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Public Company Mergers & Acquisitions and Corporate Governance

PRESENTATION TO MIT SLOAN SCHOOL OF MANAGEMENT

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I. What Makes Public Companies Different?

- Heightened scrutiny generally due to public investors
- Substantial time and cost to comply with regulatory requirements (e.g. SEC and stock exchange rules)
- Institutional investors
- Widely-held with stakeholders having different investment objectives
- Result: greater likelihood of litigation and regulatory interference

II. The Public Company Deal - The Dance

- Agreement to discuss possible transaction
- Engagement of investment bankers/financial advisors
- Execution of confidentiality agreement
- Due diligence
- Negotiation of definitive agreement
- Regulatory/3rd party approvals (e.g., stockholder approval, SEC process, lender consents, anti-trust approval)
- closing

III. Types of Deal Processes

- Friendly strategic - stock-for-stock - quickly and quietly (disclosure issues)
- Auction for cash - seller-controlled process
- Hostile deals - bear hugs and tender offers
- Corporate governance issues are paramount, more so today than ever before (e.g., *Omnicare v. NCS Healthcare*, Sarbanes-Oxley Act of 2002)

IV. Types of Structures

- Two-step <u>cash</u> merger - tender offer followed by back end merger; Seller may avoid SEC proxy rules but tender offer rules apply to both Buyer and Seller
- One -step <u>cash</u> merger – Seller stockholder meeting; SEC proxy rules apply to Seller
- One-step <u>stock</u> merger - stockholder meeting(s); SEC proxy rules and registration requirements apply
- Two-step <u>stock</u> merger - exchange offer - rare due to SEC process involving both registration and tender offer rules

V. Why Public Company Deals Get Done

A. Because management views deal favorably

B. Sell-side specific rationale:

1. Knows company's strengths and weaknesses and long-term viability
2. Not enough critical mass to execute growth strategy
3. No access to capital markets
4. Lack of analyst/market maker coverage
5. Liquidity issues, particularly for founders or other significant stockholders
6. Management role with buyer
7. Management succession/leadership issues

V. Why Public Company Deals Get Done (con't)

C. Buy-Side specific rationale
- Complimentary or new product lines
- Technology/people
- Elimination of competition
- Cash

D. Favorable market reaction

E. Institutional investor pressure

VI. How Public Company Deals Get Done

A. Anatomy generally

B. Choice of structure

1. Strategic vs. non-strategic (seller)
2. Available currency (buyer)
3. Desired currency (seller) – cash is king vs. upside participation through tax-free exchange
4. Volatility of markets/pricing – cash is safer
5. Execution risk - managing uncertainties
6. Tax considerations

VI. How Public Company Deals Get Done (con't)

C. Types of mergers

1. Cash tender/merger (two-step) - time advantage; taxable; all holders/best price rule issues (14d-10)
2. Direct merger (one-step) - requires buyer and seller stockholder approvals, tax-free if at least 38% is buyer stock
3. Forward triangular - buyer stockholder approval may be avoided; tax treatment essentially same as direct merger; consent issues

VI. How Public Company Deals Get Done (con't)

4. Reverse triangular - buyer stockholder approval may be avoided; at least 80% of seller stock must be converted into buyer stock; consent issues may be avoided

D. Management Issues

1. Management, or "social", issues drive virtually every public company M&A deal
2. Deals often die because of disagreements over social or management economic issues

VI. How Public Company Deals Get Done (con't)

3. Lack of management support for a transaction generally dooms the deal
4. Most critical in strategic stock-for-stock deals and MOEs
5. Absolutely necessary to address social and management economic issues from day one
   a. Composition of surviving company board
   b. Role of Seller CEO and other senior management in surviving company

VI. How Public Company Deals Get Done (con't)

c. Employment arrangements for Seller CEO and other senior management who will be employed by surviving company

6. Effect of change of control agreements and preplanned change of control benefit packages on deal negotiations and employment economics with Buyer

a. Preplanned change of control severance, or "golden parachutes", is paramount to attracting and retaining top management

VI. How Public Company Deals Get Done (con't)

b. Typically CEOs receive 3x salary plus bonus payment, CFOs 2x and limited group of other senior executives 1x

c. Single vs. double triggers – double trigger requires Executive to be terminated without cause or to terminate with "Good Reason" (e.g., diminution in responsibilities or compensation) within 12 or 24 month period following change of control

d. Modified single trigger – executive has double trigger through a minimum transition period, typically 6 to 12 months, followed by a limited period in which to terminate for any reason and receive payout

VI. How Public Company Deals Get Done (con't)

e. CEO typically has modified single trigger and other executives have double trigger

f. Section 280G of Internal Revenue Code – 20% excise tax on "parachute payments," defined as the excess over the executive's average 5 year W-2 income, <u>if</u> the executive receives 3x or more of that average income as a change of control benefit – company loses deduction as well

g. 280G applies to the class of most highly compensated employees

VI. How Public Company Deals Get Done (con't)

h. Must take into account acceleration of vesting of options in 280G analysis

i. Full gross up vs. cutback vs. modified cut back – latter gives the executive the greater of (x) 3x (the "cutback" amount) and (y) the amount after payment of the excise tax under 280G

j. Mitigation provisions

VI. How Public Company Deals Get Done (con't)

E. Protecting the Deal Between Signing and Closing

1. Pricing considerations in stock deals

   a. Fixed exchange ratio pricing (common in MOEs)

      1) Simplicity
      2) Both parties at risk for Buyer stock price fluctuation between sign and close
      3) Buyer at risk of overpaying as Buyer stock increases in value
      4) Seller at risk of losing value as Buyer stock decreases in value

VI. How Public Company Deals Get Done (con't)

b. Fixed value pricing
   1) Simplicity
   2) Value received by Seller stockholders is fixed
   3) Buyer at risk of dilution as Buyer stock price decreases
   4) Seller at risk of losing out on upside as Buyer stock increases

c. Collars help to balance the risks associated with fixed exchange ratio and fixed value pricing

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d. Collars help to balance these risks and provide certainty to the parties that at certain stock price levels each party is protected

e. Collars in Fixed exchange ratio deals

1) Exchange ratio fixed between a range of Buyer stock price – parties at risk within this range
2) Above upper range of collar, exchange ratio floats and adjusts downward to provide fixed value (at the upper limit of the collar) – Seller's upside is limited
3) Below lower range of collar, exchange ratio floats and adjusts upward to provide fixed value (at the lower limit of the collar) – Seller's downside is limited

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4) Walk-away right generally given to Buyer at some point below lower end of collar to prevent massive dilution to Buyer stockholders
5) Walk-away right may be given to Seller at some point above upper end of collar to prevent Seller stockholders from losing out on benefits of increase in Buyer stock price

f. Collars in fixed value deals

1) Exchange ratio fluctuates within range of Buyer stock price to deliver fixed value to Seller stockholders

VI. How Public Company Deals Get Done (con't)

2) Above upper range of collar exchange ratio is fixed, delivering increasing value to Seller stockholders as Buyer stock price increases
3) Below lower range of collar exchange ratio is fixed, delivering decreasing value to Seller stockholders as Buyer stock price decreases
4) Walk-away right generally given to Seller at some point below lower end of collar to prevent unacceptable loss of value
5) Walk-away right may be given to Buyer at some point above upper end of collar to prevent Seller stockholders from benefiting from irrational increase in Buyer stock price

VI. How Public Company Deals Get Done (con't)

g. "Fill or kill" provisions in fixed exchange ratio deals: if Buyer's stock price falls below a certain percentage of the average signing price relative to its industry peers, then Seller has termination right, except that Buyer can block Seller's termination right if it is willing to fix the exchange ratio at the lower end of the range

VI. How Public Company Deals Get Done (con't)

2. "Deal Protection Mechanisms"
    a. Requires understanding of fiduciary duties
    b. Various standards of judicial scrutiny of actions taken by a Board of Directors
        1) Business Judgment Rule
        2) <u>Unocal</u> - duties in responding to takeover threats
        3) <u>Revlon</u> - duties when considering a true change of control transactions
        4) Entire Fairness - duties in "interested" director transactions

VI. How Public Company Deals Get Done (con't)

c. Business Judgment Rule - presumption (burden on plaintiff) that directors acted in:

1) Good faith (lack of personal interest duty of loyalty issue)
2) Reasonable belief that their actions are in best interest of corporation and stockholders (diligent, informed basis)
3) With care an ordinarily prudent person would use in like position and similar circumstances (focus is on process, not substance of decision)

VI. How Public Company Deals Get Done (con't)

d. Unocal - implementation of takeover protections

1) "Omnipresent spector" that directors may be acting in their self-interest to entrench themselves

2) Two prong test, with burden on directors, to demonstrate that:

   a) Threat to corporate policy exists

   b) Defensive measure taken in response to that threat was reasonable

VI. How Public Company Deals Get Done (con't)

e. Revlon - duty to obtain highest value reasonably available to stockholders

1) "Maximize" value
2) Change of control inevitable
3) No ability of stockholders to realize any additional appreciation for their investment - last bite of the apple
4) Does not apply to pure stock-for-stock deals because no change of control
5) Market checks and auctions
6) Mixed cash and stock deals - over 10% cash and Revlon starts to apply; cash option mergers generally do not trigger Revlon

VI. How Public Company Deals Get Done (con't)

f. Entire Fairness - interested director transactions

1) Controlling stockholders and parent/subsidiary transactions
2) Majority of Seller directors have a self-interest because they are on Buyer side
3) Burden is on interested directors to demonstrate deal was "fair" - very high threshold to satisfy
4) Court will look at both the process and the substance of the directors' decision
5) Use of special committee may shift burden to plaintiff

VI. How Public Company Deals Get Done (con't)

g. Relationship of fiduciary duties to M&A deal process

1) Primarily impacts Seller's process
2) In public company context, increased scrutiny by investors and regulators (SEC, stock exchanges) that process was appropriate
3) Buyer's concern – wants deal to be consummated without delay or interference from third party competing bids

VI. How Public Company Deals Get Done (con't)

4) Seller's perspective – in general agreement with Buyer's concerns but must address fiduciary duty implications of selling:
   a) to get the best price (even if not in Revlon land)
   b) to not get sued

h. To address Buyer's concerns, Seller agrees not to "shop" itself after entering into deal with Buyer
   1) To address Seller's fiduciary duty concerns, Seller gets an exception to the no shop

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2) Scope of Seller's exception is one of the most heavily negotiated provisions of a merger agreement
3) No shop provisions generally require that Seller terminate all discussions with other bidders and, between signing and closing, prohibit Seller from soliciting bids from other parties, providing any other party with confidential information or having discussions with any such party regarding a possible transaction

VI. How Public Company Deals Get Done (con't)

4) No shop exception – Seller may provide information to and negotiate with a third party that makes a written unsolicited proposal to acquire the Seller if:
   a) such proposal is reasonably likely to lead to a "superior proposal" and
   b) the Seller's Board determines that failure to provide such information or negotiate would be inconsistent with its fiduciary duties

VI. How Public Company Deals Get Done (con't)

5) "Superior Proposal" typically defined as a proposal to acquire the company that is financially more favorable to the Seller's stockholders than the Buyer's deal

i. Seller's right to withdraw its recommendation of Buyer's deal to Seller stockholders and to terminate merger agreement (called a "fiduciary out") – in recent years subject of much debate

1) Trend over last five years was for Buyers to deny seller the right to terminate to take a Superior Proposal, allow Seller Board only to withdraw its recommendation of Buyer's deal and force Seller's stockholders to vote on Buyer's deal

VI. How Public Company Deals Get Done (con't)

2) If Seller is given right to terminate to take Superior Proposal, it typically must give Buyer a "topping" right
3) If Seller terminates, it must pay Buyer a break up fee
4) Break up fee also generally payable if prior to Seller stockholder meeting an unsolicited offer is publicly made to Seller's stockholders, the Seller's stockholders do not approve the Buyer's deal and within 12 months Seller enters into an agreement with another party to acquire Seller (fee usually payable upon closing of that deal)

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j. Another important deal protection mechanism that goes hand-in-hand with the no shop provision is the voting agreement

1) Typically, Buyer requires that significant insiders (i.e., directors and officers) enter into voting agreements with Buyer giving Buyer the right to vote these shares at the Seller stockholder meeting

2) Typically, the voting agreement terminates upon any termination of the merger agreement – there are implications if merger agreement has no "fiduciary out" or if the voting agreement survives any such termination (e.g., *Omnicare* >50% voting agreement)

VI. How Public Company Deals Get Done (con't)

k. *Omnicare v. NCS Healthcare* (Del. Supreme Ct. 2003) – Regardless of whether or not *Revlon* duties apply, *Unocal* governs judicial review of directors' decision to agree to deal protection mechanisms

1) Under *Omnicare*, court held that Seller's Board's fiduciary duties did not permit it to agree to a merger agreement that:

a) contained a "force-the-vote" provision

b) Did not contain a fiduciary out

c) pursuant to voting agreements, contemplated that the two controlling stockholders would vote in favor of the deal, which required majority vote of stockholders

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2) *Omnicare* states that such a combination of lock-up mechanisms is preclusive and coercive, and therefore fails to satisfy the second prong of the *Unocal* test

3) *Omnicare* was a rare 3-2 decision, with an adamant dissent by the Chief Justice, who believes that the majority failed to recognize the process undertaken by the Seller Board and failed to recognize that the Seller Board did not have a potential self-interest in preserving itself in office, as required by *Unocal*

4) In addition, dissent argued that nothing in Delaware case law requires minority to be protected by Board absent controlling stockholder standing on both sides of the deal (e.g., buying the company); in *Omnicare*, controlling stockholders' interests were aligned with minority (to get best deal)

VI. How Public Company Deals Get Done (con't)

3. "MACs" – Material Adverse Change conditions
   a. Generally a condition to Buyer's obligation to close the deal
   b. Typically defined as the occurrence between signing and closing of any event having a material adverse effect on the financial condition, results of operations, assets, liabilities or prospects of the Seller and its subsidiaries taken as a whole

VI. How Public Company Deals Get Done (con't)

c. Seller typically negotiates for carve outs – adverse effects due to

1) general or industry specific conditions
2) decline in Seller's stock price
3) the announcement and pendency of the deal (e.g., effects on customers, employees, distributorships)
4) actions Seller is permitted to take under the merger agreement
5) actions taken by Seller at Buyer's request or with its express consent
6) acts of war or terrorism

VI. How Public Company Deals Get Done (con't)

d. *IBP v. Tyson Foods* (Del. Ch. 2001) – Delaware court addressed applicability of MAC when Tyson sought to abandon its proposed merger with IBP

1) IBP sued Tyson to compel the merger and won
2) Court found that the short term decline in IBP's earnings (one quarter) was not sufficient to permit Tyson to invoke MAC
3) To invoke a MAC, Buyer must prove the occurrence of events that substantially threaten the overall earnings potential of the Seller in a durationally-significant manner – a short term blip in earnings is not enough

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