

## *Deal Protection in Takeovers: A New Zealand Perspective*

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Companies seeking to make an acquisition, whether by takeover, amalgamation, or scheme of arrangement, have an understandable interest in increasing the likelihood of their proposal's success. There are a number of alternative methods to achieve this, including increasing the offer price or entering into arrangements with major shareholders to ensure their support. In this article the focus is upon methods of protecting a proposal involving contractual undertakings negotiated with the target company's board of directors. Such undertakings have been a common feature of the market for corporate control in the United States since the 1980s,<sup>1</sup> but only in recent times have they become popular in New Zealand. This article will discuss the challenges these deal protection devices raise and how the law in New Zealand might rise to meet these challenges.

The emergence of deal protection devices in takeover agreements raises several key concerns. Deal protection is used by directors to induce a takeover offer for the shares of the company. A primary consideration, therefore, is the role that the board of directors should play in the takeover process. Management corruption and the safeguards against it are also key concerns because deal protection offers management the opportunity to further their own interests in preference to those of the company and its current shareholders. The value in allowing directors to negotiate deal protection must also be balanced against the potential detriment from a reduction in the competition for control of companies.

Part I of this article briefly outlines the various forms of deal protection that have been seen in New Zealand and international markets. Particular emphasis is given to exclusivity clauses and break fees here, and throughout the article, because these are the most common forms of deal protection used in New Zealand mergers and acquisitions.

Understanding the rationales for deal protection is essential to a consideration of the legal issues involved. Therefore, in Part II the motivations of both bidders and targets are discussed, including some challenges to the rationales that have traditionally been provided. A brief outline of the economic considerations is also presented to aid in determining whether it is in society's interests to allow deal protection.

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<sup>1</sup> Bainbridge, "Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions" (1990) 75 Minn L Rev 239.

This analysis will be useful later when considering proposals for the stance New Zealand's takeover laws and regulations should take.

Part III addresses the legal issues that may arise in connection with deal protection. First, consideration is given to whether directors have the power to enter into deal protection clauses. Secondly, the article addresses how directors may find themselves in breach of their duties where they have agreed to deal protection provisions. Following that is a discussion of break fees in the context of the law relating to liquidated damages and the prohibition on penalties. Controls on giving financial assistance in the purchase of shares are also considered. Finally, the application of the Takeovers Code is discussed, with particular reference to the prohibition of defensive tactics.

New Zealand's courts and regulatory bodies have yet to give much consideration to the legality of deal protection clauses. In Part IV, a brief overview of the position on deal protection taken in Australia, the United Kingdom, and the United States will be presented. This analysis, in addition to the preceding discussion, will then be used in Part V to make suggestions as to the approach that should be adopted for the regulation of deal protection in New Zealand.

## I FORMS OF DEAL PROTECTION

Deal protection provisions negotiated with the target company's Board of Directors come in a variety of forms. Several methods are outlined below and it is important to note that agreements will often include several of these protections.

### Exclusivity Clauses

Exclusivity clauses are used by bidders to restrain target directors from taking action that could lead to a rival bid succeeding. The standard form of exclusivity provision is a "no-shop" or non-solicitation clause.<sup>2</sup> This provides an undertaking by the target directors that they will not initiate or actively solicit competing bids or proposals; in other words, the directors agree not to shop the deal around. A "no-talk" clause is a stricter version of a no-shop clause, additionally requiring that directors do not provide information or have discussions with unsolicited parties who express interest in making a proposal.<sup>3</sup> This can be contrasted with a no-shop clause, where directors are free to negotiate and provide information to unsolicited third parties.

It has become increasingly common for parties to express exclusivity

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<sup>2</sup> Ibid 245.

<sup>3</sup> Brown et al, *Takeovers: A Strategic Guide to Mergers and Acquisitions* (2 ed, 2004) 16-226.

clauses subject to so-called “fiduciary outs”. Pursuant to a fiduciary out, directors retain the right to act contrary to an exclusivity clause where they would otherwise be in breach of their fiduciary duties or be acting unlawfully.<sup>4</sup>

In *Greymouth Petroleum Mining Co Ltd v Fletcher Challenge Ltd*<sup>5</sup> (one of the few New Zealand cases involving deal protection provisions) the Court of Appeal considered the operation of a no-shop provision subject to a fiduciary out. The case involved the sale of Fletcher Challenge Energy to Shell/Apache as part of the break-up of the Fletcher Challenge Group. Greymouth Petroleum had sought to conduct due diligence in furtherance of a superior offer for the division but the request was refused by Fletcher Challenge, partly in reliance upon a non-solicitation clause in the agreement with Shell/Apache. In regards to the non-solicitation clause, Thomas J noted that “the essential purpose of such a provision is to prevent a company which has entered into a firm arrangement from then using the bid contained in that arrangement to obtain a higher or better offer”.<sup>6</sup> Such a clause would not, however, stop the directors from allowing a party to conduct due diligence where they had not actively solicited or encouraged that party’s approach. This conclusion was drawn without reference to the fiduciary out provision, although the inclusion of such a clause put the issue beyond doubt. Therefore, Fletcher Challenge could not rely on the non-solicitation clause to justify their refusal of due diligence, although the Court found that the decision was justified on other grounds.

## Break Fees

A break fee is a sum of money payable, typically by the target to a friendly bidder, upon the occurrence of specified trigger events relating to the furtherance of the takeover or the success of the bid. Examples of typical trigger events include the directors failing to recommend the bid, a rival bid succeeding, or the agreement being otherwise terminated due to the actions of the target.<sup>7</sup>

The amount payable under a break fee varies depending upon deal size and jurisdiction. As the purpose of many break fees is to reimburse the costs of an unsuccessful bid, break fees, measured as a percentage of deal size, tend to be inversely proportional to the size of the bid to reflect the higher proportional costs for takeovers of smaller companies.<sup>8</sup> Break fee provisions also differ depending upon jurisdiction. In the United States,

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4 Mayanja, “No-Shop, No-Talk and Break-Fee Agreements in Merger and Takeover Transactions: The Case for a Fresh Regulatory Approach” (2002) 14 Aust Jnl of Corp Law 1, 12.

5 (7 March 2001) unreported, Court of Appeal, CA40/01.

6 Ibid [32].

7 Mannolini and Rich, “Break Fee Agreements in Takeovers” (2001) 19 C&SLJ 222, 223.

8 Boyd and Dietrich, “Study of Break Fees Reveals Interesting Results” (2001) 20 IFLR 84.

the average is approximately three per cent of deal size,<sup>9</sup> although courts have allowed break fees as high as six per cent.<sup>10</sup> The regulatory bodies in both Australia and the United Kingdom have adopted a guideline that break fees generally should be less than one per cent of the value of the target.<sup>11</sup> The New Zealand Takeovers Panel has not adopted a guideline as to the reasonable level of break fees nor have the New Zealand courts considered the issue. A summary of some recent break fee agreements in New Zealand is given below.<sup>12</sup>

Date announced	Target	Bidder	Size of break fee	Percentage of deal size <sup>13</sup>
23 July 2007	Auckland International Airport	Dubai Aerospace Enterprise	\$4m	0.09% <sup>14</sup>
30 April 2007	Tourism Holdings	MFS	\$3.5m	1.26%
1 August 2006	Feltex Carpets	Godfrey Hirst	\$1m	0.71%
29 May 2006	Gullivers Travel	S8	\$1.9m	0.81%
27 March 2006	Waste Management	Transpacific Industries	\$8m	0.92%

Break fees are a relatively new phenomenon in New Zealand mergers and acquisitions. The handful of agreements set out above, and, in particular, the most recent deals, suggest that the quantum of break fees is aimed at cost recovery because the amount recoverable in absolute terms is reasonably similar regardless of deal size.

Break fees are not always agreed for the sole benefit of the bidding company. In many cases, the bidder will be liable to pay a similar fee to the target should they withdraw from the proposal. Such a clause similarly operates to protect the deal, though this time from the perspective of the target, by protecting the expenditure the target will incur in furtherance of the proposal and reducing the incentive for the bidder to withdraw. Reciprocal break fees will be of particular utility where the proposal is a merger or amalgamation as opposed to a straight takeover offer.

9 Coates and Subramanian, "A Buy-Side Model of M&A Lockups: Theory and Evidence" (2000) 53 *Stan L Rev* 307, 335.

10 *Phelps Dodge Corp v Cyprus Amax Minerals Co* (27 September 1999) unreported, Del Ch, No Civ A 17398.

11 "Guidance Note 7: Lock-up Devices" Australian Takeovers Panel (2007) <<http://www.takeovers.gov.au/content/917/download/gn07.pdf>> (at 29 July 2008) para 7.5; "The Takeover Code" United Kingdom Takeovers Panel (2006) <<http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf.7>> (at 29 July 2008) r 21.2.

12 "Company Announcements" (NZX Deep Archive, University of Auckland Library) (at 16 November 2007).

13 Deal size being the target's market capitalization based upon the bidder's proposed offer price.

14 DAE's offer was only for 51–60% of shares. The deal's size was based upon a notional offer price of \$3.80 comprising \$2.34 cash, \$0.07 dividend, and a stapled security in the amalgamated entity.

## Other Variations

An “asset lock-up”, or “crown jewel option”, gives a friendly bidder the option to purchase key assets of the company at a favourable price should a rival bid succeed. Asset lock-ups were a prominent feature of the hostile takeover frenzy in the United States during the 1980s.<sup>15</sup> However, the decision of the Delaware Supreme Court in *Revlon Inc v MacAndrews & Forbes Holdings Inc*<sup>16</sup> and subsequent cases<sup>17</sup> has led to an almost complete disappearance of asset lock-ups in that jurisdiction.<sup>18</sup> Asset lock-ups are not a device used in the New Zealand market currently, and international trends away from asset lock-ups, combined with New Zealand company law requirements for shareholder approval on the disposal of major assets,<sup>19</sup> makes it unlikely that they will be prevalent in the future.

A “share lock-up option”, in the deal protection sense, refers to a right granted to a bidding party to be issued shares in the target should their takeover agreement be terminated. This has the effect of rewarding the friendly bidder should a rival bid be made and diminishing the returns to competing bidders by increasing the cost of mounting a higher bid.<sup>20</sup> Judicial scrutiny has again reduced the prevalence of such agreements<sup>21</sup> and they have not been a part of the New Zealand market, nor are they likely to be, particularly because such an allotment would probably be for an improper purpose.<sup>22</sup>

## II RATIONALES

### Why Would a Bidder Want Deal Protection?

Break fees and exclusivity agreements are predominantly negotiated for the benefit of bidding companies. To analyse deal protection devices, therefore, it is fundamental to first understand the concerns bidders are trying to address by negotiating them.

Takeovers can fail to be consummated for a multitude of reasons outside the control of the bidding party; for example, a higher bid emerges, regulatory approval is not granted, shareholders vote against the proposal, or circumstances change in the period before the offer closes.<sup>23</sup> Owing to

15 Kenyon-Slade, *Mergers and Takeovers in the US and UK: Law and Practice* (2004) paras 5.259–5.261.

16 *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (Del SC, 1986) [“*Revlon*”].

17 *Mills Acquisition Co v MacMillan Inc* 559 A 2d 1261 (Del SC, 1989) [“*Mills Acquisition*”].

18 Coates and Subramanian, *supra* note 9, 327.

19 Companies Act 1993, s 129; NZX, *NZX Listing Rules* (2007) <[http://www.nzx.com/regulations/rules/nzxs\\_and\\_nzdx\\_listing\\_rules](http://www.nzx.com/regulations/rules/nzxs_and_nzdx_listing_rules)> (at 7 August 2008) r 9.1.

20 Hunt, *Structuring Mergers & Acquisitions: A Guide to Creating Shareholder Value* (2 ed, 2004) 673.

21 *Paramount Communications v QVC Network* 637 A 2d 34 (Del SC 1994) [“*Paramount Communications*”].

22 *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 AC 821 (PC). See Companies Act 1993, s 133.

23 Mayanja, *supra* note 4, 9.

this uncertainty, bidding companies may be unwilling to incur the costs of making a proposal unless they can receive some comfort that the target will not walk away from the transaction. Deal protection, therefore, can serve a two-fold purpose for the bidder: it increases the likelihood that the bidder's proposal will be consummated, and, secondly, it compensates the bidder for the costs it has incurred in bidding should the deal fall over.<sup>24</sup>

Much of the prior analysis of break fees has focused on bidders' wariness of being used as a "stalking horse"<sup>25</sup> to attract higher bids.<sup>26</sup> Bidders will often spend significant amounts to search for and identify companies that are undervalued. A bid can alert other parties to the value that the target represents, allowing those parties to free-ride on the research done by the initial bidder by entering the bidding war without having to incur the expense of search.<sup>27</sup> Bidders will want to protect the investment that they have made in research and may be unwilling to bid if they believe that there is a sufficient likelihood of their investment being wasted, or their return diminished, due to a third party contesting control.

One difficulty with this traditional rationale for deal protection is that the costs a bidder incurs up until the moment of negotiating a takeover agreement are sunk and thus should not be a relevant consideration. Such sunk costs could include the cost of finding and evaluating the target, and advisers' fees incurred prior to the agreement, including those in relation to due diligence.<sup>28</sup> Therefore, if bidders are logical, their negotiation of deal protection can only be rationalized on two counts: first, if there are costs to bidding that cannot be recouped and, second, if any increase in price that they have to pay to procure the protection is more than compensated by an increase in their expected return due to the enhanced probability of the takeover succeeding.

Speaking in regard to his leveraged buy-out of Trans Union in 1981, Jay Pritzker sums up the concerns of potential bidders:<sup>29</sup>

[I]f all we did was make an offer at \$55, and were left naked with that offer, what we would have done is kicked off an auction contest at great expense to ourselves, the expense being substantial commitment fees for financing, substantial legal fees, substantial lost opportunity cost at no recompense, and then someone else could have come out and said well, we'll pay \$55.10.

The costs of bidding can include opportunity costs, internal company

24 Hunt, *supra* note 20, 673.

25 *Smith v Van Gorkom* 488 A 2d 858, 866 (Del SC, 1985).

26 Panagopoulos, "Thinking Inside the Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware" (2006) 3 Berkeley Bus L J 437, 443.

27 Easterbrook and Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv L Rev 1161, 1178.

28 Unless the takeover agreement is conditional upon due diligence (i.e. it is to take place after the takeover agreement is negotiated).

29 Owen, *Autopsy of a Merger* (1986) 60-61 as cited in Griffith, "Deal Protection Provisions in the Last Period of Play" [2003] Fordham L Rev 1899, 1958 n 249.

costs due to employee distraction, debt commitment fees, and the costs of advisers.<sup>30</sup> If no costs of bidding existed, a potential acquirer would never require deal protection to make a bid so long as they forecast a positive return to owning the target at the offer price, regardless of the probability of the deal being successful.

Expected return measures the probability-weighted average of different possible outcomes.<sup>31</sup> By increasing the probability that a proposal will be successful, a deal protection agreement can increase the expected return to the bidder. A form of deal protection compensating the bidder in the event of failure, such as a break fee, will further increase the expected return by limiting the downside. However, it is important to note that any measure that increases the probability of success, whether monetary or not, will be valuable to the bidder, even where their costs of bidding are minimal. Therefore, other forms of deal protection, like no-shop and no-talk clauses, will also increase expected returns. As such, the increase to expected return that deal protection provides is a second rationale for the bidder to seek it.

## Challenges to Bidder Rationales

Faced with costs to bidding and desirous to increase the expected return from their bid, potential acquirers are incentivized to ensure that the transaction is completed. While accepting that companies face costs in making a bid, it does not necessarily follow that break fee and exclusivity agreements are the most suitable response.

### 1 Shareholder Lock-Ups

Lock-up agreements with shareholders, as opposed to negotiated agreements with the target company itself, are arguably a more effective means for a bidder to ensure the success of a takeover proposal. In a shareholder lock-up, an individual shareholder agrees to sell into an offer made at a certain price and within a particular timeframe.<sup>32</sup> Shareholders are, after all, the final arbiters of any proposal. While the recommendation of the target's directors and the possibility of paying a break fee may influence the decisions of shareholders, they will not be decisive in all situations. The key question is whether shareholder lock-ups provide a more effective means to incentivize shareholders to sell into an offer than company-negotiated deal protection.

New Zealand's Takeovers Code requires that all shareholders

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30 Easterbrook and Fischel, "Auctions and Sunk Costs in Tender Offers" (1982) 35 *Stan L Rev* 1, 6.

31 Moles and Terry, *The Handbook of International Financial Terms* (Oxford Reference Online, University of Auckland Library) (at 26 September 2008).

32 King, "How the Code Applies to Lockup Agreements" (2004) New Zealand Takeovers Panel <<http://www.takeovers.govt.nz/speeches/art-king-lock-ups.html>> (at 30 July 2008) ["Lockup Agreements"].

receive the same consideration in an offer,<sup>33</sup> meaning that a bidder cannot offer a shareholder anything in consideration for entering a lock-up in addition to that received by all shareholders.<sup>34</sup> One might query, therefore, the incentive for an individual shareholder to enter a lock-up if they will receive nothing in compensation. A substantial shareholder may prefer that the company provides the deal protection in order to spread the cost evenly between shareholders. Otherwise, minority shareholders will receive a free ride from the substantial shareholder's commitment to the lock-up by avoiding the liability to pay damages while still receiving the opportunity to sell their shares at a premium.<sup>35</sup> Admittedly, a substantial shareholder who deems an offer attractive may be willing to grant a lock-up if it is a condition to realizing such a premium for their shares, particularly where they believe a higher rival offer is unlikely. This will particularly be the case where a major shareholder runs a competitive process to auction their holding prior to the offer being publicly announced.<sup>36</sup> A major shareholder wanting to exit may also give a lock-up without a premium as an incentive to enable a deal to happen by removing uncertainty for a potential acquirer. In some cases no bidder may emerge without such an assurance, in which case the major shareholder is trapped.

A bidder may also prefer to negotiate deal protection with the company, as opposed to individual shareholders, for other reasons. For example, the share register may be fairly open, meaning a large number of lock-ups would be required to guarantee success, or the parties may be unable to reach an agreement because shareholders are unwilling to commit due to uncertainty as to the merits of the offer. Therefore, when considered from the bidder's perspective, a shareholder lock-up should be viewed as an alternative to deal protection negotiated with the company, and not as a perfect substitute for it.

## 2 Deal Protection is Not Free

A target board should use the possibility of deal protection as leverage in negotiation to elicit a higher price from the bidder;<sup>37</sup> in other words, the bidder will have to pay for the increased certainty they are receiving from the target. Therefore, a bidder must consider whether the price it pays in

33 "The Takeovers Code" New Zealand Takeovers Panel (2002) <<http://www.takeovers.govt.nz/code/index.html>> (at 30 July 2008) r 20 ["Takeovers Code"].

34 King, "Update on the Operation of the Takeovers Code" New Zealand Takeovers Panel (2005) <<http://www.takeovers.govt.nz/speeches/sp-king-210205.htm>> (at 7 August 2008) ["Operation of the Takeovers Code"].

35 Due to the operation of r 6 of the Takeovers Code and its associated provisions, any offer to increase a party's shareholding in a code company over 20% must be accompanied by a bid extended equally to all shareholders.

36 King, Lockup Agreements, *supra* note 32. For example, Canwest's sale of its 70% holding in Canwest Mediaworks and subsequent lock-up agreement in 2007; see Vaughan, "Ironbridge gets CanWest but happy to stay listed" *The Dominion Post*, Wellington, New Zealand, 9 May 2007, C1.

37 Brantley, "Deal Protection or Deal Preclusion? A Business Judgment Rule Approach to M&A Lockups" (2002) 81 *Tex L Rev* 345, 368.



terms of a higher offer is fully compensated by both increased certainty of consummation and any payout should the proposal not succeed.<sup>38</sup>

The compensation rationale can be viewed simply as an aspect of the bidder's desire to increase expected return; a bidder will require compensation for costs to make a bid only if its expected return would otherwise be negative. Where a bidder's expected return is already positive, a break fee simply acts as a way of allocating risk between the parties. The target, in effect, grants an insurance policy to the bidder in exchange for an increase in their offer. A bidder's decision as to the desirability of a break fee must, therefore, have regard to the relative risk aversion of the parties: the less risk averse a bidder is relative to the target, the less compelling the need to extract a break fee agreement.<sup>39</sup> In other words, one should ask who is best placed to bear the risk that the costs of bidding incurred by a bidder will be lost, and this will depend upon the individual circumstances of each party. At most, therefore, the compensation rationale is a secondary consideration that will not apply in all circumstances.

Arguably, the target is best placed to assume this risk and therefore paying for a break fee agreement in the form of a higher bid may make sense for the bidder. As the target's directors are aware of their own commitment to the deal, they are in a better position to judge whether the takeover is likely to succeed. Further, whereas the bidder's expectation is either to gain from completing the acquisition or make a loss from the bidding costs, the target's shareholders know that they can at least receive the value of the initial offer, with the potential for further profit if a rival bid succeeds.

Therefore, while deal protection is typically viewed as benefiting the bidding party at the expense of the target, circumstances may dictate that such provisions are less one-sided than they first appear.

### **Why Would a Target Agree to Give Deal Protection?**

Takeovers typically create rewarding opportunities for target shareholders and they will be concerned to get the highest price possible. It is with this background that one can rationalize a target's decision to enter into deal protection provisions with a potential bidder. Typically the bidder, using a tactic known as a "bear hug", will present the target's directors with an ultimatum: agree to deal protection or forgo the chance for your shareholders to consider our offer. Therefore, to understand why a target might agree to deal protection, one must understand why a takeover offer might be valuable to shareholders and whether the increased certainty that deal protection provides might also be beneficial to the target.

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38 This analysis does simplify the situation somewhat because the parties will also be aware that a low initial bid will increase the likelihood that another party will contest control; in other words, a high offer price is also a form of deal protection.

39 Fraidin and Hanson, "Towards Unlocking Lockups" (1994) 103 Yale L J 1739, 1823.

### *1 The Value of a First Bid*

A break fee can be viewed as the price paid by the company to give shareholders a valuable benefit. Takeover proposals are typically priced at a healthy premium to the pre-bid price to induce shareholders to accept<sup>40</sup> and shareholders will generally perceive value in the opportunity to consider a takeover bid, whether it is accepted or not.<sup>41</sup> As discussed previously, a bid may also alert other prospective acquirers to the opportunity, creating a contest for control that can result in a further premium to existing shareholders.

Shareholders may also receive other benefits from a takeover proposal due to the delay between announcement and consummation of a takeover. The Takeovers Code legally requires a delay of at least 30 days,<sup>42</sup> although the offer period may be shorter for companies outside its effect.<sup>43</sup> The result of any delay is that bidders effectively grant the existing shareholders a put option, which need not be exercised until the close of the offer.<sup>44</sup> The security in being able to accept the bid at the end of the offer period can be extremely valuable to shareholders (and conversely, expensive for bidders to provide) because they are protected from any intervening decline in the company's fortunes. Furthermore, shareholders retain a stake in the upside potential of the company during the offer period because they maintain the option to reject the offer and benefit if the company's fortunes improve or another bidder enters the contest for control. The value of the option should not be overstated, however, as it is common practice for bidders to make their offer conditional upon no material adverse changes occurring in the target's business during the offer period.

### *2 The Value of a Contest for Control*

Deal protection may also be used in order to achieve a better price for shareholders where an initial bid has already been tendered. In particular, such protection may be used to entice a second bidder to contest control. In such circumstances a "white knight" ... might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved".<sup>45</sup> This will be particularly relevant where the white knight does not value the target as highly as the first bidder. If there are costs to bidding, then a party that is aware it is unlikely to succeed will not enter the contest and therefore the target will be sold at a price less than

40 See Jensen and Ruback, "The Market for Corporate Control: the Scientific Evidence," (1983) 11 *Journal of Financial Economics* 5.

41 Australian Takeovers Panel, *supra* note 11, para 7.16.

42 Takeovers Code, *supra* note 33, r 24(2)(b).

43 A "code company" is defined in r 3 of the Takeovers Code as one that is listed on a registered exchange or has at least 50 shareholders.

44 Fraidin and Hanson, *supra* note 39, 1816.

45 *Revlon*, *supra* note 16, 183.

that which an auction without bidding costs would have achieved.<sup>46</sup> By compensating a white knight for the costs involved, it is argued that the target's board can increase the premium received by target shareholders.<sup>47</sup>

One should ask, however, whether a break fee is the most appropriate response to an unsatisfactory initial bid. Faced with a bid that does not represent proper value for the target, directors could instead recommend to shareholders that they not accept the bid.<sup>48</sup> This approach has the further benefit of not lowering the value of the target from the initial bidder's perspective because there will not be an additional payment flowing to the white knight. In turn, this should allow the initial bidder to return with a higher price than would otherwise be the case. This approach has the added feature of leaving the ultimate decision on the sale of shares to shareholders themselves.

## Challenges to Target Rationales

Shareholders unarguably receive valuable benefits from the takeover process. However, it may be questionable whether deal protection is required in some or most situations to achieve those benefits, and, further, whether the disadvantages of deal protection serve to eliminate any benefits achieved. As to the need for deal protection, refer to the comments made earlier regarding whether a bidder truly requires deal protection in order to submit an offer. As to the disadvantages of deal protection, these are primarily that it can preclude, or at least impede, competition, that it may serve as a way for management to further their own interests, and that it can be coercive to shareholders.

### *1 Precluding Competition*

As discussed previously, a key rationale for bidders to demand protective measures is to reduce the likelihood of a successful rival bid. Therefore, the most obvious criticism of deal protection from the target's perspective is that it forecloses competition for control, thereby reducing the premium offered to target shareholders. This will not be a problem where directors know that the offer is the highest likely bid, as may be the case where a competitive process is run, but it is otherwise questionable whether directors will ever know what a good price is such that they can be confident deal protection will not preclude a competitive auction. An active academic debate exists as to whether deal protection forecloses competition, the main points of which are discussed in the following section on economic considerations.

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46 Fraidin and Hanson, *supra* note 39, 1828–1829.

47 Kahan and Klausner, "Lockups and the Market for Corporate Control" (1996) 48 *Stan L Rev* 1539, 1556.

48 See Takeovers Code, *supra* note 33, sch 2, cl 15.

## 2 Management Conflicts of Interest

A major criticism of deal protection is that target management and directors may use it to further their own interests. In particular, disloyal directors may grant deal protection to a potential acquirer in exchange for assurances that they will keep their positions or receive some side benefit such as equity in the combined entity.<sup>49</sup> Such actions can frustrate shareholders' desires to receive the highest price for their shares or to participate in the merger delivering the most strategic value.<sup>50</sup>

Several rebuttals can be made to this criticism. First, as will be discussed more fully in Part III, directors owe a duty to act in good faith.<sup>51</sup> This duty will be breached should directors choose to further their own interests in preference to shareholders' interests when considering deal protection, although proving such a breach is likely to be difficult. Secondly, where directors are also significant shareholders, their own self-interest in achieving the highest value may outweigh any job security considerations depending upon the value of their shareholding.<sup>52</sup> Thirdly, it is questionable whether deal protection with disloyal motivations will be effective in any event. A primary motivation for many takeovers is to replace existing management to better utilize the assets of the company. Target directors should only have reason to be concerned about their job security where this is the case. If a bidder agrees to keep on ineffective management or offer them a side deal in exchange for a lock-up, their valuation of the target will decrease because their primary method for profiting from the takeover will not be available. In turn, this will allow other parties who are willing to remove existing management to enter with a now higher valuation and outbid them.<sup>53</sup> Consequently, disloyal deal protection is unlikely to be effective, meaning that directors have less incentive to seek it.<sup>54</sup>

The concern may continue to be relevant, however, where there is only one potential bidder who can gain significant synergistic benefits. In such a scenario, if directors are aware of the unique benefits available, they may seek a side deal in exchange for deal protection and acceptance of a lower offer. Since the bidder will face a lower level of competition for the target, they may be able to afford to offer a side deal to the target's directors. However, a lower level of competition will also reduce the bidder's need for deal protection, diminishing the incentive to grant concessions to the incumbent directors in exchange for it.

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49 Bainbridge, *supra* note 1, 273.

50 Mayanja, *supra* note 4, 17–18.

51 Companies Act 1993, s 131.

52 Fraidin and Hanson, *supra* note 39, 1806.

53 Bainbridge, *supra* note 1, 275.

54 Fraidin and Hanson, *supra* note 39, 1811.

### 3 Coercive to Shareholders

A further concern for targets is that deal protection provisions, particularly break fees, may have the effect of coercing shareholders to accept an offer. Faced with a choice between selling into a takeover offer or encumbering the company with a large payout, shareholders may feel they have no option but to accept an offer.<sup>55</sup> As will be discussed in Part III, while the duty of loyalty may not always address this problem, the duty to act for proper purposes could, arguably, be extended to cover such actions. Notice, however, that coercion will only be relevant where a break fee is triggered by shareholder rejection of an offer, a trigger event that is not typical.<sup>56</sup>

### **Economic Considerations: Should Society Allow Deal Protection?**

A significant quantity of academic ink has been spilt disputing the economic advantages and disadvantages in condoning deal protection. While a full survey of the debate is beyond the scope of this article, it will outline some of the key considerations for determining whether society should allow or discourage deal protection provisions in takeovers. Two significant issues determine the economic efficacy of deal protection: first, the effect such provisions have on allocative efficiency and, second, whether deal protection acts as an impediment to the effectiveness of the market for corporate control.

#### *1 An Impediment to Allocative Efficiency?*

Allocative efficiency describes the market condition whereby resources are allocated to those who value them most. Resources will be valued more highly by people who believe that they can exploit them best. Thus, when resources are employed by the person who values them most, those resources should (at least in theory) be put to their most productive use.<sup>57</sup> As a consequence, the welfare of society as a whole is maximized as we get the most out of every resource available.

In the deal protection context, the concern is that deal protection will result in bidders purchasing a target company for less than its optimal value. To affect efficiency, therefore, it must first be determined whether deal protection affects the outcome in a contest for control. The extent to which it does will determine its impact on the efficient allocation of resources. Of particular concern here is the discouraging effect that a break fee agreement may have.

Although an active academic debate exists as to the effect of a break

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55 Brantley, *supra* note 37, 363.

56 *Ibid* 364.

57 Atiyah, *An Introduction to the Law of Contract* (5 ed, 1995) 4–5.

fee agreement,<sup>58</sup> it now appears likely that deal protection agreements do affect the outcome in a contest for control to some extent. Where deal protection provisions are fairly light, however, the likelihood is that the winner of the contest for control will value the target almost as highly and the effect on allocational efficiency will be modest. Where a large imbalance in valuation exists due to strong deal protection measures being employed, the winning bidder may be incentivized to onsell the target to the higher valuing party in any event.<sup>59</sup>

## *2 The Market for Corporate Control*

The concept of the market for corporate control demonstrates how agency costs can be reduced by the threat of takeover. If management behave disloyally, the company's share price is likely to drop and it will become a candidate for takeover, with management likely to lose their jobs. Therefore, management are incentivized by the threat of a takeover to behave loyally.<sup>60</sup> This means that measures that reduce the effectiveness of the takeover market hurt society by increasing agency costs.<sup>61</sup> Deal protection provisions may, therefore, be undesirable from society's point of view if they provide management with a means to stymie the market for corporate control. However, see the earlier discussion on management corruption where several factors diminishing this concern were highlighted.

### **III DEAL PROTECTION IN THE CURRENT NEW ZEALAND ENVIRONMENT**

The relatively recent emergence of deal protection provisions in New Zealand means the courts and the Takeovers Panel have not had to consider the legal issues that they present in much detail. This part of the article outlines the issues raised and how the courts address them.

#### **Do Directors Have the Power to Agree to Deal Protection?**

Directors have the power to decide whether the company should enter a contract pursuant to section 128 of the Companies Act 1993, which vests in the Board of Directors the powers necessary to manage the affairs of the company. In this respect, therefore, directors have the power to enter

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58 Ayres, "Analyzing Stock Lock-ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?" (1990) 90 Colum L Rev 682; Kahan and Klausner, *supra* note 47; Coates and Subramanian, *supra* note 9; Bainbridge, *supra* note 1.

59 See Fraidin and Hanson, *supra* note 39.

60 See Rappaport, "The Staying Power of the Public Corporation" (1990) 68 Harv Bus Rev 96.

61 Daines and Hanson, "The Corporate Law Paradox: the Case for Restructuring Corporate Law" (1992) 102 Yale LJ 577, 616-617.

contracts binding the company, including deal protection provisions. However, the basis upon which directors can commit the company to agreements containing deal protection clauses does present some challenges.

A key issue is whether directors have an implied mandate to induce bids for the benefit of shareholders or whether the express authorization of shareholders should be required. Directors are not normally considered to be the agents of shareholders<sup>62</sup> and do not have the power to bind shareholders to sell their shares unless expressly authorized.<sup>63</sup> However, deal protection provisions are agreed in furtherance of a proposal by the bidder to acquire the shares owned by shareholders.<sup>64</sup> Although the provisions are technically only binding upon the company, the practical effect of such clauses may be to coerce shareholders to accept the offer selected by the directors, particularly where a large break fee is payable. As shareholders will generally not have expressly authorized such actions, whether by resolution or as part of the company's constitution, it is questionable whether directors should be entering such commitments.

Commonwealth authority on the ability of directors to engage in actions designed to secure a bid for the company's shares is sparse. Comments in two Australian cases suggest directors do have such a mandate where an unsolicited bid has already been received.<sup>65</sup> In *ICAL Ltd v County Natwest Securities Australia Ltd*, Bryson J stated:<sup>66</sup>

[I]n some circumstances it may be within the scope of directors' fiduciary duties to seek a better price or another bidder... [W]idening the area of interest in the shares of the company in response to a take-over offer, [is] a measure which is obviously in the interest of shareholders. Generally promoting interest in shares and competition with the offeror is an activity on which, in my view, a high value should be placed and I am reluctant to restrain it by injunction.

In *Darvall v North Sydney Brick and Tile Company*, Mahoney JA commented:<sup>67</sup>

Uninstructed by authority, it might be thought that it is within the functions of a company and so of its directors to ensure that, where an unsatisfactory takeover offer is made, there is available to the shareholders such an offer as will enable shareholders who desire to sell their shares in that context to obtain for them a price which is in the circumstances appropriate. It would, in my opinion, be curious if this were not so.

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62 *Gramophone and Typewriter Ltd v Stanley* [1908] 2 KB 89.

63 *Allen v Hyatt* (1914) 30 TLR 444 (PC).

64 Reichel and Dyer, "Developments in Break Fees" (2004) 22 C&SLJ 439, 440.

65 *Ibid.*

66 (1988) 13 CLR 129, 167 (NSWSC).

67 (1989) 15 CLR 230, 287 (NSWCA).

These comments suggest that, in the face of an unsolicited offer, directors should have a mandate to take steps to present shareholders with the best price for their shares.<sup>68</sup> Although the exact source of this mandate is somewhat difficult to pinpoint, such a position makes sense from a practical point of view, as the statements above also attest.

The question remains whether such a mandate, if it exists, should extend to circumstances where no offer is currently tabled but the directors feel it appropriate to offer inducements to encourage an offeror. Reichel and Dyer argue that such a mandate should exist, particularly where directors feel that the full value of the company is not being recognized in the company's share price or shareholders would achieve better value by selling out to a party that could extract synergies.<sup>69</sup> Recognizing otherwise would create an odd distinction because directors would only be able to present shareholders with potentially valuable, but deal protected, offers for their shares where an initial bid by a rival had already been made.

On such an interpretation, one could also draw similarities with the so-called "*Revlon* duties"<sup>70</sup> of the United States. Directors of companies incorporated in Delaware owe a positive duty to maximize the share price in a sale for shareholders where the board has decided to abandon their long-term strategy and pursue a sale. This may happen both where an unsolicited bid has been received and where the directors decide to initiate an auction of the company.<sup>71</sup> Therefore, although directors in the Commonwealth may not owe a positive duty to obtain the best price, the Delaware position at least recognizes the value in allowing directors to seek value for the shareholders whether an unsolicited bid has been received or not.

Therefore, it is presently unclear whether directors have the power to agree to deal protection provisions as a matter of common law. However, any power that does exist will be subject to the operation of directors' duties.

## Directors' Duties

### *1 Duty to Act in Good Faith and in the Best Interests of the Company*

Pursuant to section 131 of the Companies Act 1993, directors must exercise their powers in good faith and in what they believe to be the best interests of the company. The duty has two limbs, the duty to act in good faith and the duty to act in what the director believes is the best interest of the company,<sup>72</sup> both of which are relevant to the use of deal protection.

68 Mannolini and Rich, *supra* note 7, 227.

69 Reichel and Dyer, *supra* note 64, 441.

70 *Revlon*, *supra* note 16.

71 Tarbert, "Merger Breakup Fees: a Critical Challenge to Anglo-American Corporate Law" (2003) 34 *Law & Pol Int Bus* 627, 648.

72 Rennie and Watts, "Directors' Duties and Shareholders' Rights" (Seminar delivered to the New Zealand Law Society, Wellington, 1996) 7.



## (a) Good Faith

The duty of good faith requires directors to act in the company's interest and not for a personal or collateral interest. Acts of directors motivated by personal interests have been held on innumerable occasions to constitute a breach of duty.<sup>73</sup> The duty can be applied straightforwardly where a director uses deal protection to further their own interests. A director who uses the promise of deal protection to secure an assurance that they will keep their position or receive some side benefit from the bidder is clearly acting disloyally, and not in good faith in the interests of the company.

## (b) In What the Director Believes To Be the Best Interests of the Company

The second limb of section 131 requires directors to act in what they believe are the best interests of the company. Three points arise as to the interpretation of the duty. First, it is the director's subjective belief that is relevant. The courts are generally concerned to respect the business judgement of directors and thus will be hesitant before finding a director was not acting in the company's best interests.<sup>74</sup> Therefore, where directors exercise an honest business judgement that deal protection is in the best interests of the company they will be acting in accordance with the duty; however, the effect of the term "best", and the meaning of the "company" and its "interests" must still be considered.

(i) *The effect of reference to the company's "best" interests*

The classic formulation of a director's fiduciary duty comes from the statement of Lord Greene, MR in *Re Smith & Fawcett Ltd*,<sup>75</sup> requiring that a director must exercise their discretion in what they consider to be the best interests of the company. The duty provided in section 131 adds to this by referring to the company's "best" interests. Based upon common law formulations of the duty using the term "best", the possibility of a duty of care has been recognized, prescribing the way directors must act to achieve the best interests of the company given the options before them.<sup>76</sup> Such a duty would require a decision to be one that a reasonable board would have considered the best, as opposed to merely the one that the company's board honestly believed was best. In other words, the merits of a board's decisions could be reviewed.

73 *MacFarlane v Barlow* (1997) 8 NZCLC 261, 470 (HC); *Selangor United Rubber Estates Ltd v Craddock (No 3)* [1968] 1 WLR 1555 (Ch).

74 *Carlen v Drury* (1812) 1 Ves & Bea 154, 158; 35 ER 61, 62; "Companies Act Commentary" (Brookers Online, University of Auckland Library) (at 20 August 2008) CA131.02.

75 [1942] Ch 304, 306 (CA).

76 Grantham, "Content of the Director's Duty of Loyalty" [1993] JBL 149, 159; Mayson, French and Ryan, *Company Law* (21 ed, 2004) 517.

The recognition of a prescriptive duty would have an impact on deal protection agreements. However, it is doubtful that section 131 was intended to introduce such a duty. First, section 131 requires only that directors select the option they consider is in the best interests of the company,<sup>77</sup> reflecting the common law's great reluctance to review the merits of management decisions.<sup>78</sup> However, dicta in *Hedley v Albany Power Centre Ltd (in liq)* suggests that directors must take into account all relevant considerations in determining whether a transaction is in the best interests of the company.<sup>79</sup> Such a proposition could lead to deal protection agreements being judicially reviewed. Were that the case, a court would need to ask whether the directors adequately identified and considered all potential takeover partners and the advantages and disadvantages to agreeing to deal protection. Watts states that this contention is wrong as judicial review should only be available where the constitution permits it. Rather, directors should be left free to exercise honestly their own business judgement, one facet of which is the decision to inform themselves of all the options, their advantages, and disadvantages.<sup>80</sup>

A second reason for doubting the existence of a prescriptive duty is the preamble to the Act, which states that it is "to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgement".<sup>81</sup> This suggests that the legislature did not intend to permit the courts to question management decisions. Thirdly, in two High Court decisions, *Benton v Priore*<sup>82</sup> and *Sojourner v Robb*,<sup>83</sup> the Court was of the view that the duties stated in sections 131–138 "should be seen as a restatement of basic duties in an endeavour to promote accessibility to the law".<sup>84</sup> This suggests that no change from the common law was intended by restating the principles.

Therefore, before agreeing to any deal protection provisions, directors must satisfy themselves that such provisions will be in the best interests of the company and where they do so they will generally be acting in accordance with the duty.

(ii) *Who is the company and what is in its interests?*

The final consideration deal protection raises in regards to section 131 is who the "company" is and what is in its "interests". Several formulations of the company are possible and the distinctions are important where a change of control is to be effected because the interests of the current

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77 Rennie and Watts, *supra* note 72, 8.

78 *Carlen v Drury*, *supra* note 74.

79 [2005] 2 NZLR 196, 210 (HC).

80 Watts, "Judicial Review of Directors' Decisions – Another Bad Idea" [2006] C&SLB 75.

81 Companies Act 1993, Preamble para (d).

82 [2003] 1 NZLR 564 (HC).

83 [2006] 3 NZLR 808 (HC).

84 *Benton v Priore* [2003] 1 NZLR 564, 574 (HC).

shareholders, the future shareholder, and the ongoing commercial entity may diverge. For example, the best interests of the commercial entity may be to merge with a competitor so as to allow the integration of operations, but if a large break fee is agreed to achieve this purpose, the shareholders may receive less for their shares than otherwise would have been the case.

An initial hurdle to overcome is the subjective standard of section 131: if the relevant test is whether a director believes that they are acting in the company's best interests, does it matter how we define the company and its interests? It has been recognized that a director may still be in breach of their duty under section 131, despite an honest belief that what they are doing is in the company's best interests, where they have adopted the wrong formulation of the interest of the company. This point was recognized by the High Court in *Sojourner v Robb*, where Fogarty J noted:<sup>85</sup>

In this context the standard in s 131 is an amalgam of objective standards as to how people of business might be expected to act, coupled with a subjective criteria as to whether the directors have done what they honestly believe to be right. The standard does not allow a director to discharge the duty by acting with a belief that what he is doing is in the best interest of the company, if that belief rests on a wholly inappropriate appreciation as to the interests of the company.

Therefore, a director who agrees to deal protection believing it to further the interests of the company may be in breach of section 131 where they have failed to give proper consideration to the best interests of the company on its proper formulation.

The case law is not abundantly clear as to whether directors should further the interests of shareholders or the interests of the company as a commercial entity.<sup>86</sup> There has been suggestion that future shareholders should be considered in addition to existing shareholders, which may achieve the result of identifying the company with the enterprise itself.<sup>87</sup> The predominant view, however, is that the company should be identified with the existing shareholders as a whole.<sup>88</sup>

Accepting this formulation of the company, the further issue is what is in that body's best interests. The normal assumption is that shareholders are concerned with maximizing the return on their investment, with the caveat that the constitution or legislative requirements may provide otherwise.<sup>89</sup> One might question how to define maximum return: what weight should factors such as risk, dividend, share price, and time-frame be given in the calculation? The discounted value of the company's future

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85 [2006] 3 NZLR 808, 829–830.

86 Mayanja, *supra* note 4, 25.

87 New Zealand Law Commission *Company Law Reform and Restatement: Report 9* (NZLC R9, 1989) para 189.

88 Rennie and Watts, *supra* note 72, 10; *H Timber Protection Ltd v Hickson International plc* [1995] 2 NZLR 8, 13 (CA); *Ngurli v McCann Ltd* (1953) 90 CLR 425, 438 (HCA).

89 Mayson, French and Ryan, *supra* note 76, 520.

cash flows, a measure that accounts for the time value of money, the cost of capital, and the specific risk of any project or business undertaking is arguably the best measure.<sup>90</sup> Where directors believe a higher bid is likely to be made regardless of whether an initial bid is entered or that a bid does not at least equate with the discounted value of the shares in the hands of the shareholders, then it should not be in the company's best interests to agree to deal protection.

## 2 *Duty to Act for a Proper Purpose.*

Section 133 of the Companies Act 1993 requires that a director must exercise a power for a proper purpose. While seemingly simple, the actual application of the duty is far from straightforward. The very existence of a separate proper purpose duty, as distinct from the duty to act bona fide for the good of the company, was a matter of divided case law in the Commonwealth,<sup>91</sup> but the very fact that section 133 was introduced suggests that New Zealand now recognizes a distinct duty.

Accepting that a duty to act for proper purposes exists, the scope of section 133 is also far from clear. The Privy Council's decision in *Howard Smith Ltd v Ampol Petroleum Ltd*<sup>92</sup> is regarded as the modern restatement of the duty. The case involved the issue of shares by directors for the purpose of destroying the existing majority. Although the directors believed they were acting in the best interests of the company, the Privy Council held that using the power to issue shares to change voting control was an improper purpose for which the power was not conferred.

The question that has followed *Howard Smith* is whether every power exercised by directors is reviewable, or alternatively, if the rule is only applicable to share issues. The courts have been reluctant to apply the ratio of *Howard Smith* outside the sphere of share issues, particularly in the takeover context.<sup>93</sup> The most authoritative case on this point is *Darvall v North Sydney Brick & Tile Co Ltd (No 2)*,<sup>94</sup> where the plaintiff argued, applying the principle in *Howard Smith*, that it is not part of the function of the company to determine who its shareholders are and what price they should be paid for their shares. Mahoney JA rejected this proposition, limiting the principle to share issues that change the control of the company, and finding that the prevention of a takeover offer was not an impermissible purpose. He felt it would be a curious situation were directors not entitled to respond to an unsatisfactory takeover offer by

90 This ignores those rare situations where shareholders are determined to waive some value in exchange for achieving other outcomes, such as retaining local ownership.

91 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (HCA); cf *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

92 [1974] AC 821.

93 Rennie and Watts, *supra* note 72, 27.

94 (1989) 15 CLR 230 (NSWCA).

taking steps to give shareholders who were willing to sell the opportunity to attain an appropriate price.<sup>95</sup>

The New Zealand courts have adopted a similar stance. In *Baigent v D McL Wallace Ltd*,<sup>96</sup> the directors of a takeover target — in an attempt to frustrate the takeover — had decided to sell a company asset that was the motivation for the offeror's bid. Prichard J declined to extend the principle in *Howard Smith*. His Honour commented that, absent a personal conflict, it would be very rare for the sale of a company asset to be an abuse of power. Although the case involves a takeover defence, an analogy with deal protection can easily be drawn, particularly with the so-called "crown jewel" option discussed earlier, where directors agree to sell the asset motivating a takeover should a bid for the target be bettered. Therefore, applying *Baigent* and *Darvall*, deal protection used to secure a takeover bid or frustrate a rival bid will not be a breach of the proper purposes duty save, perhaps, where the agreement involves an option to acquire newly issued shares (a stock lock-up).

On the current application of the courts, therefore, deal protection clauses are unlikely to infringe the proper purposes duty. However, there is a strong argument that section 133 is deserving of wider application, adopting a broad construction of the ratio in *Howard Smith*.<sup>97</sup> It seems a strange position to forbid directors from effecting a change of control by issuing shares, while allowing them to adopt other means to achieve the same ends. Taking the example of deal protection, directors who felt a new majority shareholder would be in the best interests of the company could agree to a large break fee with a view to coercing the current majority to sell down their stake.<sup>98</sup> Where the agreement is limited to a sell down to allow a new majority shareholder, the directors could honestly believe such a deal would best maximize the interests of current shareholders under section 131.<sup>99</sup> It is submitted, however, that such an agreement is for an improper purpose (to coerce a shareholder to sell) and thus should result in a breach of section 133. Deal protection agreed for the purpose of discouraging a rival bid should also be considered as for an improper purpose. Note that not all deal protection provisions would fall foul of such a principle, but, rather, only those for which the purpose was imposing a particular transaction upon shareholders, as opposed to simply securing an opportunity for shareholders to consider an attractive proposal.

95 *Darvall v North Sydney Brick & Tile Co Ltd (No 2)* (1989) 15 CLR 230, 286 (NSWCA).

96 (1984) 1 BCR 620 (HC).

97 See Rennie and Watts, *supra* note 72.

98 On the question of whether a company can have a legitimate interest in the identity of its shareholders compare the comments of Hoffmann J in *Re a Company* [1987] BCLC 82, 84 with those of Lord Cullen in *Dawson International plc v Coats Patons plc* [1988] SLT 854, 860.

99 Compare the situation where the purpose of directors is to coerce a full takeover: where directors know the price is not the best value for shareholders then directors could not honestly believe that they were acting in the best interests of the current shareholders as a whole.

### 3 *Duty Not to Fetter Discretion*

Directors stand as fiduciaries of the company and, as such, cannot fetter their future discretion without the consent of the company.<sup>100</sup> As a general principle, therefore, directors cannot contract as to how they will vote at board meetings or conduct themselves in the future, notwithstanding the absence of any improper purpose or motive.<sup>101</sup>

In the context of deal protection, directors agree to restrict their conduct in the future by no-shop clauses restricting solicitation of rival bidders and break fees that become payable should directors not recommend an offer to shareholders. Arguably, such provisions constitute a fetter on directors' duties and are not enforceable. Two English cases, *John Crowther Group plc v Carpets International plc*<sup>102</sup> and *Rackham v Peek Foods Ltd*,<sup>103</sup> have been used to suggest directors cannot enter a binding agreement to recommend a particular offer to shareholders.<sup>104</sup>

In *John Crowther Group*, the plaintiff entered into an agreement to buy a subsidiary company of the defendant. As the subsidiary formed a substantial part of the defendant's business, a shareholder resolution was required to approve the sale. The defendant's directors agreed, as part of the sale agreement, to use all reasonable endeavours to procure this resolution. Initially, the directors recommended the plaintiff's offer to shareholders, but on receipt of a higher offer, they recommended that the bid should not be accepted. The plaintiff claimed damages on the basis that the defendant had breached its agreement to use all reasonable endeavours to ensure the resolution was passed. In the English High Court (Chancery Division) Vinelott J found that:<sup>105</sup>

The terms of the agreement must clearly be read in the light of the fact known to all parties that directors owe a fiduciary duty to act in the interests of their company and to make full and honest disclosure to shareholders before they vote on such a resolution. It seems to me that it must have been understood by all that if the undertaking was to use reasonable endeavours to procure the passing of the resolution it was necessarily subject to anything which the directors had to do in pursuance of that fiduciary duty.

The action was dismissed because the directors' action in not recommending the bid was in pursuance of their fiduciary duty to the company.

The *Rackham* case involved similar facts. The directors of the defendant company had agreed to use their best endeavours to obtain a shareholder resolution that was necessary for their company to purchase

100 *Clark v Workman* [1920] 1 IR 107 (ICA).

101 Davies, *Gower's Principles of Modern Company Law* (6 ed, 1997) 608.

102 [1990] BCLC 460 (HC) [*"John Crowther Group"*].

103 [1990] BCLC 895 (HC).

104 Courtney, "Fettering Directors' Discretion" (1995) 16 Co Law 227, 229–231.

105 *John Crowther Group*, supra note 102, 464.

the shares in a property company held by the plaintiff. As in *John Crowther Group*, the directors initially recommended the purchase, but when the government announced changes that would have an adverse effect on property companies, the directors opted to change their recommendation. The plaintiffs claimed that the directors were in breach of the best endeavours clause in the sales agreement. Templeman J rejected the claim, stating that the best endeavours clause did not require the directors to give bad advice. The directors no longer believed the transaction was in the best interests of the company and the best endeavours clause could not conflict with the directors' duties to their company.<sup>106</sup>

In both *John Crowther Group* and *Rackham* the Court found an implied term that directors would not recommend the offer where it would not be in the company's best interests. However, note that the agreements in these cases provided that directors would use "reasonable endeavours" or "best endeavours" to procure the passing of the resolution, phrases that could imply an intention not to require directors to act in breach of their fiduciary duties.

In *Fulham Football Club Ltd v Cabra Estates Ltd*,<sup>107</sup> Neill LJ rejected the proposition that directors cannot bind themselves to exercise their powers in a particular manner in the future, suggesting *John Crowther Group* and *Rackham* should perhaps be limited to their own facts. Rather, a director can legitimately agree to act in a particular way if they believe it to be in the company's best interests at the time of contracting and, having so agreed, can be held to their contract even though the circumstances may have changed. The case involved an agreement by directors to use their powers to support a planning application by the plaintiff. The directors sought to escape from the covenant after deciding it was no longer in the best interests of the company. Neill LJ relied on the High Court of Australia case of *Thorby v Goldberg*,<sup>108</sup> where Kitto J stated:

There are many kinds of transactions in which the proper time for the exercise of the directors' discretion is the time of negotiation of a contract, and not the time at which the contract is to be performed. If at the former time they are bona fide of opinion that it is in the interests of the company that the transaction should be entered into and carried into effect, I see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board.

This reasoning is attractive because to require directors to always keep their options open would be to deny the company valuable opportunities and, thus, to prejudice its best interests. The duty should be concerned with directors who transfer their fiduciary obligations to another party,

<sup>106</sup> *Rackham v Peek Foods Ltd*, supra note 103, 920.

<sup>107</sup> [1994] 1 BCLC 363 (CA).

<sup>108</sup> (1965) 112 CLR 597, 605–606 (HCA).

involving the fundamental fiduciary obligation of loyalty, as opposed to directors limiting their options. Thus, where the directors decide to bind the company, believing it to be in its best interests as opposed to a third party's, that contract should be binding.<sup>109</sup>

In a more recent case, the English High Court in *ABN Amro Private Equity Ltd v Forward Technology Industries plc* held that an agreement requiring the payment of a break fee, if the target's board did not recommend an offer, was not an unreasonable fetter on the fiduciary duties of directors. In the course of his judgment, Patten J noted that directors must consider what is in the best interests of the company at the time of contracting, as in *Fulham Football Club*. Interestingly, however, his Honour also drew a distinction between a break fee that would not of itself tie the hands of directors, as was the case here, and an agreement that bound directors not to accept a higher offer, as in *John Crowther*, which would not have been acceptable.<sup>110</sup> This statement seems to recognize that distinctions in the type of directorial activity to which the covenant relates could decide whether an agreement is valid. Covenants that restrict directors' actions in relation to normal commercial transactions, as in *Fulham Football Club*, will be enforceable. However, covenants purporting to restrict a director in their discretion to advise shareholders may not be, unless subject to an express or implied fiduciary out.<sup>111</sup> Arguably, such a rule is justified because shareholders are often dependent upon the advice of directors and may find it difficult to take the decision if it is put in their hands.<sup>112</sup> However, shareholders are not solely dependent upon board recommendations and are provided with an independent adviser's report on the merits of the bid under the Takeovers Code.<sup>113</sup> Shareholders will also know the true weight to be placed on the directors' recommendation because directors must disclose any obligation to recommend a bid.

Therefore, the scope of the principle in *Fulham Football Club* is presently unclear. However, *ABN Amro* suggests that break fee agreements will generally not constitute an unreasonable fetter on directors' discretion. The finding in the New Zealand case of *Greymouth Petroleum* noted earlier does not expressly deal with the point but suggests that no-shop clauses will also not constitute an unreasonable fetter.

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109 Tarbert, *supra* note 71, 704.

110 [2000] EWHC (Ch).

111 Kenyon-Slade, "Improper Fettering of Directors' Discretion, or Holding Them to Their Word?" (1993) 52(2) CLJ 218, 220.

112 Davies, *supra* note 101, 609.

113 Takeovers Code, *supra* note 33, r 21. In recent years several board-recommended transactions have been unsuccessful. For example, MFS's failed bid for Tourism Holdings in 2007 and Origin Energy's failed merger proposal with Contact Energy in 2006.



(a) A Different Approach: *Rothmans Industries Ltd v Floral Holdings Ltd*

In *Rothmans Industries Ltd v Floral Holdings Ltd*,<sup>114</sup> the New Zealand Court of Appeal took a different approach to the inclusion of a clause requiring the best endeavours of directors in obtaining shareholder approval. Rather than expressing concern about the fetter upon directors' discretion, as in *John Crowther and Rackham*, the Court questioned whether any contract existed at all until shareholder approval was obtained.

The case arose out of a contest to purchase the tobacco business of Rothmans Industries. The directors of Rothmans Industries agreed to sell the business to Rothmans Australia, and, as part of their contract, the directors had further agreed to use their best endeavours to obtain the approval of shareholders. Floral Holdings, which had submitted a higher bid for the business, sought an injunction to stop the shareholder meeting. The Court of Appeal upheld the interim injunction. In coming to this conclusion, Cooke P stated:<sup>115</sup>

It is strongly arguable, in the face of article 146, that the document negotiated by the directors is no more than an agreement proposed by them, entailing no binding obligations on the company and certainly no binding obligation on it to use its best endeavours to obtain the approval of its shareholders in general meeting.

The very suggestion that by the actions of its directors a company could have imposed on it an obligation to use its best endeavours to obtain its own approval in general meeting presents formidable logical and practical difficulties.... Here on the straightforward view that appealed to Chilwell J the document of 14 March 1986 is in the category rather of being dependent on what is called sometimes, of if a little inaccurately, a condition precedent to contract.... In truth there is no contract.

Takeover agreements requiring a shareholder resolution are often framed to require the best endeavours of the target to obtain that approval. President Cooke's statement deals a double blow to such agreements. First, where an agreement is required to be subject to the approval of shareholders, the agreement may not be enforceable until such approval is gained. Shareholder approval may, on the proper construction of the contract, be a condition precedent to contract. Secondly, the statement suggests a provision that the company will use its best endeavours to obtain the approval of shareholders may not be valid, citing logical and practical difficulties.

There is weight to Cooke P's suggestion that a company cannot contract to use its best endeavours to obtain shareholder approval. The

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114 [1986] 2 NZLR 480 (CA).

115 *Ibid* 482-483.

company delegates some decisions to shareholders as a check on the powers of directors. A best endeavours clause is an agreement by the agents of the company, the directors, that purports to bind the company to persuade shareholders to exercise their decision-making power in a particular way. Such an agreement is conceptually strange because it appears to negate the purpose of the separation of powers and, arguably, goes beyond what the company would authorize directors to agree to.

Note, however, that the case was only an interim injunction hearing, and, as such, the finding of the Court was only that these points were strongly arguable. Further, the decision was made before the English cases concerning the fettering of discretion, mentioned previously, had been reported. Both *John Crowther Group* and *Rackham* involved very similar agreements to the one seen in *Rothmans*. In those cases the Court found that, although a contract existed, the best endeavours clauses implied that directors were not required to breach their fiduciary duties. One could posit this as a solution to Cooke P's difficulties; however, the obiter comments in *Fulham Football Club* limiting the earlier cases to their own facts may pose a barrier to this.

Therefore, the validity of a clause requiring the company to use its best endeavours to obtain shareholder approval is currently uncertain in New Zealand. However, the author would contend that such clauses are unlikely to be invalidated by the courts in the future, particularly because of the treatment such clauses have received in England.

#### (b) Fiduciary Outs

As referred to previously, an increasingly common practice in agreements containing deal protection is to provide that directors may act in contravention of their obligations where to do otherwise would constitute a breach of their fiduciary obligations or be otherwise unlawful.<sup>116</sup> While inclusion of fiduciary outs is common, it is not clear whether such provisions are necessarily required to make a deal protection clause enforceable. On this point, conflicting comments have been made by the courts. As mentioned earlier, Patten J in *ABN Amro Private Equity* found that the implication of a fiduciary out was not necessary to make a break fee agreement enforceable, despite both parties agreeing that, had the directors not recommended a higher bid, the directors would have been in breach of their fiduciary duties. Contrast, however, the obiter comments of Santow J in *Re Arthur Yates & Co Ltd*, a case in the New South Wales Supreme Court, suggesting that it is important that an exclusivity clause be drafted so that it is subject to an overriding obligation not to breach the directors' fiduciary duties or be otherwise unlawful.<sup>117</sup>

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116 See generally Stanchfield, "Fiduciary Duties in Negotiated Acquisitions: Questioning the Legal Requirement for 'Outs'" (2001) 27 Wm Mitchell L Rev 2261.

117 (2001) 36 ACSR 758, 759 (NSWSC).

Arguably, a fiduciary out clause should not be considered a necessary exception to deal protection provisions *per se*. Rather, the question should be considered within the wider context of the duty to act in the best interests of the company; in other words, stricter deal protection provisions, such as no-talk clauses, are less likely to be considered by directors as being in the best interests of the company at the time of contracting unless they are subject to some form of exception.

## Liquidated Damages

Parties may agree on the amount of damages payable upon breach of their contract. However, such clauses will only be enforceable where the sum payable represents a genuine pre-estimate of damage. Where, on the terms of the contract, a sum is more properly described as a penalty, the clause will be unenforceable and the party must claim damages in the ordinary way.<sup>118</sup> This raises two issues for the enforceability of break fee provisions: first, whether the events upon which a break fee becomes payable constitute a breach of contract and, second, in what circumstances will a break fee be considered a penalty.

Where a break fee is structured so as to become payable upon breach of a contractual undertaking, such as a non-solicitation clause, the break fee performs the role of a liquidated damages clause to which the prohibition on penalties applies.<sup>119</sup> However, break fee agreements are typically structured so as to become payable on the occurrence of trigger events stipulated in the contract rather than on breach.<sup>120</sup> Structured in this way, a break fee can be considered a payment right unrelated to breach of contract and thus should not be subject to the penalty scrutiny.<sup>121</sup>

To be considered a penalty, a break fee must also be unreasonable in light of the loss likely to be occasioned by any breach. Where a break fee compensates the bidder for their reliance interest, being the costs, expenses, and, possibly, opportunity costs of the failed bid, it will not be considered a penalty.

A break fee should also be considered in light of the bidder's expectation interest, which may be difficult to quantify.<sup>122</sup> It has been suggested that the expectation measure is not appropriate for determining the reasonableness of a break fee because of this uncertainty, both because a bidder could not show whether the transaction would be successful, nor

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118 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 (HL) [*"Dunlop"*].

119 May, "Break Fees: An International Perspective" (2005) 24 IFLR 9 (Supplement: Guide to Mergers and Acquisitions).

120 Dunn, "Break Fee Arrangements in New Zealand Public Takeovers" (2007) Buddle Findlay <<http://www.buddlefindlay.co.nz/upload/Break%20fee%20arrangements%20in%20NZ%20public%20takeovers.pdf>> (at 7 August 2008).

121 Davie and Palmer, "Break Fees Common But Not Always Legal" (2004) 23 IFLR 79 (Supplement: Guide to Mergers and Acquisitions).

122 Sneirson, "Merger Agreements, Termination Fees, and the Contract-Corporate Tension" [2002] Colum Bus L Rev 574, 573.

the extent of any gains it might have made.<sup>123</sup> However, this imprecision is the very type of circumstance to which liquidated damages clauses are suited. As Lord Dunedin observed in his classic statement of the law in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*:<sup>124</sup>

It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.

As such, it is unlikely that the courts would regard large break fees as a penalty where, on the construction of the terms and circumstances of the contract, the protection of the party's expectation interest was intended.

### **Financial Assistance**

An agreement to pay a break fee could be construed as the provision of financial assistance in the purchase of shares. Financial assistance in the purchase of shares is only permissible where it is given in accordance with the provisions of the Companies Act 1993. Section 76 provides that:

#### **76 Financial Assistance**

- (1) A company may give financial assistance to a person for the purpose of, or in connection with, the purchase of a share issued or to be issued by the company, or by its holding company, whether directly or indirectly, only if the financial assistance is given in accordance with subsection (2) of this section; and—
  - (a) All shareholders have consented in writing to the giving of the assistance; or
  - (b) The procedure set out in section 78 of this Act is followed; or
  - (c) The financial assistance is given in accordance with section 80 of this Act.
  
- (2) A company may give financial assistance under subsection (1) of this section if the board has previously resolved that—
  - (a) The company should provide the assistance; and
  - (b) Giving the assistance is in the best interests of the company; and
  - (c) The terms and conditions under which the assistance is given are fair and reasonable to the company.

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<sup>123</sup> Mayanja, *supra* note 4, 61.

<sup>124</sup> *Dunlop*, *supra* note 118, 87–88.

The primary issue is whether a break fee agreement can properly be described as financial assistance for the purpose of, or in connection with, the purchase of shares in the company, directly or indirectly, within the meaning of section 76(1). Arguably, a break fee does not assist the bidder in connection with a purchase of shares because where a break fee becomes payable the acquisition will have failed. In this sense, one might characterize a break fee as reassurance for the bidder of the target's intent to conclude the proposal, but not financial assistance.<sup>125</sup> Such an approach would accord with decisions of the Australian and English courts.<sup>126</sup>

However, the recent English Court of Appeal decision in *Robert Chaston v SWP Group plc*<sup>127</sup> casts doubt on this approach. In that case the English Court of Appeal found that an actual acquisition of shares is not required for the restrictions on financial assistance to apply, so long as a proposal to acquire shares has at least received financial assistance. The target paid for an accountant's report to be carried out as required by the bidder's shareholders. The payment constituted financial assistance despite the proposed acquisition never eventuating.

Arguably, this principle is not applicable to a break fee agreement, because unlike a preliminary report, where the company incurs the cost whether or not the acquisition is successful, a break fee will only be paid where the acquisition is unsuccessful. The author submits that this is an incorrect analysis. A report for shareholders is a type of bidding cost. If the proposal fails, the cost stays with the target. However, if the proposal succeeds, the acquirer, in effect, pays the cost because the value of their acquisition decreases. Where a break fee is payable, the acquirer similarly pays when the transaction goes ahead — in the form of a higher share price — but not when it fails. Therefore, there is a strong argument that the principle in *Chaston* can be extended to break fees, and thus a break fee does constitute financial assistance.

Financial assistance is permitted under the Companies Act 1993 provided that the strict procedures within the Act are complied with; although, where the amount given is less than five per cent of the equity of the company, the board need not comply with these procedural requirements, save resolving that the agreement is in the best interests of the company, and on fair and reasonable terms.<sup>128</sup> However, even where a break fee agreement has not been properly approved it will still be enforceable pursuant to section 81(1) of the Companies Act 1993.

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125 Mannolini and Rich, *supra* note 7, 229; Charnley and Breslin, "Break Fees: Financial Assistance and Directors' Duties" (2000) 21 Co Law 269, 269.

126 *British & Commonwealth Holdings plc v Barclays Bank plc* [1996] 1 WLR 1 (CA); *Burton v Palmer* [1980] 2 NSWLR 878 (NSWCA).

127 [2003] 1 BCLC 675 (CA).

128 Companies Act 1993, s 80.

## Takeovers Code

The Takeovers Panel has yet to consider the implications of deal protection in relation to the Takeovers Code.<sup>129</sup> Deal protection devices may constitute defensive tactics in contravention of rule 38 of the Code. Rule 38 provides:

### 38. Defensive tactics restricted

- (1) If a code company has received a takeover notice or has reason to believe that a bona fide offer is imminent, the directors of the company must not take or permit any action, in relation to the affairs of the code company, that could effectively result in—
  - (a) an offer being frustrated; or
  - (b) the holders of equity securities of the code company being denied an opportunity to decide on the merits of an offer.
  
- (2) Subclause (1) does not prevent the directors of a code company taking steps to encourage competing bona fide offers from other persons.

An issue of construction relevant to deal protection arises on the wording of rule 38. The rule restricts actions frustrating “an” offer, as opposed to actions frustrating “the” offer that has been made or is imminent. Arguably, therefore, the restriction on defensive tactics can apply, not only to the offer that has been made or is imminent, but also to actions affecting future offers. Applying this construction, a deal protection provision agreed with a current offeror that could frustrate a potential competing offer may be in contravention of the Takeovers Code. Break fee and no-talk provisions would be particularly susceptible to this reasoning. Competing bidders are likely to be less willing to make an offer where value will be lost through a break fee or they do not have the chance to talk with management and directors. A no-shop clause is much less likely to stop an offer being made; although, it is at least arguable that the failure of directors to shop the company around could result in potential offerors not entering the auction, denying shareholders the opportunity to consider a competing offer.

Deal protection provisions agreed with a subsequent bidder could also be construed as defensive tactics within the prohibition if they could effectively result in the frustration of the initial offer. However, sub clause (2) of rule 38 probably creates an exception for deal protection granted to subsequent bidders to encourage them to enter the auction process. Directors are permitted to “take steps to encourage competing bona fide offers”,<sup>130</sup> notwithstanding the restrictions on defensive tactics. At issue,

<sup>129</sup> New Zealand Law Society *Takeovers: Intensive* (2007) para 11.2.

<sup>130</sup> Takeovers Code, *supra* note 33, r 38(2).

therefore, is whether deal protection issued to subsequent bidders can be seen as a valid step to encourage competing bids for the purposes of the Takeovers Code. Where a break fee is sincerely used for the purposes of encouraging a rival bidder, it will be difficult to argue a breach.<sup>131</sup>

The Takeovers Panel has yet to provide any guidance upon the interpretation of rule 38(2). In particular, it is not clear whether all levels of encouragement will fall within the exception, or alternatively, whether the level of encouragement must be reasonable in the circumstances. The exception is not qualified by a requirement of reasonableness on its face: does this mean the exception will apply even to excessive deal protection agreed with subsequent bidders, such as a very large break fee? The exception seems to require a causal nexus between the steps taken and the encouragement of a competing bid; in other words, the steps taken must be for the purpose of encouraging competing bids and not to discourage the hostile bidder. Therefore, where deal protection is entered into, not to encourage a friendly bid, but rather, to reduce the hostile bidder's incentive to acquire the company, the exception should not apply and the target directors will be in breach of the defensive tactics prohibition. A large break fee may still be within the exception where it is the only way to entice a potential friendly bid. However, the author would submit that in these circumstances there will at least be an inference that the true purpose of the protection was to discourage the hostile bidder.

## IV INTERNATIONAL APPROACHES TO DEAL PROTECTION

### A Regulatory Response: Australia and the United Kingdom

London's Panel on Takeovers and Mergers has adopted a bright-line approach to the regulation of break fees. Rule 21.2 of the City Code on Takeovers and Mergers provides that an inducement fee must be de minimis, the test for which is that it must normally not amount to more than one per cent of the offer's value. Target directors and their financial advisers must also write to the Panel confirming their belief that such a fee is in the best interests of shareholders and full disclosure must be made in the offer document and takeover announcement. The policy rationales for rule 21.2, as stated by the Panel's Director-General, are to stop break fees being used to frustrate potential competing bids and to limit the dilution of target shareholder's funds.<sup>132</sup>

In addition to common law restrictions, the Australian Takeovers Panel also regulates the use of deal protection devices in Australia. *Guidance*

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<sup>131</sup> New Zealand Law Society, *supra* note 129, para 11.2.

<sup>132</sup> "Annual Report" United Kingdom Takeovers Panel (2001) <<http://www.thetakeoverpanel.org.uk/new/reports/ DATA/Report2001.pdf>> (at 7 August 2008) 14.

*Note 7: Lock-up Devices*<sup>133</sup> (“GN7”) outlines the approach of the Panel. In general terms, the Panel must assess whether deal protection devices conform with the policy of ensuring control transactions take place in an efficient, competitive, and informed market, as set out in section 602(a) of the Corporations Act 2001(Cth). To address this issue the Panel has adopted a two-stage test: first, the device must not have an anti-competitive effect by deterring the competition for control and competing proposals, and, second, the device must not be coercive to target shareholders.

Guidelines are also provided for specific devices. As in the United Kingdom, the Australian Takeovers Panel has adopted a one per cent limit for break fees unless management can demonstrate that the fee is neither anti-competitive nor coercive.<sup>134</sup> The Panel has adopted contrasting stances to no-shop and no-talk provisions. No-talk provisions are likely to be considered anti-competitive unless framed to give directors the ability to respond to a more attractive proposal. Factors such as the length of the exclusion period and whether a competitive auction for the shares has been held are also relevant. No-shop provisions, on the other hand, are considered to be materially less anti-competitive than no-talk clauses and thus are not generally required to be framed so as to give directors an out.<sup>135</sup>

The responses of the Takeover Panels in Australia and the United Kingdom provide a clear guide to companies and their advisers as to what is acceptable.<sup>136</sup> The one per cent guideline recognizes the difficulty in successfully bringing a claim for breach of fiduciary duty against company directors when there is a suspicion that deal protection provisions have been misused for the purpose of frustrating rival bids or coercing shareholders. Although undoubtedly pragmatic, the pitfall of the approach is that it may oversimplify the situation by not allowing for individual circumstances to dictate the magnitude of break fee appropriate, potentially to the detriment of shareholders.<sup>137</sup>

## United States

In stark contrast to Australia and the United Kingdom, deal protection provisions in the United States have been the subject of much judicial scrutiny, particularly in the influential State of Delaware. A comprehensive analysis of the United States position is beyond the scope of this article, particularly given that the courts have yet to adopt a clear approach. However, a brief overview of the general position and its challenges will be useful in considering New Zealand’s options.

Judicial scrutiny of deal protection provisions in the United States has focused on whether directors have acted in accordance with their

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133 Australian Takeovers Panel, *supra* note 11.

134 *Ibid* paras 7.15–7.27.

135 *Ibid* paras 7.28–7.40.

136 Tarbert, *supra* note 71, 679.

137 Curtis and Pinder, “Break Fee Restrictions: Where’s the Harm?” (2007) 14 *Agenda* 111, 121.



fiduciary duties. Directors owe fiduciary duties in managing the business and affairs of the company, and in normal circumstances the courts will respect their business judgement. However, in sale of control situations directors are subjected to enhanced scrutiny to ensure their conduct is reasonable<sup>138</sup> due to the spectre that a board may act in its own interests to the detriment of shareholders.<sup>139</sup> In *Revlon Inc v MacAndrews & Forbes Holdings Inc*,<sup>140</sup> the Delaware Supreme Court stated that directors are under a positive fiduciary duty to maximize the price for shareholders of the company when the board decides to abandon its long-term strategy and pursue a sale. Such a duty can operate both where a target initiates an active bidding process itself and where it seeks an alternative transaction in response to an unsolicited bid.<sup>141</sup>

What remains unclear is how directors' actions are to be tested under this positive fiduciary duty and, in particular, whether an ex ante or an ex post evaluation of the actions of directors is required. In both *Revlon* and *Mills Acquisition Co v MacMillan Inc*,<sup>142</sup> the Delaware Supreme Court focused on the actual effect of the devices upon shareholders, as opposed to the reasonableness of the directors' decision in the circumstances that existed at the time. Conversely, in *Paramount Communications Inc v QVC Network*, the same Court outlined an ex ante approach:<sup>143</sup>

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

A court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.

However, in *Paramount*, the commitment of the Delaware Courts to an ex ante approach was not truly tested because the decision of the directors was unreasonable both at the time it was made and in light of subsequent events.<sup>144</sup> As yet, no later case has tested the approach to be taken.

The key benefit of the United States approach is its flexibility.

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138 *Paramount Communications*, supra note 21, 42.

139 *Mills Acquisition*, supra note 17, 1287.

140 *Revlon*, supra note 16, 182.

141 *Paramount Communications v Time Inc* 571 A 2d 1140, 1150.

142 *Revlon*, supra note 16; *Mills Acquisition*, supra note 17.

143 *Paramount Communications*, supra note 21, 45.

144 Panagopoulos, supra note 26, 451.

Directors are permitted the freedom to negotiate deal protection clauses to suit the circumstances, although some limits have been placed on the type of clauses that are allowable. The test encourages directors to properly inform themselves and adopt a reasoned approach to the granting of deal protection. However, the uncertainty inherent in the test is certainly a drawback. Enforcement of such an approach is also reliant upon costly litigation in the courts, which is less of a feature of the approach in the United Kingdom and Australia.

## V SUGGESTIONS FOR NEW ZEALAND

The emergence of deal protection clauses in takeover agreements raises several key issues for law-makers. What role boards should assume in the takeover process and the safeguards needed to protect shareholders from the opportunity for management corruption is key to the selection of appropriate regulatory measures. A further consideration is the extent to which society is prepared to allow directors to impede upon the competition for control of companies.

Arguably, the existing law in New Zealand adequately addresses the issues that deal protection raises. The duties of directors to act in good faith in the best interests of the company and for proper purposes could ensure that deal protection is not used as a tool for management corruption or to impede the competition for control of companies. As argued previously, the courts could adopt a wider view of the proper purposes doctrine to help achieve this. However, unlike the United States' enhanced scrutiny test, the decisions of directors are not open to judicial review. This means that enforcement will be rare because of the difficulty in proving that directors have in fact acted in breach of their fiduciary duties. Furthermore, although such an approach offers the greatest flexibility, it is also the most uncertain.

The better and more likely approach to be taken in New Zealand is for the Takeovers Panel to employ the Takeovers Code to regulate the use of deal protection, in addition to the measures already available at common law. Rule 38 of the Code, restricting defensive tactics, suggests that the proper role of boards is not to determine the winners and losers in a takeover process. It also reflects the sentiment that directors' duties are not an adequate safeguard to management corruption in a takeover situation. As deal protection can similarly be used as a tool for management corruption and to affect the outcome of a takeover, consistency would suggest that the Panel should also regulate the use of deal protection.

Deal protection may already fall within the wording of rule 38. As it stands, however, the rule is not clear enough on the policy to be taken towards deal protection. Therefore, the Panel should issue a Practice Note

detailing the application of rule 38 to deal protection provisions.

The value of certainty and harmonization with Australia and the United Kingdom suggests a one per cent guideline on break fees should be adopted. However, this should be subject to circumstances that may require a larger fee to be paid, particularly for takeovers of smaller companies, where such a percentage may not be able to adequately compensate the bidder for their costs. Exclusivity provisions, particularly no-shop clauses, are less troublesome from a corruption and competition point of view. A no-shop clause is less likely to be considered to be a step that could result in an offer being frustrated and thus is unlikely to fall within the defensive tactic prohibition. On the other hand, no-talk clauses are more likely to frustrate a potential offer and so be interpreted as illegal. Note that, were the Panel to adopt this approach to exclusivity clauses, the New Zealand position would largely mirror that applied in Australia.

Applying the limits in rule 38 to deal protection devices addresses the issue of the board's mandate to act as agent for the shareholders in a takeover, by limiting their ability to determine the outcome. Shareholders would still have the option to permit the directors to take a more aggressive approach by condoning more meaningful deal protection devices by shareholder resolution, as provided for by rule 39(1)(a) of the Takeovers Code.

## **VI CONCLUSION**

Deal protection provisions can be a helpful negotiating tool for target directors in achieving valuable benefits for shareholders. However, New Zealand's current legal framework is too uncertain as to its treatment of such provisions and may diminish shareholder wealth, both by increasing the opportunity for management corruption and diminishing the valid use of deal protection. There is scope for the courts to adopt an interpretation of directors' duties and, in particular, the duty to act for proper purposes, to meet these challenges. However, the market would be better served by a more certain and accessible form of regulation. The preferred approach is for the Takeovers Panel to regulate this activity under the Takeovers Code. By stating clearly the principles by which deal protection devices will be judged, the Panel can create a framework that will offer clear and effective regulation, to the benefit of all participants in the market for corporate control.