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The International Comparative Legal Guide to:

Mergers & Acquisitions 2012

A practical cross-border insight into mergers and acquisitions

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Sub Editors
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Jodie Mablin

Senior Editor
Penny Smale

Managing Editor
Alan Falach

Group Publisher
Richard Firth

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Global Legal Group Ltd.
59 Tanner Street
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Tel: +44 20 7367 0720
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EDITORIAL

Welcome to the sixth edition of *The International Comparative Legal Guide to: Mergers & Acquisitions*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of mergers and acquisitions.

It is divided into two main sections:

Six general chapters. These are designed to provide readers with a comprehensive overview of key issues affecting mergers and acquisitions, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in mergers and acquisitions in 40 jurisdictions.

All chapters are written by leading M&A lawyers and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Michael Hatchard of Skadden, Arps, Slate, Meagher & Flom (UK) LLP, for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The International Comparative Legal Guide series is also available online at www.iclg.co.uk

Alan Falach LL.M
Managing Editor
Global Legal Group
Alan.Falach@glgroup.co.uk

Recent Developments in Deal Protection in U.S. and U.K. Markets

Cravath, Swaine & Moore LLP

Richard Hall

The last two years have seen a divergence in approach to deal protection in the U.S. and English M&A markets. This separation reverses a trend of several decades and reflects a shift in how the Delaware courts (as the leading regulator of U.S. deal protection) and the U.K. Takeover Panel (as the leading regulator of English deal protection) are viewing and reviewing deal protection.

What is Deal Protection?

"Deal protection" refers to the provisions in an agreement for the acquisition or merger of a public company (the target) that are intended to protect the acquirer from the execution risk that arises out of the need for the approval of the transaction by shareholders of the target. This approval can be direct, in the form of a shareholder vote, or indirect, in the form of acceptance of a tender offer or takeover bid. The deal protection provisions cover such matters as the "no-shop" covenant, the "no-talk" covenant, provisions regarding changes of recommendation by the board of directors of the target, termination fees, expense reimbursement provisions and support commitments from major shareholders.

The 2009 World

The legal principles relevant to the permissible scope of deal protection in the U.S. and England have shifted over time. At this time, a lengthy historical review is only of theoretical interest. In short, however, the U.S. market tended to lead the U.K. market over most of the period beginning in the mid-1980s, as U.K. deal practitioners suffered from a more rigid legal system and a lack of clear guidance as to the scope of permissible deal protection. As market participants in the U.K. (particularly those with U.S. M&A experience) demanded greater clarity around the legal rules governing deal protection, the U.K. rules became clearer, more flexible and unsurprisingly closer to the U.S. rules. At the same time, the U.S. rules were undergoing continuing refinement and elaboration. By 2009, however, the central principles in both markets were fairly stable and surprisingly consistent:

- The board of directors of the target lawfully may agree to some deal protection. For those who first practised M&As in the 2000's, the idea that this principle was once debated comes as a surprise, but it did take time for it to be accepted in both jurisdictions.
- The law imposed outer bounds on overly strong deal protection, particularly termination fees and expense reimbursement provisions. The precise outer legal bounds differed between the U.S. and the U.K., leading to some practical differences in how deal protection operated in the two markets.
- Within the outer legal bounds, it was the responsibility of the board of directors to negotiate the deal protection provisions, consistent with their general legal duties to the corporation and its shareholders.

Recent Developments in the U.S.

It is not surprising that the bursts of U.S. M&A activity in the late 1980's, the late 1990's and the middle 2000's stimulated a comparable burst in deal protection technology. The flow of new transactions in the U.S. in the 2004-2008 time period saw substantial developments in many aspects of deal protection, particularly "go-shops", "match rights" and provisions relating to circumstances that permitted a change in the target board's recommendation. This trend was enhanced and accelerated by improvements in technology, including surveys and studies of market practice, which lead to more rapid dissemination across market participants of developments in the substance, scope and technical drafting of deal protection. For U.S. deal practitioners, it was an arms race in which the negotiation of deal protection seemed always to start with "the last few deals", often without regard for whether the precedent transactions reflected a sensible balancing of risks, rewards and interests. What was at one moment cutting edge or off-market quickly became the norm.

However, while U.S. deal practitioners were finely honing deal protection provisions with the benefit of new technology and a better awareness of developments in practices, the legal and corporate finance academics were doing something quite different with the flood of data created by the deal flow – trying to measure the practical consequences of the myriad forms of deal protection. What is the expected difference in price to shareholders between a "go-shop" and a "no-shop with a fiduciary exception"? What is the effect of a termination fee on an initial bidder's willingness to bid and on competing bidders? What are the effects of match rights on the likelihood of a competing bidder emerging and on that bidder's pricing strategy? At one level, the work of the academics was consistent with, and served to reinforce, the prevailing model that placed an obligation on the board of directors of the target to negotiate deal protection. This work sought to provide a theoretical and empirical basis for that negotiation by offering boards of directors and deal practitioners a framework for weighing the value of the benefits and costs of various deal protection provisions and enhancing their ability to make value-maximising trades. At another level, however, the academic work (particularly when

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combined with the proliferation of deal studies) had the ability to undercut the role of boards of directors as negotiators by potentially confusing "market standard", which is a statistical construct that is intentionally divorced from the specifics of any individual transaction, with "the right deal protection" in the transaction at hand. As the academics are quick to point out, averages are just that – averages – and say little about the size of costs and benefits of particular deal protection provisions in the context of a particular target company.

Over the past several years, the U.S. M&A market has seen evidence of this confusion and its consequences. On the one hand, the judges of the Delaware Court of Chancery have been consistent and vocal in their criticism of boards of directors (and their advisors) that seem to have done little in the area of negotiation of deal protection other than agree to "what's market". The courts have reaffirmed the importance of true negotiations by reminding practitioners that "there is no one blueprint", that "all the deal protection provisions must be viewed as a whole", that what works for one company at one time is not necessarily the right answer for another company at another time, that practitioners cannot pick and choose from the specific deal protection provisions that have been judicially approved in the past and expect that the resulting package will be approved, that the mere fact that a particular provision has been judicially approved in one transaction does not assure that it will be approved in another transaction, the objective is "not perfection but reasonableness" and, perhaps most importantly, the Delaware Court of Chancery "will not second-guess a reasonable negotiation decision taken by an independent and careful board, even if [the judge himself] might have taken a different position". In these criticisms, the courts have admonished boards and directors and their advisors that market studies, academic analyses and the terms of precedent transactions should not be ignored, should be taken into account but are inputs into (and not substitutes for) the informed exercise of business judgment in the context of each transaction as to the optimal scope of deal protection. The courts were not questioning the appropriateness of boards of directors as negotiators of deal protection, merely urging them to use the available data to perform better in that role. In addition, the courts were not using the academic literature as to the expected costs of deal protection as a basis for outlawing deal protection as a whole or for flatly prohibiting particular forms of non-preclusive deal protection.

At the same time, however, the Delaware courts have been permitting plaintiffs' lawyers to challenge deal protection provisions on the basis of allegations that the individual provisions taken in isolation are "off-market". Complaints and legal motions are now replete with assertions that specific provisions are "not standard", "highly unusual", "off-market" or "pro-buyer", and judicial opinions are increasingly following that path in response. These motions and opinions may discuss at length deal studies, standard forms, precedent transactions (and judicial commentary on those transactions) and the academic literature on the "costs" of deal protection. This trend has been most obvious (and, in the view of this author, most obviously inappropriate) in the strange world of litigation over fee requests by plaintiffs' counsel in matters in which the initially-agreed deal protection has been subsequently revised in response to the plaintiffs' claims. These revisions may come in the form of a court decision enjoining enforcement of the deal protection as written or a settlement that includes amendments to the terms of the merger agreement. After any such revisions, under current judicial practice plaintiffs' counsel and the defendants are now required to engage in an argument over the benefit to the target shareholders from the revisions, which is usually completely theoretical because no competing bidder will emerge. This argument by necessity looks at each provision of the deal protection that was adjusted, whether the pre-adjustment provision was "market standard" and the expected "value" to the target shareholders. This process is profoundly flawed at a theoretical level, because it extrapolates from general statistical averages to specific cases and ignores the potential costs to target shareholders of the delay and enhanced closing risk associated with the plaintiffs' counsel's actions. More relevantly for current purposes, though, it creates a very unhealthy record of judicial scrutiny of deal protection that is entirely separated from the totality of the transaction and the exercise by the board of directors of the target of its fiduciary role as negotiator of deal protection in the light of all the facts and circumstances of the particular transaction in issue.

With the Delaware courts seemingly pulling in different directions, what is the short-term trend for U.S. deal protection? We will continue to see board of directors with a principal role as negotiator of deal protection, informed by the market studies and academic analyses. We will, however, also see a much great reluctance on the part of boards of directors to agree to provisions that are "off-market" or that the academics have shown to be "most expensive". We should expect to see less deviation on the high side of the mean for break-up fees and expense reimbursement provisions, more restrictive match rights, more pre-signing market checks and more "go-shops" in situations in which the board of directors of the target has not conducted a pre-signing market check.

However, even as deal practitioners work to resolve the conflicting guidance from the courts as to proper scope of deal protection, there is not any suggestion in the U.S. market that the board of directors should not have primary responsibility for negotiation of deal protection nor any suggestion that the courts should substantially limit the scope of permissible deal protection based on the academic analyses.

Contrast with Recent Developments in the U.K. Market

The last two years have seen a more radical restructuring of the U.K. approach to deal protection. By now, most practitioners are well aware of the history and detail of the most recent amendments to the U.K. Takeover Code, which now effectively bans most deal protection. Above the detail of the amendments, however, are a number of key principles, one of which is the rejection of the idea of the board of directors as negotiators of deal protection.

Superficially, the developments in London might be seen to echo those in Delaware, with each jurisdiction becoming more skeptical of deal protection but the Takeover Panel taking a more extreme, rule-based position. However, the changes are quite different in underlying rationale. The Takeover Panel has rejected the role of the board of directors as negotiator of deal protection in the interests of maximising value for shareholders, but not because boards of directors were performing poorly in that role. Rather, the Takeover Panel has determined to throw a little sand in the works of friendly M&A in the U.K. by limiting deal protection, thus reducing the ability of a friendly bidder to mitigate the shareholder approval risk and thus increasing the all-in effective cost to friendly bidders. The Takeover Panel has not accepted the fundamental conclusion of the legal and corporate finance academics that there may be an optimal level of deal protection that properly motivates an initial friendly

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bidder but does not overly deter potential competing bids. Rather, the Takeover Panel has consciously set the level of permissible of deal protection below any reasonable estimate of this optimal level because it did not want to create incentives for initial friendly bidders. The Takeover Panel has not adopted, in whole or in part, the analysis of the academics about the relative costs and benefits of specific forms of deal protection. Rather, the Takeover Panel has banned virtually all forms of deal protection, even those that the academics have concluded do not impose significant burdens on competing bidders.

Conclusion

With the recent amendments to the Takeover Code provisions applicable to deal protection, trans-Atlantic deal practitioners have seen the end of a lengthy trend toward more uniform approaches in the two markets. While the U.S. approach is currently undergoing another period of elaboration and refinement, the core principles that govern deal protection in the U.S. remain unchallenged. The Takeover Panel has now conspicuously embraced a very different model for deal protection. Because the two markets now regulate deal protection from such different principles, it seems very unlikely the gap between the legal regimes will substantially narrow in the foreseeable future.

Richard Hall

Cravath, Swaine & Moore LLP
Worldwide Plaza, 825 Eighth Avenue
New York, New York 10019-7475
USA

Tel: *+1 212 474 1293*
Fax: *+1 212 474 3700*
Email: *rhall@cravath.com*
URL: *www.cravath.com*

Richard Hall is a partner in Cravath, Swaine & Moore LLP's Corporate Department and is the Practice Leader of the Firm's Merger and Acquisitions practice. His practice focuses on mergers and acquisitions, particularly in the international arena and natural resources sector, corporate governance advice and general corporate matters. Mr. Hall has represented non-U.S. companies in their acquisitions of U.S. companies, U.S. companies in their acquisitions by non-U.S. companies, and non-U.S. companies in their combinations with other non-U.S. companies. His clients have included Air Products & Chemicals, Archer-Daniel-Midland Company, Anglo American plc, Barrick Gold Corporation, Cigna Corp., Edison International, Integrys Energy Group, Time Warner Inc., The Home Depot and Weyerhaeuser Company. Mr. Hall received a B.Comm with honours in 1984 and an LL.B. with honours in 1986 from the University of Melbourne, and an LL.M. from Harvard University in 1988. He joined Cravath in 1988 and became a partner in 1996.

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Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
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