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Inside M&A

Insights into legal developments affecting mergers and acquisitions.

January/February 2008

Pre-Merger Coordination: Don't Jump the Gun

In light of potentially substantial civil penalties from government enforcement agencies and increased risk of litigation from competitors or customers over pre-merger coordination between merging parties, questions regarding appropriate pre-merger activity continue to grow in importance. For example, antitrust regulators are increasingly focused on the ways in which a buyer may be involved in the activities of the target firm prior to the closing of a transaction without violating antitrust laws, as well as what restrictions, if any, a buyer may place on the pre-closing activities of the target.

Improper pre-merger coordination (also known as "gun jumping") is analyzed under both the Hart Scott Rodino (HSR) Act and Section 1 of the Sherman Act. The HSR Act generally requires parties to file notifications and observe mandatory waiting periods prior to consummating transactions valued in excess of $63.1 million (indexed to inflation). Gun jumping can occur when the parties coordinate prior to the expiration of the HSR Act waiting period to a degree that the regulators may view the buyer as having obtained beneficial ownership of the target's operations. HSR Act violations can occur even if the parties to the transaction do not compete in the same markets.

In transactions involving competitors, Section 1 of the Sherman Act imposes a separate basis for liability. Parties to a transaction are viewed by the antitrust agencies as independent competitors until their transaction is completed. Coordination of competitive activities between merging parties that are competitors, or detailed information exchanges that allow the parties to coordinate pricing (for example) can lead to a Sherman Act Section 1 challenge. Section 1 liability can arise for pre-closing activities that occur following the expiration of any applicable HSR Act waiting period.

The U.S. Department of Justice and the Federal Trade Commission have secured substantial fines for gun jumping violations. The Department of Justice levied a $5.7 million fine each against two joint venture participants in *United States v. Gemstar-TV Guide International, Inc.,* Case No. 03-0198 (D.D.C. July 11, 2003) for pre-closing coordination, in which the parties altered their independent business practices so as not to compete with the contemplated joint venture, prior to its formation.

Also, in other situations, companies have faced allegations in private civil litigation of unlawful gun jumping for exercising rights under an interim conduct clause that is part of a larger transaction agreement. Such clauses are common and give the buyer a mechanism that protects the value of the business being purchased. Those clauses usually give the buyer the right to review transactions a seller could engage in outside the ordinary course of business that have a high value. Yet even with these commonly occurring clauses, parties should be careful not to use the clause in such a way as to create even the appearance of unlawful business coordination prior to closing the transaction.

Principles Regarding Pre-Merger Coordination

For the vast majority of transactions that do not raise substantive antitrust issues, pre-merger coordination that is reasonably necessary to protect the value of the transaction will not raise significant antitrust issues. Certain conduct, such as coordination on pricing and combining significant day-to-day operations or management pre-closing, is almost always unlawful and almost never reasonably necessary in the government's view to protect the merger.

Every transaction raises unique issues that must be evaluated on a case-by-case basis. Nonetheless, several principles should be observed.

1. AVOID IMPROPER INFORMATION EXCHANGE DURING DUE DILIGENCE AND TRANSITION PLANNING.

Antitrust regulators have concerns when competitors contemplating a transaction engage in information exchange or planning discussions for legitimate purposes that "spill over" into competitive activities and may affect ongoing competition between the merging parties. Therefore, parties should use lagged or aggregated information, where possible, during the due diligence process. Also, transition planning personnel should be different from the personnel involved in the day-to-day business operations (*e.g.,* development of post-merger pricing should be walled off from the sales and marketing personnel who continue pricing during the pre-merger period). Better yet, parties may consider outsourcing

pre-closing planning functions to consulting and accounting firms, or dedicated groups of employees operating as part of a "clean team." A "clean team" can be formed using personnel who are not in a position to influence or direct their employer's core competitive activities, so disclosure of sensitive target data to them should not give rise to significant antitrust issues. Care must be taken to ensure that the information they are receiving is reasonably needed for a legitimate due diligence or transition planning purpose, and that the detailed information received by the "clean team" is not disseminated more broadly within the organization.

2. MINIMIZE COORDINATION ON SIGNIFICANT PRE-CLOSING PROJECTS OR CONTRACTS.

The antitrust regulators recognize that planning activities with regard to capital projects and significant business improvements are sometimes necessary to allow the transaction to achieve efficiencies. However, certain significant activities, such as deciding whether to pursue a major capital project, raise antitrust concerns. Often, merging parties need to take preliminary steps related to those activities prior to closing. While the regulators are skeptical about whether a buyer's participation in a seller's decision to engage in a capital project are necessary, the regulators will typically balance the need for the parties to realize efficiencies post-closing against the concern that a decision not to proceed with the project would reduce the seller's competitiveness if the merger did not close. Specifically, the regulators will evaluate the activities in light of the following factors:

- Whether the decision not to proceed with a project is reversible if the merger does not close and whether the target's competitiveness is harmed by the deferral or abandonment of the project. To the extent the target can easily restart or finish the project, the regulators are likely to have fewer concerns about the planning discussions.
- How the decision on the project was made. If the decision was reached unilaterally by the target, there should be few issues. If the buyer mandated the target make the decision or if it was a joint decision, the regulators are likely to have significant questions.
- The magnitude of the efficiencies achieved and the harm to competition. The regulators will balance the potential efficiencies achieved by the activities against the need to undertake those activities pre-closing and the potential harm to competition.
- The timing of the project. To the extent the buyer was aware of the project at the time of signing, then it is more difficult to justify the need to stop the project pre-closing.

3. ALL PRE-CLOSING CONDUCT COVENANTS IN ANY MERGER OR ACQUISITION AGREEMENT MUST BE REVIEWED TO ENSURE THAT THEY COMPLY WITH APPLICABLE ANTITRUST RULES.

Merger agreements commonly contain pre-closing restrictions on the seller's conduct so as to protect the value of the seller's business to the buyer. By way of example, merger agreements often include provisions that require the buyer's prior approval of any proposed contracts, other than those made in the ordinary course of business, above certain dollar amounts prior to the closing of the transaction. Through these clauses, the buyer can ensure that the seller does not strike a deal that the buyer believes might damage the target business or otherwise diminish its value. However, at least one case indicates that the enforcement of such a clause by two merging competitors has the potential to violate the antitrust laws, exposing the surviving company to potential treble damages.

As a baseline requirement, the target must be able to operate freely within its ordinary course of business and consistent with past practices. A clause requiring the target to operate within its ordinary course of business should be permissible. Acceptable restrictions include covenants in which a seller limits its ability to declare or pay dividends or distributions of its stock; issue, sell, pledge or encumber its securities; amend its organizational documents; acquire or agree to acquire other businesses; mortgage or encumber its intellectual property or other material assets outside the ordinary course; make or agree to make large new capital expenditures; make material tax elections or compromise material tax liability; pay, discharge or satisfy any claims or liabilities outside the ordinary course; and commence lawsuits other than the routine collection of bills.

However, even if the contractual language allows for ordinary course of business freedom, implementing that provision in a way that requires the buyer's consent and involves the buyer in the target's ordinary-course decision-making process can raise substantial antitrust risks. The buyer must use caution to avoid implementing that clause in such a way as to become unnecessarily involved in the target's business decisions prior to closing. The substance of any conduct restrictions and the manner in which they are enforced and monitored will take precedence over the language of the contractual commitments themselves. Counsel drafting contractual provisions that place limits on the seller's independent activities must be sensitive to overreaching that may create gun jumping problems.

4. MERGING PARTIES SHOULD SEEK, WHENEVER POSSIBLE, TO MINIMIZE THE TIME THAT ELAPSES BETWEEN EXECUTION OF A MERGER AGREEMENT AND THE CLOSING OF THE TRANSACTION.

The longer the time period between signing and closing, there is a greater chance that coordination issues may arise.

5. JOINT MARKETING OF THE TRANSACTION IS PERMISSIBLE ACCOMPANIED BY STRICT GUIDELINES THAT ENSURE INDEPENDENT ONGOING COMPETITION UNTIL THE TRANSACTION CLOSES.

With appropriate guidance and controls, joint advertisements promoting the transaction and controlled joint customer or supplier calls to tout the benefits of the merger are generally permissible. The regulators would have concerns if the buyer tried to redirect the seller's ordinary-course advertising program or dictate the contents of the seller's advertisements for products in which the buyer and

seller compete. With respect to joint customer calls, the parties should not discuss ordinary-course competitive selling, and the buyer clearly cannot direct or control the seller's sales force or function prior to closing.

Conclusion

Given the serious risks associated with pre-closing coordination activities, merging parties should consult with counsel early in the process to establish antitrust guidelines that govern all integration planning and related pre-closing activities. If followed, such guidelines can significantly lower antitrust risks.

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SPACs – An Emerging M&A Player

The last several years have seen a dramatic increase in the number of special purpose acquisition companies (SPACs). SPACs are publicly traded companies that raise capital through an initial public offering (IPO) in order to acquire or merge with a company within a set time frame, typically 24 months. In 2007, SPACs raised more than $7 billion, a significant increase over 2006. Although there are unique risks associated with any special purpose investment vehicle, the comparative advantages associated with SPACs appear to be outweighing these risks and leading to an even greater number of SPACs.

Many SPACs possess many characteristics that make them more attractive to potential investors than other special purpose investment vehicles. First, SPACs typically require that a business transaction be completed within 18 to 24 months of the SPAC IPO, depending on whether a signed agreement with a target company has been reached. This provides shareholders with some temporal certainty that is not usually available with other kinds of investments, such as private equity funds. Second, SPACs generally permit shareholders who vote against a proposed business combination to demand conversion of their shares into cash. This mechanism provides shareholders with a degree of control over the SPAC's investments that hedge fund investors and other investors do not normally enjoy. Further, if a certain percentage of investors opt for conversion (usually between 20 percent and 40 percent, as established by the particular SPAC), then the SPAC is barred from completing the transaction. Third, between 95 percent and 98 percent of a SPAC's proceeds are placed in trust and invested in low-risk debt instruments, further reducing a SPAC investors' risk. Finally, SPACs are generally operated by seasoned management teams, providing investors with greater assurance of a successful deal.

There are also some drawbacks to SPACs compared to more traditional investment vehicles. First, although the 18 to 24 month "hunting" period may be viewed as a positive attribute for some investors, the downside is the need for a SPAC to locate a target company, negotiate a merger or acquisition agreement, and comply with intensive, highly scrutinized U.S. Securities and Exchange Commission (SEC) initial filings, all within this narrow timeframe. A SPAC is also a public company, and therefore subject to federal securities laws, including Sarbanes-Oxley. A "hunting" period of 18 to 24 months is a relatively short period for all of those activities to occur, thereby raising deal execution risk. Second, the SEC has recently increased its focus on conflicts of interest while reviewing SPAC deals. If an affiliate of a SPAC sponsor is found to have an interest in the transaction, then there will often be an enhanced review period involving extensive comments. Some SPACs have responded to the SEC's focus by agreeing not to target companies affiliated with the SPAC's sponsors. This limitation will generally assuage the SEC, but it also limits the SPAC's investment options. Lastly, a SPAC is not an operating company and has no initial revenue stream, so investors are essentially making a blind wager that a target company will be found. However, given that nearly all of the SPAC's proceeds are invested in low-risk instruments, there is minimal downside to investors.

SPACs are a relatively new entry into the mergers and acquisitions marketplace, and the unique attributes of SPACs may leave some investors with uncertainty as to whether a SPAC investment is appropriate for the investors' specific circumstances. While there is no one-size-fits-all investing method, four practice pointers may help clarify some of a SPAC's qualities and allow investors to make an informed decision:

- A SPAC has an abbreviated time horizon from the date of the IPO in which to close a deal, usually 18 to 24 months. Consequently, investors should familiarize themselves with the potential management team and possibly even the other investors.

- In order to close a deal, a SPAC typically must clear a proxy statement with the SEC, a potentially time-consuming process. Again, diligent research into the skills of the management team and the proposed investment itself will help investors determine the SPAC's likelihood of success.

- SPACs have free liquidity and may not be able to fund a reverse break-up fee, that is, the payment to a seller by a buyer of a stipulated sum if the buyer fails to meet its obligation to close in accordance with the acquisition agreement. In recent years, reverse break-up fees have become widely adopted by well-advised sellers as deal protection devices. The precise terms and conditions of reverse break-up fees are often the subject of intense negotiation and vary among deals. If a seller has choices among rival buyers and is keen on deal protection, a SPAC's potential difficultly in agreeing to a market break-up fee may place it at a competitive disadvantage.

- SPACs, like private equity funds, are dependent upon the ability to secure acquisition financing.

A strong and well-regarded management team will have a greater chance of securing sufficient financing, as will a well-researched investment strategy. While no risk-management is perfect, investors as well as sellers should conduct sufficient research to feel confident in the skills and ideas of a specific management team.

SPACs represent an alternative, viable option to sellers when considering a sale transaction. As with any significant business event, all parties must employ forward thinking to ensure that a deal can be completed within the SPAC's limited time frame. SPAC sponsors, regular investors and potential target companies must familiarize themselves with the characteristics of SPACs to understand the impact that a SPAC structure can have on any particular transaction.

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German Securities Trading Act Notice Requirements Following M&A Transactions

Any acquisition of shares in a German company, public or private, may directly or indirectly lead to a notification duty under the German Securities Trading Act. This duty to notify could either apply to an acquired target itself or—and this may be overlooked—to any significant equity holding of the target or any of the related companies in the target's group. Furthermore, this duty should be closely monitored if the acquirer and the target together own a participation in a listed German company that requires notification. The rules of attribution of voting rights are rather complex, and the consequences of omitting such a notification are substantial.

Notification Duties According to the Securities Trading Act

Pursuant to the Securities Trading Act, if an entity (the notifying party) reaches, exceeds or falls below the thresholds of 3, 5, 10, 15, 20, 25, 30, 50 or 75 percent of the voting rights of a listed company by purchase, sale or other action, he or she must notify the company as well as the Federal Financial Supervisory Authority within four trading days after the applicable event. The listed company itself must publish the notification and must send the Federal Financial Supervisory Authority proof of such publication.

The complexity of the notification duties is significantly increased by the attribution rules of the Securities Trading Act, which direct that, under certain circumstances, voting rights of shares be attributed to the notifying party if such shares are owned by third parties on which the notifying party has some influence. Such an attribution takes place, for example, with respect to voting rights of shares that are held by a subsidiary or by another person for the account of the notifying party.

In the case of conglomerates and other groups of companies, the voting rights of shares of a listed company that are held by an entity are attributed to the respective shareholders of such entity (and subsequently, to the shareholders of such shareholders). The purpose of these regulations is to disclose the true holders of influence. As a result, within international conglomerates that have numerous holding companies as intermediaries, several companies may be required to notify.

Recently, the district court in Cologne decided in favor of minority shareholders who challenged a number of resolutions adopted at the shareholders' meeting of Strabag AG in 2006 with the argument that the majority shareholders of Strabag violated the notice requirements of the Securities Trading Act. The district court declared the challenged resolutions of the shareholders' meeting to be void. The district court found that Strabag did not disclose certain international corporate integrations, and that the ultimate parent company of Strabag SE, the majority shareholder of Strabag AG, was a holding company in which several major shareholders, including the chief executive officer, Dr. Haselsteiner, collectively owned more than 50 percent. The court concluded that these major shareholders had a detrimental influence on the holding company. Therefore, the voting rights of the shares held by Strabag SE were to be attributed to them as well.

Additionally, the court ruled that the previous change in name of Strabag AG's majority shareholder (Bauholding Strabag SE to Strabag SE) had triggered an additional notification obligation. The court held that, for transparency reasons, a new notification should be filed even in cases of marginal changes of a shareholder's name. Strabag SE unsuccessfully argued that it was not obligated to notify because the Federal Financial Supervisory Authority (BaFin) had advised Strabag SE that the change of name does not require a new notification.

Legal Consequences

The legal consequences for an omission or a default of the notification requirement are substantial. The breach of the notification requirement according to the Securities Trading Act constitutes a misdemeanor, which can result in a civil penalty fine of up to €200,000 per occurrence.

A negligent breach of the notification requirement results in a loss of that shareholder's rights to dividends and to voting rights. As a result, the rights granted to the shareholder do not exist for the time during which the company does not comply with its obligation to notify. This loss of rights occurs throughout an affiliated group. It therefore affects even shares belonging to a subsidiary, if such subsidiary's parent company did not meet its obligation to notify. The loss of rights generally includes claims for dividends granted in the Stock Corporation Act. A loss of a dividend claim may be

prevented if the notification has not been deliberately omitted and the person corrects the omission.

In the Strabag matter, the disqualification of the incorrectly exercised voting rights of the majority shareholder resulted in different outcomes for certain previously passed resolutions (among them, the resolutions on exoneration of the board members, election of an auditor and amendment of the statutes). Particularly relevant was the invalidation of the auditor's appointment. If annual accounts were audited by persons not elected as auditors, the Stock Corporation Act provides that the annual accounts may be void. A voided election of auditors is also a consequence of a successful challenge. However, the Stock Corporation Act provides a cure of such invalidity six months after the publication of the annual accounts in the *Bundesanzeiger*, if the invalidity of the annual account has not been previously asserted.

Outlook

According to the Act on the Limitation of Risks caused by Financial Investments (an amendment, *inter alia*, to the Securities Trading Act) the legal consequences of a loss of voting rights will intensify. In the future, the deliberate or grossly negligent breach of the notice requirement will result in a loss of shareholder rights for six months. This term of six months will not begin before the acquittal of the notice requirement. Consequently, voting rights of the affected shares will not be reinstated for six months even though the shareholder obligated to so notify has made up the required notice.

Conclusion

Following any acquisition of shares in a German company, public or private, the acquirer should closely review whether the acquisition directly or indirectly leads to a notification duty under the German Securities Trading Act.

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