KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

November 10, 2009

Deal Protection — One Size Does Not Fit All

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

As noticeable as it is for its size, the recent Berkshire Hathaway/Burlington Northern transaction 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 could be viewed as "off-market" individually, but more middle-of-the-road when taken as a whole.

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 a seller 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 as to be preclusive of a higher bid 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. Much as we argued in our recent *M&A Update* entitled "Deal Certainty: The Fallacy of a New Market," we suggest that market participants and their advisers avoid arguments based on recent precedent and instead engage in the "nuanced, fact-intensive inquiry" deemed necessary by VC Strine 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.

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) and, from the target's perspective, to allow its directors to fulfill their fiduciary duties to their shareholders. Market participants are surely familiar with these negotiated provisions such as break-up fees, matching rights, fiduciary termination rights, change of recommendation, force-the-vote provisions, etc.

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 four percent level as compared to the historical three percent level, tighter definitional requirements are being placed on judging whether a competing bid is "superior," and 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. Matching rights, under which the buyer is granted an opportunity to shadow and then match a competing superior bid, are now nearly universal, with the time periods and rebidding opportunities becoming longer and more expansive. We suspect that these trends reflect a combination of increased bargaining leverage for buyers in a weak selling environment, amplified buyer focus on deal-jumping risk given the uncertain valuation environment, and a willingness on the part of sellers to trade tighter deal protections in favor of greater certainty of closing (with a nod to reciprocity).

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 this 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 by VC Strine in *Toys;* and
- the balance between the deal protection terms and other agreement provisions such as certainty of closing.

In the Berkshire/Burlington Northern agreement, the break-up fee is less than one percent of the deal's equity value, reflecting the fact that Berkshire, already a significant shareholder of the target, would benefit from the premium inherent in any topping bid and perhaps mindfulness of VC 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; in a deal of this size under current credit market conditions, obtaining firm financing is likely to be an (insurmountable?) obstacle for an interloper.

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, while at the same time avoiding 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 some or all of the protections will be voided by the court). 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. VC 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."

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