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WSJ M&A 101: Guide to Mergers, Part 2: Deal Protections

By **DEAL JOURNAL**
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By Ronald Barusch

In my last post on merger agreements, I dealt with issues similar to those your lawyer would worry about when you buy a house—how and when buyers have a right not to close.

But selling a company isn't quite like selling a house. For one thing, when a buyer negotiates with management and directors of a target corporation, not all of the necessary parties are at the negotiating table. Corporations are created by statutes and those statutes generally require shareholders to approve sales of their company—either by voting for a merger or agreeing to the sale of their stock.

Since shareholders generally think more is better when it comes to price, what happens if a third party wants to step in and offer a higher price after the board has approved the contract, but before shareholders formally make their decision?

Principles of Deal Protection. Clever lawyers for buyers (who by the way also represent sellers about half the time) long ago figured out how to protect their buyer clients from a competing bid. A target board may not be able to sell a company without shareholder approval, but there are many things management can and does agree to which could make it very difficult for any third party considering a bid—so-called "deal protection."

But of course, the courts—particularly in Delaware—quickly saw through agreements that "lock up" a target. The courts have put limits on what the directors can authorize in

terms of "deal protection." The basic principle the courts pronounce is that deal protections can be made to "enhance the bidding"—meaning to induce the first buyer to sign a merger agreement—but deal protection provisions cannot "stymie" the bidding.

You don't need to be an M&A lawyer to realize what enhances the first bidder to sign basically is usually intended by that bidder to stymie his competition. So the courts have, in a number of cases which are not always consistent, balanced the two concepts and given some guidance on what deal protections are acceptable. **Here is an overview of the common deal protections a buyer gets:**

The No-Shop and the Fiduciary Out. Buyers insist that once a target signs an agreement, it immediately cease soliciting competing bids. And buyers go further requiring the agreement to say that the target should not have any further discussions with any other party or provide any confidential information to other parties who might be interested in a making a competing bid. It is well understood that the courts, however, will not permit this broad of a prohibition because that almost makes it impossible for a third party to bid.

Therefore, all merger agreements limit the "no talk" provisions and include what is known as a "fiduciary out." This means that if a board of directors receives an unsolicited competing proposal it thinks will be a superior proposal and the directors would be violating their fiduciary duties if they did not provide information to, and negotiate with, a third party, the directors are free to talk and provide information to the third party.

These provisions are a critical part of the agreement. Typically the lawyers spend significant time arguing about what qualifies as a proposal, what "superior" means and how certain a board must be about risking a violation of its fiduciary duties. If interested, take a look at the Section 5.03(a) (the no-shop) and (b) (the fiduciary out) of Hertz/Dollar thrifty merger agreement, which had real world application: when Avis made a competing bid, you can be sure the lawyers studied those words carefully.

Termination Rights. What a target company usually gets in the deal protection provisions is the right to terminate the original merger agreement if a "Superior Proposal" is made that the board of the target wants to accept. But the buyer does not make this option easy or cheap for a target.

Topping Rights. Initial buyers insist on being told exactly what is going on in negotiations with a competing bidder. And usually, before a target is permitted to exercise its termination rights it must give the initial buyer several days advance notice so that the initial buyer has an opportunity to renegotiate.

This may sound harmless, but it is very controversial in the legal community. It can cost millions of dollars to do the preparatory work and a huge investment of management time to make a bid and negotiate an agreement. Thus, a competing bidder which has

decided to top an existing offer is anxious to have a signed agreement giving it some deal protections—at least covering its costs if the original bidder rebids.

Topping rights give the initial bidder the right to sit back and wait with no risk until after a competing bidder has put together a firm bid, and only then decide to match. This discourages a competitive bid because even if the competing bidder "wins" a round of the bidding, the original bidder keeps its deal protections and the competitor gets nothing if the initial bidder exercises its topping rights. I expect that there will be more litigation in the future over topping rights.

Break up fees. Ultimately, if the initial buyer is outbid and the target terminates the agreement to accept the higher offer, the initial buyer gets a break up fee. How much? The buyer wants as much as possible and the board of the target—duty bound to enhance the bidding and not stymie it—must try to pay as little as possible without forcing the initial buyer to walk away over the issue.

Based on limited case law, it is generally believed that 3% or even 4% of the purchase price is reasonable. But as you might imagine, with no bright line, there is a tendency for this amount to creep up since buyers frequently have the leverage. Thus, buyers have added to the 3-4% break up fee a provision requiring reimbursement of expenses.

Then there is the question of what to apply the percentage to—what if, for example, there is significant debt on the target? There is some case law to the effect that it should be applied to enterprise value—equity plus debt. That can result in very large break up fees relative to the equity purchase price—particularly for troubled companies.

Go-Shop. Suppose in the final negotiation phase of a merger agreement, buyer and seller reach an impasse over an important issue—such as price or even the deal protections.

On price, the target may argue that it thinks it should get more. Buyer says, "$X is all we will pay. But if you think you can get more, here is what we will do. Take 30 days after you sign the merger agreement and make a public announcement and look for a better deal. If you find one, take it and some of our deal protection package won't apply. We will accept a lower break up fee in this situation. But if you don't come up with a better deal, we get to buy for $X and we will then be entitled to a full package of deal protections after that 30 day period."

This is also a controversial area as the time periods provided for in go-shops are not generally sufficient for many potential buyers to complete their work from a cold start.

Dynamic Impact of Deal Protection Provisions. Transactions can fall apart over these issues in the negotiation stage, because are so critical to each of buyers and sellers. More often, the price and deal protection issues come together at the end.

As the target asks for a higher price, the buyer says "I can go a bit higher than my prior offer, but if I do that, you must agree to my deal protection package." And that is why Delaware courts are active in this area. Buyers of companies– like buyers of most other things– **live by the "golden rule": he who has the gold makes the rules**. And when buyers overreach on deal protections, a court may step in.

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In this post I covered the complexities arising from the target not having necessary parties—its shareholders– at the negotiating table. In my final post on merger agreement basics, I will discuss those situations where the buyer does not have all the parties at the table—a private equity firm's financing sources—which lead to targets needing deal protection, too. And I will also discuss how "social issues"—how management is treated after a merger—are addressed in deal negotiations.

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