statute--perhaps to reduce regulation of community and regional banks and end-users. As noted above, we also likely will see financial regulators halt current rulemaking efforts and engage in new efforts to relax or clarify some of the more restrictive aspects of their current regulatory regimes.

### **A. An emboldened Congress**

A Republican presidency and Republican-controlled Congress will likely usher in a new flurry of legislative activity designed to reduce financial regulation. We believe that the House and possibly the Senate will focus on addressing the concerns raised by many regarding certain aspects of Dodd-Frank, effecting administrative changes to the operations and structure of market regulators, and curtailing the powers of certain financial regulatory agencies.

Undoing Dodd-Frank in its entirety would be an onerous process, but Chairman Hensarling's Financial CHOICE Act serves as a potential means of moving towards that end. As noted below, the exact nature of reform is unknown, but given general Republican sentiments towards the jurisdictional overreach of regulatory agencies, we should expect, at minimum, reform with respect to the extraterritorial application of current and proposed regulation. For example, the much-discussed CFTC cross-border regulations have been a partisan point of contention for quite some time. The Financial CHOICE Act would limit the jurisdictional reach of the CFTC and rein in excessive government regulations by implementing heightened cost-benefit requirements for rulemaking and limiting the extraterritorial reach of the swaps compliance regime.

In addition to a slowing of agency efforts to finalize Dodd-Frank requirements, we are likely to see administrative changes to market regulation. In particular, we expect increased scrutiny and pressure on financial agencies to prepare more detailed and robust cost-benefit analyses for their proposed

regulations and structural changes to agency staffing, enforcement and funding. Notably, increased emphasis by Congress on agencies' use of cost-benefit analysis is a viable mechanism to effect the President-elect's intent to place a moratorium on regulations. Although financial industry observers have already been quick to note that it would be difficult for the President to stop independent agencies such as the Federal Reserve and Consumer Financial Protection Bureau (CFPB) from enacting new regulations, heightened cost-benefit standards and scrutiny would serve as an implicit barrier to extensive rule promulgation where such standards are statutorily mandated. Noting the significant overlap and alignment of sentiment between Congress and the President-elect on this issue, it is possible that we will see near-term legislative reforms to the administrative procedures agencies undergo prior to enacting new regulations.

With respect to reform of the financial regulators themselves, we have seen sentiment from both the President-elect and Congress expressing the need to curtail the powers of independent agencies. For example, in June this year, the House Financial Services Committee introduced and passed the Fed Oversight Reform and Modernization Act (FORM Act), H.R. 3189, which is designed to bring greater accountability and transparency to the Federal Reserve. In addition to Federal Reserve reform, a 2015 White Paper by CFTC Commissioner Giancarlo also may serve as a roadmap for changes to the CFTC's swaps trading regime. In particular, the White Paper called for greater flexibility in trade execution methods, which could help with market fragmentation, liquidity and innovation issues. Similar, if not identical, legislation and rulemakings could be introduced in the short term given President-elect Trump's statements with regard to reducing the footprint of regulatory agencies.

## **B. A focus on lending markets**

A part of the President-elect's economic recovery plan centers on an increased access to credit. Reform within this space could include modifying certain capital, liquidity and other prudential standards, but it may also entail additional reforms to financial institutions' use of derivatives. If loosened prudential standards result in increased lending, as intended, financial institutions will increase their hedging of these positions with derivatives. Republicans in Congress have already been a strong proponent of making derivatives work for end-users of these products; going forward, we can expect to see similar Republican support in both the House and Senate on proposals to encourage community banking and overall business lending.

## **C. An increased focus on end-user concerns**

Traditionally, Congress and the regulators have been sympathetic to the concerns of the commercial end-user community. In the early years of Dodd-Frank, the end-user community served as the canary in the coal mine example for overregulation and government intrusion. With the likely overhaul of the current regulatory regime and an increased focus on domestic economic growth, we can expect to see increased prominence for the end-user community. Given the President-elect's desire to stimulate business lending, we should expect Congress and the White House to be paying close attention to the downstream effects of financial markets regulation on commercial end-users.

## **D. Possible domestic arbitrage opportunities**

A consistent message of the Trump campaign has been to create an environment where banks can lend to American businesses. In that regard, we should expect the resulting architecture of any changes to the existing regulatory regime to create an environment that makes lending and engaging in financial transactions in the United States appealing from a regulatory standpoint when compared to foreign jurisdictions, such as the European Union. This appeal might be particularly strong for banks and businesses looking to move their London operations as a result of Brexit.[12]

## **E. Reform, not repeal, of Dodd-Frank**

As noted above, while the President-elect has signaled his intent to repeal Dodd-Frank, actual repeal is likely impossible given the composition of the Senate. Nevertheless, continued Republican control of both the House and Senate means we are likely to see a number of proposals to overhaul or at least significantly curtail the reach of Dodd-Frank. Although many Republicans in Congress have called for the repeal of Dodd-Frank, the prospects of a repeal bill passing the Senate are extremely slim. In the 115th Congress, the U.S. Senate will have two more Democrats, leaving Republicans holding either a 51-49 or 52-48 majority. That is not a recipe for the passage of legislation almost certain to be filibustered.

Moreover, the President-elect's exploration of a new Glass-Steagall regime, coupled with his support of the Volcker Rule, suggests that Dodd-Frank is not likely to disappear entirely.[13] That said, some changes seem reasonably likely. The House is almost certain to pass a host of amendments to Dodd-Frank. And the Senate, with a number of Democrats on the Senate Banking Committee up for reelection in red or purple states,[14] may be amenable to targeted reforms.

The President-elect has remained largely silent with respect to the CFPB. While quick to denounce the CFPB's architect, Senator Warren, the President-elect noted his commitment to "helping African American businesses get the credit they need" during his call for financial reform.[15] Although it is too early to tell, this sentiment may indicate a willingness to work within a modified construct of the CFPB in executing his presidency's reform of Dodd-Frank. A reworked CFPB could result in the agency taking on a traditional commission structure similar to the CFTC or SEC, whereby it would be reliant on congressional appropriations and the authority of its Director limited.

## **F. Likely moratorium on current regulatory proposals**

The sudden shift in political power has caught many of the agencies by surprise. As a number of Dodd-Frank provisions have yet to be finalized, we will likely see agency progress on many proposed rulemakings grind to a halt. The CFTC, for example, may well slow its work on its current regulatory initiatives, which include the recent Cross-Border Proposal and the Supplemental Proposal to Regulation AT. Interestingly, however, we have heard that the CFTC is still moving forward internally with its review of a draft of its final Position Limits Rule. We also have heard that, notwithstanding the election results, the CFTC may be set to adopt this final rule sometime in either the first or second week of December. Given President-elect Trump's statements regarding placing a moratorium on non-essential agency actions, it is very unlikely that this rule would become effective even if the current CFTC

commissioners adopt it. Similarly, there is the potential for further delay and modification of the SEC's final security-based swap rules.

More generally, it is likely that the President-elect will follow the practice of the last several Administrations in issuing a directive on day one of his presidency, calling on executive departments and agencies (1) not to finalize any rules by sending them to the Federal Register unless they have been reviewed by a Trump appointee, (2) to withdraw from the Federal Register final regulations that have not been published, and (3) to postpone the effective dates of any regulations that were published in the Federal Register but have not taken effect.<sup>[16]</sup> The Trump equivalent of the "Card" and "Emanuel" memos likely would take an equally aggressive position on midnight regulations.

Also of relevance is the potential invocation of the Congressional Review Act (CRA), which provides expedited procedures for Congress to rescind federal regulations with which it disapproves.<sup>[17]</sup> The CRA has been used successfully to overturn only one final agency rule--the Ergonomics Rule--but its design makes it particularly applicable in just this circumstance--where the presidency changes parties and the incumbent's party controls both congressional chambers. The CRA is potentially applicable to any final rule submitted to Congress after May 16, 2016, including rules promulgated by independent agencies. Hence, the President-elect, acting in concert with Congress, may choose to seek to overturn certain agency rules using this procedure.

### III. Conclusion

Deregulation, lower tax rates and an increased focus on cost-benefit analyses have been championed by the President-elect as the jump start that this economy needs. Although we have yet to see detailed plans of action, we can expect that regulatory reform by the President-elect will benefit community facing financial institutions and lending services. In the short-term, we will likely experience a moratorium on rulemaking as agencies transfer power. In the longer-term, it is expected that Congress will begin to chip away at Dodd-Frank. Although the President-elect has not included financial reform in his first 100-day Plan,<sup>[18]</sup> it is expected that the Senate Banking and Finance Committee and the House Financial Services Committee will be working closely with the President-elect to provide a degree of regulatory relief to the financial industry.

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[1] H.R. 83, 113th Cong. § 630 (2014) ("Consolidated and Further Continuing Appropriations Act, 2015"); 15 U.S.C. § 8305.

[2] For information on the Financial CHOICE Act, *see* <http://financialservices.house.gov/choice/>.

[3] Donald Trump, *Regulations*, Trump-Pence Campaign, *available at* <https://www.donaldjtrump.com/policies/regulations/>.

[4] Donald Trump, *Address to the Detroit Economic Club* (Aug. 8, 2016), available at <http://time.com/4443382/donald-trump-economic-speech-detroit-transcript/>; see also Donald Trump, *Address to the New York Economic Club* (Sept. 15, 2016), available at <http://time.com/4495507/donald-trump-economy-speech-transcript/>.

[5] In each instance that we've found, the President-elect has followed his "moratorium" charge with examples related to job and industry growth, with particular focus on the EPA and its emissions regulations. See *id.*

[6] Donald Trump, *Financial Services*, Great Again (accessed Nov. 10, 2016), available at <https://www.greatagain.gov/policy/financial-services.html>; see also *Trump: Economic bubble about to burst*, The Hill (Oct. 14, 2015), available at <http://thehill.com/homenews/campaign/256851-trump-economic-bubble-about-to-burst>.

[7] *Id.*

[8] Ryan Tracy, *Donald Trump's Transition Team: We Will 'Dismantle' Dodd-Frank*, Wall Street Journal (Nov. 10, 2016), available at <http://www.wsj.com/articles/donald-trumps-transition-team-we-will-dismantle-dodd-frank-1478800611>.

[9] Emily Stephenson, *Trump calls for '21st century' Glass-Steagall banking law*, Reuters (Oct. 26, 2016), available at <http://www.reuters.com/article/us-usa-election-trump-banks-idUSKCN12Q2WA>.

[10] Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Rethinking the Aims of Prudential Regulation, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, IL* (May 8, 2014), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.pdf>.

[11] See *Chair Janet L. Yellen*, Board of Governors of the Federal Reserve System (accessed Nov. 11, 2016), available at <https://www.federalreserve.gov/aboutthefed/bios/board/yellen.htm>; *Vice Chairman Stanley Fischer*, Board of Governors of the Federal Reserve System (accessed Nov. 11, 2016), available at <https://www.federalreserve.gov/aboutthefed/bios/board/fischer.htm>.

[12] See Client Alert, *BREXIT Update – Finance and Derivatives Markets Focus*, Gibson Dunn (June 29, 2016), available at <http://www.gibsondunn.com/publications/Pages/BREXIT--Finance-and-Derivatives-Markets-Focus.aspx>.

[13] In particular, we would note that during his primary bid, President-elect Trump voiced his implicit support for Dodd-Frank provisions related to proprietary trading. When asked if he approved of the Volcker Rule, President-elect Trump said, "Well I'm not sure if [Paul Volcker] likes it, but if he's . . . happy, I'm happy." He went on to note that "He was a terrific guy. I've met him a few times. And I thought he was terrific. But I think his policy and his demeanor -- there was something very solid about him. His demeanor were [sic] very good." Patrick Brennan, *Is Donald Trump Starting to Sound a Little Serious?* National Review (Aug. 4, 2015), available at <http://www.nationalreview.com/corner/422041/donald-trump-starting-sound-little-serious-patrick-brennan>.

[14] Senators Brown, Tester, Heitkamp and Donnelly are all up for reelection in 2018.

[15] Tim Hains, *Trump Proposed "New Deal for Black America" in Charlotte*, Real Clear Politics (Oct. 26, 2016), available at [http://www.realclearpolitics.com/video/2016/10/26/trump\\_proposes\\_new\\_deal\\_for\\_black\\_america\\_in\\_charlotte.html](http://www.realclearpolitics.com/video/2016/10/26/trump_proposes_new_deal_for_black_america_in_charlotte.html).

[16] See, e.g., Assistant to the President and Chief of Staff, *Regulatory Review Plan*, 66 Fed. Reg. 7702 (Jan. 24, 2011) ("Card Memo"), and The White House Office, *Memorandum for the Heads of Executive Departments and Agencies*, 74 Fed. Reg. 4435 (Jan. 26, 2009) ("Emanuel Memo").

[17] 5 U.S.C. §§ 801, 802.

[18] *Here Is What Donald Trump Wants To Do In His First 100 Days*, NPR (Nov. 9, 2016), available at <http://www.npr.org/2016/11/09/501451368/here-is-what-donald-trump-wants-to-do-in-his-first-100-days>.



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## Shareholder Nominates First Proxy Access Nominee

11/10/2016 | Posted by Elizabeth Ising; Ronald Mueller; Lori Zyskowski; James Moloney  
Topic: Proxy Access ; Corporate Governance

In what appears to be the first use of a company's proxy access bylaw, GAMCO Asset Management filed today a Schedule 13D/A (available [here](#) ) and a Schedule 14N (available [here](#) ) announcing that it has used the proxy access bylaw at National Fuel Gas (NFG) to nominate a director candidate for election at NFG's 2017 Annual Meeting. According to the 13D/A, GAMCO and its affiliates beneficially own in the aggregate approximately 7.81% of NFG's Common Stock and yesterday delivered a letter to NFG nominating Lance A. Bakrow to the Board of Directors. NFG described itself in its most recent Form 10-K as "a diversified energy company engaged principally in the production, gathering, transportation, distribution and marketing of natural gas." According to the Schedule 13D/A, Mr. Bakrow is the "co-founder and a director of Greenwich Energy Solutions, a private company that provides independent energy solutions in the northeastern United States."

### *NFG's Proxy Access Bylaw*

NFG amended its Bylaws to adopt proxy access in March 2016. The Bylaws provide that a shareholder, or a group of up to 20 shareholders, owning 3% or more of the Company's outstanding Common Stock continuously for at least three years may nominate and include in the company's proxy materials directors constituting up to 20% of the board, provided that the shareholders(s) and the nominee(s) satisfy the bylaw requirements. NFG's proxy access bylaw is available [here](#) .

### *GAMCO's Activism at NFG*

Based on past Schedule 13Ds, GAMCO and its affiliates have beneficially owned in the aggregate at least 5% of NFG's outstanding shares since 2010 and have been advocating for several years that NFG consider a spin-off of certain of its operations. This included GAMCO submitting for consideration at NFG's 2015 Annual Meeting a Rule 14a-8 shareholder proposal asking that "the Board of Directors and management, act expeditiously consistent with effective tax considerations, to engage an investment banking firm to effectuate a spin-off of the Company's utility segment, which represents the operations of National Fuel Gas Distribution Corporation, into a separate publicly traded C-corporation." That shareholder proposal received support from 17.8% of votes cast.

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November 1, 2016

## **SEC PROPOSES NEW UNIVERSAL PROXY CARD RULES FOR CONTESTED ELECTIONS**

To Our Clients and Friends:

On October 26, 2016, the Securities and Exchange Commission (SEC) voted (2-to-1) to issue proposed rules that would mandate the use of universal proxy cards by both issuers and dissidents in contested proxy solicitations for the election of directors. Advancing rules to require universal proxy cards has been a priority of SEC Chair Mary Jo White, and she and Commissioner Kara Stein voted to issue the proposed rules while Commissioner Michael Piwowar dissented. The SEC proposal also includes new disclosure requirements designed to ensure that voting options and standards applicable to the election of directors are clearly presented to shareholders.

In issuing the proposed rules, the Commissioners supporting the rule proposals aimed to minimize the differences that currently occur in contested director elections when shareholders vote by proxy instead of in person at the shareholder meeting. In his dissent, Commissioner Piwowar voiced concern that a universal proxy card may serve to empower special interest groups that seek to use their influence to the detriment of other shareholders, particularly retail investors, and that any increased costs associated with the use of universal proxy cards would be borne by shareholders. He also noted that the minimum solicitation requirement, discussed below, may result in retail shareholders not being included in the dissident's proxy solicitations.

### **Background**

Currently, under SEC rules, a proxy card (and the corresponding voting instruction form distributed to shareholders who hold their stock through a bank or brokerage firm) can include a director nominee's name only if that candidate has consented to the soliciting party (the issuer or the dissident) including the nominee's name on that party's proxy card. As a result, in a contested election of directors, the issuer's proxy card typically lists only the issuer's nominees and not the dissident's nominees, while the reverse applies to the dissident's proxy card. This situation can be particularly challenging when a dissident has nominated fewer candidates than the number of directors to be elected (a "short slate"), because a shareholder who returns the dissident's proxy card is not able to instruct the dissident as to which (if any) of the issuer's nominees to vote for to round out the slate.

A universal proxy card lists all director candidates, regardless of whether the candidate was nominated by the issuer or a shareholder. In a contested election, universal proxy cards thus allow shareholders to authorize proxy voting for a full slate of directors of their choice using a single proxy card, regardless of who nominated each candidate.



In 2013, the SEC's Investor Advisory Committee (IAC) recommended revising the rules for proxy ballots to permit universal ballots for proxy contestants in short-slate campaigns. The IAC's recommendations are available [here](#). The SEC is required by statute to review recommendations from the IAC and issue a public statement including what actions the SEC plans to take as a result of the recommendations. On February 19, 2015, the SEC held a roundtable to discuss universal proxy cards and retail shareholder proxy participation, the transcript of which is available [here](#). The SEC's proposed rules follow the passage by the U.S. House of Representatives, in July 2016, of a spending bill (still pending in the U.S. Senate) with a rider aimed at preventing universal proxy card rules. The rider seeks to achieve this goal by restricting the SEC's use of funds to pursue rulemaking on the basis that universal proxy cards may increase proxy contests to the detriment of shareholders, who may indirectly bear the cost. These sentiments were echoed by Commissioner Piwowar.

## **Summary of the Proposed Rules**

*Applicability and Requirements.* Under the proposed rules, any participant in a contested solicitation for the election of directors, including the issuer and any dissidents, would be required to provide shareholders with a universal proxy card that includes the names of all director nominees. The proposed rules also would require nominating shareholders to solicit proxies from at least a majority of the voting power of shares entitled to vote on the election of directors, which would create a minimum solicitation requirement where none exists now. The SEC's proposed rules also include presentation and formatting requirements for universal proxy cards, including that:

- the universal proxy card must clearly distinguish between issuer nominees, dissident nominees, and any proxy access nominees;
- the nominees must be listed in alphabetical order by last name on the proxy card within each group of nominees;
- the same font type, style and size must be used to present all nominees on the proxy card;
- the proxy card must prominently disclose the maximum number of nominees for which authority to vote can be granted; and
- the proxy card must prominently disclose the treatment and effect of a proxy executed in a manner that grants authority to vote for more nominees than the numbers of directors being elected, in a manner that grants authority to vote for fewer nominees than the number of directors being elected, or in a manner that does not grant authority to vote with respect to any nominees.

The proposed rules would not otherwise change how proxies are solicited in contested elections today; each side would file and disseminate its own proxy statement, include the universal proxy card with its materials and solicit shareholders to sign and return the universal proxy card to it.

*Notices and Deadlines.* In order to allow all parties to create and distribute universal proxy cards, issuers and dissidents would be required to notify each other of their respective director candidates by certain pre-established deadlines. For dissidents, this notification would be in addition to its obligation to

comply with any applicable advance notice bylaw, and the deadline would be no later than 60 calendar days prior to the first anniversary of the previous annual meeting. The deadline for issuers would follow 10 days later, with notice required to the dissident no later than 50 calendar days prior to the first anniversary of the previous annual meeting. If an issuer changed the date of its annual meeting by more than 30 calendar days from the previous year or if the issuer did not hold an annual meeting during the previous year, the proposed rule would require that the dissident provide notice by the *later of* (i) 60 calendar days prior to the date of the annual meeting, or (ii) the tenth calendar day following the day on which the issuer first publicly announces the date of the annual meeting, and issuers would be required to provide notice to the dissident no later than 50 calendar days prior to the date of the annual meeting. Both the issuer and the dissident also would be required to include in their respective proxy statements a reference to the existence and availability of the other party's proxy materials. Dissidents would be required to file their definitive proxy statements with the SEC by the *later of* (i) 25 calendar days prior to the meeting date, or (ii) 5 calendar days after the issuer files its definitive proxy statement.

*Issuers Subject to the Proposed Rules.* The proposed universal proxy card rules would apply to all solicitations for contested director elections other than those involving (i) foreign private issuers or companies with reporting obligations arising only under Section 15(d) of the Exchange Act, (ii) registered investment companies, or (iii) business development companies.

## **Comparison of Proxy Access and Universal Proxy Cards**

Proxy access is similar to, but operates differently from, the SEC's proposed universal proxy cards that would be used in a contested solicitation. A shareholder utilizing proxy access has the ability to include a limited number of shareholder-nominated director candidates on the issuer's proxy card and to include a statement of support for those candidates in the issuer's proxy statement, provided that the shareholder satisfies the ownership and other bylaw requirements for proxy access. With a universal proxy card, a shareholder likewise will be able to include shareholder-nominated director candidates on a single proxy card that is utilized by both the issuer and the shareholder, but the nominating shareholder will be required to file and distribute its own proxy materials, and will not be entitled to include a statement in support of its nominees in the issuer's proxy statement. Proxy access requires a nominating shareholder to file a Schedule 14N with the SEC and is typically conditioned upon satisfying certain ownership and other eligibility requirements beyond those that apply in the context of a traditional proxy contest, including restrictions on the nominating shareholder's intention to change or influence control. Accordingly, when comparing the requirements to use proxy access with the alternative of filing a proxy statement and satisfying the conditions to use a universal proxy card, many nominating shareholders may elect to conduct a traditional proxy contest using universal proxy cards instead of utilizing proxy access.

## **Proxy Card and Proxy Statement Disclosures Regarding Director Election Voting Standards**

The SEC also proposed new rules with respect to the presentation of voting options relating to the election of directors, which would apply for both contested and uncontested solicitations. These rules are intended to address ambiguities both in the SEC rules and in some issuers' disclosures in light of the widespread adoption of majority voting standards in the election of directors. To clarify the nuanced

disclosure differences that are required depending on whether plurality or majority voting applies in the election of directors, the SEC's proposed rules would amend Rule 14a-4(b) to require that all proxy cards for director elections in which majority voting is the applicable voting standard to include an "against" and an "abstain" voting option. Further, proxy statements would be required to clearly disclose the effect of "withhold" votes when the election is governed by a plurality voting standard.

## **Materials from SEC Open Meeting**

Chair White's statement during the open meeting proposing the universal proxy rules is available [here](#), Commissioner Stein's statement is available [here](#), and Commissioner Piwowar's statement is available [here](#). The SEC's proposing release, including a fact sheet, is available [here](#), and the proposed rules are available [here](#). In her opening remarks, Chair White specifically asked for comments on the logistical and technical aspects of the rules, as well as whether the SEC's regulatory objective can be better met through other procedural mechanics. The comment period for the proposed rules will expire 60 days after the proposed rules are published in the Federal Register.

## **Considerations for Companies and Commenters**

While the proposed universal proxy card rules leave in place many of the mechanisms that are currently implicated during a proxy contest, such as advance notice bylaws, dueling solicitations and efforts to obtain the last voted proxy, the proposed rules nevertheless could significantly impact the dynamics for companies that are engaged in, or that are negotiating to avoid, a proxy contest. Companies should work with their outside proxy solicitors, legal counsel and other advisors in evaluating how the proposed rules – including the notice and timing requirements – would operate in various contexts. Based on those reviews, companies may wish to submit comments on the proposed rules. In this respect, the SEC appears particularly open to comments on the mechanics and logistics of the proxy solicitation process, including whether the deadlines and notice requirements are feasible for parties in a contested solicitation. Companies should also consider whether any bylaw amendments would be appropriate to avoid unintended consequences if the proposed rules go into effect.

Regardless of whether or when the proposed rules are adopted, companies should carefully review their proxy card and proxy statement disclosures regarding director elections. As evidenced by recent SEC staff comments, the proposed rules on proxy card options and proxy statement disclosures regarding these standards confirm what already is commonly disclosed under existing SEC rules. Thus, these provisions should be implemented by issuers even in advance of final rules being adopted.



*Gibson Dunn lawyers are available to assist in addressing any questions you may have about these developments. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, any lawyer in the firm's Securities Regulation and Corporate Governance practice group, or any of the following practice leaders and members:*

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# DEAL LAWYERS

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## **Schedule 13G “Passive” Investor Status: When Being a Little Active Is Still Passive!**

*By Jim Moloney and Brian Lane, Partners of Gibson Dunn & Crutcher LLP*

In July, the Staff in the Division of Corporation Finance posted a new C&DI on Section 13(d) that provides stockholders (and issuers) with some helpful insights, and perhaps greater clarity, on when significant stockholders can engage in a dialogue with management and still remain on Schedule 13G. As many practitioners know, Schedule 13G (the “short form” for reporting beneficial ownership of equity positions of 5% or more) often requires an affirmative certification from the reporting person(s) that the securities were not acquired, and are not held, with the purpose or effect of changing or influencing control of the issuer. This is commonly referred to as the “passive” investor certification which is set forth at the end of Schedule 13G, directly above the signature line.

In short, to report beneficial ownership on Schedule 13G the reporting person(s) must be “passive” (i.e., not active) with respect to any intent or attempt to exercise control over the issuer. The only exception to this passive investor certification is for security holders who are either “grandfathered” or have acquired their securities gradually (i.e., those that acquired securities before the class of equity was registered with the SEC or have accumulated their stake slowly over time—less than 2% in any twelve-month period). See Rule 13d-1(d) and Section 13(d)(6)(B) of the Exchange Act.

Of course, the certification (when required in order to report on 13G) begs the question of whether certain activities, such as submitting a 14a-8 shareholder proposal to management, lobbying for improved corporate governance measures or even pushing for increased share buybacks or dividends would (by itself) trigger a 13G amendment obligation and thus cause the reporting person(s) to have to report their ownership on Schedule 13D (the longer, more onerous, disclosure form and reporting regime) going forward.

The new guidance makes clear that certain limited activities, such as engaging management or the board in discussions regarding specified corporate governance topics including removal of a staggered board, majority voting standards for the election of directors, and/or elimination of poison pill rights plans, alone, would not cause the loss of 13G eligibility, so long as the purpose of the discussions is to improve corporate governance generally.

In a similar vein, discussions regarding executive compensation or matters of social or public interest (i.e., environmental policies) would not, by itself, give rise to the loss of 13G eligibility. The Staff further clarified that the threshold test for determining when a notice is required under the Hart-Scott-Rodino Act would not, by itself, be determinative as to when a beneficial owner is no longer eligible to report on Schedule 13G.

In providing this helpful guidance, the Staff emphasized that the ability to continue reporting on Schedule 13G will be determined by “all relevant facts and circumstances.” Noting that if the dialogue is really a precursor to facilitating a change of control transaction (e.g., pushing for a merger, removal of directors in an election contest, or sale of a significant amount of assets) then such activities would likely be deemed inconsistent with the passive investor certification required by Schedule 13G and the reporting person(s) would need to amend and report on Schedule 13D.

This guidance is a welcome ray of sunshine on the sorts of activities that will and will not preclude reporting on the short form Schedule 13G. While there may still be some room for debate on the issue, such as when a stockholder proposes the addition of an independent director, and recommends one individual in particular, we expect this guidance will result in greater uniformity among 13(d) reporting persons and more accurate and timely identification of those reporting persons who are seeking to effect control or influence over issuers.

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# 2016 Year-End Activism Update

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## Gibson Dunn 2016 Year-End Activism Update

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January 9, 2017

To Our Clients and Friends:

This Client Alert provides an update on shareholder activism activity involving domestically traded public companies with equity market capitalizations above \$1 billion during the second half of 2016. Notwithstanding a difficult market backdrop in 2016, including the surprise “Brexit” vote, a bitterly fought U.S. presidential campaign, a significant decline in oil prices, and vigorous public debate on “short-termism,” activist investors continued to be busy across a wide range of industries (even if fewer campaigns made major headlines). Furthermore, in 2016 as compared to 2015, our survey found relative consistency in the total number of public activist actions (90 vs. 95), the number of activist investors involved in such actions (60 vs. 56), and the number of companies targeted by such actions (78 vs. 81).

In this edition of Activism Update, our survey covers 48 total public activist actions, involving 35 different activist investors and 43 companies targeted, during the period from July 1, 2016 to December 31, 2016. Four of those companies faced advances from multiple investors, including one company that faced actions by three investors and another company that saw two activists temporarily coordinate their efforts. Equity market capitalizations of the targets range from just above the \$1 billion minimum covered by this survey to approximately \$280 billion.

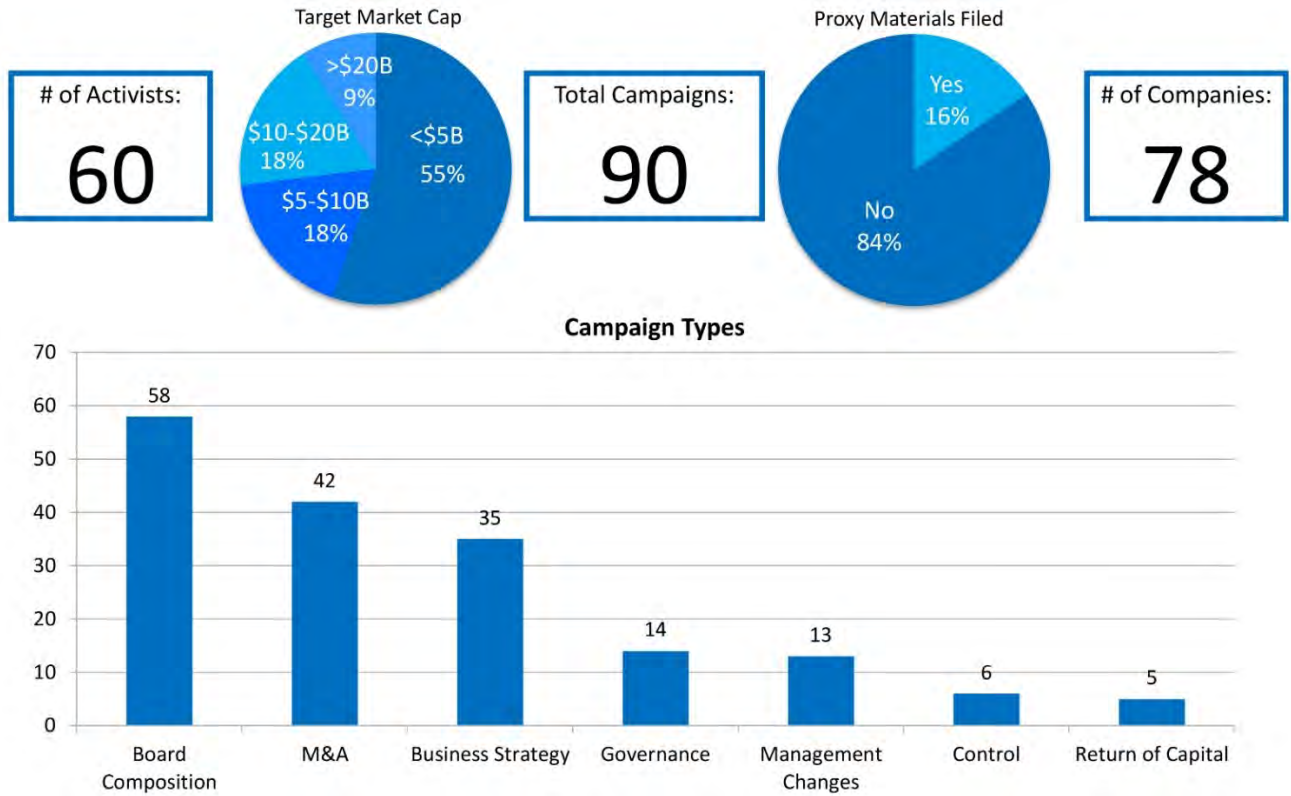
For the second half of 2016, changes to board composition, including gaining representation on the board, continued to be the most common objective of activist investors (52.1%). In addition to goals related to M&A, including pushing for spin-offs and advocating both for and against sales or acquisitions (39.6%), activist investors frequently took on target companies’ business strategy plans (39.6%). Large equity capitalization companies were infrequently targeted, as only 8.3% of the companies included in this edition of Activism Update had equity market capitalizations greater than \$20 billion, while the majority of campaigns included in our survey involved small capitalization companies, as 53.5% of the companies in our survey had equity market capitalizations below \$5 billion. The trend toward smaller targets continued from the first half of 2016 (for the first half of 2016, 10.5% of the companies were above \$20 billion and 55.3% of the companies were below \$5 billion).

We also note an increase in publicly filed settlement agreements in 2016, as this survey covers 13 settlement agreements publicly filed in the second half of 2016, making it 30 total settlement agreements in 2016 compared to 22 such agreements in 2015. Within the settlement agreements publicly filed in the second half of 2016, standstill periods and voting agreements remain nearly ubiquitous, and the marked increase in the inclusion of other strategic initiatives (e.g., replacement of management, spin-off company governance, etc.) seen in the first half of 2016 continued through the second half of the year (92.3% in the second half of 2016 and 86.7% for 2016 in total). We delve further into the data and the details in the latter half of this edition of Gibson Dunn’s Activism Update, in which we have included a chart of the activist campaigns covered by the survey and statistical analyses of various trends for the second half of 2016, as well as a survey of settlement agreement terms with breakdowns of settlement agreements publicly filed during the second half of 2016 and updated statistics on key settlement terms from 2014 through 2016.

We hope you find Gibson Dunn’s 2016 Year-End Activism Update informative. If you have any questions, please do not hesitate to reach out to a member of your Gibson Dunn team.



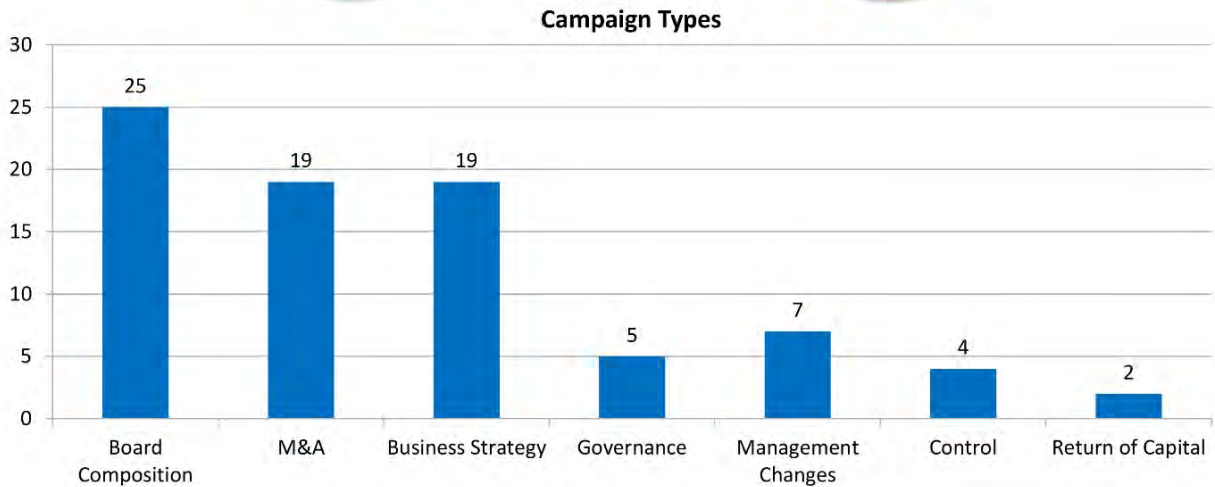
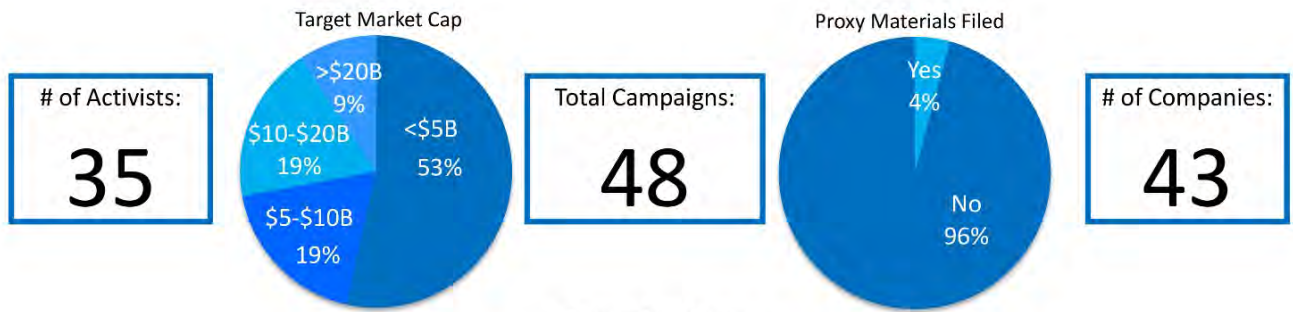
## By the Numbers – 2016 Full Year Public Activism Trends



\*Includes data compiled for both 2016 Mid-Year and Year-End Activism Update publications.

\*\*All data represented here is derived from the data compiled from the campaigns studied for Activism Update.

## By the Numbers – H2 2016 Public Activism Trends



\*Study covers selected activist campaigns involving domestically traded companies with equity market capitalizations of greater than \$1 billion as of the last business day of 2016 (unless company is no longer listed).

\*\*All data is derived from the data compiled from the campaigns studied for the 2016 Year-End Activism Update.

## Survey of Selected H2 2016 Activist Public Actions

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Ownership**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
<b>Abrams Bison Investments, LLC</b>	Signet Jewelers Limited	NYSE: SIG	9/23/16	\$6.56	6.0%	Business strategy	N	In 9/16, Abrams disclosed its stake in the Company and that it had discussions with the Company's management and board regarding a strategic evaluation of the Company's credit portfolio and capital structure
<b>Abrams Capital, LLC</b>	NorthStar Asset Management Group, Inc.	NYSE: NSAM	8/17/16	\$2.82	5.8%	M&A	N	In 8/16, Abrams issued a letter critical of a proposed merger between the Company, NorthStar Realty Finance Corp. and Colony Capital, Inc.; in 11/16, the Company filed a proxy statement urging shareholders to vote in favor of the proposed merger; in 12/16, the Company's shareholders approved the merger
<b>Ampera Capital LLC</b>	The WhiteWave Foods Company	NYSE: WWAV	7/7/16	\$9.86	<5%	M&A	N	In 7/16, Ampera issued a letter calling on the Company to demand a higher offer from prospective buyer Danone; in 10/16, the Company's shareholders approved the proposed merger
<b>Anchorage Capital Group, L.L.C.</b>	Houghton Mifflin Harcourt Company	NASDAQ: HMHC	11/24/15	\$1.33	16.6%	Board composition	N	In 12/16, the Company entered into an agreement with Anchorage to appoint an Anchorage designee to the board
<b>Appaloosa Management LP</b>	TerraForm Power, Inc.	NASDAQ: TERP	12/1/15	\$1.79	10.9%	Board composition; business strategy; control; M&A	N	In 7/16, Appaloosa signed a letter agreement with Brookfield Asset Management wherein the parties agreed to cooperate in an effort to acquire all of the equity interests then held by SunEdison, Inc. in the Company, in response to which the Company adopted a poison pill; in 9/16,

\*Study covers selected activist campaigns involving domestically traded companies with equity market capitalizations of greater than \$1 billion as of the last business day of 2016 (unless company is no longer listed), subject in all cases to the judgment and discretion of the authors.

\*\*Ownership is highest reported ownership since the public action date (includes exposure to derivatives as applicable).

## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								Appaloosa and the Company settled a lawsuit Appaloosa had filed to prevent the Company from buying SunEdison's assets and the Company agreed to segregate its information technology systems from SunEdison and appoint a new independent director to its board; in 11/16, it was reported that Appaloosa and Brookfield were engaging in a joint attempt to acquire at least a majority of the Company's outstanding shares; Brookfield signed a confidentiality agreement with the Company in 12/16
<b>Atlantic Investment Management</b>	Harman International Industries Inc.	NYSE: HAR	12/15/16	\$7.76	2.3%	M&A	N	In 12/16, Atlantic opposed the sale of the Company to Samsung Electronics and encouraged the Company to seek a better price
<b>Blue Harbour Group, L.P.</b>	Rowan Companies plc	NYSE: RDC	8/22/16	\$2.37	8.0%	Board composition	N	In 8/16, the Company entered into an agreement with Blue Harbour to appoint a Blue Harbour designee to the board
<b>Brookfield Asset Management Inc.</b>	TerraForm Power, Inc.	NASDAQ: TERP	7/22/16	\$1.79	12.1%	Control; M&A	N	In 7/16, Brookfield signed a letter agreement with Appaloosa Management wherein the parties agreed to cooperate in an effort to acquire all of the equity interests then held by SunEdison, Inc. in the Company, in response to which the Company adopted a poison pill; in 11/16, Brookfield expressed its interest in making an all-cash offer for 100% of the Company's shares if the Company would not explore merger options (it was

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								reported that Appaloosa may be involved, as well); in 12/16, Brookfield and the Company entered into a confidentiality agreement permitting Brookfield to be part of the Company's strategic review process
<b>Bulldog Investors</b>	New York REIT, Inc.	NYSE: NYRT	10/10/16	\$1.69	1.5%	Board composition	N	In 10/16, Bulldog disclosed its stake in the Company and stated that it had met with the Company's CEO and had urged him to reach a settlement with WW Investors regarding WW Investors' efforts to elect five directors to the board
<b>Caerus Investors</b>	Kate Spade & Co.	NYSE: KATE	11/14/16	\$2.39	<5%	M&A	N	In 11/16, Caerus issued a letter to the Company's board criticizing it for failing to create shareholder value and encouraging it to consider a sale to a strategic buyer; in 12/16, the Wall Street Journal reported that the Company is exploring a sale and has contacted potential buyers
<b>Carl Icahn</b>	Federal-Mogul Holdings Corporation	NASDAQ: FDML	1/7/08	\$1.74	82.0%	Control	N	In 2/16, Icahn sent a letter to the Company's board proposing to acquire all of the shares he did not already own (he owned 82% at the time); in 6/16, Icahn raised his offer; in 9/16, Icahn officially started a tender offer to acquire the remaining shares; in 12/16, Icahn extended his tender offer for a third time to 1/4/17
<b>Cevian Capital</b>	ABB Ltd.	NYSE: ABB	4/6/15	\$45.74	6.2%	M&A; business strategy	N	In 9/16, Cevian recommended that the Company spin off its power grids division and list it as a separate company, following up on past demands for the Company to break up; in

\* Study covers selected activist campaigns involving domestically traded companies with equity market capitalizations of greater than \$1 billion as of the last business day of 2016 (unless company is no longer listed), subject in all cases to the judgment and discretion of the authors.

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								10/16, the Company announced it would not break up and that it would attempt to increase margins in the power grids division, a decision with which Cevian publicly disagreed
<b>Cohen Capital Management, Inc.</b>	Chicago Bridge & Iron Company NV	NYSE: CBI	8/24/16	\$3.18	1.0%	Management changes	N	In 8/16, Cohen issued a letter criticizing the Company's performance and calling for the removal of the President/CEO; in 9/16, the Company promoted a new COO but, to date, has not removed the President/CEO
<b>Corvex Management LP</b>	Williams Companies, Inc.	NYSE: WMB	12/18/13	\$23.40	8.4%	Board composition; control	Y	In 8/16, Corvex nominated ten of its own employees for election to the Company's board just prior to the nomination deadline, stating the nominees would be replaced by suitable independent directors upon election; in 9/16, Corvex ended its proxy contest after the Company appointed two new independent directors, said it would add two more new independent directors, and announced that three current directors would not stand for reelection at the annual meeting in 11/16
<b>Elliott Management Corporation</b>	CDK Global, Inc.	NASDAQ: CDK	5/11/15	\$8.92	9.3%	Board composition; business strategy	N	In 8/16, Elliott and the Company entered into a letter agreement wherein the Company agreed to appoint two Elliott designees and undertake a capital allocation review
<b>Elliott Management Corporation</b>	Citrix Systems, Inc.	NASDAQ: CTXS	6/11/15	\$14.01	8.6%	M&A	N	In 7/16, the Company announced the merger of its GoTo business with LogMeIn, and Elliott, which was previously granted a Company board designee,

\* Study covers selected activist campaigns involving domestically traded companies with equity market capitalizations of greater than \$1 billion as of the last business day of 2016 (unless company is no longer listed), subject in all cases to the judgment and discretion of the authors.

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								agreed to limit its stakes in Citrix, GoTo and LogMeIn
<b>Elliott Management Corporation</b>	LifeLock, Inc.	NYSE: LOCK	6/16/16	\$2.27	10.9%	M&A	N	In 6/16, Elliott disclosed its stake in the Company; in 8/16, the Company announced a review of strategic alternatives; in 11/16, the Company announced that it would sell itself to Symantec
<b>Elliott Management Corporation</b>	Marathon Petroleum Corporation	NYSE: MPC	11/21/16	\$26.59	4.0%	Business strategy; M&A	N	In 11/16, Elliott issued a letter to the Company's board, recommending that the Company consider a tax-free separation of its Speedway subsidiary or a full-tax separation into three separate businesses, and calling on the board to implement a larger drop down plan than it was considering; in 12/16, the Company extended its director nomination deadline to 1/9/17
<b>Elliott Management Corporation</b>	Mentor Graphics Corp.	NASDAQ: MENT	9/29/16	\$4.04	8.3%	Business strategy; M&A	N	In 9/16, Elliott disclosed its stake in the Company; in 11/16, Elliott and the Company entered into an agreement wherein Elliott agreed to support a proposed merger between the Company and Siemens
<b>Elliott Management Corporation</b>	PulteGroup, Inc.	NYSE: PHM	6/7/16	\$6.08	<5%	Board composition	N	In 7/16, Elliott reached an agreement with the Company to add three Elliott designees to the Company's board
<b>Engaged Capital, LLC</b>	Benchmark Electronics, Inc.	NYSE: BHE	2/24/16	\$1.49	5.0%	Board composition	N	In 12/16, Engaged reached an agreement with the Company giving Engaged the right to request the addition of a mutually acceptable independent director to the Company's board; previously, in 5/16, Engaged waged a proxy contest in which two of its three nominees were

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**H2 2016 Activist Public Actions** *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								elected to the Company's board
<b>First Pacific Advisors LLC</b>	Esterline Technologies Corporation	NYSE: ESL	6/27/16	\$2.64	12.6%	Board composition; governance	N	In 9/16, First Pacific agreed to temporarily not buy additional shares in the Company and engaged in governance discussions with the Company; in 10/16, the Company entered into an agreement with First Pacific to appoint a First Pacific designee and another independent director to the board and to submit a proposal to declassify its board at either the 2018 or 2019 annual meeting
<b>Fortress Investment Group LLC</b>	HRG Group, Inc.	NYSE: HRG	3/31/15	\$3.09	16.4%	Board composition; business strategy	N	In 7/16, the Company appointed a Fortress designee to its board, prior to which Fortress and another large shareholder had taken three seats and forced out the Company's founder; in 11/16, the Company launched a strategic review
<b>GAMCO Investors, Inc.</b>	Federal-Mogul Holdings Corporation	NASDAQ: FDML	9/9/16	\$1.74	6.0%	M&A	N	In 9/16, the New York Post reported that GAMCO opposes Carl Icahn's proposed takeover of the Company as undervaluing the Company; later in 9/16, Icahn launched a tender offer to increase his 82% stake; in 12/16, Icahn extended the tender offer deadline for a third time, and GAMCO indicated that it would not tender its shares for an offer that it believed undervalued the Company
<b>GAMCO Investors, Inc.</b>	National Fuel Gas Company	NYSE: NFG	5/9/14	\$4.82	8.1%	Board composition	Y	In 11/16, GAMCO attempted to nominate a candidate for the Company's board via the Company's recently adopted proxy access bylaw (notably,

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\*\* Ownership is highest reported ownership since the public action date (includes exposure to derivatives as applicable).



## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								the first attempt by an activist to use proxy access), but the Company rejected the nomination for failure to comply with the terms and conditions of the bylaws, causing GAMCO to withdraw its nomination; in 12/16, the Company appointed an unrelated new independent director
<b>GAMCO Investors, Inc.</b>	Viacom Inc.	NASDAQ: VIAB	12/3/15	\$14.10	0.7%	Management changes	N	In 7/16, GAMCO CEO Mario Gabelli stated that the Company's CEO Philippe Dauman would have to leave the Company; in 8/16, the Company announced that Dauman would no longer serve as the Company's CEO or Chairman
<b>GAMCO Investors, Inc.</b>	Wells Fargo & Co.	NYSE: WFC	11/15/16	\$276.78	<5%	Board composition	N	In 11/16, GAMCO CEO Mario Gabelli stated that he would welcome Warren Buffett becoming a director of the Company; in 11/16, the Company split the roles of Chairman and CEO and required that the Chairman and Vice Chairman be independent
<b>Glazer Capital Management</b>	Private-Bancorp, Inc.	NASDAQ: PVTB	12/1/16	\$4.32	<5%	M&A	N	In 12/16, Glazer issued an open letter to the Company's shareholders urging them to reject the proposed acquisition of the Company by CIBC at the Company's 12/8/16 special meeting, which the Company subsequently postponed on 12/7/16 until likely Q1 2017
<b>Hudson Executive Capital LP</b>	Eagle Pharmaceuticals Inc.	NASDAQ: EGRX	6/27/16	\$1.22	6.1%	Board composition; business strategy; M&A; return of capital	N	In 6/16, Hudson disclosed its stake in the Company and that it had engaged in discussions with the Company; in 7/16, the Company announced that

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**H2 2016 Activist Public Actions** *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								Hudson's co-founder had been appointed to the board
<b>Industrivärden</b>	Ericsson	NASDAQ: ERIC	8/19/16	\$19.30	15.2%	Board composition; business strategy; management changes	N	In 8/16, a Swedish newspaper reported that Industrivärden is seeking to replace the Company's board chairman; in 9/16, the Financial Times reported that Industrivärden had pressured the Company to cut costs; in 10/16, the Company appointed a new CEO, a move supported by Industrivärden; in 12/16, the Company announced the acceleration of its cost-cutting plans, but, to date, the chairman remains in place
<b>Iron Compass LLC</b>	Simpson Manufacturing Company	NYSE: SSD	8/1/16	\$2.08	<5%	Business strategy; governance; M&A	N	In 8/16, Iron Compass disclosed a letter sent to the Company's board on 7/6/16, recommending that the Company sell its commercial construction business, restructure its balance sheet, return capital to shareholders, and appoint three new directors with strategic alternatives expertise; in 8/16, the Company announced a 2.5x increase of its buyback program, but stood by its business strategy; in 11/16, the Company removed its poison pill
<b>JANA Partners LLC</b>	Harris Corporation	NYSE: HRS	8/2/16	\$12.73	2.0%	Board composition; business strategy	N	In 8/16, the Company entered into an agreement with JANA to appoint two mutually agreed upon directors to the Company's board; in 10/16, the Company launched a sale of certain non-core assets
<b>JANA Partners LLC</b>	Time Inc.	NYSE: TIME	9/6/16	\$1.77	5.0%	Board composition; business strategy;	N	In 9/16, the New York Post reported that JANA principal Barry Rosenstein met with the Company's management in which JANA urged the

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H2 2016 Activist Public Actions (continued)

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
						management changes		Company to consider a consolidation strategy and to refresh its board; later in 9/16, the Company replaced its CEO and, in 10/16, replaced its CFO
<b>Land and Buildings Investment Management, LLC</b>	MGM Resorts International	NASDAQ: MGM	3/17/15	\$16.53	0.4%	Business strategy; management changes	N	In 9/16, Land and Buildings issued a letter calling for the removal of the Company's CEO/Chairman; in 10/16, Land and Buildings reiterated its demand that the CEO/Chairman be removed and outlined a business plan to cut costs, divest assets and reduce debt; Land and Buildings previously ran an unsuccessful proxy campaign at the Company in 2015
<b>Land and Buildings Investment Management, LLC</b>	NorthStar Asset Management Group, Inc.	NYSE: NSAM	1/11/16	\$2.82	2.0%	M&A	N	In 6/16, Land and Buildings issued a letter to the Company's board objecting to its announced merger with NorthStar Realty Finance Corp. and Colony Capital, Inc.; in 7/16, Land and Buildings called for governance changes; in 11/16, Land and Buildings agreed to vote in favor of the merger, and it was announced that the entity surviving the proposed merger would have a declassified and reduced 10-member board, which would include two new independent directors
<b>Land and Buildings Investment Management, LLC</b>	Taubman Centers, Inc.	NYSE: TCO	10/18/16	\$6.32	1.0%	Business strategy; board composition; governance	N	In 10/16, Land and Building issued a letter calling on the Company to make certain governance changes, including declassifying its board, cutting costs, and considering strategic alternatives; in 12/16, the Company appointed a lead director and filled a board

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								vacancy, but Land and Buildings issued another letter voicing its displeasure and launched a campaign website
<b>Marcato Capital Management LP</b>	Buffalo Wild Wings Inc.	NASDAQ: BWLD	7/25/16	\$2.81	5.2%	Board composition; business strategy; management changes	N	In 7/16, Marcato disclosed its stake in the Company and stated that the Company should increase its percentage of franchised locations; in 8/16, the Company announced an increased buyback program, which Marcato criticized and then called for changes to the Company's board and management with shareholder input; in 10/16, the Company announced that its chief strategy officer would resign, appointed a new CFO, and added three new independent directors, which Marcato criticized; in 12/16, Marcato launched a campaign website and issued a letter to the Company's franchisees outlining value creation strategies
<b>Marcato Capital Management LP</b>	Terex Corporation	NASDAQ: TEX	7/28/16	\$3.34	5.1%	Board composition; business strategy	N	In 7/16, Marcato disclosed its stake in the Company and that it had discussed business strategy and board composition with directors of the Company, though Marcato was reported to support the Company's CEO; in 10/16, Marcato said that the Company should reduce costs and sell assets
<b>MSD Capital, L.P.</b>	NorthStar Asset Management Group, Inc.	NYSE: NSAM	9/19/16	\$2.82	10.24%	Governance; M&A	N	In 9/16, MSD opposed a merger between the Company, NorthStar Realty Finance Corp. and Colony Capital, Inc.; in 10/16, MSD agreed to support the merger after the Company announced

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								governance changes at the surviving company and an increased pre-closing dividend
<b>Pershing Square Capital Management, L.P.</b>	Chipotle Mexican Grill, Inc.	NYSE: CMG	9/6/16	\$10.92	10.0%	Board composition; management changes	N	In 9/16, Pershing Square disclosed its stake in the Company and held discussions with the Company; in 12/16, the Company eliminated its dual CEO structure and later added four new directors to its board, including two Pershing designees, pursuant to an agreement between Pershing Square and the Company
<b>SailingStone Capital Partners LLC</b>	Range Resources Corporation	NYSE: RRC	6/20/16	\$8.39	10.8%	Board composition; business strategy	N	In 6/16, SailingStone disclosed its stake in the Company; in 8/16, the Company entered into an agreement with SailingStone to appoint a mutually agreed upon director, improve board engagement with shareholders, and amend incentive awards for management
<b>Sandell Asset Management Corp.</b>	Viavi Solutions Inc. (f/k/a JDS Uniphase Corp.)	NASDAQ: VIAV	10/1/14	\$1.88	5.1%	Board composition; business strategy; return of capital	N	In 7/16, following the expiration of a prior standstill in relation to which two Sandell designees were appointed to the board, Sandell announced that it would continue its discussions with the Company and initiate discussions with third parties; in 8/16, Sandell issued a letter calling on the Company to sell its service enablement businesses, add new board members, and increase buybacks; in 9/16, the Company extended its buyback program, but not to

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
								the extent demanded by Sandell
<b>Scopia Capital Management LP</b>	Forest City Realty Trust, Inc.	NYSE: FCEA	6/6/16	\$5.43	9.5%	Governance	N	In 8/16, Scopia urged the Company to eliminate its dual-class stock structure; in 12/16, the board announced that it would recommend to shareholders a proposal to eliminate the dual-class share structure at the 2017 annual meeting
<b>Shanda Investment Group Limited</b>	Legg Mason, Inc.	NYSE: LM	12/20/16	\$3.02	10.4%	Board composition	N	In 12/16, the Company entered into an agreement with Shanda to appoint two Shanda executives to the board
<b>Stadium Capital Management, LLC</b>	Ascena Retail Group, Inc.	NASDAQ: ASNA	11/7/16	\$1.19	7.6%	Board composition	N	In 11/16, Stadium Capital disclosed its stake in the Company and that it would discuss board representation with the Company
<b>Starboard Value LP</b>	Perrigo Company plc	NYSE: PRGO	9/11/16	\$11.93	6.2%	Business Strategy	N	In 9/16, Starboard Value issued a letter asking the Company to focus on its core business and consider divesting non-core assets, such as its generics unit and royalty streams on MS drug Tysabri; in 10/16, Starboard and the Company separately stated that the parties had had productive discussions; in 11/16, the Company approved a strategic review of the Tysabri royalty streams and other business lines
<b>Starboard Value LP</b>	Rockwell Collins, Inc.	NYSE: COL	12/1/16	\$12.11	<5%	M&A	N	In 12/16, Starboard Value urged the Company to reconsider acquiring B/E Aerospace Inc. and instead consider alternative options, including a sale

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## H2 2016 Activist Public Actions *(continued)*

Investor	Company*	Exchange: Ticker	Public Action Date	Market Cap (in billions)	% Owner- ship**	Type of Campaign	2016 Proxy Solicitation (Y/N)	Latest News (as of 12/31/16 unless noted)
<b>WW Investors LLC</b>	New York REIT, Inc.	NYSE: NYRT	5/18/16	\$1.69	<5%	Board composition; M&A	Y	In 6/16, WW Investors nominated five candidates for election to the Company's board in order to prevent the completion of a merger between the Company and JBG Companies; in 8/16, the Company cancelled the proposed merger and instead adopted a liquidation plan, which WW Investors had also called for in 6/16; later in 8/16, WW Investors issued a letter demanding that the Company expedite the liquidation and hold director elections immediately; in 9/16, the Company began searching for new directors and a new external manager to oversee the liquidation process, but WW Investors criticized the Company's approach; in 10/16, WW Investors sought appointment as the Company's external manager and proposed to manage the liquidation process itself; later in 10/16, WW Investors settled its proxy contest with the Company, as the Company agreed to opt out of MUTA and appoint three new directors to oversee the liquidation process with the rest of the board; a shareholder vote on the liquidation is expected in 1/17

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## By the Numbers – Trends in Settlement Agreements (2014-2016)

### H2 2016 Board Representation Analysis

Category	Average
Board Seats Granted	1.9
Total Board Size*	10.6
Percent of Board*	17.7%

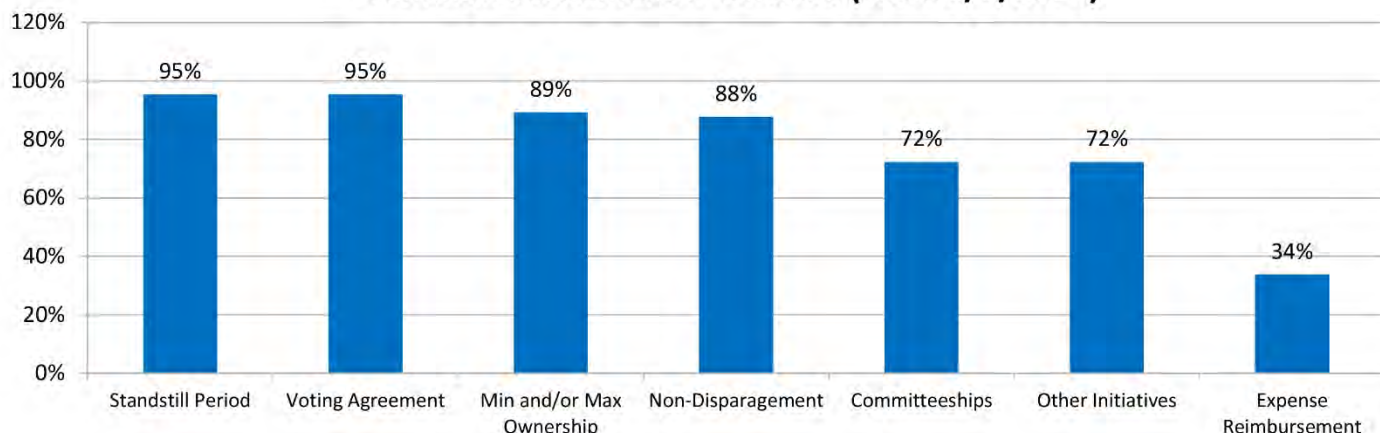
\*Following settlement agreement

### 2014-16 Board Representation Analysis

Category	Average
Board Seats Granted	2.1
Total Board Size*	11.3
Percent of Board*	19.6%

\*Following settlement agreement

### Common Settlement Provisions (since 1/1/2014)



\*All data represented here is derived from the data compiled from the campaigns studied for Activism Update and includes 12 agreements filed in 2014, 22 agreements filed in 2015, and 30 agreements filed in 2016.



## H2 2016 Settlement Agreement Key Terms

	Anchorage Capital Group	Blue Harbour Group
<b>Company</b>	Houghton Mifflin Harcourt Company	Rowan Companies plc
<b>Agreement Date</b>	October 19, 2016	August 22, 2016
<b>Board Seats</b>	1/9 (the Board to increase in size to nine directors to accommodate the Anchorage designee).	1/10 (the Board to increase in size to ten directors to accommodate the Blue Harbour designee).
<b>Standstill (including term)</b>	Yes; until the later of (i) the date that is 30 days prior to the nomination deadline for the 2018 Annual Meeting and (ii) the date that the Anchorage designee ceases to serve on the Board.	Yes; until the date that is 30 days prior to nomination deadline for the 2018 Annual Meeting; <i>provided, however,</i> that if the Company prior to such date notifies Blue Harbour in writing of its irrevocable agreement to nominate the Blue Harbour designee, and the Board does so nominate him, then the Support End Date shall be extended to the date which is 30 days prior to the last day on which a shareholder may timely notify the Company of such shareholder's intention to nominate a candidate for election as a director at the 2019 annual general meeting of shareholders of the Company.
<b>Committee Membership</b>	Anchorage designee to be appointed to the Nominating, Ethics and Governance Committee.	None.
<b>Other Strategic Initiatives</b>	Anchorage designee to be nominated for reelection at the 2017 Annual Meeting.	Blue Harbour designee to be nominated for reelection at the 2017 Annual Meeting.
<b>Voting</b>	At the 2017 Annual Meeting, Anchorage shall vote all shares (i) for all directors nominated by the Board for election at any stockholders meeting and (ii) in accordance with the recommendation of the Board on any precatory or nonbinding proposals that come before any stockholder meeting.	At the 2017 Annual Meeting, Blue Harbour shall vote in favor of any and all directors nominated by the Board for election.
<b>Min/Max Ownership</b>	<b>Min:</b> Anchorage must beneficially own in the aggregate at least 10% of the shares.	None.
<b>Expense Reimbursement</b>	None.	None.
<b>Non-Disparagement</b>	Yes.	None.

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>Elliott Management</b>	<b>Elliott Management</b>
<b>Company</b>	CDK Global, Inc.	Mentor Graphics Corporation
<b>Agreement Date</b>	August 2, 2016	November 12, 2016
<b>Board Seats</b>	2/10 (the Board to increase in size to ten directors to accommodate two Elliott designees chosen from a list submitted by Elliott).	None.
<b>Standstill (including term)</b>	Yes; until the earlier of (i) August 2, 2017 and (ii) the date that is 30 days prior to the last day of the advance notice window for the 2017 Annual Meeting, subject to certain triggering events, including (A) announcement by the Company of an agreement with respect to certain extraordinary transactions that would result in the acquisition of more than 50% of the Company’s common stock, (B) commencement of any tender or exchange offer (by a person other than Elliott) which would constitute certain extraordinary transactions that would result in the acquisition of more than 50% of the Company’s common stock, where the Company files a Schedule 14D-9, other than a “stop, look and listen” communication, (C) issuance of proxy materials in connection with the 2016 Annual Meeting that is inconsistent with the terms of the agreement and (D) adoption of any amendment to the Company’s certificate of incorporation or bylaws that would substantially impair the ability of a stockholder to submit nominations for election to the Board or stockholder proposals in connection with any future Company annual meeting.	Yes; until the earlier of (i) the approval of the merger agreement between Mentor Graphics and Meadowlark by the affirmative vote of the holders of at least a majority of the outstanding shares of Company Stock, (ii) termination of the merger agreement or (iii) the time (if any) at which the Board shall have made an adverse recommendation change.
<b>Committee Membership</b>	The Board shall appoint each of the new directors to an appropriate committee of the Board.	None.
<b>Other Strategic Initiatives</b>	The Board shall not be larger than ten directors prior to the earlier of (i) August 2, 2017 and (ii) the date that is 30 days prior to the last day of the advance notice window for the 2017 Annual Meeting.	None.
<b>Voting</b>	At the 2016 Annual Meeting, Elliott shall vote all shares (i) in favor of the election of directors nominated by the Board and (ii) in accordance	Elliott shall vote all shares (i) in favor of the consummation of the merger; <i>provided, however,</i> that Elliott may vote at its discretion any

H2 2016 Settlement Agreement Key Terms (continued)

	Elliott Management	Elliott Management
	with the Board’s recommendation on any proposal not related to certain extraordinary transactions (tender offers, mergers, liquidations, etc.) outside the Company’s ordinary course of business.	amendment to the merger agreement or any action that could result in the amendment, modification or a waiver of a provision therein, in a manner that (A) imposes any material restrictions or additional material conditions on the consummation of the merger or the payment of the merger consideration to shareholders of the Company, (B) extends the End Date (360 days after the date of the merger agreement) or (C) decreases the amount or changes the form of the merger consideration, (ii) against any merger (other than the merger), consolidation, combination, sale of substantial assets, reorganization, recapitalization, dissolution, liquidation or winding up of or by the Company, (iii) against any acquisition proposal and (iv) against any amendment of the articles of incorporation or bylaws of the Company or other proposal or transaction involving the Company, which amendment or other proposal or transaction would in any manner impede, frustrate, prevent or nullify any provision of the merger agreement. Otherwise, Elliott irrevocably grants to, and appoints, the Company as Elliott’s proxy and attorney-in-fact (with full power of substitution), to vote all of Elliott’s shares.
<b>Min/Max Ownership</b>	<p><b>Min:</b> If Elliott’s beneficial ownership decreases to less than 3% of the Company’s Common Stock as a result of dispositions by Elliott, Elliott loses the right to select replacements for its nominees.</p> <p><b>Max:</b> Elliott may not have beneficial ownership of more than 9.9% of the Company’s Common Stock or economic exposure to more than 14.9% of the Company’s Common Stock.</p>	<b>Max:</b> Elliott may not have beneficial ownership of 20% or more of the any class of equity of the Company.
<b>Expense Reimbursement</b>	None.	None.
<b>Non-Disparagement</b>	Yes.	None.

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>Elliott Management</b>	<b>Engaged Capital</b>
<b>Company</b>	PulteGroup, Inc.	Benchmark Electronics, Inc.
<b>Agreement Date</b>	July 20, 2016	December 19, 2016
<b>Board Seats</b>	3/13 (the Board to increase in size to 13 directors to accommodate three Elliott designees).	1/8
<b>Standstill (including term)</b>	Yes; until the earliest of (i) July 20, 2017, (ii) upon five business days' prior written notice delivered by Elliott to the Company following a material breach of the agreement by the Company if such breach has not been cured within such notice period, (iii) announcement by the Company of an agreement with respect to certain extraordinary transactions that would result in the acquisition of more than 50% of the Company's common stock, (iv) commencement of any tender or exchange offer (by a person other than Elliott) which would constitute certain extraordinary transactions that would result in the acquisition of more than 50% of the Company's common stock, where the Company files a Schedule 14D-9, other than a "stop, look and listen" communication, (v) issuance of proxy materials in connection with the 2016 Annual Meeting that is inconsistent with the terms of the agreement, and (vi) adoption of any amendment to the Company's certificate of incorporation or bylaws that would substantially impair the ability of a stockholder to submit nominations for election to the Board or stockholder proposals in connection with any future Company annual meeting.	Yes; until the date that is 30 days prior to the nomination deadline for the 2018 Annual Meeting.
<b>Committee Membership</b>	The Board shall appoint a specific Elliott designee (the "Selected Designee") to serve on the Board's Finance Committee, CEO Search Committee and the Audit Committee and a second specific Elliott designee to serve on the Board's CEO Search Committee and such other committees of the Board as the Board shall determine.	None.
<b>Other Strategic Initiatives</b>	Elliott designees to be nominated for reelection at the 2017 Annual Meeting.	Engaged shall have the right to request that the Board elect an additional director to the Board

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>Elliott Management</b>	<b>Engaged Capital</b>
		who is mutually acceptable to the Board and Engaged.
<b>Voting</b>	At any stockholders’ meeting during the standstill period, Elliott shall vote all shares (i) in favor of the election of the Selected Designee as the director nominee nominated by the Board (ii) against the election of any director nominees that are not nominated by the Board and (iii) in accordance with the Board’s recommendation on all other proposals and business that comes before such annual or special meeting of shareholders, other than with respect to (A) an Extraordinary Transaction, (B) any proposed issuance of Company common shares or any securities convertible into, or exercisable or exchangeable for, Company common shares, (C) approval of any compensatory plan or arrangement relating to the compensation of Company employees or the members of the Board that is submitted for shareholder approval (but, for the avoidance of doubt, excluding the Company’s “say on pay” proposal, which the Elliott Parties shall vote all shares in accordance with the Board’s recommendation) or (D) any proposal by the Company to implement any takeover defense measures or any other proposal by the Company that would diminish the rights of Company shareholders.	At the 2017 Annual Meeting, Engaged shall vote all shares (i) in favor of the election of the Company’s slate of director nominees and (ii) against any shareholder nominations for director that are not approved and recommended by the Board for election.
<b>Min/Max Ownership</b>	<b>Min:</b> Elliott must beneficially own in the aggregate at least 3.0% of the shares.	<b>Min:</b> Engaged must beneficially own in the aggregate at least 4.0% of the shares.
<b>Expense Reimbursement</b>	None.	Yes; up to \$463,615.89.
<b>Non-Disparagement</b>	Yes.	Yes.

**H2 2016 Settlement Agreement Key Terms** (continued)

	First Pacific Advisors	JANA Partners
<b>Company</b>	Esterline Technologies Corporation	Harris Corporation
<b>Agreement Date</b>	October 18, 2016	July 29, 2016
<b>Board Seats</b>	1/10 (the Board to increase in size to ten directors to accommodate one FPA designee).	2/12 (first JANA designee appointed to the Board immediately, second JANA designee appointed to the Board at the 2016 Annual Meeting; the Board to temporarily increase in size to 13 directors and return to 12 directors following the 2016 Annual Meeting).
<b>Standstill (including term)</b>	Yes; until the earlier of (i) the date that is 15 days prior to the deadline for the submission of stockholder nominations for the 2020 Annual Meeting and (ii) the date that is 100 days prior to the first anniversary of the 2019 Annual Meeting.	Yes; until the earlier of (i) the date that is 30 days prior to the expiration of the Company's advance notice period for the nomination of directors at the 2017 Annual Meeting and (ii) a material breach by the Company of its obligations under the agreement that is not cured within 15 days after receipt of written notice.
<b>Committee Membership</b>	FPA designee shall be appointed to such committees and subcommittees as determined by the Board; <i>provided, however</i> , that the Board shall not create an Executive Committee or otherwise delegate executive authority.	<ul style="list-style-type: none"> <li>• If so requested by JANA, the Board shall appoint each of the JANA designees to two committees of the Board out of the Finance Committee, Audit Committee, Management Development and Compensation Committee, Governance and Corporate Responsibility Committee and Ad-Hoc Technology Committee (as selected by the Board in its sole discretion).</li> <li>• If the Board forms a committee for the purpose of considering an extraordinary transaction or other strategic alternatives during the standstill period, the Board shall appoint at least one of the JANA designees to such committee.</li> </ul>
<b>Other Strategic Initiatives</b>	<ul style="list-style-type: none"> <li>• The Board shall re-nominate FPA designee at the 2017 Annual Meeting in the class of directors with terms expiring at the 2020 Annual Meeting.</li> <li>• An additional new independent director may be appointed by the Nominating and Corporate Governance Committee, with respect to which FPA may submit candidates.</li> <li>• FPA shall have the right to request that the Board allow the stockholders of the Company to vote at the 2018 Annual Meeting</li> </ul>	<ul style="list-style-type: none"> <li>• The Board shall not nominate more than 12 individuals for election at the 2016 Annual Meeting (including the two JANA designees).</li> <li>• The Board shall not increase the size of the Board in excess of 13 directors prior to the 2016 Annual Meeting or 12 directors following the 2016 Annual Meeting.</li> </ul>

H2 2016 Settlement Agreement Key Terms (continued)

	First Pacific Advisors	JANA Partners
	on a binding proposal to amend the Company's Certificate of Incorporation to declassify the Board.	
<b>Voting</b>	At the 2017 Annual Meeting, FPA shall vote all shares (i) in favor of the election of director nominees recommended by the Board, (ii) in favor of the ratification of the appointment of Ernst & Young, LLP as the Company's independent registered public accounting firm, and (iii) in accordance with the Board's recommendation with respect to the Company's "say-on-pay" proposal, unless Institutional Shareholder Services Inc. and Glass Lewis & Co., LLC recommends otherwise with respect to such "say-on-pay" proposal.	JANA shall vote all shares in favor of the JANA designees and all current directors nominated by the Board and shall vote in accordance with the Board's recommendations with respect to any other proposal or business; <i>provided, however</i> , that JANA may vote at its sole discretion with respect to (i) proposals to authorize or approve certain extraordinary transactions, (ii) matters related to the implementation of takeover defenses or (iii) new or amended incentive compensation plans.
<b>Min/Max Ownership</b>	<p><b>Min:</b> FPA must own at least 10% of the Company's Common Stock, otherwise FPA may not nominate replacements for its directors if they resign or are removed. The FPA designee to resign if FPA drops below this threshold.</p> <p><b>Max:</b> FPA may not own more than 15% of the Company's Common Stock prior to the earlier of (i) the conclusion of the 2018 Annual Meeting and (ii) February 28, 2018, and 20% of the Company's Common Stock thereafter.</p>	<p><b>Min:</b> JANA must have beneficial or other ownership of at least 1.5% of the Company's Common Stock, otherwise JANA may not nominate replacements for its directors if they resign, refuse to serve or are unable to serve.</p> <p><b>Max:</b> JANA may not have beneficial or other ownership of more than 10% of the Company's Common Stock. A company held by JANA or any JANA affiliate may not have beneficial or other ownership of more than 4.9% of the Company's Common Stock.</p>
<b>Expense Reimbursement</b>	Yes; up to \$125,000.	None.
<b>Non-Disparagement</b>	None.	Yes; <i>provided, however</i> , that JANA will be able to make objective statements that reflect JANA's view, as a shareholder, with respect to factual matters concerning specific acts or determinations of the Company and that the Company will be permitted to make objective statements that reflect the Company's view with respect to factual matters concerning specific acts of JANA.

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	MSD Capital	Pershing Square Capital Management
<b>Company</b>	NorthStar Asset Management Group, Inc.	Chipotle Mexican Grill, Inc.
<b>Agreement Date</b>	October 16, 2016	December 14, 2016
<b>Board Seats</b>	None.	4/12 (the Board to increase in size to 12 directors to accommodate four Pershing Square designees).
<b>Standstill (including term)</b>	Yes; until the earlier of (i) the Amendment Release is not issued by NSAM by 9:00 a.m. ET on October 17, 2016, (ii) the merger agreement amendment and executive agreement amendments are not fully executed by the parties by 9:00 a.m. ET on the Release Date, or the merger agreement amendment or executive agreement amendments as executed vary in any respect from the versions set forth in Exhibit A and Exhibit B, respectively, (iii) the merger agreement is terminated, (iv) the merger agreement or any executive agreements are further amended after the execution of the merger agreement amendment and executive agreement amendments in any material respect (which shall include, without limitation, any amendment (A) to the economics of the transactions contemplated thereby or the post-closing governance arrangements for the combined company, (B) relating to executive compensation or (C) that reverses or otherwise alters the revisions to the transaction terms as set forth in the Amendment Release, the merger agreement amendment or the executive agreement amendments), (v) there is a Polaris Change of Recommendation or (vi) March 17, 2017.	Yes; until the later of (i) 30 calendar days after the date that neither of two specified Pershing Square designees serve on the Board of Directors and (ii) the date that is 30 calendar days prior to the nomination deadline for the 2019 Annual Meeting. If the Company notifies the Pershing Square Group that it will not be nominating a specified Pershing Square designee for election to the Board at the 2019 Annual Meeting, the Standstill Termination Date shall be the later of (i) the date that is five calendar days after the date that such Pershing Square designee no longer serves on the Board and (ii) the date that is 30 calendar days prior to the nomination deadline for the 2019 Annual Meeting.
<b>Committee Membership</b>	None.	None.
<b>Other Strategic Initiatives</b>	<ul style="list-style-type: none"> <li>The Company will opt out of the Maryland Unsolicited Takeover Act, which would have permitted the Company to elect without stockholder approval to adopt a classified board structure and other anti-takeover provisions.</li> <li>The Company stockholders will have the right to remove directors at a special meeting</li> </ul>	Two Pershing Square designees to be re-nominated at the 2017 and 2018 Annual Meetings.



H2 2016 Settlement Agreement Key Terms (continued)

	MSD Capital	Pershing Square Capital Management
	<p>of stockholders, with or without cause, by majority vote.</p> <ul style="list-style-type: none"> <li>The post-merger Board to decrease in size to ten directors with five members jointly selected by NSAM and NorthStar Realty Finance, and include two additional named independent directors who are real estate experts.</li> </ul>	
<b>Voting</b>	At the NSAM special meeting, MSD shall vote its shares in favor of the NorthStar and Colony transaction.	Pershing Square Group shall vote its shares in favor of all nominees of the Company in its proxy statement for the applicable annual meeting for election to the Board at the applicable annual meeting and in favor of routine management proposals (including compensation related matters) and against (i) any stockholder nominations for director which are not recommended by the Board for election at the applicable annual meeting, (ii) any proposals or resolutions to remove any member of the Board and (iii) any other proposals that are not recommended by the Board.
<b>Min/Max Ownership</b>	None.	<b>Min:</b> If Pershing Square owns less than 5.0% of outstanding common stock, Pershing Square shall cause a specified Pershing Square designee to tender his resignation from the Board.
<b>Expense Reimbursement</b>	None.	None.
<b>Non-Disparagement</b>	None.	Yes.

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>SailingStone Capital Partners</b>	<b>Shanda Asset Management</b>
<b>Company</b>	Range Resources Corporation	Legg Mason, Inc.
<b>Agreement Date</b>	August 7, 2016	December 19, 2016
<b>Board Seats</b>	1/11 (the Board and SailingStone to mutually recommend a director candidate to each other and agree upon a joint appointee to the Board).	2/13 (the Board to increase in size to 13 directors to accommodate two Shanda designees).
<b>Standstill (including term)</b>	Yes; until the earlier of (i) 30 calendar days prior to the last date on which individuals may be nominated for election as directors at the first annual meeting of the Company after the 2017 Annual Meeting and (ii) such other date established by mutual written consent of each of the parties.	Yes; until the earlier of (i) the close of business on the three-year anniversary of the date hereof and (ii) breach of the standstill provisions.
<b>Committee Membership</b>	None.	One Shanda designee shall be appointed to the Nominating and Corporate Governance Committee.
<b>Other Strategic Initiatives</b>	<ul style="list-style-type: none"> <li>The Board will nominate the joint appointee for election as a director at the next annual stockholders' meeting.</li> <li>The Board will implement a Stockholder Engagement Policy, including at least one opportunity annually for at least five of the ten largest stockholders, including SailingStone, to meet with either independent lead director or two or more independent directors of the Board to give feedback to the Board.</li> <li>Additional performance criteria for compensation awards will be implemented: (i) drilling rate of return criterion at a weight of 15%; (ii) payout percentage with respect to 12.5% of performance shares will be debt-adjusted reserve growth per share metric; and (iii) payout percentage with respect to 12.5% of performance shares will be debt-adjusted production growth per share.</li> </ul>	In addition to or in lieu of the Shanda designees, Shanda shall be entitled to appoint a Board observer.
<b>Voting</b>	SailingStone shall vote or consent in accordance with the recommendations of the Board with respect to: (i) the election or removal of the	At any stockholders' meetings during the standstill period, Shanda shall vote all shares (i) in favor of each director nominated and

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>SailingStone Capital Partners</b>	<b>Shanda Asset Management</b>
	Company directors, including the election of the Company’s nominees to the Board, including the Joint Appointee, (ii) the “say-on-pay” proposal and (iii) any other proposals or nominations proposed or supported by any other stockholder of the Company that (A) relate specifically to the matters in clauses (i) and (ii) above or otherwise relate to Board makeup or structure or (B) relate to extraordinary transactions.	recommended by the Board for election at any such meeting, (ii) against any shareholder nominations for director which are not approved and recommended by the Board for election at any such meeting and (iii) with respect to all “say-on-pay” resolutions recommended by the Board, in favor of such resolutions or in direct proportion to the votes of the other shareholders of the Company who cast votes with respect to such resolutions.
<b>Min/Max Ownership</b>	<b>Max:</b> SailingStone may not have beneficial ownership of more than 14.9% of the Company’s Common Stock.	<b>Min:</b> Shanda must own for a period of 30 consecutive days that the stock is open for trading, common stock equal to at least 10.0% of the outstanding shares of common stock to maintain rights for (i) the appointment of a Shanda designee to a second Board seat, (ii) appointment of a Shanda designee as Vice Chairman and (iii) appointment of a Shanda designee as a member of the Company’s Nominating and Corporate Governance Committee. Shanda must own in the aggregate for a period of 30 consecutive days that the stock is open for trading, common stock equal to at least 5.0% of the outstanding shares of common stock to maintain appointment rights for both Shanda designees.
<b>Expense Reimbursement</b>	None.	None.
<b>Non-Disparagement</b>	Yes.	None.

**H2 2016 Settlement Agreement Key Terms** *(continued)*

	<b>WW Investors</b>
<b>Company</b>	New York REIT, Inc.
<b>Agreement Date</b>	October 23, 2016
<b>Board Seats</b>	3/9 (the Board to increase in size to nine directors to accommodate three WW designees).
<b>Standstill (including term)</b>	Yes; until the later of (i) December 31, 2017 and (ii) the date that two of the WW designees no longer continue to serve on the Board, or on the date that the Company files its definitive proxy statement in respect of an annual meeting at which two of the WW designees are not nominated for election to the Board.
<b>Committee Membership</b>	<ul style="list-style-type: none"> <li>• One WW designee appointed to the Audit Committee, and another WW designee appointed to the Compensation Committee.</li> <li>• Until the expiration of the standstill period, if at least one of the WW designees remains on the Board, the Company shall not establish an executive committee of the Board without the approval of the WW designee(s).</li> </ul>
<b>Other Strategic Initiatives</b>	The Company shall use reasonable best efforts to hold the 2016 Annual Meeting simultaneously with the stockholders' meeting to vote upon the proposed plan of liquidation to sell all or substantially all of the assets of the Company and to liquidate and dissolve the Company.
<b>Voting</b>	At the 2016 Annual Meeting, WW Investors shall vote its shares in support of the Company's nine director nominees and irrevocably withdraw and renounce any intention to nominate any person for election as a director.
<b>Min/Max Ownership</b>	<b>Max:</b> WW Investors may not beneficially own any voting stock of the Company that, together with any voting stock beneficially owned thereby, represents in the aggregate in excess of 4.9% of the Company's outstanding voting stock.
<b>Expense Reimbursement</b>	Yes; up to \$700,000.
<b>Non-Disparagement</b>	Yes.

July 21, 2016

## "COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE" RELEASED

To Our Clients and Friends:

Today a group of 13 executives at leading companies and institutional investors released "Commonsense Principles of Corporate Governance" for public companies, their boards of directors and their shareholders. The Principles are described as being intended "to provide a basic framework for sound, long-term-oriented governance" and to "promote further conversation on corporate governance." An open letter accompanying the Principles describes them as "conducive to good corporate governance, healthy public companies and the continued strength of our public markets." Full-page ads summarizing key parts of the Principles were published in national and international newspapers.

The Principles, which are the product of meetings that have been reported on for several months, acknowledge that not every Principle will work for every company or be applied in the same manner given the many differences among public companies. Institutional investor signatories include representatives of Berkshire Hathaway, BlackRock, Capital Group, J.P. Morgan Asset Management, State Street, T. Rowe Price and Vanguard. The signatories also include the chief executive officers at General Electric, General Motors Co., JPMorgan Chase and Verizon. The chief executive officers of hedge fund ValueAct Capital and the Canada Pension Plan Investment Board, a public pension fund, also are signatories.

The Principles are organized into eight areas: (1) Board of Directors – Composition and Internal Governance; (2) Board of Directors' Responsibilities; (3) Shareholder Rights; (4) Public Reporting; (5) Board Leadership (including the lead independent director's role); (6) Management Succession Planning; (7) Compensation of Management; and (8) Asset Managers' Role in Corporate Governance. Some of the Principles address matters that are already required by state law, the corporate governance requirements in listing standards or the Securities Exchange Commission rules.

Recent high-profile public company governance issues and other matters that are addressed include:

- **Proxy access:** The Principles report on the terms generally adopted by most companies, but do not advocate the adoption of proxy access or the adoption of specific terms.

- **Board leadership:** "The board's independent directors should decide, based upon the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles." When the CEO/chair roles are combined, the board should have a "strong designated lead independent director and governance structure." The Principles also include a list of possible duties for the lead independent director.
- **Non-GAAP numbers:** The Principles state that non-GAAP numbers "should be sensible and should not be used to obscure GAAP results." The Principles also note "that *all* compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings."
- **Earnings guidance:** The Principles state that companies "should not feel obligated to provide earnings guidance – and should determine whether providing earnings guidance for the company's shareholders does more harm than good."
- **Board diversity:** The Principles state that "[d]irectors should have complementary and diverse skill sets, backgrounds and experiences. Diversity along multiple dimensions is critical to a high-functioning board. Director candidates should be drawn from a rigorously diverse pool."
- **Director election voting standard:** The Principles state that directors should be elected using majority voting. They do not mention specifics such as whether majority voting should only be used in uncontested elections or advocate the adoption of companion director resignation policies.
- **Board tenure:** Instead of adopting a bright-line view on board tenure, the Principles emphasize the need for considering board refreshment and tempering "fresh thinking and new perspectives" with "age and experience" on the board.
- **Term limits/retirement ages:** Consistent with the approach on board tenure, the Principles do not recommend the adoption of retirement ages or term limits but instead state that, to the extent a board permits an exception to any such policy, the board explain the reasons for the exception.
- **Director effectiveness:** The Principles state that boards "should have a robust process to evaluate themselves on a regular basis" and "the fortitude to replace ineffective directors."
- **Industry experience:** The Principles state that a "subset" of directors should "have professional experiences directly related to the company's business" and that the board should be "continually educated" on the company's industry.

- **Ability of shareholders to act by written consent and call special meetings:** The Principles state that the ability of shareholders to act by written consent and call special meetings "can be important mechanisms for shareholder action" but, when adopted, should require "a reasonable minimum amount of outstanding shares . . . [to act] in order to prevent a small minority of shareholders from being able to abuse the rights or waste corporate time and resources."
- **Director engagement with shareholders:** The Principles encourage boards to engage in robust communication of the board's thinking to shareholders. They note that there are many ways to do so, including designating certain directors "in coordination with management" to "communicate directly with shareholders on governance and key shareholder issues."
- **Audit committee review of financial statements:** The Principles state that audit committees "should focus on whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation." This Principle was recommended during a 2002 Securities and Exchange Commission roundtable by Warren Buffett, a signatory to the Principles and at the time a member of the Coca-Cola Audit Committee, as one of several questions audit committees should be asking auditors.
- **Access to management:** The Principles state that "directors should have unfettered access to management, including those below the CEO's direct reports."
- **Director compensation:** The Principles recommend that companies consider both paying "a substantial portion" of director compensation in equity and requiring directors "to retain a significant portion of their equity compensation during their tenure" on the board.
- **Executive compensation:**
  - Executive compensation plans should "ensure alignment with long-term performance" and "have both a current component and a long-term component."
  - "Benchmarks and performance measurements ordinarily should be disclosed to enable shareholders to evaluate the rigor of the company's goals and the goal-setting process."
  - "Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments."

The Principles do not explicitly mention some prominent governance issues, such as classified boards, supermajority voting requirements, poison pills or sustainability.

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The Principles also address the role of asset managers in corporate governance. The Principles state that "[a]sset managers should exercise their voting rights thoughtfully and act in what they believe to be the long-term economic interests of their clients." They also note that when voting on matters, asset managers "should give due consideration to the company's rationale for its positions" on those matters and vote based on "independent application of their own voting guidelines and policies." The Principles also encourage asset managers to evaluate the performance of the boards at the companies in which they invest.

Public companies – especially those whose institutional investor base includes significant holdings by the institutional investors who signed the Principles – should consider promptly distributing the Principles to their boards and/or governance committees. Public companies also should consider ways to enhance their shareholder communications – including proxy materials – to emphasize the Principles that the companies follow. Finally, directors may find it useful to review a summary of or discuss how the company's governance practices compare to the Principles and, where they are different, the reasons why.

The **Principles** (*click on link*) and the **open letter** (*click on link*) from the signatories are available at <http://www.governanceprinciples.org/>.



Gibson Dunn's lawyers are available to assist in addressing any questions you may have about these developments. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, any lawyer in the firm's Securities Regulation and Corporate Governance practice group, or any of the following:

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