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MARKETCHECK

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The Beguiling Appeal of Earn-Outs

> "Circumstances aligned in 2024 for the Delaware courts to provide deal makers with an object lesson in the complexity of drafting earn-out provisions through at least eight different opinions addressing earn-out disputes."

Earn-outs have a beguiling appeal for deal makers as a way of bridging valuation gaps between buyers and sellers. What could be a simpler way to bring parties together who have differing views of a business's prospects than to agree that the seller will receive extra consideration if the business actually achieves the promised performance? An earn-out allows a buyer to tell a seller to put its money where its mouth is. After all, why should a buyer pay for unproven projections? For the seller, the flipside is true. Rather than accept a lower price based on the buyer's assessment of what the business is likely to achieve, why not receive the full value of the business once its prospects are known?

The reality, of course, is more complicated. Circumstances aligned in 2024 for the Delaware courts to provide deal makers with an object lesson in the complexity of drafting earn-out provisions through at least eight different opinions addressing earn-out disputes.[1] Most of these cases involved the pharmaceutical and medical device sector. Earn-outs in this sector are often based on concrete milestones associated with the receipt of necessary regulatory approvals against which achievement of targets can be readily benchmarked due to the significant valuation implications of these approvals or the failure to obtain them. But we see earn-outs, and their public M&A cousin the contingent value right,[2] in many industries.[3] The temptation to bridge valuation gaps with earn-outs is present wherever some unknown future event has significant pricing implications. Use cases include allocating the risk of obtaining regulatory approvals for key future products, the outcome of pending litigation, the ultimate value of noncore assets the parties expect to be divested, or simply the achievement of seller's revenue or earnings targets.

The disputes leading to the spate of cases in Delaware this past year spanned a range of circumstances and provide a flavor of the kinds of disputes that can arise.

Three of the reported decisions arose out of full trials. In *Shareholder Representative Services v. Alexion*,[4] seller prevailed at trial in a dispute over whether certain drug development milestones had been achieved and in its argument that buyer

1. For more detailed information on the percentage of disputed earn-outs, see the chart on page 29 of this issue.
2. "Spike in Contingent Value Rights," *Debevoise & Plimpton MarketCheck*, December 2023, at 16.
3. See page 29 of this issue for more detailed information on the percentage of public target deals that include contingent value rights and the industries in which they are most often utilized. See page 29 of this issue for more detailed information on the use of earn-outs in private target deals.
4. C.A. No. 2020-1069-MTZ (Del. Ch. Sept. 5, 2024).

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had failed to use contractually required efforts to achieve other milestones. *Fortis Advisors*,[5] similarly, involved a bench trial of claims that a buyer of a surgical robot business had not used its contractually agreed-upon efforts to develop the business so that milestones could be met and had instead prioritized development of its own competing product. Seller prevailed and was awarded substantial damages.[6] In *Himawan vs. Cephalon*,[7] the Delaware Court of Chancery issued an opinion after a bench trial finding that buyer had met its contractual efforts obligations to achieve a contested earn-out milestone for a drug it had acquired.

Other cases involved decisions at the more preliminary motion to dismiss stage, where well-pleaded allegations made by the plaintiffs are presumed to be correct for purposes of the determination. The dispute in *Medal v. Beckett Collectibles*[8] arose in connection with the sale of a business that provided a technology solution for the valuation of collectibles and involved seller allegations that an earn-out was improperly not paid by buyer. The Delaware Court of Chancery denied buyer's motion to dismiss, in an opinion that turned on a unique question of contract interpretation relating to the triggers for milestone payments in that transaction. In *WT Representative v. Philips Holdings*,[9] seller's claim partially survived a motion to dismiss in a case addressing, among other claims, whether a benchmark relating to FDA approval of certain stent technology had been achieved. The case involved interpretation of contract language describing the nature of the benchmark and related disputes over whether buyer had acted in bad faith and in violation of its covenants.

In a case involving *Medtronic*,[10] buyer prevailed on a motion to dismiss claims that it had failed to use contractually required efforts to achieve milestones with respect to a "smart insulin pen" product. This victory was driven by a narrowly drafted efforts standard that required buyer only to forbear from actions taken for the "primary purpose of frustrating the payment" of earn-out consideration to seller. In *STX Business Solutions vs. Financial-Information-Technologies*,[11] the dispute related to whether buyer had used appropriate efforts to achieve revenue targets that would have triggered an earn-out payment. As in the *Medtronic* case, the claims were dismissed at the motion to dismiss stage, with the Delaware Court of Chancery holding that the facts pled did not support a finding that a narrowly drafted efforts provision (prohibiting only actions taken in bad faith) had been violated.

What can we learn from these cases, and how do we prevent these kinds of disputes in future transactions?

Every earn-out is at root designed to test whether a particular future event, such as a regulatory approval for a product or an EBITDA target, has been achieved—and to compensate the seller if that happens. So, the first thing parties must agree on is the targets themselves. A number of the Delaware cases this year involved ambiguity in the benchmarks.[12] Drafting these with the necessary precision can be a challenge, particularly when the subject matter is technical. But precision is essential for both parties, particularly for a buyer hoping to prevail on a motion to dismiss. The business teams must be closely involved in drafting these provisions. Ambiguity in benchmark drafting can result in a need for the court to consider parole evidence outside the contract and a more complex dispute resolution process.

5. C.A. No. 2020-0881-LWW (Del. Ch. Sept. 4, 2024).
6. Sellers also raised fraud claims, which survived a motion to dismiss because buyer had not bargained for a "non-reliance" clause protecting it from fraud claims arising out of alleged extra-contractual assurances made in the course of negotiation. See our blurb "Non-Reliance Clauses: Not Just for Sellers Anymore" on page 17 of this issue for additional detail on sellers' fraud claims. *Trifecta Multimedia Holdings, Inc., et al. v. WCG Clinical Services, LLC* C.A. No. 2023-0699-JTL (Del. Ch. June 10, 2024), presented a similar situation.
7. C.A. No. 2018-0075-SG (Del. Ch. April 30, 2024).
8. C.A. No. 2023-0984-VLM (Del. Ch. Aug. 22, 2024).
9. C.A. No. 2024-0170-PRW (Del. Ch. Aug. 16, 2024).
10. C.A. No. 2023-1055-MAA (Del. Ch. July 29, 2024).
11. C.A. No. 2024-0038-JTL (Del. Ch. Oct. 31, 2024).
12. See *Alexion, Philips and Beckett Collectibles, supra*.

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The benchmarks, however, are in some ways the easy part of negotiating an earn-out. Agreeing on an efforts standard can be more challenging. On the one hand, a seller will be naturally suspicious that a buyer will not take the necessary steps to achieve the earn-out benchmarks. A buyer, on the other hand, does not want to have its management of the combined business hamstrung by earn-out covenants.

The cases illustrate many different approaches. The clauses that are most protective of buyers are those that specifically state that buyer may take its own priorities into account without regard for the achievement of the earn-out. Seller often in these cases seeks to bargain for some kind of anti-avoidance language barring buyer from taking action with the purpose of avoiding payment of the earn-out (*see, e.g., Medtronic* and *Financial-Information-Technologies, supra*). Provisions of this kind can work for all parties where incentives are naturally aligned.

A seller, on the other hand, will often prefer a formulation that requires the buyer to use some level of contractually specified efforts to achieve the earn-out benchmarks. Buyers will generally be reluctant to agree to an unfettered efforts obligation and will seek to reserve the right to run their business in a manner that takes into account their overall business interests. Efforts standards therefore typically limit buyer's obligations by some measure of reasonableness. Those standards may be "outward-facing," as in *Alexion*, so that efforts are "measured by what a similarly situated company would do."[13] Or they may be "inward-facing" and refer more directly to the buyer's own past practices as a comparison point for reasonable behavior.

The drafting of these provisions can become quite baroque. In appropriate cases, quantitative metrics (such as specific spending obligations or personnel commitments to a project) can be a helpful way to limit the scope for disputes to which softer "reasonableness" standards are susceptible. Another topic for discussion is whether the buyer may take into account the cost of the earn-out itself in making future business decisions that will affect the payability of the earn-out, such as whether to pursue the acquired technology that is burdened by an earn out over a rival technology.[14]

It is worth noting that remaining silent is usually not the answer: in general, when the parties do not specify any efforts standard in an agreement containing an earn-out, courts will infer a duty of the buyer to use good-faith commercial efforts to achieve the earn-out targets.

In the end, where disputes arise, the parties are agreeing to put themselves at the mercy of a judge. The facts and circumstances nature of the analysis, combined with the fact that a material portion of the purchase price is often on the line, can be a formula for litigation.

Negotiation and client counseling around these standards should take into account the extent to which the payability of a particular earn-out is likely to be demonstrable on bare pleadings at the motion to dismiss stage. The buyer should recognize that, even if it performs its obligations punctiliously, the discovery and trial process create risk and expense that could generate settlement value for a seller claim. Seller, on the other hand, can be expected to argue that the need to undertake a fact-specific analysis of the achievement of benchmarks and buyer's performance of its obligations should not be a reason to give buyer latitude to undermine the premise of the earn-out through neglect or malfeasance.

The fundamental lesson is that there is no such thing as a cookie cutter, "standard" earn-out provision. When an earn-out is necessary to bring the parties together, all involved should enter these arrangements with eyes open and care to minimize the prospects for misunderstanding.

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13. *Alexion*, at 1.
14. As noted in our blurb "Non-Reliance Clauses: Not Just for Sellers Anymore" on page 17 of this issue, buyers should also not lose sight of the importance of obtaining non-reliance waivers from sellers to mitigate the risk of post-closing fraud claims.

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Minimum Tax, Maximum Uncertainty – Navigating the Current State of the Corporate Alternative Minimum Tax

On September 13, 2024, the U.S. Department of Treasury and the Internal Revenue Service released long-awaited proposed regulations on the corporate alternative minimum tax (CAMT), more than two years after the CAMT was created as part of the Inflation Reduction Act of 2022. While taxpayers hoped that the regulation package would fill some of the voluminous gaps that Congress left for implementation, in some ways things are less settled than ever, particularly in the wake of the 2024 elections. Taxpayers looking to nail down their financial and tax reporting for 2024 and to plan for 2025 will need to chart a path without final rules. In addition, corporate taxpayers must consider CAMT implications when engaging in transactions with other corporations or partnerships.

Background of the CAMT and Uncertainty About Its Future

At a high level, CAMT imposes a minimum tax on an "applicable corporation" equal to the excess (if any) of (i) 15% of its "book" income, with certain adjustments (referred to as adjusted financial statement income or AFSI) over (ii) its regular corporate tax for the year. An "applicable corporation" is any regular C corporation with average annual AFSI in excess of $1 billion for any period of three consecutive tax years ending in 2022 or later.

The CAMT also applies to a U.S. corporate subsidiary of a foreign-parent group if the group has over $1 billion and the U.S. subsidiary at least $100 million, in each case, in average AFSI for any period of three consecutive tax years ending in 2022 or later. Neither the $1 billion nor the $100 million threshold is inflation indexed, potentially expanding the number of applicable corporations over time.

The CAMT created an entirely new tax base for large corporate taxpayers that merges accounting and tax concepts and, in some cases, creates new concepts not found in existing accounting and tax rules. The Proposed Regulations lean into the inherent complexity of this new system, requiring numerous adjustments to book and tax calculations to determine whether a company is in scope for CAMT and, if CAMT applies, its CAMT liability.

Certain sections of the Proposed Regulations would apply to tax years ending on September 13, 2024, while other sections apply to tax years ending after the date the final regulations are published, which may not be for some time. While taxpayers may elect to apply provisions of the Proposed Regulations early, anti-cherry-picking rules require taxpayers who do so to apply various other aspects of the Proposed Regulations as well and to ensure that certain affiliates follow along. An early opt-in is effective for each subsequent taxable year until final regulations are published. Affected taxpayers may hesitate to opt in to the rules if the full package contains provisions they dislike, or if they simply cannot assess the full impact of the decision. We suspect that many taxpayers will take a hard look with their advisors at the aspects of the Proposed Regulations they favor and consider whether they could apply them either under the initial notices that preceded the Proposed Regulations or as a reasonable interpretation of the statute without formally opting in to the entire Proposed Regulations as they stand today.

On top of the substantive complexity introduced by the Proposed Regulations, the recent U.S. presidential and congressional elections create significant uncertainty for both the timing and content of final regulations. While a Republican congressional majority conceivably could target the CAMT for outright repeal, given that CAMT resulted from legislation passed only by Democrats in 2022, many observers believe

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that to be an unlikely scenario because removal of CAMT would create unfavorable budget scoring in a reconciliation process. In addition, legislators will be under significant pressure to free up budgetary capacity to extend the tax cuts they enacted in 2017, many of which expire at the end of 2025, to say nothing of other tax priorities on which they campaigned.

Even if the CAMT were left in place, incoming administrations often freeze rulemaking in progress, and finalizing the CAMT guidance easily could be deprioritized to provide more resources to develop new tax legislation for 2025. It is not uncommon for proposed regulations to remain unfinalized for years, even decades. The administration alternatively could choose to overhaul the Proposed Regulations. This backdrop leaves corporations with significant uncertainty in projecting their potential CAMT liability and heightens the potential impact of the choice between applying the Proposed Regulations early or applying the statute without them.

Ownership of Domestic Corporation Stock and Corporate Transactions

Basic Principles

As a general matter, the Proposed Regulations introduce the concept of a CAMT entity (which may be a corporation, partnership or trust) that holds stock in a domestic corporation that is not part of the CAMT entity's tax consolidated group. A CAMT entity excludes from its AFSI any amount included in its financial statement income (FSI) that results from merely holding the stock (e.g., mark-to-market adjustments or income inclusions attributable to the application of the equity method with respect to the stock). However, a CAMT entity generally is required to take into account transactions that involve other domestic corporations, such as distributions on stock as well as gain (or loss) from the sale or dispositions of the stock.

M&A transactions can result in realized gain or loss for accounting purposes while qualifying for tax deferral under the regular tax system. The Proposed Regulations generally provide for different CAMT treatment for transactions that would be fully tax-free (Covered Nonrecognition Transactions) under the regular tax system and transactions that would not (Covered Recognition Transactions). In determining the CAMT consequences of these transactions, the Proposed Regulations create "shadow" concepts of CAMT inputs (including CAMT basis and retained earnings) that must be separately tracked and taken into account by taxpayers, which draw from U.S. tax principles but use values derived from FSI.

Covered Recognition Transactions

In general, the consequences of Covered Recognition Transactions under the Proposed Regulations are determined using financial accounting principles, but with CAMT inputs in lieu of financial accounting inputs.

For a taxable stock sale, the Proposed Regulations provide that a seller will have AFSI gain (or loss) determined using CAMT basis, and an acquiror will take CAMT basis in the acquired stock equal to AFS basis (i.e., fair value). Any purchase accounting or push down adjustments, where the assets of a target and its subsidiaries would be marked to fair value for FSI purposes, will be disregarded for CAMT purposes (preserving any built-in gain in target assets, resulting in increased AFSI in a subsequent asset sale to match taxable income).

With respect to a taxable asset sale, a seller will have asset gain (or loss) determined using CAMT basis, and an acquiror will take CAMT basis in the assets equal to adjusted financial statement basis (i.e., fair value). It is worth noting that a taxable stock sale with a Section 338(h)(10) election is treated as a deemed asset sale for CAMT purposes, as is the case under regular tax rules. The target corporation determines AFSI using regular tax principles but with CAMT inputs.

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Covered Nonrecognition Transactions

In general, the consequences of Covered Nonrecognition Transactions are determined using regular tax principles (and not financial accounting principles) but use CAMT inputs in lieu of regular tax inputs.

The Proposed Regulations provide for the nontaxability of Covered Nonrecognition Transactions (e.g., reorganizations, spin-offs, split-offs, formations and liquidations) that qualify in whole for nonrecognition treatment for regular tax purposes and that do not result in the recognition of any amount of gain (or loss) for CAMT purposes. However, if a transaction results in the recognition of any amount of gain or loss for regular tax purposes, a "cliff effect" would prevent the transaction from qualifying as a Covered Nonrecognition Transaction and would instead treat the transaction as taxable for CAMT purposes. The "cliff effect" does not apply if a distributing corporation that receives "boot" (property or other money) in a spin-off or split-off from the spun-off corporation distributes all of the boot to its shareholders and securityholders in a tax-free "boot purge," thereby preserving nonrecognition treatment for CAMT purposes.

In determining whether a transaction is a Covered Recognition Transaction or Covered Nonrecognition Transaction, each component of the transaction is examined separately. The impact of taxable gain (or loss) in a transaction component that fails to be a Covered Nonrecognition Transaction can have very different impacts depending on the type of transaction. For example, for shareholders in a reorganization (such as a "Type A merger"), AFSI will be recognized based on general tax principles, such that the receipt of $10 of boot generates $10 of AFSI. However, in other cases, such as a spin-off where boot is not purged completely in a tax-free manner, AFSI will be computed on financial accounting principles, which can result in outsized gain in comparison to what would have typically occurred under regular tax principles. Thus the "cliff effect" is relevant for certain nonrecognition transactions (in particular certain asset contributions and transfers), substantially raising the stakes of the application of the technical reorganization rules. It is important for companies evaluating an M&A transaction to consider the implications under CAMT in addition to the regular tax system to avoid unwelcome surprises.

Investments in Partnerships

Adjustments to a Partner's AFSI

The CAMT rules provide that the AFSI of a partner in a partnership is adjusted so that it takes into account only the partner's distributive share of the partnership's AFSI. The Proposed Regulations take a "bottom-up" approach in implementing this rule, which generally requires a CAMT entity partner to remove from its AFSI any amount on its AFS attributable to its interest in the partnership and compute its AFSI adjustment starting with the AFSI determination at the partnership level. This approach would require each partnership in a tiered-partnership structure to determine the distributive share of each CAMT entity partner in the tiered-partnership chain. The exact methodology has been heavily criticized as a counterintuitive approach that can lead to results such as partner shares that do not add up to 100% or even a single partner having an AFSI pickup greater than the entire partnership's FSI.

The Proposed Regulations would also impose far-reaching reporting and filing requirements on both CAMT entity partners and partnerships. Each CAMT entity partner generally is required to request information from the partnership to determine its share of AFSI, and partnerships are required to provide the information. These obligations will likely be a significant point of negotiation with third-party investment partnerships.

Contributions to and Distributions from Partnerships

Under regular tax principles, partners can contribute property with a built-in gain or loss to

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partnerships without recognizing gain or loss and partnerships can distribute property to its partners without recognizing gain or loss. By contrast, the accounting treatment of a contribution or distribution generally triggers gain or loss.

For CAMT purposes, the Proposed Regulations would not follow the tax or accounting approach and would instead create a new "deferred sale" regime that requires partnerships and partners to take into account gain or loss ratably over a recovery period. The deferred sale rules are intended to align the CAMT and regular income tax profile of the transaction, though the closeness of the match will depend on the income tax elections made.

Conclusion

Corporate taxpayers should take particular care when pricing, diligencing and structuring potential transactions with other corporations or partnerships. For example, buyers that are not currently subject to CAMT should analyze whether they will become subject to CAMT as a result of an acquisition increasing their size, while sellers will need to model any CAMT consequences of the disposition, particularly in transactions that are expected to be largely tax-free. A company considering opting into the Proposed Regulations early may need to model recent and upcoming transactions under both these rules and under prior guidance to determine the best course of action. All taxpayers subject to CAMT will need to work closely with their tax return preparers and advisors to stake out reasonable positions where the current state of the law or the Proposed Regulations (or both) are unclear.

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> “…by preparing Phase Is early in the deal process, the seller should have sufficient time to research and evaluate any identified issues, quantify the remediation costs and identify any information that would mitigate the identified risks.”

Environmental Considerations: Six Steps to Safely Divest a Business Unit

Public companies seeking to divest business units are finding that buyers are increasingly concerned about environmental risks that carry with them legal, reputational and financial challenges. Whether it be contamination issues, allegations of noncompliance, high-profile claims, liabilities related to per- and polyfluoroalkyl substances (PFAS) or some other environmental concern, buyers are conducting more comprehensive environmental due diligence and seeking indemnification for identified issues.

Here are six steps public companies can take to anticipate and address potential buyer concerns:

Consider a Sell-Side Phase I. A seller might consider retaining an environmental consultant to prepare Phase I environmental site assessments for the business unit facilities that are likely to pose environmental risks, such as those conducting manufacturing or other chemically intensive operations. Sell-side Phase Is help bidders assess potential contamination concerns relatively quickly and factor any identified risks into their bids. A Phase I generally consists of a site inspection, interviews with facility and other knowledgeable personnel, a review of historical records and environmental documentation and searches of certain environmental databases. They do not include any drilling or sampling activities. Phase Is can usually be completed in only a few weeks, providing sufficient time for a seller to comment on draft reports and for the bidders to review final reports, even in a compressed deal time frame.

Although Phase Is can be conducted confidentially and with minimal disruption to the business, sellers may fear that a Phase I will uncover issues that could jeopardize the sale or warrant buyer requests for indemnification. However, by preparing Phase Is early in the deal process, the seller should have sufficient time to research and evaluate any identified issues, quantify the remediation costs and identify any information that would mitigate the identified risks.

In cases where sell-side Phase Is are not made available for facilities with chemically intensive operations, bidders may be more likely to seek indemnification for pre-closing environmental issues or commission their own Phase Is. Buy-side Phase Is are more likely to result in buyer requests for indemnification, as consultants working for the buyer are more likely to misidentify an issue (in contrast to sell-side reports, which are often

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reviewed for accuracy by facility personnel). In addition, consultants preparing buy-side reports are likely to take a more expansive view in identifying potential issues.

Sell-side Phase Is will not make sense for every deal, such as where there is only one bidder and that bidder has made clear it intends to commission its own Phase Is. Similarly, there may be timing issues or other deal dynamics that undermine the utility of sell-side reports. Nonetheless, the seller should weigh the pros and cons of sell-side Phase Is as early as possible in the deal process to help best position itself with a buyer.

Evaluate Environmental Risks. Prior to opening a data room to bidders, the seller should conduct its own high-level review of the business unit's environmental issues, working with its environmental personnel and any third-party advisors to review all environmental documents being made available to bidders. Armed with this information, the seller will be better prepared to address any issues raised by bidders and head off requests for indemnification, rather than left scrambling to respond late in the bidding process.

Resolve Noncompliance Issues. The seller should resolve environmental noncompliance issues that can be addressed with minimal cost and disruption, such as obtaining missing environmental permits and authorizations. Doing so can help avoid a situation where bidders overstate the costs for resolving the noncompliance issues and either factor those costs into their bids or seek indemnification protection.

Get Organized. A well-organized data room can help demonstrate to bidders that the business unit has its environmental house in order. The data room should contain any site assessments, investigation and remediation studies, closure letters, permits, claims-related and compliance documentation, notices of violations and information concerning environmental reserves and capital expenditures. The seller should consider how to most effectively organize the documents in the data room so that bidders and their environmental advisors can easily digest available information. Where the data room contains voluminous documentation concerning a particular issue, such as multiple investigation and remediation reports addressing site contamination, the seller can facilitate a bidder's review by including in the data room a summary of the issue as well as a status update.

Prepare for a Site Visit. Before a bidder's environmental consultant visits a target facility (*e.g.*, in connection with a Phase I), the facility should mitigate overt environmental concerns by cleaning minor spills, eliminating petroleum and chemical odors and removing accumulated waste, among other things. Addressing such issues may appear superficial, but failing to do so can create the impression that more significant environmental concerns are lurking.

Evaluate PFAS Issues. Liabilities associated with PFAS are raising red flags for many financial sponsors and strategic acquirers, with some walking away from deals or seeking indemnification for such issues. PFAS, a class of chemicals used in products such as medical devices, cookware, clothing, cosmetics, furniture and firefighting foam due to their resistance to water, oil and heat, are known as "forever chemicals" because of their inability to break down in the human body and the environment.

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High-profile lawsuits have been filed against companies alleging adverse health effects, obligations to remediate contamination or other damages resulting from the presence or release of, or exposure to, PFAS. In addition, some federal and state authorities have begun regulating the manufacturing, distribution, sale and use of products containing PFAS.

As a result of the PFAS litigation and the increasing regulation of PFAS, bidders are conducting comprehensive due diligence of PFAS-related risks. Sellers should be prepared to respond to PFAS-related questions or concerns that a bidder may raise. Sellers should gather available information about any PFAS used or contained in products sold by the business unit. Sellers will also need to identify any PFAS-related claims made by regulatory authorities or private parties and any insurance policies covering such claims. Finally, sellers should evaluate how any PFAS-related risks are allocated among its suppliers and customers.

The blueprint above can help sellers better position themselves to sell business units to financial sponsors and strategic buyers concerned about environmental risks. As every deal has its own dynamics, certain actions may not be warranted. Nonetheless, the sooner a seller considers the steps outlined above, the better position it will be in to address potential buyer concerns about environmental risks.

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Five Top-of-Mind Thoughts for Public Company M&A in 2025

The outcome of the 2024 election may lead to significant changes, as the Republican party takes control of the White House and the U.S. Senate, and maintains its majority in the U.S. House of Representatives. With the inauguration set to occur later this month, below are five ways in which a Republican-controlled federal government could affect public company M&A in 2025.

1. **Regulatory Environment.** Conventional wisdom holds that the incoming Republican administration should present a more favorable regulatory environment for M&A, setting the stage for big mergers in the media space and more transactions in sectors that in recent years have attracted close antitrust scrutiny, such as health care and technology.

   It's unlikely, however, that there will be smooth sailing for all. CFIUS will likely continue to be a meaningful obstacle to inbound M&A from China and other disfavored jurisdictions, and it could become a tool to extract trade concessions by threatening to block transactions involving jurisdictions and industries that are subject to tariffs in the new administration. Further, federal antitrust enforcement may become more idiosyncratic, with transactions being investigated, or even sought to be blocked, based on political factors.

   Cross-border deals may also face challenges. To the extent the U.S. pursues protectionist trade policies and steps up CFIUS enforcement, regulators in jurisdictions perceiving themselves as being targeted by such policies are likely to be less hospitable to inbound M&A from the U.S. Additionally, the recent Outbound Investment Rule restricting U.S. investment in certain Chinese industries became effective at the beginning of the new year. While the resulting uncertainty may chill U.S. outbound M&A activity, it probably will not translate into a reduction in overall M&A volume. We expect companies to continue to look to domestic M&A to fuel growth that cannot be obtained organically and, in some cases, to reduce dependency on foreign suppliers.

2. **ESG.** The pervasive anti-ESG backlash will likely continue and intensify in the coming year. Companies will need to be able to justify their "social" programs by drawing a direct connection to the bottom line. Such programs, including diversity efforts, should become a focus of M&A due diligence, so that acquiring companies do not step unaware into DEI beartraps.

3. **Activism.** Many commentators forecast increased levels of shareholder activism.[1] Their thesis likely depends on an overall improvement in the M&A market (perennially the most common objective of activists), perhaps as well as a less robust enforcement environment for Section 13 disclosure deficiencies and HSR filing infractions. If the M&A market improves, in addition to more activism overall, we could expect a resurgence of "bumpitrage," in which activists seek to block negotiated transactions to extract higher purchase prices.

4. **AI Governance.** Artificial intelligence capabilities are likely to continue to advance rapidly in 2025, but the technology as it

1. For a survey of trends in recent activist campaign settlements, refer to our article, "Surveying Recent Activist Campaign Settlements," starting on page 13 of this issue.

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exists today presents many companies with opportunities and risks. Boards of companies affected by AI should focus on appropriate governance and risk management frameworks, as they face an increasingly complex compliance and disclosure landscape. AI is likely to stimulate M&A, including acquisitions of AI native companies and transactions catalyzed by the disruptive effect of the technology in certain sectors. Effective due diligence in this context is key. Many boards will need to improve their familiarity with the evolving AI landscape and its potential business impact.[2]

5. **Tax Changes.** By design, important tax cuts enacted in the 2017 Tax Cuts and Jobs Act will expire in 2026, which would increase individual tax rates and reduce the standard deduction and child credits and the gift and estate tax exemption. Congressional Republicans intend to use budget reconciliation procedures to extend these tax cuts. As one way of offsetting the cost, Congress may seek to increase the current 1% excise tax on stock repurchases by public companies. Because that tax applies to share purchases funded with borrowings based on the target's balance sheet in connection with M&A transactions, a meaningful increase in the tax rate could cool private equity interest in going private transactions, which typically involve significant acquisition leverage. The buyback tax also applies to cash or other taxable consideration in tax-free reorganizations and so would also increase the cost of these transactions

2. For a more detailed overview of AI considerations for boards of directors, see our blurb "AI Checklist for Boards" on page 18 of this issue.

Author

William D. Regner
Partner

> “These recent campaigns also underscore the importance of routinely evaluating company leadership and whether refreshment of the board is appropriate.”

Surveying Recent Activist Campaign Settlements

I. Activism in 2024

Shareholder activism surged to the second highest level on record, with 243 campaigns being brought globally in 2024.[1] This increase does not merely reflect a return to an earlier level of activity: the activity in 2024 represents a 17% increase over the average of activity for the years 2020-2023, and 2022-2024 has been the busiest three-year period on record.[2] The number of activist campaigns in the United States increased 6% in 2024 as compared to 2023. In Asia, the increase was 83%, with Japanese campaigns driving this trend.[3] The top three stated campaign objectives globally in 2024 were mergers and acquisitions (43%), board changes (31%) and capital return (23%), which is largely consistent with recent years.[4] Roughly half of the M&A campaigns in 2024 advocated for a sale of the entire company over a divestiture/break-up strategy.[5] There was also an increase in investor focus on operational and strategic improvements, with 22% of campaigns stating that this was the primary goal.[6] Despite all of this activist activity, many of the campaigns that develop into proxy fights are still settled or withdrawn.[7] In 2024, approximately a quarter of proxy fights in the U.S. were settled.[8]

II. Director Appointments in Settlement Agreements

Regardless of the activist's primary campaign objective, the majority of settlement agreements entitle the activist to appoint one or more directors to a target company's board.[9,10] An activist may also seek an agreement from the company to cap the size of the board through the next meeting in an effort to preserve its agreed level of influence over the board. Target companies are often successful

1. “2024 Review of Shareholder Activism”, Barclays Shareholder Advisory Group.
2. *Ibid.*
3. *Ibid.*
4. *Ibid.*
5. *Ibid.*
6. *Ibid.*
7. Factset data of U.S. proxy fights as of December 31, 2024. For a visual depiction of this data, please see the Charts section of this issue starting on page 28.
8. *Ibid.*
9. Camila Panama and Alexander Dussault, *2023 Activism Recap*, https://bit.ly/3VoJ1Kb, (March 11, 2024).
10. From 2019 through 2023, 81% of U.S. activist campaigns featuring a board representation demand settled rather than going to a vote. Please see the Charts section of this issue starting on page 28. “Shareholder Activism Annual Review 2024”, Diligent, 2024, https://learn.diligent.com/rs/946-AVX-095/images/Shareholder_Activism_2024.pdf?version=0.

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in requiring that the activist hold some minimum number of company shares in order to maintain board representation.

The background and experience of new director appointees can vary. Early activist campaigns often sought to appoint investment professionals from the activist's own shop, but the activist playbook has generally evolved to also seek appointments of credentialed independent directors from outside their own shop. In some instances, an activist has nominated experts with decades of relevant industry experience to serve as a director; in others, an activist may identify a qualified C-suite-level executive from an adjacent or complementary industry to serve. Regardless of an appointee's credentials, appointments to the board are typically conditioned upon the target company's receipt of satisfactory information regarding each new director.

When an activist's investment professional is named a director of the target, it is common for the settlement agreement to address information sharing between the director and the activist fund. Many settlement agreements require that the activist-backed directors, including those employed by the activist firm, be bound by the same confidentiality, conflicts of interest, related party transactions, fiduciary duties, codes of conduct, trading and disclosure policies as other directors, which often means that non-public information sharing with the activist firm is not permitted. In other settlement agreements, information sharing between the activist-backed directors and the activist is expressly permitted but only after a confidentiality agreement between the activist and the target company is in place.

III. Recent Activist Case Studies

In 2024, three high-profile activist campaigns settled with multiple director appointments for the activists, revealing important lessons for companies dealing with activist investors.

a. Southwest's Strategic Struggles Spur Elliott to Action

Southwest Airlines, known for its economy only, free bag check and first-come first-served seating, has faced challenges from two Elliotts in recent years. In late December 2022, Winter Storm Elliott overwhelmed Southwest's systems, causing the airline to cancel almost 17,000 flights over a 72-hour period that coincided with peak holiday travel. The incident cost Southwest Airlines approximately $1.2 billion, which included a record $140 million fine paid to the U.S. Department of Transportation. And then, between April and July 2024, Elliott Investment Management, the most active activist hedge fund in 2024,[12] quietly amassed ownership of a roughly 11% stake in Southwest. Elliott claimed that Southwest's leadership was too entrenched to make the necessary strategic changes and had failed to modernize the company's technology, contributing to the flight cancellations in 2022. Elliott sought to oust Southwest's CEO, Bob Jordan, and its executive chairman, Gary Kelly, a 40-year veteran of the airline who had previously served as CEO.

Southwest's board stood by its CEO and took steps to counter Elliott's campaign. On July 3, Southwest's board adopted a "poison pill" that would be triggered upon a stockholder acquiring more than 12.5% of the airline's stock to prevent Elliott from increasing its stake after the expiration of the waiting period of its HSR filing. On September 24, the airline also announced a new strategic plan to sell premium seating and enhance operational efficiency with assigned seating and a structured boarding process. Finally, the Southwest board proposed a settlement framework, under which the board would interview potential Elliott candidates and appoint up to three to a 13-person board, down from 15, that would be further reduced to 12 following Gary Kelly's planned retirement after the 2025 stockholders meeting. However, Elliott was

11. "Southwest hit by record $140 million fine for holiday service meltdown in 2022", Pete Muntean and Chris Isidore, CNN (December 18, 2023) https://www.cnn.com/2023/12/18/business/southwest-fine-canceled-flights/index.html.
12. "2024 Review of Shareholder Activism", Barclays Shareholder Advisory Group.

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not appeased and exercised its right as a stockholder to call a special meeting to remove eight then-current Southwest directors, including Gary Kelly, and elect in their stead eight Elliott-nominated directors to Southwest's 15-member board. To promote its slate of director nominees, Elliott produced and released a podcast available on Apple, Spotify and YouTube featuring an interview with its dissident director nominees. Nine days later, on October 23, 2024, Southwest signed a cooperation agreement with Elliott, which withdrew its request for a special meeting. As part of the settlement, the airline agreed to appoint five Elliott nominees to the board, appoint an additional new independent director and keep the board at the current 15-member size with Kelly resigning in November 2024 instead of the next spring. Bob Jordan kept his job as CEO of the airline, reporting to a reconstituted board. The board will be reduced to 13 members after Southwest's 2025 annual shareholder meeting.

b. Operational Weaknesses Lead to Proxy Fight at Norfolk Southern

In February 2023, a Norfolk Southern freight train derailed, resulting in a hazardous chemical spill in East Palestine, Ohio, which Norfolk Southern estimates will cost more than $1 billion to address and remediate. In the wake of that costly accident, Ancora Holdings, an activist hedge fund, waged a proxy fight that sought to (i) elect seven Ancora-nominated directors to the 13-member Norfolk Southern board and (ii) oust Norfolk Southern's CEO. Ancora notched the recommendations of ISS for five of its nominees (and ISS recommended that shareholders withhold support from five of Norfolk Southern's slate, including the chairman, who had a decade-long tenure on the board) and of Glass Lewis for six of its nominees. The Ancora nominees backed by ISS and Glass Lewis had decades of experience in transportation and the railroad industry, except for John Kasich Jr., the former governor of Ohio and presidential candidate. Ultimately, Ancora, owning just 0.3% of Norfolk Southern common stock on the record date for the 2024 annual meeting, won three of the 13 board seats on the Norfolk Southern board at the 2024 annual meeting, but failed to replace the CEO. Ancora Holdings and Norfolk Southern subsequently entered into a settlement agreement on November 13, 2024 pursuant to which Norfolk Southern agreed to (i) expand the board by one director and to work with Ancora to mutually agree on a new independent director candidate to fill the seat and (ii) support the election of the three Ancora-backed directors elected at the 2024 annual meeting at the 2025 annual meeting.

c. Financial Underperformance Attracts Activist at CVS

CVS Health Corporation has struggled with its financial performance following its $69 billion acquisition of Aetna in 2018. The strategic rationale for the acquisition was that it would help CVS expand and diversify its business in the face of mounting pressure from rival retailers and online pharmacies. However, since that acquisition, CVS has repeatedly cut its forecasts and fallen far short of analyst estimates. Since the start of 2024, CVS's stock price has fallen 27%, attracting various activists like Sachem Head Capital Management LP, Third Point LLC and Glenview Capital Management LLC to take up positions and increase those stakes during the third quarter. According to the Wall Street Journal, representatives of Glenview, a healthcare-focused fund with a "constructivist" track record, met privately with CVS executives to propose strategic improvements short of a breakup of the conglomerate. On November 18, 2024, following several weeks of behind-the-scenes engagement between Glenview and CVS executives, CVS agreed to (i) expand CVS's 12-person board of directors to 16 directors, (ii) appoint three new independent directors with relevant healthcare experience to the CVS board, (iii) appoint Glenview's founder to the CVS board and (iv) replace CVS's existing Chief Executive Officer.[13]

13. 27 CEO resignations occurred in 2024, up from the previous four-year average of 16. "2024 Review of Shareholder Activism", Barclays Shareholder Advisory Group.

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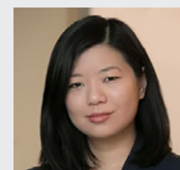
IV. Lessons Learned from Recent Activist Case Studies

These campaigns demonstrate that poor financial performance, particularly if it is disproportionate to that of peers, can provide activist investors with leverage over a leadership team. Underperformance puts management in a defensive posture at the start and increases the likelihood that other stockholders will back an activist's alternate vision of corporate leadership and strategy. When headwinds arise, company leadership should not only formulate a strategy to confront those headwinds but engage with shareholders even before an activist focuses attention on them. That is why it is important to have in place a well-functioning investor relations team that can deftly and nimbly articulate a clear vision in response to a campaign. Furthermore, a consistent track record of shareholder engagement can increase shareholder confidence in management and the board and provide a private outlet for shareholder feedback.

These recent campaigns also underscore the importance of routinely evaluating company leadership and whether refreshment of the board is appropriate. Long-tenured directors and CEOs have been described as being more resistant to change or lacking skills to confront the company's current challenges and opportunities. In the Southwest Airlines proxy fight, Elliott's campaign resulted in the resignation of six Southwest directors with an average tenure of over 14 years, while seven incumbent directors with an average tenure of under three years continued to serve post-settlement.[14] Some practitioners have suggested that the Universal Proxy rules have also encouraged a more surgical approach by activists, targeting fewer entrenched directors but at a higher success rate.[15] According to Spencer Stuart's 2024 U.S. Board Index, the average tenure of independent directors has ticked down 7% to 7.8 years from the average tenure ten years ago. Codifying the view that long-tenured directors are entrenched, corporate governance codes in various countries such as France, Singapore, Spain and the U.K. provide that a director is no longer independent after board service of between nine and twelve years. If these trends continue, boards would be remiss not to routinely evaluate their composition to confirm their members have an appropriate mix of skills and experience relevant to the company's current circumstances.

14. See also the March 2024 settlement between Ventas and Land & Building Investment Management (L&B). L&B's campaign against Ventas focused on director James D. Shelton, who had spent sixteen years as a director at the company. L&B was later successful in replacing Shelton, who resigned on the same day the settlement agreement was reached.
15. The average number of seats won by activist investors in U.S. public campaigns dropped to 1.9 in 2023 and 1.8 in the first half of 2024, which is a decrease from the average number of seats won in public settlements in 2020 to 2022, which ranged from 2.4-3.2. Pat Tucker et al., *What Settlement Data Says About the Evolution of Activism*, https://bit.ly/3Z3OpEl (July 15, 2024). However, activists won nearly 80% of U.S. board seats demanded, up from 66% historically. Andrew Freedman, *Shareholder Activism – 2024 Mid-Year Review*, https://bit.ly/49s0BTC (June 17, 2024) (citing "Q1 2024 Review of Shareholder Activism", https://corpgov.law.harvard.edu/2024/04/22/q1-2024-review-of-shareholder-activism/).

Authors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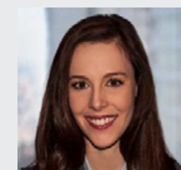
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The Blurbs

Non-Reliance Clauses: Not Just for Sellers Anymore

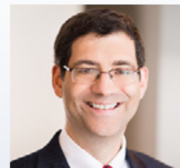
To avoid M&A-related fraud claims—which are relatively easy to plead and notoriously difficult to defeat at the motion to dismiss stage—it has become customary practice in M&A transactions for sellers to require buyers to disclaim reliance on any representations or warranties or other statements made outside the four corners of the purchase agreement. Because reliance is an element of a cause of action for fraud, disclaiming reliance is tantamount to waiving any future claim for fraud based on statements made outside of the purchase agreement.

Unlike sellers, buyers tend to be less inclined to require a reciprocal non-reliance provision, especially in cash deals, on the theory that once the deal is closed and sellers have been paid, a post-closing fraud claim against buyer is highly unlikely. While buyers do often include reciprocal non-reliance provisions in stock-for-stock deals, the recent decision from the Delaware Court of Chancery in the *Fortis* case[1] should serve as a stark reminder that buyers ought to consider requiring reciprocal non-reliance clauses in other contexts as well, particularly in transactions with earn-outs or contingent value rights.

The *Fortis* dispute arose from a buyer's acquisition of Aulis, a developer of surgical robots, for $3.4 billion in upfront cash and up to another $2.35 billion upon the achievement of eight different milestones. The bulk of the case involved breach of contract claims, but plaintiffs (in this case, the sellers) also claimed that the buyer engaged in fraud.[2] Plaintiffs' fraud claims focused on alleged statements made by the buyer (outside of the purchase agreement) regarding its development plan for the robots and its "light touch" integration process, and statements by the buyer that it was "highly certain" that at least one of the milestones would be achieved. Plaintiffs argued that they had entered into the merger agreement in part on the strength of these statements. Defendant countered that the merger agreement contained a standard integration clause which barred a fraud claim based on any statements outside of those contained in the purchase agreement. The court reminded the defendant, however, that the general rule in Delaware is that "integration clauses do not operate to bar fraud claims based on factual statements not made in the written agreement." To do that, you need a robust non-reliance provision (i.e., a statement that you are disclaiming reliance on any statements other than those contained in the purchase agreement). Here, the buyer did disclaim reliance, but there was no reciprocal disclaimer from the sellers. Thus, the plaintiffs were free to pursue their fraud claim. The court ultimately awarded plaintiffs more than $1 billion in damages, highlighting the importance of including a disclaimer in the purchase agreement by ***sellers*** of reliance on statements not memorialized in the agreement itself, particularly in transactions where the parties are expected to have an ongoing relationship post-closing.

1. C.A. No. 2020-0881-LWW (Del. Ch. Sept. 4, 2024).
2. This blurb focuses specifically on the claims of fraud in the *Fortis* decision and related reminders regarding the potential need for reciprocal non-reliance clauses. For a more detailed discussion of the breach of contract claims in the *Fortis* decision and other relevant litigation addressing earn-out disputes, see our article "The Beguiling Appeal of Earn-Outs" starting on page 1 of this issue.

Author



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AI Checklist for Boards

As artificial intelligence continues to reshape businesses and industries, boards of directors have an important duty of oversight to ensure that AI initiatives are aligned with the company's best interests and adequately managed to mitigate risks. The significance of the board's duty of oversight with respect to AI depends on the importance of AI to the company's business. AI's potential impact is multi-faceted and context dependent. It can represent opportunities or threats to many technology companies, enhance innovation in fields such as pharmaceuticals, materials science and education, and unlock greater efficiency and effectiveness in business functions such as customer service and sales and marketing.

The following checklist provides general guidance for boards in the context of a company's particular circumstances.

1. **Establish a clear oversight structure for AI.** Assign responsibility for AI oversight to the full board or a committee, recognizing that full board consideration and monitoring of rapidly evolving and potentially strategically significant topics such as AI can be beneficial.

2. **Ensure an appropriate level of AI expertise and education on the board.** Depending on the importance of AI to the business, consider recruiting at least one board member with AI expertise and providing ongoing AI training to all board members, and consider discussing the board's AI qualifications and approach to AI in the company's proxy statement.

3. **Ensure the company has a comprehensive AI governance framework.** Hold management accountable for developing and executing AI programs and policies covering key areas such as vendor management, quality control, incident response, and data governance. Consider governance frameworks of industry regulatory bodies if applicable.

4. **Identify company-specific risks and ensure ongoing monitoring.** Identify company-specific risks posed by AI, such as breaches of confidentiality, privacy violations, biases, and inaccuracies, and require management to conduct periodic AI risk assessments. In regulated industries such as healthcare, insurance and finance, AI may handle sensitive data, raising significant privacy, confidentiality and compliance concerns. Ensure SEC, website and other disclosures are current and consistent with the company's identified risk profile.

5. **Remain current regarding regulatory developments.** Ensure the company is monitoring the evolving regulatory landscape for AI, including international, state, and local regulations, as well as the social and ethical implications of AI, such as privacy, discrimination, and environmental impact.

6. **Ensure senior management responsibility for AI.** Assess whether a senior executive or management committee should be responsible for AI risk and regulatory compliance to ensure clear accountability and oversight at the management level.

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7. **Be alert to the risk of "AI washing."** It is important that a company's public disclosure does not overstate the degree to which it is using or may benefit from AI. The SEC has brought multiple enforcement actions focusing on allegedly exaggerated disclosures about AI capabilities.

8. **Prepare for AI-related crises.** Ensure the company has developed a crisis response plan for AI-related incidents, covering incident reporting, internal investigations, stakeholder communications and post-crisis recovery. Addressing AI- and cyber-related crises promptly and effectively is crucial for minimizing damage.

9. **Document AI oversight activities.** Record the board's AI oversight activities and management's compliance efforts in board minutes and supporting materials, demonstrating the board's diligence and engagement in AI governance and compliance.

10. **Coordinate AI and cybersecurity risk management.** Many AI initiatives present increased cybersecurity risk for the company. It is important for the board to ensure that management properly considers and addresses the cybersecurity risks associated with the company's adoption of AI.

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Industry Updates

California Governor Vetoes Controversial Bill Restricting Private Healthcare Investments

On September 28, 2024, California Governor Gavin Newsom vetoed Assembly Bill 3129, a proposed law aimed at increasing oversight of private equity and hedge fund investments in the state's healthcare sector. The bill, introduced by Assemblymember Jim Wood and approved by the full legislature, would have (i) required PE companies and hedge funds to notify and obtain written consent from the California Attorney General at least 90 days before making certain healthcare investments and (ii) imposed restrictions on management relationships between PE or hedge fund-backed management services organizations and physician/dental practices.

In his veto message, Governor Newsom cited concerns regarding the redundancy of the bill, given the California Office of Health Care Affordability's (OHCA) extant authority to review and evaluate healthcare transactions. Although Governor Newsom acknowledged that OHCA cannot block transactions, he emphasized that OHCA has the authority to refer transactions to other entities, including the AG, for further review. The Governor's veto aimed to streamline the regulatory process and avoid duplication of efforts, reinforcing OHCA's role as the primary authority on healthcare transactions in the state.

Reactions to the Governor's veto decision have been mixed. Advocacy groups and some lawmakers warned that a lack of strong oversight could worsen healthcare affordability and access. These include the bill's author, who expressed concern that OHCA's current authority is insufficient to prevent harmful healthcare consolidation. Conversely, PE firms and healthcare providers lauded the veto as a win that could prevent unnecessary delays and uncertainty in healthcare transactions.

Concerned AB 3129 would discourage private funding of healthcare investments in the state, lobbying efforts from affected stakeholders, including the California Hospital Association, resulted in the bill's contents being diluted a mere two weeks before the bill landed on the Governor's desk—specifically, the State Senate amended the notice and consent provisions to expressly exempt hospital acquisitions.

Where the issue goes from here is not clear. Assemblymember Wood, who has long been the California legislature's anti-consolidation stalwart, is not seeking reelection and finished out his term in December 2024. It is unknown whether the bill's co-sponsor, Senator Melissa Hurtado, will take up Assemblymember Wood's cause in the 2025 legislative session.

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On a national scale, concerns over the impact of consolidation and private investment in healthcare continue to grow. Several states—including Connecticut, Illinois, Indiana, Massachusetts, Minnesota, Nevada, New York, Oregon, Pennsylvania and Washington—have passed or proposed laws requiring pre-transaction notice or approval for healthcare mergers and acquisitions. Most recently, on December 30, 2024, the Massachusetts legislature passed House Bill 5159 (HB 5159), which, among other things, significantly broadens the extant oversight authority of the Health Policy Commission (HPC) over the activities of "significant equity investors," which term includes any private equity company with a financial interest in a provider, provider organization, or management services organization (MSO). Time will tell whether more governors will, like Governor Newsom, find reasons to veto these sorts of bills, or whether states' interests in regulating relatively minor transactions may wane as they continue to evaluate the expense and infrastructure required to facilitate overbroad pre-transaction review processes.

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National Security Comes for Healthcare: Update on the BIOSECURE Act

On September 9, 2024, the U.S. House of Representatives passed the latest version of the BIOSECURE Act (the Act), which is an ongoing effort by Congress to address concerns that the nation's healthcare industry and related supply chains face growing risks from commercial relationships with certain Chinese companies, particularly related to perceived efforts by the Chinese government to "dominate" the biotechnology industry and concerns that health and genetic data of U.S. individuals held by private Chinese companies may be provided to the Chinese government without consent.[1]

The Act would address these concerns through restrictions on the freedom of federal agencies to (i) procure or obtain "biotechnology equipment or services" from certain "biotechnology companies of concern" or (ii) enter into any contract that would require use of biotechnology equipment or services produced or provided by such companies. The restrictions would also extend to loans and grants provided by federal agencies – such funds could not be used for any purpose subject to the procurement and contracting restrictions just noted.

The Act names BGI, MGI, Complete Genomics, WuXi Apptec Inc. and WuXi Biologics as "biotechnology companies of concern" and, consequently, the Act's restrictions with respect to these companies would become effective shortly after the Act's adoption. However, the Act also requires that the Secretary of Defense, in coordination with other federal agencies, identify within its first year a list of entities that constitute biotechnology companies of concern based on certain statutory considerations, including whether the company (i) is subject to or operates on behalf of the Chinese government; (ii) is involved in the manufacturing, distribution, provision or procurement of biotechnology equipment or services; and (iii) poses a risk to the national security of the United States (x) based on ties to China's military, internal security forces or intelligence agencies or (y) because it provides multiomic data to the Chinese government or obtains human multiomic data without express and informed consent.

1. We discuss the Act in more detail in our *Debevoise National Security and Life Sciences Update: The BIOSECURE Act*.

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The Act proposes to prohibit procurement or use of "biotechnology equipment or services" from designated companies; other dealings with these companies would not be restricted under the Act (although other restrictions, such as licensing requirements under U.S. export controls, may separately apply). The Act, however, defines "biotechnology equipment or services" broadly to include any equipment that is designed for use in the research, development, production or analysis of biological materials (including related components, accessories, firmware and software) and any service for the research, development, production, analysis, detection or provision of information related to biological materials, including supporting services related to biotechnology equipment and services related to disease detection or genealogical information.

Restrictions would become applicable to new procurement and contracts effective approximately a year-and-a-half after adoption. The Act also "grandfathers" contracts with biotechnology companies of concern executed prior to the Act's effective date (until 2032) and includes a safe harbor provision for equipment or services that were formerly, but are no longer, produced or provided by such companies. These measures appear designed to incentivize U.S. companies to diversify away from using Chinese-based biotechnology goods and services in the near-term but in a manner intended to minimize disruption.

The Senate also considered its own versionof the BIOSECURE Act (the principal difference from the House version being that pre-effective date contracts are wholly grandfathered, without the eight-year limitation in the House version). However, a compromise bill between the chambers was not reached, and the Act did not becaome law before the 118th Congress ended.

Nonetheless, potentially affected companies should continue to monitor this legislation and, recognizing that the overall concern driving the legislation is likely to persist, should consider (i) reviewing their supply and development chains to identify if and how they are exposed to risks from China-based suppliers and partners; (ii) weighing the risks of entering into new agreements with named "biotechnology companies of concern"; (iii) steps to diversify existing business away from such entities; and (iv) developing a supply chain mitigation and response plan should the federal government identify a direct or indirect supplier as a "biotechnology company of concern."

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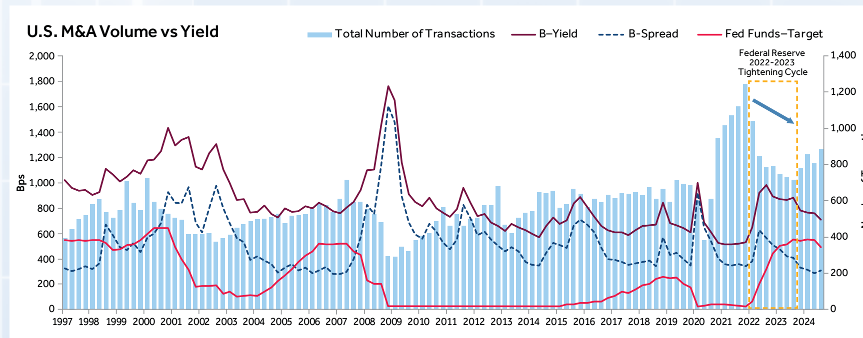
BANKER'S CORNER

GUEST ARTICLE

The Interplay Between Interest Rates and M&A Activity: A Strategic Perspective

GUEST ARTICLE – The Interplay Between Interest Rates and M&A Activity: A Strategic Perspective

M&A represents a vital mechanism for executing corporate strategies that drive shareholder value. By facilitating rapid market entry, operational scale or technological advancement, M&A serves as a cornerstone of corporate development. While interest rates, sector trends and broader macroeconomic conditions are all key factors in influencing M&A activity, interest rates often take center stage due to their immediate impact on deal financing and valuations. While short-term volatility in interest rates tend to disrupt M&A activity, history demonstrates that once rates stabilize—whether they stabilize at "low" rates or at "high" rates relative to contemporary norms—deal-making resumes. M&A is too indispensable to corporate strategy to be abandoned altogether; once counterparties gain comfort and align on valuation and financing expectations, M&A activity follows.



Expected Interest Rate Activity and Its Influence on M&A Activity

When interest rates fluctuate unpredictably, dealmakers face challenges in valuation, securing financing and aligning buyer and seller expectations. Rising interest rates drive up the cost of capital, which in turn exerts pressure on valuations—frequently, different stakeholders react to changing interest rates at different paces. Buyers tend to veer toward the practical financing realities ('At what price can we raise capital today?'); sellers often anchor to historical valuations ('Our share price was XX% higher three months ago'). The result is often valuation mismatches among buyers and sellers, increasing the size of a key hurdle to execute what may otherwise be compelling transaction rationale.

Even if buyers and sellers reach alignment on indicative terms, capital providers may restrict funding, stalling execution. Lenders may require stricter covenants and greater security; appetite for financing a particular sector or asset class may evaporate altogether.

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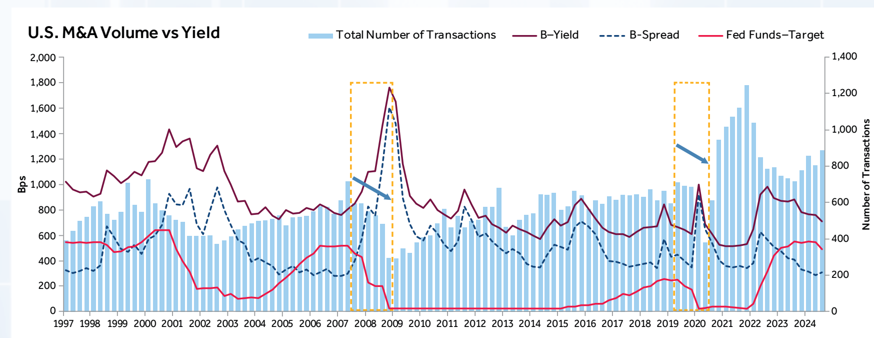
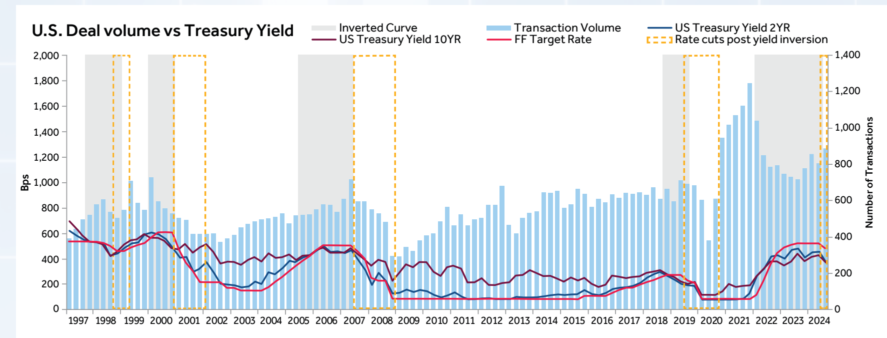
BANKER'S CORNER (continued from page 23)

During the U.S. Federal Reserve's 2022-2023 tightening cycle—where the Fed raised rates ~500+ bps—global M&A volume dropped ~40% year-over-year. Banks exposed to interest rate movements had significant losses, access to credit tightened and the willingness of dealmakers to deploy capital weakened as decision-makers exercised caution amid inflationary concerns and uncertainty over near-term credit.

Similar dynamics can be seen in *rapidly* reduced interest rate environments. When central banking authorities pivot to more accommodating monetary policy—particularly via sudden changes—it is often in response to broader macroeconomic challenges, such as financial crises or recessions (or fear of a recession). The cost of debt can be lowered, but risk-averse decision-makers often prefer to conserve cash amid uncertain economic conditions. Valuation mismatches present themselves again, as counterparties anchor to valuation benchmarks most favorable to their position. And if indicative terms can be agreed upon, lenders may be reticent to deploy capital amid heightened economic risks.



During the 2008 financial crisis and early 2020 pandemic onset, M&A volumes fell precipitously, with the number of deals in the U.S. falling over 50% during the Global Financial Crisis and over 45% during the Covid-19 pandemic—both despite the cost of financing precipitously dropping as the Fed dropped interest rates to near zero.



Instances in which the Fed cut rates following periods in which the market had priced in concerns over near-term macroeconomic conditions—as indicated when the yield on short-term treasury bonds exceeded the yield on long-term treasury bonds ("inverted yield curve")—M&A volumes also precipitously fell. These periods have strong overlap with recessions since the inverted yield curve is implicitly predictive of a recession, so it is unclear whether the yield curve itself is indicative of M&A activity.

In either case, the fall in M&A activity was understandable. Despite the theoretically cheaper cost of debt, greater uncertainty over the economy led to cautious postures by many would-be dealmakers.

With either rising or falling interest rate environments, if strategic decision-makers sense uncertainty in either the financing markets or in broader macroeconomic conditions, M&A activity tends to stutter.

Stability as a Tipping Point: Interest Rate Stabilization Re-Ignites M&A Activity

While interest rate fluctuations understandably create hesitancy in dealmakers, once interest rates hit a period of "stabilization," M&A activity invariably resumes. Successful execution of M&A requires alignment between buyers and sellers on purchase price and transaction execution risk (among other factors), both of which are possible in either "reduced" interest rate

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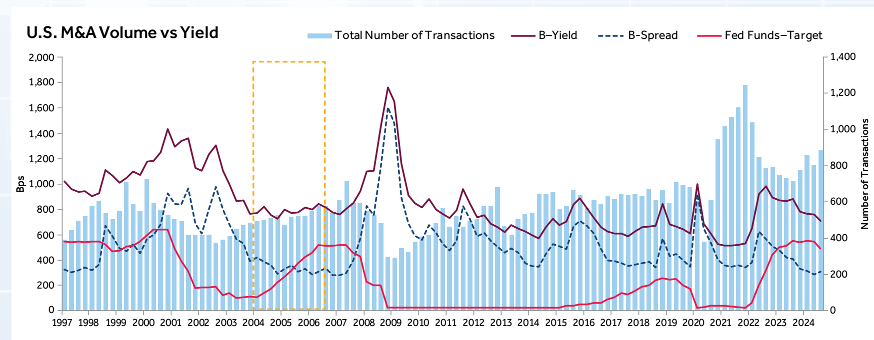
environments or "elevated" interest rate environments—*as long as* buyers and sellers have comfort around financing and broader macroeconomic conditions. It isn't the absolute financial impact of interest rates that stalls M&A activity; it is the mismatched expectations of key stakeholders induced by *changing* interest rates that stalls M&A activity. Once interest rates stabilize, buyers get comfort around financing alternatives, sellers loosen themselves from the anchor of historical benchmarks and lenders find themselves prepared to deploy capital amid greater economic visibility. This stabilization creates the environment for valuation alignment (or more precisely, purchase price alignment) and greater financing (i.e., transaction) certainty, which subsequently opens the door for M&A execution.

Implications for Corporate Strategists and M&A Professionals

Even with this theoretical framework as a guide, the challenge with predicting M&A activity lies with defining "stabilization." The backdrop of events that leads to changing interest rate environments is unique for each central banking decision. The decision to drop interest rates to near-zero in response to the 2008 financial crisis was underpinned by different macroeconomic concerns than the decision to drop interest rates to near-zero in response to the Covid-19 pandemic. In turn, the implied perception of "stability" held by market participants on both the interest rate environment and the broader economy differed in each instance.



The same is true when comparing rate hikes in 2004-2006 and rate hikes in 2022-2023. Although in both instances the Fed raised rates 400+ bps, the rate hikes in 2004-2006 were perceived as a return to economic stability (rates had never been sustained at near zero levels in modern history prior to the 2008 financial crisis), whereas the rate hikes in 2022-2023 were in response to inflationary pressures. Correspondingly, M&A activity grew alongside the 2004-2006 rate hikes while activity fell in 2022-2023. Similarly, the reduction in interest rates that began in the second half of 2024 was not in response to an adverse macro shock but rather to signs that inflation was returning to target levels and the yield curve was normalizing. In fact, this will likely be one of the few instances in which the inversion of the yield curve did not predict a recession. As a result, interest rate cuts in an environment characterized by a generally favorable economic outlook and attractive valuations are likely to be a greater accelerant to M&A activity than in other historical periods.

There are too many factors beyond changes in interest rates to pinpoint exactly when M&A markets will return to "normal" following significant rate movements—but there is certainty that M&A will return.

With this in mind, corporate strategists, financial sponsors and their advisors should refrain from zeroing in on changing interest rates as the key driver of the timing of M&A. Shifting the focus to long-term strategic objectives—how does a company want to be positioned five-ten years from now and what are the most efficient mechanisms to get it there—will enable strategic leaders to rise above the myopia of short-term disruption in M&A markets and properly focus on long-term shareholder value creation.

That focus on long-term value may reveal that M&A is still the best tactical approach to executing on a targeted strategy. In the near term it appears that readily available financing may be the best way to fund acquisitions. But if that were to change and speed is critical to executing a given strategy—and it often is—one can lean into creative alternatives to get those transactions done. Equity as transaction consideration has the

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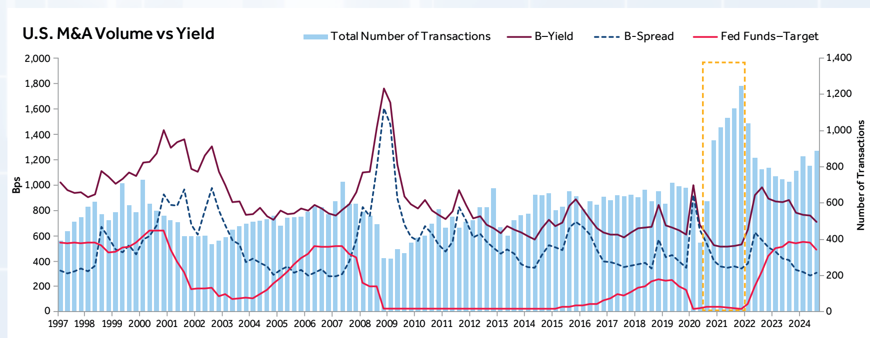
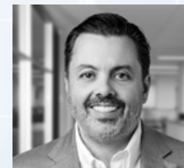
benefit of sharing risk among buyers and sellers in uncertain environments, and at times can eliminate the need for third-party financing to complete a transaction. Credit silos may isolate risk and deliver required comfort for selected stakeholders to effect strategic combinations and enable synergistic value creation. Joint ventures can deliver many of the strategic benefits of a business combination while limiting risk by management teams. Each of the above comes with its own tradeoffs but can enable the achievement of strategic objectives through the highly expedient tool of M&A, even in uncertain environments.

Maintaining strategic dialogues is important not only for the previously discussed reasons, but also because once M&A activity restarts, it has the potential to be re-ignited at a rapid pace. The strategic rationale of a given combination often persists through periods of financing market disruptions, and the pent-up M&A demand can be flooded into the market once stabilization occurs. A prime example of this occurred following the Covid-19 pandemic, where M&A volumes roughly doubled in the six quarters following the Fed's pandemic response. As strategic decision-makers gained clarity on the pandemic's impact on their business models (which was true for selected industries, such as technology and healthcare), M&A activity exploded. Following this bump in activity, the M&A market returned to "normalized" transaction levels, signifying that the boom may only be temporary.



The implication is that if decision-makers are not prepared to execute when the M&A spigot is turned on, they very well may lose out on valuable M&A opportunities—potentially crippling their ability to achieve their strategic objectives. Today, M&A bid-ask valuation spreads appear to be tightening, signifying that one of the key hurdles to kickstarting M&A execution—eliminating the valuation mismatches between buyers and sellers—may be resolving itself. M&A pipelines have been steadily growing as well. We are in a period in which all signs lead to increased M&A activity: the Fed is cutting rates following a yield curve inversion in an environment where the likelihood of a recession seems low, questions about tax policy appear to be resolved favorably and the regulatory environment is likely to improve. Decision-makers keen on business acquisitions to execute long-term strategy would be well-served to prepare as diligently as possible for M&A execution as early as Q1 2025.

Guest Authors: Guggenheim Securities



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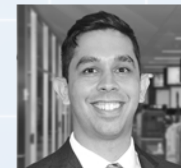

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Deal Nook

On September 5, 2024, Verizon announced its agreement to acquire Frontier Communications, the largest pure-play fiber internet provider in the U.S., in an all-cash deal valued at $20 billion. Acquiring Frontier, which derives more than 50% of its revenue from fiber products and has fiber subscribers across 25 states, furthers Verizon's long-term strategy of continuing to expand its fiber footprint across the U.S., accelerating its delivery of premium mobility and broadband services to customers.

The backdrop for Frontier's decision to embark on a strategic review process included agitation from an activist stockholder—JANA Partners—which in December 2023 publicly called for Frontier to immediately start a strategic review process, including evaluating a sale transaction. Verizon submitted its initial bid to acquire the company in early August 2024, ultimately prevailing over a competing bidder and moving swiftly to a signing approximately one month after the date of its first bid letter. The deal was approved by Frontier stockholders in November 2024.

Note: Debevoise represents Verizon on this transaction.

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Debevoise Quarter

Below are links to articles and publications of interest.

2025 International Capital Markets Outlook

CSDDD for Asset Managers

Treasury Issues Final Rule on CFIUS Review & Enforcement

2025 Executive Compensation Reminders for Public Companies

Governance Round-Up Issue 14

Debevoise Digest: Securities Law Synopsis – December 2024

Nasdaq Board Diversity Rule Vacated by Fifth Circuit

DOJ Antitrust Compliance Guidance

Rethinking Clawback Policies for the 2025 Compensation Season

Key Considerations for the 2024 Annual Reporting Season

U.S. Election 2024: Financial Services Outlook

Debevoise Digest: Securities Law Synopsis – October 2024

2025 SEC Division of Examinations Priorities

U.S. Antitrust Agencies Finalize Expanded HSR Notification Rules and Requirements

CFIUS 2023 Annual Report in Context: Focus on Monitoring and Enforcement Continues

SEC Announces Settled Charges Against Rimar Capital Entities and Owner for Defrauding Investors in "AI Washing" Scheme

Westlaw: The Death of Chevron: Implications of the Loper Decision for Public Companies

Debevoise Digest: Securities Law Synopsis – September 2024

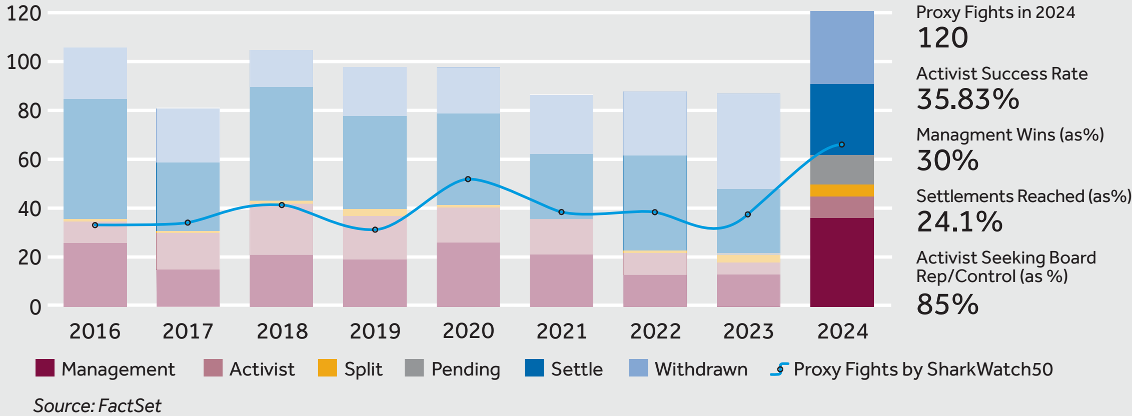
Insider Trading & Disclosure Update – Special Issue

2024 Proxy Season in Review

Federal Court Sets Aside FTC Final Noncompete Rule Nationwide

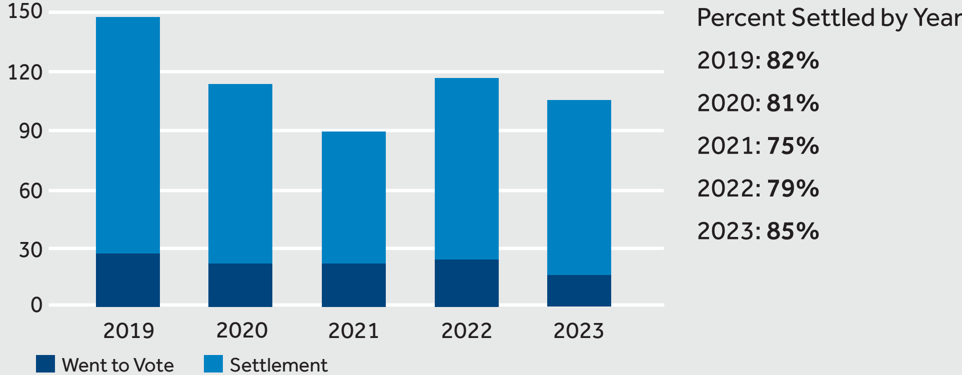
The Charts

Proxy Fight Analysis – All, United States



Source: FactSet

Number of Resolved Board Representation Demands by Method



Source: "Shareholder Activism Annual Review 2024", Diligent, 2024,
https://learn.diligent.com/rs/946-AVX-095/images/Shareholder_Activism_2024.pdf?version=0

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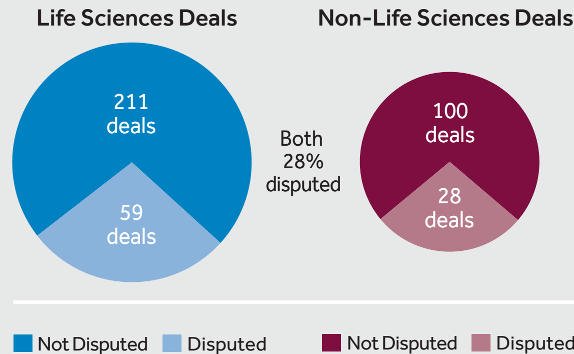
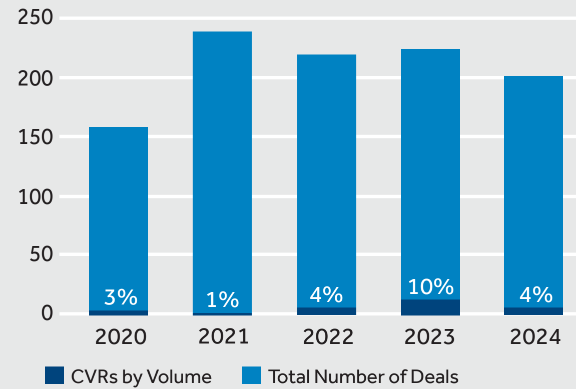
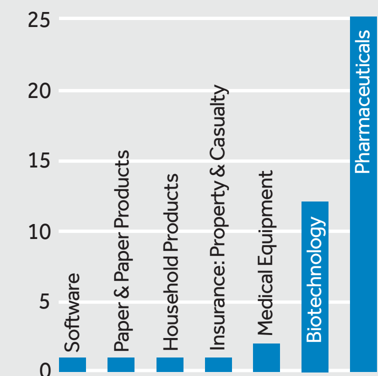
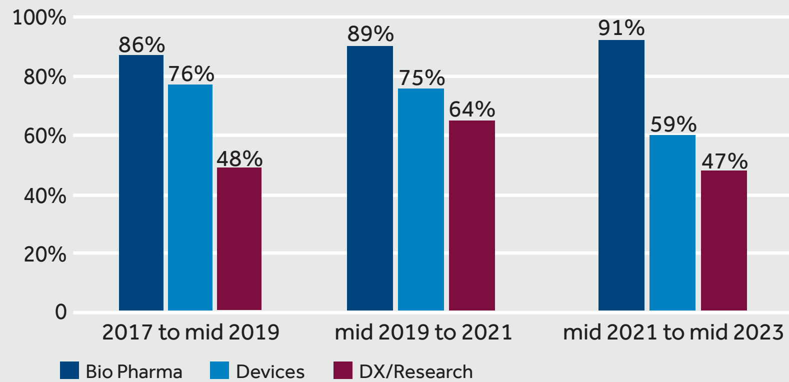
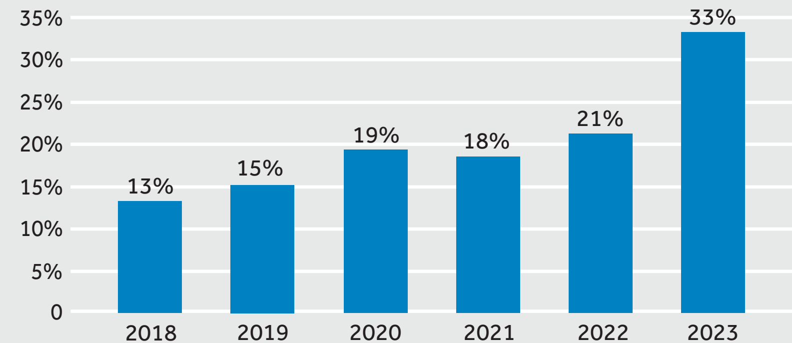










* *Note that the information provided by SRS Acquiom, Inc. is limited to the transactions in which SRS is engaged as the shareholders' representative.*

Crossword Puzzle

Across

3 Airline that filed Chapter 11 in 2024

5 When a sponsor buys a public company

6 Use stock as collateral

8 Chancellor that ruled against Musk's pay package

9 Test for a board taking defensive measures in a takeover

Down

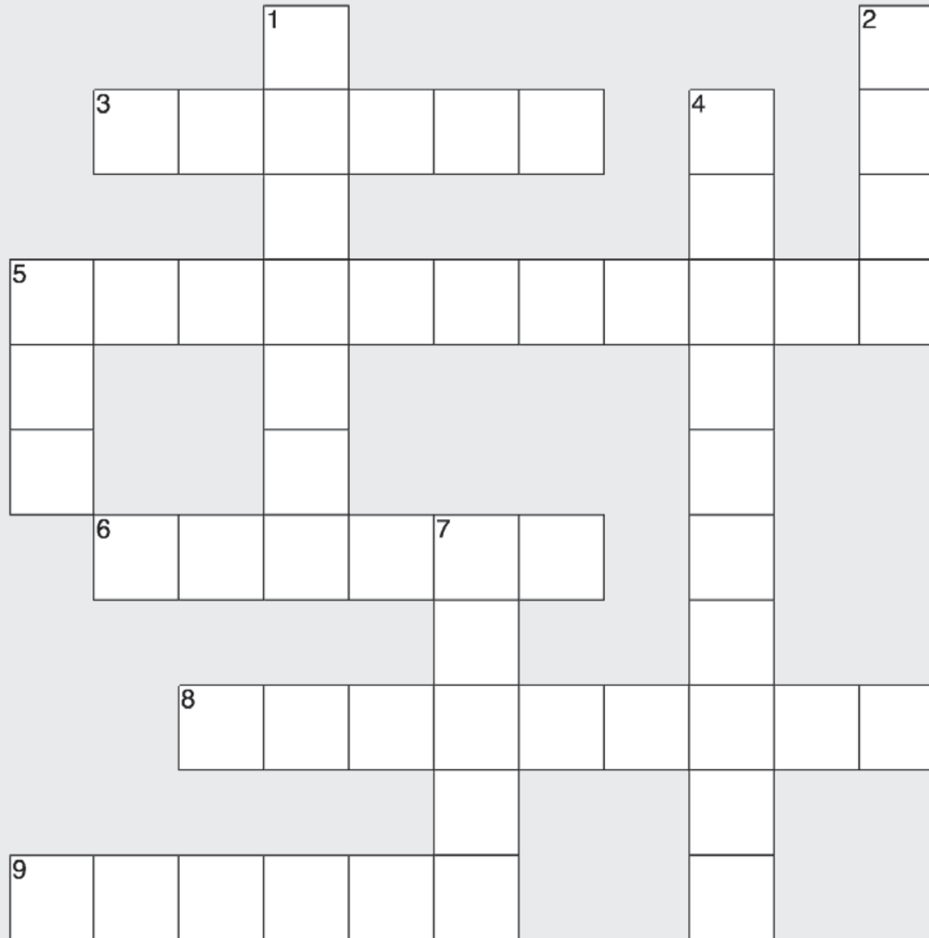
1 Biggest IPO of 2024

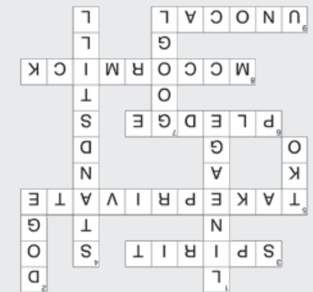
2 Cryptocurrency or Italian duke

4 Protective provision in a public company NDA

5 Buyer of Endeavor's sports assets

7 Trading symbol for Alphabet voting stock





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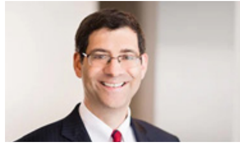

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