## INTRODUCTION

Blue and Red will negotiate Blue's purchase of Red's wholly owned subsidiary Red Chocolate, including its staff and premises. Blue will seek to offer mutually advantageous propositions with the overall objective of protecting its best interests while balancing Red's requirements. Blue will maintain a co-operative but rational approach to each issue under negotiation, and view the issues holistically. In addition, any solutions sought or agreed to by Blue must consider the desire to finalise the acquisition by April 2015, although additional time is allowable if it will significantly improve the content of the deal.

## ISSUES FOR NEGOTIATION

### 1. PURCHASE PRICE

Goal: Blue seeks that Red moderate its expectations of synergies and incremental sales increases and accordingly, its requested purchase price, from US$120 million to a more reasonable figure. Blue's valuation of Red Chocolate at US$70 million was solidly based on due diligence results, as well as discounted cash flow and EBITDA/multiples analyses. Blue also identifies Red's co-operation on other issues as a significant factor to be taken into account in determining the purchase price. Blue seeks a compromise between the two proposed prices which reflects the overall outcomes of the negotiations.

#### REASONABLE ADJUSTMENTS

Blue's is accountable to its shareholders, so any increase in Blue's expenditure on acquiring Red Chocolate must be reasonable and beneficial to Blue's overall investment in the enterprise. If Red refuses to sell at Blue's originally offered purchase price, Blue would invite Red to consider any secondary purchase price proposal/s Blue will present. Any increase in offered price would therefore be incremental, and linked with the timing of any executed agreement and the prospects of sales growth and synergies, as influenced by the outcomes of the negotiations on other issues.

#### APPROACH AND FLEXIBILITY

Should Red agree with Blue's agenda, Blue will consult with Red on other issues prior to discussing substantive points on the total price – a final and definitive issue. Blue anticipates that each party will thereby have the opportunity to express their concerns and objectives relating to matters with less final consequences attached, and to identify the most effective style of communicating with their counterparts. Moreover, mutual knowledge of each party's perspective would facilitate fair discussion on the purchase price. Should Red disagree with Blue's proposed agenda, Blue will co-operate with Red's preferred agenda as much as is possible without jeopardising Blue's interests.

#### BATNA

If immediate agreement proves impractical, Blue may suggest an agreement to defer negotiating the purchase price. Instead, an agreement could be reached to take the relevant action/s required to resolve any outstanding matters. The agreement would provide for, subject to each party's performance, re-negotiation on the purchase price within a mutually agreed, narrower price range by 1 March 2015.

Blue's objective is an agreement for a reduced purchase price and unencumbered scope for Blue's new chocolate division to prosper (dependent on other issues under negotiation). Blue would achieve this by considering the outcomes of those other negotiated issues, maintaining flexibility on price and accommodating short-term time extensions for settlement.

### 2. PERSONNEL: CAROLINA CHEN AND GEORGE SULLIVAN

Goal: Blue seeks to retain Carolina Chen as Director of Research and Development within Blue's confectionary division. Blue recognises Chen's capability in R&D and this role provides the opportunity for her to apply her skills in chocolate development to targeting the markets for confectionary sales already secured by Blue's confectionary division.

Goal: Blue seeks to retain its current management as directors of Blue's confectionary division. It seeks to create synergies by employing its staff's accumulated expertise to lead sales and administration for the task of integrating chocolate sales within Blue's established customer base, and the expansion thereof.

Blue proposes that George Sullivan remain at Red Corp so he can best apply his knowledge of Red's management tradition to Red's other business divisions. The recent plateau of chocolate sales growth in Negoland and lack of innovative products on the market [*R* p. 57] suggest that external ideas and new strategy are required.

Blue looks forward to consulting with Red Corp regarding the feasibility of this plan. The options presented below account for Red's potentially different perspectives, however Blue seeks to consult with Red before contemplating any alternative action. Blue's agreement to any alternative would be contingent upon Red's co-operation with Blue on other issues under negotiation, particularly the Representations and Warranties about the Factory Site issue.

**TEMPORARY RETENTION OF MR SULLIVAN**

Blue recognises that Carolina Chen and George Sullivan may have an established professional relationship. Should Ms Chen wish to retain that relationship after commencing work at Blue, Blue may accommodate her wishes by employing Mr Sullivan on a temporary contract in an advisory role within management, e.g. Sales Advisor. Blue is of the view that 12 months as a reasonable period of time for Ms Chen to establish new working relationships with Blue's own management team. Mr Sullivan's salary would be adjusted to $800,000. Blue sees this salary as a fair salary in relation to Blue's standards, and it is a promotion from the average adviser/manager salary of US$700,000.

Upon the expiry of Mr Sullivan's temporary contract, Ms Chen would be invited to review her position in light of her experience with Blue's management team. Should she, at this juncture, require continuation of her professional relationship with Mr Sullivan, Blue would invite Ms Chen and Mr Sullivan to meet with Blue's human resources and management teams to present their reasons for such a proposal. Blue would consider these in combination with performance reviews of both Ms Chen and Mr Sullivan.

**ADVISORY ROLE**

Should Ms Chen and Mr Sullivan require certainty that their professional relationship will continue, Blue may employ Mr Sullivan as Sales Advisor for 2 years. Blue may increase this time-frame to a maximum of 3 years should Red request it. This compromise could also be influenced by any information Red might reveal about the retirement policies and regulations in Red and in Negoland.

**REMUNERATION**

In the event that Ms Chen and Mr Sullivan would object to a significant disparity between their remunerations, Blue may employ Mr Sullivan on a higher salary with financial support from Red Corp. Blue would achieve its objective of retaining Ms Chen by taking into consideration Red's cooperation on other issues under negotiation. Red's requests for Mr Sullivan's to transfer to Blue could be addressed by employing Mr Sullivan but restraining the duration and authority of his role at Blue.

## 3. ENVIRONMENTAL CONTAMINATION

**REPRESENTATIONS AND WARRANTIES**

Goal: Blue seeks a warranty by Red that the land currently used as the Red Chocolate premises is free from environmental contamination. Red must also covenant that it will cover any expenses incurred in decontaminating the site, if investigation reveals that it is contaminated.

Blue's agreement on terms other than these (as outlined below) is contingent on Red's co-operation with Blue with regard to other issues under negotiation, particularly the Personnel issue.

The land was previously occupied by an industrial manufacturer, and was purchased prior to the enactment of strict environmental regulations. Until now, there has been no testing or investigation of the site despite new laws imposing liability on owners. If required, the clean-up costs would range from US$5-30 million. As the prospective landowner, Blue would be liable for these costs and Blue therefore cannot purchase land attaching such a liability without sufficient security from Red.

**INITIAL INVESTIGATION**

Red's omission to conduct environmental testing or examinations of the site has left it potentially in breach of Negoland law and at risk of criminal liability [*R* p. 1]. Blue proposes that Red engage environmental experts to investigate contamination at Red's own expense. Blue will also request Red disclose any knowledge it currently has on this matter.

**WARRANTY**

Blue recognises Red's reluctance to bear costs for contamination caused by a third party. On the other hand, as current landowner, Red is liable for costs under Negoland law. Should Red prefer not to make both representations and warranties, Red may instead covenant to cover the clean-up costs should the site was found to be contaminated.

**QUANTUM**

Should Red demonstrate reluctance to covenant to cover the complete clean-up cost (in the event that environmental contamination is discovered), Blue could instead accept a cap on the amount that Red will cover, such as US$25 million. Should Red prefer to nominate its own limit to the sum it covenants to bear, Blue would invite Red's consultation on the matter.

**INITIAL CLEAN-UP**

Should Red prefer that its covenant to cover clean-up costs places a cap on its financial liability, Red may jointly covenant to include, additionally, a non-monetary contribution towards the clean-up project. This may include, for example, Red providing its staff as labour, or use of any of its facilities as support to the experts performing the clean-up. Dependent on the stages of the clean-up process, Red might also commence preliminary clean-up of the Red Chocolate site prior to its transfer to Blue, thereby reducing Red's liability for remaining costs thereafter.

Blue would achieve its objective by seeking Red's representations and warranties by remaining open to less comprehensive representations and Red covering an absolute minimum of 50% of the clean-up costs. Blue would use Red's current legal liability as leverage and consider Red's co-operation on the Personnel issue in making reasonable compromises.

**4. BREAK-UP FEE**

Goal: Blue seeks exclusion of a break-up fee from the agreement for the purchase of Red Chocolate. Break-up fees are not standard commercial practice. In comparable jurisdictions such lock-up devices are discouraged or prohibited for their anti-competitive effects. For example, in Australia the Takeovers Panel stipulates (in Guidance Note 7) that break fees exceeding 1% will generally be unacceptable.

The desired purchase price for Red Chocolate ranges from US$70 million – US$120 million in the views of Blue and Red respectively. Red's proposed 3% break-up fee would therefore range from $2.1 million–

$US3.6 million. This penalty is unreasonable absent Red providing specific reasons or some other gesture of cooperation by Red in the negotiations. Blue may accept the inclusion of a break-up fee, contingent on Red's co-operation with Blue on other negotiated issues, particularly the Dealings with Zeta issue.

**EXPLANATION**

Blue invites Red to provide stronger and more specific reasons for the inclusion of a break-up fee in this otherwise standard takeover agreement. If Red insists on including a break-up fee, Blue could also propose the inclusion of a second, reverse break-up fee, applying to the vendor (Red) in addition to the first break-up fee applying to the acquirer (Blue).

**REDUCTION**

Should Red strongly prefer inclusion of a break-up fee, Blue would require a reduction of the fee from the abovementioned figures, to a maximum of US$1 million, which is equal to a fee of 1.43% - 0.83% of purchase price (if the purchase price ranges from US$70 million – US$120 million).

### 5. DEALINGS WITH ZETA

Goal**:** Blue seeks a representation from Red that Red Chocolate does not trade directly or indirectly with Zeta-related parties. While Blue recognises that Arbitrian law does not apply to a Negoland corporation, should the negotiations successfully produce an agreement, Arbitrian law would apply to future chocolate trading and may impact profits if it involves Zeta-related parties and/or results in Blue inclurring a "large fine". This would negate the positive effect of any synergies, and also discourages Blue from paying a higher price.

Blue's agreement on terms other than these (as outlined below) is contingent upon Red's co-operation with Blue on other issues under negotiation, particularly the Break-up Fee.

**INVESTIGATION**

Should Red prefer not to make this representation without knowledge of whether it indirectly trades with Zeta-related parties, Blue proposes that Red conduct a 'diligent inquiry' into the matter. If Red can then represent that it does not directly trade with Zeta related parties, as they are "sure" they do not [*R* p. 51], and also warrants that they thoroughly investigated the company to discover any indirect trade, then this would be sufficient as it would not constitute a malicious case and would not attract fines as well as decreasing the risk of transactions being stopped.

**RESPONSIBILITY**

Should Red prefer not to conduct investigations into its present trading partners, Blue proposes that Red represents that Red has neither direct nor indirect dealings with a Zeta-related party to the best of its knowledge. Red would then pay for Blue to conduct the investigation immediately after the conclusion of the Stock Purchase Agreement.

## CONCLUSION

Ultimately, Blue's approach to the negotiation must take into account the longstanding relationship between Red and Blue, and the need to maintain a strong working relationship in the future. This will be vital if the acquisition proceeds and the companies enter an implementation process. Therefore, all matters agreed to by Blue must accommodate the concerns and preferences of Red. However, as Blue is accountable to its shareholders, all decisions must be commercially justified and in the best interests of Blue's current and future shareholders. If Red is not willing to consider the reasonable requests of Blue during the negotiations, then Blue could exercise its authority to either defer issues to a future negotiation, keeping in mind the ideal goal of reaching final agreement by April 2015.