break-up fees serve different functions and only break-up fees are constrained in size by law. More importantly, however, while the use of "crown jewel" assets as break-up fees has generally disappeared from practice, targets might want to seek an ATF that consists of more than just cash (as in the AT&T/T-Mobile transaction). In the event a transaction fails, cash is cool but baubles are better. Assets received as, or as a part of, an ATF may allow (and at least may give the market the perception of allowing) a target to emerged from a failed deal in a strategically better position than when it entered into the deal.

- *Using two-tier ATFs to exert additional pressure*. Two-tier break-up fees have been around for a while and are often used to provide for a lower break-up fee during a "go shop" period so as to potentially increase the attractiveness of the target during the period. ATFs could be structured in a similar manner—increasing amounts the more time that passes without receipt of antitrust approval. The typical long runway of regulatory review would obviously have to be factored in when deciding when the ATF would increase in amount, but an increasing fee may put additional pressure on acquirers to resolve issues with the regulators.

### From an Acquirer's Point of View

In considering ATFs and efforts covenants, acquirers may want to focus on:

- *Decoupling the size of the ATF from the scope of the efforts covenant*. From an acquirer's point of view, an ATF is "just" money (assuming there are no other baubles included) and amounts paid as an ATF are likely tax deductible to the acquirer thereby further reducing the apparent pain. The demands of regulators, however, may have the effect of fundamentally changing the nature of the acquirer's business or the benefits the acquirer was expecting to obtain from the target business. Therefore, acquirers should generally be willing to trade big ATFs for meaningful covenant limitations.

- *Using specificity of obligations as opposed to an ATF*. In many antitrust sensitive transactions, the likely scope of the remedies that regulators will require is apparent to the parties at the outset. Rather than negotiate fees for failure, and rather than limit covenants in vague ways that rely on concepts of materiality, acquirers may be better off deciding what they will risk, and specifying such in the merger agreement. Practitioners sometimes worry that this approach may provide blind mice regulators with a "roadmap." But this should not be a real concern given the sophistication of antitrust regulators, and should be far outweighed by the potential benefits of the specificity approach.

## CHANGING ITS MIND: A BOARD'S PREROGATIVE?

*By Clare O'Brien, Rory O'Halloran and Gregory Gewirtz*

*Clare O'Brien and Rory O'Halloran are partners, and Gregory Gewirtz is an associate, in the Mergers and Acquisitions Group of Shearman & Sterling LLP. The views and opinions expressed in this article are those of the authors and do not necessarily represent those of Shearman & Sterling LLP or its clients. Contact: cobrien@shearman.com, rory.o'halloran@shearman.com or gregory.gewirtz@shearman.com.*

Under Delaware law, the board of directors of each company executing a merger agreement is required to adopt a resolution approving the merger agreement and declaring its advisability,[1] although Delaware law also provides that a company may "agree to submit a matter to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving such matter that such matter is no longer

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advisable and recommends that the stockholders reject or vote against the matter."[2] Further, under the Securities Exchange Act of 1934, for transactions involving a tender offer or exchange offer, the target is required to file a Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9, disclosing the target board's position as to whether its stockholders should accept or reject the tender offer or defer making a determination regarding such offer.[3]

The terms of public company merger agreements typically require the target's board of directors to recommend that its stockholders either vote in favor of the proposed merger or tender their shares into the tender offer or exchange offer, as applicable, and contain limitations on the target board's ability to subsequently withdraw or qualify its recommendation. The merger agreement will, however, typically have exceptions, referred to as "fiduciary outs," that permit the board to change its recommendation in certain circumstances. Although market practice, as well as Delaware case law, supports the view that some restrictions on a target board's ability to change its recommendation are consistent with directors' discharge of their fiduciary duties—including the board's disclosure obligations under Delaware's duty of candor— the scope of those permissible restrictions will depend on the particular terms (and other relevant facts and circumstances) of each transaction. Market practice in this regard has also evolved over the last several years, particularly with respect to the introduction, and then increasing use, of a so-called "intervening event" (discussed below) as a trigger for a board's ability to change its recommendation.

Delaware courts have not expressly stated whether a board's recommendation to its stockholders is, in itself, a fact that falls within the requirements of the duty of candor, although evolving Delaware case law suggests that restrictions on a board's ability to change its recommendation could implicate that duty. As described in *Lynch v. Vickers Energy Corp.,*[4] the duty of candor (also referred to as the duty of disclosure) is a fiduciary duty owed by a board to its stockholders requiring ‘‘ ‘complete candor' in disclosing fully ‘all the facts and circumstances surrounding the' transaction," though later, in *Stroud v. Grace*,[5] the Delaware Supreme Court clarified that the board's disclosure obligations are limited to disclosure of material facts. A board's obligation to comply with the requirements of the duty of candor applies in all transactions in which stockholder action is sought, regardless of the structure of the transaction.

In *Malone v. Brincat,*[6] the Delaware Supreme Court found the disclosure requirements under the duty of candor to be broad enough to require a board to disclose to its stockholders its honest view about a transaction, stating that "[w]henever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty."

Delaware case law further suggests that the duty of candor may impose limitations on permissible terms of a merger agreement. As the Delaware Chancery Court stated in *Energy Partners v. Stone Energy*, there are ". . .legal constraints on contractual attempts to circumscribe the ability of directors to fulfill their fiduciary duties."[7] Moreover, in *Frontier v. Holly*, in finding that a board's change of recommendation of a merger agreement did not amount to repudiation, the Delaware Chancery Court held that a board's ongoing obligation to assess its support of a transaction "was not merely something that the Merger Agreement allowed the Holly Board to do; it was the duty of the Holly Board to review the transaction to confirm that a favorable recommendation would continue to be consistent with its fiduciary duties."[8]

The broadest formulation of a fiduciary out—one

that clearly does not facially conflict with a target board's fiduciary duty of candor—permits the board to change its recommendation following its determination that it is required to change its recommendation to comply with its fiduciary duties, typically subject to the board's having first consulted with its external legal and financial advisors. However, parties to a merger agreement often agree to narrower fiduciary outs that leave open the possibility that a target board will determine that it should change its recommendation in respect of a transaction, but is contractually restrained from doing so because the underlying reason for the board's determination does not fall within the scope of the fiduciary out triggers agreed in the merger agreement.

One of the more restrictive formulations of a fiduciary out clause limits the board's ability to change its recommendation to circumstances where an alternate transaction proposal has been received that the board determines is a superior proposal. Exercise of this right is typically subject to satisfaction of certain criteria, including requiring the board to have consulted with its external legal and financial advisors, and having evaluated the financial terms, likelihood of consummation, other legal and regulatory aspects of the alternate proposal, and any consequential changes to the terms of the executed merger agreement that are proposed by the counterparty to the merger agreement in response to the alternate proposal. Despite the relative lack of flexibility that this formulation affords directors to exercise and discharge their duty of candor, it has historically been a common approach and is still invoked today, although sparingly.

In the middle of the spectrum, a formulation that has become increasingly prevalent in recent years, as part of a limited fiduciary out, is to allow a target board to change its recommendation either in response to a superior proposal or when an "intervening event" is deemed to have occurred, often defined as a material event not known or foreseeable at the time of the execution of the merger agreement. Intervening event definitions differ in breadth. An intervening event definition may exclude events known or reasonably foreseeable by a target before the signing date, varying as to the extent to which unknown events, or unforeseeable consequences of known events, are included within the definition. The more flexibility that an intervening event definition affords to a board to change its recommendation, the more likely it is that this formulation will not result in a conflict with the directors' fiduciary duty of candor.

Target companies are continuing to agree to restrictions on the ability of their board to change its recommendation. Upon review of the terms of 81 public merger agreements governed by Delaware law signed from July 1, 2014 to July 21, 2015, and valued at over $1 billion,[9] 59 (or 73%) of the transactions limited the ability for a board to change its recommendation to circumstances in which the target receives a superior proposal or in which an intervening event occurs, and another four (or 5%) of the transactions limited the ability for a board to change its recommendation only to circumstances in which the target receives a superior proposal. Only 17 (or 21%) of the transactions provided for a broad fiduciary out that may be exercised upon a determination by a target board that not changing its recommendation would be inconsistent with its fiduciary duties. For one transaction involving an all-stock combination of two affiliated parties, the merger agreement provided for no fiduciary out. In light of these findings, it appears that target companies and their advisors typically allow some restrictions on a board's ability to change its recommendation.

As mentioned above, Delaware courts have not directly addressed the extent to which restrictions agreed between parties to a merger agreement that limit a target board's ability to change its recommendation are inconsistent with directors' fiduciary duties. However, there is some commentary in the public domain that may be instructive. For example, at a 2009 panel discussion at the Tulane Corporate Law

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Institute at which restrictions on a target board's ability to change its recommendation were discussed, Leo Strine (now Chief Justice of the Delaware Supreme Court, but then-Vice Chancellor of the Delaware Court of Chancery) was reported in the media to be "openly skeptical" of whether certain restrictions would be consistent with Delaware law.[10]

More recently, in *In re NYSE Euronext Shareholders Litigation*, then-Chancellor Strine of the Delaware Court of Chancery, in a bench ruling following oral argument, declined to issue a preliminary injunction on a stockholder vote to approve the proposed merger between NYSE Euronext ("NYSE Euronext") and IntercontinentalExchange, Inc. ("ICE"). While noting that the definition of "superior proposal" in the merger agreement would have excluded a hypothetical alternate transaction proposal from a bidder who sought to acquire discrete businesses of NYSE Euronext, then-Chancellor Strine stated that he shared the plaintiffs' skepticism that "contractual promises to lie in the future have any real commercial utility."[11]

However, then-Chancellor Strine's further comments during his bench ruling in denying an injunction for the NYSE Euronext and ICE merger acknowledged that "the board's decision, in terms of its fiduciary judgment in dealing with a contract, can't be just isolated provision by provision." In other words, restrictions on a board's ability to change its recommendation that are agreed between parties, notwithstanding any potential conflict with the exercise of a board's duty of candor, would be viewed as one aspect of a broader review of the terms of the merger agreement and the transaction process. Despite case law suggesting that restrictions on a board's ability to change its recommendation may conflict with the requirements of the duty of candor, a court could conclude that a board properly accepted restrictions on its ability to change its recommendation as part of an overall transaction process that resulted in the best deal reasonably available for its stockholders, finding that the benefits gained in exchange for agreeing to the limitation outweigh the restrictions imposed on the board limiting its freedom to change its recommendation.

This approach is consistent with the case-by-case approach taken by Delaware courts. As articulated by then-Chancellor Strine during his *In re Ancestry.com* bench ruling, holding that a "don't ask, don't waive" standstill provision cannot be held to be *per se* unlawful, "[*p*]*er se* rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be. It's inconsistent with the model of our law. . .This Court is a court of equity. . . And it's usually for the Legislature to determine when something is *per se* unlawful."[12]

Although there is some lack of clarity on the scope of permissible restrictions on a target board's ability to change its recommendation in respect of a pending transaction (in terms of both such restrictions, as well as the quantum of "termination fees" that may be payable by the target following a change in target board recommendation that is not connected to target's receipt of a superior proposal), it is clear that transaction participants and advisors should approach this issue carefully with the goal of crafting provisions that are appropriate in light of the facts and circumstances of the particular transaction, as well as the other terms of the merger agreement.

## ENDNOTES:

[1]Section 251(b) of the Delaware General Corporation Law ("DGCL").

[2]Section 146 of the DGCL.

[3]Schedule 14D-9, 17 C.F.R. Section 240.14d-101.

[4]*Lynch v. Vickers Energy Corp*., 383 A.2d 278 (Del. 1977).

[5]*Stroud v. Grace*, 606 A.2d 75, 85 (Del.1992).

[6]*Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

[7]*Energy Partners, Ltd. v. Stone Energy Corp.*, C.A. No. 2402-N (Del. Ch. Oct. 11, 2006).

[8]*Frontier Oil Corp. v. Holly Corp.*, C.A. No.

20502 (Del. Ch. Apr. 29, 2005).

[9]Practical Law database, accessed July 2015.

[10]"Deal Lawyers Are Getting Creative," Steven Davidoff Solomon, *New York Times*, April 14, 2009, available at http://dealbook.nytimes.com//2009/04/14/deal-lawyers-start-getting-creative/.

[11]*In re NYSE Euronext Shareholders Litigation*, C.A. No. 8136-CS (Del. Ch. May 10, 2013) (transcript).

[12]*In re Ancestry.com Inc. Shareholder Litigation*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) (transcript).

# PRACTICAL TIPS TO NAVIGATE THE DEVELOPING MARKET OF REPRESENTATION AND WARRANTY INSURANCE

*By Paul M. Tiger and Matthew Heinz*

*Paul Tiger is a partner in the New York office of Cleary Gottlieb Steen & Hamilton LLP and Matthew Heinz is a Senior Managing Director at Aon Transaction Solutions. Contact: ptiger@cgsh.com or matthew.heinz@aon.com.*

So-called representation and warranty insurance ("RWI") has been an often-discussed innovation in M&A circles for several years, with seemingly perpetual speculation that a mature market for the product is just over the horizon. In the last few years, however, M&A practitioners have seen a notable increase in the number of policies priced and bound. A number of factors have led to this increase, including improvement in the pricing of policies by carriers against historical levels, expansion of coverage terms by carriers that bring the policies' terms closer to a traditional seller indemnity and buyers' increasing familiarity with the product and increasing comfort in carriers' track records in paying claims, not to mention the general rebound in M&A activity since the recession.

In part because the market for RWI is still developing, there remain significant traps for the unwary in negotiating a policy. And although an RWI policy can be a useful tool in bridging negotiation gaps between buyer and seller—particularly in a rebounding yet still unstable environment where financial sponsors and even some strategics are looking to exit investments using a "public company" style approach without post-closing indemnities—it is paramount that buyers and their counsel understand what they are buying.

## Find an Experienced Broker

A client's first instinct when insurance is raised as a potential solution in a deal is to call their usual broker, which is not surprising. While those brokers may be knowledgeable or even expert in D&O coverage or property and casualty policies, etc., they may have limited familiarity with the world of RWI policies, which often require more familiarity with and comfort in M&A practice than traditional insurance concepts. While many brokers proclaim fluency with respect to RWI policies, there are few who can provide a truly transparent view on pricing and real assistance when it comes time to negotiate the terms of the actual policy. Most M&A lawyers would concur that there are only a handful of people in the country who spend enough time with this product on a daily basis to provide adequate counsel as brokers. It is worthwhile to ask your broker how many policies he or she has bound and about his or her experience with the product generally.

## Process, Process, Process

For those new to the rep & warranty policy market, there are a number of procedures to be mindful of in order to keep the negotiation process running smoothly. The broker will need to provide prospective carriers with several pieces of information for the carriers to provide quotes and draft a policy. In particular, the carriers will need:

- the offering memorandum or other promotional materials that have been circulated by the sell-


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