2006 M&A Report

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2006 Review

2006 was a record year for mergers and acquisitions. While M&A deal volume worldwide decreased slightly, from 31,524 in 2005 to 29,312 in 2006, deal value increased by 34%, from $1.91 trillion to $2.56 trillion, led by AT&T's $85.4 billion acquisition of BellSouth. Deal value in 2006 exceeded the previous record of $2.33 trillion in 2000, at the peak of the Internet boom.

Average deal size based on M&A transactions where the price was disclosed jumped 38% to $198.2 million in 2006, from $143.3 million in 2005. The fourth quarter saw the highest average deal size of $223.4 million—the highest quarterly average since the first quarter of 2000.

US M&A activity largely mirrored global trends. The US M&A deal volume of 11,269 in 2006 was essentially equal to the 11,222 deals in the prior year. However, US deal value increased by almost 23%, from $1.01 trillion to $1.24 trillion. The fourth quarter produced the largest quarterly deal value, at $363 billion—the highest quarterly total since the third quarter of 2000. Average US deal size increased 26% to $294.7 million in 2006 from $234.0 million in 2005.

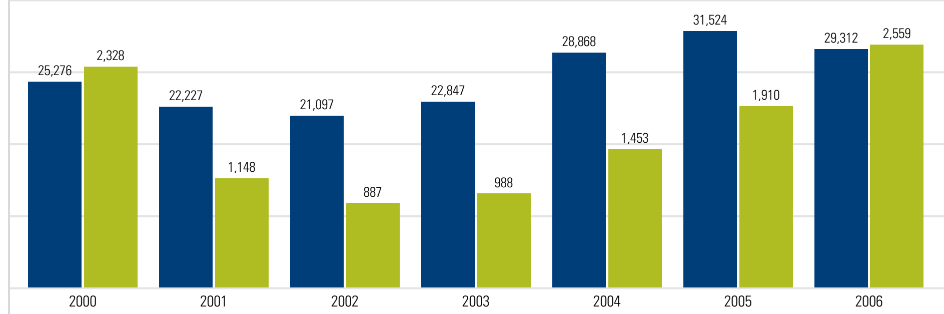
European M&A deal volume decreased approximately 11% from 12,908 in 2005 to 11,494 in 2006. However, the total deal value increased by almost 44%, reaching $1.20 trillion in 2006 compared to $838 billion the year before. Average European deal size clocked in at $272.1 million in 2006, up 45% from $187.4 million in 2005.

The Asia-Pacific region saw continued growth in deal value, although deal volume dipped for the first time in several years. While the number of Asia-Pacific deals decreased from 9,332 in 2005 to 8,777 in 2006, the aggregate deal value increased 32% from $326 billion to $431 billion. Average Asia-Pacific deal size increased 36% to $83.2 million in 2006 from $61.3 million in 2005.

The increases in average deal size globally and in each geographic market are primarily due to the growth in the number of billion-dollar transactions. Overall, the number of billion-dollar transactions increased 38%, from 331 in 2005 to 458 in 2006. Aggregate global billion-dollar deal value increased 46% from $1.21 trillion in 2005 (63% of total global deal value) to $1.77 trillion in 2006 (69% of total global deal value). US billion-dollar transactions increased 32% from 167 in 2005 to 220 in 2006, and aggregate US deal value increased 28% from $684 billion (68% of total US deal value) to $873 billion (70% of total US deal value). Billion-dollar transactions involving European companies experienced the strongest growth, with the number of such transactions increasing 36%, from 164 in 2005 to 223 in 2006, and aggregate deal value increasing 62%, from $534 billion to $863 billion. According to the *Wall Street Journal*, there were a record 55 transactions over $10 billion in 2006—exceeding the previous record of 39 in 2000.

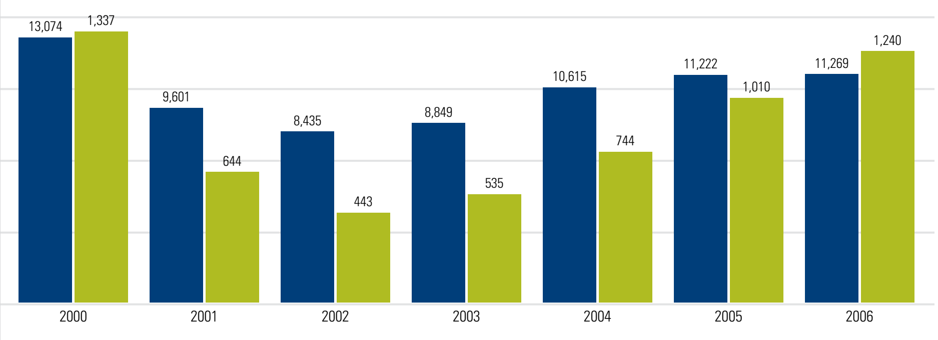
Private equity continued to play an increasingly important role in M&A activity in 2006, often outbidding strategic buyers. Private equity firms concluded half of the largest M&A transactions, including the acquisitions of Harrah's

M&A Activity – Worldwide



Source: MergerStat

M&A Activity – United States



Source: MergerStat

Entertainment, Clear Channel, HCA and Equity Office Properties Trust.

Sector Analyses

Much of the strength of the 2006 M&A market can be attributed to the strength of the financial services sector and M&A activity in several technology sectors.

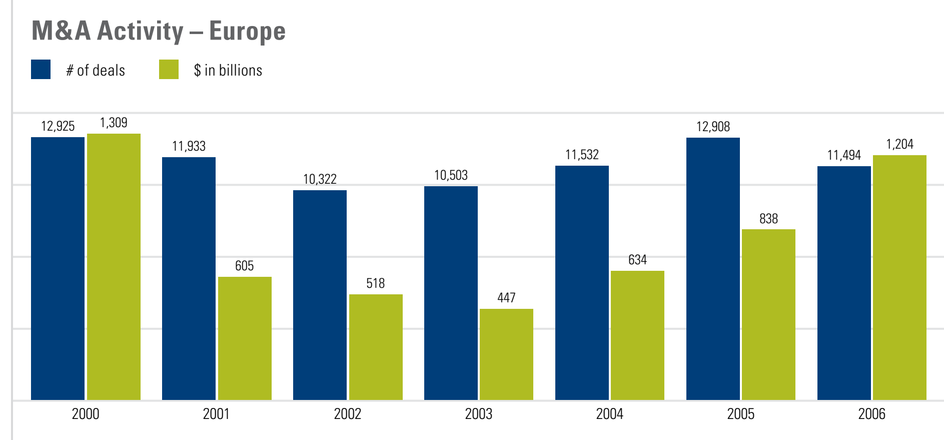
The global financial services sector saw an 11% decrease in deal volume, from 1,824 in 2005 to 1,630 in 2006. Aggregate global financial services sector deal value, however, increased 50% from $219 billion to $331 billion, led by Wachovia's $23.9 billion acquisition of Golden West Financial.

M&A deal flow in the US financial services sector was largely unchanged from the prior year, as deal volume increased modestly from 647 in 2005 to 655 in 2006. Aggregate deal value increased 28%, from $116 billion in 2005 to $149 billion in 2006.

The telecommunications sector experienced a 6% decline in the number of M&A deals globally, from 1,115 in 2005 to 1,052 in 2006. Global telecommunications deal value, however, increased 10% from $206 billion in 2005 to $226 billion in 2006. US deal volume fell 13% from 417 in 2005 to 364 in 2006. US aggregate telecommunications deal value experienced a 68% increase from $72 billion in 2005 to $122 billion in 2006 (the 2006 figure, however, was buoyed by AT&T's acquisition of BellSouth).

Global M&A transaction activity in the life sciences sector decreased by 6% for the year, from 1,086 deals in 2005 to 1,017 deals in 2006. Global life sciences deal value, however, saw a 29% increase from $104 billion in 2005 to $134 billion in 2006, led by Johnson & Johnson's $16.6 billion acquisition of Pfizer's Consumer Healthcare business. The US life sciences sector saw a 4% decrease in deal volume, from 511 in 2005 to 490 in 2006, and aggregate US life sciences deal value declined 10%, from $82 billion to $74 billion.

The total number of information technology deals decreased 8.5%, from 4,360 in 2005 to 3,990 in 2006.



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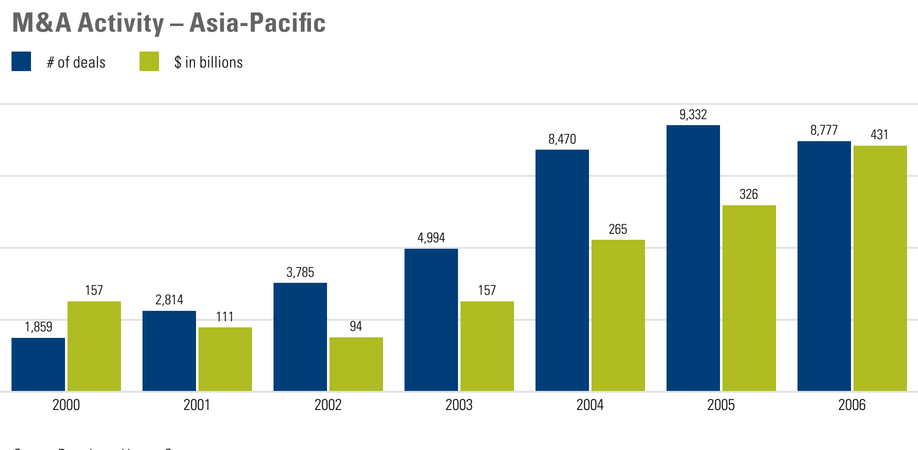


Source: Dow Jones VentureOne

Global IT deal value increased almost 16%, from $108 billion to $125 billion (the largest deal was the $16.2 billion acquisition of Freescale Semiconductor by a private equity consortium led by The Blackstone Group). US IT deal volume remained largely flat in 2006, with aggregate deal volume decreasing 6% from 2,184 in 2005 to 2,049 in 2006. US aggregate IT deal value posted a 1% year-on-year decrease, from $83.4 billion in 2005 to $82.9 billion in 2006.

Cross-border M&A activity continued to increase in 2006. Piper Jaffray reports that middle market (defined as companies with enterprise values of $25–$500 million) transatlantic cross-border deal value increased 13% from 2005 to 2006, with December 2006 transatlantic deal value increasing 18% from the prior December—perhaps suggesting an increasing pace in this sector.

The M&A market for venture-backed companies saw a modest increase in sale prices on virtually unchanged deal volume. The number of reported acquisitions of venture-backed companies declined from 407 in 2005 to 404 in 2006 while total

deal value increased from $30.1 billion to $31.2 billion. The median acquisition price increased 10% from $47.5 million in 2005 to $52 million in 2006—marking the fifth consecutive annual increase. While this figure is well below the median acquisition prices of 1999–2000—including the staggering $100 million median in 2000—it is higher than the median acquisition prices of the 1996–1999 time period.

The median acquisition price for venture-backed companies in 2006 got a boost from the increase in the number of very large sales. In 2006, a total of 23 venture-backed companies were acquired for at least $250 million, compared to 15 in the prior year. The largest deal of the year (Google's acquisition of YouTube for $1.65 billion) more than tripled the size of the largest deal of 2005.

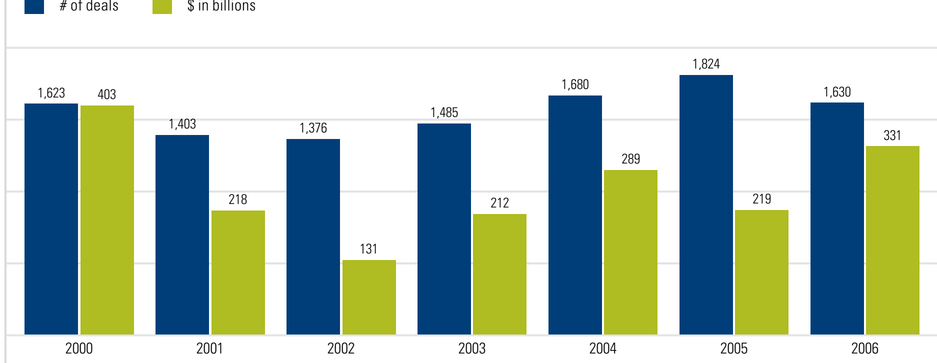
The median amount raised by venture-backed companies prior to acquisition increased 10% over the previous year, rising from $20.6 million to $22.6 million. In 2006, the median time from initial funding to acquisition was 6 years, up from 5.4 years in 2005—which in itself was almost a year longer than the median time in 2004.

2007 Outlook

We believe the strong 2006 M&A results are attributable to a variety of factors, including:

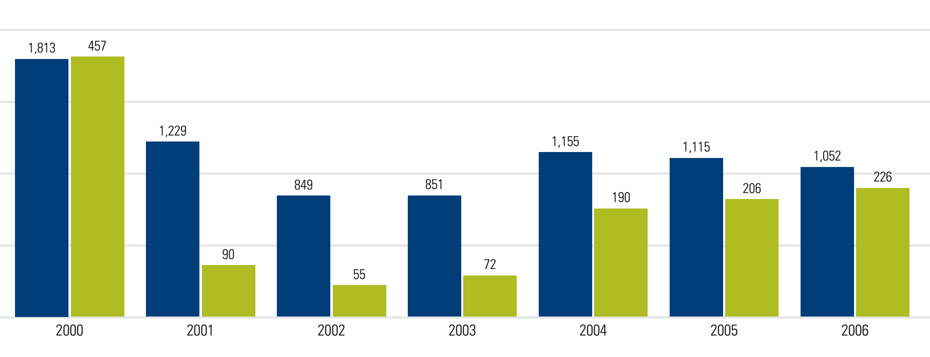
- The overall strength of the US and world economies
- Increased corporate profits and cash balances among buyers
- Stable debt and equity markets
- The desire of strategic buyers to acquire new technologies and gain market share rapidly
- The abundance of private equity money, fueled by continued investments from pension funds, university endowments and other institutional investors attracted by the potential for high returns
- Interest rates that remain low by historical standards

M&A Activity – Financial Services



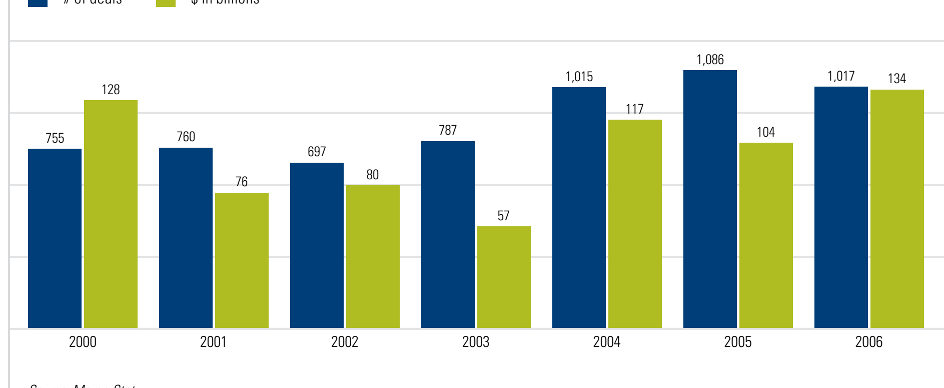
Source: MergerStat

M&A Activity – Telecommunications



Source: MergerStat

M&A Activity – Life Sciences



Source: MergerStat

- The entry of hedge funds into the M&A market
- In the case of VC-backed private companies, less favorable IPO conditions coupled with more attractive sale valuations

These factors will likely remain drivers of the 2007 M&A market, and our outlook for technology companies in particular continues to be favorable.

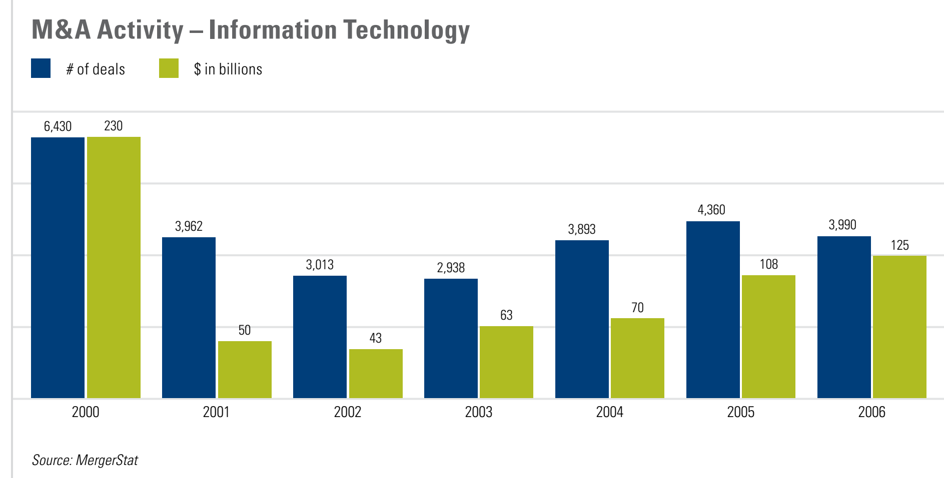
Existing private equity funds reportedly have as much as $750 billion to invest in M&A activity, and private equity participants are continuing to partner with each other and with strategic investors on deals, resulting in ever-increasing deal sizes. Competition between private equity and strategic buyers is robust, as is competition among private equity firms. According to Dealogic, there were multiple bids for 29% of the private equity buyouts in 2006, up from just 4% in 2005. Every indication is that these trends will continue in 2007.

For many private companies, an M&A transaction is the exit vehicle of choice given the demanding standards of the IPO market, the lack of secondary offerings that provide the real liquidity to investors, and the diminished appeal of being a public company in the face of increased regulatory burdens.

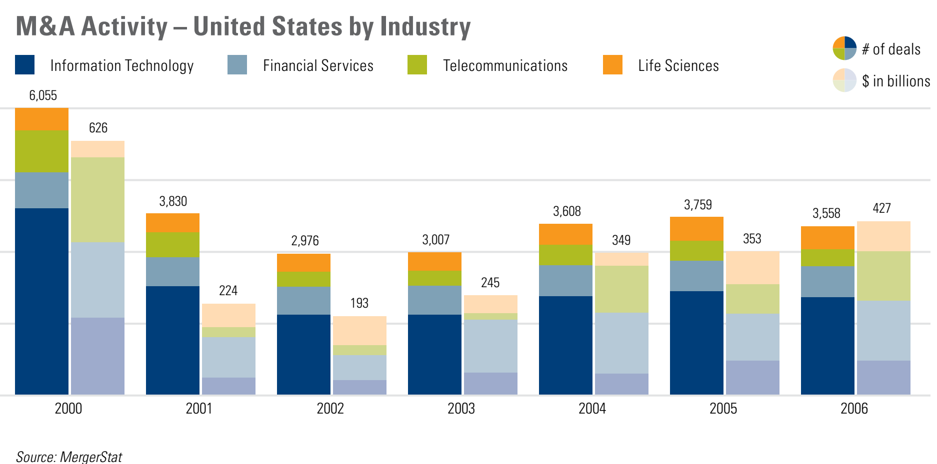
For now, the economy remains strong, interest rates remain at historically low levels and capital is widely available for M&A activity. However, there is a risk of too much capital chasing too few deals, which could result in the withdrawal of large amounts of private equity from the M&A market. Also, rising interest rates could raise the cost of capital in leveraged acquisitions, thus reducing investment returns and making some deals less attractive to private equity participants.

In spite of these risks, 2007 looks to present another favorable year for M&A activity. ■

January 2007



Source: MergerStat



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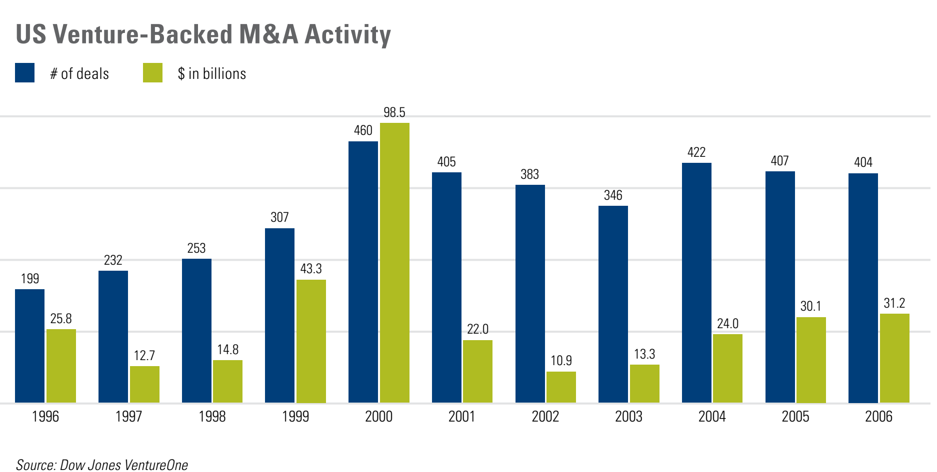


Source: Dow Jones VentureOne

Post-Closing Challenges by the Antitrust Agencies

The Hart-Scott-Rodino Act (HSR Act) requires parties to a merger or acquisition meeting a specified size threshold ($59.8 million as of February 14, 2007) and other requirements to report their transaction to both the Federal Trade Commission (FTC) and the Department of Justice (DOJ), and to observe the prescribed waiting period before closing.

Before Congress enacted the HSR Act, the FTC and DOJ could rarely investigate transactions before deals closed. By providing for pre-closing notification and review of substantial transactions, the HSR Act addressed two related problems:

- By the time the agencies could investigate an anticompetitive deal, litigate the matter and obtain an order invalidating the transaction, it was often too late to provide an effective remedy. Typically, several years had passed since closing, and the parties had closed plants, eliminated brands, terminated employees, or taken other actions, making it difficult or impossible to "unscramble the eggs" and restore the competition lost through the transaction.
- Merging parties lacked a structured process to obtain pre-closing review of their transaction. Accordingly, for transactions likely to attract antitrust scrutiny, parties often faced possible post-closing investigations that could drag on for years, potentially resulting in litigation and an order requiring unwinding long after closing.

Despite the possible benefits to merging parties of pre-closing review in some circumstances, parties generally breathe a collective sigh of relief when a merger is exempt from HSR notification or does not meet the thresholds necessitating a filing for pre-clearance, or when the statutory waiting period passes without agency action. That sigh, however, could be premature; the HSR Act, in fact, does not grant immunity from post-closing challenges.

Merger Challenges under the Clayton Act

Section 7 of the Clayton Act—but not the HSR Act—prohibits mergers that may substantially lessen competition. The HSR Act provides only the regulatory framework under which parties must notify the DOJ and the FTC before consummating the proposed transaction. Although fewer proposed mergers remain subject to the requirements of the HSR Act as the reporting thresholds have increased over the years, the standard of legality under Section 7 of the Clayton Act has remained the same: the transaction is illegal when "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

Also under Section 7, the US antitrust agencies retain authority to investigate and challenge transactions even after a transaction has closed or was previously cleared in the HSR review process. Moreover, there is no statute of limitations for government challenges under Section 7 or other antitrust statutes governing mergers. Antitrust agencies can seek divestiture of the acquired assets or other remedies to restore competition if the completed merger is found to have resulted in anticompetitive effects, even many years post-consummation. The FTC has been very clear: "Although the fact that a merger has been consummated increases the complexity of the Commission's decision to seek relief, that hurdle is not sufficient for the agency to forgo a challenge to a transaction that is likely to lead to anticompetitive effects."

In addition, completed transactions are always subject to litigations brought by state attorneys general or private parties, which are not part of the HSR Act process.

Post-Closing Challenges of Reportable Transactions

While the antitrust agencies have inquired into completed transactions that give indications of an exercise of market power, they had never actually challenged a reportable consummated transaction (for anything other than an HSR violation) until just a few years ago. Then, in 2001, the FTC ordered the unwinding of a transaction reported under HSR that had closed in 1999.

In *Chicago Bridge & Iron Co.* (*CB&I*), the FTC staff apparently did not determine that the transaction raised substantial antitrust concerns until after the 30-day HSR waiting period expired—at which time they began to investigate. Although the parties knew about this ongoing investigation and the possibility that the FTC might ultimately challenge the transaction, they nevertheless closed it, giving the combined firm a monopoly or near-monopoly in markets for thermal vacuum chambers and a dominant market position for two types of liquid gas storage tanks.

The circumstances surrounding *CB&I* probably do not mean that the agencies will depart from their general practice of investigating reportable transactions—if at all—before they close, since doing so would undermine the merger enforcement improvements that the HSR Act has provided. Furthermore, *CB&I* is not like the usual case in which the agency has let the waiting period lapse with the intention of signaling that it has closed its investigation. Rather, the FTC recognized that it had erred in closing the investigation quickly, and the parties were on notice that the FTC was continuing its investigation well before the transaction was closed. *CB&I*'s most important lesson is apparent: the expiration of the HSR waiting period is not an absolute guarantee against a post-closing challenge.

Although these types of investigations and challenges will likely remain quite rare, if merging parties find themselves in the unusual circumstance of being free to close while on notice of an ongoing agency investigation, they are well advised to weigh carefully the benefits and risks of completing their transaction during a pending investigation.

Challenges of Unreported, Consummated Transactions

More commonly, the agencies investigate and sometimes challenge completed mergers that were not reportable because they fall under the filing threshold or were a type of deal that the HSR Act does not reach. In fact, the antitrust agencies have increased their efforts to investigate non-reportable transactions as Congress has raised the size of transaction thresholds, thereby excluding from pre-merger review many more transactions

raising possible antitrust issues. And, while challenges to transactions not reportable under the HSR Act remain rare, the agencies have conducted many more investigations that did not lead to challenges, but did impose substantial expense and burden on the parties.

To identify unreported mergers that could harm consumers, the agencies employ a variety of sources to replace the information typically made available by the parties in the course of an HSR filing, including the trade press and other news articles, the Internet, consumer and competitor complaints, hearings, and economic studies. The risk of such an investigation increases substantially if customers complain or there are other suggestions that the deal has facilitated the exercise of market power.

If there is cause for suspicion, the objective of an agency's inquiry will be the same as for a transaction reported under the HSR Act—to determine if there are significant price increases or other anticompetitive effects attributable to the transaction. The decision to issue a complaint will depend on whether any anticompetitive effects resulted from the transaction or whether they were caused by an exogenous factor, such as increases in input costs. In essence, the analysis is whether the merger, by itself, harmed competition. But, unlike pre-closing investigations that are forward-looking and predictive, the agencies have the benefit of hindsight.

Practical Guidance

The infrequency with which the antitrust agencies launch investigations into—and even more infrequently challenge—consummated merger transactions makes it difficult to offer concrete steps to avoid post-closing trouble. Parties, however, are cautioned to remain sensitive to the effects of their deals on competition and how others view those deals, and should keep the following in mind:

- Do not assume that the agencies will forgo the investigation of consummated transactions, whether the deal was not reportable in the first instance or was allowed to close with expiration of the applicable HSR Act waiting period.
- Handle public statements about non-reportable transactions or those that have cleared the HSR waiting period with the same care as statements about transactions actively under scrutiny by the FTC or DOJ.
- Even when a transaction need not be reported under HSR, carefully monitor and prepare internal communications about matters that raise antitrust concerns, such as price increases, market position or dominance, output reductions, or consequences to competitors. These are the first types of documents an antitrust agency would request in an investigation.
- Pay attention to the sources that could report a completed merger that might concern the antitrust agencies, including industry media, unhappy customers and affected competitors. Use common sense. Do not, for example, suggest to customers that their prices will rise because of the deal. There may be opportunities to satisfy concerns of the agencies and third parties before an expensive investigation is launched or a challenge is made.
- After consummation, continue to assess the expected and actual economic impact of the transaction for issues that would raise concerns (e.g., rising prices, reduced output or failing competitors, etc.). What is only a prediction beforehand—whether the deal will or will not **substantially** lessen competition—can be hard fact when an agency looks at the deal after it closes.
- When the deal will result in a dominant position in a relevant market or is likely to generate antitrust concerns, consider if it's in the parties' interest to tell the FTC or DOJ about the transaction in advance and offer to provide information, even if the deal is not subject to the HSR Act.

In sum, parties need to realistically assess whether the competitive impact of their transactions would survive FTC and DOJ scrutiny, recognize that good faith and full compliance with their HSR Act obligations may not be enough, exercise common sense in their post-closing behavior, and be prepared to defend the merits of their transactions should the agencies ever come calling. ■

Recent Agency Challenges to Consummated Transactions

MSC.Software Corporation

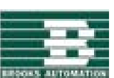
In 2001, the FTC, claiming that MSC was the dominant supplier of a popular type of advanced computer-aided engineering software known as "Nastran," issued an administrative challenge to MSC's 1999 acquisitions of the only other two suppliers of Nastran. Because MSC eliminated its only competitors, the FTC required MSC to replicate and license its key assets to restore competition. In making the challenge, the FTC emphasized that "even transactions such as these, which were not reported to the government before consummation, eventually will reach our radar screen if they harm consumers."

Software Company

More recently, in a challenge brought one year after consummation of an HSR-exempt transaction, the FTC claimed that the buyer's acquisition of a competing software company directly led to the combination of two of the three largest firms in the relevant sector. The combination resulted in the buyer having a 75% market share, with the largest remaining competitor—which had already been losing market share—as a weak number two. The FTC expressed concerns that entry by possible new competitors into the relevant product markets would not be timely or sufficient to deter the alleged anticompetitive effects of the merger, and that the merger would likely lead to reduced innovation competition in the relevant product markets. As a result, the acquiror, among other remedies, divested to a new competitor all acquired assets that overlapped in the relevant market and had to provide incentives for engineering talent necessary to support the viability of the restored competitor. In discussing the remedy, the FTC said: "The fact that the parties to an anticompetitive transaction were not required to file a pre-merger notification form and have consummated their transaction does not imply that the Commission will turn a blind eye. Parties bear the burden of restoring the competition that their transactions eliminated."

Counsel of Choice for Mergers and Acquisitions

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

Client	Transaction	Counterparty	Value	Date
RSA Security	*acquisition by*	EMC	$2,300,000,000	September 2006
PepsiCo	*acquisition of*	Stacy's Pita Chip Company	Undisclosed	January 2006
Kronos	*acquisition of*	Unicru	$150,000,000	August 2006
WiderThan	*acquisition by*	RealNetworks	$350,000,000	October 2006
Akamai	*acquisition of*	Nine Systems	$160,000,000	December 2006
Danaher	*acquisition of*	Sybron Dental Specialties	$2,200,000,000	May 2006 (co-counsel)
Lifeline	*acquisition by*	Philips Electronics	$750,000,000	March 2006
BD	*acquisition of*	GeneOhm Sciences	$230,000,000	February 2006
GlycoFi	*acquisition by*	Merck	$400,000,000	June 2006
IMlogic	*acquisition by*	Symantec	$90,000,000	February 2006
Verizon	*acquisition of*	MCI	$8,500,000,000	January 2006 (regulatory counsel)
Arlington Tankers Ltd	*asset acquisition from*	Stena Group	$92,000,000	January 2006
SkillSoft	*acquisition of NETg from*	Thomson	$285,000,000	Pending*
I-Logix	*acquisition by*	Telelogic	$80,000,000	March 2006
HMS Holdings Corp.	*acquisition of the Benefits Solutions Practice Area division of*	Public Consulting Group	$100,000,000	September 2006
WebMD	*acquisition of*	Subimo	$60,000,000	December 2006
Thermo Fisher Scientific	*acquisition of*	Cohesive Technologies	Undisclosed	December 2006
IDX	*acquisition by*	GE Healthcare	$1,200,000,000	January 2006
PAREXEL.	*acquisition of*	California Clinical Trials Medical Group and Behavioral and Medical Research	$65,000,000	November 2006
 Brooks Automation	*acquisition of*	Synetics	$48,500,000	June 2006
IDEXX Laboratories	*acquisition of Critical Care Division of*	Osmetech	$44,900,000	Pending*
Infinity Pharmaceuticals	*acquisition of*	Discovery Partners	$162,500,000	September 2006
GeoTrust	*acquisition by*	VeriSign	$125,000,000	September 2006
domantis	*acquisition by*	GSK	£230,000,000	January 2007
Softricity	*acquisition by*	Microsoft	Undisclosed	July 2006
Linde	*acquisition of*	BOC Group	$14,800,000,000	September 2006 (worldwide antitrust counsel)
Lucent Technologies	*merger with*	Alcatel	$13,000,000,000	November 2006 (US CFIUS counsel and worldwide antitrust co-counsel)
Lehman Brothers	*acquisition of*	Capital Crossing Bank	$210,000,000	Pending*
MatrixOne	*acquisition by*	Dassault Systèmes	$408,000,000	May 2006
Kabel BW	*acquisition by*	EQT	Undisclosed	June 2006 (counsel to Blackstone)
Savient Pharmaceuticals, Inc.	*sale of oral liquid pharmaceuticals business to*	Close Brothers Private Equity	$176,000,000	August 2006
Blackboard	*acquisition of*	WebCT	$180,000,000	February 2006
BrassRing	*acquisition by*	Kenexa	$115,000,000	November 2006
Red Hat	*acquisition of*	JBoss	$420,000,000 (including earnout)	June 2006

* as of January 8, 2007

Structuring Friendly Acquisitions as Tender Offers: Resurgence in 2007?

Structuring a negotiated acquisition of a public company as a friendly tender offer may expedite the closing of the deal by eliminating the delays associated with preparing and mailing a merger proxy statement and holding a stockholder meeting to approve the transaction. Recent amendments to the SEC's "best-price rule" have removed a significant impediment to more widespread use of tender offers for friendly acquisitions.

Background

Rule 14d-10 (known as the best-price rule) requires that all target stockholders who participate in a tender offer must receive the highest consideration paid to any target stockholder. Prior to the adoption of the recent amendments to Rule 14d-10, some US federal courts found that stay bonuses, severance packages and other forms of compensation paid to target company executives constituted additional consideration for the executives' stock, and therefore required that all target stockholders be paid an amount per share equal to the largest amount per share deemed to be received by any target company executive. This requirement could result in bidders paying exorbitantly high amounts per share.

Although not all courts adopted this interpretation of the best-price rule, the possibility of such a draconian outcome has been widely perceived to be a significant risk. As a result, in recent years, parties to friendly acquisitions have routinely structured deals as one-step mergers—where the best-price rule is inapplicable—rather than as tender offers.

The Recent Amendments

Effective December 8, 2006, the SEC adopted amendments clarifying that in a third-party tender offer, the best-price rule applies only with respect to consideration paid for the securities tendered in the tender offer. The amendments expressly exempt from the best-price rule all payments made pursuant to the negotiation, execution or amendment of any employment compensation, severance or other employee benefit arrangement where the amount payable under the arrangement (1) relates solely to past services performed, or future services to be performed or refrained from performing, by an employee or director; and (2) is not based on the number of securities the employee or director owns or tenders. The arrangement may be conditioned on the successful completion of the tender offer (although not on the individual's tender of his or her own shares).

The amended rule also contains a new safe harbor. An employment compensation, severance or other employee benefit arrangement will be immune from challenge if it is approved by the target company's independent compensation committee members or other independent directors, or, if the bidder is paying the additional compensation, by the bidder's independent compensation committee members or other independent directors.

Likely Impact:
More Friendly Tender Offers

By removing the obstacle posed by troublesome case law in deals involving the negotiation and payment of stay bonuses, severance packages and other compensation to target company executives, the amendments should result in increased use of the friendly tender offer structure.

Structuring a friendly acquisition as a tender offer may reduce the time between signing and closing the deal by several weeks, and doing so may significantly reduce the risk that the deal will not close. In most states, including Delaware, the closing of the tender offer can be followed expeditiously by the acquisition of any untendered shares at the public tender price through a "second-step" short-form merger if at least 90% of the shares are tendered.

But Not Every Deal…

Not every deal, however, is best structured as a tender offer. As a practical matter, tender offers work best in the following situations:

- Cash tender offers (as distinct from equity exchange offers)
- Deals where at least 90% of the shares are likely to be tendered within a reasonable timeframe
- LBOs and MBOs in which each member of management either "rolls over" all of his or her outstanding shares into the newly leveraged company or tenders them all (as distinct from rolling over some and tendering the rest)
- LBOs and MBOs involving unsecured financing (rather than financing that is secured by target assets)
- Deals having no significant antitrust concerns

And, of course, hostile tender offers continue to have the practical impediment that the bidder is unable to perform due diligence on the target company. In a Sarbanes-Oxley world, only a very hardy acquiror is likely to shoulder such a risk and proceed with a hostile offer.

Practice Tips

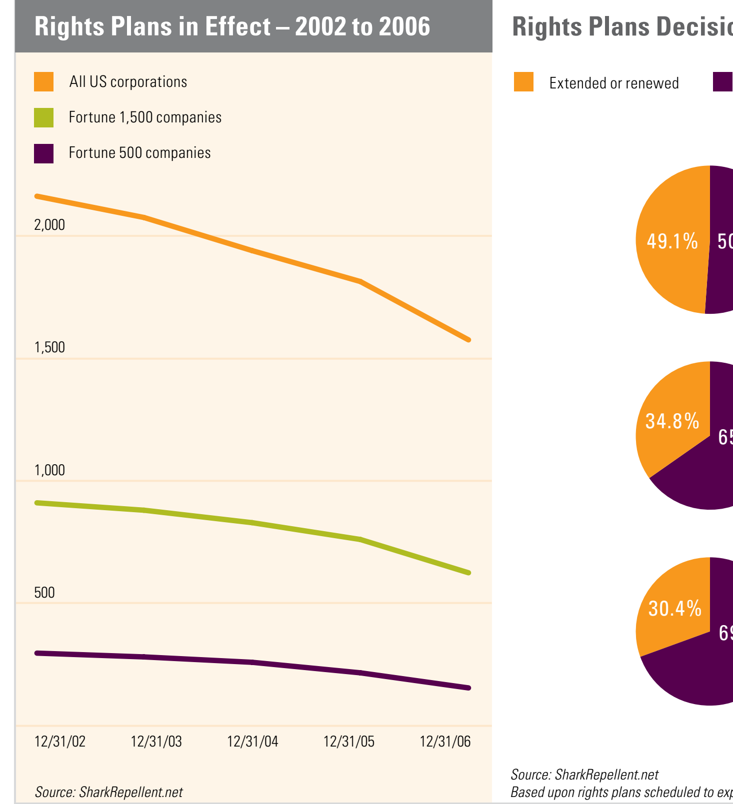
Experience has shown that the documentation for a friendly tender offer, though subject to a number of arbitrary rules, is manageable in scope and should not ordinarily lead to unexpected comments from the SEC staff when reviewed following the mailing to stockholders.

In the new friendlier environment for certain tender offers, we offer the following practice tips:

- Carefully review the terms of credit agreements, employment contracts, options, warrants and other documents to make sure that the conclusion of the first-step tender offer does not inadvertently trigger consequences that only make sense upon the closing of the second-step merger, such as the acceleration of outstanding borrowings.
- Get a good head start on the documentation while the merger agreement is still being negotiated—at least two weeks earlier than work is customarily begun on a merger proxy statement.
- Plan appropriately for the fact that the acquiror and its lawyers must play a much greater role in the tender offer documentation than they ordinarily would in a merger proxy statement. ■

Beginning in the late 1980s, shareholder rights plans, or "poison pills," were frequently prescribed by corporate lawyers and investment bankers as a common remedy for all types of corporate ailments: undervalued stock, threatening acquirors, market accumulators and unruly shareholders, among others. Poison pills are easy to administer because they require director action alone and, if not redeemed or otherwise terminated, are very effective: "Take one pill and call me in 10 years."

While still part of any good treatment plan, the adoption of a new rights plan or the extension of an expiring rights plan has in recent years come to be viewed like chemotherapy—potentially poisonous to both the would-be acquiror and the company that adopts it. As a result, this remedy is more often dispensed only to companies in the midst of a crisis, such as a hostile takeover or aggressive market accumulation.



Why the Change in Treatment Options?

First, shareholders—especially institutional shareholders—have vociferously opposed rights plans and have been increasingly successful when challenging them at the polls. According to SharkRepellent.net, 309 proposals to redeem rights plans or require shareholder votes on rights plans were voted upon between 2001 and 2006, and approximately 70% of those proposals passed. Of the 30% that failed to pass, approximately 13% nonetheless received more yes than no votes.

Second, in early 2005, Institutional Shareholder Services (ISS) adopted a policy to withhold votes for all incumbent directors up for election at the first meeting of shareholders following any adoption or renewal of a rights plan unless the plan will be put to a vote of shareholders within 12 months of its adoption. In light of the influence ISS has on voting positions taken by institutional shareholders and the significant and successful opposition to rights plans already taking place at the polls, boards have generally not wanted to face the prospect of a significant number of withheld votes for directors by adopting a rights plan without subjecting it to shareholder approval and view the likelihood of obtaining such approval as very low.

What Are the Results?

The number of rights plans in effect has dropped during each of the past four years, with the biggest decline occurring during 2006. The decrease is even higher, in percentage terms, for the largest companies—from December 31, 2002 to December 31, 2006, the cumulative decrease in rights plans was 26.5% among all US public corporations, 29.8% among Fortune 1,500 companies and 43.0% among the Fortune 500. In addition, over the past three years, the percentage of companies that did not renew their rights plans has increased each year, and companies electing to let their rights plans expire now exceed those that renew their rights plans by more than a two-to-one margin.

Boards of directors are increasingly alert to higher levels of hostile transactions, and shareholders are ever more forceful in threatening or mounting election contests to force a change in corporate direction. Of course, rights plans were never an antidote to contested board elections, but they can help treat other symptoms that may accompany or follow such contests. In light of the developments at the polls and at ISS, boards continue to evaluate rights plans very carefully, but in most cases, elect to use this medication only in emergencies.

What Else Can You Do?

The corporate medicine cabinet might also contain other antitakeover elixirs. As a practical matter, any that must be accomplished through a charter provision need to be implemented prior to an IPO, and they all are likely to encounter institutional shareholder resistance to one degree or another:

- Classified board of directors
- Limitations on shareholders' rights to act by written consent, call meetings, increase the number of directors or fill vacancies
- Advance notice by stockholders of director nominations or other business to be raised at shareholder meetings
- Supermajority vote to amend charter or bylaws ■

Sales of venture-backed companies raise a number of unique issues. Some arise from the complex capital structures of most venture-backed companies, including the presence of multiple classes of preferred stock and the relatively greater prevalence of optionholders and warrantholders among the holders of equity. Other issues, such as the means by which acquirors seek to secure indemnification obligations and concerns about liquidity of the acquiror's stock issued in payment of the purchase price, are primarily related to deal size and the nature of the parties involved. And looming over the resolution of all these issues are the fiduciary duties of the target's directors, even when the company is private.

Effect of Preferred Stock Rights on Deal Structure

Addressing the rights of multiple classes of equity stakeholders in the sale of a venture-backed company requires a close reading of the target's charter documents and can be challenging. Some points to consider include:

- The liquidation preference that each class of preferred is entitled to receive will be an important factor in determining how a transaction should be structured.
- In many cases, the purchase price may be insufficient to trigger conversion of all preferred stock or to satisfy the liquidation preferences of each class of preferred stock.
- Where separate class votes are required to approve the sale of the target, there is sometimes a "re-trading" of the purchase price among the various preferred classes in order to obtain a favorable vote from each class. This is often accomplished through a charter amendment, but must be structured carefully to comply with the target board's fiduciary duties.

Another complicating factor is the identity of the parties required to participate in the post-closing indemnification obligations. While it may initially seem fair for each equity participant to share proportionately in the indemnification obligations, the company's charter may provide otherwise. A resolution will often require significant changes to a deal's liability structure; at the very least, the solution probably will make the escrow arrangements more complex.

A related issue arises if the target's charter contains a "no impairment" clause, which generally prevents the company from taking any action that would have the effect of impairing the preferred shareholders' rights. To avoid running afoul of this kind of charter provision, the acquiror may need to structure the deal so that no one class is singled out for less favorable treatment than other classes (except to the extent provided in the charter), even where the holders of that particular class are not otherwise an important part of the transaction.

Consequently, a solid understanding of the target's preferred stock rights—and the fiduciary duties of the target's directors—is critical to an acquiror's ability to structure a transaction that will secure board and shareholder approval and proceed smoothly toward completion.

Treatment of Stock Options and Warrants

Many venture-backed companies generously award options to employees as an incentive to retain them, often at lower levels of cash compensation than are otherwise available in the marketplace. Similarly, warrants are frequently issued to lenders, landlords and vendors in an attempt to stretch valuable early-stage cash. An acquiror must be fully conversant with the target's option and warrant plans and documents since they will determine whether the treatment of those instruments will be simple and straightforward (as in situations where they can be bought out with a cash payment) or more complicated (as in cases where the desired treatment of outstanding options and warrants is not contemplated by, or is in contravention of, their terms).

As a related matter, in circumstances where outstanding options and warrants cannot be cashed out, and particularly where they form a disproportionately large segment of the target's equity, the acquiror faces a dilemma with respect to the deal's indemnification and escrow mechanisms:

- On one hand, it is usually better (from the acquiror's perspective) to have as many of the selling equityholders obligated to stand behind the representations, warranties and covenants as possible, so excepting a large group of optionholders and warrantholders from this liability is not ideal.
- On the other hand, trying to include optionholders and warrantholders in the indemnification arrangements tends to complicate the escrow mechanisms—sometimes enormously so.

Furthermore, acquirors are usually reluctant to make indemnification claims against the target's key employees—who often hold the bulk of the target's options—when they join the acquiror following deal completion. As a result, acquirors often seek to place the entire escrow burden on the non-employee shareholders. Trying to strike the proper balance among these considerations is frequently difficult and sometimes contentious.

Trends in Indemnification and Escrow Terms

Target shareholders are universally expected to indemnify acquirors for breaches of representations, warranties and covenants, and these indemnities are usually secured with escrows. The details of these arrangements, however, often require extensive negotiations, as the outcome can fundamentally affect deal economics for sellers. Typical parameters include:

- A cap on indemnification liability, almost always set below the purchase price and often limited to the escrow, with exceptions that might include fraud and willful misrepresentations, as well as capitalization, tax and other fundamental matters
- An escrow for 10%–20% of the purchase price lasting 12 to 24 months—the amount and duration of escrows has increased modestly following the 2001 elimination of pooling accounting treatment, which had capped most indemnity arrangements at 10% and 12 months
- The escrow is the acquiror's exclusive remedy under the indemnity, subject to the exceptions described above

Please see pages 14–15 of this report for a more detailed analysis of recent trends

in indemnification, escrow and other terms in sales of venture-backed companies.

Deal Protection

Acquirors of private companies want to fully lock up a deal as early in the sale process as possible in order to reduce the risk of a superior offer upsetting the deal. In contrast, it has long been viewed as both customary and legally mandated for public company transactions to contain at least some exclusivity exceptions, thereby allowing the target's board of directors to discharge its fiduciary duty to obtain the best value for shareholders (although this general consensus has not prevented the actual parameters of these exceptions from continuing to be heavily negotiated in each transaction).

In spite of the desire of acquirors for deal certainty, the boards of venture-backed target companies must be cognizant of their fiduciary duty to maximize shareholder value. Like their public company counterparts, venture-backed company boards often try to discharge this duty by seeking either:

- the affirmative right to contact other potential acquirors prior to closing in order to perform a "market check" on the deal's terms, or
- more frequently, the passive right to accept an unsolicited superior bid and terminate the original purchase agreement prior to closing, or at least a right to change the board's recommendation to shareholders.

Without fiduciary duty exceptions to the exclusivity provisions, a target board could be forced to choose among:

- breaching its fiduciary duties by locking up a deal prematurely,
- breaching the acquisition agreement's exclusivity provisions if a better offer surfaces, or
- avoiding a breach of fiduciary duty claim by waiting until the "drop dead" date in the acquisition agreement to explore alternative transactions, but thus risking the loss of both the original and the alternative offer due to lapse of time (and possibly violating a covenant in the acquisition agreement to use best efforts to close the original deal).

The above provisions are usually the subject of fierce debate, both on a conceptual level and within the confines of each particular transaction. These issues are also present when a letter of intent containing exclusivity restrictions is signed for a prospective transaction.

Acquirors have attempted to strike a balance between the need of target boards to perform at least some baseline market check and the desire of acquirors to lock up deals as quickly as possible by drawing on precedents from public company acquisitions, such as:

- limiting the number of shares bound by voting agreements to less than a majority, or
- coupling the target board's termination rights with break-up fees that would have to be considered as part of the board's evaluation of alternative offers.

One approach that is increasingly used to lock up the acquisition of a venture-backed target (and that typically is unavailable for a public company target) is to give the target a public company–style "fiduciary out" in the acquisition agreement while requiring shareholder approval of the transaction (often by written consent) promptly after the agreement has been signed. This mechanism is usually coupled with the acquiror's right to terminate the agreement if the target shareholders fail to approve the transaction within a short period of time after its execution, thus minimizing the length of time during which the deal's closing is uncertain.

This technique may not be attractive in transactions where shareholder approval cannot be obtained quickly by written consent, or where regulatory action is required before shareholder approval may be sought, such as in transactions involving a California fairness hearing.

Liquidity of Deal Consideration

The issuance of the acquiror's securities as deal consideration can raise challenging securities law issues. To have meaningful liquidity, the shares must be registered, either upon issuance of the shares (on a Form S-4 registration statement) or following the closing (usually on a Form S-3 resale registration statement). If the shares cannot be issued at closing pursuant to registration or a valid exemption from registration, the acquisition cannot be closed with stock consideration.

Pre-closing registration on Form S-4 will delay the closing and subject the acquiror to the potential liabilities associated with every registration statement. Post-closing registration on Form S-3 is more common because it permits a quicker closing. However, it poses several risks to the target's shareholders:

- The shares received cannot be resold until the registration statement becomes effective, although this delay may be brief and should not be a concern at all if the acquiror qualifies as a "well-known seasoned issuer" under SEC rules.
- If the acquiror has the right to delay or terminate the registration (for example, because of unannounced material developments within the acquiror), the target shareholders may be left with illiquid shares for some period of time.
- Selling shareholders under Form S-3 are potentially liable for misstatements or omissions, although they may have recourse against the acquiror under indemnity provisions in the acquisition agreement.

Post-closing registration is only possible if the acquiror can issue its securities at closing pursuant to a valid exemption from registration. If the target has too many equityholders for a valid exemption, the issuance usually must be made pursuant to a pre-closing Form S-4 registration statement. Alternatively, the acquiror might be able to cash out options and/or certain classes of stock to reduce the number of target shareholders and qualify for an exemption from registration, but this would further complicate the allocation of the purchase price, and may present fiduciary duty issues for the target's board.

The preferred approach in any given transaction will depend heavily on the factual circumstances of the transaction and the long-term plans of the target's shareholders. ■

We reviewed all merger transactions involving venture-backed targets signed up or consummated in 2004, 2005 and 2006 (as reported in Dow Jones VentureOne)—a total of 54 transactions in 2004, 39 transactions in 2005 and 53 transactions in 2006—where the merger documentation was publicly available and the deal value was $25 million or more. Of the 2004 merger transactions, 23 (or 43%) were for cash, 22 (or 41%) were for stock and nine (or 17%) were for a mixture of cash and stock. Of the 2005 transactions, 27 (or 69%) were for cash, four (or 10%) were for stock and eight (or 21%) were for a mixture of cash and stock. Of the 2006 transactions, 36 (or 68%) were for cash, four (or 8%) were for stock and 13 (or 24%) were for a mixture of cash and stock.

Based on this review, we have compiled the following deal data:

Deals with Earn-Out		2004	2005	2006
Deals that provided contingent consideration based upon post-closing performance of the target (other than balance sheet adjustments)	With Earn-Out	24%	15%	17%
	Without Earn-Out	76%	85%	83%

Deals with Indemnification		2004	2005	2006
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification			
	By Target's Shareholders	89%	100%	94%
	By Buyer[1]	37%	46%	38%

Survival of Representations and Warranties		2004	2005	2006
Length of time that representations and warranties survived the closing for indemnification purposes[2]	Shortest	6 Months	9 Months	12 Months
	Longest	36 Months	24 Months	36 Months
	Most Frequent	12 Months	12 Months	12 Months

Caps on Indemnification Obligations		2004	2005	2006
Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	85%	100%	100%
	Limited to Escrow	72%	79%	84%
	Limited to Purchase Price	7%	5%	2%
	Exceptions to Limits[3]	74%	73%	84%
	Without Cap	15%	0%	0%

[1] *The buyer provided indemnification in 48% of the 2004 transactions, 25% of the 2005 transactions and 41% of the 2006 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions, 17% of the 2005 transactions and 35% of the 2006 transactions where the buyer provided indemnification, buyer stock was used as consideration.*

[2] *Measured for representations and warranties generally; specified representations and warranties may survive longer.*

[3] *Generally, exceptions were for fraud and willful misrepresentations.*

Escrows		2004	2005	2006
Deals having escrows securing indemnification obligations of the target's shareholders	**With Escrow**	83%	97%	96%
	% of Deal Value			
	Lowest	4%	2%	3%
	Highest	23%	20%	20%
	Most Frequent	10%–20%	10%	10%
	Length of Time			
	Shortest	6 Months	6 Months	12 Months
	Longest	36 Months	24 Months	36 Months
	Most Frequent	12 Months	12 Months	12 Months
	Exclusive Remedy	64%	84%	90%
	Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[4]	72%	66%	86%

Baskets for Indemnification		2004	2005	2006
Deals with indemnification where a specified "first dollar" amount did not count towards indemnification, expressed either as a "deductible" (where such amount can never be recovered) or as a "threshold" (where such dollar amount cannot be recovered below the threshold but once the threshold is met all such amounts may be recovered)	**Deductible**	39%	38%	48%
	Threshold	51%	62%	52%

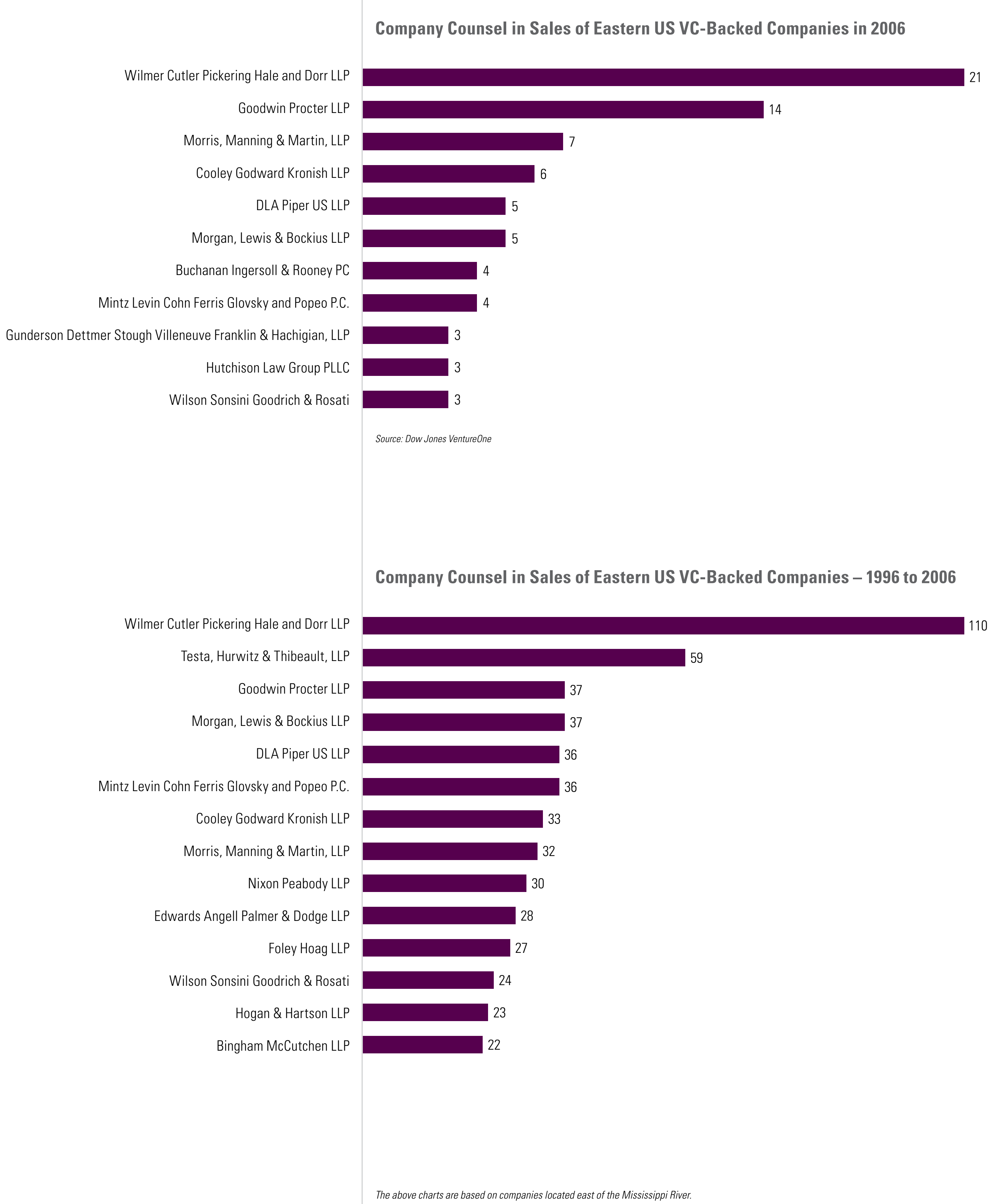
MAE Closing Condition		2004	2005	2006
Deals where the buyer or the target had as a condition to its obligation to close the absence of a "material adverse effect" with respect to the other party or its business, either in condition explicitly or through representation brought down to closing	**Condition in Favor of Buyer**	81%	82%	98%
	Condition in Favor of Target[5]	30%	13%	23%

Exceptions to MAE		2004	2005	2006
Deals where definition of "material adverse effect" for the target contained specified exceptions	**With Exception[6]**	78%	79%	85%

[4] *Generally, exceptions were for fraud and criminal activity.*

[5] *In 50% of these transactions in 2004, in 80% of these transactions in 2005 and in 83% of these transactions in 2006, buyer stock was used as consideration.*

[6] *Generally, exceptions were for general economic and industry conditions.*



The above charts are based on companies located east of the Mississippi River.

Source: Dow Jones VentureOne

Want to know more about the latest in the IPO and venture capital markets?

See our *2006 IPO Report* for a detailed analysis of the 2006 IPO market and 2007 outlook. The report features regional IPO market breakdowns, a review of the PIPEs and Rule 144A markets, an update on the securities offering reforms, insight on the new disclosure rules for executive compensation, a look at the latest developments under SOX Section 404, considerations for US companies looking to an AIM flotation, and a discussion of best practices for public companies.

Our *2006 Venture Capital Report* offers an in-depth analysis of the US and European venture capital markets and outlook for 2007. The report features industry and regional breakdowns, practical advice on implementing management carve-out plans, an overview of trends in VC deal terms, tips for venture capital fundraising, and a summary of the stockholder approval exceptions under the Section 280G "golden parachute" rules.

For summaries and analysis of compensation data collected from hundreds of executives and private companies located throughout the country, see the *2006 Compensation and Entrepreneurship Report in Information Technology* and the *2006 Compensation and Entrepreneurship Report in Life Sciences* at www.wilmerhale.com/compreports.

To request a copy of any of the reports described above, or to obtain additional copies of the *2006 M&A Report*, please contact the WilmerHale Marketing and Business Development Department at marketing@wilmerhale.com or call +1 617 526 5600. An electronic copy of this report can be found at www.wilmerhale.com/2006M&Areport.

Data Sources

M&A data is sourced from MergerStat. Data for sales of VC-backed companies is sourced from Dow Jones VentureOne. For law firm rankings, sales of VC-backed companies are included under the current name of each law firm.

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