DuPont Capital

EQUITY STRATEGY REVIEW
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Merger Arbitrage

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During the quarter, M&A volumes and deal count were down significantly due to COVID-19. The decline was not a surprise, as companies devoted more attention to internal crisis management rather than weighing time-consuming deals and integration risk. Furthermore, the due diligence process was hindered by the inability to conduct onsite asset inspections and participate in face to face negotiations. After all, M&A is a relationship process and there is only so much that can be accomplished via Zoom. Recent conference calls with M&A bankers have tried to paint a brighter picture with reports that prospective buyers are using drones to remotely inspect assets. We are cognizant that bankers are almost perennially bullish on future M&A prospects, but we are sympathetic to their view that the M&A cycle has been paused rather than entirely derailed. Once M&A starts to rebound, we expect most corporate deals to use stock as currency, as the economics of the deal depend on the relative stock valuation between the buyer and seller at a point in time. In a cash deal, there is more risk to the buyer around the timing of the cycle. In merger arbitrage, we focus more on the potential arb spread rather than the particular consideration, although implementing stock deals may depend on the available short borrow in less liquid deals.

Going forward, we believe new deal volume will be impacted by a few factors. As discussed previously, COVID-19 has slowed deal making and we expect a re-escalation in the number of cases will have a similar impact. We also expect cross-border M&A may be hampered by rising protectionist measures as several host countries have recently floated proposals to protect domestic companies in sensitive industries from unwanted M&A advances. Last, we believe deal activity may be subdued until after November's US presidential election when management teams will have better visibility of the regulatory and economic environments.

Although several pending deals successfully closed during the quarter, deal breaks that have entered litigation are occurring at a much higher rate than in the past. Typically, deal breaks occur during downcycles as buyers second guess the rationale for the deal, or the weakening economic environment erodes the deal economics. In these cases, the buyer alleges that the target has suffered a material adverse event (MAE) and breached ordinary course covenants. However, as discussed last quarter, the burden to prove an MAE is quite challenging. In the entire legal history of Delaware chancery court, there has only been a single proven MAE - the Akorn/Fresenius deal in 2018. In that case, the court ruled that an MAE must be durationally significant, meaning the target's weakness must last years rather than months or quarters. Given COVID-19 was only declared a pandemic in March 2020, it is far too early to definitively conclude that economic weakness is durationally significant. As such, precedent should favor the seller. Furthermore, several of the merger agreements specifically carve out pandemic effects, so COVID-19 would not qualify as an MAE regardless of duration unless it could be proven that it has had a disproportionately negative impact on the target relative to its peer group. However, a disproportionality test is only conducted if an MAE is determined meaning durational significance would still need to be proven. This creates a very high hurdle favoring the sellers in litigation.

Buyers are alternatively pursuing "back door MAE" strategies by arguing that recent actions by sellers during the pandemic have breached ordinary course covenants to conduct business consistent with past practices. There is no strong legal precedent around such claims, leaving significant uncertainty about how the courts will interpret what constitutes "consistent" and what are reasonable deviations in times of stress.

Recent litigation highlights just how gray this area can be. For example, in a case involving Simon Property Group (buyer) and Taubman Centers (seller), the buyer alleged that the seller was not aggressive enough in restructuring actions such as cutting salaries and furloughing employees. However, in a case involving Advent (buyer) and Forescout Technologies (seller), the buyer argues that the seller's headcount restructuring was a deviation from ordinary course. In one case, the buyer insists the seller did not reduce headcount enough, while in the other case, the buyer claimed the seller's job reductions were inappropriate.

Courts will likely be reluctant to get mired in the details of whether a five or fifteen percent headcount reduction was appropriate during the pandemic. We instead believe the courts will consider the actions of company peers in determining what is ordinary course. We also expect future merger agreements will be far more specific on the actions permitted under ordinary course.

We see these types of strategies as a "Hail Mary" - if the buyer loses, they would at worst have to complete a deal already agreed to. Why not take a risk, prolonging the deal so there is more time to see the potential effect of economic weakness on the target? In most cases, however, courts have upheld the sanctity of merger contracts. By allowing buyers to wiggle out of deals whenever the economy weakens, courts could open Pandora's box. It is always difficult to predict the nuances of specific case outcomes, but we feel comfortable in most instances today, that sellers have strong justification and legal protection to enforce the merger agreement.

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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