



# AM&AA GLOBAL

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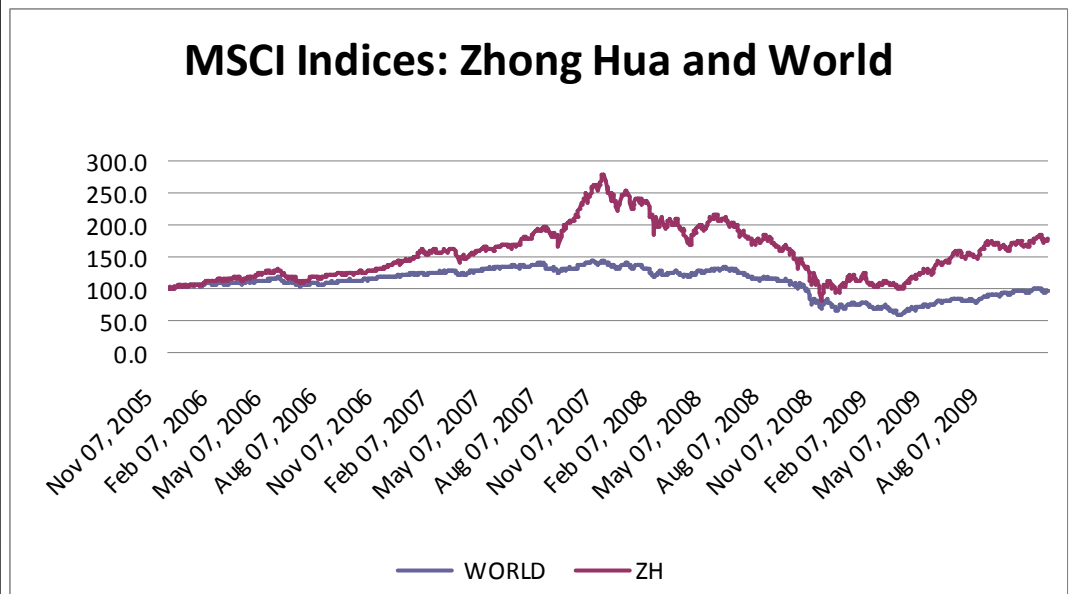
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If you would like to submit an article to be considered for this newsletter, please email it to: [karim.pakravan@sbcglobal.net](mailto:karim.pakravan@sbcglobal.net)

## Graph of the Month

### MSCI Indices: Zhong Hua and World



**Zhong Hua is an composite MSCI global equity index for China Mainland and Hong Kong shares.**



### EDITOR'S NOTE: CHINA'S REBOUND RAISES HOPES AND QUESTIONS

The global financial and economic crisis has significantly raised China's profile and established it as an influential global player—a role which was underscored at the recent G-20 Summit in Pittsburgh. Not only has the Chinese economy survived the global recession relatively unscathed, but it also has become one of the major regional and global engines of economic recovery. China's recent economic releases show a return to rapid growth, with output rising by 8.9% (y/y, year-on-year) in second quarter of 2009 from a low of 6.1% in the first quarter of the year—GDP growth is expected to reach 8% for the year as a whole. Much of the improvement was the result of a massive stimulus program (in the form of new infrastructure investment) of \$586 billion (14% of GDP) and a government-directed surge in credit (which rose by 35% in the first half of 2009). While, exports dropped by 16% in the first three quarters of the year, leading to a sharp decline in the current account surplus—down from almost 10% of GDP in 2008

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to 6.4% in the first half of 2009, foreign exchange reserves continued to climb, reaching \$2.273 trillion at the end of September. China is the single largest holder of US government securities (approximately \$800 billion).

The economy rebalanced somewhat in 2009, with domestic demand accounting for a bigger share of growth this year. However, by implicitly tying its currency to the US dollar, China is well positioned to take advantage of the seemingly accelerating global recovery. Overall, China's strong performance has made it into an engine of growth for the region, allowing it to pull East Asia out of recession. However, whether it can pull the rest of the world out of recession on its own is doubtful.

While this strategy has worked in the short term to revive economic growth, it remains risky and China will have to rebalance its economy in the years to come. The first imbalance is the high degree of dependence of the economy on fixed capital formation. In the boom year of double-digit growth preceding the global recession (2003-2007), China's economic performance was heavily dependent on investments, which contributed to 40-50% of total growth. In 2009, capital expenditures have accounted for about 2/3 of output growth, an unsustainable level in the medium term, and China needs to rebalance its growth towards consumption.

The second imbalance is the rapid growth of credit. In the past two decades, periods of rapid credit expansion have been followed by high level of losses related to non-performing loans for the banking system, forcing government intervention and the creation of large publicly funded "bad banks". While the largest state-owned banks are highly profitable, the banking system as a whole could be vulnerable to rising future losses. The third imbalance is the credit-fuelled stock market surge. The Chinese stock market has a history of high volatility, and while the rising profits of some of the big players may justify such high multiples, the current boom could be followed by a painful bust. While the Shanghai composite index has surged by 69% year-to-date, with P/E multiples rising to 34, doubling in the last year, this performance has to be put in perspective against other major indices—the MSCI -EM Asia and MSCI-BRIC were up respectively by 63% and 83% over the same period. While the Chinese authorities are aware of these trends, they continue to place a heavy emphasis on growth (and social peace), and are likely to continue to pump credit and stimulus money in the economy.

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## DIRECTOR DUTIES IN CONNECTION WITH M&A TRANSACTIONS IN THE UNITED STATES

BY: BY PETER FLÄGEL, COUNSEL, AND ANN M. BATCHELOR, ASSOCIATE, CARTER LEDYARD & MILBURN LLP.

Every director of a U.S. corporation, be it a public or privately held corporation, owes fiduciary duties to the corporation and its stockholders and can be held personally liable for a breach of such duties. Accordingly, it is important for foreign corporations setting up subsidiaries in the U.S. to understand the concepts underlying these duties, in particular if other investors have an equity stake in such a subsidiary.

### The General Duties of Directors to a Corporation's Shareholders

The two primary fiduciary duties directors of a U.S. corporation have are (i) the duty of care and (ii) the duty of loyalty. In Delaware, the State in which most U.S. corporations are incorporated because Delaware courts are traditionally the most sophisticated in corporate matters and have developed case law that is most beneficial to management, the courts have generally described the duty of care as the obligation to use the amount of care which an ordinarily careful and prudent person would use in similar circumstances which includes an obligation to take action where a careful person would have taken action. The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its stockholders and not in their own individual interest.

Fiduciary Duties in Connection with M&A Transactions*The General Revlon Duty*

In certain situations, a director is subject to a heightened duty of care, including in the context of an acquisition of the corporation in an M&A transaction. In the event of an acquisition, Delaware courts have held that the board of directors has the burden of achieving the highest value reasonable available to stockholders (known as the *Revlon* duties because these duties were developed and described for the first time in *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*). These duties apply once the directors decide to sell the company, or before that, if a sale becomes inevitable. Once the duties apply, if the directors fail to meet them, they must show that the sale transaction was entirely fair to the corporation. Usually, the highest value is interpreted to mean the highest purchase price paid by a buyer, but the board of directors can consider other factors, such as the certainty of completion and required governmental consents. For instance, a buyer who is offering to buy a corporation for a certain purchase price funded with its own cash resources may be preferable to a buyer who is offering a higher purchase price but needs to fund the entire amount or a portion through third party financing.

*Specific Guidance by Delaware Courts*

In *Ryan v. Lyondell*, the Delaware Supreme Court re-affirmed the board's *Revlon* duty to get the best price for the stockholders. Although the court has declined to specify what specific actions directors need to take when the *Revlon* duties are implicated, the court has given guidance on some actions a board should adopt:

Monitor negotiations between the CEO (or other management) of the corporation and the buyer.

Conduct a meaningful market check to confirm the absence of the possibility of a better deal. For example, a Delaware court found (*In re Netsmart Technologies, Inc. Securities Litigation*) that a board of directors did not employ a reasonable market check process when it conducted a limited auction with private equity buyers only, excluding potential strategic buyers. The court found further that a "window shop" provision (a provision that prohibits the corporation from actively soliciting new offers, but permits the board to consider unsolicited offers, provide the would-be offeror with information and accept the offer if necessary to avoid violating the board's fiduciary duties) in the merger agreement did not cure the directors' failure to satisfy their duty of care.

Review any valuations of the corporation and consider alternative valuation methodologies.

Consider the particular circumstances affecting the corporation. For example, the auction of a smaller corporation can require significantly more marketing than a widely-held public corporation in order to be considered reasonable.

Review any potential conflicts of interest and disclose such interests to the stockholders. If any directors have a personal interest in the transaction, a special committee of disinterested directors should be convened. Parties with a personal interest in the transaction should not negotiate the terms of the transaction.

*Repercussions of the Revlon Duties on M&A Agreements*

The *Revlon* duties do not cease to exist once the corporation has entered into an acquisition agreement. There can be a significant period between signing and closing in which other (better) sale opportunities may arise. Hence, there is an inherent tension between the board's *Revlon* duties on the one hand and the generally binding nature of an acquisition agreement on the other hand. Because directors are subject to a heightened fiduciary obligation in an M&A transaction through the closing of an acquisition, they need to be able to consider superior offers even after the acquisition agreement has been executed, without being fully locked up by the terms of the acquisition agreement. Directors need the ability to withdraw their approval of a transaction and terminate the agreement if a better opportunity to sell the corporation arises (also known as a "fiduciary out"). Although a seller may successfully negotiate a fiduciary out provision in any acquisition agreement, fiduciary out provisions are particularly common in public company merger agreements. However, although buyers understand that they must allow the target corporation to walk away from the deal if the board's fiduciary duty requires it to accept a better deal, they will usually request in such a case that at least the target corporation compensate the buyer financially for the time, effort and fees spent on the transaction. Accordingly, most acquisition agreements with a fiduciary out also provide for the payment of a break-up fee which is typically 2% to 4% of the transaction value. Fiduciary outs with break-up fees are generally valid.

A fiduciary out must be meaningful in order for the board to satisfy its fiduciary obligations. In *Omnicare v. NCS Healthcare, Inc.*, the Delaware court found that the board members breached their fiduciary duties even though

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the merger agreement contained standard fiduciary out language. The fiduciary out was essentially irrelevant because the merger agreement contained a provision under which the board was forced to submit the merger agreement to the corporation's shareholders for approval and the largest shareholders had already agreed to vote in favor of the transaction. This meant the transaction would be approved even if the board in light of its Revlon duties recommended to the shareholders to vote against it. Accordingly, the board was effectively precluded from pursuing another, better, sale opportunity.

*Conclusion*

Generally, fiduciary duties in connection with M&A transactions can be a trap for the unwary, in particular for foreign companies doing business in the U.S. who are not familiar with the concepts related to the limitation of a company's board's discretion based on its duties to shareholders. These fiduciary duties have a significant impact on a board's strategy to look for a potential buyer, but also on the structure of an acquisition agreement. Competent legal advice should be sought the very instant a corporation's board begins to consider a sale of the corporation to avoid potential liabilities to shareholders.

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