Social Covenants in Mergers – Legal Promises or Moral Commitments?

Parties may want to consider various tools to enhance the post-closing enforceability of the social covenants to close a potential gap between expectations and legal rights.

With the return of acquirer stock as a featured form of consideration in many recent deals, dealmakers are once again focusing on "social" issues in striking a merger agreement. As compared to most straight cash takeovers where price garners the overwhelming share of, if not exclusive, attention, an acquisition featuring stock consideration, and especially a so-called merger-of-equals, often involves significant discussion between the parties of softer issues, including governance, board composition, management, people, and corporate identity (e.g., corporate and brand names, headquarters and facility locations, and charitable and community commitments). A number of deal developments over the last few years highlight some of the risks and considerations unique to these social terms.

While negotiation of these issues may involve significant emotion, the long-held view among practitioners has been that enshrining the buyer's commitments about these issues solely in "social covenants" in the merger agreement largely bound the acquirer post-closing from a moral/reputational, though not necessarily a legal, standpoint. This perspective was driven by the fact that the parties to the merger agreement are the buyer and the target, with the target being absorbed into the buyer family at closing. As a result, and similar to the often elaborate covenants about treatment of target employees post-closing, there is no person or entity with a contract right to hold the buyer accountable for failing to uphold these covenants after the deal closes, a fact that was often overlooked or downplayed by negotiators and the broader market. This is not to suggest that buyers cynically offered these covenants with the intent to treat post-closing compliance as optional, but buyers may have been willing to agree to more, and more robust, covenants (and sellers probably did attach, or perhaps should have attached, less value to these covenants) as a result of this simple legal truth.

The 2012 closing of the Duke/Progress Energy merger highlighted some of the risks to a buyer of relying too heavily on these assumptions. In the combination, the parties agreed that the CEO of the target Progress would become the CEO of the combined company. Within hours of closing, the board of the combined company, dominated by former Duke directors, ousted the new CEO in favor of the former Duke CEO. While the former Progress directors cried foul saying the executive arrangements had been critical to their support of the deal, the simple fact was that neither the frustrated Progress directors nor the former Progress shareholders had any rights under the merger agreement to hold the board answerable for this alleged "bait-and-switch". But in this case, other parties stepped in and Duke, the buyer, ended up being held accountable by other means. North Carolina regulators, whose approval had been a crucial closing condition, launched an inquiry into whether they had been misled about the intended post-closing leadership of the combined company, resulting in a settlement that forced the early departure of the then-reseated Duke CEO. Separately, shareholders of the combined company brought a Federal securities disclosure suit, arguing that the failure to disclose the details of the intended "boardroom coup" resulted in a drop of the combined company's stock price when the news came out. The litigation was ultimately settled in 2015 with a payment of $146 million to shareholders.

While the facts in that case were extreme, the painful outcome for the buyer highlighted for acquirers that these agreements are more than mere bromides. Perhaps of equal or greater significance from a marketplace perspective, targets were reminded of the absence of a clear and straightforward legal pathway to enforce these

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agreements which are often viewed as crucial components of the combination.

While we have not seen a sea-change in approach to these issues, a small number of targets have taken steps to counter, or at least limit, this enforcement shortcoming. For example, in the 2015 acquisition of Pharmacylics by AbbVie, the perceived legal enforcement gap was addressed by giving the former target CEO and Chairman (who also was an 18% shareholder) post-closing express third party enforcement rights with respect to covenants regarding retention of corporate name, ownership of a key asset, and certain other operational actions for five years post-closing. This provision shares similarities with the independent special committee on editorial independence that was established upon closing of the acquisition of Dow Jones by News Corp. to address concerns raised by the founding Bancroft family who held a majority of the voting power of the target. The merger agreement granted explicit third party enforcement rights to the committee and its members to ensure that the committee's mandate and powers were respected.

Other deals, especially those with equal or near-equal splits in combined company shareholdings, have featured somewhat less direct mechanisms to seek to achieve this goal particularly as to distribution of board and executive positions. For example, in the later-terminated Omnicom/Publicis combination announced in 2013, the parties sought to preserve the principle of equal representation on the post-closing board and executive allocations by including in the charter documents of the combined company a requirement that two-thirds of the directors vote to change that balance. This approach builds on similar constructs in many earlier large merger-of-equals transactions such as Bell Atlantic/GTE and Morgan Stanley/Dean Witter where governance principles statements, implementing board resolutions and/or bylaws provided that a super-majority board vote was required to make changes to the agreed post-closing governance provisions.

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Social terms remain an important component of deal negotiations in many public stock deals and a more limited number of cash deals. In some cases, buyer commitments in these areas are crucial to gaining support for the transaction among various target constituencies, including the board, management, shareholders, employees, regulators and local communities. Because these considerations are most pressing at the time of deal announcement and approval of the transaction, the acknowledged absence of a clear legal enforcement mechanism may not attract as much attention or even concern among targets, with reputational considerations affecting the buyer being deemed sufficient protection. The Duke/Progress Energy saga highlighted some of the legal weaknesses in the traditional construct, as well as offered a cautionary note to buyers that, in some circumstances, other means of accountability may arise. While not necessary or appropriate in many circumstances, parties may want to consider various tools to enhance the post-closing durability of the covenants to close this perceived gap between expectations and legal rights.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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