132. Non-financial covenants in public M&A

A survey of prevalence and trends of non-financial covenants in public offers since 2015

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In public M&A, offerors typically commit to non-financial covenants that protect the business and its stakeholders following settlement of the offer. In this contribution we analyse data from public offers since 2015. We show which non-financial covenants are most prevalent and discuss trends and differences in our data set, both in strategic and private equity offers. We also pay attention to the enforcement of non-financial covenants.

1. Introduction

In public offers in the Netherlands the target boards[2] typically negotiate certain non-financial covenants ('**NFCs**') to safeguard the business and its stakeholders. NFCs are covenants, intentions or acknowledgments agreed by the offeror in the merger protocol, primarily with respect to matters such as strategy, impact on the workforce or financing, applicable during a certain period following settlement of the offer. Although NFCs are sometimes used in private transactions, they are a significant feature of public offers for listed companies. The broad range of NFCs and the detail to which they go in Dutch public M&A usually need explanation to offerors, particularly foreign investors.[3]

NFCs as a specific topic in Dutch public M&A have been given little attention in the legal literature.[4] In this article we will analyse data from 22 public offers in the Netherlands meeting the criteria as set out in paragraph 3.1. After a review of the background and nature of NFCs, we will list and categorize the NFCs most often used in our data set and highlight trends, including those in the context of a public bid by a financial sponsor. We consider how ESG goals are currently reflected in NFCs. Lastly we will cover the enforcement mechanism for NFCs.

2. Background and rationale for NFCs

2.1 Stakeholder model

2.1.1 NFCs to discharge duties in stakeholder model

In a public takeover process, target boards are required under Dutch law to act in the interest of the company. NFCs are a way for target boards to protect the corporate interest and to fulfil their fiduciary duties towards stakeholders in accordance with the stakeholder model under Dutch law[5] (as clarified by the Cancun decisions) and the Dutch Corporate Governance Code 2022 (the 'Code').[6] NFCs enable

1 The authors wish to thank their colleagues Christiaan Schuurs and Jesse Algra for their contributions to this article.

2 For readability we refer to 'boards' to cover both management and supervisory boards (or non-executives in a one-tier board) as supervisory or non-executive board members will be closely involved, although of course there is a distinction in corporate responsibilities. See e.g. M.W. Josephus Jitta & B.R. van der Klip, *De rol van het bestuur en de raad van commissarissen bij een openbaar bod, Handboek Openbaar Bod*, M.P. Nieuwe Weme et al. (eds.), OO&R series nr. 46, Deventer: Kluwer 2008 (hereinafter: 'Handboek Openbaar Bod'), G.N.H. Kemperink, *Vennootschappelijk toezicht op de doelvennootschap bij openbare biedingen*, 2013, par. 6.4, C.J.C. de Brauw, 'Overnames van beursvennootschappen', *VDHI* nr. 143, 2017 (hereinafter: 'De Brauw 2017'), par. 5.1.9.10-5.1.9.11, and Best practice 2.8.1 of the)Dutch Corporate Governance Code 2022.

3 From practitioners in France, Germany and the UK we understand that arrangements similar to NFCs in public offers in the Netherlands sometimes occur, but are not as pervasive as in Dutch practice.

4 See e.g. C.J.C. de Brauw & J.H.L. Beckers, 'Kroniek Openbaar Bod 2012-2014', *TOP* 2015/203, par. 2.4; De Brauw 2017, par. 9.9.4.16; C.J.C. de Brauw & O. Valk, 'Kroniek openbare biedingen 2015-2021 – Deel 2', *TOP* 2021/481 (8), par. 1.1.

5 See also De Brauw 2017, par. 5.1.4.2.6-5.1.4.2.7. About the Dutch stakeholder model in general, see recently B.P. Assink & L. Timmerman, 'Wie vaart er nu in een empty vessel?', *WPNR* 7378. The discussions in the Netherlands, Europe and the US about corporate purpose are outside of the scope of this contribution.

6 See De Brauw 2017, par. 9.9.4.16.1, and S.B. Garcia Nelen, 'Besluiten over overnames en bescherming van beursvennootschappen', in: De Jongh e.a. (eds.), *Bestuursbesluiten* (IvO-series nr. 123) 2021/1.2.

boards to both respond to these fiduciary duties and to address the topics required by regulatory disclosure obligations under the Dutch Decree on public takeover bids *Besluit openbare biedingen Wft* (the '**Decree**').[7] Although they are referred to as 'non-financial', some NFCs can have a financial consequence as they can relate to, for example, maximum debt levels or undertakings that imply certain cost levels.

Target boards negotiate non-financial covenants to protect the business and its stakeholders

The Cancun decisions[8] guide directors in exercising their duties in accordance with the corporate interest, holding that the corporate interest lies usually and mainly in the promotion of the continued success of the company's business. In addition, the board has a duty of care towards all stakeholders involved with the company and that duty of care can require that the board, in serving the corporate interest, does not unnecessarily or disproportionately affect the interests of stakeholders.[9]

The Code also reflects this stakeholder approach, focusing on sustainable long-term value creation for the company and its business, and taking into account the stakeholder interests that are relevant in this context. However, the Code goes a step further and refers in Principle 1.1 of the Code to directors' duties to take into account externalities arising from the company's actions towards people and the environment.[10]

2.1.2 Also in special situations

In contrast to jurisdictions in which management is compelled to give overriding priority to the best deal for shareholders only, such as Revlon duties[11] under Delaware law, the boards in a Dutch context could decide that an offer that is less financially beneficial to the shareholders (either compared to the standalone scenario because, for example, it implies a low control premium, or that is lower than a competing offer) is nevertheless superior for the continued success of the business and should therefore take precedence.[12] In such a case, in addition to strategic fit considerations, the boards could point to NFCs that support the boards' choice for a financially inferior offer.[13] Such NFCs could for example safeguard the strategy, protect against a break-up of the company, protect the brand and location of the business or contain undertakings regarding ongoing funding and limits on leverage.

NFCs can also be used by the boards to mitigate an adverse impact on a particular stakeholder group. Although the boards are required to take into account the interests of stakeholders, the Cancun decisions also recognise that certain stakeholder interests may be adversely impacted by a choice that serves the corporate interest. An obvious example is that in a public offer context the integration of the offeror business and the target business may lead to job losses. NFCs could prevent this during the term of the NFCs, allowing employees time to prepare themselves, or could place other restrictions on integration. In this manner the boards can nevertheless recommend an offer which could, absent NFCs, have an adverse impact on a particular stakeholder group such as employees.

2.2 Disclosures

The Decree requires the offeror or the target to make certain disclosures on topics that are often also covered by NFCs, but the full range of NFCs remain largely a matter of market practice. Amongst others, the Decree requires:

- the offeror to announce the method of financing of the offer;[14]
- the offeror to announce the rationale behind the offer, intentions with respect to the continuation of the activities and the place of business of the target (and to the extent impacted by the offer, the place of business of the offeror);[15]
- the offeror to specify its intentions with respect to the continuation of employment for the workforce, and managing and supervisory directors of the target and the offeror, and any material changes in employment conditions; [16]
- the offeror to specify any intentions regarding a change of the target's articles of association;[17] and
- the target to specify the impact of the offer on employment, employment conditions and the places of business of the target.[18]

7 See par. 2.2.
8 HR 4 April 2014, ECLI:NL:HR:2014:797 (*Cancun*), *NJ* 2014/286, par. 4.2.1 and 4.2.2.
9 See for a broader discussion De Brauw 2017, par. 5.1.4.
10 In public offer documentation the term 'sustainable success' is often used to reflect the criteria laid down in *Cancun*. We will use 'continued success' to distinguish from the use of 'sustainable' in the Code referring to environmental and social sustainability.
11 Revlon Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986), that kick in once the board has decided to sell the company. See Gilson & Black, *The law and finance of corporate acquisitions*, Foundation Press, 1995, p. 1103-1108.
12 Enterprise Chamber 21 March 2017, ECLI:NL:GHAMS:2017:930 (*TMG*), «JOR» 2017/229, with annotation Sinninghe Damsté, and Enterprise Chamber 29 May 2017, ECLI:NL:GHAMS:2017:1965 (*Akzo Nobel*), «JOR» 2017/261, with annotation Bulten.
13 See also De Brauw 2017, par. 5.1.8.3.
14 Schedule A, par. 2, sub 6, Decree
15 Schedule A, par. 2, sub 7, Decree. If possible the bidder should support the intentions with a numerical analysis, specifically relating to the financial expectations in respect of the continuation of the activities.
16 Schedule A, par. 2, sub 8, and in the case of a full offer Schedule B, par. 2, sub 1, Decree.
17 Schedule B, par. 2, sub 3, Decree.
18 Schedule G, par. 1, Decree.

Most of the above disclosure requirements can be dealt with in appropriate NFCs. Boards can therefore use NFCs to meet their disclosure obligations and signal that they have fulfilled their fiduciary duties and carefully considered the interests of all stakeholders, including shareholders. NFCs can evidence that boards have negotiated the inclusion of measures that will ensure the continued success of the business. Target boards will therefore include the agreed NFCs, most relevant in that particular offer, in the initial announcement upon signing of the merger protocol. If an offer is launched, then any NFCs will usually be reflected in full in the offer memorandum and published in the target's position statement for the reasons set out above.[19]

2.3 Broad spectrum of NFCs

NFCs differ materially from offer to offer in the extent to which they are expressed as being binding and the level of detail that the offer goes to in describing a particular NFC. One could (at least partly) see this as a proxy for how much importance the boards attach to the subject of the relevant NFC. In each case, a close reading of the actual wording of the NFC is crucial to determine how 'strong' an NFC is.

Over the past three years, certain NFCs have become standard such as support for (joint) strategy, employee safeguards and prudent financing

For example Gilde/Ten Cate had only one sentence with respect to financing, namely that *'the Offeror shall procure that the Company will remain prudently financed to safeguard the continuity of the business and the execution of the Business Strategy'*. Whereas in KKR/Accell, also an offer by a financial sponsor, a similar statement is followed by a further three paragraphs describing in detail the debt financing structure of the offer, specifying that the group shall not attract additional incremental debt to the extent that a maximum net leverage ratio would be exceeded, and in addition an undertaking is given in respect of a credit facility that will be available to the group and a best efforts obligation to procure a cash deposit for working capital purposes.

Although the inclusion of NFCs is market standard in Dutch public offers, there is room to find a suitable balance between intention and commitment, and between generality and specificity. The strength and detail of NFCs will no doubt be affected by the negotiating power of each party, but also public interest in the offer, the strength of labour representatives and the nature of the target business. For example, in the media business, editorial statutes are commonplace and an offeror can expect NFCs such as agreed in Mediahuis/TMG, where fairly detailed NFCs to protect editorial independence were agreed. In that offer the offeror agreed that it would '*procure that the Editorial Boards shall maintain their independence (which covenant will be everlasting)*' and that the rights of the Editorial Boards under the editorial statutes would be maintained. In FedEx/TNT, an NFC was agreed regarding TNT's airline with respect to finding '*a structure for the airline that complies with European and U.S. airline ownership rules, with possible commitments to accommodate a sale of airlines to a European third party*'.

3. Prevalence

3.1 Introduction

For our analysis we used a sample of all voluntary public offers for Dutch NVs where the Dutch Authority for Financial Markets ('**AFM**') reviewed the offer memorandum and which were announced from 2015 through 2022 with an implied equity value of at least EUR 50 million, whereby we have excluded withdrawn offers.[20] This is a set of 22 offers. The data set is too small to yield statistically significant results, but the results do give an indication of the prevalence and nature of typical NFCs, also because target and offeror usually agree to disclose the NFCs in full in the offer documentation.

3.2 Overview of NFCs

Figure 1 (see next page) shows the prevalence of NFCs in public offers from 2015 to 2022 included in our data set, whereby NFCs are grouped by category.

The period during which NFCs apply following settlement of the public offer (i.e. once the offeror acquires control over the company), ranges from a minimum of one year to a maximum of four years. Figure 2 (see next page) sets out the distribution of the agreed NFC term. The average term in our data set is 30 months and the median is 36 months. It should be noted that NFCs for the protection of minority shareholders typically have an earlier expiry period, such as when the shares are entirely held by the offeror or at an agreed stage of the statutory buy-out process.

3.3 NFCs in take-privates

Given the difference in nature between private equity offerors and strategic offerors, it is useful to look at how NFCs in offers made by these parties differ. Figure 3 shows some of the more noteworthy differences in prevalence of NFCs for private equity backed offers as opposed to strategic offers across the whole time period.[21] We note that in private equity offers, NFCs regarding the independence

19 Although we see that the description of NFCs sometimes differs in the position statement as opposed to the offer memorandum, in general the position statement and the offer memorandum contain a similar description of the NFCs.

20 The DSM-Firmenech merger is also not part of our data set, because, although structured as a public offer, no NFCs have been made public. This is not surprising, as the DSM shareholders will be the majority shareholders after settlement and DSM provides both the co-CEOs and the CFO.

21 Family offices are included in the private equity category.

	Nr.	Topic	Frequency (%)
Strategy	1	Support for (joint) strategy	100
	2	Commitment to implement specific (jointly agreed) business plan	9
	3	Specific R&D investments	20
	4	No divestments during a certain period (or in respect of specific divisions within the target)	59
	5	Target will continue to operate independently and maintain its integrity	55
Employees	6	Safeguards for employees in respect of reorganisation or integration	95
	7	Protection of rights of target's current employees	100
Governance	8	Protection of minority shareholders	91
	9	Continued service for all or some of the current board members of target	64
Financing	10	Prudent financing of target after settlement (leverage, debt ratio etc.)	82
	11	Limitation on dividends	14
M&A	12	Available capital for future M&A	23
	13	Agreed criteria and/or support for future M&A	32
Other	14	Keep headquarters of target at the current location	59
	15	Legal structure for the protection of the target (keep or apply the large company regime, or other continuation or change of the legal structure)	64
	16	Continue current brand name, corporate identity and/or culture	73

1 - 25 26 - 50 51 - 75 76 - 100

Figure 1. NFCs in public offers from 2015 to 2022

of the target, maintaining the legal structure, location of headquarters and support for M&A strategy, are substantially more prevalent than in strategic offers, while also limitations on the leverage of the target by reference to Debt:EBITDA ratios and other requirements for prudent

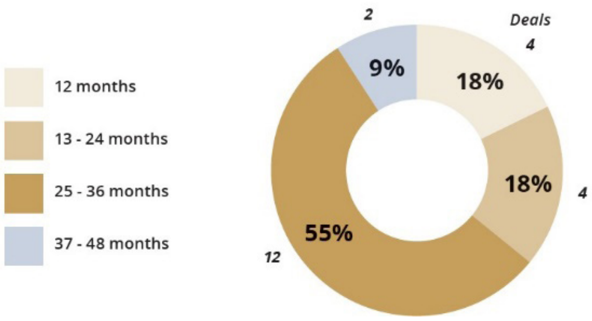

Figure 2. Duration of NFCs

financing are more common in private equity offers.

Boards may seek additional and stronger NFCs against the background of the PCM and Estro cases, two decisions of the Dutch Enterprise Chamber relating to private equity acquisitions.[22] Although these cases did not involve publicly listed targets, they point to the special attention that boards should pay to the corporate interest when evaluating an offer made by a financial sponsor. In both cases the Enterprise Chamber concluded that the boards had failed to adequately weigh the advantages and disadvantages of the financing of the acquisition and its impact on the target. The boards were also criticised for failing to secure adequate undertakings from the financial sponsors with respect to the implementation of M&A strategy, which was seemingly one of the reasons for the investment.

Some of the NFCs agreed in this context are:

- **Debt:EBITDA ratios:** 'The Offeror shall procure that after Settlement the Group shall not incur additional third party debt resulting in a higher ratio of net third party debt to EBITDA than three (3) times post-IFRS-16 EBITDA.' (NPM/ICT Group). Where specific ratios were required, the average Debt:EBITDA ratio across our data set was 4.55.

22 Enterprise Chamber 27 May 2010, ECLI:NL:GHAMS:2010:BM5928 (*PCM*), «JOR» 2010/189, with annotation Stevens, and Enterprise Chamber 10 December 2019, ECLI:NL:GHAMS:2019:4359 (Estro), «JOR» 2020/144, with annotation Duynstee.

- **Agreement and support M&A strategy:** 'The Offeror acknowledges that the Group may require additional capital in order to pursue add-on acquisitions as part of its buy-and-build strategy and intends to make additional equity capital available in order to finance such add-on acquisitions, subject to the Group's applicable approval policies and (financial) parameters as applicable from time to time, and in order to use a balanced combination of debt and equity.' (PAI/Refresco).

In take-privates, NFCs regarding the independence of the target, maintaining the legal structure, location of headquarters and support for M&A strategy are substantially more prevalent

A combination of NFCs along these lines will provide a counterweight to financing strategies that may jeopardise the continued success of the business.

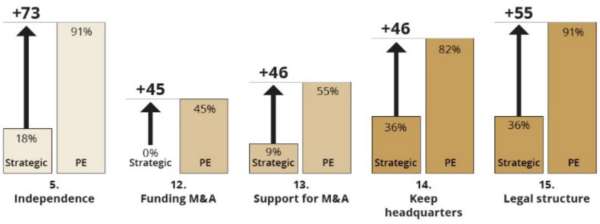

Figure 3. PE vs. Strategic offerors - difference in percentage points

4. Recent trends

4.1 Trends in general

4.1.1 Recent developments

Most NFCs reflected in Figure 1 have not changed materially over the last three years (compared to the years before). Three types of NFCs can be said to have become standard, that is (i) support for (joint) strategy, (ii) employee safeguards in respect of reorganisation/integration and protection of existing rights, and (iii) prudent financing after settlement (possibly including debt and leverage restrictions). This last item was the only material change over the past three years, with an increase of 31%. This could also be informed by the predominantly private equity nature of the offers in the period. We do note, however, that the data points reflect only that the topic is addressed as an NFC and include NFCs ranging from a strong commitment to a weak intention.

4.1.2 ESG

Although we see an increased reference to ESG in NFCs, it cannot yet be said that ESG has become a standard part of NFCs or that all more recent public offers contain a reference to ESG elements. In our data set we have found eight references to ESG in the NFCs. In 2022, two of the three offers in our data set contained commitments in the NFCs to ESG goals. In the last four offers where ESG NFCs were agreed, the offeror referred to its support for the ESG goals as set out in the sustainability reports or in the annual reports of the target. Given the pressure on boards to evidence their commitment to ESG goals, both at national and at European level, we expect that offerors will be asked to offer commitments on ESG goals in the context of NFCs particularly in industries that face close scrutiny from an ESG perspective.

4.1.3 Other observations

In the HAL offer for Boskalis it is the target rather than the offeror that binds itself to NFCs, which is not illogical given that most NFCs are about the way in which the target runs its business. It will be interesting to see whether this marks a new development.

Also in situations where one would not necessarily expect NFCs, they are nevertheless used. In the sale of an indirect majority stake in Hunter Douglas to 3G, although no public offer was announced or made at the time, control shifted as a result of the sale of a stake in a holding company owning (indirectly) about 94% of the shares in Hunter Douglas by Mr Sonnenberg to 3G. As part of the process, in a Support Agreement the holding vehicle committed to a set of NFCs towards Hunter Douglas, and Hunter Douglas committed to cooperation with a backend restructuring, among other arrangements.

4.2 Trends in take-privates

In Figure 4 we set out some shifts in NFCs in private equity offers over the past three years. As mentioned in paragraph 4.1, NFCs mentioning prudent financing requirements or maximum leverage and debt ratios which were already prevalent in private equity deals, have become, in our data set, standard (100%). This is also the case for NFCs protecting the legal structure of the target and continuing the brand, identity or culture. As explained in paragraph 4.1, this should not be read as an inclusion of a strong and detailed commitment in respect of these topics, but does indicate that the topic is addressed in some form.

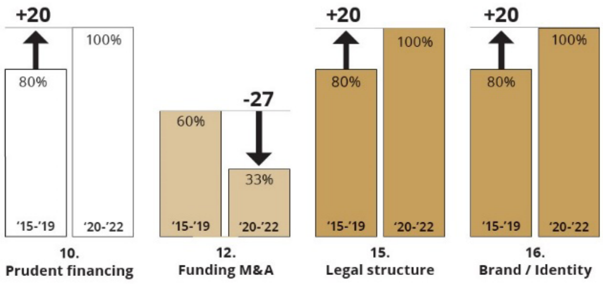

Figure 4. Trends in PE offers – difference in percentage points

5. Enforcement

5.1 Independent supervisory board member

Neither Dutch law nor the AFM require NFCs be agreed as part of public offers and therefore there is no statutory or regulatory enforcement mechanism.[23],[24] Parties to a merger protocol must therefore agree on contractual enforcement mechanisms. All public offers in our data set make use of independent supervisory or non-executive board members to ensure that NFCs are honoured for the agreed term. Any deviation from the NFCs will require the approval of the Supervisory Board, including the affirmative vote of at least one, or sometimes all, of the independent supervisory board members. For a one-tier board this mechanism can be applied with reference to independent non-executive members of the board fulfilling this role.

The veto rights of independent supervisory board members are frequently backed up by a third-party stipulation in favour of the independent supervisory board members. In addition, to ensure that the third-party stipulation will survive a change in the Supervisory Board, the merger protocol often includes an obligation on a withdrawing independent supervisory board member to assign the benefit of such stipulation to the replacement supervisory board member.

We expect that bidders will be asked to offer commitments on ESG goals in the context of NFCs

As a further undertaking to facilitate the enforcement of NFCs, the merger protocol generally also includes a provision that the target company will bear the costs of any actions by the independent supervisory board members to enforce the NFCs. The merger protocol will also typically require that, if the business is sold or restructured, the offeror must procure that the NFCs will continue to apply to any successor entities, to ensure that the NFCs survive any restructuring or sale.

5.2 Alternatives

Although in theory the parties to a merger protocol could agree to allow, for example by way of a third party stipulation for no consideration, the works council to enforce NFCs protecting employees, we have not seen this in offer documentation since 2015.[25]

23 Unlike in the UK, where under the UK Takeover Code post-offer undertakings, not enforceable by a particular party, must be complied with under the Takeover Code.

24 De Brauw and Stevens have observed that certain statements, and possibly NFCs, made in the course of the public offer process could be binding towards third parties. See De Brauw 2017, par. 9.9.4.23, in respect of stakeholders and NFCs, and T.M. Stevens in respect of shareholders in 'Het fusieprotocol', in: *Handboek Openbaar Bod*, par. 5.3.

25 In offers older than our data set there is precedent for granting the right to enforce NFCs to third parties: in Mexichem/Wavin (2011) the offeror had a separate agreement with the works council for employee-related NFCs and in JAB/DEMB (2013) the right to enforce certain NFCs was granted to the supervisory board of a Dutch subsidiary with a large-company regime having to approve deviation with a 4/5 majority.

5.3 Ben&Jerry's

The enforcement of non-financial covenants in a public offer process has to our knowledge not been tested in the Dutch courts. The recent Ben & Jerry's dispute with Unilever in the US context is an interesting example of a non-financial covenant which came under fire.

When the Ben & Jerry's business was sold to Unilever in 2000, certain provisions were included in the merger agreement (governed by the law of the state of New York) with the intent of maintaining in perpetuity the corporation's social mission. The Ben & Jerry's subsidiary would have an independent board of directors to help provide leadership for the social mission and the brand's integrity. The members of the independent board, and not Unilever, would appoint its successors. Moreover, this subsidiary board had the right to sue Unilever, at Unilever's expense, for breaches of the merger agreement.[26] The test of this undertaking came in June 2022, when Unilever licensed the Ben & Jerry's business in Israel to an Israeli businessman to circumvent Ben & Jerry's controversial decision to no longer sell its products in Israel. Ben & Jerry's sought injunctive relief in a Manhattan court, but could not meet the requirements of the irreparable harm test for injunctive relief. Ben & Jerry's announced that they would amend their pleadings and return to court. However, on 15 December 2022 Unilever announced that a settlement had been reached, without giving any details as to the terms of settlement.[27]

6. Summary

In this article we have discussed that the use of NFCs to protect stakeholders flows from the Dutch stakeholder model. NFCs provide a tool for the boards to evidence that in the context of a public offer they have protected the corporate interest and mitigated adverse impacts on particular stakeholder groups.

Our analysis shows that public offers in the Netherlands routinely include a broad range of NFCs on matters such as support for strategy and M&A plans, governance, impact on employees and restrictions on financing, such as maximum leverage and debt ratios. We analysed the difference between NFCs agreed in PE deals and strategic deals. We see that boards in PE deals ask more frequently for commitments on continued independence of the target, maintaining the legal structure, limits on financing and support for M&A strategy. This is to be expected in the context of Dutch case law.

Looking at trends in the past three years, overall we see a material increase in NFCs for prudent financing requirements. ESG is increasingly referred to, whereby a target's

26 https://www.sec.gov/Archives/edgar/data/768384/000091205700030913/defm14a.txt

27 https://www.reuters.com/business/retail-consumer/unilever-says-litigation-with-ben-jerrys-board-has-been-resolved-2022-12-15/

sustainability report is used as the basis for NFC commitments in this regard.

NFCs vary from weak statements of intention to strong commitments on detailed and specific aspects. There is clearly substantial room to manoeuvre within the Dutch public offer market practice, but offerors should realise that in all instances some level of commitment on NFCs will be expected.

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