

# Client Alert

March 2018

## Regulatory Obstacles as a Hostile Takeover Defense

Companies sometimes raise regulatory obstacles in defending hostile takeover attempts. They can be raised with great conviction that a transaction is not possible. Other times, they may be used to delay the process to explore alternatives or negotiate improved deal terms. Earlier this month, the Trump administration blocked a hostile bid to acquire Qualcomm on national security grounds. In resisting the bid, Qualcomm unilaterally petitioned the Committee on Foreign Investment in the United States (“CFIUS”) to review the transaction. CFIUS’s recommendation to block the hostile bid is significant. It reflects an expansive view of US national security and also signals a potentially broad barrier to some types of foreign investment in the US. It is also a reminder of the various factors that target boards of directors should consider in raising regulatory concerns as a defense to a hostile takeover.

### Background

On March 12, 2018, President Trump issued an order prohibiting Broadcom Ltd. from acquiring Qualcomm, Incorporated, a US technology company, because it “threatens to impair the national security of the United States.”<sup>1</sup> Broadcom is a Singapore-domiciled company, but around half of its employees are based in the US. Just before the hostile bid was disclosed, Broadcom announced its intention to redomicile to the US.

Broadcom’s \$117 billion bid would have been the largest takeover in the technology industry if completed. Qualcomm’s board of directors and management, however, claimed that the bid undervalued the company. In addition, Qualcomm disagreed with Broadcom’s claim that the transaction could obtain regulatory approval in 12 months.

In pursuit of its bid, Broadcom initiated a proxy contest to replace Qualcomm’s directors at its 2018 annual meeting. During the pendency of the proxy contest and unbeknownst to Broadcom, Qualcomm unilaterally petitioned CFIUS to review the transaction. Regulators’ chief concern was the US’s competitive advantage in developing 5G technology. During the CFIUS review, Broadcom committed to support research and development in 5G networking technology. Broadcom also said it was accelerating its redomicile to the US, but that announcement reportedly angered CFIUS. CFIUS initially ordered Qualcomm to delay its stockholder vote. It then concluded that the merger threatened the US’s national security interests, and based on CFIUS’s recommendation, President Trump issued an order blocking the transaction.

### Observations

#### *Growing Barrier to Some Foreign Investment*

The government’s action against Broadcom has been described as “extraordinary” and signals a growing barrier to foreign bidders in friendly and, especially, hostile transactions. Many people will view the

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<sup>1</sup> Presidential Order Regarding the Proposed Takeover of Qualcomm Incorporated by Broadcom Limited, Mar. 12, 2018.

government's intervention as consistent with President Trump's protectionist agenda. It may also be part of a larger global surge of nationalistic government policies in which we see more countries objecting to foreign investment and adversely affecting cross-border M&A. In this particular instance, CFIUS's action may also draw retaliation from China.

### *Evolving View of National Security and the CFIUS Process*

The government's action also reflects a broad view of what might threaten or impair national security, at least in the technology industry. The government cited the importance of developing 5G technology in the US and expressed concern over Broadcom's relationships with China. Other technology transactions that have been abandoned recently in connection with CFIUS reviews include Moneygram's proposed \$1.2 billion sale to Chinese company Alibaba and Lattice Semiconductor's proposed sale to an investment firm with ties to the Chinese government. Foreign bidders will need to consider CFIUS's jurisdiction carefully even in deals that do not fall within national securities areas like military products and defense contracting.

CFIUS also showed flexibility by responding on a compressed timeline and acting outside its normal review process. Typically, the merging parties work together to submit an application, which has a 30-day review period before CFIUS decides whether to conduct an investigation. Here, the petition was filed unilaterally without a signed merger agreement, and CFIUS promptly proceeded to its investigation stage. CFIUS also flexed its power by forcing Qualcomm to delay its stockholder meeting.

### *Regulatory Obstacles as a Takeover Defense*

Raising regulatory obstacles in defending a hostile bid is not novel, but it has usually been based on antitrust laws.<sup>2</sup> Broadcom/Qualcomm shows how CFIUS can be used against a foreign hostile bidder.

Under Delaware law, a board that has reasonable grounds for believing a hostile bid poses a threat to corporate policy and effectiveness can respond with reasonable and proportionate defenses.<sup>3</sup> Thus, a board of directors, in complying with its fiduciary duties of care and loyalty, can resist a transaction that it determines is unlawful, cannot be completed, or, if stockholders are receiving an equity interest in the acquiring or combined company, is subject to unacceptable risk of being unwound or subjected to burdensome conditions after closing.<sup>4</sup> An antitrust defense has been described as "one of the few potential 'show-stoppers' in the target's arsenal."<sup>5</sup>

One issue that may arise is whether the board of directors should continue to resist the hostile bid if the merger could be subject to a closing condition requiring that the regulatory approvals be obtained. The hostile bidder and even the target's stockholders may argue that the closing condition eliminates the risk of illegality or, if the target's stockholders would receive equity in the acquiring or combined entity, that the transaction would be unwound or subjected to burdensome obligations that materially harm the stockholders. In addition, parties might negotiate reverse termination fees to compensate the target in the event of a regulatory failure. These were not issues in Broadcom, however, since CFIUS quickly conducted its review before Qualcomm's stockholders could even vote on Broadcom's proposed slate of director nominees.

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<sup>2</sup> See, e.g., David Millstone & Guhan Subramanian, *Oracle v. PeopleSoft: A Case Study*, 12 HAR. NEGOT. L. REV. 1 (20017) (discussing PeopleSoft's antitrust defense in resisting a hostile bid).

<sup>3</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>4</sup> See *id.* at 954 (noting that examples of threats include, among other things, "questions of illegality").

<sup>5</sup> ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, 1 TAKEOVER DEFENSE: MERGERS & ACQUISITIONS § 12.01 at 12-3 (6<sup>th</sup> ed. 2010).

The target's board, of course, could still defend against the bid if the board believes it undervalues the company, which was also the case for Qualcomm.<sup>6</sup> But regardless of price, the closing condition is not a panacea for all regulatory risk. Entering into a merger agreement will limit the target's ability to pursue other strategic alternatives, restrict the target's business operations, distract management from pursuing its long-term strategy, and require a significant investment of time and money—potentially for a prolonged period. Other potential risks of tying up the company in a prolonged regulatory review include losing key personnel, customers, and suppliers; impact on employee morale; and sharing sensitive information with the acquirer who may also be a competitor. A board may decide that, given the unlikelihood of obtaining regulatory approval—either at all or on favorable conditions—it is not in the best interests of stockholders to enter into an agreement.<sup>7</sup>

There are numerous considerations in deciding if and how to raise regulatory obstacles as a defense to a hostile bid. Raising regulatory issues can sometimes be used as a delaying or negotiating tactic to seek an improved price, negotiate other favorable deal terms, or give the target more time to consider other alternatives. In that situation, the target needs to be careful in crafting its public statements questioning the ability to obtain regulatory approval because they may be difficult to take back. Moreover, once a proposed transaction draws regulatory scrutiny, the target can quickly lose control of the process by letting the regulatory cow out of the barn. After all, a target's board of directors might change its view of the hostile bid, such as in response to an increased price, and decide to accept the regulatory risk. But at that point, it may be quite difficult to convince regulators that the target's previously expressed concerns were misplaced.

Another reason for target companies to be vigilant in making public statements is because they could give rise to liability under federal securities laws. In an active hostile takeover attempt, the target company will have to communicate with its stockholders through securities law filings, including a proxy statement in connection with a contested stockholders meeting or a Schedule 14D-9 in response to the hostile bidder's tender offer. Stockholders will be focused on the board's assessment of regulatory risk.

Finally, a successful regulatory defense can end the hostile threat, but it can also place significant pressure on the target management and board of directors going forward. This is particularly the case if stockholders were skeptical of the target's proffered regulatory concerns, which skepticism may be deepened if stockholders do not believe the target meaningfully engaged with the hostile bidder to discuss regulatory risk. If the transaction fails, those stockholders may have heightened expectations for the target's management to perform well rather than accept the regulatory risk associated with a premium-to-market transaction.

In light of the above, boards raising a regulatory defense need to be well informed on the merits of the defense, its implications for the target's negotiating strategy, and the potential consequences of the defense (e.g., drawing the regulators' interest that may be difficult to stop). In addition, given the very legal nature of a regulatory defense, the board should carefully document its reliance on legal counsel and other third-party advisors in articulating the threat and the company's response.<sup>8</sup> Delaware's anti-takeover jurisprudence was developed in the 1980s when boards were often composed of numerous insiders who might have been acting to protect their jobs. Although board composition has changed dramatically over the past thirty years, Delaware courts will still apply enhanced scrutiny to takeover defenses to make sure directors are acting loyally and not out of self-interest.

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<sup>6</sup> See *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) (declining to order a target company to redeem its rights plan where the board of directors believed that continuing as a standalone business would result in greater value for stockholders).

<sup>7</sup> See *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573 (Del. Ch. 2010) (rejecting challenge to a board's decision to accept a facially lower offer where the board determined that a competing proposal faced greater regulatory challenges).

<sup>8</sup> See *Chesapeake Corp. v. Shore*, 771 A.2d 293, 301 n.8 (Del. Ch. 2000) (“[T]he defendants have the burden of showing the reasonableness of their investigation, the reasonableness of their process and also of the result that they reached.”) (citation omitted).

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