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J&J's Dispute With Merck, Schering Centers On 'Control'

By Peter Loftus
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Get out your Webster's because the multibillion-dollar dispute among Johnson & Johnson (JNJ), Merck & Co. (MRK) and Schering-Plough Corp. (SGP) over an arthritis drug franchise may come down to the definition of "control."

At stake are the international rights to the drug Remicade and the \$2.1 billion in sales it generated last year for Schering-Plough, as well as the financial success of Schering's impending \$41 billion merger with Merck.

J&J and Schering-Plough jointly market Remicade and a new drug, Simponi, with Schering handling non-U.S. sales and J&J the U.S. J&J argues that Schering - through its March deal to be acquired by Merck - is undergoing a change of control that forfeits the drugs' international rights to J&J under their distribution agreement.

J&J racked up \$3.75 billion in 2008 revenue from Remicade, its biggest seller.

Merck and Schering, though, say there is no change of control because they specifically engineered the merger to be a complex, two-step deal in which Schering, of Kenilworth, N.J., will be the surviving corporation, even though the company would be named Merck and its board would have more Merck representatives.

Some legal experts favor J&J's argument more, although Merck, Whitehouse Station, N.J., has its supporters, too. Many agree that legal intricacies could be swept aside by a settlement in which Merck and Schering get to keep the international rights to the drugs but pay a higher royalty to J&J or fork over another asset.

J&J, New Brunswick, N.J., said this week it's taking the case to arbitration, seeking a ruling that a change of control has occurred that can terminate the pact, with full rights to the drugs reverting to J&J. Merck and Schering fired back that J&J has no right to terminate the agreement.

The arbitration process could take up to a year and linger even after the merger closes, expected by year's end. Both sides may want to avoid leaving the decision to an arbitrator, whose ruling may not be predictable and who could consider factors outside of the contract's language, which is as dense as Faulkner and with none of the literary merit.

First, the 1998 pact defines "control" as the ability of any entity to direct more than half of the voting rights of another entity; or the right to receive more than 50% of the profits; or to otherwise control the management decisions of the other entity.

The agreement says that if either party is acquired by a third party or otherwise comes under control - as defined above - then the other party has the right to terminate the pact.

That language seems to give J&J the upper hand. Merck is gaining the abilities to direct the voting rights of Schering-Plough, to receive more than half its profits and to control Schering's management decisions.

"I would say, yes there's ambiguity but probably the better argument is for J&J," said Geoffrey Parnass, a New York lawyer who recently analyzed the dispute with colleague Stephen Vasil on the blog Private Equity Law Review.

But that's not the end of it. The agreement goes on to state "change of control" means one of four things. Inserting Schering as the party in question, they are:

-Any transaction in which Schering isn't the surviving corporation.

-If anyone excluding Schering's affiliates become owner of more than half of Schering's common shares outstanding or combined voting power.

-If members of Schering's incumbent board cease to constitute at least a majority of the board (though new directors authorized by the incumbent board shall be considered to be incumbent directors).

-Approval by Schering's shareholders of a complete liquidation or dissolution of the company.

These criteria muddy the waters, and might give Merck and Schering the upper hand because of the reverse-merger structure, which involves newly created Schering subsidiaries. Before the merger closes, all but three Schering directors will resign effective upon completion of the deal. And before closing, the Schering board will elect Merck's directors - 15 currently - to the board of the new entity effective upon the merger's completion, giving Merck directors a clear majority.

"The change-of-control language in the contract supports Merck's side," said George Triantis, a professor Harvard Law School who has researched contract law.

Several Wall Street analysts also believe Merck and Schering have the upper hand, citing legal consultants, who argue that the merger doesn't fall into the more detailed definitions of change of control in the distribution agreement.

All of which makes a settlement the most likely outcome.

"We expect the parties to settle" before the merger closes this year, Wachovia analyst Larry Biegelsen said, "with [J&J] either receiving a higher royalty on Remicade and Simponi or another asset."

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