Valeant Fails In Its Effort to Acquire Allergan—What is the Future of the Bidder-Activist Collaboration Model?

(Fried Frank has been involved in this matter, acting on the Allergan side.)

On Monday, Allergan, Inc. announced a $66 billion merger agreement with Actavis plc, thwarting the pending $53 billion bid for Allergan by Valeant Pharmaceuticals International Inc. Valeant had teamed up with Pershing Square, a fund run by activist investor Bill Ackman, to facilitate an acquisition of Allergan by Valeant. Although the Valeant bid has failed, Pershing Square apparently will recognize a gain of well over $2 billion on consummation of the Actavis merger.

The distinguishing feature of Valeant's now-failed pursuit of Allergan was the bidder-activist collaboration itself, which was the focal point for public attention throughout the saga. Corporate America's initial reaction to the Pershing Square-Valeant model was fear that the model would be followed by others, unleashing a new wave of hostile takeover activity in a context that appears to make target companies particularly vulnerable. Now, at the end-point of Valeant's bid for Allergan, we note the following:

- The bidder-activist model as structured by Valeant-Pershing Square probably will not be generally followed.

We have predicted from the outset that the model in its current form likely would not be followed. While the model proved highly advantageous to the activist, the benefits to the bidder were more elusive.

- We have noted in previous memoranda the high economic cost to the bidder in forgoing the opportunity for a return on the pre-announcement acquisition of an equity stake in the target; the inherent significant conflicts of interest between the bidder and the activist; and the legal and regulatory issues involved, including those relating to the activist's acquisition of an equity stake based on the bidder's non-public plans to make an unsolicited offer for the target company.

- A California federal district court judge found this month that there were "serious questions" about whether Pershing Square's pre-announcement acquisition of Allergan shares, as Valeant's "co-bidder", constituted insider trading. Although not a definitive ruling on the subject, the decision creates serious legal uncertainty and potential insider trading liability for the activist partner in the model. As the pre-announcement acquisition of shares was the linchpin of the collaboration model, it appears that, on this basis alone—absent judicial validation, significant changes in the model's structure that make the activist a "true" co-


bidder, or a deal that does not include a tender or exchange offer—the model in its current form will probably not be followed.

■ The Valeant-Pershing Square bid for Allergan proceeded mostly conventionally.

As we have pointed out in previous memoranda, and as continued to be the case to the end, the Valeant-Pershing Square bid for Allergan unfolded rather conventionally notwithstanding the bidder-activist collaboration.

○ Valeant increased its cash-and-stock offer price a number of times, commenced an exchange offer, and commenced a proxy contest to take control of the board. Allergan challenged the sufficiency of the price, the value of the portion of the price that consisted of Valeant stock, and the viability of Valeant’s announced business and growth plans; and pursued strategic alternatives culminating in a superior offer for the company. The Allergan shareholders were patient in letting events unfold, and their patience was rewarded.

○ Litigation over the date of the Allergan shareholder meeting was settled after a lengthy process. The scheduled December 18 meeting date would have come nine months after Valeant and Pershing Square went public with their bid. Any perception of an advantage from the activist’s involvement in permitting an early informal meeting of shareholders through which Allergan could be pressured to negotiate with Valeant, or from an ability to vote the shares acquired by Pershing Square at a formal meeting of shareholders early in the process (since Hart-Scott-Rodino clearance was obtained more quickly for Pershing Square as a non-competitor than it could have been for Valeant), proved to be illusory in this case.

○ One of the only unusual aspects of the proposed deal was the significant distraction and negative public reaction relating to the model itself, and to the litigation relating to Pershing Square’s overnight billion dollar gain (and thereafter, significantly greater gain) on its pre-announcement stake that was acquired based on the non-public information from Valeant that Valeant intended to make a bid for Allergan. A critical element to success of an unsolicited bid that consists of a substantial amount of the bidder’s equity as part of the offer is a strong and undistracted focus—from the time the bid is announced and continuously thereafter—on the value of the bidder’s equity, the bidder’s business plan, and the synergies and other advantages of the proposed combination. In this case, the primary focus was never on “selling” Valeant’s equity or the transaction, but on explaining and defending the arrangements with Pershing Square.

○ The model did not appear to be positioned to upset long-settled principles relating to unsolicited takeovers—and, as it has turned out, it has not. With or without an activist collaborator, an unsolicited bid generally will not succeed if made by a non-credible bidder or at a less than “full price”, and should succeed if made by a credible bidder at a full price unless the target company otherwise creates (or credibly demonstrates an ability to create) superior value.

■ A possible alternative bidder-activist collaboration model.

We have previously suggested a possible alternative bidder-activist collaboration model. The alternative model would avoid the uncertainty about insider trading compliance and have other significant advantages to the bidder over the Pershing Square-Valeant model.
The alternative approach would be for a bidder to acquire the pre-announcement equity stake for its own account and then, sometime after announcement of the acquisition proposal—when the bidder would have more information (about the Hart-Scott-Rodino timing, the target company’s reaction to the bid, the emergence or not of other bidders, and so forth)—to determine whether to collaborate with one or more activists for support. Armed with the gain on the pre-announcement equity stake that arises from announcement of the bid, if the bidder then believed that collaboration with an activist would be to its advantage, the bidder would be in a position to make appealing offers to activists that likely would not have to be as much as the 85% share of the gain on the Allergan equity stake in effect paid by Valeant to Pershing Square.

If collaboration with an activist at that point did not seem attractive, the bidder could, of course, use the gain instead to increase its offer price to target shareholders. Valeant’s having relinquished its own opportunity to acquire the pre-announcement stake cost Valeant (a) approximately $6-7 per share (or about $2 per share more than that if Pershing Square had not volunteered its $600 million give-back to Valeant) that could have been used at any point to increase the offering price to get the deal done before the Actavis bid materialized (or to compete with Actavis), and (b) in the context of the Valeant bid not succeeding, more than $2 billion in profit on the pre-announcement equity stake.

The inherent conflict of interest between the bidder and the activist in the collaboration model was underscored at the end-point.

We have previously pointed out the significant conflicts of interest in the model between the bidder and the activist. At the end-point of the battle—as the December 18 Allergan shareholder meeting approached, and as it was reported that Allergan was trying to reach a deal with Actavis—the essential conflict was heightened.

Valeant’s interest was to acquire Allergan, while Pershing Square’s basic financial interest was to maximize its profit.

Pershing Square was almost certainly better off if a competing bidder emerged and won—the price would be higher and the terms agreed with Valeant would not apply (such as, the initial agreements to provide up to $400 million of additional financing for the Valeant bid if requested and to retain the equity interest in Allergan for a year after the acquisition; and the later volunteered commitments to take all stock in the offer even if other shareholders were offered cash and stock and the give-back to Valeant of $600 million of the proceeds on its Allergan shares if the Valeant bid succeeded). Thus, Pershing Square appears to be approximately $1.2 billion better off, on an immediate basis, with the Actavis transaction than it would have been had Valeant’s bid succeeded.

Considerations at the end-point.

Valeant appears to have indicated that it will not continue its fight for Allergan in the face of the Actavis agreement. Valeant, which initially offered $47 billion for Allergan and ultimately offered $53 billion, publicly announced yesterday that it could not justify to its own shareholders paying the $66 billion price Actavis offered for Allergan. At the end-point of the Pershing Square-Valeant collaboration for the acquisition of Allergan, the following questions arise:
Who has benefitted and who has been disadvantaged?

- As we predicted early on, Pershing Square has been positioned from the outset to benefit from the arrangement. As discussed above, the failure of the Valeant bid appears to have only contributed more to Pershing Square’s financial success. While Pershing Square faces ongoing litigation and potential insider trading liability, its profit is apparently well over $2 billion.

- The Allergan board achieved an approximately 35% increase for the Allergan shareholders from the initial price offered for the company.

- Valeant has expended an enormous amount of time and effort, and has been significantly distracted from running its business and pursuing other possible acquisitions.

Valeant seems to have obtained no significant advantage from the collaboration. Conceivably Pershing Square’s actions may have enabled Valeant to offer a higher price than it otherwise could have (for example, by Pershing Square having bought the pre-announcement stake and, later, having unilaterally agreed to take all-stock consideration and to give back $600 million of its gains to Valeant). These benefits appear to pale, however, to the disadvantage to Valeant of not having acquired the pre-announcement equity stake itself. Without the collaboration, Valeant would have had available to it all of the gain on any pre-announcement equity stake it had acquired (rather than now receiving 15% of the gain on Pershing Square’s pre-announcement equity stake), and that gain could have been used to increase Valeant’s price or would have been profit for Valeant in the context of a failed bid.

Did Valeant ask Pershing Square to forgo some more of its gain to enable Valeant to raise its price further? Once Actavis was interested, Pershing Square would have had to evaluate the economic consequences of obtaining Actavis’ higher premium and an investment in Actavis stock versus obtaining Valeant’s lower premium and the long-term benefits of owning Valeant stock. Whatever Pershing Square’s views about Valeant’s prospects, it is hard to believe that they could have outweighed the substantial price differential offered by Actavis. Thus, it appears that Pershing Square would not have had any reason to have agreed to a request by Valeant for further concessions once Actavis was involved (while, previously, Pershing Square could have been incentivized to possibly increase its give-back to Valeant to try to avoid the potential of there being no deal for Allergan).

How could Valeant have improved its likelihood of success? Would it have changed the result if Valeant had made its best and final bid (and otherwise addressed Allergan’s concerns about the Valeant equity) earlier in the process? Did Valeant consider at any point addressing some of the uncertainty about the value of its stock and business plan by providing a value assurance mechanism for the stock portion of the proposed merger consideration? Would the proxy contest have created enough credibility and pressure without the offer? (The insider trading issues would have been eliminated if Valeant had not commenced an exchange offer.)

If Valeant had been successful in replacing a majority of the Allergan board, how would the Valeant-nominated directors have proceeded? Could they have immediately approved Allergan’s entering into a merger agreement with Valeant? The Valeant slate,
which was comprised of independent directors, after their election would have had to act solely in the interest of Allergan’s shareholders. As such, depending on what they learned about what Allergan’s process had been in terms of shopping the company, and their investment bankers’ view of the potential for other interest in the company, they would have had to consider actively shopping or auctioning the company, as well as negotiating with Valeant to try to obtain better terms.

**Conclusion.** We had predicted that the Valeant-Pershing Square collaboration model would not be generally followed because of significant inherent economic costs, conflicts of interest, legal issues, and distraction from “selling” the transaction. That conclusion is supported by the facts that:

- the process unfolded in a mostly conventional way and was neither simplified nor shortened (in fact, it was complicated and probably lengthened) by the collaboration;
- the collaboration did not result in a successful bid for Allergan (and, in fact, it seems that it may well have disadvantaged the bid); and
- in the nine months since the collaboration model was introduced by Pershing Square and Valeant, we are not aware of any instance of its having been followed.

We anticipate that collaboration between bidders and activists will continue to evolve. The specifics will depend partly on developments in the legal arena—such as whether there are further judicial developments with respect to the insider trading claims against Pershing Square and whether the SEC moves (as it has from time to time indicated it may) to change the 13D rules relating to reporting of beneficial ownership of shares (for example, to close the so-called “13D filing window” or to require a “pause” after the acquisition of 5% of a company’s shares). Even more so, the specifics will depend on the circumstances of the particular bidder, activist, and transaction. (In the Allergan situation, for example, the model would have worked much better for Valeant if Allergan’s bylaws had not provided it with as much control over the timing of a special shareholders meeting—since the model did provide for early availability of voting shares to support the bid, but then the shareholder meeting was not to be held until nine months later.)

Among the critical issues for a bidder when deciding whether to collaborate with an activist will be:

- whether the bidder has the wherewithal to launch a bid on its own;
- whether the bid can be structured without a tender or exchange offer (or the activist partner can be a “true co-bidder”);
- the likely timing of Hart-Scott-Rodino approval and the defensive posture of the target (including whether it has a staggered board and whether it has significant control over the timing of a special shareholder meeting); and
- the terms on which an activist is willing to collaborate.

We anticipate that activists will be eager to collaborate along the lines of the Valeant-Pershing Square model—but that, in most cases, as discussed above, it would be to a bidder’s advantage to proceed on its own, and to collaborate with an activist only *after* a bid is made rather than before.

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