University of Illinois College of Law
Examination Cover Sheet

Mergers & Acquisitions
Professor Amitai Aviram
Spring Semester 2015
Number of Pages: 4 (including this page)
Time Allotted: Until 10am on the day following the day you received the exam
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Exam Instructions

1. **Permissible material**: This is an open book exam. You may use any materials you want, whether in hardcopy or electronic format.
2. **Anonymity**: The exams are graded anonymously. Do not put your name or anything else that may identify you (except for your four-digit exam ID number) on the file that contains your answer to the exam.
3. **Receiving and submitting the exam**
   a. Notify my assistant immediately (within 1 hour) if you did not receive by e-mail a copy of the exam by 10am on the day you selected (or on the default date, if you did not select an exam date).
   b. You must submit your response as a .doc (Microsoft Word) file e-mailed to my assistant no later than 10am on the day after you received the exam. The file name should be your 4-digit exam ID number.
4. **Confidentiality**: Once you receive this exam form, you are not allowed to discuss the exam with anyone until after the last day of the exam period. Students enrolled in this course are not allowed to solicit or receive information about the exam if the source of the information (directly or indirectly) is a person who has seen the exam.
5. **Length limit**: The total length of your answer may not exceed 1,000 words. For every 10 words in excess of the length limit (rounded up), one point will be taken off the exam's raw score.
6. **Answering the exam**: Cite relevant case and statutory authority. Subject to the length limit, answer all relevant issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
7. **Assumptions**: Unless the exam question specifies otherwise, assume that -
   a. The relevant jurisdiction applies the Restatement (Third) on Agency, Delaware corporate law, RUPA, and U.S. securities law.
   b. Each corporation's charter states that: the corporation is a stock corporation; it has limited liability & perpetual existence; the corporation may conduct any lawful act or activity; the board may amend the bylaws; director fiduciary duties are limited to the maximum degree allowed under DGCL §102(b)(7).
   c. Each corporation's bylaws state that: the chairperson of the board is authorized to call a board meeting; and the board is authorized to call both annual & special shareholder meetings.
8. **"Fact" patterns are fiction**: The "facts" presented in this exam were constructed for an educational purpose, and are not intended to inform about any real person or event.

Otsuka Ltd. ("Otsuka") is a high-end furniture retailer and a publicly-traded Delaware corporation. Otsuka's founder, the 71-year-old Ken Otsuka ("Ken") began as a cabinet salesman, opened a small furniture store in 1969, and turned the business into a leading retailer of top-of-the-line furniture.

Ken was Otsuka's CEO and the Chairman of its board. In addition to him, Otsuka's board consisted of two other directors: Darren and Danielle. Darren was a partner in a prestigious law firm, and has been a close friend of Ken for decades. Danielle was the CEO of a high-end jewelry retailer. Otsuka had a single class of common shares, with 10M shares outstanding. Ken owned 25%. His daughter, Kelly Otsuka ("Kelly"), owned 10%. A hedge fund, Silver Partners ("Silver"), owned 20%. No other shareholder owned over 5%.

Ken cultivated Otsuka's luxury image for decades. To shop at an Otsuka store, one had to become a "member", sign in upon arriving at a store (as if it were a private club), and shoppers would be escorted through the showrooms by concierges. Prices were very high, in line with the brand's luxurious image.

Over the years, Ken groomed Kelly to become his successor in running the business. Kelly went to a prestigious business school, worked as a banker and as a consultant in firms unrelated to Otsuka.

An economic downturn in 2008 caused Otsuka to swing to a loss for the first time in decades, as financially-pinched customers turned to lower-priced furniture retailers like IKEA. That same year, Otsuka was fined for violating an environmental regulation. The combination of these events created a sense that the firm needed to make some changes, and in 2009 Kelly replaced Ken as CEO (Ken remained the Chairman).

Kelly believed that Otsuka had to broaden its customer base to tap a growing middle-market that was currently dominated by retailers such as IKEA. She eliminated Otsuka's membership system, renovated stores to present more products, and opened a line of mid-priced stores. Otsuka quickly returned to profitability.

Ken, however, was horrified by Kelly's strategy. In his view, the loss in 2008-2010 was a "blip", an isolated drop in customers due to the economic crisis that was unlikely to repeat itself. He interpreted the return to profit not as a vindication of Kelly's strategy, but as a natural rebound as the effects of the economic downturn faded. Meanwhile, he was worried that Kelly was creating irreparable damage to Otsuka's luxury image, which was cultivated over decades.

Ken tried to persuade Kelly to return to the previous strategy he had been executing for decades, but Kelly was certain that her strategy was better and that Otsuka needed to change to adapt to a changing world. Interactions between father and daughter became increasingly acrimonious.

Finally, in early 2015 Ken asked the board to fire Kelly and reappoint him as CEO. He gave a passionate presentation to the board about the loss of "Otsuka's way", while Kelly gave an equally passionate presentation about the need to change and broaden the customer base. The board then voted 2-0 (with Ken not participating due to his conflict) to fire Kelly and rehire Ken.

Upon returning to the CEO position, Ken immediately prepared plans to undo Kelly's changes, including shutting down the mid-priced stores, reinstating the membership system, and renovating stores again to present only the most luxurious products. This restructuring created short-term costs for Otsuka (e.g., renovation costs, severance packages for fired employees, etc.), and its cash reserves were insufficient to cover these costs. Otsuka's board approved Ken's restructuring plans and instructed him to borrow money to cover these costs.

Meanwhile, Kelly met with Silver's CEO to explore a joint acquisition of Otsuka. Soon, word of these negotiations leaked to the pages of the Wall Street Journal ("the WSJ article"). The WSJ article quoted an unnamed source who said an acquisition price of $280M was contemplated. This was 40% above Otsuka's current market value of $200M. Otsuka's shares jumped up by 30% in anticipation of a tender offer.

Ken responded by meeting with Silver's CEO and agreeing to borrow from Silver the money Otsuka needed: $10M, equal to about one year's average profit, or to 5% of Otsuka's market capitalization. Under the borrowing agreement, Otsuka would issue to Silver $10M in 30-year bonds, paying a generous interest rate. The bonds included a change of control covenant ("CoC covenant") that stated that if there was a change in control of Otsuka that did not receive the approval of Otsuka's board, the bonds could be redeemed immediately for five times their face value (i.e., for $50M). A 'change of control' was defined in the CoC covenant to include not only structural and stock acquisition methods, but also the replacement in a proxy contest of the majority of board members with candidates who were not nominated by the board. Otsuka's board could waive the CoC covenant for any particular transaction by approving a change of control.

In the borrowing agreement Silver agreed not to act or consent to actions that would cause it to acquire more shares in Otsuka, to sell the shares it owned in Otsuka, or to otherwise cause a "change of control" as defined in the CoC covenant (the "standstill obligation"). Otsuka's board could, at its discretion, waive the standstill obligation.

The borrowing agreement was subject to the board's approval, and Ken brought it before Otsuka's board, which unanimously approved it after thorough investigation and deliberation, announcing that "Otsuka is undergoing major restructuring to correct the damage caused by Kelly, and until this restructuring is completed and the value it will create is unlocked, Otsuka is not for sale."

When this was announced, Otsuka's shares dropped by almost 25% as the prospect of an acquisition vanished. Many shareholders were disappointed. Ken sought to placate them, and preempt a proxy contest, by telling the board he was interested in acquiring full ownership of Otsuka. The board created a special committee consisting of a single director: Danielle. The board authorized the committee to consider Ken's offer as well as any alternatives (including doing nothing, or selling the company to alternative buyers), and negotiate a deal with any potential buyer if it was in the shareholders' interest. The committee was authorized to hire independent experts as needed to advise it, and to waive the CoC covenant and the standstill obligation for any offer deemed in the shareholders' interest.

The committee hired an M&A lawyer who was to be paid a fixed amount per billable hour, and an investment banker who was promised a fee of 1% of the value for which Otsuka was acquired (if such a transaction took place) or $1M if the committee concluded it is best not to sell Otsuka at this point. The committee asked the banker for a valuation of Otsuka, and the banker calculated that Otsuka was worth $200M (which was its market value before the acquisition rumors). The committee then concluded that any sale at a valuation above $200M was in the shareholders' interest, and waived the CoC covenant and standstill obligation for any offer to acquire Otsuka at a valuation above $200M. The committee issued a press release announcing this waiver and instructed the banker to search for other potential buyers. After several weeks of efforts, the banker informed the committee that she could not find any interested buyers (other than Ken) who were willing to acquire Otsuka at a valuation above $200M.

Danielle told Ken that if he wanted the committee's approval, he would have to offer at least the price that was rumored in the WSJ article (a valuation of $280M). Ken resisted at first, but eventually believed that if Danielle was driving such a hard bargain there must be other bidders for Otsuka – perhaps an offer from Kelly. Ken eventually agreed to pay a valuation of $280M for a freezeout triangular merger in which he would become the sole owner of Otsuka ("the deal"). The deal was subject to approval by a majority of Otsuka's minority shareholders present at the meeting, as well as the approval of the special committee and of Otsuka's board. The deal did not contain a termination fee, but also did not allow the board to "shop" Otsuka (i.e., to seek better offers). The board approved the deal 2-0 (Ken didn't participate due to his conflict).

The board called a SH meeting to approve the deal. 7M shares voted in favor of the deal (including Ken's 2.5M shares and Silver's 2M shares), 1M shares voted against, and the rest (including Kelly's 1M shares) weren't present. The board declared the deal approved.

Meanwhile, Ken learned that Danielle drove a hard bargain without having competing offers. Upset at her and at Darren (who knew about this and didn't inform Ken), he used a written consent to remove them and appoint two new directors: Daphne and Desmond. Daphne was Ken's wife, while Desmond was a professor of business strategy with no familial or financial connection to Ken.

Before the merger was executed, shareholder Sam sued to enjoin the deal, claiming that Ken, Darren and Danielle breached their fiduciary duties by entering into the deal. **Discuss Sam's suit**.

Model answer for Spring 2015 M&A exam:[1]

Flaws:

- *Revlon* claim against the board for selling Otsuka to Ken;[2]
- *MFW* claim against Ken as controller for freezing out MSHs at an unfair price.

1. **Standing**

a. The *MFW* claim is direct, since (applying the tests in *Tooley* and *Agostino*) the harm is that MSHs were underpaid. This is a zero-sum situation in which the breach of FD causes one SH (Ken) to receive more of Otsuka's value at MSHs' expense.

b. The *Revlon* claim is more complicated. Typically, *Revlon* claims allege the board should have shopped for a better deal – harm inflicted on the firm as a whole (it's Otsuka's interest, not just MSHs', to secure best sale terms). Furthermore, a *Revlon* claim may imply director entrenchment (selling firm to a buyer who would keep directors in their jobs), harming the firm and establishing a derivative claim. However, this deal is a controller freezeout; if the controller gains from the harm inflicted on the firm, harm may come only to MSHs, suggesting a direct claim.[3]

c. If the *Revlon* claim is derivative, demand is excused: Because a majority of the board was replaced between the alleged CoA and the suit (Darren/Danielle > Daphne/Desmond), *Rales* rather than *Aronson* applies. Is there reasonable doubt that a majority of the board was independent? Yes, 2 out of 3 directors have CoI.[4] Ken is conflicted for the *Revlon* claim because he is the acquirer. Daphne has CoI because she's Ken's wife. Sam has standing.

2. ***Revlon* claim**

a. Duty: Ken, Darren & Danielle owe FD as directors.

b. SoR: Upon negotiating with Ken (which was the result of the Committee determining that selling Otsuka to Ken at $280M is superior to doing nothing), the board embarked on a transaction that would result in a CoC, triggering *Revlon*'s enhanced scrutiny. *Unocal* doesn't apply because the committee waived the defenses and publicized the waiver.

c. Application – Quasi-BJR – possibly fails for lack of banker independence

1. Good faith: Danielle is independent, but her banker isn't because compensation structure makes her prefer selling Otsuka at any valuation over $100M (and getting 1% of that), rather than accepting $1M with no sale. Banker has incentive to find the highest offer, but also to give Otsuka a low valuation so a sale takes

[1] The exam fact pattern combined elements from a couple of recent events. See: Atsuko Fukase, *Father Fights to Oust CEO Daughter*, WSJ (3/19/15), p. B9 (the background story of a father-daughter corporate conflict); Liz Hoffman, *Lenders Feel Heat as Suits Ramp Up*, WSJ (4/29/15), p. C1 (discussing CoC covenants – of 'proxy puts' – in corporate debt).

[2] A *Revlon* claim alleges a breach of the duty of loyalty (bad faith due to acting with an improper purpose), not a breach of the duty of care (negligence). Therefore, it is a mistake to consider a *Revlon* claim as a negligence claim.

[3] Many exams simply asserted that Otsuka (or MSHs) were harmed, without specifying the claims and what harm specifically they allege. This lost most of the points on that issue, which are given for applying the facts to the law (here, to the *Tooley*/*Agostino* rule).

[4] No SLC was created in this case, and SLC analysis was inappropriate. The special committee that was created was not authorized to determine the merits of Sam's suit, and did not purport to do so.

place even if offer is low. This flaw may be mitigated by Danielle's insistence of a price that's much above the banker's valuation. Purpose: Committee believes Ken's offer is the best available – legitimate purpose under *Revlon* (short-term SH wealth maximizing).

2. Reasonable investigation: No evidence of negligence.

d. Application – Reasonableness:[5] Did inability to shop the deal violate *Revlon*? *Revlon* requires board to find the best offer, which normally requires shopping. But the committee searched for other offers before entering deal, banker's compensation structure incentivized her to find highest offer, and public announcement of defense waiver put potential bidders on notice. *Revlon* only requires board to make "a reasonable choice [to maximize sale value] that a loyal & careful board could adopt in the circumstances" (*Dollar Thrifty*). If the committee already shopped before signing the deal, trading a "no-shop" for other deal terms (like a higher price) is reasonably in SHs' short-term interests.

3. ***MFW* claim**

a. Duty: Ken owes MSHs FD because he controls Otsuka. Under *Ivanhoe*, FD owed "only if [SH] owns a majority interest in or exercises control over the business affairs of the corporation". Ken only owns 25%, but he exercises control over the board through being the founder and largest SH, as seen when board fired Kelly, appointed Ken as CEO and approved his strategy.[6]

b. SoR: Ken is on both sides of the Deal. He is the acquirer, but also controls the board of the target. Therefore, under *MFW*, entire fairness applies unless deal has "robust protections":

1. Special committee approval: Committee includes the only director completely independent of Ken. Committee was duly authorized to seek alternatives to selling to Ken (including doing nothing), and hired advisers. Banker has flawed incentives to give low valuation, but also to find the highest bidder.
2. MSH approval: Deal must be conditioned on approval of majority of all MSHs (not just those present). Did a majority of MSHs approve? If Silver is a MSH, then yes: 4.5M shares in favor, 3M against or withheld. But if Silver is part of a control group with Ken, then no: 2.5M shares in favor, 3M against or withheld. Silver would be part of the control group if connected in some legally meaningful way (e.g., contract to work together towards a shared goal) (*Frank*). Here, only contract is the standstill obligation, it is with Otsuka, not Ken, and it only prevents Silver from voting for a CoC, so likely Silver is not part of the control group, and

[5] The *Unitrin* structure of the second prong of enhanced scrutiny (coercion/preclusion/proportionality) is suitable for takeover defenses (*Unocal* claims), and is not ideal to address what makes an action reasonable under *Revlon* (which is that it was "a reasonable choice [to maximizing sale value] that a loyal & careful board could adopt in the circumstances" (*Dollar Thrifty*)). There is no coercion (since CoC covenant and standstill agreement were waived and deal had no lockup, SH can vote the deal down (indeed, deal was conditioned on MSH approval)), and no preclusion (defenses were publicly waived and banker unsuccessfully sought other bidders). If either existed, there would have been a *Unocal* claim as well as the *Revlon* claim.

[6] Ken's position as CEO does not establish control. As CEO, he is (at least formally) subject to the board's control, rather than controlling the board. To show that Ken controls Otsuka, evidence needs to demonstrate Ken's control of the board, rather than just that Ken makes decisions for Otsuka on behalf of the board (as any CEO would).

deal was approved by majority of all MSH. Still, it was not conditioned on this approval, so BJR does not apply.

Entire fairness applies, but because of the protection of the special committee approval, BoP to show fairness lies on Sam.

c. Application – entire fairness
   1. Fair process: The process was only slightly flawed. Flaws were: (a) banker's compensation structure (which made banker biased towards selling at any price, but also made banker seek the highest price); (b) conditioning deal on approval of majority of MSH present at meeting, rather than majority of all MSH (but majority of all MSH did approve the deal, if Silver is considered a MSH); (c) no shopping after deal signed (but extensive shopping before).
   2. Fair price: Banker failed to find a bidder even at $200M; Ken offered $280M. Also, BoP is reversed to Sam because of special committee approval. Price is fair.
   3. Outcome: In some cases flawed process can breach FD even when price is fair. But here process is mostly fair, so likely Ken didn't breach FD.