

Delaware Court of Chancery Finds Board's Use of Rights Plan Reasonable Based on Creeping Takeover and Effective Negative Control Threats by Activist Shareholders

BY ALEXANDRA D. KORRY

Alexandra Korry is a partner in the New York office of Sullivan & Cromwell LLP. Contact: korrya@sullcrom.com.

In a recent opinion,¹ the Delaware Court of Chancery (Parsons, V.C.) refused to preliminarily enjoin the Sotheby's annual meeting based on claims from activist hedge fund Third Point LLC and other shareholders that the Sotheby's board breached its fiduciary duties by adopting a two-trigger shareholder rights plan and later, in connection with Third Point's proxy contest, denying Third Point's request to waive the lower 10% ownership cap that applied to it and allow it to acquire up to the higher 20% cap in the company. The decision is notable for recognizing that activist share accumulations and the potential for negative control at low ownership thresholds can pose a cognizable threat under *Unocal Corp. v. Mesa*

*Petroleum Co.*² and for making clear that it is not easy to defeat a rights plan on the basis of shareholder disenfranchisement

CONTINUED ON PAGE 4

Content HIGHLIGHTS

Interview: What's Next for Pharmaceutical M&A 7

Ardagh/Saint-Gobain Settlement Triggers Strong Dissent Regarding Efficiencies Claims

By Laura A. Wilkinson and Meaghan P. Thomas-Kennedy 9

"Commercially Reasonable Efforts" Diligence Obligations in Life Science M&A

By Kristian Werling, Richard B. Smith and Daniel Goldstein 16

Complete Table of Contents listed on page 2.



THOMSON REUTERS

Table of CONTENTS

Delaware Court of Chancery Finds Board's Use of Rights Plan Reasonable Based on Creeping Takeover and Effective Negative Control Threats Created by Activist Shareholders

The Court refused to preliminarily enjoin Sotheby's annual meeting based on claims from activist shareholders that Sotheby's board breached its fiduciary duties by adopting a two-trigger shareholder rights plan and denied shareholder Third Point's request to waive the lower 10% ownership cap that applied to it.

By *Alexandra D. Korry, Sullivan & Cromwell LLP (New York)* 1

From the Editor

By *Chris O'Leary, Managing Editor*..... 3

Interview: What's Next for Pharmaceutical M&A

Mega-mergers of pharmaceutical companies may be getting the headlines of late, but the future of Big Pharma looks a lot more subtle, with carve-outs and asset swaps likely to be heavy in the mix for new deals.

By *David Shine, Fried, Frank, Harris, Shriver and Jacobson LLP (New York)*..... 7

Ardagh/Saint-Gobain Settlement Triggers Strong Dissent Regarding Efficiencies Claims

The FTC's agreement with Ardagh for its proposed acquisition of Saint-Gobain requires Ardagh to divest assets. But Commissioner Joshua D. Wright issued a vigorous dissent, critical of the FTC's methodology used to weigh potential efficiencies against the likelihood of consumer harm.

By *Laura A. Wilkinson and Meaghan P. Thomas-Kennedy, Weil, Gotshal and Manges LLP (Washington DC, New York)* 9

Handling Data Privacy Issues in M&A Transactions

Potential acquirors might not be aware of relevant sensitivities concerning the Internet and user data. A look at due diligence analysis and purchase agreement provisions to protect a buyer from risks associated with a target's failure to comply with data privacy laws and regulations.

By *Daniel Glazer and Jason Greenberg, Fried, Frank, Harris, Shriver and Jacobson LLP (New York)* 13

"Commercially Reasonable Efforts" Diligence Obligations in Life Science M&A

More than 80 percent of deals in the pharmaceutical, medical device and biotech industries include an earnout structure that provides contingent or delayed payment of proceeds to the sellers. This consideration is frequently contingent on post-closing achievement of certain clinical study results, product approvals, reimbursement or sales.

By *Kristian Werling, Richard B. Smith and Daniel Goldstein, McDermott, Will & Emery LLP (Chicago, Boston)*..... 16

Editorial Board

CHAIRMAN:

PAUL T. SCHNELL
Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY

MANAGING EDITOR:

CHRIS O'LEARY

BOARD OF EDITORS:

BERNARD S. BLACK
University of Texas Law School
Austin, TX

FRANCI J. BLASSBERG
Debevoise & Plimpton
New York, NY

DENNIS J. BLOCK
Greenberg Traurig
New York, NY

ANDREW E. BOGEN
Gibson, Dunn & Crutcher LLP
Los Angeles, CA

H. RODGIN COHEN
Sullivan & Cromwell
New York, NY

STEPHEN I. GLOVER
Gibson, Dunn & Crutcher LLP
Washington, DC

EDWARD D. HERLIHY
Wachtell, Lipton, Rosen & Katz
New York, NY

VICTOR I. LEWKOW
Cleary Gottlieb Steen & Hamilton LLP
New York, NY

PETER D. LYONS
Shearman & Sterling
New York, NY

DIDIER MARTIN
Bredin Prat
Paris, France

FRANCISCO ANTUNES MACIEL MUSSNICH
Barbosa, Mussnich & Aragão Advogados,
Rio de Janeiro, Brasil

PHILLIP A. PROGER
Jones Day
Washington, DC

PHILIP RICHTER
Fried Frank Harris Shriver & Jacobson
New York, NY

MICHAEL S. RINGLER
Wilson Sonsini Goodrich & Rosati
San Francisco, CA

PAUL S. RYKOWSKI
Ernst & Young
New York, NY

FAIZA J. SAEED
Cravath, Swaine & Moore LLP
New York, NY

CAROLE SCHIFFMAN
Davis Polk & Wardwell
New York, NY

ROBERT E. SPATT
Simpson Thacher & Bartlett
New York, NY

ECKART WILCKE
Hogan Lovells
Frankfurt, Germany

GREGORY P. WILLIAMS
Richards, Layton & Finger
Wilmington, DE

WILLIAM F. WYNN, JR
White & Case
New York, NY

The M&A Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

© 2014 Thomson Reuters

One Year Subscription ■ 10 Issues ■ \$762.00
(ISSN#: 1093-3255)

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

From the EDITOR

Heading Into a Hot Summer

As of early June 2014, new deal volume is at a strong pace in a host of M&A sectors, few of which are hotter than pharmaceuticals and life science companies, whose volume was up 53% year-over-year in the first quarter alone. In this issue's interview with Fried Frank's co-head of M&A David Shine, *The M&A Lawyer* finds that it's not only the mega-mergers like Pfizer/AstraZeneca (which may be dead, barring another Pfizer bid), but also more subtle combinations: pharmaceuticals swapping units or spinning off R&D divisions that don't fit their core businesses.

As Shine says, this presents a great opportunity for M&A lawyers. "It's hard for companies to effectuate carve-outs, for example, because untangling the knot is enormously time-consuming and these companies have a business to run," he says. "So in transactions like Merck/Bayer there is a greater role for bankers and lawyers to play. They can help clients in a meaningful way to anticipate and to navigate these kinds of issues."

Also, late spring 2014 brought a few interesting court and regulatory decisions into the mix. The *Third Point LLC v. Ruprecht* opinion, for instance, "makes clear that the Delaware courts are prepared, at least in some circumstances, to respect an independent board's well-considered view that an activist poses a sufficient threat to corporate policy and effectiveness to justify the adoption and decision not to amend or waive a rights plan containing a 10% trigger," writes Sullivan & Cromwell's Alexandra Korry. "It also

makes clear that it will be hard for an activist to invoke *Blasius* to defeat a rights plan so long as there is an identifiable basis for the plan other than shareholder disenfranchisement."

That said, the decision isn't "a blanket endorsement of a board's decision to impose a two-trigger rights plan that "discriminates" against activists or a board's decision not to redeem or waive a two-trigger pill as a result of the threat of negative control that may be exerted by an activist seeking to nominate a short slate to a board," Korry writes.

There's also the FTC's recent agreement for the Ardagh Group's proposed acquisition of Saint-Gobain, which requires Ardagh to divest six plants and related assets to get the go-ahead for the merger. The FTC claimed that the merger of the two glass container companies could have "posed risks of coordinated effects that would harm consumers," write Weil, Gotshal & Manges' Laura Wilkinson and Meaghan Thomas-Kennedy. The twist is that one commissioner dissented, using his opinion to highlight his concerns about the FTC's process of considering efficiency claims, questioning "whether the burden of proof facing parties seeking to establish cognizable efficiencies is or should be meaningfully different than the burden facing the agency in establishing that a proposed merger is likely to substantially lessen competition."

Just a reminder that the next issue of *The M&A Lawyer* will be our summer double issue, which will go to press in early August. We hope that all readers have a good and productive summer: we'll see you in two months.

CHRIS O'LEARY
MANAGING EDITOR

CONTINUED FROM PAGE 1

claims where a plausible purpose other than disenfranchisement exists.

Background

The Sotheby's board, comprised of a majority of independent directors, adopted its rights plan in the face of an increasing activist threat. Starting in May 2013, Third Point, Triam Fund Management, L.P. and Marcato Capital Management LLC announced purchases of Sotheby's stock in filings with the SEC. Third Point later amended its Schedule 13D, indicating that it had increased its stake to 9.4% and that it intended to seek certain management and board changes. Two days later, the Sotheby's board adopted a rights plan with a one-year term (unless approved by shareholders or readopted by the Sotheby's board) and a 10% ownership trigger threshold for "active" shareholders (*i.e.*, Schedule 13D filers) and 20% ownership trigger for all other shareholders. The rights plan defines ownership broadly to include derivatives and excepts acquisitions made pursuant to any-and-all, all cash offers open for at least 100 days. Following the adoption of the rights plan and after failed settlement negotiations, Third Point again amended its Schedule 13D to announce that it had further increased its stake closer to the 10% cap and intended to nominate a short slate of three directors. After commencing a proxy fight, Third Point requested that Sotheby's waive the 10% cap so that it could acquire up to 20% of the company's common stock. The Sotheby's board rejected the request shortly after receiving an update from its proxy advisors that Third Point was almost certain to prevail in the proxy contest if it acquired an additional 10%. Third Point and certain other shareholders subsequently filed suit. Following the Court's decision and before Sotheby's annual meeting, Sotheby's and Third Point agreed to a settlement that provides Third Point with three out of 15 board seats and the ability to increase its ownership interest to 15%, and that requires Sotheby's to terminate its rights plan.

The Court of Chancery's Decision

Board's Adoption of Rights Plan Was Reasonable Response to Activists and Primary Purpose of the Adoption of the Pill Was Not to Disenfranchise Stockholders

The Court first determined that the intermediate standard of review set forth in *Unocal* applied to the Sotheby's board's actions, finding that both the Court of Chancery and the Delaware Supreme Court have applied *Unocal* exclusively in determining whether a board has complied with its fiduciary duties in adopting and refusing to amend or redeem a rights plan, even when those actions have been taken outside of the hostile takeover context.

Applying *Unocal* first to the adoption of the rights plan, the Court determined that the plaintiffs did not have a reasonable probability of success of showing that the Sotheby's board breached its fiduciary duties. The Court found that the Sotheby's board's actions met *Unocal*'s first prong—on the basis of good faith and reasonable investigation, the Sotheby's board determined that Third Point and other shareholders posed an objectively reasonable and legally cognizable threat to corporate policy. The Court stated that at the time it adopted the rights plan, the Sotheby's board reasonably concluded that several hedge funds which were simultaneously accumulating Sotheby's stock (while Third Point rapidly increased its stake) could form a "wolfpack" and create a control block without paying a control premium.

While acknowledging that the more burdensome *Blasius Industries, Inc. v. Atlas Corp.*³ standard could be implicated at the same time as *Unocal* in the rights plan context, requiring the Sotheby's board to provide a "compelling justification" for its actions, the Court found that Third Point likely could not show that the Sotheby's board acted for the primary purpose of interfering with the franchise of any shareholder, a requisite showing for *Blasius* to apply.⁴ In the Court's view, the Sotheby's board could likely demonstrate that it was motivated by creeping takeover and negative control threats and that any adverse impact to

electoral rights was incidental. The Court noted that because the record was “devoid of facts that would support an inference of entrenchment” of the Sotheby’s board, citing to the above-average turnover rate of directors and the lack of evidence that the Sotheby’s directorship was material to the directors, the Court stated it would be hard to meet *Blasius*’s “primary purpose” test in the instant case.⁵

Moreover, the Court could not find evidence of any impermissible animus toward Third Point’s CEO that might have driven the Sotheby’s board’s decision to adopt the rights plan. Finally, the Court found that the terms of the rights plan—it does not force shareholders to vote in favor of the incumbent board or induce votes in its favor and the possibility existed that either Sotheby’s or Third Point could have prevailed in the proxy contest—make clear that it is neither coercive nor preclusive, and therefore weighed against a conclusion that it was adopted for the primary purpose of interfering with the stockholder franchise.

While noting that the validity of the rights plan’s 10% trigger was not challenged, the Court further determined that the Sotheby’s board’s response to the creeping control threat was reasonable and proportionate to the threat of Third Point and other stockholders acquiring control without paying a premium, satisfying *Unocal*’s second prong. Having concluded that the adoption of the rights plan was neither preclusive nor coercive, the Court found two factors persuasive in finding that the Sotheby’s board’s response in adopting a rights plan with a low trigger was proportionate: (i) a 10% threshold permitted activists to buy a substantial stake given that the Sotheby’s board collectively owned less than 1% and (ii) a trigger higher than 10% could allow a small group of activists to gain control without paying a premium through “conscious parallelism.”⁶ Moreover, the Court determined that, while it was not endorsing the discriminatory nature of the rights plan’s two-trigger structure because it “raises some valid concerns”, the adoption of such a rights plan was not disproportionate.⁷ In particular, the Court found that (i) the differing treatment of passive and active investors arguably better addresses Sotheby’s need

to prevent activists from achieving control when compared with a more standard rights plan that universally restricts ownership levels regardless of the holder’s interest in asserting influence and (ii) although in theory a court could find a rights plan unreasonable or disproportionate because it allowed Schedule 13G filers who were more likely to vote with management to acquire 20% of the company’s shares than because it capped activists at 10%, in this instance, because no 13G filer had a greater ownership interest than the 9.6% of common shares of Sotheby’s held by Third Point, the issue was not relevant.

Board’s Refusal to Waive Rights Plan Was Reasonable Response to Effective Negative Control Threat

Applying the *Unocal* standard to the Sotheby’s board’s denial of Third Point’s request to waive the 10% cap in the rights plan and allow it to increase its ownership to 20%, the Court found that the Sotheby’s board sufficiently showed that it determined after a good faith and reasonable investigation that allowing Third Point to acquire a 20% stake presented an objectively reasonable and legally cognizable threat—negative control. The Court further determined that the refusal to grant the waiver was likely within the range of reasonable responses. The Court stated that the waiver decision presented a much closer question than the original decision to adopt the rights plan. Noting that it was skeptical that at the time of the waiver request Third Point continued to pose a “creeping control” risk, the Court found that Sotheby’s could have legitimate concerns that waiving the 10% cap to allow Third Point to obtain a 20% ownership interest might permit it to exercise disproportionate “effective negative control” over corporate decision making. The Court’s view of the trigger differs from ISS’s poison pill position that rights plans should not have a trigger lower than 20%.

While stating that it did not want to allow negative control to easily become a license for the adoption of defensive measures, the Court noted that in the instant case, two factors supported an inference of a reasonable belief that Third Point

would exert disproportionate negative control: Third Point's ownership interest in Sotheby's would be significantly higher than that of any other shareholder and the Third Point CEO's past aggressive conduct directed at Sotheby's. In so finding, the Court, however, indicated that the question of whether the Sotheby's board refused to grant Third Point a waiver for the purpose of interfering with its franchise rights in order to affect the outcome of the ongoing proxy contest was "uncomfortably close" in that the Sotheby's board rejected the waiver soon after being informed by its proxy advisors that Third Point was almost certain to prevail in the proxy contest if it acquired an additional 10%. "Plaintiffs' claims that the challenged actions ... improperly impinge on the shareholders franchise appear to be at least colorable and raise important policy concerns that deserve careful consideration in the examination of poison pills under *Unocal*,"⁸ the Court stated.

Irreparable Harm Could Have Been Established

The Court went on to indicate that if Third Point had established a likelihood of success on the merits, its reduced odds of winning the closely contested proxy contest likely would have qualified as a threat of irreparable harm.⁹ The Court stated that the harm Third Point would have suffered if it had lost the proxy fight because of the 10% trigger would likely be irreparable insofar as "the harm to a dissident slate from a flawed stockholder vote typically cannot be remedied after-the-fact by holding a second meeting" and that Third Point would be denied a presence on the Sotheby's board until next year's meeting, when it would have to bear the costs and uncertainty of running another proxy contest.¹⁰ However, the Court rejected plaintiffs' attempt to show that the Sotheby's board's "self-interested use of the corporate machinery to interfere with the stockholder franchise and manipulate the proxy contest" was the basis for a finding of irreparable harm.¹¹ Contrasting *Kallick v. SandRidge Energy, Inc.*,¹² where the Court had held that a board improperly used a "proxy put" to coerce shareholders into

voting for the incumbent directors or risk causing the company to suffer severe financial consequences, the Court found that the Sotheby's rights plan was not coercive because nothing about it forced shareholders to favor the incumbent slate.

Implications

The *Third Point* opinion makes clear that the Delaware courts are prepared, at least in some circumstances, to respect an independent board's well-considered view that an activist poses a sufficient threat to corporate policy and effectiveness to justify the adoption and decision not to amend or waive a rights plan containing a 10% trigger. It also makes clear that it will be hard for an activist to invoke *Blasius* to defeat a rights plan so long as there is an identifiable basis for the plan other than shareholder disenfranchisement. While the decision upheld the two-trigger plan the Sotheby's board adopted, it does not, however, provide a blanket endorsement of a board's decision to impose a two-trigger rights plan that "discriminates" against activists or a board's decision not to redeem or waive a two-trigger pill as a result of the threat of negative control that may be exerted by an activist seeking to nominate a short slate to a board. It is fact-specific. In circumstances, for example, in which shareholders other than the activists hold a significant percentage of a company's stock or the holdings by insiders make the activist's cap particularly meaningful, the imposition of a lower cap on the activist shareholder may not be viewed by the Court as defensible.

Separately, *Third Point's* extensive quoting of Sotheby's Chairman and CEO's emails to other directors and his family highlights the possible risks associated with the use of email by decision-makers, as a court is likely, as it did in *Third Point*, to view such emails as an accurate contemporaneous record when they may be no more than ad hoc musings.

NOTES

1. *Third Point LLC v. Ruprecht*, C.A. No. 9469-VCP, slip op. (Del. Ch. May 2, 2014) [hereinafter *Slip Op.*].
2. 493 A.2d 946 (Del. 1985).
3. 564 A.2d 651 (Del. Ch. 1988).

4. The Court noted that the plaintiffs failed to cite any Delaware decision invoking *Blasius* to examine a rights plan, distinguishing *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998), on the basis that the *Carmody* Court invoked *Blasius* because of the preclusive and coercive effects of a so-called “dead hand” poison pill on a proxy contest, not because the trigger level of the rights plan at issue required a compelling justification.
5. *Slip Op.* at 42.
6. *Id.* at 47. The fact that the Sotheby’s board apparently did not consider the effect of the 15% threshold under Section 203 of the DGCL when adopting a rights plan with a 10% trigger and later when it denied Third Point’s waiver request was irrelevant in the Court’s view—while Third Point would face additional challenges in extracting non-pro rata benefits if its stake went above 15%, the Court said that the board is entitled to protect against a transfer of control without the payment of an appropriate premium.
7. *Id.* at 48 n.37.
8. *Id.* at 52 n.39.
9. The Court acknowledged that it was not clear that the relief requested would be necessary as Third Point had a 10-to-1 advantage in stock ownership over the incumbent Sotheby’s board, the chances of winning the proxy contest essentially amounted to a 50-50 coin flip, nothing prevented Third Point from making its case to shareholders and it was not certain that Third Point would acquire any additional shares and only purchase those shares from holders who were backing the incumbent Sotheby’s board.
10. *Slip Op.* at 58.
11. *Id.* at 59.
12. 68 A.3d 242 (Del. Ch. 2013).

the straight-up merger route to pursue more subtle and strategic options, such as spinning off divisions, doing carve-outs of specific product lines or, as in the recent case of GlaxoSmithKline, Eli Lilly and Novartis, undertaking complex swaps of assets.

In the latter case, GSK sold its cancer treatment business to Novartis while acquiring the latter’s vaccine units and it also entered into a joint venture with Novartis to create the largest consumer healthcare business worldwide. At the same time, Novartis did a sideline \$5.4 billion deal to sell its animal health division to Eli Lilly.

In an interview with *The M&A Lawyer* conducted in late May, David Shine, co-head of M&A at Fried, Frank, Harris, Shriver and Jacobson LLP, said he believes the GSK-Eli Lilly-Novartis combinations and the recent carve-out sale of Merck’s consumer care business (to be acquired by Bayer AG for \$14.2 billion), are a sign of what lies ahead for pharmaceutical M&A. Expect a strong pace of new deal activity but also far more complex deals than in the past, deals that will require every tool at lawyers’ disposal to get right.

M&A Lawyer: *Would you say there’s a boom in pharmaceutical M&A underway, and if so, when did it begin?*

David Shine: There’s clearly a lot of activity in the pharmaceutical space now and I expect that will continue for quite a while. It’s probably been in the last year or so that it’s really taken root. Some of what’s driving the volume is a bit of musical chairs: once it starts, no one wants to be left standing alone when the music ends. So deal activity begins to take on a life of its own.

MAL: *Was there a period where there wasn’t much going on in pharmaceuticals, especially after the market crash of 2008? Is the sector’s volume dependent on M&A deal activity trends?*

Shine: I don’t think so. After the financial crisis, the first big deals that came out of the chute in 2009 were pharma deals: Merck’s \$41 billion acquisition of Schering Plough [Fried Frank represented Merck] and Pfizer’s \$68 billion acquisition of

Interview: What’s Next for Pharmaceutical M&A

Pfizer’s unsuccessful (as of now) \$120 billion bid for AstraZeneca made pharmaceutical M&A the subject of international headlines, but mega-deals like Pfizer/AstraZeneca are only part of the story in that sector. More often now, the largest pharmaceutical companies are eschewing

Wyeth. I think because it's such a broad and high profile industry, pharmaceutical M&A is a little bit untethered from overall M&A market trends.

MAL: Fried Frank is currently acting as counsel to Merck in its deal to sell its consumer care business to Bayer. How did this deal come about?

Shine: Let's start more broadly. There's definitely pressure for Big Pharma to change because as public companies, growth is king. So while research and development in the Big Pharma world is highly desired, it's also expensive, difficult and it relies to some extent on serendipity. And there are no synergies, no cost savings, to be found in R&D. So what you're seeing now, I think, is that M&A is the new R&D.

The Merck carve-out is a perfect example of this. Merck had these wonderful iconic consumer brands: Claritin, Coppertone, Dr. Scholl's. And as part of rationalizing their business they decided they wanted to move out of this area. And not only did Merck sell its consumer care business for a great price, but it also acquired a compelling cardiovascular collaboration with Bayer. This collaboration is important because at the end of the day these companies are in the pharma business, not the cash business.

MAL: Are deals like Merck's carve-out going to be the main way many pharmaceutical companies will contend with R&D in the future: focusing on specific businesses and discarding others? As market analysts say, there's no more low-hanging fruit in the drug space, and the generic manufacturers have taken a great part of the market share of the low-hanging fruit.

Shine: You can still do mega-mergers, like Pfizer/AstraZeneca [the deal was still in play when this interview took place], but those deals are often like using a sledgehammer to solve your problems. They're full of antitrust issues, integration issues and they typically will create new strategic issues because these deals always come with businesses and products that the buyer doesn't really want.

More companies are picking and choosing. They're doing asset swaps like the Novartis deal. We're seeing more carve-outs like the one we did

for Merck. There's a lot of activity in the licensing space. People are trying to be more selective in what they do and to use more of a scalpel than a sledgehammer.

MAL: So a massive merger like Pfizer/AstraZeneca is going to be an anomaly in the current market?

Shine: It's hard to know fully what was really driving that deal—the tax angle may have been a big part of it. My gut is that you're not going to see a lot of big consolidations in Big Pharma, but you'll see a lot more subtle transactions.

On the other hand, from an antitrust point of view, this is still an industry where big deals can get done. The pharma business consists of a lot of different products, so there are always fixes available to satisfy antitrust concerns. People say there are no big mergers left in the airline industry because the carriers all do the same thing and there are no real divestiture options anywhere because the industry is so consolidated. But that's not true in the pharma space. Pharma products can almost always be divested.

MAL: Most of these companies are public. Are activist shareholders a factor, pro or con, in whether a deal succeeds?

Shine: There is the Allergan situation [Valeant Pharmaceuticals' bid for Allergan, which is supported by Allergan's biggest shareholder, the hedge fund manager William Ackman] but that's fairly unique. Mostly it's a public company growth story: the Street is focused on growth and the question is how do you get it. Companies are focusing more on synergistic opportunities—Merck has said publicly, for example, that it still wants to add to its animal health assets. You have to figure out what you're good at and figure out how to grow it while staying focused on the shareholders.

MAL: Does that make due diligence more laborious and time-consuming?

Shine: It's much, much more complicated than selling a stand-alone company for two reasons. First, a carve-out is really a misnomer. It's actually not akin to getting a sharp knife and carving

something out. It's more like untangling a knot in a way that you don't cause any damage to what you're transferring or to what you're leaving behind. In order to figure out how to do that requires a lot of due diligence. It's hard sometimes to figure out where the business is, internally. For example, in the Merck carve-out, the consumer products being sold are in various places in the Merck structure and the team had to figure out where they are and then how to separate them.

The second reason is that indemnifications go on after the closing in carve-out transactions. In a public company transaction, once the deal is closed, it's closed. But when Merck sells its consumer care businesses to Bayer, there are indemnifications that continue after the deal closes. So the focus on diligence and scheduling becomes very intense.

MAL: In five years, will the Big Pharma landscape look markedly different from today, or will it be essentially the same set of players with different parts?

Shine: I think it's going to be the latter. I don't think the big companies are going anywhere. Each of them have critical infrastructure that's almost impossible to replicate worldwide. They have large global marketing, distribution, manufacturing and regulatory capacities. You can't build that anymore: it's too hard. But while I don't think they're going anywhere, I do think they're going to look different.

To bring up the idea of musical chairs again, you have CEOs who will look around and see what Novartis did with its oncology business, see what Eli Lilly did with its animal health business and they'll want to do something similar. I think there's going to be a more subtle focus on rationalizing businesses without doing big mergers. I don't have a crystal ball but that's my gut.

MAL: Do other market sectors have similarities to pharmaceuticals, and if so, could a similar wave of deals take place there?

Shine: We do think about that. Another area is aerospace & defense where for years pundits have been saying that it's time to subtly reconsolidate

that sector. But that hasn't really happened and I don't have a good explanation for it.

MAL: For M&A lawyers, do you see a niche for developing more twists on the "subtle deal" formula?

Shine: That's a good point. It's hard for companies to effectuate carve-outs, for example, because untangling the knot is enormously time-consuming and these companies have a business to run. They're not in the business of untangling themselves. So in transactions like Merck/Bayer there is a greater role for bankers and lawyers to play. They can help clients in a meaningful way to anticipate and to navigate these kinds of issues.

Ardagh/Saint-Gobain Settlement Triggers Strong Dissent Regarding Efficiencies Claims

BY LAURA A. WILKINSON AND
MEAGHAN P. THOMAS-KENNEDY

Laura Wilkinson is an antitrust partner in the Washington, DC office of Weil, Gotshal & Manges LLP. Meaghan Thomas-Kennedy is an associate in Weil's New York office. Contact: laura.wilkinson@weil.com or meaghan.thomas-kennedy@weil.com.

The Federal Trade Commission recently reached an agreement with the Ardagh Group S.A. (Ardagh) regarding its proposed acquisition of Saint-Gobain Containers, Inc. (St. Gobain), the U.S. subsidiary of Compagnie de Saint-Gobain.¹ The agreement requires Ardagh to divest six plants and related assets in order to form a new supplier of glass containers for beer and spirits. The FTC issued a statement describing its reasons for requiring the settlement agreement.² Commissioner Joshua D. Wright issued a vigorous dissent from the Commission's decision.³ The dissent is

notable because it is critical of the methodology used by the Commission to weigh potential efficiencies against the likelihood of consumer harm.

Background

Ardagh agreed to acquire St. Gobain in January 2013 for approximately \$1.7 billion. After an investigation, in June 2013, the Commission issued an administrative complaint and authorized Commission staff to seek an injunction to prevent consummation of Ardagh's planned acquisition of St. Gobain.⁴ The Commission challenged the acquisition, alleging that it would reduce competition in the US market for glass containers used for beer and spirits, and that post-acquisition Ardagh/St. Gobain and Owens-Illinois together would control more than 75 percent of the market for glass containers sold to brewers and distillers.⁵ Commissioner Wright dissented from the decision to issue the complaint.⁶

Chief Administrative Law Judge D. Michael Chappell presided over the administrative trial, which was scheduled for a hearing on the merits on March 18, 2014. The matter was withdrawn from adjudication once the FTC staff and Ardagh agreed to the material terms of a consent proposal to be forwarded to the Commission for approval.⁷

On April 10, 2014, the Commission announced a settlement with Ardagh that allows the acquisition of St. Gobain to go forward, but requires Ardagh to divest six of its nine U.S. glass manufacturing plants and related assets, including a corporate headquarters and other facilities, to a single buyer within six months.⁸ The assets being divested had been acquired by Ardagh in 2012 as part of its acquisition of Anchor Glass Container Corporation.⁹ The Commission said the divestitures will create "an independent third competitor" to fully replace the competition in the beer and spirits glass container markets that would have been lost as a result of the merger.¹⁰ The Commission voted 3-1 to accept the settlement agreement, with Commissioner Wright dissenting.¹¹

On April 28, 2014, the Commission announced that Ardagh applied for approval to sell the assets to be divested to an affiliate of KPS Capital Partners LP.¹² The Commission will determine

whether to approve the sale after the conclusion of a 30-day public comment period.

The Commission's Statement

The Commission explained that the proposed transaction presented the factors that the 2010 Merger Guidelines indicate are likely to face regulatory challenge: "(1) the merger would significantly increase concentration and lead to a moderately or highly concentrated market; (2) that market shows signs of vulnerability to coordinated conduct...; and (3) the Agencies have a credible basis on which to conclude that the merger may enhance that vulnerability."¹³ The Commission found evidence that the glass container market is already highly concentrated and vulnerable to post-acquisition coordination as a result of low demand growth, tight capacity, high and stable market shares and high barriers to entry.¹⁴ The Commission also found that "glass manufacturers already have access to a wealth of information about the markets and each other, including plant-by-plant production capabilities, profitability, the identities of each other's customers, and details regarding each other's contracts and negotiations with customers."¹⁵ Accordingly, the Commission concluded that the acquisition posed risks of coordinated effects that would harm consumers.

The Commission also found that brewers and distillers reaped substantial benefits from the head-to-head competition between Ardagh and St. Gobain, the second- and third-largest glass container manufacturers, respectively, and the acquisition would have eliminated those benefits.¹⁶ Therefore, the Commission concluded that the proposed transaction would produce harmful unilateral effects.

Having concluded that there was a *prima facie* showing of competitive harm, the Commission considered whether there was evidence of "verifiable, merger-specific efficiencies that could offset this harm."¹⁷ However, the Commission found that many of the efficiencies proffered by Ardagh could have been accomplished without the acquisition. In addition, the Commission determined that the merging companies did not offer suffi-

cient evidence showing that the level of substantiated and verified synergies would outweigh the clear evidence of consumer harm.”¹⁸

As a result, the Commission concluded that the proposed order requiring Ardagh to sell six manufacturing plants and related assets, including a corporate headquarters and engineering facilities, to a single buyer would be needed to effectively replace the competition lost through the acquisition.¹⁹

Commissioner Wright’s Dissenting Statement

On the other hand, after reviewing the factual record and FTC staff’s analysis, Commissioner Wright concluded that “there is no reason to believe the transaction violates Section 7 of the Clayton Act because any potential anticompetitive effect arising from the proposed merger is outweighed significantly by the benefits to consumers flowing from the transaction’s expected cognizable efficiencies.”²⁰ Commissioner Wright agreed with the Commission that the proposed merger is likely to result in unilateral price effects. However, in his view, the evidence only supports a “fragile” inference that the transaction may “result in very modest unilateral price effects at best.”²¹

With respect to coordinated effects, Commissioner Wright was not convinced that coordination in the market was likely. He found that because prices are negotiated individually and are not particularly transparent, the incentive to cheat on any price agreement likely would undermine a collusive outcome.²² Therefore, in Commissioner Wright’s view, any estimated coordinated effect “would need to be discounted by a probability of successful coordination that is less than one.”²³

Since the proposed acquisition likely would generate modest unilateral price effects, Commissioner Wright assessed whether there were any “cognizable efficiencies” that would offset the potential consumer harm.²⁴ He found that with reasonable assumptions, the cognizable efficiencies are likely to be substantial. Accordingly, his review of the record evidence led him to conclude that “expected cognizable efficiencies are up to six times greater than any likely unilateral price effects.”²⁵ In Commissioner Wright’s view, the

magnitude of such efficiencies should be dispositive, and the acquisition should not have been challenged.²⁶

Against this backdrop, Commissioner Wright used his dissenting opinion in Ardagh/St. Gobain as a platform to highlight his concerns about *how* the Commission considers efficiency claims.²⁷ Specifically, he questioned “whether the burden of proof facing parties seeking to establish cognizable efficiencies is or should be meaningfully different than the burden facing the agency in establishing that a proposed merger is likely to substantially lessen competition.”²⁸ He acknowledged that in this matter the Commission appears to agree that the magnitude of the respective burdens should not differ *in theory*.²⁹ However, his chief concern is whether *in practice* merging parties must overcome a greater burden of proof on efficiencies than the agency faces in satisfying its *prima facie* burden of establishing anticompetitive effects.³⁰ Commissioner Wright believed that there has been a lack of transparent guidance regarding the standard that the government applies in practice to efficiency claims, which has led to significant uncertainty.³¹

Commissioner Wright argued that “there is a potentially dangerous asymmetry from a consumer welfare perspective of an approach that embraces probabilistic prediction, estimation, presumption, and simulation of anticompetitive effects on the one hand but requires efficiencies to be *proven* on the other.”³² In his view, such imbalanced burdens “do not make economic sense and are inconsistent with a merger policy designed to promote consumer welfare.”³³ Rather, according to Commissioner Wright, “symmetrical treatment in both theory and practice of evidence proffered to discharge the respective burdens of proof facing the agency and merging parties is necessary for consumer-welfare based merger policy.”³⁴

The Commission addressed Commissioner Wright’s dissent, but respectfully disagreed with his conclusions. According to the Commission’s statement, the Commission did not impose an unduly high evidentiary standard in analyzing the parties’ efficiencies claims.³⁵ The Commission also disagreed with Commissioner Wright’s concern about a potentially “dangerous asymmetry.”

Although both competitive effects and efficiencies analyses involve some degree of estimation, there are a variety of sources of data and information to assess competitive effects, while data and information about efficiencies come almost entirely from the merging parties.³⁶ Therefore, according to the Commission, consistent with the Merger Guidelines and established case law, the need to independently verify efficiencies data “animates the requirement that, to be cognizable, efficiencies must be substantial and verifiable.”³⁷ “Indeed, ‘if this were not so, then the efficiencies defense might well swallow the whole of Section 7 of the Clayton Act.’”³⁸

In contrast, Commissioner Wright argued that the “pressing concern at present is whether application of asymmetric burdens of proof in merger review will swallow the efficiencies defense.”³⁹

Conclusion

The contrasting views expressed by the Commissioners in Ardagh/St. Gobain have put a spotlight on the efficiencies defense in mergers. The majority of the Commission appears to remain cautious regarding what efficiencies are credited as merger-specific and verifiable. However, there may be an opening for merging parties to more forcefully assert efficiencies defenses before the agencies and in courts using some of the arguments that Commissioner Wright outlined in his dissent.

NOTES

1. See Federal Trade Commission Press Release, “Ardagh Group SA Settles FTC Litigation Charging That Acquisition of Rival Saint-Gobain Containers, Inc. Would be Anticompetitive.” (April 10, 2014), available at: <http://www.ftc.gov/news-events/press-releases/2014/04/ardagh-group-sa-settles-ftc-litigation-charging-acquisition-rival> (“FTC April 10, 2014 Press Release”).
2. Statement of the Federal Trade Commission, *In the Matter of Ardagh Group S.A., Saint-Gobain Containers, Inc., and Compagnie de Saint-Gobain* (“Ardagh/St. Gobain”), File No. 131-0087 (April 11, 2014), available at: <http://www.ftc.gov/system/files/documents/cases/140411ardaghcommstmt.pdf> (“Commission Statement”).
3. Dissenting Statement of Commissioner Joshua D. Wright, *In the Matter of Ardagh Group S.A., Saint-Gobain Containers, Inc., and Compagnie de Saint-Gobain*, File No. 131-0087 (April 11, 2014), available at: <http://www.ftc.gov/system/files/documents/cases/140411ardaghstmt.pdf> (“Dissenting Statement”).
4. See Federal Trade Commission Press Release, “FTC Challenges Ardagh Group, S.A.’s Proposed Acquisition of Rival Glass-Container Manufacturer Saint-Gobain Containers, Inc.” (July 1, 2013), available at: <http://www.ftc.gov/news-events/press-releases/2013/07/ftc-challenges-ardagh-group-sa%E2%80%99s-proposed-acquisition-rival-glass> (“FTC July 1, 2013 Press Release”).
5. Administrative Complaint, *In the Matter of Ardagh Group S.A. and Saint-Gobain Containers, Inc. and Compagnie de Saint-Gobain*, Dkt. No. 9356 (June 28, 2013), available at: <http://www.ftc.gov/sites/default/files/documents/cases/2013/07/130701ardaghcmpt.pdf>.
6. FTC July 1, 2013 Press Release.
7. See Order Granting Request to Certify Joint Motion to Withdraw Matter from Adjudication, *In the Matter of Ardagh Group S.A. and Saint-Gobain Containers, Inc., and Compagnie de Saint-Gobain*, Dkt. No. 9356 (March 10, 2014, Chappell, ALJ), available at: <http://www.ftc.gov/system/files/documents/cases/140311ardaghadmorder.pdf>, and Order Withdrawing Matter from Adjudication for the Purpose of Considering a Consent Proposal, *In the Matter of Ardagh Group S.A. and Saint-Gobain Containers, Inc. and Compagnie de Saint-Gobain*, Dkt. 9356 (March 17, 2014, Federal Trade Commission), available at: <http://www.ftc.gov/system/files/documents/cases/140417ardagholder.pdf>.
8. FTC April 10, 2014 Press Release.
9. See Analysis of Agreement Containing Consent Orders to Aid Public Comment, *In the Matter of Ardagh Group S.A. and Saint-Gobain Containers, Inc. and Compagnie de Saint-Gobain* at 1, 3, Dkt. No. 9356, available at: <http://www.ftc.gov/system/files/documents/cases/140410ardaghanalysis.pdf>.
10. Commission Statement at 3.
11. FTC April 10, 2014 Press Release.
12. Federal Trade Commission Press Release, “FTC Requests Public Comments on Ardagh Group S.A.’s Application for Approval to Sell Six Plants and Related Assets to Glass Container Acquisition LLC,” (April 28, 2014), available at: <http://www.ftc.gov/news-events/press-releases/2014/04/ftc-requests-public-comments-ardagh-group-sas-application>.
13. Commission Statement at 1 (quoting from the U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines §7.1 (August 19, 2010) (“Merger Guidelines”), available at: <http://www.justice.gov/atr/public/guidelines/hmg-2010.html>).
14. Commission Statement at 1.

15. *Id.*
16. *Id.* at 2.
17. *Id.*
18. *Id.*
19. *Id.* at 3.
20. Dissenting Statement at 1.
21. *Id.* at 2.
22. *Id.* at 2, n. 3.
23. *Id.* at 2.
24. *Id.* at 2-3.
25. *Id.* at 3.
26. *Id.*
27. *See id.* at 4-7.
28. *Id.* at 4.
29. *Id.*
30. *Id.* at 4-5.
31. *See id.* at 5-7.
32. *Id.* at 5.
33. *Id.* at 7; *see also id.* at 5, n.5. Commissioner Wright also discusses commentary from academics, agency officials, and practitioners over the years that have noted “that although efficiencies are frequently a significant part of the business rationale for a transaction, receiving credit for efficiencies in a merger review is often difficult.” *Id.* at 6-7.
34. *Id.* at 6.
35. Commission Statement at 3.
36. *Id.*
37. *Id.*
38. *Id.* (quoting *United States v. H&R Block, Inc.*, 833 F. Supp. 2d 36, 46 (D.D.C. 2011)).
39. Dissenting Statement at 7.

Handling Data Privacy Issues in M&A Transactions

BY DANIEL GLAZER AND JASON GREENBERG

Daniel Glazer is a corporate partner and co-head of the Technology Transactions Practice in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Jason Greenberg is a corporate associate at the firm. They focus on transactional intellectual property matters, including licensing and outsourcing arrangements, and the IP and technology aspects of M&A. Contact: daniel.glazer@friedfrank.com or jason.greenberg@friedfrank.com.

Facebook’s announcement last February that it had agreed to purchase WhatsApp in a trans-

action valued at \$19 billion made headlines for all the expected financial reasons: it was by far Facebook’s largest acquisition to date; it was the second-largest technology, media and telecommunications deal announced in the first quarter of 2014 (surpassed only by Comcast’s proposed \$45 billion acquisition of Time Warner Cable); and the purchase price amounted to \$344 million per WhatsApp employee.

But the deal also was noteworthy for the privacy issues it raised. European data protection authorities instantly voiced concerns that any use by Facebook of WhatsApp’s user data would violate numerous data protection and privacy laws. The consumer protection and privacy watchdog groups, The Electronic Privacy Information Center (EPIC) and The Center for Digital Democracy (CDD), filed a joint complaint with the Federal Trade Commission (FTC) alleging that Facebook “routinely makes use of user information for advertising purposes and has made clear that it intends to incorporate the data of WhatsApp users in the user profiling business model,” a practice they claimed would violate WhatsApp’s representations to users that it would not use their data for advertising revenue.

In April, the FTC sent a letter to both Facebook and WhatsApp echoing EPIC’s and CDD’s concerns and cautioning that the failure to honor WhatsApp’s promises to consumers about the use of user data would constitute a deceptive practice under the FTC Act.

Facebook presumably understood these legal risks and the potential for negative publicity when it was negotiating the acquisition documents, as Facebook itself is subject to a 2012 FTC order obligating the company to maintain a comprehensive privacy program and conduct a biennial privacy audit. However, potential acquirors with more limited experience handling issues concerning the Internet and user data might not be aware of the relevant sensitivities. This article discusses due diligence analysis and purchase agreement provisions that can help protect an M&A purchaser (Buyer) from the legal risks associated with a target company’s (Company) failure to comply with data privacy laws and regulations.

Privacy Laws and Regulations

Specific representations and warranties regarding privacy issues frequently are absent from purchase and merger agreements, especially where Company and Buyer are not consumer retailers, e-commerce businesses, or in heavily regulated industries (*e.g.*, banking/financial services, healthcare). However, if Company conducts even a minimal amount of business with customers online, it may be subject to data privacy laws and regulations applicable to companies that collect “personal information” or “personally-identifiable information”—data about an identified or identifiable individual, such as name, Social Security number, driver’s license number, bank account number, credit or debit card number, street address, telephone number, e-mail address and user name.

Whether they know it or not, companies have to comply (and Buyers should confirm that Companies comply) with a multitude of data-related laws and regulations. In addition to the FTC Act discussed above, there is the Gramm-Leach-Bliley Act (applicable to certain financial institutions and personal financial data), Health Insurance Portability and Accountability Act (applicable to certain health information), and Children’s Online Privacy Protection Act (applicable to the collection of information from children online), as well as a host of other laws applicable to education privacy, marketing privacy, and workplace privacy.

Additionally, many states have implemented “baby FTC Acts” outlawing unfair and deceptive practices, and several states (notably California and Massachusetts) have enacted statutes specifically addressing the protection of their residents’ personal information. Nearly every state has enacted notification laws regarding personal information security breaches. There also are self-regulatory regimes, such as the Payment Card Industry Data Security Standard (PCI DSS), which regulates the collection, processing, and protection of credit card information. Finally, of increasing importance to U.S. companies as they consider cross-border M&A transactions is the EU Data Protection Directive, which strictly regulates and restricts the transfer of personal

information of EU citizens to locations outside of the European Union.

The Scope of Due Diligence

The first step during privacy-related due diligence is to determine the extent to which Company collects information from customers and clients¹, and the nature of any such information. This typically is done through discussions with Company’s personnel and the review of privacy policies and other relevant documents. Next, Buyer should seek to understand the manner in which Company uses and protects that information and whether Company shares that information with third parties. After this initial review is completed, Buyer and M&A counsel may consider engaging local counsel if Company’s business or the proposed transaction involves the collection or transfer of information across borders.

Once Buyer is familiar with Company’s internal data collection and use policies, it should closely review Company’s customer-facing privacy policies (*e.g.*, on its website). A website privacy policy frequently includes statements by Company regarding how it will (or will not) use and share customer information. Such a provision was the focus of intense FTC scrutiny in Borders Group’s recent bankruptcy proceedings, during which Barnes & Noble agreed to acquire Borders’ customer list. However, Borders previously had promised not to share customer information with third parties without each customer’s express consent. To satisfy privacy concerns expressed by the FTC and others, Barnes & Noble and Borders advertised in major newspapers and sent emails to customers to advise them of their ability to opt out of any information transfer. Accordingly, it is crucial that counsel determine whether consummation of a proposed M&A transaction will violate, or trigger any obligations or restrictions under, Company’s customer-facing data policies.

Buyer also should determine whether Company has implemented internal written information security policies (WISPs). These policies are legally mandated in certain circumstances in some states (*e.g.*, Massachusetts) and widely are considered to be a best practice for companies that collect,

use, and transfer personal information. Failure to have or comply with a WISP, where required by law, could expose Company (and potentially Buyer) to civil fines, private lawsuits and injunctions. Therefore, if Company does not have a WISP, Buyer should consider whether it should request or require Company to implement one prior to closing the proposed transaction.

Buyer's diligence also should include a review of any information security and PCI DSS audits, and Company should prepare for and conduct such audits well in advance of any potential M&A transaction. In addition to allowing Company an opportunity to address any security vulnerabilities or deficiencies on its own terms, routine information security audits may demonstrate to potential acquirors Company's diligence in complying with its information security obligations. In instances where personal information is key to Company's business or the value of the transaction, Buyer might consider engaging its own auditors to confirm Company's compliance with security standards.

Finally, Company should disclose to Buyer any complaints, notices, or investigations regarding data privacy and security that Company may have received from customers or regulatory authorities. Buyer should confirm the extent of any potential liability and, if material, consider negotiating a special indemnity or purchase price adjustment.

Sample Representations and Warranties

Failure to comply with data privacy laws and regulations can lead to significant financial liability. For example, Google agreed to pay \$22.5 million in 2012 for its alleged failure to comply with an FTC settlement regarding the placement of cookies in Apple's Safari browser. Due diligence inherently is an imperfect process, so negotiating appropriate representations and warranties is key to protecting Buyer and appropriately allocating risk between Buyer and Company.

Below are sample Buyer-friendly definitions and representations for M&A purchase and merger agreements, taken from publicly-dis-

closed transaction documents. Note in particular the focus on Company's compliance with laws, regulations, policies, and procedures, both those promulgated by governmental authorities as well as by Company itself. Because Company may not be aware of all laws applicable to its operations, Company's counsel will likely seek to limit Company's potential liability by adding knowledge or materiality qualifiers. As with most purchase and merger agreement negotiations, the resolution of such concerns will depend on each party's leverage and appetite for risk.

- **“Company IT Assets”** means the Company Websites and all other software, systems, servers, computers, hardware, firmware, middleware, networks, data communications lines, routers, hubs, switches and all other information technology equipment, and all associated documentation, used or held for use in the operation of the Company Business.
- **“Company Websites”** means all Internet or intranet websites owned and/or operated by or for the Company.
- **Privacy Matters.** The operation of the Company IT Assets by or on behalf of the Company, and the use, collection, storage and dissemination of personally identifiable information, customer and user data, and other data and content (“Data”) in connection therewith or otherwise in connection with the Company Business, have not violated, and do not violate, any applicable Laws or any Person's privacy, publicity or confidentiality rights (collectively, “Privacy Laws”). The Company has (i) posted a privacy policy, or a link thereto, governing and disclaiming liability for its use of Data (“Privacy Policy”) in a clear and conspicuous location on all user-facing pages on the Company Websites, and (ii) complied at all times with the Privacy Policy and all other rules, policies and procedures the Company has established concerning Data (all of the foregoing, the “Privacy Rules”). There is no action or claim pending, asserted or threatened by or against the Company alleging any violation of any Privacy Laws or

Privacy Rules. Neither the consummation of the Transactions nor the negotiation, execution, delivery or performance of the Transaction Documents will cause a violation of, or require the consent, waiver or authorization of or declaration, filing or notification to any Person under, any Privacy Laws or Privacy Rules. The Company has at all times taken reasonable measures consistent with industry best practices to ensure that all Data collected or accessed in the operation of the Company Business is protected against unauthorized access, use, modification, disclosure or other loss, and no such loss has occurred. The Company has not collected or permitted any other Person to collect credit card information from any customer or user of any Company Website.

- The Privacy Policy discloses, and at all times has disclosed, to customers and users: (i) the corporate entity that is operating, and the nature of all Data collected on or in connection with, the applicable Company Website; (ii) the methods used to collect Data (including the use of cookies and other methods of Data collection that are not readily evident to customers and users); (iii) the circumstances under which, and Persons to whom, Data may be disclosed; and (iv) the means pursuant to which customers and users can opt-out of receiving future communications.
- On each Company Website, the Company has posted conspicuously on each web page on which Data is collected a notice to customers and users that (i) the Company Websites are operated by and the responsibility of the Company, and (ii) Data is collected and used in accordance with the Privacy Laws and Privacy Rules.

NOTES

1. We note that the proper handling of employee data also is a critical diligence point but is beyond the scope of this article.

“Commercially Reasonable Efforts” Diligence Obligations in Life Science M&A

BY KRISTIAN WERLING, RICHARD B. SMITH AND DANIEL GOLDSTEIN

Kristian Werling is a partner, and Daniel Goldstein is an associate, in the Chicago office of McDermott, Will & Emery LLP. Richard Smith is a partner in the firm's Boston office. Contact: kwerling@mwe.com or rbsmith@mwe.com or dgoldstein@mwe.com.

More than 80 percent of all deals in the pharmaceutical, medical device and biotech industries include an earnout structure that provides some type of contingent or delayed payment of proceeds to the sellers.¹ Trends vary widely, but in many transactions, the earnout consideration can far exceed the up-front payment to the sellers. This earnout consideration is frequently contingent on post-closing achievement of certain clinical study results, product approvals, reimbursement or sales. As a result, sellers during transaction negotiations intensely focus on the obligations of buyers to use corresponding “diligence” to achieve the goals that will trigger the contingent payment to the seller. This focus frequently comes to rest on the obligation of a buyer to use “commercially reasonable efforts” and the related definition of this obligation in transaction documentation. This article reviews the common approaches to defining “commercially reasonable efforts” and analyzes several recent cases interpreting the definitions in deal documentation.

Common Approaches to Defining Commercially Reasonable Efforts

Outward Facing Definition

An outward facing definition of commercially reasonable efforts applies an industry-standard

requirement or looks to other participants in the industry to define the diligence obligations of the buyer. An example of this type of definition is:

“Commercially Reasonable Efforts” means the efforts consistent with the past practice of similarly situated pharmaceutical companies with respect to similarly situated pharmaceutical products.

This definition is generally viewed as more favorable to the seller of a technology, as it enables the seller to point to other industry standards that would have the buyer take additional steps to achieve the goal that would result in a payout on the earnout.

Inward Facing Definition

In contrast, an inward facing definition applies the buyer’s own standard for undertaking research, regulatory approvals, and sales and marketing efforts. An example of an inward facing definition of commercially reasonable efforts is:

“Commercially Reasonable Efforts” means efforts consistent with the past practice of Buyer related to research and development, regulatory approval, commercialization, sales and marketing of similar oncology therapeutic products with similar market potential at a similar stage in its development.

This definition is more favorable to a buyer because it allows the buyer to point to its own investment thresholds and decision processes. Buyers can typically point to a similar situation where a step or expenditure of funds would not have been taken.

No Definition

An option for buyers and sellers is to leave the term undefined. In the event of a dispute, a judge or mediator would look to case law and the facts of the situation to determine whether the appropriate level of diligence was utilized. It should be noted, however, that some states’ courts (most notably, Illinois) have interpreted terms such as

“best efforts” and “commercially reasonable efforts” to be so vague as to be unenforceable.² For an excellent discussion of courts’ varying interpretations of different due diligence standards, including commercially reasonable efforts requirements, see Kenneth A. Adams’ 2004 article.³

Recent Cases

Many transaction documents incorporate mandatory arbitration provisions. In fact, sophisticated buyers understand that there are frequently dramatic changes post-closing related to medical products and, therefore, include a variety of structures to amicably settle earnout related disputes outside the courtroom. As a result, most disputes related to diligence obligations are handled out of court, which results in a limited number of cases that directly address the interpretation of commercially reasonable efforts obligations. Two recent cases, however, have given insight to judges’ review of these obligations.

Volcano Corporation/CardioSpectra

In *Banas v. Volcano Corp.*, the former owners of CardioSpectra, Inc. challenged whether Volcano Corporation used appropriate diligence to develop and sell CardioSpectra’s medical device system.⁴ The merger agreement required Volcano to use “commercially reasonable efforts” and to “act in good faith” when working to achieve the goals that would result in additional merger consideration payable to the former shareholders of CardioSpectra. The merger agreement defined commercially reasonable efforts as:

...the use of efforts, sales terms, expertise and resources normally used by [Volcano] for other products, which, as compared with the OCT Products; are of similar market potential at a similar stage in its development or product life, taking into account all reasonable relevant factors affecting the cost, risk and timing of development and the total potential of the applicable OCT Products, all as measured

by the facts and circumstances at the time such efforts are due...

The definition used in the CardioSpectra merger agreement was inward facing and required the sellers to demonstrate that commercially reasonable efforts were not used compared with efforts made for other similarly situated Volcano products. The court granted summary judgment to Volcano because the sellers failed to present any evidence that demonstrated Volcano's efforts with similarly situated products. The judge determined that without such evidence, the sellers could not make claim for breach of the merger agreement.

In addition to addressing commercially reasonable efforts, the judge examined whether Volcano failed to act in good faith in development efforts. The merger agreement did not define act in good faith, so the court looked to case law to determine the standard. Examining the evidence, the court found that Volcano had expended significant resources, hired sufficient personnel and had not willfully abandoned the development of the CardioSpectra system. As such, it determined that Volcano had not breached the merger agreement by failing to act in good faith.

Sekisui / America Diagnostica, Inc.

Also in the first quarter of 2014, a judge examined counterclaims in a lawsuit brought by Sekisui America against the former shareholders of America Diagnostica, Inc. (ADI).⁵ In counterclaims against Sekisui, the former shareholders of ADI alleged that Sekisui America had breached the stock purchase agreement by failing to use "commercially reasonable efforts" and omitting actions "with the intent of preventing [ADI] from meeting ... revenue targets ..." The term commercially reasonable efforts was not defined in the stock purchase agreement.

The court found that the sellers had failed to prove a breach of the diligence obligations because they did not present evidence establishing the objective standard for commercially reasonable efforts in the regulatory context of the U.S. Food and Drug Administration, nor did they explain how Sekisui America deviated from that standard. Further, the court found that there was

no evidence demonstrating that Sekisui America intentionally omitted actions to prevent the revenue targets from being met.

Tips and Takeaways

Inward Facing Definitions Add Hurdles for Sellers

As demonstrated by *Volcano*, an inward facing definition of commercially reasonable efforts adds significant hurdles for the sellers attempting to prove that diligence requirements were breached.

Additional Requirements to Use "Good Faith" Should Be Defined

Sometimes drafters will toss in additional references or requirements to use good faith in the diligence obligation section of an M&A document. Such terms should be cautiously used because, as seen in both *Volcano* and *Sekisui America*, this allows a seller to further attack the buyer's effort. If good faith is an obligation of the buyer, consider defining the requirement further.

Define the Impact of a New Technology Acquisition

Acquisition documentation frequently fails to address the impact of newly acquired technology. If it is not specifically addressed in the document, courts will be left to discern the intent of the parties if a new acquisition is made that impacts existing diligence or milestone obligations. Ideally, a buyer would have a clear statement that the acquisition of a new technology involving the same therapeutic area is permitted.

Business Teams Should Be Aware of Implications of "Shelving" the Acquired Technology

Although not examined in either *Volcano* or *Sekisui America*, other litigation and mediation involving diligence obligations have shown that sellers can win large damage awards if the buyer's business team "shelves" or otherwise abandons an acquired technology where the acquisition

documentation included a diligence obligation. It is worth the additional time and effort to avoid protracted litigation to establish strong documentation as to why development, regulatory or sales efforts related to a technology were shelved.

Consider the Impact of Specific Diligence Milestones

In addition to requiring a buyer to use commercially reasonable efforts, sellers will often require a buyer to meet certain specific diligence milestones, regardless of whether buyer is using commercially reasonable efforts. The diligence milestones are typically key product development or commercialization events, and will often trigger one or more earnout payments. A buyer's failure to achieve a milestone may result in breach of its obligations to a seller, even in the event that a buyer was otherwise using commercially reasonable efforts to meet such milestone.

Buyers Should Consider the Benefit of Safe Harbor Provisions

In the event that the buyer satisfies a specified milestone in a timely manner, a safe harbor provision can deem a buyer to have used commercially reasonable efforts in achieving such milestone. This will relieve the buyer of all or part its obligation to use commercially reasonable efforts. Such milestones may include development achievements, regulatory approvals or financial events such, as net sales achievements. Preferably, a buyer will want to negotiate optional safe harbor events that, if met, will demonstrate the buyer's use of commercially reasonable efforts without creating mandatory obligations.

Consider Third Party Diligence Obligations

Buyer should be aware that, to the extent that it acquires intellectual property through a sublicense issued by a seller (*i.e.*, seller has in-licensed intellectual property from a third-party licensor), the seller may have its own diligence obligations it owes to its third-party licensor that will need to be satisfied to retain its in-license. It is also likely

that, with respect to the technology sublicensed to the buyer, the seller will rely on the buyer's diligence to satisfy the seller's obligations to its licensor. Therefore, the seller's hands may be tied when it comes to negotiating a buyer's diligence obligations and remedies. If such diligence obligations and remedies are unacceptable to the buyer, the only acceptable alternative may be for the seller to renegotiate its diligence obligations with the third-party licensor.

Define Specific Circumstances Under Which Buyer Will Be Excused

Despite good faith intentions, events can occur that make unreasonable the continued use of commercially reasonable efforts. In addition to *force majeure*, such events can include failure to obtain regulatory approval as expected, unexpected safety concerns, unexpected market shifts or unfavorable commercial circumstances that adversely affect product viability, and inability to obtain commercially viable reimbursement levels. It is best to anticipate the possibly of such events and provide reasonable tolling and other remedial provisions.

Consider Disclaimers

If a buyer and seller agree that no specific diligence standard will be required (*i.e.*, the buyer will not be required to use commercially reasonable efforts, or any other level of efforts for that matter), the agreement should include a disclaimer on point. It is otherwise too easy for a court to imply at least some level of good faith efforts into the agreement that were never intended or agreed to by the parties.

NOTES

1. 2012 SRS Life Sciences M&A Study (*available at: <https://www.srsacquiom.com/>*).
2. See *Kraftco Corp. v. Kolbus*, 274 N.E.2d 153, 156 (Ill. App. Ct. 1971).
3. Kenneth A. Adams, "Understanding 'Best Efforts' and Its Variants (Including Drafting Recommendations)," *The Practical Lawyer*, August 2004.
4. *Banas v. Volcano Corp.*, 2014 WL 1309720 (N.D. Cal. 2014).
5. *Sekisui America Corp. v. Hart*, 2014 WL 687222 (S.D. N.Y. 2014).

The M&A LAWYER

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

FIRST CLASS
MAIL
U.S. POSTAGE
PAID
WEST

The M&A LAWYER

West LegalEdcenter

610 Opperman Drive, Eagan, MN 55123
Phone: 1-800-344-5009 or 1-800-328-4880
Fax: 1-800-340-9378
Web: <http://westlegaledcenter.com>

WEST®

YES! Rush me *The M&A Lawyer* and enter my one-year trial subscription (10 issues) at the price of \$762.00. After 30 days, I will honor your invoice or cancel without obligation.

Name _____

METHOD OF PAYMENT

Company _____

BILL ME

Street Address _____

VISA MASTERCARD AMEX

City/State/Zip _____

Account # _____

Phone _____

Exp. Date _____

Fax _____

Signature _____

E-mail _____

Postage charged separately. All prices are subject to sales tax where applicable.