IT IS TIME TO RETHINK THE USE OF FIDUCIARY OUT TERMINATION PROVISIONS AND THE RESTRICTION ON CHANGES IN BOARD RECOMMENDATION IN CANADIAN MERGER AGREEMENTS[1]

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In negotiating an agreement[2] for the acquisition of a public company, some of the most heavily negotiated terms are a host of provisions generally referred to as "deal protection provisions." These provisions are designed to increase the likelihood of success for the purchaser since it is impossible for the target board to bind the public company's shareholders and thereby guarantee that the agreed upon transaction will close.

In a *paper* released today, we focus primarily on those aspects of deal protection provisions which are generally referred to as "fiduciary out" provisions. These provisions allow a target board to terminate a merger agreement with a purchaser in the event an unsolicited, *bona fide* superior proposal is received from a third party after the signing of a merger agreement. Based on our experience and a review of various studies with respect to public company M&A transactions,[3] fiduciary out provisions are standard in Canada.

We also consider the prevailing practice in Canadian merger agreements for deal protection provisions to provide that a board recommendation in favour of a merger agreement cannot be withdrawn or otherwise negatively altered unless it is in connection with a superior proposal; this could lead to a target board agreeing to limit disclosure and its advice to its shareholders, therefore risking that shareholders will be making a decision that is not informed.

Based on our review of Delaware jurisprudence, including the much criticized decision of the Delaware Supreme Court in *Omnicare, Inc. v. NCS Healthcare, Inc.*,[4] and considered from a Canadian perspective with limited Ontario jurisprudence, we argue that a target board may, without breaching its fiduciary duty or engaging in oppressive conduct, agree to the demands or requests of a purchaser to not include fiduciary out provisions in the deal protection provisions of a merger agreement in return for appropriate consideration. We are of the view that if a target has more freedom to negotiate deal protection provisions, it can create greater value for the company and its shareholders. This flexibility provides a target's board with another method to

extract additional consideration or privileges from a prospective purchaser for the benefit of the target.

We also suggest in the paper that the duty of loyalty must, at the very least, impose an obligation on a target board to provide shareholders with up-to-date and truthful recommendations, particularly as it relates to the shareholders' sacrosanct right to vote. We therefore suggest that a broader exception to the deal protection provisions pertaining to changing board recommendations based on, at a minimum, material intervening events should be a standard clause in merger agreements. Accordingly, the current practice of limiting a board's right to change its recommendation is highly problematic and likely to be in breach of a board's fiduciary duty. Ultimately, a target board should ensure that, under the terms of a merger agreement, it preserves the right to fulfill its obligation to provide a "current, candid and accurate merger recommendation."[5]

by Paul Davis and Sandra Zhao

1 The views expressed in this bulletin are those of the authors and should not be attributed to McMillan LLP.

2 In the context of a takeover bid for a Canadian company, these are usually referred to as support agreements, and in respect of plans of arrangement they are referred to as arrangement agreements. In this bulletin, we will refer to all such agreements as merger agreements.

3 Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Fifth Annual Edition* (2013); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Sixth Annual Edition* (2014); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Seventh Annual Edition* (2015); American Bar Association, *2013 Canadian Public Target M&A Deal Points Study (For Transactions Announced in 2011 and 2012)*.

4 818 A.2d 914 (Del. 2003).

5 In *Re Complete Genomics, Inc. Shareholder Litigation*, C.A. No. 7888-VCL, 16 (Del. Ch. 2012).

a cautionary note