

TAKEOVERS PANEL FINDS PRE-DEAL EXCLUSIVITY ARRANGEMENTS UNACCEPTABLE (AGAIN)

28 February 2022 | Australia

Legal Briefings - By **Tony Damian and Nicole Pedler**

The Takeovers Panel has declared the pre-deal exclusivity arrangements granted by Virtus Health Ltd (**Virtus**) as a whole to CapVest Partners LLP (**CapVest**), involving a hard exclusivity period (with no fiduciary carve-out), notification and matching rights and break fees, to be unacceptable. The declaration follows a similar stance taken by the Takeovers Panel in AusNet Services Limited 01 [2021] ATP 9 (**AusNet 01**) to apply the Takeovers Panel guidance on exclusivity arrangements at the non-binding offer stage.

IN BRIEF

- The Takeovers Panel has found that exclusivity arrangements granted by a target at the non-binding offer stage that involved a period of approximately one-month 'hard' exclusivity with no fiduciary carve-out together with other features including notification, equal information and matching rights and a break fee, when taken as a whole, had an anti-competitive effect and were unacceptable.
- This follows a similar approach taken by the Takeovers Panel in AusNet 01 and suggests scrutiny of targets offering exclusivity at the non-binding proposal stage will increase. Bidders and targets will need to ensure that the settings of any exclusivity arrangements as a whole do not have an anti-competitive effect, or risk them being unenforceable.

BACKDROP - AUSNET 01

As outlined in our previous update,¹ in December 2021 in AusNet 01 the Takeovers Panel considered a limited period of 'hard' exclusivity arrangement (without a 'fiduciary out') together with a suite of other deal protection mechanisms for the first time. The arrangements are not uncommon and a variety of approaches are taken to them in the pre-deal phase. The Panel found the arrangements that AusNet Services Limited (**AusNet**) had granted, when taken together, had an anti-competitive effect and were unacceptable. It also clarified that Takeovers Panel Guidance Note 7 (Lock-up devices) (**GN7**) applies to limited-period exclusivity arrangements to progress non-binding proposals, which will shape a narrower approach by bidders and targets as GN7, for example, provides that the absence of a fiduciary carve-out to an obligation not to talk to other potential bidders (also known as 'hard' exclusivity) is likely to be unacceptable.

BGH and CapVest non-binding proposals and the CapVest Process Deed

On 14 December 2021 Virtus announced that BGH Capital Pty Ltd (**BGH**) had submitted a non-binding proposal to acquire all of the shares in Virtus for \$7.10 cash per share by way of a scheme of arrangement. The following day BGH notified it had a relevant interest of 19.9% in Virtus.

On 20 January 2022 Virtus announced that

- it had received a non-binding indicative proposal from CapVest to acquire control of Virtus by way of scheme of arrangement at a price of at least \$7.60 per Virtus share or an acquisition of at least 50.1% of the share capital in Virtus by way of an alternative transaction structure (such as an off-market bid) at \$7.50 per Virtus share (the alternative transaction structure would have the effect that CapVest could acquire control of Virtus despite BGH's 19.9% stake); and
- it had entered into a process deed with CapVest (the **Process Deed**), as the basis on which to progress the CapVest proposal; and
- the Virtus board had determined that the CapVest proposal was superior to the BGH proposal and that, subject to agreeing an implementation deed with CapVest, the board intended to unanimously recommend the CapVest proposal (subject to the view of an independent expert and in the absence of a superior proposal).

BGH made an application to the Takeovers Panel submitting that a number of features of the exclusivity arrangements had a significant adverse impact on the competition for control of Virtus.

On 28 February 2022 Virtus announced that BGH had submitted a revised conditional non-binding proposal to acquire all the shares in Virtus at a price of \$7.65 cash per share provided that Virtus and BGH enter into an agreement that includes certain discrete provisions of the CapVest Process Deed. At the time of writing the Virtus Board was yet to evaluate the revised proposal.

CIRCUMSTANCES AND TIMING OF ENTRY INTO THE PROCESS DEED

As part of BGH's submissions, it stated that the entry into the Process Deed was premature after Virtus had indicated it would revert to BGH following its proposal and had not attempted to meaningfully engage with BGH or otherwise facilitate an auction process.

Directors in Australia do not have a positive obligation to facilitate an auction process once a control proposal is received, unlike in the United States where such duties, called Revlon Duties after the leading case on them, do apply.

In AusNet 01 the Takeovers Panel clarified that it does not consider that there is any requirement for a target company to undertake a public auction process prior to entry into any exclusivity arrangements.^[2]

However, GN7 provides that a no-talk restriction is *"less likely to give rise to unacceptable circumstances if the target has conducted an effective auction process before agreeing to it"*. The Panel in AusNet 01 assessed the nature of the process leading up to agreement of AusNet's exclusivity arrangements with Brookfield and found AusNet did not conduct an effective auction process before entering into them. This was one of the combination of factors when, taken as a whole, led to a finding of unacceptable circumstances in AusNet 01.

The fact that the exclusivity arrangements were granted at the indicative proposal stage where there was no guarantee that Virtus shareholders would receive a binding bid was one of the factors the Panel used in support of its view that the arrangements between Virtus and CapVest as a whole were anti-competitive.

Whilst there may be no requirement to commence an auction, it seems that the Panel is ready to draw a negative inference where stringent exclusivity arrangements are agreed to in the absence of one.

KEY TERMS OF THE PROCESS DEED, AND BGH'S SUBMISSIONS

Some of the key aspects examined by the Panel are as follows.

EXCLUSIVITY PERIOD

The Process Deed provided for an exclusivity period applying from the date of the Process Deed to the date 40 business days after the business day after Virtus notified CapVest that the data room was open to CapVest (**Data Room Open Date**). The Data Room Open Date was not apparent from public disclosures, which is something the Panel indicated added to the overall issues with the exclusivity regime as a counter bidder would not have been able to work out precisely when exclusivity would end. The Panel also found that the duration of the overall exclusivity arrangement was a factor that contributed to the anti-competitive effect of the exclusivity arrangements between Virtus and CapVest.

EXCLUSIVITY ARRANGEMENTS

The exclusivity arrangements that applied during that period included the following.

- **No shop, talk or DD:** No shop, no talk and no due diligence exclusivity obligations requiring Virtus not to solicit proposals, participate in discussions regarding other proposals or grant due diligence in relation to a third party control proposal.
- **Hard exclusivity period:** A fiduciary carve-out to the no talk and no due diligence restrictions (**Fiduciary Out**) applied from the date which was 15 business days after the Data Room Open Date, meaning there was an approximately one month '*hard*' exclusivity period where no fiduciary carve-out applied.
- **Notification and matching right:** A right for CapVest to be notified of competing proposals, including a requirement to provide CapVest (among other things) details of a person who made any approach and all materials terms and conditions of the approach including as to value and price.
- **Matching right:** The matching right for CapVest was recurring such that each successive competing proposal gave them another opportunity to match.
- **Break fee:** A break fee for the benefit of CapVest in the amount of \$2 million in circumstances where before a specified date CapVest has given to Virtus (among other things) an implementation agreement which Virtus does not execute within a specified time period or the payment of a \$4 million break fee to CapVest where Virtus enters into an agreement to give effect to a superior proposal, or recommends a takeover bid made for Virtus, during a period of approximately six months after the date of the Process Deed (**Competing Proposal Fee**).

BGH pointed out that the Competing Proposal Fee was payable regardless of whether CapVest ultimately delivered a binding proposal and regardless of the quantum of actual costs incurred by CapVest in pursuing the CapVest proposal. The break fee also extended to matters known to Virtus but had not been publicly disclosed, which would constitute a breach of its continuous disclosure obligations or a material adverse event (as defined). BGH's submissions requested that the Competing Proposal Fee be removed, or failing that, amended such that it would operate as a cost recovery provision reflective of the actual and reasonable third party adviser costs incurred by CapVest, up to a cap of \$2 million.

- **Non-Public Information Provision:** The exclusivity arrangements also included an obligation on the part of Virtus to provide to CapVest any non-public information about its business or affairs that was provided or made available to any person in connection with a competing proposal and which had not previously been provided to CapVest (Non-Public Information Provision).

DECLARATION AND ORDERS

The Panel considered that (in summary) the following aspects of the exclusivity arrangements in the Process Deed, taken together in the context of the factual matrix, had an anti-competitive effect and would inhibit or were likely to inhibit the acquisition of control over voting shares in Virtus taking place in an efficient, competitive and informed market and accordingly that the circumstances were unacceptable:

- the Fiduciary Out did not apply during a period of approximately 1 month;
- the effectiveness of the Fiduciary Out was unclear in certain circumstances and was limited by the notification obligation;
- the non-public information provision was not subject to any exception; and
- the duration of the exclusivity arrangements and the fact that they were granted at the indicative proposal stage where there was no guarantee that Virtus shareholders would receive a binding bid.

The orders provided by the Panel were that:

- Virtus and CapVest were prohibited from entering into (in effect) a scheme implementation agreement to acquire Virtus, and CapVest was prohibited from making a takeover bid for Virtus, on and from the date of the Panel's orders until the expiry of 10 business days from the date Virtus makes the disclosure set out in the third bullet below.
- Certain of the exclusivity arrangements in the Process Deed, including the no-talk and no due diligence restrictions and the Non-Public Information Provision, were to be of no force and effect unless the Process Deed was amended to ensure it was clear that the Fiduciary Out was effective and that the Non-Public Information Provision contains an exception; and
- Virtus was required to disclose the material terms of the Process Deed as affected by the Panel's orders and disclose the "Data Room Open Date".

On 24 February 2022 Virtus released to ASX a copy of the amendment deed to the Process Deed containing the relevant amendments.

Given the pace of these sorts of transactions, it has to be noted that BGH's application was made on 2 February 2022 and the declaration and orders of the Takeovers Panel were published on 23 February 2022, giving CapVest a further three weeks of due diligence in the meantime. Such lead time on another bidder can be decisive and we would hope that with the emerging guidance in this space, decisions can be made swiftly so as to avoid Pyrrhic victories.

What's next for exclusivity arrangements in non-binding proposals?

The Panel was careful to emphasise that it was the arrangements taken as a whole that led them to the conclusion that they were unacceptable. In particular, the hard exclusivity period was not singled out in this regard. The reasons for the decision are yet to be published and the relative weight given to the various components of the unacceptable circumstances will be of keen interest.

For bidders and targets the challenge is to strike the right balance at the critical early stages between giving bidders the confidence to dedicate the substantial time, deal team focus and cost required to take a non-binding proposal to a binding proposal, with the target's need to retain the flexibility necessary to meet its directors' duties and preserve an efficient, competitive and informed market for the acquisition of control.

With the recent declarations of unacceptable circumstances in Virtus and AusNet and the fact that ultimately it is in bidders' and targets' interests to enter into enforceable arrangements, we expect to see:

- increased negotiation around whether to grant exclusivity at an early stage;
 - a rebalancing of exclusivity arrangements, where it is agreed to be granted in the non-binding proposal period, to more closely align to the customary settings in a binding scheme implementation deed;
 - more disclosure of exclusivity arrangements at the non-binding proposal stage; and
 - more bidders seeking to maintain the confidentiality of their proposals for longer periods, irrespective of whether exclusivity arrangements are agreed, as a proxy for a similar effect.
-

1. <https://www.herbertsmithfreehills.com/latest-thinking/deal-protection-in-the-context-of-non-binding-proposals-the-takeovers-panel%E2%80%99s>
2. AusNet Services Limited 01 [2021] ATP 9, paragraph 46



If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



TONY DAMIAN
PARTNER, SYDNEY

+61 2 9225 5784
Tony.Damian@hsf.com



NICOLE PEDLER
PARTNER, SYDNEY

+61 2 9225 5694
Nicole.Pedler@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2022

SUBSCRIBE TO STAY UP-TO-DATE WITH INSIGHTS, LEGAL UPDATES, EVENTS, AND MORE

Close