LATHAM&WATKINS LLP

M&A Commentary

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SHAREHOLDER PUSHBACK ON M&A DEALS

Highlights

- Shareholder resistance to announced M&A transactions became a real issue in 2007. While the phenomenon may be waning, it still presents a troublesome execution risk in conventional merger transactions involving public company targets because of the need for a favorable shareholder vote.
- Hedge funds, traditional mutual fund investors and ISS have shown a significant appetite for effectively communicating with each other and mounting a challenge to the pricing in private equity take-private deals, reflecting at least in part the market's skepticism about the efficacy of the special committee process to overcome inherent conflicts of interest.
- More telling, perhaps, is that institutional investors and ISS have shown a similar appetite to challenge strategic transactions where there is no possible conflict of interest taint, again on grounds of price inadequacy.
- To combat shareholder pushback against announced deals, parties have used a combination of tactics, including more focused communications with investors and ISS, drawing a "best and final price" line in the sand, trying to appease the market through modest price increases and moving record dates to disenfranchise shareholders who sell their stock after the original record date and enfranchise in their place shareholders who bought stock after the original record date.
- A perhaps more effective tactic to combat actual or potential shareholder resistance is to use a two-step combination structure, consisting of a first-step tender offer followed by a second-step merger, in place of the more standard one-step merger structure.
- The advantages of a two-step structure beginning with a first-step tender offer over a one-step merger include the absence of a vote in the tender offer (thereby eliminating ISS and other proxy advisory firms from the decisional process), the avoidance of the disenfranchisement/enfranchisement issues embedded in record dates and the creation of economic incentives to tender rather than hold out, which are not present in a one-step merger.
- As a result of these advantages, as well as the widely recognized timing benefits of a tender offer, parties to a combination transaction should favor a two-step structure in most cases where there are no significant regulatory hurdles or deal dynamics that would neutralize the timing advantages of, or otherwise penalize, the tender offer structure.

Setting the Stage

For years it was a truism in M&A that once a deal was signed, shareholder approval would be virtually automatic; assuming, of course, no higher credible bid emerged before the shareholder meeting. This truism began to lose its luster in 2006 and became quite debatable during the first half of 2007. Many prominent deals in this time frame were subjected to significant shareholder pushback. Many of these shareholder “revolts” petered out, and the initial deal eventually won approval. A surprising number, however, ended differently, including:

- the Clear Channel Communications acquisition by Bain Capital and Thomas H. Lee
- the Genesis Healthcare acquisition by Formation Capital
- the Laureate Education acquisition by a KKR led private equity consortium
- the Biomet acquisition by a TPG led private equity consortium
- the Lone Star Steakhouse acquisition by a private equity group
- the Outback Steakhouse acquisition by Bain and Catterton Partners
- the ICOS acquisition by Eli Lily
- the Inter-Tel acquisition by Mitel
- the Reckson Associates acquisition by SL Green Realty.

In each of these deals, the buyer sweetened its price at least once in order to win shareholder approval. The extreme case of investor pushback may have been in the Formation/Genesis transaction where initial shareholder resistance to the deal triggered not only a price bump but also a lessening of deal protection terms. This, in turn, paved the way for a bidding war with the cover bidder that was eventually won by Formation only after five rounds of bidding increased the price from $63 to $69.35 per share.

The reasons for the trend toward greater shareholder assertiveness against announced M&A deals include:

- A growing number of hedge funds (some of which were historical investors in the target and others of which were more like arbitragers) took the position that the merger price was not at the top end of the range and agitated for a price increase by lobbying fellow investors to vote against the announced deal.
- A number of traditional mutual fund investors, like T. Rowe Price and Fidelity, somewhat surprisingly, also began to oppose announced merger deals openly where they felt the pricing of the deal was inadequate, instead of just going along with the transaction and not rocking any boats.
- An informal, but highly effective, communication system developed among investors protesting deal pricing, consisting of filings with the SEC, Internet messaging and telephone calls arguing the inadequacy of consideration (often with extensive analytical back-up), but never requesting proxy authority to avoid application of the SEC’s proxy rules.
- ISS and its smaller competitor proxy advisory firms took an increasingly assertive stance recommending “no” votes on a number of mergers, accompanied by a written analysis of reasons, which sometimes incorporated the analyses of the investor opponents.
- Finally, but hardly least important, a wide-spread conviction took hold that take-private transactions were not being negotiated sufficiently aggressively—in effect, a vote of no confidence in the special committee process and negotiating prowess of the committee and its advisers.

Following the credit market dislocations of the late Spring and Summer of 2007, many observers predicted that the days of shareholder pushback on signed M&A deals would come to a halt. The leveraged finance markets seized up, making take-privates of large public companies infeasible; M&A activity as a whole slowed down dramatically; and M&A pricing of the past 18 months came under increasing criticism as having been too aggressive and the product of an easy credit “bubble.”

Confounding Events

It is six months after the fault lines began to appear in the M&A market, and the pace of M&A in the United States has slowed dramatically, with November 2007 being significantly below November 2006. Nonetheless, and somewhat surprisingly, we continue to experience serious investor pushback on M&A deals during this time frame.

- In mid-July, well into the leveraged credit crunch, investors turned down Carl Icahn's proposal to take Lear Corporation private, notwithstanding a price bump by Icahn at the last minute and his statements that the increased price was his "best and final" bid.
- Late September saw another strong pushback by investors against the proposed all cash bid by LKQ Corporation for Keystone Automotive Industries, notwithstanding that the acquirer was a strategic buyer, not a private equity fund, and the negotiation was totally arms-length.
- About a month later, investors again threatened to deny a majority vote in a strategic acquisition with no conflict of interest baggage in the URS Corporation acquisition of Washington Group International for a combination of stock and cash.

Moreover, it is clear from the latest two episodes that we cannot attribute investor concerns that these deals had been mispriced to an aversion to private equity take-private transactions or suspicions about conflicts of interest impeding an arms-length negotiation. Rather, it seems that even in a less than robust M&A market where private equity firms have retreated, investors and proxy advisors are still willing to take aggressive stances against announced deals based on their analysis of the fairness of the deal price or their perception of the availability of other opportunities to create shareholder value.

Responses to Shareholder Pushback

Historically, parties to a merger that runs into significant shareholder opposition have used one or a combination of the following tactics to secure the requisite shareholder support.

- Bidders in today's M&A market recognize the importance of an affirmative recommendation for a deal from ISS and will seek a meeting with ISS to explain the deal pricing and underlying analytics. Not all of these meetings accomplish their purpose, and it appears ISS is increasingly willing to recommend against mergers based on ISS' internal analytics. Once a negative ISS recommendation issues, getting ISS to change it without any change in deal terms is extraordinarily difficult, even if the participants in the merger believe ISS' analysis is flawed. This reality puts a strong premium on establishing and maintaining a constructive working relationship with the group in ISS that handles merger analysis so that the parties to the deal have an opportunity to "appeal" an imminent negative recommendation before it is made public.
- In situations where the parties are not able to obtain a favorable recommendation from ISS, or where a number of significant shareholders agitate against the deal on pricing grounds, some buyers have elected to stand pat and take the position that the deal price is the their "best and final" offer. This approach, of course, is akin to a game of "chicken" and the ultimatum may or may not convince shareholders to back the deal. Indeed, while this tactic seemed to be effective for most of 2006, its win ratio declined in 2007, perhaps because investors gained further confidence in the merits of a pushback strategy.
- As a result, a more common tactic in 2007 has been for the buyer to put more money on the table at the end of a troubled solicitation process in an attempt to win shareholder approval. Sometimes the amount of extra consideration is nominal, and sometimes significant. However, in every case determining a market clearing price is tricky and fraught with the possibility of paying too little or too much. In particular, if the initial top-up amount is not enough to clear the market (as proved to be the case in the

proposed Icahn take-private of Lear), the bidder is faced with the difficult choice of having the courage of its pricing convictions and allowing the deal to go away, or to throw yet additional money onto the table.

- Often an analysis of the target's shareholders indicates that many purchasers after the record date would vote in favor of the deal, but are not mechanically able to do so. Likewise, some number of record date holders who have sold stock will not vote their record-date positions. This phenomenon, sometimes called "lost votes," can be very adverse in the context of a close vote on a merger, particular where there has been significant post record date arbitrage buying. The related phenomenon, where investors acquire voting positions without exposure to the underlying economics of share ownership—so-called "empty" voting—can also distort merger voting. To deal with these factors, the target sometimes will set a new record date and meeting date, either in conjunction with another tactic or just on a stand-alone basis.

    - It should be noted that changing the meeting and record date does raise potentially challenging legal questions relating to the need to circulate supplemental proxy material, the time frame required to do so and, by no means least, and the validity of any investor claims that the board motives in so doing were improper.
    - It is helpful that in the recent *Inter-Tel* case in Delaware, the court concluded that the board had not breached its fiduciary duty by resetting the record date with the result that the target captured the favorable vote of shareholders who had purchased after the record date. In doing so, however, the court relied, in part, on the board's determination that it moving the record date was needed to provide additional time for the company to disseminate more up-to-date financial information.
    - While many legal observers believe a Delaware court would permit a record-date postponement solely for the purposes of enfranchising buyers of stock after the original record date, provided there were no obvious self interest on the part of the directors making the decision, there is no clear-cut judicial decision to this effect.

An Alternative Solution—The Tender Offer

In June and July 2007, toward the end of the take-private "bubble," two private equity consortiums experimented with a different approach to shareholder pushback against announced deals involving Laureate Education and Biomet.

- In Laureate, as the merger proxy review process at the SEC reached its end, the buy-out syndicate counted noses among shareholders of Laureate and concluded that opposition to the pricing of the transaction led by T. Rowe Price, among other investors, made obtaining a favorable majority vote problematical. To avoid a negative vote, the buy-out group and the special committee of Laureate raised the purchase price and restructured the deal as a classic two-step deal, starting with a cash tender offer with a 50 percent minimum tender condition, to be followed by a merger. The cash tender offer was successful and ultimately resulted in over a 90 percent tender and a short-form merger.
- In Biomet, the required shareholder vote was 75 percent of outstanding shares, not the traditional majority. When ISS issued a negative voting recommendation approximately one week before the shareholder meeting, the buy-out group took a leaf from the Laureate book by raising the price and negotiating a switch in transaction structure from a traditional one-step merger to a two-step deal starting with a cash tender offer, with a minimum 75 percent tender condition, to be followed by a merger. Notwithstanding the unusually high 75 percent tender condition, the tender offer was successful and the back-end merger closed soon thereafter.

The success of these tender offers highlighted a number of significant structural benefits of the two-step structure of a tender offer followed by a merger, compared to the more traditional one-step merger that has been pervasive over the past decade.

- First, unlike a one-step merger, the two-step transaction does not require a target shareholder vote on the critical first-step tender offer. For this reason, ISS and its smaller proxy advisory competitors do not issue voting or other recommendations with regard to the tender offer. Given the importance of ISS and the other proxy advisory firms to the outcome of the voting process, this alone is a significant advantage.
- The absence of a vote on the first-step tender offer has a second important advantage. The decision to tender is at most institutions a portfolio manager decision, not a voting committee decision. This helps avoid the spill-over effect that a negative ISS recommendation may have on voting committees at institutional investors, which as a matter of practice review ISS' analysis and recommendation as part of the committee process. This may be particularly important for index and other quantitative investors that don't have an infrastructure for assessing the economic merits of a merger vote.
- Also, unlike not voting at all or voting against a one-step merger, there is an important moral hazard in deciding not to tender stock, which is well understood by retail and institutional investors. In a merger, a shareholder does not suffer an economic disadvantage if it fails to vote or votes no on the merger, because doing so will not affect receipt of the merger consideration at the same time as all other shareholders so long as the merger receives the minimum vote. This is not true in a tender offer, where a failure to tender in the initial offer will result in a delay in receipt of the consideration if the back-end merger does not follow immediately upon completion of the tender offer. Moreover, the risk of delayed receipt is heightened in the tender offer context because it can be avoided only by a short form merger, which requires at least a 90 percent tender, contrasted to the typical 50 percent vote needed to assure completion of a one-step merger. A shareholder which wants to play a hold-up game by voting no on a merger can do so, knowing that failure does not delay receipt of consideration. Similarly a shareholder who doesn't bother to vote in a merger (behavior which has the same effect as a no vote) can all too easily rely on the assumption that its failure to vote won't matter and the deal will be approved in any event. Shareholders cannot make the same assumption in a tender offer. There is an all too obvious moral hazard in a failure to tender.
- A tender offer by its very nature eliminates all disenfranchisement of late-coming shareholders. A tender offer does not rely on a record date for eligibility, as does a one-step merger. Rather, the owner of each share has until the very last day of the tender offer to tender. This means parties who sell shares prior to the conclusion of a tender offer lose the decision-making power to tender, as they should, and parties who buy shares up until the end of the tender offer gain the decision-making power to tender as an economic owner should. Moreover, strategies to acquire votes without exposure to the economics of ownership — "empty voting" — are wholly ineffective in a tender offer. For these reasons, the impact of "lost votes" and "empty votes" disappears in a tender offer. The economic owners, and only the economic owners, of the stock make the critical decision whether to tender.
- Finally, many observers would argue that the pricing dynamic for a buyer is far better in a tender offer than a merger because the tender offer introduces a more challenging "collective action" effect. Although it may be nothing more than the other side of the moral hazard coin discussed above, there seems to be a real market dynamic that makes it harder for any one shareholder not to tender than not to vote or to vote no. To the extent this observation is correct, a given price should more easily clear a tender offer process than a merger process.

Conclusion

Although the risk of shareholder pushback against announced M&A deals may be receding as the M&A market softens, it is not going away. In light of this added execution risk, parties negotiating a merger should structure the transaction to minimize it to the extent feasible. One readily available way to do this is to use a two-step transaction structure consisting of a tender offer followed by a merger, instead of a traditional one-step merger. The two-step transaction was at one time the prevailing deal structure, and it should become so again. After all:

- The SEC has finally solved the best price rule interpretation problem that for many years acted as a virtual veto on tender offers. Although not without its technical difficulties, a year of experience has proven the basic validity of the SEC safe harbor approach in the revised rule.
- The SEC has also acted to eliminate the timing disadvantage formerly suffered by tender offers utilizing stock as consideration by permitting early commencement of so-called “exchange offers” before effectiveness of the required registration statement. Early commencement is designed to permit completion of an exchange offer within the minimum 20 business day period required for all tender offers, thus leveling the playing field between cash and stock offers.
- Tender offers provide significant speed of execution advantages over one-step mergers, except where difficult regulatory approvals are required. The more rapid execution of the tender offer benefits target shareholders, selling companies and buyers alike by avoiding unnecessary delays in completion of a deal and thereby adding certainty and clarity to the process.

The conclusion seems inescapable that for most acquisitions of US public companies, a two-step deal structure offers truly superior execution compared to the long-favored one-step merger process

If you have any questions about this M&A Deal Commentary, please contact Charles Nathan in our New York office.