FUSION: A Quarterly Exchange to Power Your M&A Deals

Public Company M&A Environment:

Are You Prepared for Potential Hostility? How Do You Respond?

Web Conference Date: March 22, 2007

Introduction

The panel for the March 22, 2007 session of Fusion: The M&A Web Conference Series included Patrick G. Quick, Foley partner and member of the firm's Transactional & Securities Practice and Sports Industry Team; John K. Wilson, Foley partner and member of the firm's Transactional & Securities Practice and Energy Industry Team; and Matthew Parr, managing director in the Mergers & Acquisitions Group of UBS Investment Bank. The panel discussed trends in the mergers and acquisitions (M&A) marketplace as well as best practices for public companies to be prepared to respond to potentially hostile approaches.

Industry Trends

Increased Hostile M&A Activity

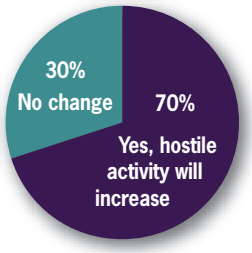
Hostile M&A activity has increased steadily since 2002. According to Thomson Financial, hostile acquisitions increased 87 percent in 2006 compared to 2005, with 157 hostile acquisitions worldwide representing approximately $498 billion in value. This figure represented approximately 13 percent of global announced M&A activity in 2006, which was a record $3.8 trillion.

Factors contributing to the rise in hostile activity include: high levels of available cash; relatively inexpensive and easy-to-obtain financing due to continued low interest rates; increased institutional shareholder and hedge fund activism; consolidation within certain industries; and third-party breakups of strategic mergers.

Additionally, many public companies have reduced their takeover defense strategies in response to corporate governance concerns and, as such, are becoming increasingly vulnerable to hostile takeovers.

POLLING QUESTION

Do you expect general economic conditions will contribute to greater hostile M&A activity in the next six months?



Reduced Takeover Defenses

While maintaining takeover defenses continues to be a common practice, some public companies are abandoning such defenses. For example, according to SharkRepellent.net, the percentage of S&P 500 companies with classified boards decreased to 41 percent in 2006 from 47 percent in 2005, and those with rights plans decreased to 34 percent in 2006 from 45 percent in 2005.

These percentages remain higher at companies with smaller market capitalizations whose corporate governance practices are subject to less scrutiny.

Continued Institutional Shareholder Activism

Institutional shareholders continue to object to takeover defenses and voice their concerns through shareholder proposals and corporate governance ratings, and by withholding votes for directors. Shareholder proposals to repeal classified boards, eliminate supermajority votes, or redeem or vote on rights plans continue to receive high levels of support.

Increased Hedge Fund Activism

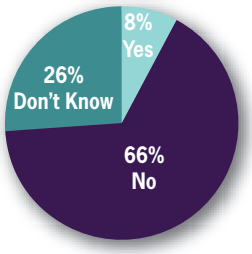
Global hedge fund assets, for which significant returns are expected, are currently estimated to range between $1.4 trillion and $2 trillion. Increasingly, hedge funds have taken on the role of investors, not just traders. Also, the investment strategies hedge funds use create an incentive for hedge funds to be drivers of events at portfolio companies.

Hedge fund activism can take different forms:

- Challenging management and boards of directors to review business strategy
- Pursuing increased dividends or stock repurchases, or the restructuring, breakup, or sale of a company
- Launching hostile takeovers and proxy contests
- Blocking a sale transaction to force the acquirer to pay a higher price

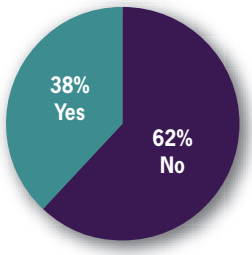
POLLING QUESTION

Does your organization have any hedge fund shareholders that are known to be activist hedge funds?



POLLING QUESTION

Do you believe your organization has an adequate takeover defense team and policies and procedures in place to respond quickly in the event of an unsolicited offer?



Often, hedge funds act in parallel using "wolf pack" tactics. It is not uncommon for a number of hedge funds to acquire more than 50 percent of a public company's shares. Because individual hedge funds often stay below 10 percent, takeover defenses and statutes may not be effective.

Preparing for Unsolicited Offers

To be prepared to respond to hostile activity, it is important that a public company establish a takeover defense team and maintain a current contact list that includes key officers, a financial advisor, legal counsel, investor relations, and a proxy solicitor.

A public company also should have a policy that its representatives not provide comments to the press or others regarding acquisition activity or rumors. The company should appoint a sole spokesperson to address all inquiries on these matters and prepare scripted responses. These policies help the target company avoid a duty to disclose third-party overtures and ensure that it is speaking with one voice.

Involving the Board

To assist the board of directors to be prepared with respect to unsolicited offers, the board should have an annual takeover defense and M&A market review in which the financial advisor and outside counsel participate. Boards should consider adopting an independence policy in connection with the review of the company's strategic plan, and they should make clear the CEO's authority in dealing with unsolicited acquisition proposals.

Board members also should be prepared to call and attend a special board meeting on short notice (i.e., within 24 hours) if a proposal is received.

Reviewing and Maintaining Takeover Defenses

While takeover defenses will not prevent a third party from acquiring control of a public company, they do provide an informed board the opportunity to control a company's destiny consistent with the board's view of the best long-term interests of shareholders. These defenses also help a company avoid having an outsider dictate the corporate agenda.

Increasing the bargaining power of the board can lead to an increase in the takeover premium, so companies must evaluate, strategize, and prioritize their defenses in the face of demands to reduce takeover defenses.

Rights Plans

Rights plans can be a strong defense against a hostile tender offer; however, growing shareholder activism is leading to an increasing number of companies repealing or letting expire their rights plans. Companies should consider whether an "off-the-shelf" rights plan or a shareholder-approved rights plan that meets Institutional Shareholder Services (ISS) standards is appropriate. Likewise, if applicable under state law, companies should evaluate whether a business combination statute is sufficient protection.

Classified Boards

A classified board is a strong defense against proxy contests that ultimately may be intended to remove a rights plan or statutory defenses. At a minimum, it provides the board time to implement strategic alternatives.

If a company currently does not have a classified board in place, it can be difficult to establish one, since it requires a charter amendment. Additionally, growing shareholder activism is leading to an increased number of companies repealing their classified board status. But, if a company has a classified board in place, it would be wise in this marketplace to consider sustaining it.

Advance Notice Bylaws

Placing advance notice provisions in the company's bylaws can help restrict activists' ability to commence a proxy contest and eliminate the element of surprise with respect to shareholder proposals. If shareholders may act by less-than-unanimous written consent under state law and a company's charter documents, then advance notice provisions should apply to consent solicitations as well, including procedures for establishing the record date and effective dates for consents.

State Statutes

Some states have implemented takeover defense statutes that may be available to companies, depending upon their locations. ISS and other proxy advisory firms, however, often penalize companies that are incorporated in states that have these defensive types of statutes.

Some state statutes that are in place include:

- Business combination — Prohibits an acquirer from engaging in a second step squeeze-out merger for a stated period (e.g., three years) after the acquirer has become an interested shareholder (e.g., 10 or 15 percent) unless the board approved the acquisition of stock
- Control share — Reduces voting power for shareholders who acquire more than a specified percentage (e.g., 20 percent) of a company's shares
- Fair price — Requires approval of business combinations that do not meet a specified adequacy of price standards by shareholders other than the shareholder proposing a business combination

Preparing for Hedge Fund and Other Activist Attacks

In preparing for potential hedge fund and activist attacks, public companies should maintain a response team similar to the takeover response team previously described. Likewise, similar to takeover defense review, the board should be prepared to deal with an activist situation.

The board needs to understand the company's strategic plan and other potential strategic alternatives. Although a hedge fund attack may be intended to facilitate a takeover or to force a sale, takeover defenses may be of limited use with respect to an initial attack.

Investor Relations

Having a solid investor relations team is key to defending against these types of attacks. The team must proactively communicate the company's strategy and explain reasons for any performance shortfalls. It also should monitor and report significant stock holdings and trading to identify potentially problematic shareholders. In addition, it is important for the team to stay abreast of the changing climate and review analysts' reports for opinions that may appeal to hedge funds.

The company's investor relations professionals should understand alternatives that activists may propose — including share buybacks, special dividends, sale of company/division, spin-off, or other restructuring — so the company can respond accordingly.

Strong investor relations can help avoid hostility from shareholders by maintaining open communication with institutional shareholders and responding to all shareholder inquiries quickly and efficiently.

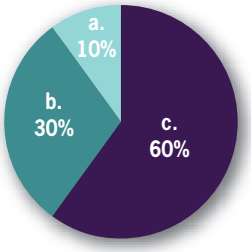
POLLING QUESTION

How would you rate your organization's ability to respond to activist hedge funds?

a. Highly organized

b. Somewhat organized

c. Not organized at all



Fiduciary Duties of the Board

Takeover Defenses and Offers

Under Delaware law, there are three standards of judicial review for decisions by directors with respect to adopting and maintaining takeover defenses and responding to hostile offers:

- Business judgment rule
- Enhanced scrutiny, including *Unocal* for defensive measures and *Revlon* for the sale of a public company
- Entire fairness in situations where directors have a conflict of interest

Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company and its shareholders. Board decisions are protected, and not second-guessed by a court, unless the plaintiff meets the burden of proof demonstrating that a board did not meet its duty of care or loyalty. The business judgment rule generally applies to a target board decision not to accept an unsolicited offer.

Enhanced Scrutiny

Delaware courts will not defer to the board under the business judgment rule and will apply an enhanced scrutiny standard in certain circumstances:

- The board decided to undertake defensive action in response to a threat to corporate control. In this case, under *Unocal*, the board must show that (i) it had reasonable grounds to believe a danger to corporate policy and effectiveness existed and (ii) the defensive measure was reasonable in relation to the threat posed.
- The board decided to approve a sale of control or a break-up of the company. In this case, under *Revlon*, once the board has decided to sell the company, the board must achieve the highest value reasonably available for the stockholders.

If the enhanced scrutiny standard is applicable, the court will:

- Review the board's decisional process
- Examine the reasonableness of the board's decision

Entire Fairness

If a majority of the board has a conflict of interest, then the court will determine if the transaction is entirely fair to stockholders. The court will consider both fair dealing and fair price by examining the board process, quality of result achieved, and quality of disclosures to shareholders.

Responding to Unsolicited Inquiries and Offers

Informal Approach

If an offeror makes an informal approach to a public company (e.g., the CEO or a director is called), the company has no duty to discuss, negotiate, or meet with the offeror. If the CEO is contacted, he or she should indicate that the company is not for sale and that it plans to remain independent. If a director is contacted, the call should be referred to the CEO in accordance with the company's sole spokesperson policy.

If the offer is not a firm offer (i.e., a written proposal with a stated price), then the board is not required to consider it. However, management should inform the board of serious approaches so the board is prepared to respond, if necessary.

There is no duty to disclose such an approach unless a leak of information by company personnel occurs.

Nonpublic Firm Offer or "Bear Hug" Letter

If a public company receives a nonpublic firm offer, there also is no duty for the company to discuss, negotiate, or meet with the offeror. The takeover defense team should consider its response to the bidder, inform directors, and call a special board meeting to consider the offer. If the board determines the offer is not in the best interests of stockholders, it has no duty to accept an offer — even if it is in excess of the market price. Again, there is no duty to disclose the offer unless a leak occurs. In such situations, the company should continue to monitor stock activity closely.

Public Firm Offer or "Bear Hug" Letter

The first response to the bidder should be simply, "we will call you back." The takeover defense team should consider whether to meet with the bidder, meanwhile informing the directors and calling a special board meeting to consider the offer. The board has no duty to accept an offer — even one above market price — if it is determined that the offer is not in the best interests of stockholders. In a tender offer, a target company must file a Schedule 14d-9 within 10 business days; otherwise, there should be no public statement other than a "stop-look-and-listen" letter. Stock activity should be monitored closely.

Special Board Meeting to Consider Firm Offer

At the special meeting, management, financial advisors, and legal counsel should give presentations to offer perspective on the decision. The board should be informed:

- Of its fiduciary duties of care and loyalty
- Whether the business judgment rule or enhanced scrutiny will be applicable
- That it must act in good faith and on reasonable basis, with defensive action proportional to the threat posed
- That it has a duty to prevent transfer of control without premium, keeping in mind that a premium over market is not necessarily a fair price
- That, unless *Revlon* duties are present, it has no duty to accept or negotiate an offer

The board may and should consider:

- Anticipated effect on stockholder value of remaining independent and executing strategic plan
- Inadequacy of offer price or structure of the offer
- Other terms, conditions, and contingencies included in the offer
- Timing of the offer
- Risk of nonconsummation or illegality of the offer
- Impact of the offer on constituencies other than stockholders

Strategic alternatives, defenses, and responses for the board to consider include:

- "Just say 'no'" or "just say 'more'" defenses
- Litigation against the bidder
- Proxy fight to keep control of board
- Implementation of additional takeover defenses (e.g., if the company does not have in place a rights plan)
- Strategic divestitures, spin-offs, recapitalizations, stock repurchases, acquisitions, or other actions that decrease likelihood of takeover
- Strategic alliance or "white knight" transaction
- Auction of the company
- Negotiations with the bidder, including a standstill agreement or "greenmail"

Responding to Hedge Fund Activist Approach

Approaches by hedge funds often are private, but can be made public through a Schedule 13D. In the case of a hedge fund or activist attack, the company should assemble its defense team to determine an appropriate response and to develop an investor relations strategy. Also, it should advise the board so it is prepared and call a special meeting if necessary.

Similar to a takeover offer, the company generally has no duties to discuss, negotiate, meet, or disclose information regarding the activist attack. The decision whether to meet with the activist should be made on a case-by-case basis. If the decision is made to meet, the company should consider putting confidentiality and standstill agreements into place.

As always, monitoring stock activity and maintaining contact with large institutional investors and proxy advisory firms is key during this process.

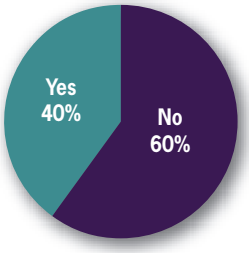
Summary

The rise in hostile M&A and hedge fund activity means that more public companies will need to prepare for and defend against unsolicited offers and activists. While takeover defenses cannot fully protect a company, some tactics can help make a company less vulnerable. However, to be able to effectively respond to these threats, the key is for public companies and their advisors to be prepared in advance.

Please visit **Foley**.com/Fusion for more information or to experience a recording of the "Public Company M&A Environment: Are You Prepared for Potential Hostility? How Do You Respond?" conference.

POLLING QUESTION

Do you believe your organization and board of directors currently have a firm understanding of strategic alternatives available in the event of a hostile M&A bid?



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