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Insights from an M&A Monitor

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With the United States economy in the midst of a deep recession, it may seem an odd time to focus on merger activity. But with credit markets thawing, hundreds of billions of new dollars injected into the banking system, and publicly-traded equity values that are down sharply, the time is ripe for cash-heavy firms and investors to launch a new wave of M&A activity. At the same time, however, the financial crisis has given rise to heightened concern about systemic risk and overall skepticism of big business. As a result, firms should anticipate increased scrutiny of M&A transactions.

Increased scrutiny of proposed mergers both at home and abroad suggests the likelihood that regulatory authorities will require the divestiture of overlapping assets as conditions for merger approval. One of the tools available to regulators is the requirement that the acquirer employ a monitor to oversee divestiture commitments. Thus it is essential for general counsel and other C-level decision makers to incorporate effective strategies for working with a government-appointed monitor into their overall M&A strategic planning.

GOVERNMENT RETAINS DECISION-MAKING POWER

When a divestiture remedy is applied, U.S. and European regulators frequently make use of two types of trustees in their rulings. Divestiture trustees are appointed to direct the sale of the business or unit. Monitoring trustees are appointed by regulators to help establish that the parties to the transaction maintain overall compliance with settlement commitments.

This latter enforcer is called a monitoring trustee in Europe, and a monitor, interim monitor or auditor trustee in the United States. For purposes of this article, the term M&A monitor or monitor is used to describe the entity functioning in this compliance role. In practice the M&A monitor can be the same person or entity as the divestiture trustee, but with a different objective.

When a proposed merger has anti-competitive potential, regulatory authorities have the option to challenge it, claiming that completion would violate Section 7 of the Clayton Act and/or Section 5 of the FTC Act. However, in some cases only a subset of the holdings, business units, or brands have anti-competitive overlap, rather than the two companies as a whole. In these cases, authorities may agree not to prosecute the case, approving the merger conditioned upon commitments to sell

one side of the overlapping assets within a certain time.

This overlap may be one or more brands, products, divisions, or subsidiaries. In one recent example— BASF SE's proposed $5.1 billion acquisition of Ciba Holding — the European Commission approved the merger in March 2009, under the condition that the parties divest seven specialty chemicals products in the world market for paper, dyestuffs, plastics and skin care.

Regulatory agencies look to monitors to support and report on compliance with competition goals. Under consent decrees, merging parties are required to maintain the viability and competitiveness of the assets being sold. Without such commitments, the acquirer would have incentive to allow the designated assets to deteriorate. This would position the acquirer's remaining assets to succeed ahead of the newly-formed competitor created by the divested asset. Such a scenario defeats the purpose of the agreed-upon divestiture because the merged parties will not face the strong competitor that the regulator was aiming to create.

To help ensure the successful implementation of commitments, the regulators may appoint an M&A monitor, an independent third-party appointed to oversee the merging parties compliance with the consent order. While the FTC is a frequent user of monitors, the Department of Justice uses them less frequently, often looking to its internal personnel first.

Monitors are the eyes and ears of the antitrust authority. They are accountable only to the antitrust authority, but are retained by the merging parties. In essence, it is a three-way relationship: the monitor observes company behavior for the government, while also providing guidance to the merging parties about compliance. Importantly, the government is the decision-maker, not the monitor.

MONITOR'S DUTIES

The duties of the Monitor generally fall into six categories:

- Corporate Autonomy. An important aspect of ensuring that a business unit or brand can be sold successfully is enabling it to be autonomous from the legacy organization. It is crucial that separate management be established quickly, and that it be provided with sufficient resources. The monitor reports on whether corporate autonomy is being created in line with the obligations.
- Ring-Fencing. A component of corporate autonomy is the swift establishment of structures and procedures to ensure that the parties do not disclose to the retained business any confidential information related to the research, development, manufacturing, marketing and sales of the business to be divested. The goal of ring-fencing is to provide evidence of tangible efforts to restrict access to confidential business information. Depending upon the size of the company and the quantity of purged information, verification through e-discovery and statistical sampling techniques can be useful monitoring techniques.
- Economic Viability. The M&A monitor reports on the viability, marketability, and competitiveness of the assets being divested by analyzing internally-measured financial and operational data and externally-measured sales data from third-party sources. An experienced monitor will often utilize appropriate third-party sales data to complement company financials in order to evaluate overall market performance, market share and other key metrics. When third-party sales data do not cover the entire market or such data are not available, a company's internal shipment and inventory data can be useful.
- Divestiture Progress. The outcome of a successful settlement between regulatory authorities and merging parties is the divestiture of overlapping assets to a competitor, so it is not surprising that a monitor's duties include reporting on the progress of the sales process. The M&A monitor will assess whether the divested business is sold in a manner consistent with thorough compliance with the conditions and obligations set by the regulator. This includes reporting on whether every potential purchaser receives the same relevant information and equal access to a data room.
- Divestiture Suitability. When working as a monitoring trustee on a case for the European Commission or other European regulatory bodies, one may be asked to provide a reasoned opinion of proposed buyers. This would entail a review of each potential purchaser against criteria established in conditions and obligations. The results of the analysis are a key source of information for regulators as they consider approval of the potential buyer.
- Transition Activities. The monitor may be asked to confirm the execution of obligations designed to successfully transition assets to the buyer. In contrast to more general definitions for viability and competitiveness, transition obligations are often described in detail in the orders. These obligations may include supply commitments or other ongoing commercial relationships between the merging parties and the buyer, for a pre-determined period. Typically, they also include the transfer of necessary hard assets, intangible assets, books and records, or other data.
- Reporting. Regulatory authorities usually require monthly or bi-monthly reporting from the monitor about divestiture implementation and company compliance with obligations.

Reporting is a sensitive area that needs to be discussed early. While much of the analysis described above is an interactive process with the merging companies, reporting is not. The companies involved may not receive access to the M&A monitor's reports, unless specifically granted permission by the regulatory authority.

SELECTING A MONITOR

While monitors are approved by the government, the selection process begins with a recommendation by the acquirer. Selection often occurs with guidance from outside counsel.

A good monitor possesses four key qualities: (1) business and industry knowledge, (2) familiarity with antitrust issues and transactions sufficient to enable good communication with the antitrust agencies and the respondent's legal counsel, (3) the ability to leverage highly qualified local resources, as needed (an integrated cross-country team from the affected countries reduces duplication of effort and decreases cost to the merging parties) and (4) depth of experience in areas such as accounting, economics, corporate finance, valuation and industry-specific skills covering a wide range of potentially relevant issues.

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These four key qualities often are readily found in larger accounting firms, as confirmed in the 2005 European Commission DG Competition Merger Remedies Study. While boutique firms may specialize in one area or another, global accounting firms can draw on talent and resources in each of these areas.

WORKING WITH A MONITOR

There are a number of ways that the merging parties' counsel can improve the ability of the monitor to do the job quickly and cost-effectively. First and foremost, counsel can provide cooperation, support, and the information required for the monitor to perform his/her duties. This includes the information needed to perform a proper assessment of the six categories described above.

Regular and open communication, and early identification of problems are critical. Counsel and management communications with staff that are unfamiliar with the regulatory process smooths interactions with the monitor. It also shows the company's commitment to the divestiture process, particularly with respect to non-disclosure agreements and other ring-fencing procedures.

Time frames for working with monitors vary considerably. Much depends on how quickly potential buyers are identified, the complexity of the assets being divested and the need for on-going transition obligations. Presentation of a buyer before orders are enacted can save the merging parties valuable time. In our experience, monitoring engagements can last from a few months to as long as a decade, depending upon the extent of the commitments or whether there are any long-term transition agreements in place.

In the merger of Procter and Gamble and Gillette, PricewaterhouseCoopers was engaged as the monitoring trustee by the European Commission and the interim monitor by the FTC. In Europe, P&G was mandated to divest its Crest SpinBrush toothbrush business, for which a buyer was found quickly. Related monitoring lasted approximately twelve months.

For its settlement with the FTC, P&G divested the Crest SpinBrush toothbrush business, as well aa Gillette's Rembrandt tooth whitening products and Right Guard brand deodorant products, and dissolved a joint venture. In this instance, monitoring went on for close to two years.

In summary, being proactive and taking critical components of the M&A monitoring process into consideration can result in a more effective and successful arrangement. It enables companies to reduce the costs of having a monitor and to work more effectively to achieve their transaction objectives.

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