Are you considering bidding for a public company? Has your public company received an acquisition bid? What should you do?

Public company acquisitions are highly choreographed affairs within confined conditions dictated by Delaware judicial decisions on the subject—to the extent a deal strays past such guardrails, it is subject to close scrutiny by both plaintiffs’ lawyers and judges in Delaware.

This article is a basic entry-level primer for those either unfamiliar or rusty with public company deals. These are general themes, and this list is not a substitute for review by knowledgeable counsel.

YOU MAY (STILL) GET SUED: In recent years, more than 80% of public company acquisitions were subject to Delaware lawsuits—most of these stemming from purportedly deficient disclosure in publicly filed SEC documents. Such suits often settled in return for amended disclosure, payment of plaintiffs’ lawyers’ fees and a release against any future litigation from the pre-signing conduct in the deal. Throughout 2015, however, the Delaware courts have increasingly and more loudly sent a clear message of their opposition to the rubber-stamping of such settlements. The days of convenient settlements—where plaintiffs’ lawyers collected a substantial fee in return for often dubious additional disclosure plus a release of any future claims arising from a deal—are over.

That said, litigation remains a definite possibility for any transaction that does not follow a prescribed, proper process. Accordingly, any Buyer should beware and be prepared to run a thorough and thoughtful process with a public company Target. Key disclosure areas are the background events to the transaction or the financial metrics and others focusing on conflicts of interest. More substantive suits often revolve around process—how and why a Target board weighed competing offers or whether the Target board was made aware of conflicts of interest. There thus remains great incentive to listen closely to Delaware judicial precedent as well as to SEC guidance.

THERE IS A BUYER. AND A TARGET: Although “mergers of equals” exist as an academic term, they rarely come to fruition. While there is always a larger company and a smaller company, board composition of the combined company can be subject to negotiation. And in a case where a Target’s board has no appetite to sell at a given price, then, to avoid the entreaties of a prospective Buyer, the Target’s board must rely upon sound business reasoning—not merely knee-jerk indignant intransigence.

CONFIDENTIALITY AGREEMENT/STANDSTILL: Before anything is discussed with the other party, there should be a confidentiality and standstill
agreement in place. It should not be a generic NDA that you would use in other parts of your business, but instead it needs to be narrowly tailored for the acquisition context. Delaware rulings in recent years have demonstrated that very slight nuances in NDA language can have the effect of precluding various deal strategies later (including going public with a “bear hug” or hostile with a tender offer)—even though a party may have thought nothing of seemingly innocuous language at the time the NDA was executed.

The NDA protects each side from having its confidential information used against it if negotiations break down. When coupled with a standstill (which, among other things, prohibits each party from buying the stock of the other party in the open market), the agreement prevents a party from going hostile and only effecting a deal through a negotiated transaction with the Target board. Standstill provisions are absolutely vital (and completely standard) to protect a smaller Target from being bullied in the future.

**TIME FRAME/STRUCTURE:** There are two routes to do deals, both of which are subject to detailed SEC rules. The ordinary public company acquisition would be a “reverse triangular merger” in which the Target is merged with and into a shell subsidiary of the Buyer, and thus Target survives post-closing as a wholly owned subsidiary of Buyer through:

(A) Tender offer: Buyer publicly solicits Target’s shareholders to sell shares for a set price; or

(B) Merger: Calling a special stockholders meeting in which Target’s stockholders (and if the deal requires issuing more than 20% of Buyer’s outstanding stock, Buyer’s stockholders as well) vote to approve a merger of Target, usually into a subsidiary of Buyer.

While a merger/proxy solicitation historically was the preferred alternative to tender offers, since the SEC clarified tender offer regulation around the best price rule last decade, and more recently since Delaware amended its law on short form mergers in 2013, all-cash tender offers have surged back and are favored for their speed of execution.

Changes to Delaware law in 2013 have made tender offers even more attractive. In an ordinary third-party tender transaction where at least 50% of Target’s outstanding shares tender their shares to Buyer, who then closes the tender, the Buyer can now immediately effect a back-end merger to cash out the remaining shares that were not tendered. Previously, unless Buyer had achieved a 90% tender level (as opposed to 50%), Buyer would have had to either (a) solicit a stockholder vote after the tender offer closed, including a full long-form merger and associated SEC proxy statement, which increased time and cost to a transaction, or (b) in circumstances where near 90% tendered (but not quite 90%), companies would take advantage of a “top-up option.” Delaware has, however, streamlined its process, and this is no longer the case. As long as over 50% of shares have been tendered, the back-end cash-out can quickly occur on the same terms as the first part of the tender.

Proxy solicitations likely remain the preferred alternative over tender offers for:

(A) stock-for-stock transactions, as registering stock for a tender offer is a complex and little-used route; and

(B) transactions that are expected to take a long (several month) period to reach closing either due to regulatory clearance hurdles or other third-party conditions, such as customer consents. So long as a tender is open, a third party can intervene with a superior offer and either dislodge the original Buyer or create a bidding war to drive up the price. However, under Delaware law, once a stockholder vote has occurred (such as at a special meeting of stockholders), the “fiduciary out” allowed to breakoff a transaction is eliminated, and the Seller is locked into eventual performance with Buyer.

Certain tenders may be negotiated as “dual track” transactions (first invented in 2010) where Buyer and Target both agree to do a tender offer, but if the transaction draws out, they revert to a proxy statement/stockholder vote. For various reasons, including the changes in Delaware law, the “dual track” deal remains unusual.
A final timing note: Proxy statements for special meetings often receive greater SEC scrutiny, and unlike with a tender offer, disclosure documents cannot be finalized mailed until the SEC’s review has been complete. The process may take 15 or more days longer than a tender offer. While this period at first blush may seem small, it can generally appear an eternity to a Buyer if alternate bidders are in the wings and possibly engaged in a post-signing bidding war with topping bids.

**DOCUMENTATION:** In a friendly deal, both structural alternatives involve a negotiated, complex acquisition contract (and accompanying disclosure schedule). After executing the contract, a tender offer requires the filing of an offer to purchase on Schedule TO by Buyer (and Target’s disclosure on Schedule 14D-9), whereas a merger agreement requires a Form S-4 registration proxy statement, which registers the deal consideration stock (if applicable) and contains the stockholder meeting disclosure for Target (and Buyer, where applicable, due to Buyer stock consideration in excess of 20% of Buyer’s capitalization). In a hostile transaction, Buyer will bypass merger agreement negotiations (and Target’s board) by going straight to Target’s stockholders through the filing of a tender proposal on Schedule TO with the SEC.

**DUE DILIGENCE:** A cash deal (such as an all-cash tender offer) will require diligence by Buyer on Target, but not vice versa, except to confirm the availability of cash or financing commitments. Conversely, a deal in which the consideration is only, or in part, Buyer’s stock requires “reverse” diligence by Target on Buyer. Large deals with well-established Targets may take limited diligence since counsel will argue that the public filings are sufficient. On the other hand, Target that is a small public company with limited leverage may be required to produce extensive diligence before Buyer is comfortable going forward.

**NO INDEMNIFICATION AND NO CONTINGENT CONSIDERATION:** Representations and warranties in transactions for privately held companies almost always include post-closing indemnification, such that a breach of representations and warranties triggers recourse against a holdback amount from Buyer or an escrow account. Because clawing back deal consideration from “street” holders of publicly traded stock simply isn’t feasible, indemnification does not exist for deals involving publicly traded Targets. Representations and warranties remain in public acquisition agreements in order to assess whether a breach is significant enough to trigger a pre-closing condition/termination right, but they are not available for post-closing recourse. A Buyer should thus be careful in its diligence and realize the risks it may be assuming post-closing, for all intents and purposes, without future recourse. Likewise, since no post-closing payments are feasible, there cannot be any contingent consideration or “earn-out” payments. The consideration must be all upfront at the time of closing.

**REGULATORY REVIEW:** Almost all public company Targets will be large enough to meet the transaction size test for a Hart-Scott-Rodino (HSR) antitrust filing (the size of a transaction test in 2016 is $78.2 million). Assuming no substantive issues, a transaction is normally approved within 45-60 days (which runs simultaneously, and often coterminous, to the tender offer and proxy statement time frames listed). However, either U.S. or foreign (EU or unique jurisdictions) antitrust issues have the potential to cause delay. Also, antitrust concerns, particularly preexisting ones involving the Buyer, may cause a Target to negotiate the inclusion of a reverse termination fee in the acquisition agreement in the event the transaction falls apart for antitrust reasons.

**BOARD ROLE:** For Targets, outside directors have a key role in any change of control. Best practice is to have the Target board immediately appoint a committee of three (or so, but more than that number can become unmanageable given the short timeline and need for availability) to essentially run the process. This is not a strict “special committee,” which is a term of art for a highly regulated situation where the Target is being taken private by management or other conflicts of interest exist. A transactional committee of convenience allows for a smaller group of directors, generally those on the Target board who are independent but also deal savvy, to supervise the process and make nimble tactical decisions while protecting against any appearance of conflict of interest by management.
In fact, any change of control discussions, no matter how seemingly nascent or exploratory, should be vetted with and directed by the Target board (or its transactional committee), and any unilateral/unsupervised management-to-management discussions about future management composition or compensation should definitely be avoided; no matter how generalized or routine such communication may appear at the time, it can be made to seem inappropriate in retrospect.

Nonetheless, although a “transactional committee” may run with the lead in negotiating a deal, Delaware still puts responsibility on all directors—so formal board meetings should be regularly held—and materials should be sent well enough in advance for intelligent review by board members.

While there is no bright line on what constitutes a “management buy-out/take private,” a general rule of thumb is that if the current management will own 10% or more of the post-closing combined company, it qualifies for SEC disclosure under Schedule 13e-3. Such transactions involve rigorous and voluminous additional disclosure and scrutiny beyond even customarily lengthy standard disclosure. More importantly, failing to effect appropriate corporate governance safeguards could potentially shift the burden of proof that a deal is reasonable onto a Target’s board, which then has to prove the transaction is “fair” as to both (a) process and (b) price. It is a significant undertaking.

PRECEDENTS MATTER: One key factor of public company transactions is that such transaction documents are always filed and publicly available on the SEC’s website system, EDGAR. Conversely, in many private company transactions only a simple, opaque press release may be available. Accordingly, one should work to assemble a list of appropriate transactions from the outset and use precedent documents when negotiating a purchase agreement.

FINANCIAL ADVISORS: A “fairness opinion” from an investment bank (IB) will be advised under Delaware practice to be delivered to the Target stockholders (and in some cases a separate IB will need to deliver an opinion to the Buyer stockholders). The earlier there is a selection “bake-off” and bankers are involved, the better. The overwhelming majority of IB fees are contingent upon closing. Any IB engagement letter should be carefully negotiated, as terms such as “fee tails” need to be narrowly and thoughtfully structured. Bankers are very useful in both negotiating up front, as well as lending credibility for the record (again, litigation protection). For example, in a stock-for-stock deal, there is always the question of whether “collars” (prescribed ranges in which the shares of each company can float prior to closing without creating a termination right) are appropriate. In light of a relatively important 2014 Delaware case where an investment bank was found to have liability for aiding and abetting in flawed analyses, processes and conflicts of interest, investment banks in the future are likely to be more careful than in the past about the level of rigor used in the fairness opinion process, including being more skeptical in evaluating underlying financial assumptions and data.

TRACK THE PROCESS: Make note of all meetings and contacts (including via telephone) between management teams, boards and outside advisors with time/date/place and general description. Such a timeline becomes crucial when drafting disclosure documents or, unfortunately, if litigation arises.

SECRECY: Confine knowledge of this activity to a small group—the circle of trust will need to expand in tranches over time, but, initially, it need be only a couple of folks. Public leakage is dangerous as it may drive up Target’s pre-signing trading price and thus erode the signing date price premium, which can be optically problematic even if the historical trading averages indicate a healthy premium. In addition, after a transaction closes, in order to police insider trading, stock exchange regulatory authorities routinely poll participants at both Buyer and Target, as well as their legal and financial advisers, with lists of stockholders who traded immediately prior to the announcement of a deal.

To learn more, visit www.orrick.com or contact:

Ed Batts
ebatts@orrick.com
T +1 650 614 7473

orrick.com