Bloomberg BNA

Mergers & Acquisitions Law Report™

Reproduced with permission from Mergers & Acquisitions Law Report, 15 MALR 1667, 11/26/2012. Copyright © 2012 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

MERGER ACTIVITY

Financial Advisor Topics in Hostile Takeover Defenses: A Discussion of Fee Arrangements, Potential Conflicts and Inadequacy Opinions

BY H. H. SEAN WEE

The M&A market has continued to experience heightened hostile M&A activity. Despite an inherently high failure rate, hostile offers remain an option for acquisitive strategic companies as well as hedge funds and activist investors. Hostile M&A has been fueled by several factors, including challenges to organic growth faced by strategics in a weak economic environment, lower market valuations of targets relative to historical market highs, significant cash reserves held by would-be acquirors and access to available debt financing. In addition, the success of shareholder activism against takeover defenses has raised at least a perception of increased vulnerability.

Mr. Wee is a partner at Manatt, Phelps & Phillips LLP. He was formerly a partner at Dewey & LeBoeuf LLP where he was involved in that firm's representation of Illumina Inc., The Talbots, Inc., and financial advisors to NRG Energy, Inc., Sun Capital Partners, Caremark, Inc. and The TriZetto Group, Inc., in connection with the transactions referenced in this article. Paula Hufschmid, an associate at Manatt, assisted with the research for this article.

Fortunately for targets and their boards, the process that should be undertaken in responding to a hostile takeover proposal is fairly well established. Perhaps first and foremost among the actions to be taken by the target is the retention of experienced legal and financial advisors to assist with evaluating the unsolicited proposal and to provide tactical advice. Most ''bulge-bracket'' investment banks and top boutique financial advisory firms will have experience with hostile takeover defense. Targets will often hire more than one financial advisor.

This article will provide an overview of customary financial advisor fee arrangements for a takeover defense, followed by a discussion of potential conflicts in the hostile M&A context (with particular attention to concerns arising from a financial advisor's securities positions), and will then explore fundamental aspects of the inadequacy opinions that financial advisors are asked to provide when the board of a target publicly rejects a hostile bidder's offer.

1. Fee Arrangements

When an investment bank is engaged to advise a company regarding a typical, negotiated M&A transaction, all or a significant portion of the financial advisor's fee is customarily contingent on the consummation of the transaction. If the investment bank is acting as the

financial advisor of the company to be sold, this transaction fee or ''success fee'' is usually structured as a percentage of the value of the transaction. This provides an incentive to the financial advisor to assist the company in maximizing the price obtained from the acquiror.

In a typical hostile M&A defense engagement, the financial advisor to the target receives the same type of transaction fee upon consummation of a sale even if the eventual acquiror is the party that approached the company on a hostile basis. However, to balance this incentive in favor of a sale, the financial advisor will also seek and often receives lower but still sizable compensation that is not contingent on the sale. The aggregate amount of this defense-related compensation is subject to negotiation.

Hostile defense fee structures take various forms. In some cases, they involve the payment of an initial advisory fee followed by additional advisory fees paid periodically during the course of the engagement. Some involve the payment of an independence or defense fee upon the withdrawal of the hostile offer or more typically on a specified anniversary date if no transaction has been consummated or agreed to at that time. Other compensation may be tied to an escalation of hostile activity such as public announcement of the hostile offer or launch of a tender offer or proxy contest. Finally, the financial advisor may receive a fee if it delivers an inadequacy opinion. If a transaction is ultimately consummated for which the financial advisor is entitled to receive a transaction fee, some or all of these defense-related fees are typically credited against the transaction fee.

These fee structures can be observed in some examples of the Schedule 14D-9 required to be filed by the target after a tender or exchange offer is commenced. For example, in connection with an unsolicited exchange offer by Exelon to acquire NRG Energy and related proxy contest in 2008 and 2009, NRG Energy publicly disclosed in its Schedule 14D-9 that it had agreed to pay its financial advisors, Citigroup and Credit Suisse, a portion of their compensation upon engagement, a portion upon delivery of inadequacy opinions and a portion no later than the second business day after NRG Energy's 2009 annual meeting. In connection with Goldman Sachs' engagement by Casey's General Stores in its takeover defense against Couche-Tard, Casey's General Stores publicly disclosed that it had paid its financial advisor an initial fee upon engagement and that a significant portion of Goldman Sachs' fees became payable upon the announcement of the Couche-Tard proposal and another significant portion would be payable if the proposal was outstanding on a specified date. In its defense against Sanofi-Aventis, Genzyme agreed to pay Credit Suisse and Goldman Sachs each an initial upfront fee and a fixed quarterly fee for up to four quarters.

What is often heavily negotiated is the amount of the defense-related fees. On the one hand, it would be arguably optimal from a process perspective for the financial advisor's compensation to be the same regardless of whether or not a transaction is consummated. On the other hand, a return to the status quo results in the financial advisor's fee becoming a cost borne by the target without any liquidity event. In addition, it can be argued that, if a hostile offer is successfully rebuffed, then the financial advisor would indirectly benefit from the continued existence of its client. This would be especially true if the financial advisor has been granted a right of first refusal on future financings or transactions. Nevertheless, financial advisors often succeed in negotiating significant defense-related fees relative to the transaction fee they would otherwise receive in the event that the proposed hostile transaction were consummated. Based on public filings filed in connection with Roche's lengthy campaign to acquire full ownership of Genentech in 2008 and 2009, Genentech agreed to pay its financial advisor, Goldman Sachs, quarterly advisory fees of up to a maximum amount of $34.8 million, as compared to maximum total fees of $55 million if the transaction were consummated. In connection with its successful defense of an attempted takeover by Roche earlier this year, Illumina publicly disclosed that it agreed to pay its financial advisors, Goldman Sachs and BofA Merrill Lynch, quarterly advisory fees totaling approximately $26 million, as compared to maximum total fees of $38.2 million if the transaction were consummated. In both these examples, significantly more than 50% of the financial advisors' fees in question were not contingent on a transaction being consummated. On the other hand, in the case of Talbots, which was acquired by Sycamore Partners this year, it was disclosed that aggregate fees of approximately $5.8 million would be paid to Perella Weinberg, Talbots' financial advisor, if the acquisition were consummated, as compared to defense-related fees disclosed to have been previously paid or due to Perella Weinberg of $2.25 million in the aggregate, consisting of $750,000 in retainer fees and an additional $1.5 million in connection with the unsolicited proposal by Sycamore Partners.

Of course, compensation of the financial advisor that is not contingent on the consummation of a sale makes obvious and practical sense in a hostile defense context. It may also indicate the strength of the target's commitment to remaining independent as opposed to rejecting an inadequate price in favor of a better one. For example, in the case of Human Genome Sciences which rejected the initial offer price made by its hostile suitor, GlaxoSmithKline, but later accepted an increased price after conducting a sale process, the principal portion of the financial advisors' compensation was contingent on consummation of a sale and the financial advisors would have received substantially less or no compensation if no sale had taken place. In addition, although customary contingent-based transaction fee structures have survived judicial scrutiny, courts have, under certain circumstances, faulted fee arrangements that appeared tailored to favor a particular outcome such as in the *Caremark* decision (where the financial advisors' ''fee tail'' was triggered only if Caremark entered into a merger agreement with a specific buyer, CVS) and more recently in the *EL Paso* decision (where one of El Paso's two financial advisors retained due to a conflict issue involving the other financial advisor's interests in the acquiror, Kinder Morgan, was compensated solely in the event of a sale even though the company had actively considered a spin-off alternative for which only the other conflicted financial advisor would have been compensated).

There is flexibility in structuring and negotiating the amount of defense-related financial advisor compensation, but, by promoting outcome neutrality, meaningful defense-related fees that are not contingent on the consummation of a transaction can be and have been used

 COPYRIGHT © 2012 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

as an effective way to counter the notion that a financial advisor's advice would be tainted by a conflicting fee interest in favor of an eventual sale.

2. Potential Conflicts

As another source of potential conflicts of interest, the existence of past and current relationships between the target's financial advisor and either party to the transaction, particularly the acquiror, has received increasing focus in M&A shareholder litigation. It is often the case that the financial advisor has provided past services to one or both parties. A financial advisor may also have positions in the securities of one or both parties. The courts have made clear that these relationships should be disclosed by the financial advisor to target boards and their outside counsel.

When in a hostile M&A context, there is heightened sensitivity to the existence of relationships between the target's financial advisor and a hostile bidder. The point at which prior relationships become unacceptable to the target's board and its legal counsel can be more easily reached than in a non-hostile setting. Perhaps with limited exception for participation in existing credit facilities and foreign exchange, trading, treasury and similar non-investment banking products and services, the financial advisor should avoid providing services to the hostile bidder during the engagement even if unrelated to the transaction. In addition, target boards and their outside counsel may wish to assess the financial advisor's prior and existing relationships with the target for potential concerns regarding lack of independence (particularly since there could be ''entrenchment'' challenges to the defensive measures taken by the target) or if it could appear that the financial advisor would be unduly biased against the hostile offer due to a desire to keep an existing corporate client. However, these potential concerns are more often outweighed in the target board's view by the benefit of having a financial advisor that is familiar with the target and its business.

More problematic than prior or even current service relationships, a financial advisor's securities positions, including derivative positions, can if large enough extend beyond being a matter of disclosure and instead become a matter of substantive concern that the financial advisor would be conflicted by its separate financial interest in the transaction. This was the case in the *El Paso* decision by the Delaware Chancery Court involving EL Paso's sale to Kinder Morgan where Goldman Sachs, one of El Paso's sell-side financial advisors, held a 19% stake in Kinder Morgan and had two seats on the board of Kinder Morgan. Prior to the parties' reaching agreement, Kinder Morgan had threatened to go public with a hostile takeover.

Concerns regarding a potential conflict of interest in an overtly hostile M&A context due to the financial interests of a financial advisor in securities of the target were raised this year in connection with Roche's failed attempt to acquire Illumina. One of Illumina's financial advisors, Goldman Sachs, held significant financial interests in Illumina as a result of certain derivative transactions, which Goldman Sachs had entered into with Illumina concurrently with Illumina's convertible notes offering in 2007, and related hedging activities. Among other things, Goldman Sachs held warrants to acquire Illumina shares in 2014 (if the warrants were in-the-money) and also had engaged in short sales in Illumina shares that hedged against Goldman Sachs' long position resulting from the warrants. It was disclosed in Illumina's Schedule 14D-9 that, in confirming Goldman Sachs' engagement as financial advisor, Illumina's board had discussed what might be considered an appearance of a conflict given the fact that, if the Roche offer or other ''cash-out'' transaction were consummated prior to the scheduled maturity of Goldman Sachs' warrants in 2014, Goldman Sachs would be entitled to receive a payment for the early cancellation of the warrants and also given that the timing and price of any cash-out transaction such as the Roche offer would affect the determination of the cancellation amount. Illumina's board determined to engage BofA Merrill Lynch as co-financial advisor to the board as a means to address the issue.

During the pendency of Roche's hostile offer, several shareholder lawsuits were brought challenging the defensive actions taken by the Illumina board. The shareholder complaints pressed the allegation that Goldman Sachs was conflicted by the derivative transactions with most alleging that Goldman Sachs had a vested interest against the Roche offer. One complaint alleged that, ''[d]epending on the then current offer price and the status of Goldman Sachs' hedging and shorting strategy, Goldman Sachs may be motivated to recommend that the Board oppose a fair deal or to accept an unfair deal.'' In particular, the complaints cited disclosure in Illumina's Schedule 14D-9 that, in the event of an acquisition of Illumina by Roche at the then offer price, approximately $454 million would be payable by Goldman Sachs to securities lenders to settle Illumina shares sold short in hedging activity by Goldman Sachs as opposed to an estimated payment of only $272.8 million that would be due to Goldman Sachs for the early cancellation of the warrants. Several complaints also faulted Illumina's Schedule 14D-9 for not disclosing how a change in Roche's offer price would affect the payments and the fact that Goldman Sachs hedging activities were ongoing.

In the updated Schedule14D-9 subsequently filed in response to an increase in Roche's offer price, the disclosure regarding Goldman Sachs' hedging activities was expanded to describe generally that they were part of Goldman Sachs' ordinary practice and intended to neutralize exposure to changes in the price of Illumina shares resulting from the original derivative transactions. The disclosure also explained that this type of hedging is typically designed by Goldman Sachs to offset any significant gains or losses to Goldman Sachs from the derivative transactions as a result of fluctuations in the price of Illumina shares, including fluctuations relating to Roche's offer. As a consequence of its hedging activity, increases in the price of Illumina shares which would increase the value of Goldman Sachs' warrants would also result in an offsetting increase in the amount owed by Goldman Sachs to close short sales. Contrary to the allegations made in the shareholder complaints, the disclosure stated that the amount of any loss or profit to Goldman Sachs could not be determined simply by subtracting the amount payable to stock lenders to close out any short position at a particular price on a particular date from the estimated payments that would be received by Goldman Sachs in connection with canceling or exercising the warrants at such price and on such date. The disclosure indicated some of the factors that would determine

Goldman Sachs' ultimate loss or profit on the derivative transactions, including, among other things, the price at which Goldman Sachs established its initial hedge position and the profit and loss realized by Goldman Sachs in connection with rebalancing its stock hedge positions (such rebalancing occurring as frequently as daily).

It is noteworthy as a comparison to this disclosure that it was also disclosed in the same filing that, after employees of BofA Merrill Lynch, Illumina's other financial advisor, had discovered that one of its affiliates was a counterparty to a capped call derivative contract with a third party involving Illumina shares, BofA Merrill Lynch informed Illumina's counsel that it was in the process of taking actions to fully offset the position in order to eliminate the exposure to BofA Merrill Lynch to the capped call transaction and any question regarding BofA Merrill Lynch's independence.

In light of the *El Paso* decision and the more conservative approach taken by BofA Merrill Lynch, it would have been informative for a court to have addressed Goldman Sachs' financial interests in Illumina and the sufficiency of the disclosures made in the Schedule 14D-9. However, following the filing of the updated Schedule 14d-9, Illumina's shareholders voted to retain the company's current board at its annual meeting, and Roche withdrew its offer. A joint motion to dismiss without prejudice one of the shareholder lawsuits was subsequently filed in July.

The appropriateness of financial advisors holding significant derivative positions and hedging those positions and the required level of disclosure of these matters remains unsettled. In the closing days of Roche's bid for Illumina, GlaxoSmithKline began its ultimately successful campaign to acquire Human Genome Sciences. As did Illumina, Human Genome Sciences retained Goldman Sachs as its financial advisor notwithstanding the fact that Goldman Sachs also held derivative positions in Human Genome Sciences. In this case. Goldman Sachs was a counterparty to capped call transactions with Human Genome Sciences and was engaged in hedging activities to reduce its risk. According to the Schedule 14D-9 filed in response to GlaxoSmithKline's tender offer, in confirming Goldman Sachs' engagement as Human Genome Sciences' financial advisor to assist the board of Human Genome Sciences in its evaluation of strategic alternatives, the board discussed potential conflicts of interest that might arise from the capped call transactions. The board discussed the benefit of engaging a co-financial advisor to provide additional assistance as a means to address any potential conflict issue, and Credit Suisse was so engaged. In contrast to Illumina, the disclosures in Human Genome Sciences' Schedule 14D-9 regarding the capped call transactions and related hedging activities did not include an estimate of the amount that would be paid by Goldman Sachs to Human Genome Sciences for the cancellation of the capped call transactions in the event that the transaction with GlaxoSmithKline was consummated or quantification of Goldman Sachs' related hedging activities. These types of estimates had been specifically cited in the shareholder complaints against Illumina. Ultimately, Human Genome Sciences did disclose an estimate of the cancellation payment as well as the number of Human Genome Sciences shares held by Goldman Sachs in an amended Schedule 14D-9 but only after it had reached agreement with GlaxoSmithKline regarding a sale.[1] This disclosure indicated that the estimated cancellation payment to be made by Goldman Sachs to Human Genome Sciences was approximately $14.3 million, which would be less than Goldman Sachs' transaction fee of approximately $25 million. The disclosure also indicated that Goldman Sachs held a long hedge position of approximately 800,000 Human Genome Sciences shares at the time.

Definitive takeaways from Illumina and Human Genome Sciences are limited. In each case, Goldman Sachs preemptively raised the possibility of a potential conflict or appearance of a potential conflict due to its securities positions and the issue was considered by the target's board. In each case, a second financial advisor was retained to address the issue. It should also be noted that Goldman Sachs' hedging activities were handled by its Securities Division which was separate from its Investment Banking Division. However, given the negative outcome in the *El Paso* decision and the un-adjudicated shareholder plaintiff allegations made in Illumina, target boards and their counsel should weigh carefully whether the particular facts and circumstances permit the retention of a financial advisor with significant securities positions in one or both transaction parties and whether the risks involved are warranted.

3. Inadequacy Opinions

The first two parts of this article discussed potential considerations affecting the financial interests of the target's financial advisor in a hostile M&A context. In this third and final part, we turn to an important component of the advice itself. In determining to reject an offer that has been publicly disclosed, the target's board may ask the financial advisor for an ''inadequacy'' opinion. Generally, an inadequacy opinion indicates to the board the financial advisor's opinion to the effect that the offer price is inadequate from a financial point of view. In the *Airgas* decision, the Delaware Chancery Court rejected Air Products' suit seeking to compel the redemption of Airgas' poison pill by acknowledging that price inadequacy constituted a legitimate threat to Airgas under the *Unocal* standard and specifically citing the receipt by the Airgas board of inadequacy opinions from Airgas' three financial advisors in determining that the actions of Airgas' board passed muster.

Inadequacy opinions are closely related to ''fairness'' opinions and are in the same species. However, classification of inadequacy opinions as ''negative'' fairness opinions would be an oversimplification as there are aspects that historically have differentiated and, in some cases, continue to differentiate the two.

Substantively, the notion of inadequacy is generally thought to be broader than ''not being fair.'' As such, while an offer price that is ''unfair'' would be ''inadequate,'' an offer price may still be ''inadequate'' even if it may be ''fair.'' Accordingly, whereas investment banks began long ago to limit fairness opinions by ad-

[1] In 2008 the Delaware Chancery Court granted a preliminary injunction on Apax Partners' acquisition of TriZetto Group based on inadequate disclosures in the merger proxy statement relating to the derivatives positions held by TriZetto Group's financial advisor. The court held that quantification (even in the form of a range, if necessary) was required.

 COPYRIGHT © 2012 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

dressing the ''consideration'' to be received in the transaction from a financial point of view instead of the ''transaction'' itself, inadequacy opinions have not universally followed suit. Instead, some inadequacy opinions continue to address the inadequacy of the ''Offer'' as recently as in the opinion delivered by Credit Suisse to Human Genome Sciences in May 2012. In supporting inadequacy opinions, financial advisors may look to types of analyses and consider other factors that are broader than those customarily relied upon to support a fairness opinion such as premium offered, future trading price, affordability, absence of market check and preclusive offer terms. For example, Goldman Sachs' inadequacy opinion letters typically indicate that Goldman Sachs held discussions with members of the senior management of the target regarding their assessment of the strategic rationale of the acquiror for, and the potential benefits for the acquiror of, the proposed offer. This language is not typically included in sell-side cash fairness opinions presumably because the value to the acquiror of effecting the transaction is not considered in assessing whether the price paid for the target is fair to the target's shareholders. This type of ''strategic rationale'' and ''potential benefits'' reference in an inadequacy opinion suggests that the financial advisor may take into account what the acquiror could be willing to pay, a factor the financial advisor would not customarily consider in a sell-side fairness opinion involving an all-cash sale of the company.

However, in terms of form and practice, there has been a trend toward conforming inadequacy opinions to many fairness opinion conventions. Although it is arguable that inadequacy opinions are not literally subject to the FINRA Rule 5150 requirements relating to ''fairness opinions,''[2] inadequacy opinions are now commonly delivered in writing and contain ''fairness opinion'' disclosures regarding, among other things, contingent and other significant compensation, material relationships and use of a fairness committee. Written inadequacy opinions are routinely disclosed when a target files a Schedule 14D-9 as required in response to commencement of a tender or exchange offer.

In the past, inadequacy opinions were not always delivered in writing because practitioners reasoned that disclosure of a written inadequacy opinion might be detrimental to the target's defense to the extent that the contents of the opinion could be examined by the hostile bidder and other transaction observers and potentially criticized or exploited. This concern did not materialize in reality given the mostly formulaic nature of what is said in the opinion letter (however, it is still the case where this concern is clearly applicable that the financial analysis performed by the financial advisor is not summarized or described in the Schedule 14D-9). More telling than the contents of the inadequacy opinion is simply the fact of whether or not an inadequacy opinion was delivered. For example, in connection with the 2008 takeover of Kellwood Company by Sun Capital Partners in which the target's board determined to take no position on a hostile tender offer, it appears that neither of the target's financial advisors, Banc of America Securities nor Morgan Stanley, provided an inadequacy opinion.

In sum, the inadequacy opinion is a close relative of the fairness opinion that is delivered by the target's financial advisor in a hostile takeover defense. Inadequacy opinions are similar in form to fairness opinions but can reflect additional factors and considerations not customarily relied on in a fairness opinion context.

* * *

Increasingly, financial advisors have become a focal point in M&A shareholder litigation. In the hostile M&A context, financial advisors play a key role in assisting the target of a hostile offer in connection with its evaluation and response. As such, familiarity with their compensation arrangements and with topical issues relating to potential conflicts in the hostile M&A context, as well as an understanding of the inadequacy opinions financial advisors are asked to deliver, are important to all participants in a takeover defense.

[2] In late 2007, certain disclosure and procedural requirements for fairness opinions issued by member firms of FINRA became effective. These requirements apply if, at the time a fairness opinion is issued to the board of directors of a company, the member firm issuing the fairness opinion knows, or has reason to know, that the fairness opinion will be provided or described to the company's public shareholders. In the FINRA notice regarding the requirements, a fairness opinion was described as addressing, from a financial point of view, ''the fairness of the consideration in a transaction.''