M&A LAB

Outbound Acquisition By India Inc.

Sun Pharma – Taro Pharma Dissection

Dissected by – *Team M&A* and *Team Globalisation*:

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April 15, 2009

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Nishith Desai Associates ("**NDA**") is a research oriented international law firm with offices in Mumbai, Bangalore, Singapore and USA. The firm specializes in providing strategic legal and business solutions coupled with industry expertise. Core practice areas of the firm include mergers and acquisitions, structuring and advising on outbound & inbound investments, private equity investments and fund formation, international tax, globalisation, intellectual property and dispute resolution. From an industry perspective, the firm has practice groups which have developed significant expertise relating to various industries including but not limited to banking and financial services, insurance, IT, BPO and telecom, pharma and life sciences, media and entertainment, real estate, infrastructure and education sectors.

NDA has been included in the Asian Legal Business Watchlist as one of the 'Top 10 firms to watch in 2009' in the Asia Pacific region. It has also been named one of the top law firms in India for IT, Media & Telecommunications, Taxation and Venture Capital & Private Equity by the India Business Law Journal. NDA was honored with the Indian Law Firm of the Year 2000 and Asian Law Firm of the Year (Pro Bono) 2001 awards by the International Financial Law Review, a Euromoney publication. In an Asia survey conducted by International Tax Review (September 2003), the firm was voted as a top-ranking law firm and recognized for its cross-border structuring work. For further details, please refer to our website at www.nishithdesai.com and for any queries on Mergers & Acquisitions, please contact Mr. Nishchal Joshipura, Head of M&A practice at NDA at nishchal@nishithdesai.com or Mr. Siddharth Shah, Head of corporate and securities practice at NDA at siddharth@nishithdesai.com.

PRELUDE

This is one scuffle which has rocked the two crown establishments in pharma space and has taken them through a roller coaster ride. The battalion of group companies for one of India's leading drug maker Sun Pharmaceutical Industries Limited would have swiftly expanded to include another gigantic drug making company of Israel i.e. Taro Pharmaceutical Industries Limited. At the outset of entering into a concord for a friendly merger between **Sun Pharmaceutical Industries Limited** (India) and **Taro Pharmaceuticals Industries Limited** (Israel) (the "**Proposed Transaction**"), none of the parties would have contemplated that they would end up battling in courts or trying to settle the disputes through mediation. Manifestly, what was supposed to be the second largest outbound acquisition by an Indian company in the pharma space is now into disputed waters.

This M&A Lab probes the commercial, legal, tax and regulatory aspects of the Proposed Transaction between Sun Pharmaceutical Industries Limited and Taro Pharmaceuticals Industries Limited.

PARTIES INVOLVED IN THE PROPOSED TRANSACTION

Sun India Group

*Sun Pharmaceutical Industries Limited ("**Sun India**")* – India: Sun India is an internationally integrated specialty pharmaceutical company which manufactures and markets a large number of pharmaceutical formulations as branded generics as well as generics in India, USA and several other markets across the world. Sun India is a listed company on the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).

*Alkaloida Chemical Company Exclusive Group Limited ("**Alkaloida**")* – Hungary: ICN Hungary (renamed as Alkaloida) was acquired by Sun India from Valeant Pharmaceuticals in 2005. Alkaloida is an indirect wholly owned subsidiary of Sun India.

*<u>Aditya Acquisition Company Limited ("**Aditya**") – Israel</u>*: Aditya is a wholly owned subsidiary of Alkaloida and was incorporated in Israel solely for the purpose of entering into the merger agreement and merge into Taro Pharmaceuticals Industries Limited.

*<u>Sun Pharmaceutical Industries Inc. ("**Sun USA**") – Michigan, USA</u>*: Sun USA is a wholly owned subsidiary of Sun India. It has plants in Ohio and Cranbury. Its products are distributed and sold by Caraco Pharmaceutical Laboratories incorporated in Detroit, which is one of Sun India's group companies.

*<u>Sun Development Corporation ("**SDC**") – New York, USA</u>*: It is a wholly owned subsidiary of Sun USA and was incorporated solely for the purpose of entering into the USA Merger Agreement in USA.

Taro Israel Group

*<u>Taro Pharmaceuticals Industries Limited ("**Taro Israel**") – Israel</u>*: Taro Israel is a science based multinational pharmaceutical company incorporated and operating in Israel. It operates principally through the following entities – (i) Taro Israel (ii) Taro Pharmaceuticals U.S.A., Inc. and (iii) Taro Pharmaceuticals Inc., Canada.

*<u>Taro Pharmaceuticals U.S.A., Inc. ("**Taro USA**") – New York, USA</u>*: Taro USA is the principal operating subsidiary of Taro Israel in USA. It markets a broad range of prescription and over-the-counter products in the USA. It accounts for around 80% of Taro Israel's global sales.

*<u>Taro Development Corporation ("**TDC**") – New York, USA</u>*: TDC is a private company under the control of Barrie Levitt, M.D. (Director and Chairman of the Board of Directors), Daniel Moros, M.D. (Director and Vice-Chairman of the Board of Directors) and members of their families.

ABSTRACT & OUTLINE OF THE M&A LAB

<u>PROPOSED SCHEME OF MERGER</u>

To get a full control over Taro Israel and TDC, the parties (as mentioned below) entered into certain agreements for the purpose of facilitation of the acquisition of Taro Israel by Alkaloida in Israel and the acquisition of TDC by Sun USA in USA. Following agreements were entered into between Sun India group and Taro Israel group initially:

MERGER AGREEMENT BETWEEN ALKALOIDA, ADITYA AND TARO ISRAEL ("ISRAEL MERGER AGREEMENT")

Sun India through its wholly owned indirect subsidiary Alkaloida and Aditya (wholly owned subsidiary of Alkaloida) entered into an agreement of merger on May 18, 2007 with Taro Israel to effect a reverse triangular merger of Aditya into Taro Israel, upon consummation of which Aditya would cease to exist and Taro Israel would become a wholly-owned subsidiary of Alkaloida.

MERGER AGREEMENT BETWEEN TDC, SDC, SUN USA ET AL ("USA MERGER AGREEMENT")[1]

This USA Merger Agreement was also entered into on May 18, 2007, by and among Sun USA, SDC, TDC, Barrie Levitt ("**BL**") and Daniel Moros ("**DM**"). The agreement provided for reverse triangular merger of SDC into TDC, upon consummation of which SDC would cease to exist and TDC would become a wholly owned subsidiary of Sun USA. This agreement was an integral part of the whole process as TDC holds 6.4%

[1] Israel Merger Agreement and the USA Merger Agreement shall hereinafter together be referred to as "**Merger Agreements**".

equity shares and 1/3 of voting rights in Taro Israel. In addition, TDC holds 3.1% equity shares and 50% voting rights in Taro USA. Taro USA is a principal subsidiary of Taro Israel in USA.

OPTION LETTER AGREEMENT[2]

Factoring the possibility of a failed merger as envisaged in the Israel Merger Agreement; TDC, BL, Tal Levitt ("**TL**") and DM entered into an Option Letter Agreement with Alkaloida thereby granting certain options to Alkaloida. The options were (a) TDC granted the option for its own acquisition pursuant to a merger whereby a new wholly-owned subsidiary of Alkaloida would merge into TDC for a total merger, consideration of USD 18,088,275; (b) BL, TL and DM granted the option to sell 2,405,925 ordinary shares held by them to Alkaloida at a purchase price of USD 7.75 per ordinary share; and (c) BL granted Alkaloida an option to acquire all Class B common stock of Morley and Company, Inc. ("**Morley**") held by BL for no consideration. The period for exercising these options was thirty days after the termination of the Israel Merger Agreement. As a condition in the Option Letter Agreement, all the options had to be exercised together.

Please refer to the diagrammatic representation of the Proposed Transaction.

OUTLINE OF THE M&A LAB

This M&A Lab is divided into two parts:

- **Part A** – **Pre Termination of the Merger Agreements** – This part covers the commercial, legal, regulatory and tax framework in case the Merger Agreements would have got consummated; and

- **Part B** – **Post Termination of the Merger Agreements** – This part covers the commercial, legal, regulatory and tax issues in light of the current position of the Proposed Transaction and issues between Sun India and Taro Israel.

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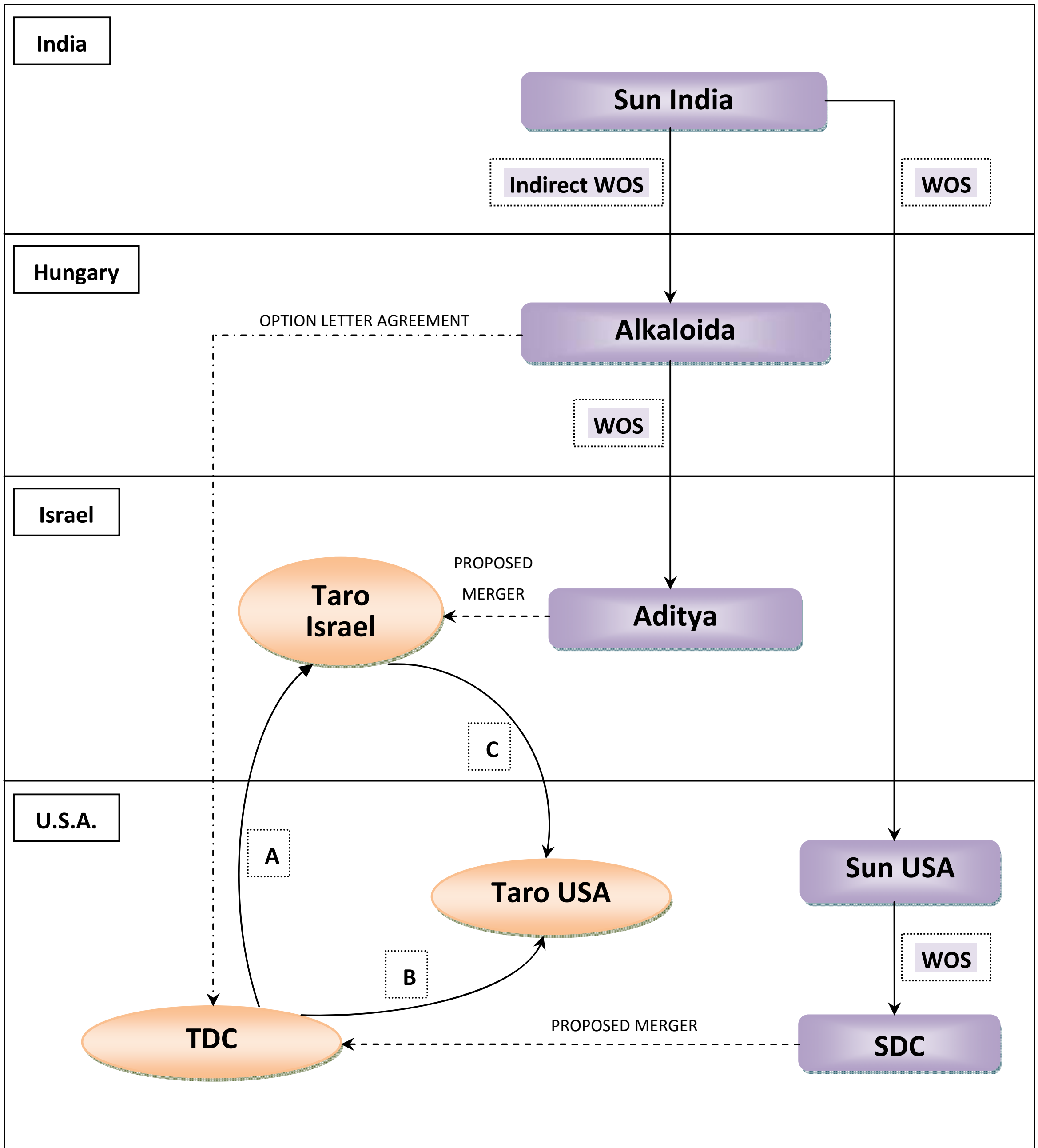
[2] The Option Letter Agreement and reasons triggering it have been dealt further in Part B of this M&A Lab.

STRUCTURE DIAGRAM



LEGENDS	
A – 6.40% equity & 1/3rd voting rights **B** – 3.1% economic rights & 50% voting rights	**C** – 96.9% economic rights & 50% voting rights **WOS** – Wholly Owned Subsidiary

PART A – PRE TERMINATION OF THE MERGER AGREEMENTS

This Part A deals with the commercial, legal, regulatory and tax considerations of the Proposed Transaction on the basis of all such issues which may have triggered had the parties successfully consummated the transaction.

COMMERCIAL FRAMEWORK

Why did Sun India want to acquire Taro Israel?

Taro Israel would have been one of the best acquisitions for Sun India considering the operations of Taro Israel in 5 countries around the world with a strong market presence in USA. The focused therapeutic portfolio and branded generic experience of Taro Israel in USA made it an ideal acquisition target for Sun India. The strategy of Taro Israel was similar to that of Sun India as they focused on some selected therapeutic areas and thus offering synergies of operations and cross-utilization of assets. Taro Israel's experience in branded generics in the USA and strength in dermatology and paediatrics would have opened up new avenues for Sun India in USA.

Further to the above, the UK and Irish operations of Taro Israel would have been good entry points for Sun India into the European markets.[3] This would have greatly helped Sun India in expanding its operations. Further, Taro Israel built a strong brand franchise for quality among USA healthcare providers and regulators which could have been used by Sun India to promote its other products.

Why was the acquisition structured in the form of a merger?

The transactions contemplated under the Merger Agreements were in the best interest of Taro Israel as Taro Israel was in severe financial crunch and was in need of both immediate and long term funding. Further, preceding the Proposed Transaction, Alkaloida had invested USD 40.725 million in Taro Israel by purchasing 6,787,500 ordinary shares at USD 6 per share. In the absence of such investment by Alkaloida, Taro Israel would not have been able to meet its bond payment obligations. On this backdrop and on the advice of the financial advisors of Taro Israel, the Blackstone Group; the board of directors took the decision that the merger of the operations of Sun India and Taro Israel would be in the best interest of Taro Israel in light of financial and operational difficulties that were faced by it.

USA Merger Agreement was an integral part of the whole merger process as TDC holds 6.4% equity shares and 1/3 of voting rights in Taro Israel. Further, TDC also holds 3.1% equity shares and 50% voting rights in Taro USA which is a principal subsidiary of Taro Israel in USA as 80% of Taro Israel's global sales are generated from its operations in USA.[4]

How were the mergers proposed to be effected?

Alkaloida and Aditya had entered into the Israel Merger Agreement with Taro Israel to effect the reverse triangular merger of Aditya into Taro Israel in Israel. Simultaneously, USA Merger Agreement was executed which provided for reverse triangular merger of SDC into TDC in New York. Upon proposed consummation of both the mergers, Aditya would have ceased to exist and Taro Israel would have become a wholly owned subsidiary of Alkaloida and, similarly, SDC would have ceased to exist and TDC would have become a wholly owned subsidiary of Sun USA.

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[3] Source: http://www.moneycontrol.com/news_html_files/news_attachment/2008/tfp20080902.pdf

[4] Source: http://www.tarousa.com/CorporateInfo/Welcome/Page.html

In a **Reverse Triangular Merger**, the acquiring company sets up a subsidiary which in turn merges with the target company. As a result of the merger, target company becomes the subsidiary of the acquiring company and the shareholders of target company receive cash in return or shares of the acquiring company. Reverse Triangular Merger is a preferred mode for structuring any acquisition / merger, since Reverse Triangular Mergers are exempt from local taxes in certain jurisdictions.

What was the swap ratio in both the proposed mergers?

Israel Merger Agreement

Under the Israel Merger Agreement, each ordinary share of Taro Israel (other than shares held by TDC, Morley or any other wholly owned subsidiary of Taro Israel) shall solely have the right to receive USD 7.75 in cash, without interest and less any applicable withholding tax.

Similarly, all the outstanding and unexercised options existing in Taro Israel immediately prior to the effective date of the merger, whether or not vested, and having an exercise price of less than USD 7.75 would be cancelled in exchange for the right to receive an amount in cash per option equal to USD 7.75, less the exercise price of such option and any applicable withholding tax.

USA Merger Agreement

TDC, directly or through its subsidiaries, held (i) 2,600 founder shares of Taro Israel and (ii) 50% of the voting rights and 3.1% of Taro USA and (iii) 2,333,971 ordinary shares of Taro Israel. In order to acquire TDC's interest in Taro USA and the founder shares in Taro Israel, SDC shall merge with TDC. The sole consideration that shall be received by the shareholders of TDC is the number of ordinary shares held in Taro Israel by TDC, multiplied by USD 7.75, without any interest and less any applicable withholding tax.

What were the litigations vis-à-vis the minority shareholders?

Franklin Advisers and Templeton who held the beneficial interest of approximately 9% of the equity shares of Taro Israel filed a motion in Tel Aviv District Court seeking remedies intended to prevent alleged oppression of minority shareholders and passing of an injunction blocking the merger on the ground of oppression of the minority shareholders. However, Tel Aviv district court refused to pass any temporary injunction and ruled in favour of the Proposed Transaction.

LEGAL AND REGULATORY CONSIDERATIONS

I. ISRAEL LAW IMPLICATIONS

MINIMUM REQUISITE VOTE

Under the Israeli Company law, some of the major approvals required from the shareholders, for the approval of the Israel Merger Agreement and the transactions contemplated therein are as follows:

- 75% of the voting power of Taro Israel present and voting at the extraordinary general meeting in person or in proxy;
- 75% of the ordinary shares present and voting at the meeting of the ordinary class shareholders in person or in proxy; and

- 75% of the founder shares present and voting at the meeting of the founder class shareholders in person or in proxy.

ISRAELI INVESTMENT CENTER

As mentioned above, upon consummation of the transactions contemplated under the Israel Merger Agreement, Aditya would cease to exist and Taro Israel would become a wholly-owned subsidiary of Alkaloida. This acquisition of control of Taro Israel by Alkaloida would require the approval of the Investment Center of the Ministry of Industry and Trade of the State of Israel.

ISRAEL LANDS ADMINISTRATION

Taro Israel is a party to various long-term lease agreements with the Israel Lands Administration ("**ILA**"). Under the terms of these leases, the acquisition of control of Taro Israel by Alkaloida shall require the approval of ILA and such an approval is also laid down as a condition in the Israel Merger Agreement.

OFFICE OF THE CHIEF SCIENTIST

Grants up to 50% of project's expenditure are given under the Research and Development Programs that meet specified criteria and are approved by a governmental committee of the Office of the Chief Scientist under the Law for the Encouragement of Industrial Research and Development, 1984, in exchange for the payment of royalties from the sale of products developed under the program. Under the terms of such grants, the Israel Merger Agreement would require the prior approval of the Office of the Chief Scientist.

II. USA LAW IMPLICATIONS

ANTITRUST LAW

Parties to both the proposed mergers (Israel and USA) must determine as to whether the proposed transaction triggers the applicable threshold limits as prescribed under the laws of the countries depending upon the size of the parties or turnover. In case wherein the applicable threshold limits are triggered, there ought to be filed before the applicable competition authorities the scheme of the proposed merger. Such authority would look into the aspect of competitive concerns of the proposed merger taking into account the merger specific efficiencies and on their approval, the scheme of the merger can be implemented.

Due to the proposed merger in Israel, Alkaloida and Taro Israel are required to file a notification giving all the requisite details of the transaction to the Antitrust Division of the USA Department of Justice (the "**USA DOJ**") and the USA Federal Trade Commission (the "**FTC**") under the pre notification provisions of the Hart Scott Rodino Act ("**HSR Act**"). HSR Act prohibits the parties from completing a proposed merger, if they trigger the applicable threshold limits as mentioned in the HSR Act, unless all the details are filed with USA DOJ and FTC. There is a waiting period of 30 days wherein the USA DOJ and FTC shall inquire into whether the proposed merger has any competitive concerns.

FTC had challenged the Proposed Transaction on the grounds of being anticompetitive as it would cause consumers in USA to pay higher prices for three distinct generic formulations of the anticonvulsant drug carbamazepine. To remedy the anticompetitive concerns pointed out by FTC, Sun India had entered into a consent order with the FTC where they agreed to sell all rights and assets in respect to three drugs to Torrent Pharmaceutical Limited, another generic drug manufacturer based in India.[5]

[5] Source: http://www.ftc.gov/opa/2008/08/suntaro.shtm

III. INDIAN LAW IMPLICATIONS

ODI REGULATIONS

Any Indian company that wishes to acquire or invest in a foreign company outside India must comply with the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 ("**ODI Regulations**").

Under the ODI Regulations, an Indian company is permitted to invest in a joint venture or a wholly owned subsidiary up to 400%[6] of the net worth of the Indian company, in the form of equity, loan or guarantee, as on the date of the last audited balance sheet without seeking the prior approval of the Reserve Bank of India ("**RBI**") *inter alia* if the Indian company:

a) is not on the RBI's caution list or under investigation by the Enforcement Directorate;
b) routes all the transactions relating to the investment in the joint venture or the wholly owned subsidiary through only one branch of an authorized dealer; and
c) files the prescribed forms with the RBI.

Regulation 13 of the ODI Regulations permits a wholly owned subsidiary set up by an Indian company to set up a step down subsidiary. Extant ODI Regulations are ambiguous on whether setting up further down line subsidiaries will require prior approval of the RBI.

Whether the acquisition was permitted under the ODI Regulations?

In the proposed structure, Alkaloida is an indirect wholly owned subsidiary of Sun India. Creation of a further down line subsidiary by Alkaloida in form of Aditya, as mentioned above, may require prior approval of the RBI in terms of the ODI Regulations.

The issue therefore is whether Sun India sought permission of the RBI prior to the incorporation of Aditya as Aditya is an indirect wholly owned subsidiary of Sun India. (*Please refer to the structure diagram above*).

There is a debate on whether an Indian company can set up wholly owned subsidiaries beyond two step down subsidiaries since Regulation 13 can be interpreted to cover multiple layers of step down subsidiaries. While the RBI's approach on such ambiguity is unclear, we understand based on the earlier precedents that RBI has recently been liberal and has permitted to allow Indian entities from setting up multiple layers of step down wholly owned subsidiaries.

FOREIGN CURRENCY CONVERTIBLE BONDS ("FCCB")

Sun India had the intention of using its FCCB proceeds to fund the acquisition of Taro Israel.[7] On December 3, 2004, Sun India had announced that it raised a total of USD 350 million Zero Coupon Foreign Currency Convertible Bonds with 4.61% per annum yield to maturity.[8]

> **Foreign Currency Convertible Bonds** means bonds subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part. It is expressed in foreign currency and the principal and interest in respect of which is payable in foreign currency.

[6] This ceiling is not applicable where the investment is funded out of balances held by the Indian party in its Exchange Earners' Foreign Currency (EEFC) account.

[7] Source: http://www.moneycontrol.com/india/news/news/sun-pharma-acquires-taro-pharma-for-36;454m/18/16/282143

[8] Source: http://www.sunpharma.com/admin/news/upload/197.pdf

Under the External Commercial Borrowings Guidelines, FCCB proceeds cannot be utilized for any domestic acquisition; however, the same can be utilised for any overseas acquisition. Hence, Sun India could have used the FCCB proceeds for the purpose of merger with Taro Israel.

ANTITRUST LAW (INDIAN LAW)

The Indian anti-trust laws are contained in the Monopolies and Restrictive Trade Practices Act, 1969 ("**MRTP Act**") which shall, in due course, be replaced by the Indian Competition Act, 2002 ("**Competition Act**"). Though the MRTP Act and the new Competition Act are concurrently in force; currently, the substantive provisions of the Competition Act relating to anti-competitive agreements, abuse of dominance and regulation of combinations have not yet been notified.

In terms of the Competition Act, parties to the proposed merger must notify to the Competition Commission of India ("**CCI**") providing the details of the proposed merger in the event the proposed merger triggers the applicable threshold limits as prescribed under Section 5 (c) of the Competition Act. Pursuant to the notification, CCI shall do its due investigation on the basis of the criterion laid down under the Competition Act (*inter alia* level of combination of the market, market shares) to determine whether the acquisition causes or is likely to cause an adverse appreciable effect on competition within the relevant market in India and the CCI shall give its ruling within a maximum period of 210 days. Further, the Competition Act provides for extra territorial jurisdiction of the CCI to probe into an overseas acquisition if it causes or is likely to cause an adverse effect on competition in relevant market in India.

TAX CONSIDERATIONS

What are the material tax consequences of the merger of TDC and SDC under the federal law of USA?

The indirect wholly-owned subsidiary of Sun India, being SDC, was proposed to be merged into TDC, rather than having TDC selling its ordinary shares in Taro Israel directly to SDC. This may have been done to ensure that the shareholders of TDC would be subjected to only a single level of taxation in the USA.

What are the material tax consequences for USA shareholders of the merger of Aditya and Taro Israel under the federal law of USA?

As per the Federal income tax law governing the United States, the receipt of cash by the shareholders of Taro Israel in connection with the merger will be a taxable transaction. The amount on which the income tax shall be payable will be equal to the difference between the amount of cash received in connection with the merger and the aggregate adjusted tax basis of the shares surrendered by shareholders in the course of the merger. The gains or loss so made may be categorized as long term or short term. If the Taro Israel shares surrendered were held for a period of more than one year from the effective date of the merger, it should be classified as long term capital gains (loss), if not then it would be classified as short term capital gains (loss). In the case of a non-corporate USA shareholder, long term capital gains are subject to a maximum USA federal income tax rate of 15%.

What are the material tax consequences for Israeli shareholders of the merger of Aditya and Taro Israel under the law of Israel?

Under the income tax law of Israel, the transfer of shares of an Israeli company is deemed to be a sale of capital assets. Like the Indian tax law, Israeli tax law imposes a capital gains tax on the sale of capital assets located in Israel, including shares in Israeli resident companies, by both residents and non-residents of Israel.

For individual shareholders, the tax rate applicable to capital gains derived on or after January 1, 2003 is approximately 20%. However, the tax basis of shares acquired prior to January 1, 2003, will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. Companies are subject to tax on capital gains derived from the sale of shares either at the general corporate rate of 29% or 25% depending on the circumstances.

Why was Hungary (Alkaloida) used as an intermediate jurisdiction by Sun India for the acquisition of Taro Israel?

Hungary has always attracted foreign investors due to its favorable domestic tax regime and its wide network of international tax treaties. In addition, there is presently no withholding tax on dividend, interest, royalties or fees for technical services in Hungary making it a very favorable jurisdiction to repatriate funds outside Hungary.

Once the entire structure would have been implemented as proposed, Aditya would have merged into Taro Israel, thereby making Taro Israel a wholly owned subsidiary of Alkaloida. For the repatriation of profits captured in Israel to Hungary in the form of dividend, there is presently a withholding tax of 20%[9] however, as per the Hungary Israel tax treaty, this tax rate is reduced to 5%. As regards the taxation of dividend in Hungary, it should not be liable to any taxation in Hungary because of the participation exemption. As per the participation exemption rules in Hungary, the dividends flowing from subsidiaries other than controlled foreign corporations are exempt from domestic corporate income tax and solidarity surtax, regardless of the entity's home jurisdiction. However, in order to claim this exemption, the participation must be to an extent of at least 30% of the capital of the foreign subsidiary and must span for a period of at least 1 year.

> **Participation exemption** is a general term relating to an exemption from taxation for a shareholder in a company on dividends received, and capital gains arising on the sale of shares. The existence of a participation exemption under a local tax regime enhances a jurisdiction's attractiveness as a holding company jurisdiction.
>
> Countries with a participation exemption *inter alia* include Netherlands, Belgium and Switzerland.[10]

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[9] Source: www.ibfd.org

[10] Source: www.wikipedia.org

PART B – POST TERMINATION OF MERGER AGREEMENTS

This Part B deals with the commercial, legal, regulatory and tax issues involved between Sun India and Taro Israel in light of the current standing of the transaction.

COMMERCIAL FRAMEWORK

Why did Taro Israel terminate the Israel Merger Agreement?

On May 28, 2008, Taro Israel had issued a press release[11] for the termination of the Israel Merger Agreement on the ground that the transactions contemplated under the Israel Merger Agreement were no longer in the best interests of Taro Israel and it did not reflect the operational and financial turnaround that Taro Israel had achieved in the first half of 2008. The net income of Taro Israel had increased from USD 21 million in 2007 to USD 51 million in 2008. Further, the board of directors of Taro Israel also claimed operational constraints in the Israel Merger Agreement which were interfering with the company's ability to manage its business for the benefit of the stakeholders.

Sun India had offered to consider raising the merger price to USD 10.25 per share. The board of directors of Taro Israel had determined, in the light of the advice received by them from their financial advisors, that USD 10.25 per share was inadequate from the valuation perspective.

What is the consequence of failing or termination of the Israel Merger Agreement?

TDC, BL, TL and DM had entered into an Option Letter Agreement with Alkaloida thereby granting certain options to Alkaloida and its affiliates in the event of the failing or termination of the Israel Merger Agreement. The options which were exercisable within a period of 30 days from the termination of the Israel Merger Agreement are:

- Acquire TDC pursuant to a merger whereby a new wholly-owned subsidiary of Alkaloida would merge into TDC for a total merger consideration of USD 18,088,275;
- BL, TL and DM granted the option to sell 2,405,925 ordinary shares held by them to Alkaloida at a purchase price of USD 7.75 per ordinary share; and
- Acquire all Class B common stock of Morley held by BL for no consideration. This option becomes relevant in the light of the fact that Morley holds one third of the voting rights of Taro Israel.

As was agreed under the Option Letter Agreement, all the above options had to be exercised together.

What was the Irish angle?

One of the major contentious issues between Sun India and Taro Israel is with respect to Taro Israel's operation in Ireland. It was claimed by Taro Israel that the Irish operations are not part of the Company's core business whereas Sun India repeatedly refused to consent under the Israel Merger Agreement to the sale of those Irish operations. Sun India's chairman Mr. Dilip Sanghvi was quoted as saying, "*it is one of the most important businesses that Sun India will inherit by the proposed merger plan and it has repeatedly refused to consent under the merger agreement to the sale of those operations*."[12]

[11] Source: http://phx.corporate-ir.net/phoenix.zhtml?c=114698&p=irol-newsArticle&ID=1151068&highlight=

[12] Source : http://www.livemint.com/2008/06/05221525/Sun-to-stop-Taro8217s-inten.html

It was claimed by Taro Israel that the sale of the Irish operations would enhance the profitability and cash resources of Taro Israel. However, Sun India has, from time to time, issued letters for opposing the sale of the Irish operations. In response to such continued opposition to the sale of the Irish operations, Taro Israel had initiated legal action on June 15, 2008 to prevent Sun India from "*engaging in practices that we deemed detrimental to our ability to maximize the value of the Irish operations in a sale*"[13].

Did Sun India make a tender offer under the Option Letter Agreement?

Taro Israel had terminated the Israel Merger Agreement on May 28, 2008 on the grounds mentioned above. In consequence to the termination, on June 25, 2008, Alkaloida exercised its option under the Option Letter Agreement to acquire all the shares held by the controlling shareholders of Taro Israel. Sun India, through Alkaloida, had exercised its rights to protect its rights under the Option Letter Agreement. Further, as required under the Option Letter Agreement, it commenced a tender offer for all outstanding ordinary shares of Taro Israel for USD 7.75 per share in cash.

Why did the board of directors of Taro Israel reject Sun India's tender offer?

The board of directors of Taro Israel rejected the offer price of Sun India stating that Sun India's offer is financially inadequate in light of the present market value of the shares of Taro Israel and is a "*sham offer*"[14]. On July 10, 2008, the board of directors of Taro Israel issued a press release to all the shareholders of Taro Israel urging them not to tender their shares on the grounds that the offer price was "*absurdly low, unfair, financially inadequate and coercive".*[15]

What were the litigations involved?

Israel Litigation

Pursuant to the termination of Israel Merger Agreement, Taro Israel and its outside directors had filed a motion in the Tel-Aviv district court seeking a declaratory ruling that in the event that Alkaloida exercised the options granted under the Option Letter Agreement, it must comply with the 'special tender offer'[16] rules under the Israeli law, which are meant to protect the interest of the minority shareholders.

The Tel-Aviv district court on August 26, 2008 rejected Taro Israel's contention that Alkaloida should have conducted a 'special tender offer' under Israeli law. It was observed by the Tel-Aviv district court that it was disingenuous for Taro Israel's directors to claim that a 'special tender offer' was required after they had approved the Israel Merger Agreement.

Taro Israel appealed to the Supreme Court of the State of Israel (the "**Israel Supreme Court**") against the decision issued by the Tel-Aviv district court. At the request of Taro Israel, the Israel Supreme Court had granted an injunction, thus, precluding Alkaloida from acquiring the shares of Taro Israel vide a tender offer until the appeal process is concluded.

USA Litigation

Sun India and its affiliates Aditya, Alkaloida, Sun Pharmaceutical Industries, Inc. (Canada), and SDC had filed proceedings in the Supreme Court of New York, USA against BL, TL, Dr. Jacob Levitt, DM, TDC and Taro Israel levying charges of fraudulent inducement, declaratory judgment in the cases of the merger,

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[13] Source: http://www.financialexpress.com/news/taro-sues-sun-pharma-over-sale-of-irish-ops/325558/

[14] Source: http://phx.corporate-ir.net/phoenix.zhtml?c=114698&p=irol-newsArticle&ID=1173465&highlight

[15] Ibid.

[16] Special tender offer has been explained in detail further below.

anticipatory breach of Option Letter Agreement, breaches of the duties of good faith and fair dealing and unjust enrichment.

The proceedings are currently pending in the Supreme Court of New York, USA.

What was Sun India's revised offer?

In consequence to the Tel Aviv district court order, Sun India filed an amendment to its previously announced tender offer. The amendment provided for the waiver of certain conditions to the tender offer. Thereafter, on January 2, 2009, Sun India proposed to consider two alternatives as part of the settlement negotiations:

- Revise the offer price to USD 9.5 per share instead of the earlier USD 7.75 per share only in the event that Taro Israel withdraws its purported termination of the Israel Merger Agreement; or

- Revise the offer price to USD 9 per share in the event that Taro Israel withdraws the injunction and thus allow Sun India to close the tender offer to acquire Taro Israel's shares.

Taro Israel rejected both these offers claiming that it was substantially lower than the price Sun India paid to acquire an 8% minority interest from another shareholder in February 2008. Taro Israel demanded the merger offer price to be revised upwards to USD 15 per share. Sun India rejected Taro Israel's offer on the ground that it was more than the market value of the shares.

Why did the parties enter into mediation?

On January 26, 2009, on the recommendation of the Israel Supreme Court, the parties to the litigation in Israel, as well as the BL and DM families, agreed to a mediation process to attempt to resolve the dispute.

On March 31, 2009, Sun India has made a disclosure to the BSE and NSE that the mediation between Sun India and Taro Israel was unsuccessful and the parties could not reach to an agreement. Accordingly, they await the decision of the Israel Supreme Court.

LEGAL AND REGULATORY CONSIDERATIONS

I. ISRAEL LAW IMPLICATIONS

TENDER OFFER UNDER ISRAELI LAWS[17]

The legal framework applying to tender offers in Israel is found in the Companies Law 5759-1999 (the "**Companies Law**"), in the Securities Regulations 5760-2000 ("**Tender Offer Regulations**") and in the various orders and directives circulated by the Israeli Securities Authority in this respect.

The Companies Law and the Tender Offer Regulations provides for three types of tender offers:

1. **Special Tender Offer ("STO")**

This is a tender offer in which a person acquires a substantial level of holdings of voting rights of a public company. In these instances, the law requires the acquirer to execute the share acquisition by way of STO. STO is required in the following circumstances:

[17] Source: "*Israel Takeover Guide*" by Menachem Neeman and Daniel Lowbeer Herzog, Fox & Neeman.

- in a share acquisition in a company, granting the acquirer 25% or more of all voting rights at the general meeting of the company ("**Control Block**"), where there is no other person in the company holding a Control Block in the company;
- in a share acquisition in a company, granting the acquirer more than 45% of the voting rights in the company, where there is no other person holding more than 45% of voting rights in the company.

2. **Full Tender Offer ("FTO")**

This is a tender offer in which a person wishes to acquire all the shares in the company.

Threshold: A person may not acquire more than 90% of the shares or a class of shares in a public company other than by way of a FTO. Moreover, a person who holds more than 90% of the shares or any class of shares in a public company may not acquire additional shares of the same class for so long as such person holds more than 90% of the same class of shares.

3. **Regular Tender Offer ("RTO")**

A regular tender offer is a tender offer which is neither considered a FTO nor a STO; however, the intention of the acquirer is to acquire more than 5% of the securities of a certain class registered for trading in a public company.

Comparison of Israel Tender Offer Regulations with Indian SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 ("Takeover Code") – Unlike the Israeli laws, under the Takeover Code, there is no distinction as a STO or a FTO. The Takeover Code provides for certain trigger points *inter alia* providing that no acquirer shall acquire 15% or more of the shares or voting rights in a target company unless the acquirer makes a public offer of acquiring at least additional 20% of the shares. Further, in the event that the acquirer wishes to acquire control over the target company, then irrespective of level of shareholding of the acquirer in the company, it shall make public offer to acquire at least additional 20% shares of the target company.

Manner of execution of tender offer in Israel – The tender offer must be made pursuant to a written specification to all the holders of securities of the class proposed for acquisition. The Tender Offer Regulations regulates the tender offer timetable, methods of acceptance of the tender offer, and other technical aspects connected with a tender offer and its completion. The Tender Offer Regulations also provides for the content of the tender offer in accordance with the type of the tender offer.

TAX CONSIDERATIONS

Why was the Option Letter Agreement entered into by Alkaloida (Hungary) instead of Sun India?

Hungary has wide network of tax treaties with various nations, including most of the European Union members and several Asian, American and African countries.

Alkaloida entered into the Option Letter Agreement with TDC instead of Sun India because of two reasons. Firstly as explained above, the Hungary-USA treaty is amongst the very few treaties with USA which does not have a 'Limitation of Benefit' clause, thereby allowing an entity in Hungary to avail the treaty benefits and thereby making Hungary as one of the preferred jurisdictions to make investments into USA. Secondly, in the event that the Option Letter Agreement would come into effect, TDC would fall under the control and management of Alkaloida.

Limitation of benefit clause is a distinctive feature of the various tax treaties entered into by USA. Limitation of benefits clause typically limits the benefits of the treaty to qualified residents of the respective contracting states and significantly restricts the third country nationals to treaty shop. For example, a foreign corporation may not be entitled to a reduced rate of withholding in USA unless beneficial owners of the foreign corporation are citizens or residents of the treaty country. Internationally, except for USA, most tax treaties do not contain comprehensive limitation of benefit clause.

As per the domestic tax laws of USA, there is presently a withholding tax of 30%[18] on the dividend distributed by TDC to Alkaloida; however, as per the USA Hungary tax treaty, this tax rate gets reduced to 5%. As regards the taxation of dividend in Hungary is concerned, subject to satisfying certain conditions, Alkaloida should not be liable to any taxation in Hungary because of the participation exemption. As per the participation exemption rules in Hungary the dividends flowing from subsidiaries other than controlled foreign corporations, are exempt from corporate income tax and solidarity surtax, regardless of the entity's home jurisdiction.

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[18] Source: www.ibfd.org

CHRONOLOGY OF KEY EVENTS[19]

PART A – PRE TERMINATION OF THE MERGER AGREEMENTS	
Date	**Key Event**
May 18, 2007	Sun India and Taro Israel entered into definitive Merger Agreements valuing the merger at USD 454 million (approx.)
May 21, 2007	Sun India and Taro Israel merger proceeded after favorable court ruling in Israel proceedings initiated by the minority shareholders of Taro Israel
June 12, 2007	Taro Israel scheduled shareholders meeting on proposed merger with Sun India on July 23, 2007 and later postponed it to September 25, 2007; further rescheduling it on the availability of the financial results.
May 28, 2008	Taro Israel terminated Merger Agreements with Sun India

PART B – POST TERMINATION OF THE MERGER AGREEMENTS	
Date	**Key Event**
May 29, 2008	Sun India responded to Taro Israel's termination of Merger Agreements
June 5, 2008	Sun India responded on Taro Israel's potential sale of its Irish operations, followed by another letter on June 24, 2008
June 26, 2008	Sun India exercised its option to acquire the shares of the controlling shareholders of Taro Israel under the Option Letter Agreement
June 30, 2008	Alkaloida commenced an all cash tender offer to purchase the ordinary shares of Taro Israel for USD 7.75 per share. Taro Israel's board of directors announced that they will evaluate the tender offer from Alkaloida and asked their shareholders not to take any action at that moment
July 10, 2008	Taro Israel's board of directors concluded that Alkaloida's tender offer was financially inadequate and urged its shareholders not to tender their shares
August 27, 2008	The Tel-Aviv Court ruled in favor of Sun India that no special tender offer was necessary for the offer. Sun India (for Alkaloida) announced the filing of amendment to tender offer for Taro Israel waiving certain conditions. On an ongoing basis Sun India has been extending the tender offer for Taro Israel on July 14, 2008, September 3, 2008, December 19, 2008, January 7, 2009, January 29, 2009, March 6, 2009 and March 20, 2009
December 8, 2008	On an appeal filed by Taro Israel against the ruling of the Tel Aviv district court in respect to the tender offer requirement, the Supreme Court of Israel heard the parties and instructed them to negotiate the dispute
January 2, 2009	Sun India (for Alkaloida) offered to raise its offer price from USD 7.75 per share to USD 9.0 per share as part of the settlement discussions (USD 9.5 was for a merger)
March 31, 2009	The mediation between Sun India and Taro Israel was unsuccessful and the parties could not reach to an agreement. Accordingly, parties are now awaiting the decision of the Supreme Court of Israel

[19] The chronology of key events has been obtained from the disclosures made on the website of Sun India (www.sunpharma.com) and Taro Israel (www.taropharma.com).

EPILOGUE

From a friendly starter to a battling conclusion, Sun India and Taro Israel have come a long way. As the fate of the acquisition of Taro Israel shares by Sun India lies at the helm of the Israel Supreme Court, the court shall be facing the deep conflict between the protection of the current shareholders and the merits of the case at hand.

The delay in reaching a settlement is costing Sun India a stronger presence that it would have gained through Taro Israel. Taro Israel, in turn, is losing out on an opportunity to align with one of the largest Indian pharma companies, which has a strong drug and R&D portfolio. Since both the parties appear tenacious, it is improbable to predict when this long fought battle is going to conclude.

DISCLAIMER

Team M&A and Team Globalisation would like to thank **Harshal Shah (Associate)**, **Kunal Kanungo (Intern)** and **Adil Ladha (Intern)** for their contribution in this dissection.

As you would be aware, we have been providing regular information on latest legal developments. M&A Lab is our initiative to provide you knowledge based analysis and more insight on latest M&A deals. You can direct your views / comments / suggestions on our initiative to mateam@nishithdesai.com.