KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

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Something Old, Something New…

A Quick Survey of Recent Developments in Public M&A Deal Terms

While much was written on the revolutionary impact of the credit crisis on deal terms, recent developments in the "market" for deal terms shows that evolutionary changes continue even during stable periods for M&A.

With the seeming full return of the public M&A market, we thought it was an opportune moment to reflect briefly on a number of recent trends in deal terms. The non-exhaustive list below is intended more as an observation rather than an analysis or judgment on the propriety of any of the terms. Some of the trends are fully developed, while others are nascent; either way, dealmakers should be aware of these market developments as they consider their upcoming deals:

1. *Deal Certainty* — As we argued 18 months ago, the unexpected developments in deal certainty provisions for strategic and financial buyers in the immediate aftermath of the credit crisis did not represent a new "market" or "deal paradigm" but rather reflected a more thoughtful and nuanced approach to issues of certainty of closing in light of market conditions. While we have continued to see a blurring of some of the techniques from the pre-crash poles of full specific performance (strategic acquirers) and full optionality for a small reverse termination fee (financial buyers), recent evidence has shown a continuing shift towards a return to the traditional bifurcated deal certainty models described above depending on the identity of the buyer. Again, we believe this reflects economic conditions, particularly in the credit markets, with strategic buyers increasingly willing to offer greater certainty because of renewed confidence in the staying power of the current favorable liquidity environment and sellers willing to accept the inherent optionality in the private equity buyer model, relying on the buoyancy of the debt markets and more sizable reverse termination fees to impose economic discipline on a wavering financial buyer.

2. *Hybrid Go-Shop* — The hybrid go-shop, where no-shop prohibitions on post-announcement active solicitation of competing offers apply but the bifurcated termination fee structure feature of the go-shop is used, with a lower break-up fee applying in the event the unsolicited topping bid surfaces during a defined initial period after the deal signing, has continued to make slow inroads in the strategic market since we last addressed this issue six months ago. A number of recent strategic deals, including *Nicor/AGL* and *AES/DPL*, have included this hybrid approach. As expected, these deals were struck at modest premiums and use one-step merger structures (as compared to two-step tender offers), factors that contribute to the relevance and efficacy of this model.

3. *Fiduciary Change of Recommendations* — While it has long been accepted that target boards must contractually maintain the right to change their recommendations of, and, in many agreements, terminate, the initial deal in favor of a "superior proposal", lawyers have long debated whether seller boards should or must maintain the right to change their recommendation in favor of the initial deal even absent a superior proposal. Using the paradigmatic example of the target company discovering a gold mine under its headquarters rendering the initial price woefully inadequate, some lawyers have argued that a court would mandatorily impose such a right even if not provided contractually. A useful middle ground has developed over the past few years, with the agreement allowing such a change of recommendation but only if the development driving this change is an "intervening event". While the definition varies, it generally requires that the event was unknown or unforeseeable at the time the agreement was signed. A few deals such as *Tyco/Brinks*, *Bristol Myers/ZymoGenetics* and *Golden Gate/Lawson* have augmented this approach with a higher break-up fee payable to the buyer if it terminates the deal following an intervening event change of recommendation by the target.

4. *Fees/Expense Reimbursements on "Naked No Votes"* — While most merger agreements provide for a break-up fee (usually between 2% and 4% of deal value) upon a rejection of an initial deal by the target shareholders while a competing bid is on the table (in many cases payable if and when the an alternative deal is completed during a "tail" period following the rejection and termination of the first deal), historically the remedies in favor of a buyer in the case of a so-called "naked no-vote" (i.e., a rejection by target shareholders absent a competing bid) have been very limited. Usually, no fee was payable in such a circumstance, perhaps coupled with a fairly modest capped expense reimbursement. Despite judicial acceptance of a 1% fee in the *Lear* litigation arising out of Carl Icahn's takeover bid, it was generally thought that a meaningful penalty was inappropriately coercive in the face of shareholders exercising their right to reject a deal in the absence of a competing bid that enticed this rejection. Recently, we have noticed a very modest shift in favor of remedies in these circumstances in the form of a more significant expense reimbursement cap (often up to 1% of the deal value, depending on size) or even an explicit "partial break-up fee" or "turn down fee" (again, often around 1%).

5. *Defining "Willful Breach"* — Most merger agreements provide that, other than any applicable break-up fee obligations, the parties have no further liabilities to each other following a termination with the exception of claims for "intentional" or "willful" breaches. Some practitioners were surprised by the Delaware Chancery court decision in the *Hexion* litigation that held that in order for a breach to be "knowing and intentional", and therefore engender post-termination damages claims, the relevant act merely had to be conscious (i.e., not accidental) and not with knowledge or intent to breach the merger agreement. In response, many merger agreements now define "willful breach", a term sometimes viewed as interchangeable with "intentional". Some have sought to "reverse" the *Hexion* outcome by defining "willful breach" as an "act…with <u>the actual knowledge</u> that… such… <u>would cause a breach</u> of this Agreement" (see, e.g., *Cerberus/Dyncorp*, *Schwab/optionsXpress*), while others have sought contractually to confirm the *Hexion* outcome by defining it as "a <u>deliberate</u> act… <u>regardless</u> of whether breaching was the conscious object of the act…" (see, e.g., *Silgan/Graham Packaging*).

6. *Social Issues* — While merger agreements for "mergers of equals" often tackle in detail so-called "social issues", such as allocation of board seats, sharing of executive positions, maintenance of corporate or brand names, continued charitable commitments, and location of headquarters or facilities, given the primacy of those issues in the absence of a clear buyer and seller (and resulting premium), these provisions were rarely included in merger agreements for true takeovers (although sometimes addressed in a deal press release or letter to target employees). However, in a number of recent takeover deals such as *Bucyrus/Caterpillar*, *ABB/Baldor*, and *Exxon/XTO*, the parties have included social covenants in the merger agreement itself. While questions exist as to who would have the ability to enforce such a post-closing covenant given that the target company is absorbed into the acquirer at closing, we believe that parties have become increasingly sensitive to the importance of preemptively addressing possible concerns of ancillary constituencies such as local communities and politicians and target employees. This is particularly true in the case of companies with long histories and close identification with local communities. Social covenants are a convenient and very public means of achieving these aims.

7. *Deal Protections* — We have <u>previously commented</u> on the tilt in favor of buyers in the negotiation of deal protection terms, although we argued that a "one size fits all" approach to such issues was inappropriate. This trend has continued over the last two years — for example, recurring matching rights in favor of the first bidder are nearly universal and were again blessed by Delaware courts in the *Dollar Thrifty* litigation. It bears noting that at least one recent deal (*Leonard Green/Prospect Medical*) eliminated certain matching rights if the second bidder exceeded the initial buyer's price by more than 10%; however, this approach does not appear as yet to have gained popular acceptance. In another pro-buyer example, the recent *TI/National Seminconductor* deal allowed the buyer to walk away and collect its full break-up fee if the target board does not reject (with a neutral position being deemed a failure to reject) any competing bid within seven days of it being made public. The recent

Schwab/optionsXpress deal included a somewhat similar provision providing the buyer a termination right and fee if the target continues negotiations (excluding any due diligence period) with an interloper for 10 days. In light of recent Delaware decisions such as *Lyondell, Dollar Thrifty* and *Atheros* confirming that target boards have wide latitude in running a sale process and agreeing to deal protections, especially when selling to strategic buyers, we expect that the slow creep of deal protections in favor of buyers may continue unless and until checked by judicial review.

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

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