DEAL PROTECTION: ONE SIZE DOES NOT FIT ALL

Throughout the aftermath of the 2007 credit crisis and emerging economic recovery, a shift in the perception of "what's market" in public deals has led to a noticeable tightening of deal-protection terms favoring buyers. **David Fox** and **Daniel Wolf** of Kirkland & Ellis LLP suggest that dealmakers and their advisers should avoid arguments to appeal to recent precedent and to instead negotiate the terms of deal-protection devices on the basis of the specific facts and circumstances of their transaction.

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In almost every public company merger, deal-protection provisions are among the most heavily negotiated terms of the transaction agreement. "Deal protection" describes a suite of merger agreement terms designed to protect the buyer's deal from being jumped by a competing bidder. Of course, many sellers would like to leave open the possibility of a superior bid emerging for reasons both practical (obtaining a better price) and legal (under Delaware law, a target board may not agree to a combination of deal-protection mechanisms that are so onerous they prevent a higher bid from emerging).

Since the collapse of the credit markets in 2007 and with the emerging recovery, we have seen a noticeable trend toward ever tighter deal-protection terms favoring buyers in many public merger agreements. While this trend is certainly not without exception, it does reflect a shift in perceived "market terms" on many of these negotiated issues. However, market participants and their advisers should avoid arguments based on recent precedent and instead engage in the "nuanced, fact-intensive inquiry" deemed necessary by Vice Chancellor Strine of the Delaware Court of Chancery (Chancery Court) in his 2005 decision in the *Toys "R" Us* litigation, with the goal of ensuring that the right balance is struck in light of the particular circumstances in question.

THE PACKAGE OF DEAL-PROTECTION TERMS

With the demise of the so-called "no-talk" provisions (which sought to prohibit a target from responding to even an unsolicited superior bid) following a string of Delaware court decisions in 1999, deal protection has largely centered around "no-shop" provisions that generally allow a target's board to respond only to an unsolicited, potentially superior offer from a competing bidder. With this basic principle as the backbone, merger agreements contain a slew of "bells and whistles" designed, from the buyer's perspective, to protect its deal from interlopers (and compensate it appropriately if its deal is ultimately topped). From the target's perspective, these provisions allow the board of directors to fulfill its fiduciary duties to the shareholders. Market participants are familiar with these negotiated provisions, which include break-up fees, matching rights, fiduciary termination rights, change of recommendation and force-the-vote provisions.

RECENT TRENDS

Over the past 24 months, the market has seen a perceptible shift in favor of buyers in these terms. For example:

- Break-up fees seem to be trending closer to the 4% level as compared to the historical 3% level. To take a recent example, JDA Software agreed to a 3.79% break-up fee in its agreement to acquire i2 Technologies.

- Tighter definitional requirements are being placed on judging whether a competing bid is "superior." For example, the Thoma Bravo/AMICAS LBO merger agreement specifically requires that the topping bid be higher than the existing deal price, rather than the traditional formulation of "more favorable from a financial point of view." The Green Mountain/Diedrich merger agreement takes another approach, requiring that the topping bid be comprised of only cash and/or publicly traded securities.
- Force-the-vote provisions (where buyers have the right to force the target to allow its shareholders to vote on the buyer's deal even in the face of a superior proposal preferred by the board) are appearing in a few more merger agreements (recent examples include the Exxon Mobil/XTO and Windstream/Iowa Telecommunications merger agreements).
- "Go-shops," under which the target company has a specified period, usually 30 to 60 days, in which to actively solicit competing bids before a customary "no-shop" provision commences, often combined with a lower break-up fee for striking an alternative deal during that period or with a competing bidder that surfaces during that period, are much less common than they were during the LBO boom.
- Matching rights, under which the buyer is granted an opportunity to shadow and then match a competing superior bid, are now nearly universal. In addition, time periods and rebidding opportunities are becoming longer and more expansive. Notably, the recent Chancery Court decision in the *NACCO Industries, Inc. v. Applica Inc.* litigation shows that judges expect parties to thoughtfully and meaningfully comply with these bargained-for rights.

We suspect that these trends reflect a combination of:

- Increased bargaining leverage for buyers in a weaker selling environment.
- Amplified buyer focus on deal-jumping risk given the uncertain valuation environment.
- A willingness on the part of sellers to trade tighter deal protections in favor of greater certainty of closing (with a nod to reciprocity).

>> Summaries of the following recent deals mentioned in this article are available on the PLCWhat's Market database.

>> Under Public Merger Agreements, search the first-named party:

Berkshire Hathaway Inc./Burlington Northern Santa Fe Corporation

Exxon Mobil Corporation/XTO Energy Inc.

Green Mountain Coffee Roasters, Inc./Diedrich Coffee, Inc.

JDA Software Group, Inc./i2 Technologies, Inc.

Project Alta Holdings Corp./AMICAS, Inc. (referred to in this article as the Thoma Bravo/AMICAS LBO)

Windstream Corporation/Iowa Telecommunications Services, Inc.

As such, the perceived shift of deal-protection terms in favor of buyers is not by any means permanent, but rather is properly viewed as part of the normal ebb and flow of deal terms that result from changing economic and deal environments.

NEGOTIATE THE WHOLE

Even in today's tenuous deal environment, deal protection should not be considered, by buyers or sellers, in a vacuum. Whether or not a specific package of deal-protection terms is appropriate for a particular transaction, and whether a fight for any particular term is worth expending negotiating coinage, is a function of many other variables outside of the simple question of, "What is market?"

A non-exhaustive list of these factors includes:

- The nature and extent of any auction or "market-check" by the target ahead of entering into a deal with the buyer.
- The level of "need" or "desire" of the buyer and the target to do the deal.
- The relationship of the buyer's price and acquisition premium to historical trading levels and comparable market and transaction prices.
- A critical assessment by both parties of the likelihood of competing bidders emerging post-announcement.
- Any existing relationship, equity or otherwise, between the parties.
- The give-and-take of the negotiations, an important factor cited in *Toys*.
- The balance between the deal-protection terms and other agreement provisions such as certainty of closing.

THE FALLACY OF A SINGLE METHOD

Last year's Berkshire Hathaway/Burlington Northern transaction, already noticeable for its size, is also conspicuous as an apparent example of the parties taking a thoughtful approach to the issue of deal protection in crafting a package of terms that may be viewed as "off-market" individually, but more middle-of-the-road when taken as a whole.

PRACTICE NOTES | DOCUMENTS | CLAUSES | CHECKLISTS | ARTICLES

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>> Simply search the title OR resource number

No-shops and Their Exceptions or 8-386-1078

Break-up or Termination Fees or 6-382-5500

What's Market: Fiduciary Out or 5-386-5737

In the Berkshire Hathaway/Burlington Northern agreement, the break-up fee is less than 1% of the deal's equity value. This reflects the fact that Berkshire, already a significant shareholder of the target, would benefit from the premium inherent in any topping bid, and was perhaps mindful of Vice Chancellor Strine's admonition in his *Toys* decision that, in mega-deals, the absolute size of a break-up fee can be offensive irrespective of being within range of historical percentages ("the preclusive differences between termination fees starting with a 'b' rather than an 'm'"). The matching rights are short (two business days) and are limited to notice, rather than a requirement on the target to negotiate. On the flip-side, the definition of "superior proposal" includes specific reference to the competing offer having financing that is fully committed or reasonably likely to be obtained — an obstacle, in a deal of this size under current credit-market conditions, likely to prove insurmountable for all but the most well-heeled interloper.

That there is no single template of market terms for dealmakers to follow has been illustrated by the courts as well. A recent letter decision by Chancellor Chandler on a motion for expedited discovery relating to the acquisition of 3Com by Hewlett Packard shows that courts will also take account of the "facts on the ground" when assessing fiduciary-duty claims relating to deal-protection provisions.

In a very brief review, the Chancery Court held that a combination of a no-shop provision, robust matching rights and a termination fee exceeding 4% of equity value, coupled with a failure to solicit other buyers prior to signing the merger agreement, did not produce a colorable claim of breaches of fiduciary duties by the 3Com board. The Chancery Court, citing a string of cases including *Toys*, noted that the provisions in question are "standard" and "not *per se*" unreasonable. More interestingly, the Chancery Court highlighted the "notable absence of any other interested bidders" as a relevant factor in assessing whether the deal-protection terms were preclusive of a competing offer. An interesting question for dealmakers is whether the Chancery Court may have arrived at a different conclusion had such a (potential?) competing bidder surfaced, emphasizing once again the importance of being cognizant of deal-specific dynamics, not only the "market," in tailoring deal-protection terms for a particular transaction.

OBTAINING BALANCE

Deal-protection terms should reflect a reasonable balance of the competing interests of the two parties to a transaction within the framework of the relevant market and deal-specific framework. The twin goals should be to achieve a reasonable outcome that:

- Weighs the economic interests of both parties.
- Avoids the risk that a court will find that a seller's board breached its fiduciary duties by agreeing to overly burdensome protections (and thereby also exposing the buyer to the risk that the court will void some or all of the protections).

Both of these objectives require an assessment of the impact of the overall package presented by all of the terms, rather than an isolated negotiation of each individual term. An outcome on any given issue that may be within the "market" for that specific term may not pass the test of reasonableness when viewed in combination with the final outcome on the other deal-protection variables.

Vice Chancellor Strine perhaps best summed up the task for dealmakers in his *Toys* decision:

> "That reasonableness inquiry does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal."