

Litigation Notes

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POTENTIAL LAWSUIT BY JOHNSON & JOHNSON TO TERMINATE CENTOCOR AGREEMENT WITH SCHERING-PLOUGH

Merck agreed to acquire **Schering-Plough** for over \$41 billion, but the combination was structured as a reverse merger in which the surviving corporation will be Schering-Plough, which will subsequently change its name to Merck. Nevertheless, Merck will fund the cash portion of the transaction, and its shareholders will wind up with 68% of the total shares outstanding. The reason for the reverse merger structure is that if the transaction were structured as a regular merger, Schering-Plough would lose about \$3 billion in revenue from Remicade and Golimumab, owned by **Johnson & Johnson** and licensed to Schering-Plough by Centocor prior to its acquisition by Johnson & Johnson. The distribution agreement between Centocor and Schering-Plough provides that if there is a change of control of one party, then the other party has the right, within 30 days after notice, to terminate the agreement.

In our analysis of the agreement between Schering-Plough and Centocor, Johnson & Johnson has the right to terminate the distribution agreement and recover for itself the revenue stream from Remicade and Golimumab. We think that Johnson & Johnson will file a suit in the relatively near future and that it will have a strong hand in its subsequent negotiations, if any, with Merck. We do not believe that Johnson & Johnson will be graceful about it and simply allow Merck to acquire these rights without a fight.

The trigger for Johnson & Johnson's opportunity to terminate the agreement between Centocor and Schering-Plough is provided at Paragraph 8.2(c) of the agreement, which is entitled "Change in Control." The paragraph has two parts, beginning with three operative sentences describing the right to terminate and the mechanism by which that right is to be exercised. The second part is a definition of "Change of Control," meaning that whenever the phrase "Change of Control" appears in the agreement, it has the definition that is indicated. The agreement has a section devoted to definitions, and that section includes Paragraph 1.4 defining the word "Control," but the definition of "Change of Control" is not present in the definitions section.

We found three different ways in which Johnson & Johnson can demonstrate that a triggering event has occurred or will occur as a result of Merck's acquisition, thus giving Johnson & Johnson the right to terminate Schering-Plough's distribution rights to the two Centocor products. The first way, which we regard as the strongest, does not even involve the definition of "Change of Control" provided in the second part of Paragraph 8.2(c). In fact, the defined term "Change of Control" does not appear anywhere in the agreement other than in its definition. Accordingly, it appears that the term was defined for no reason at all insofar as it was never used by the drafters in an operative provision of the agreement.

The three sentences comprising the first part of Paragraph 8.2(c), which contains the operative language of the right to terminate, read as follows:

- (c) Change in Control. If either party is acquired by a third party or otherwise comes under Control (as defined in Section 1.4 above) of a third party, it will promptly notify the other party not subject to such change of control. The party not subject to such change of control will have the right, however not later than thirty (30) days from such notification, to notify in writing the party subject to the change of Control of termination of the Agreement taking effect immediately. As used herein “Change of Control” shall mean....

The capitalization and non-capitalization of the terms in the above quote is faithful to the original and is critical to the analysis. It is extremely clear, we think, that the term “Control” as used in the first sentence refers back to the definition in Section 1.4, since it says so in parentheses. That definition reads as follows:

“Control” means the ability of any entity (the “Controlling” entity), directly or indirectly, through ownership of securities, by agreement or by any other method, to direct the manner in which more than fifty percent (50%) of the outstanding voting rights of any other entity (the “Controlled” entity), whether or not represented by securities, shall be cast, or the right to receive over fifty percent (50%) of the profits or earnings of, or to otherwise control the management decisions of, such other entity (also a “Controlled” entity).

Because of the reverse merger structure, ownership of securities does not give Merck control over Schering-Plough, but we think that Merck would have control over Schering-Plough “by agreement,” and we think it would also have control “by any other method,” which language was probably intended by the drafters, we think, to be broad. The provision also has the phrase “otherwise control the management decisions of [the Controlled entity].” Stripped of excess verbiage, the definition states that Merck has “Control” when, by agreement or by some other method, it can control the management decisions of Schering-Plough. That, we think, describes the current deal regardless of its reverse merger structure.

Once it is understood that Merck satisfies the definition of “Control,” the first sentence of Paragraph 8.2(c) is applicable regardless of the definition of “Change of Control” set out later in the paragraph. The issue is whether Schering-Plough “otherwise comes under Control (as defined in Section 1.4 above) of a third party” as a result of signing the merger agreement, and we think it is evident that this condition is satisfied. The use of language in the first and second sentences referring to “such change of control” without initial capitalization means that it refers to the “change of Control” as defined in Section 1.4 and not the more limited definition of Change of Control set out later in the paragraph.

If Schering-Plough fails to give the required notice to Centocor, then that would be a breach on the part of Schering-Plough, but it would not affect Johnson & Johnson’s rights to terminate the agreement.

The second way in which the agreement permits termination by Johnson & Johnson is in the definition of “Change of Control” set forth in the second part of Paragraph 8.2(c). The second part reads as follows:

As used herein “Change of Control” shall mean (i) any merger, reorganization, consolidation or combination in which a party to this Agreement is not the surviving corporation; or (ii) any “person” (within the meaning of Section 13(d) and Section 14(d)(2) of the Securities Exchange Act of 1934), excluding a party’s Affiliates, is or becomes the beneficial owner, directly or indirectly, of securities of the party representing more than fifty percent (50%) of

either (A) the then-outstanding shares of common stock of the party or (B) the combined voting power of the party's then-outstanding voting securities; or (iii) if individuals who as of the Effective Date constitute the Board of Directors of the party (the "Incumbent Board") cease for any reason to constitute at least a majority of the Board of Directors of the party; provided, however, that any individual becoming a director subsequent to the Effective Date whose election, or nomination for election by the party's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board shall be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest with respect to the election of removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a person other than the Board; or (iv) approval by the shareholders of a party of a complete liquidation or the complete dissolution of such party. [The grammatical mistake of (ii) appears in the original.]

The reverse merger structure clearly bypasses subparagraph (i), but in our analysis, Merck still has to contend with subparagraph (ii), since the meaning is clear despite its grammatical awkwardness. Since corporations are "persons" under the Securities Exchange Act of 1934, it is reasonable to say that Merck is a person, and the question is whether, as a result of the merger agreement, it becomes the beneficial owner, directly or indirectly, of more than 50% of the common stock of the party [i.e., the "party" being either Centocor or Schering-Plough] or, if other securities also have voting power, of more than 50% of the combined voting power of the party's then outstanding voting securities.

Since Merck shareholders will ultimately own 68% of the combined enterprise, the issue is whether Merck, on signing the merger agreement, becomes the *beneficial* owner, *directly or indirectly*, of more than 50% of the common stock of Schering-Plough. It is well-recognized that a beneficial owner does not have to be an actual owner to satisfy the definition, and it is also well-known that "directly or indirectly" is a phrase that does not have precise boundaries. The concept of an "indirect beneficial owner" could well apply to many types of relationships, and Johnson & Johnson could make a good argument that Merck has become at least an indirect beneficial owner of Schering-Plough by reason of the merger agreement itself, without regard to the aftermath once the deal has closed.

The third way for Johnson & Johnson to demonstrate a triggering event for its termination clause is to invoke subparagraph (iii) of the definition of "Change of Control." The Schering-Plough directors will not constitute a majority of the new board, which is a triggering event under (iii), but the agreement provides a way around this provision, which is to nominate and vote on the new directors one at a time. If that procedure is used, and we assume that it will be used, then Schering-Plough will be able to avoid the trigger of this subparagraph.