

Introduction

RECENT M&A TRENDS

The pace of mergers and acquisitions (M&As) picked up in the early 2000s after collapsing in the wake of the subprime crisis. M&A volume was quite strong over the period 2003–2007. This strength was apparent globally, not just in the United States. However, the United States entered the Great Recession in 2008 and the recovery from this strong economic downturn would prove difficult. A number of deals that were planned in 2007 were canceled.

Figure 1.1 shows that the aforementioned strong M&A volume over the years 2003 to 2007 occurred in both Europe and the United States. M&A volume began to rise in 2003 and by 2006–2007 had reached levels comparable to their peaks of the fifth wave. With such high deal volume, huge megamergers were not unusual (see Tables 1.1 and 1.2). In the United States, M&A dollar volume peaked in 2007, whereas in Europe, this market peaked in 2006. Fueled by some inertia, the value of total M&A was surprisingly strong in 2008 when one considers that we were in the midst of the Great Recession. The lagged effect of the downturn, however, was markedly apparent in 2009 when M&A volume collapsed.

The rebound in U.S. M&A started in 2010 and became quite strong in 2011, only to weaken temporarily in 2012 before resuming in 2013. The U.S. M&A market was very strong in 2014, and in 2015 it hit an all-time record, although, on an inflation-adjusted basis, 2000 was the strongest M&A year. In 2016, the M&A market was still strong in the United States, although somewhat weaker than 2015.

The story was quite different in Europe. After hitting an all-time peak in 2006 (it should be noted, though, that on an inflation-adjusted basis, 1999 was the all-time

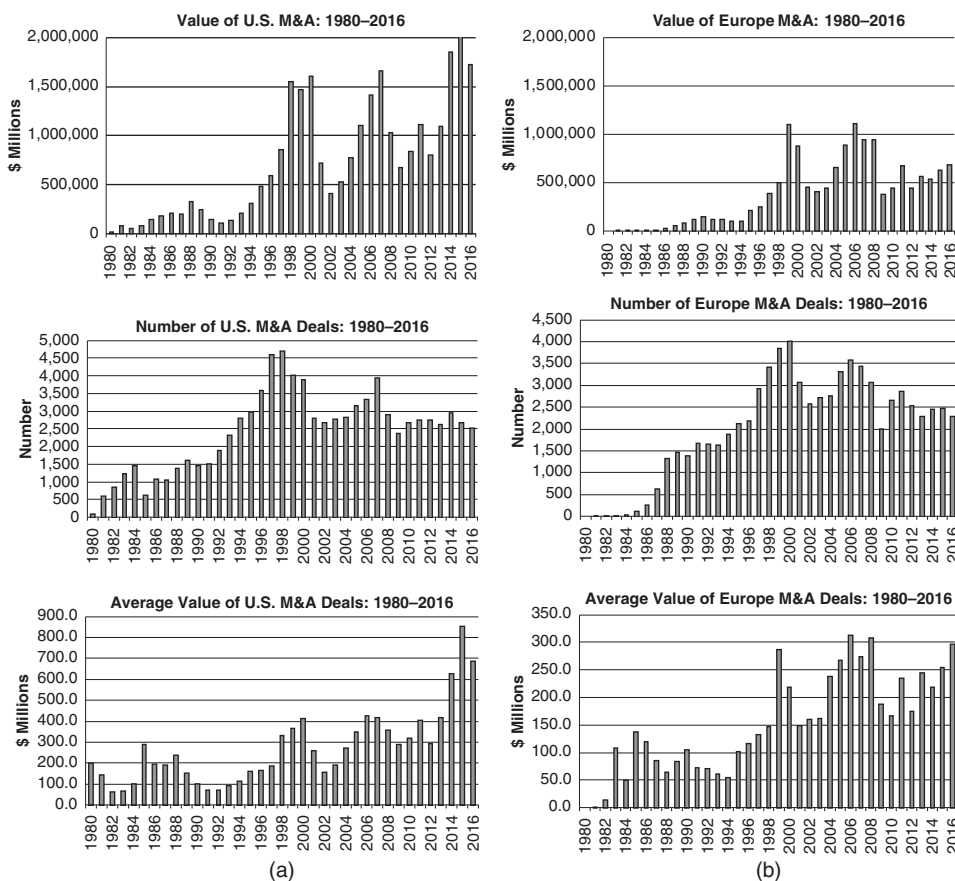


FIGURE 1.1 Value of M&As 1980–2016: (a) United States and (b) Europe.

peak in M&A for Europe), the market weakened a little in 2007 and 2008, although it was still relatively strong. However, Europe's M&A business shrank dramatically in 2009 and 2010 as Europe was affected by the U.S. Great Recession and also its financial system also suffered from some of the same subprime-related issues that affected the U.S. financial system.

The M&A business rebounded well in 2011, only to be somewhat blunted by a double-dip recession in Europe, which was partly caused by the European sovereign debt problems. The Eurozone had a 15-month recession from the second quarter of 2008 into the second quarter of 2009, but then had two more downturns from the fourth quarter of 2011 into the second quarter of 2012 (9 months) and again from the fourth quarter of 2012 into the first quarter of 2013 (18 months). M&A volume was more robust in 2015 and 2016 but unlike in the United States, Europe remained well below the level that was set in 2006.

TABLE 1.1 Top 10 Worldwide M&As by Value of Transaction

Date Announced	Date Effective	Value of Transaction (\$ Millions)	Target Name	Target Nation	Acquirer Name	Acquirer Nation
11/14/1999	4/12/2000	202,785.13	Mannesmann AG	Germany	Vodafone AirTouch PLC	United Kingdom
1/10/2000	1/12/2001	164,746.86	Time Warner	United States	America Online Inc	United States
6/26/2015	8/9/2015	145,709.25	Alice SA	Luxembourg	Alice SA	Luxembourg
9/2/2013	2/21/2014	130,298.32	Verizon Wireless Inc	United States	Verizon Communications Inc	United States
8/29/2007	3/28/2008	107,649.95	Philip Morris Intl Inc	Switzerland	Shareholders	Switzerland
9/16/2015	10/4/2016	101,100.89	SABMiller PLC	United Kingdom	Anheuser-Busch Inbev SA/NV	Belgium
4/25/2007	11/2/2007	98,189.19	ABN-AMRO Holding NV	Netherlands	RFS Holdings BV	Netherlands
11/4/1999	6/19/2000	89,167.72	Warner-Lambert Co	United States	Pfizer Inc	United States
12/1/1998	11/30/1999	78,945.79	Mobil Corp	United States	Exxon Corp	United States
1/17/2000	12/27/2000	75,960.85	SmithKline Beecham PLC	United Kingdom	Glaxo Wellcome PLC	United Kingdom

Source: Thomson Financial Securities Data, January 12, 2017.

TABLE 1.2 Top 10 European M&As by Value of Transaction

Date Announced	Date Effective	Value of Transaction (\$mil)	Target Name	Target Nation	Acquirer Name	Acquirer Nation
11/14/99	06/19/00	202,785.13	Mannesmann AG	Germany	Vodafone AirTouch PLC	United Kingdom
6/26/2015	8/9/2015	145,709.25	Altice SA	Luxembourg	Altice SA	Luxembourg
08/29/07	03/28/08	107,649.95	Philip Morris Intl Inc	Switzerland	Shareholders	Switzerland
9/16/2015	10/4/2016	101,100.89	SABMiller PLC	United Kingdom	Anheuser-Busch Inbev SA/NV	Belgium
04/25/07	11/02/07	98,189.19	ABN-AMRO Holding NV	Netherlands	RFS Holdings BV	Netherlands
01/17/00	12/27/00	75,960.85	SmithKline Beecham PLC	United Kingdom	Glaxo Wellcome PLC	United Kingdom
10/28/04	07/20/08	74,558.58	Shell Transport & Trading Co	United Kingdom	Royal Dutch Petroleum Co	Netherlands
04/08/15	02/15/16	69,445.02	BG Group PLC	United Kingdom	Royal Dutch Shell PLC	Netherlands
09/29/14	09/01/15	65,891.51	UBS AG	Switzerland	UBS AG	Switzerland
02/25/06	07/22/08	60,856.45	Suez SA	France	Gaz de France SA	France

Source: Thomson Financial Securities Data, January 12, 2017.

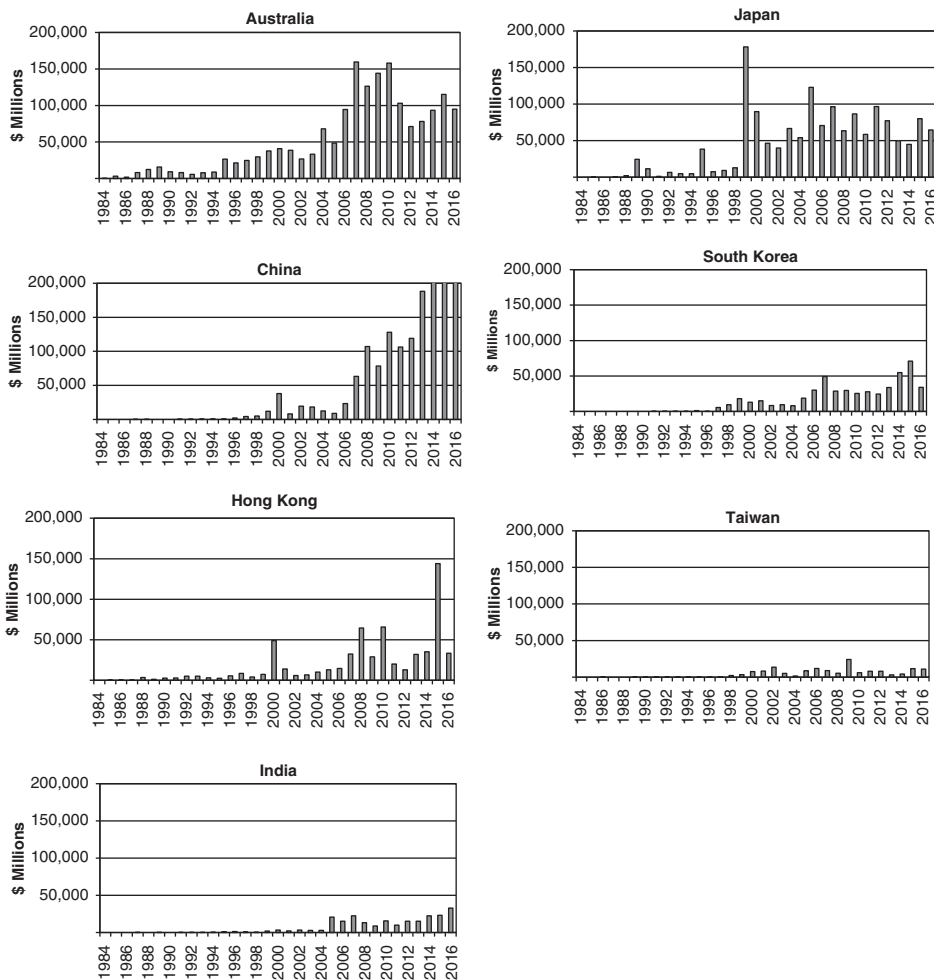


FIGURE 1.2 Value of M&A 1984–2016: By nation. *Source:* Thomson Financial Securities Data, January 12, 2017.

Deal volume in most regions of the world generally tends to follow the patterns in the United States and Europe (see Figure 1.2). Australia, for example, exhibits such a pattern, with deal volume growth starting in 2003 but falling off in 2008 and 2009 for the same reason it fell off in the United States and Europe. Australian deals rebounded in 2013 and have grown since except for a modest decline in 2016.

The situation was somewhat different in China and Hong Kong. The value of deals in these economies has traditionally been well below the United States and Europe but had been steadily growing even in 2008, only to fall off sharply in 2009. China's economy has realized double-digit growth for a number of years and is now more than one-half of the size of the U.S. economy (although on a purchasing power parity basis it is approximately the same size). Economic growth slowed in recent years from double-digit levels to just under 7% per year even with significant government efforts to try to return to prior growth levels.

TABLE 1.3 Top 10 Asian M&A by Value of Transaction

Date Announced	Date Effective	Target Name	Target Nation	Acquirer Name	Acquirer Nation	Value of Transaction (\$mil)
03/26/14	08/25/14	CITIC Ltd	China	CITIC Pacific Ltd	Hong Kong	42,247.47
01/09/15	06/03/15	Cheung Kong (Hldg) Ltd-Ppty	Hong Kong	Shareholders	Hong Kong	36,890.56
02/29/00	08/17/00	Cable & Wireless HKT	Hong Kong	Pacific Century CyberWorks Ltd	Hong Kong	37,442.15
10/04/00	11/13/00	Beijing Mobile, 6 others	China	China Telecom Hong Kong Ltd	Hong Kong	34,161.79
05/25/08	10/15/08	China Netcom Grp (HK) Corp Ltd	Hong Kong	China Unicom Ltd	Hong Kong	25,416.14
01/09/15	06/03/15	Huchinson Whampoa Ltd	Hong Kong	Cheung Kong (Holdings) Ltd	Hong Kong	23,639.61
10/14/15	10/31/15	China-Telecommun Tower Assets	China	China Tower Corp	China	18,349.33
08/22/12	12/31/12	China Telecom Corp-3G Assets	China	China Telecom Corp Ltd	China	18,047.28
05/12/08	11/17/08	St George Bank Ltd	Australia	Westpac Banking Corp	Australia	17,932.98
04/11/07	07/25/07	SK Corp-Petrochemical Business	South Korea	Shareholders	South Korea	16,984.45

Source: Thomson Financial Securities Data, January 12, 2017.

There are many regulatory restrictions imposed on M&As in China that inhibit deal volume from rising to levels that would naturally occur in a less-controlled environment. The Chinese regulatory authorities have taken measures to ensure that Chinese control of certain industries and companies is maintained even as the economy moves to a more free market status. This is why many of the larger Asian deals find their origins in Hong Kong (see Table 1.3). Nonetheless, the M&A business in China over the past few years has been at its highest levels. While Chinese demand for foreign targets rose to impressive heights in 2016, in the second half of 2016 and 2017 the Chinese government took measures to limit capital from leaving China—something that is necessary to complete most foreign deals. Financing for such deals became more difficult, and the Chinese Commerce Ministry began taking a hard line on some large deals.

In Hong Kong, the number of deals has been rising over the past three years and the outlook remains positive. The same is true of Taiwan and South Korea.

The M&A business has been increasing in India, as that nation's economy continues to grow under the leadership of its very probusiness Prime Minister Modi. The demographics of the Indian economy imply future economic growth, and are the opposite of Japan. This helps explain why the Japanese economy has been in the doldrums for the past couple of decades. Since 2011, M&A volume in Japan has been steady, but without major growth or a return to the pre-subprime crisis days.

VODAFONE TAKEOVER OF MANNESMANN: LARGEST TAKEOVER IN HISTORY

Vodafone Air Touch's takeover of Mannesmann, both telecom companies (and actually alliance partners), is noteworthy for several reasons in addition to the fact that it is the largest deal of all time (see Table 1.1). Vodafone was one of the world's largest mobile phone companies and grew significantly when it acquired Air Touch in 1999. This largest deal was an unsolicited hostile bid by a British company of a German firm. The takeover shocked the German corporate world because it was the first time a large German company had been taken over by a foreign company—and especially in this case, as the foreign company was housed in Britain and the two countries had fought two world wars against each other earlier in the century. Mannesmann was a large company with over 100,000 employees and had been in existence for over 100 years. It was originally a company that made seamless tubes, but over the years had diversified into industries such as coal and steel. In its most recent history, it had invested heavily in the telecommunications industry. Thus, it was deeply engrained in the fabric of the German corporate world and economy.

It is ironic that Vodafone became more interested in Mannesmann after the latter took over British mobile phone operator Orange PLC. This came as a surprise to Vodafone, as Orange was Vodafone's rival, being the third-largest mobile operator in Great Britain. It was also a surprise as Vodafone assumed that Mannesmann would pursue alliances with Vodafone, not move into direct competition with it by acquiring one of its leading rivals.^a

Mannesmann tried to resist the Vodafone takeover, but the board ultimately agreed to the generous price paid. The Mannesmann board tried to get Vodafone

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to agree to maintain the Mannesmann name after the completion of the deal. It appeared that Vodafone would do so, but eventually they chose to go with the Vodafone name—something that made good sense in this age of globalization, as maintaining multiple names would inhibit common marketing efforts.

Up until the mid-1990s, Germany, like many European nations, had a limited market for corporate control. The country was characterized as having corporate governance institutions, which made hostile takeovers difficult to complete. However, a number of factors began to change, starting in the second half of the 1990s and continuing through the 2000s. First, the concentration of shares in the hands of parties such as banks, insurance companies, and governmental entities, which were reluctant to sell to hostile bidders, began to decline. In turn, the percentage of shares in the hands of more financially oriented parties, such as money managers, began to rise. Another factor that played a role in facilitating hostile deals is that banks had often played a defensive role for target management. They often held shares in the target and even maintained seats on the target's board and opposed hostile bidders while supporting management. One of the first signs of this change was apparent when WestLB bank supported Krupp in its takeover of Hoesch in 1991. In the case of Mannesmann, Deutsche Bank, which had been the company's bank since the late 1800s,^b had a representative on Mannesmann's board but he played no meaningful role in resisting Vodafone's bid. Other parties who often played a defensive role, such as representatives of labor, who often sit on boards based on what is known as codetermination policy, also played little role in this takeover.

The position of target shareholders is key in Germany, as antitakeover measures such as poison pills (to be discussed at length in Chapter 5) are not as effective due to Germany's corporate law and the European Union (EU) Takeover Directive, which requires equal treatment of all shareholders. However, German takeover law includes exceptions to the strict neutrality provisions of the Takeover Directive, which gives the target's board more flexibility in taking defensive measures.

It is ironic that Vodafone was able to take over Mannesmann, as the latter was much larger than Vodafone in terms of total employment and revenues. However, the market, which was at that time assigning unrealistic values to telecom companies, valued Mannesmann in 1999 at a price/book ratio of 10.2 (from 1.4 in 1992) while Vodafone had a price/book ratio of 125.5 in 1999 (up from 7.7 in 1992).^c This high valuation gave Vodafone "strong currency" with which to make a stock-for-stock bid that was difficult for Mannesmann to resist.

The takeover of Mannesmann was a shock to the German corporate world. Parties that were passive began to become more active in response to a popular outcry against any further takeover of German corporations. It was a key factor in steeling the German opposition to the EU Takeover Directive, which would have made such takeovers easier.

^a Simi Kidia, "Vodafone Air Touch's Bid for Mannesmann," Harvard Business School Case Study #9-201-096, August 22, 2003.

^b Martin Hopner and Gregory Jackson, "More In-Depth Discussion of the Mannesmann Takeover," *Max Planck Institut für Gesellschaftsforschung*, Cologne, Germany, January 2004.

^c Martin Hopner and Gregory Jackson, "Revisiting the Mannesmann Takeover: How Markets for Corporate Control Emerge," *European Management Review* 3 (2006): 142–155.

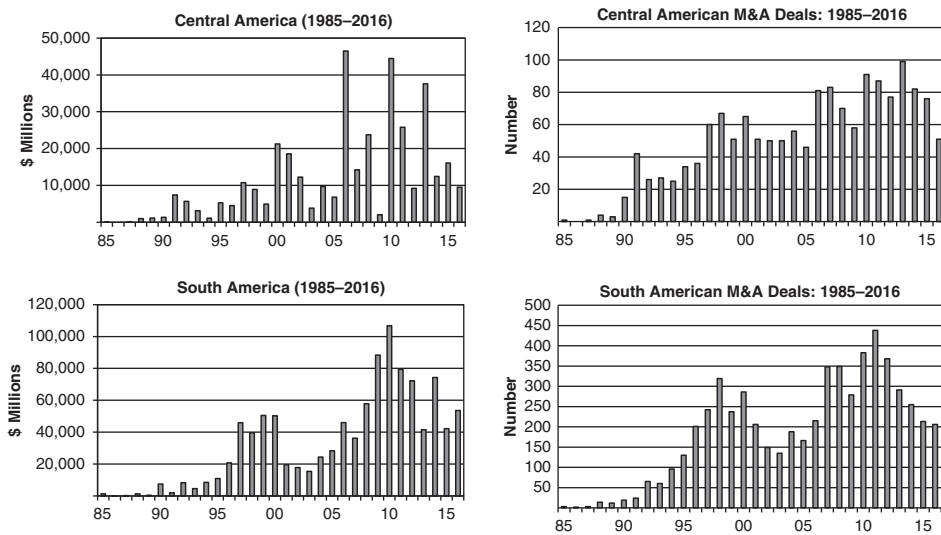


FIGURE 1.3 Central America and South America, 1985–2016. *Source:* Thomson Financial Securities Data, January 12, 2017.

The total volume of deals in South and Central America (see Figure 1.3 and Table 1.4) is small compared to the United States and Europe. South America has been relatively weak in recent years. Argentina has experienced years of economic problems and only now has a pro-business president, Mauricio Macri, who faces major challenges trying to undo the effects of years of poorly thought out economic policies. Brazil, once the powerhouse of South American M&A, has been rocked by a recessionary economy that has been badly hurt by falling commodity prices and political scandals.

In considering the combined Central America and Mexico market, the larger deals are attributable to Mexico. Mexico had been undergoing something of an economic resurgence with annual growth as high as 5.1% in 2010. This growth had been boosted by recent attempts to deregulate major industries, such as petroleum and telecommunications, while fostering greater competition. Factors such as falling commodity prices have slowed Mexican economic growth to a little over 2%. This has contributed to weak M&A volume in the combined Mexico/Central America region.

TERMINOLOGY

A merger differs from a consolidation, which is a business combination whereby two or more companies join to form an entirely new company. All of the combining companies are dissolved and only the new entity continues to operate. One classic example of a consolidation occurred in 1986 when the computer manufacturers Burroughs and Sperry combined to form Unisys. A more recent example of a consolidation occurred in 2014 when Kinder Morgan consolidated its large oil and gas empire. It had Kinder Morgan,

TABLE 1.4 Top 5 Central American M&A by Value of Transaction, Top 5 South American M&A by Value of Transaction

Top 5 Central American M&A by Value of Transaction					
Date Effective	Value of Transaction (\$mil)	Target Name	Target Nation	Acquirer Name	Acquirer Nation
01/19/07	31,756.677	America Telecom SA de CV	Mexico	America Movil SA de CV	Mexico
06/04/13	17,995.711	Crupo Modelo SAB de CV	Mexico	Anheuser-Busch Mexico Holding	Mexico
06/16/10	17,807.347	Carso Global Telecom SAB de CV	Mexico	America Movil SA de CV	Mexico
06/10/08	16,170.822	Telmex Internacional SAB de CV	Mexico	Shareholders	Mexico
02/07/01	15,098.655	America Movil SA	Mexico	Shareholders	Mexico
Top 5 South American M&A by Value of Transaction					
Date Effective	Value of Transaction (\$mil)	Target Name	Target Nation	Acquirer Name	Acquirer Nation
09/29/10	42,877.032	Brazil-Oil & Gas Blocks	Brazil	Petro Brasileiro SA	Brazil
06/24/99	13,151.700	YPF SA	Argentina	Repsol SA	Spain
05/08/08	10,309.087	Bovespa Holding SA	Brazil	BM&F	Brazil
07/10/00	10,213.310	Telecomunicacoes de Sao Paulo	Brazil	Telefonica SA	Spain
05/28/15	9,742.793	GVT Participacoes SA	Brazil	Telefonica Brasil SA	Brazil

Source: Thomson Financial Securities Data, January 12, 2017.

Inc., acquire Kinder Morgan Energy Part LP, Kinder Morgan Management LLC, and El Paso Pipeline Partners LP. The acquired entities were master limited partnerships that provided certain tax benefits but that limited the ability of the overall business to grow and do larger M&As.

In a consolidation, the original companies cease to exist and their stockholders become stockholders in the new company. One way to look at the differences between a merger and a consolidation is that with a merger, $A + B = A$, where company B is merged into company A. In a consolidation, $A + B = C$, where C is an entirely new company. Despite the differences between them, the terms *merger* and *consolidation*, as is true of many of the terms in the M&A field, are sometimes used interchangeably. In general, when the combining firms are approximately the same size, the term *consolidation* applies; when the two firms differ significantly in size, *merger* is the more appropriate term. In practice, however, this distinction is often blurred, with the term *merger* being broadly applied to combinations that involve firms of both different and similar sizes.

VALUING A TRANSACTION

Throughout this book, we cite various merger statistics on deal values. The method used by Mergerstat is the most common method relied on to value deals. Enterprise value is defined as the base equity price plus the value of the target's debt (including both short- and long-term) and preferred stock less its cash. The base equity price is the total price less the value of the debt. The buyer is defined as the company with the larger market capitalization or the company that is issuing shares to exchange for the other company's shares in a stock-for-stock transaction.

TYPES OF MERGERS

Mergers are often categorized as horizontal, vertical, or conglomerate. A horizontal merger occurs when two competitors combine. For example, in 1998, two petroleum companies, Exxon and Mobil, combined in a \$78.9 billion megamerger. Another example was the 2009 megamerger that occurred when Pfizer acquired Wyeth for \$68 billion. If a horizontal merger causes the combined firm to experience an increase in market power that will have anticompetitive effects, the merger may be opposed on antitrust grounds. In recent years, however, the U.S. government has been somewhat liberal in allowing many horizontal mergers to go unopposed. In Europe, the European Commission has traditionally been somewhat cautious when encountering mergers that may have anticompetitive effects or that may create strong competitors of European companies.

Vertical mergers are combinations of companies that have a buyer-seller relationship. A good example is the U.S. eyeglasses industry. One company, an Italian manufacturer, Luxottica, expanded into the U.S. market through a series of acquisitions. It was able to acquire retailers such as LensCrafters and Sunglasses Hut, as well as major brands such as Ray-Ban and Oakley. It is surprising to some that the company

was allowed by regulators to assume the large vertical position it enjoys in the U.S. eyeglasses market.¹ In 2017, Luxottica announced it planned to merge (pending global antitrust approval) with the French lens company Essilor, creating a \$49 billion company in terms of market value.

A conglomerate merger occurs when the companies are not competitors and do not have a buyer–seller relationship. One example was Philip Morris, a tobacco company, which acquired General Foods in 1985 for \$5.6 billion, Kraft in 1988 for \$13.44 billion, and Nabisco in 2000 for \$18.9 billion. Interestingly, Philip Morris, which later changed its name to Altria, had used the cash flows from its food and tobacco businesses to become less of a domestic tobacco company and more of a food business. This is because the U.S. tobacco industry has been declining, although the international tobacco business has not been experiencing such a decline. The company eventually concluded that the litigation problems of its U.S. tobacco unit, Philip Morris USA, were a drag on the stock price of the overall corporation and disassembled the conglomerate. The aforementioned megamergers by Philip Morris/Altria were later undone in a series of selloffs.

Another major example of a conglomerate is General Electric (GE). This company has done what many others have not been able to do successfully—manage a diverse portfolio of companies in a way that creates shareholder wealth (most of the time). GE is a serial acquirer, and a highly successful one at that. As we will discuss in Chapter 4, the track record of diversifying and conglomerate acquisitions is not good. We will explore why a few companies have been able to do this while many others have not.

In recent years the appearances of conglomerates have changed. We now have “new-economy” conglomerates, such as Alphabet, the parent company of Google, Amazon, and perhaps even Facebook. These companies grew from one main line of business that generated significant cash flows that enabled them to branch out into other fields through M&As. For example, Alphabet/Google controls Android, YouTube, and Waze. Facebook acquired Instagram, WhatsApp, and Oculus. Amazon acquired Zappos.com, Kiva Systems, Twitch, and in 2017, Whole Foods. These companies look different from the conglomerates of old but they also have many characteristics in common.

MERGER CONSIDERATION

Mergers may be paid for in several ways. Transactions may use all cash, all securities, or a combination of cash and securities. Securities transactions may use the stock of the acquirer as well as other securities, such as debentures. The stock may be either common stock or preferred stock. They may be registered, meaning they are able to be freely traded on organized exchanges, or they may be restricted, meaning they cannot be offered for public sale, although private transactions among a limited number of buyers, such as institutional investors, are permissible.

¹ Patrick A. Gaughan, *Maximizing Corporate Value through Mergers and Acquisitions: A Strategic Growth Guide* (Hoboken, NJ: John Wiley & Sons, 2013), 160–163.

If a bidder offers its stock in exchange for the target's shares, this offer may provide for either a fixed or floating exchange ratio. When the exchange ratio is floating, the bidder offers a dollar value of shares as opposed to a specific number of shares. The number of shares that is eventually purchased by the bidder is determined by dividing the value offered by the bidder's average stock price during a prespecified period. This period, called the *pricing period*, is usually some months after the deal is announced and before the closing of the transaction. The offer could also be defined in terms of a *collar*, which provides for a maximum and minimum number of shares within the floating value agreement.

Stock transactions may offer the seller certain tax benefits that cash transactions do not provide. However, securities transactions require the parties to agree on not only the value of the securities purchased but also the value of those that are used for payment. This may create some uncertainty and may give cash an advantage over securities transactions from the seller's point of view. For large deals, all-cash compensation may mean that the bidder has to incur debt, which may carry with it unwanted, adverse risk consequences.

Merger agreements can have fixed compensation or they can allow for variable payments to the target. It is common in deals between smaller companies, or when a larger company acquires a smaller target, that the payment includes a contingent component. Such payments may include an "earn out" where part of the payments is based on the performance of the target. A related concept is contingent value rights (CVRs). CVRs guarantee some future value based on the occurrence of some events such as a sales target. An example of their use was pharmaceutical firm Allergan's 2016 acquisition of Tobira Therapeutics, where Allergan paid \$28.35 for each share of Tobira but also gave CVRs that could equal up to \$49.84 based on certain regulatory and business achievements.

Sometimes merger agreements include a *holdback provision*. While alternatives vary, such provisions in the merger agreement provide for some of the compensation to be withheld based upon the occurrence of certain events. For example, the buyer may deposit some of the compensation in an escrow account. If litigation or other specific adverse events occur, the payments may be returned to the buyer. If the events do not occur, the payments are released to the selling shareholders after a specific time period.

MERGER PROFESSIONALS

When a company decides it wants to acquire or merge with another firm, it typically does so using the services of attorneys, accountants, and valuation experts. For smaller deals involving closely held companies, the selling firm may employ a business broker who may represent the seller in marketing the company. In larger deals involving publicly held companies, the sellers and the buyers may employ investment bankers. Investment bankers may provide a variety of services, including helping to select the appropriate target, valuing the target, advising on strategy, and raising the requisite financing to complete the transaction. Table 1.5 is a list of leading investment bankers and advisors.

TABLE 1.5 U.S. Financial Advisor Rankings, 2016

Rank	Legal Advisor	Total Deal Value (\$ Billions)	Total Number of Deals
1	Goldman Sachs & Co.	705.4	173
2	Morgan Stanley	603.7	142
3	Bank of America Merrill Lynch	597.0	118
4	JPMorgan Chase & Co	522.4	174
5	Citigroup	449.1	100
6	Credit Suisse	425.8	102
7	Barclays Plc	412.7	116
8	Evercore Partners Inc.	272.3	120
9	Lazard	258.2	97
10	Centerview Partners LLC	243.9	33

Source: Mergerstat Review, 2017.

Investment Bankers

The work that investment bankers do for clients is somewhat different, based on whether they are on the sell side or the buy side of a transaction. On the buy side, they can assist their clients in developing a proposal that, in turn, contemplates a specific deal structure. They may handle initial communications with the seller and/or its representatives. In addition, they do due diligence and valuation so that they have a good sense of what the market value of the business is. Investment bankers may have done some of this work in advance if they happened to bring the deal to the buyer.

On the sell side, investment bankers consult with the client and may develop an acquisition memorandum that may be distributed to qualified potential buyers. The banker screens potential buyers so as to deal only with those who both are truly interested and have the capability of completing a deal. Typically, those who qualify then have to sign a confidentiality agreement prior to gaining access to key financial information about the seller. We will discuss such agreements a little later in this chapter. Once the field has been narrowed, the administrative details have to be worked out for who has access to the “data room” so the potential buyers can conduct their due diligence.

The investment banker often will handle communications with buyers and their investment bankers as buyers formulate offers. The bankers work with the seller to evaluate these proposals and select the most advantageous one.

Legal M&A Advisors

Given the complex legal environment that surrounds M&As, attorneys also play a key role in a successful acquisition process. Law firms may be even more important in hostile takeovers than in friendly acquisitions because part of the resistance of the target may come through legal maneuvering. Detailed filings with the Securities and Exchange

TABLE 1.6 U.S. Top 10 Legal Advisors, 2016

Rank	Legal Advisor	Total Deal Value (\$ Billions)	Total Number of Deals
1	Sullivan & Cromwell LLP	619.0	116
2	Cravath Swaine & Moore LLP	489.0	63
3	Simpson Thacher & Bartlett LLP	419.4	104
4	Wachtell Lipton Rosen & Katz	417.6	72
5	Weil Gotshal & Manges LLP	386.0	154
6	Skadden, Arps, Slate, Meagher & Flom LLP	354.6	159
7	Davis Polk & Wardwell LLP	310.0	98
8	Jones Day LP	287.1	267
9	Kirkland & Ellis LLP	259.4	319
10	Latham & Watkins LLP	252.0	244

Source: Mergerstat Review, 2017.

Commission (SEC) may need to be completed under the guidance of legal experts. In both private and public M&As, there is a legal due diligence process that attorneys should be retained to perform. Table 1.6 shows the leading legal M&A advisors. Accountants also play an important role in M&As by conducting the accounting due diligence process. In addition, accountants perform various other functions, such as preparing pro forma financial statements based on scenarios put forward by management or other professionals. Still another group of professionals who provide important services in M&As are valuation experts. These individuals may be retained by either a bidder or a target to determine the value of a company. We will see in Chapter 14 that these values may vary, depending on the assumptions employed. Therefore, valuation experts may build a model that incorporates various assumptions, such as different revenue growth rates or costs, which may be eliminated after the deal. As these and other assumptions vary, the resulting value derived from the deal also may change.

AVIS: A VERY ACQUIRED COMPANY

Sometimes companies become targets of an M&A bid because the target seeks a company that is a good strategic fit. Other times the seller or its investment banker very effectively shops the company to buyers who did not necessarily have the target, or even a company like the target, in their plans. This is the history of the often-acquired rent-a-car company, Avis.

Avis was founded by Warren Avis in 1946. In 1962, the company was acquired by the M&A boutique investment bank Lazard Freres. Lazard then began a process where it sold and resold the company to multiple buyers. In 1965, it sold Avis to its

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conglomerate client ITT. When the conglomerate era came to an end, ITT sold Avis off to another conglomerate, Norton Simon. That company was then acquired by still another conglomerate, Esmark, which included different units, such as Swift & Co. Esmark was then taken over by Beatrice, which, in 1986, became a target of a leveraged buyout (LBO) by Kohlberg Kravis & Roberts (KKR).

KKR, burdened with LBO debt, then sold off Avis to Wesray, which was an investment firm that did some very successful private equity deals. Like the private equity firms of today, Wesray would acquire attractively priced targets and then sell them off for a profit—often shortly thereafter.

This deal was no exception. Wesray sold Avis to an employee stock ownership plan (ESOP) owned by the rent-a-car company's employees at a high profit just a little over a year after it took control of the company.

At one point, General Motors (GM) took a stake in the company: For a period of time, the major auto companies thought it was a good idea to vertically integrate by buying a car rental company. The combined employee-GM ownership lasted for about nine years until 1996, when the employees sold the company to HFS. Senior managers of Avis received in excess of \$1 million each while the average employee received just under \$30,000. One year later, HFS took Avis public. However, Cendant, a company that was formed with the merger of HFS and CUC, initially owned one-third of Avis. It later acquired the remaining two-thirds of the company. Avis was then a subsidiary within Cendant—part of the Avis Budget group, as Cendant also had acquired Budget Rent A Car. Cendant was a diversified company that owned many other subsidiaries, such as Century 21 Real Estate, Howard Johnson, Super 8 Motels, and Coldwell Banker. The market began to question the wisdom of having all of these separate entities within one corporate umbrella without any good synergistic reasons for their being together. In 2006, Cendant did what many diversified companies do when the market lowers its stock valuation and, in effect, it does not like the conglomerate structure—it broke the company up, in this case, into four units.

The Avis Budget Group began trading on the New York Stock Exchange in 2006 as CAR. Avis's curious life as a company that has been regularly bought and sold underscores the great ability of investment bankers to sell the company and thereby generate fees for their services. However, despite its continuous changing of owners, the company still thrives in the marketplace.

MERGER ARBITRAGE

Another group of professionals who can play an important role in takeovers is arbitrageurs. Generally, *arbitrage* refers to the buying of an asset in one market and selling it in another. Risk arbitrageurs look for price discrepancies between different markets for the same assets and seek to sell in the higher-priced market and buy in the lower one. Practitioners of these kinds of transactions try to do them simultaneously, thus locking in their gains without risk. With respect to M&A, arbitrageurs purchase stock of companies that may be taken over in the hope of getting a takeover premium when the

deal closes. This is referred to as *risk arbitrage*, as purchasers of shares of targets cannot be certain the deal will be completed. They have evaluated the probability of completion and pursue deals with a sufficiently high probability.

The merger arbitrage business is fraught with risks. When markets turn down and the economy slows, deals are often canceled. This occurred in the late 1980s, when the stock market crashed in 1987 and the junk bond market declined dramatically. The junk bond market was the fuel for many of the debt-laden deals of that period. In addition, when merger waves end, deal volume dries up, lowering the total business available. It occurred again in 2007–2009, when the subprime crisis reduced credit availability to finance deals and also made bidders reconsider the prices they offered for target shares.

In general, the arbitrage business has expanded over the past decade. Several active funds specialize in merger arbitrage. These funds may bet on many deals at the same time. They usually purchase the shares after a public announcement of the offer has been made. Under certain market conditions, shares in these funds can be an attractive investment because their returns may not be as closely correlated with the market as other investments. In market downturns, however, the risk profile of these investments can rise.

We will return to the discussion of merger arbitrage in Chapter 6.

LEVERAGED BUYOUTS AND THE PRIVATE EQUITY MARKET

In a leveraged buyout (LBO), a buyer uses debt to finance the acquisition of a company. The term is usually reserved, however, for acquisition of public companies where the acquired company becomes private. This is referred to as *going private* because all of the public equity is purchased, usually by a small group or a single buyer, and the company's shares are no longer traded in securities markets. One version of an LBO is a *management buyout*. In a management buyout, the buyer of a company, or a division of a company, is the manager of the entity.

Most LBOs are buyouts of small and medium-sized companies or divisions of large companies. However, what was then the largest transaction of all time, the 1989 \$25.1 billion LBO of RJR Nabisco by Kohlberg Kravis & Roberts, shook the financial world. The leveraged buyout business declined after the fourth merger wave but rebounded in the fifth wave and then reached new highs in the 2000s (Figure 1.4). While LBOs were mainly a U.S. phenomenon in the 1980s, they became international in the 1990s and have remained that way since.

LBOs utilize a significant amount of debt along with an equity investment. Often this equity investment comes from investment pools created by private equity firms. These firms solicit investments from institutional investors. The monies are used to acquire equity positions in various companies. Sometimes these private equity buyers acquire entire companies while in other instances they take equity positions in companies. The private equity business grew significantly between 2003 and 2007; however, when the global economy entered a recession in 2008 the business slowed markedly

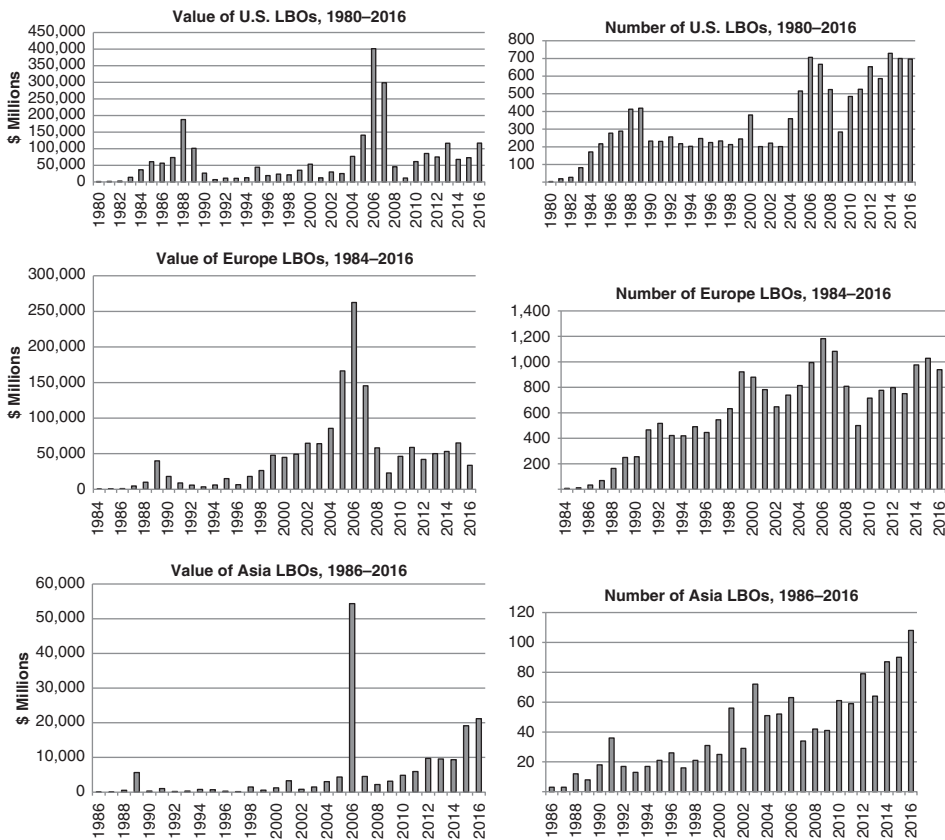


FIGURE 1.4 The value of worldwide leveraged buyouts, 1980–2016. *Source:* Thomson Financial Securities Data, January 12, 2017.

for some time but rebounded strongly in the years 2013–2017. We will discuss this further in Chapter 9.

CORPORATE RESTRUCTURING

The term *corporate restructuring* usually refers to asset sell-offs, such as divestitures. Companies that have acquired other firms or have developed other divisions through activities such as product extensions may decide that these divisions no longer fit into the company's plans. The desire to sell parts of a company may come from poor performance of a division, financial exigency, or a change in the strategic orientation of the company. For example, the company may decide to refocus on its core business and sell off non-core subsidiaries. This type of activity increased after the end of the third merger wave as many companies that engaged in diverse acquisition campaigns to build conglomerates began to question the advisability of these combinations. There are several forms

of corporate sell-offs, with divestitures being only one kind. Spin and equity carve-outs are other ways that sell-offs can be accomplished. The relative benefits of each of these alternative means of selling off part of a company are discussed in Chapter 11.

MERGER NEGOTIATIONS

Most M&As are negotiated in a friendly environment. For buyer-initiated takeovers, the process usually begins when the management of one firm contacts the target company's management, often through the investment bankers of each company. For seller-initiated deals, the seller may hire an investment banker, who will contact prospective bidders. If the potential bidders sign a confidentiality agreement and agree to not make an unsolicited bid, they may receive nonpublic information. The seller and its investment banker may conduct an auction or may choose to negotiate with just one bidder to reach an agreeable price. Auctions can be constructed more formally, with specific bidding rules established by the seller, or they can be less formal.

The management of both the buyer and seller keep their respective boards of directors up to date on the progress of the negotiations because mergers usually require the boards' approval. Sometimes this process works smoothly and leads to a quick merger agreement. A good example of this was the 2009 \$68 billion acquisition of Wyeth Corp. by Pfizer. In spite of the size of this deal, there was a quick meeting of the minds by management of these two firms, and a friendly deal was agreed to relatively quickly. However, in some circumstances, a quick deal may not be the best. AT&T's \$48 billion acquisition of TCI is an example of a friendly deal, where the buyer did not do its homework and the seller did a good job of accommodating the buyer's (AT&T's) desire to do a quick deal at a higher price. Speed may help ward off unwanted bidders, but it may work against a close scrutiny of the transaction.

Sometimes friendly negotiations may break down, leading to the termination of the bid or a hostile takeover. An example of a negotiated deal that failed and led to a hostile bid was the tender offer by Moore Corporation for Wallace Computer Services, Inc. Here, negotiations between two archrivals in the business forms and printing business proceeded for five months before they were called off, leading to a \$1.3 billion hostile bid. In 2003, Moore reached agreement to acquire Wallace and form Moore Wallace. One year later, Moore Wallace merged with RR Donnelley.

In other instances, the target opposes the bid right away and the transaction quickly becomes a hostile one. One classic example of a very hostile bid was the 2004 takeover battle between Oracle and PeopleSoft. This takeover contest was unusual due to its protracted length. The battle went on for approximately a year before PeopleSoft finally capitulated and accepted a higher Oracle bid.

Most merger agreements include a *material adverse change* clause. This clause may allow either party to withdraw from the deal if a major change in circumstances arises that would alter the value of the deal. This occurred in 2017 when Verizon and Yahoo! both agreed to reduce the price paid for Yahoo!'s Internet business by \$350 million, down to \$4.48 billion, as a result of the data breaches at Yahoo!

Auctions versus Private Negotiations

Many believe that auctions may result in higher takeover premiums. Boone and Mulherin analyzed the takeover process related to 377 completed and 23 withdrawn acquisitions that occurred in the 1990s.² Regarding the auctions in their sample, they found that, on average, 21 bidders were contacted and 7 eventually signed confidentiality and standstill agreements. In contrast, the private negotiated deals featured the seller dealing with a single bidder.

Boone and Mulherin found that more than half of deals involved auctions; the belief in the beneficial effects of auctions raised the question of why all deals are not made through auctions. One explanation may be agency costs. Boone and Mulherin analyzed this issue using an event study methodology, which compared the wealth effects to targets of auctions and negotiated transactions. Somewhat surprisingly, they failed to find support for the agency theory. Their results failed to show much difference in the shareholder wealth effects of auctions compared to privately negotiated transactions. This result has important policy implications as there has been some vocal pressure to require mandated auctions. The Boone and Mulherin results imply that this pressure may be misplaced.

Confidentiality Agreements

When two companies engage in negotiations, the buyer often wants access to nonpublic information from the target, which may serve as the basis for an offer acceptable to the target. A typical agreement requires that the buyer, the recipient of the confidential information, not use the information for any purposes other than the friendly deal at issue. This excludes any other uses, including making a hostile bid. While these agreements are negotiable, their terms often are fairly standard.

Confidentiality agreements, sometimes also referred to as nondisclosure agreements (NDAs), define the responsibilities of *recipients* and *providers* of confidential information. They usually cover not just information about the operations of the target, including intellectual property like trade secrets, but also information about the deal itself. The latter is important in instances where the target does not want the world to know it is secretly shopping itself.

NDAs often include a standstill agreement, which limits actions the bidder can take, such as purchases of the target's shares. Standstill agreements often cover a period such as a year or more. We discuss them further in Chapter 5. However, it is useful to merely point out now that these agreements usually set a stock purchase ceiling below 5%, as purchases beyond that level may require a Schedule 13D disclosure (discussed in Chapter 3), which may serve to put the company in play.

In cases where there is a potential merger between horizontal competitors, the parties may also sign a joint defense agreement (JDA) that governs how confidential information will be handled after a possible merger agreement but where there is opposition by antitrust or other regulatory authorities.

² Audra L. Boone and J. Harold Mulherin, "How Are Firms Sold?" *Journal of Finance* 62, no. 20 (April 2007): 847–875.

Initial Agreement

When the parties have reached the stage where there are clear terms upon which the buyer is prepared to make an offer that it thinks the seller may accept, the buyer prepares a *term sheet*. This is a document that the buyer usually controls but that the seller may have input into. It may not be binding, but it is prepared so that the major terms of the deal are set forth in writing, thus reducing uncertainty as to the main aspects of the deal. The sale process involves investing significant time and monetary expenses, and the term sheet helps reduce the likelihood that parties will incur such expenses and be surprised that there was not prior agreement on what each thought were the major terms of the deal. At this point in the process, a great deal of due diligence work has to be done before a final agreement is reached. When the seller is conducting an auction for the firm, it may prepare a term sheet that can be circulated to potential buyers so they know what is needed to close the deal.

While the contents will vary, the typical term sheet identifies the buyer and seller, the purchase price, and the factors that may cause that price to vary prior to closing (such as changes in the target's financial performance). It will also indicate the consideration the buyer will use (i.e., cash or stock), as well as who pays what expenses. While many other elements could be added based on the unique circumstances of the deal, the term sheet should also include the major representations and warranties the parties are making.

Letter of Intent

The term sheet may be followed by a more detailed *letter of intent* (LOI). This letter delineates more of the detailed terms of the agreement. It may or may not be binding on the parties. LOIs vary in their detail. Some specify the purchase price while others may only define a range or formula. It may also define various closing conditions, such as providing for the acquirer to have access to various records of the target. Other conditions, such as employment agreements for key employees, may also be noted. However, many merger partners enter into a merger agreement right away. An LOI is something less than that, and it may reflect one of the parties not necessarily being prepared to enter into a formal merger agreement. For example, a private equity firm might sign an LOI when it does not yet have firm deal financing. This could alert investors, such as arbitrageurs, that the deal may possibly never be completed.

Given the nonbinding nature of many LOIs, one may wonder what their real purpose is. However, they can help set forth some initial major deal parameters such as price. They also can be used to establish the seriousness of the merger partners before lenders. The LOI may also contain an exclusivity provision which may limit the seller's ability to shop the target. This latter benefit will be subject to Revlon Duties—an issue that will be explored in Chapters 3 and 5.

The due diligence process varies greatly from deal-to-deal. It is a process that involves the extensive use of accounting, legal, and valuation consultants. It is so extensive that it is worthy of a book of its own; thus we will not go further into the process here.

Disclosure of Merger Negotiations

Before 1988, it was not clear what obligations U.S. companies involved in merger negotiations had to disclose their activities. However, in 1988, in the landmark *Basic v. Levinson* decision, the U.S. Supreme Court made it clear that a denial that negotiations are taking place, when the opposite is the case, is improper.³ Companies may not deceive the market by disseminating inaccurate or deceptive information, even when the discussions are preliminary and do not show much promise of coming to fruition. The Court's decision reversed earlier positions that had treated proposals or negotiations as being immaterial. The *Basic v. Levinson* decision does not go so far as to require companies to disclose all plans or internal proposals involving acquisitions. Negotiations between two potential merger partners, however, may not be denied. The exact timing of the disclosure is still not clear. Given the requirement to disclose, a company's hand may be forced by the pressure of market speculation. It is often difficult to confidentially continue such negotiations and planning for any length of time. Rather than let the information slowly leak, the company has an obligation to conduct an orderly disclosure once it is clear that confidentiality may be at risk or that prior statements the company has made are no longer accurate. In cases in which there is speculation that a takeover is being planned, significant market movements in stock prices of the companies involved—particularly the target—may occur. Such market movements may give rise to an inquiry from the exchange on which the company trades. Although exchanges have come under criticism for being somewhat lax about enforcing these types of rules, an insufficient response from the companies involved may give rise to disciplinary actions against the companies.

DEAL STRUCTURE: ASSET VERSUS ENTITY DEALS

The choice of doing an asset deal as opposed to a whole entity deal usually has to do with how much of the target is being sold. If the deal is for only part of the target's business, then usually an asset deal works best.

Asset Deals

One of the advantages for the acquirer of an asset deal is that the buyer does not have to accept all of the target's liabilities. This is the subject of negotiation between the parties. The seller will want the buyer to accept more liabilities while the buyer wants fewer liabilities. The benefit of limiting liability exposure is one reason a buyer may prefer an asset deal. Another benefit of an asset acquisition is that the buyer can pick and choose which assets it wants and not have to pay for assets that it is not interested in. All the assets acquired and liabilities incurred are listed in the *asset purchase agreement*.

³ *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). The U.S. Supreme Court revisited this case in 2014 and addressed the case's reliance on the efficiency of markets in processing information. The Court declined to reverse *Basic* on this issue.

Still other benefits of an asset deal are potential tax benefits. The buyer may be able to realize *asset basis step-up*. This can come from the buyer raising the value of the acquired assets to fair market value as opposed to the values they may have been carried at on the seller's balance sheet. Through such an increase in value the buyer can enjoy more depreciation in the future, which, in turn, may lower its taxable income and taxes paid.

Sellers may prefer a whole entity deal. In an asset deal, the seller may be left with assets it does not want. This is particularly true when the seller is selling most of its assets. Here, they are left with liabilities that they would prefer getting rid of. In addition, the seller may possibly get hit with negative tax consequences due to potential taxes on the sale of the assets and then taxes on a distribution to the owners of the entity. Exceptions could be entities that are 80% owned subsidiaries, pass-through entities, or businesses that are LLPs or LLCs. Tax issues are very important in M&As. This is why much legal work is done in M&As not only by transactional lawyers but also by tax lawyers. Attorneys who are M&A tax specialists can be very important in doing deals, and this is a subspecialty of the law separate from transactional M&A law.

There are still more drawbacks to asset deals, in that the seller may have to secure *third-party consents* to the sale of the assets. This may be necessary if there are clauses in the financing agreements the target used to acquire the assets. It also could be the case if the seller has many contracts with *nonassignment* or *nontransfer clauses* associated with them. In order to do an asset deal, the target needs to get approval from the relevant parties. The more of them there are, the more complicated the deal becomes. When these complications are significant, an asset deal becomes less practical, and if a deal is to be done, it may have to be an entity transaction.

Entity Deals

There are two ways to do an entity deal—a stock transaction or a merger. When the target has a limited number of shareholders, it may be practical to do a stock deal, as securing approval of the sale by the target's shareholders may not be that difficult. The fewer the number of shareholders, the more practical this may be. However, when dealing with a large public company with a large and widely distributed shareholder base, a merger is often the way to go.

Stock Entity Deals

In a stock entity deal, deals that are more common involving closely held companies, the buyer does not have to buy the assets and send the consideration to the target corporation as it would have done in an asset deal. Instead, the consideration is sent directly to the target's shareholders, who sell all their shares to the buyer. One of the advantages of a stock deal is that there are no *conveyance issues*, such as what there might have been with an asset deal, where there may have been the aforementioned contractual restrictions on transfer of assets. With a stock deal, the assets stay with the entity and remain at the target, as opposed to the acquirer's level.

One other benefit that a stock deal has over a merger is that there are no *appraisal rights* with a stock deal. In a merger, shareholders who do not approve of the deal may

want to go to court to pursue their appraisal rights and seek the difference between the value they received for their shares in the merger and what they believe is the true value of the shares. In recent years, the volume of appraisal litigation in Delaware has risen. This is, in part, due to the position the Delaware court has taken regarding the wide latitude it has in determining what a “fair value” is.⁴ We will discuss appraisal litigation later in this chapter.

One of the disadvantages of an entity deal is that the buyer may have to assume certain liabilities it may not want to have. One way a buyer can do a stock deal and not have to incur the potential adverse exposure to certain target liabilities it does not want is to have the seller indemnify it against this exposure. Here, the buyer accepts the unwanted liabilities but gets the benefit of the seller’s indemnification against this exposure. However, if the buyer has concerns about the long-term financial ability of the target to truly back up this indemnification, then it may pass on the stock deal.

Another disadvantage of a stock-entity deal is that the target shareholders have to approve the deal. If some of them oppose the deal, it cannot be completed. When this is the case, then the companies have to pursue a merger. When the target is a large public corporation with many shareholders, this is the way to go.

Merger Entity Deals

Mergers, which are more common for publicly held companies, are partly a function of the relevant state laws, which can vary from state-to-state. Fortunately, as we will discuss in Chapter 3, more U.S. public corporations are incorporated in Delaware than any other state, so we can discuss legal issues with Delaware law in mind. However, there are many similarities between Delaware corporation laws and those of other states.

In merger laws, certain terminology is commonly encountered. *Constituent corporations* are the two companies doing the deal. In a merger, one company survives, called the *survivor*, and the other ceases to exist.

In a merger, the surviving corporation succeeds to all of the liabilities of the nonsurviving company. If this is a concern to the buyer, then a simple merger structure is not the way to go. If there are assets that are unwanted by the buyer, then these can be spun out or sold off before the merger is completed.

In a merger, the voting approval of the shareholders is needed. In Delaware the approval of a *majority* of the shareholders is required. This percentage can vary across states, and there can be cases where a corporation has enacted supermajority provisions in its bylaws. Shareholders who do not approve the deal can go to court to pursue their appraisal rights.

Forward Merger

The basic form of a merger is a *forward merger*, which is sometimes also called a *statutory merger*. Here the target merges directly into the purchaser corporation, and then the target disappears while the purchaser survives. The target shares are exchanged for cash

⁴ *Huff Fund Investment Partnership v. CKX, Inc.*, C.A. No. 6844-VCG (Del Ch. Nov. 1, 2013).

or a combination of cash and securities. The purchaser assumes the target's liabilities, which is a drawback of this structure. However, given the assumption of these liabilities, there are usually no conveyance issues. Another drawback is that Delaware law treats forward mergers as though they were asset sales, so if the target has many contracts with third-party consents or nonassignment clauses, this may not be an advantageous route for the parties. Given the position of Delaware law on forward mergers, these deals look a lot like assets deals that are followed by a liquidation of the target, because the assets of the target move from the target to the buyer and the target disappears while the deal consideration ends up with the target's shareholders.

A big negative of a basic forward merger is that the voting approval of the shareholders of both companies is needed. This can add an element of uncertainty to the deal. Another drawback is that the buyer directly assumes all of the target's liabilities, thereby exposing the buyer's assets to the target's liabilities. It is for these reasons that this deal structure is not that common. The solution is for the buyer to "drop down" a subsidiary and do a *subsidiary deal*. There are two types of subsidiary mergers—forward and reverse.

Forward Subsidiary Merger

This type of deal is sometimes called a forward triangular merger, given the structure shape shown in Figure 1.5. Instead of the target merging directly into the purchaser, the purchaser creates a merger subsidiary and the target merges directly into the subsidiary. There are a number of advantages of this structure. First, there is no automatic vote required to approve the deal. In addition, the purchaser is not exposing its assets to the liabilities of the target. In this way, the main purchaser corporation is insulated from this potential exposure.

As with much of finance, there are exceptions to the approval benefit. If the buyer issues 20% or more of its stock to finance the deal, the New York Stock Exchange and NASDAQ require approval of the purchaser's shareholders. There could also be concerns about litigants piercing the corporate veil and going directly after the purchaser corporation's assets.

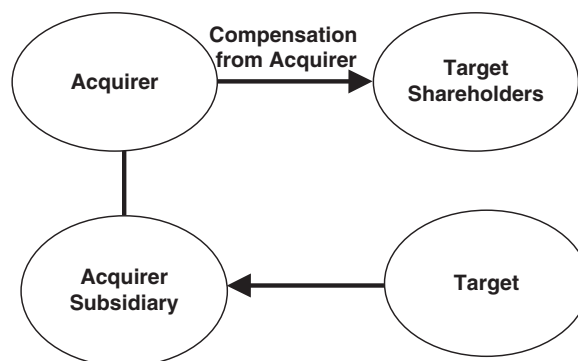


FIGURE 1.5 Forward triangular merger.

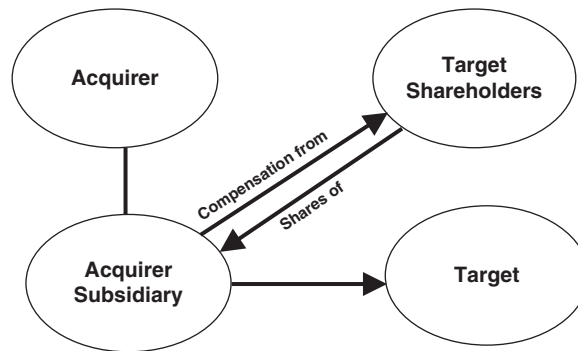


FIGURE 1.6 Reverse triangular merger.

Reverse Subsidiary Merger

Reverse subsidiary mergers, also called reverse triangular mergers (see Figure 1.6), improve upon the forward subsidiary merger by reversing the direction of the merger. The acquirer subsidiary pays the target's shareholders and receives the shares in the target in exchange. Here, the subsidiary formed for the purposes of the deal merges directly into the target. The target corporation survives, and the subsidiary goes out of existence.

There are key advantages of this structure. One is that the assets of the target do not move anywhere. Therefore, there should be no problems with nonassignment or nonassignability clauses.

MERGER AGREEMENT

Once the due diligence process has been completed, the law firms representing the parties prepare a detailed merger agreement. It is usually initiated by the buyer's law firm and is the subject of much back-and-forth negotiation. This document is usually long and complex—especially in billion-dollar deals involving public companies. However, some of the key components are sections that define the purchase price and consideration to be used. The agreement also includes all representations and warranties, what is expected of the seller and buyer prior to closing, the details of the closing (i.e., location and date), and what could cause a termination of the agreement. If the buyer incurs a penalty if it terminates, those termination fees are defined. Attached to the merger agreement is a whole host of supporting documents. These may include copies of resolutions by the seller's board of directors approving the deal as well as many other documents that are far too numerous to be listed here.

As noted earlier, the merger agreement may contain a material adverse event (MAE) or change clause that may allow the buyer to back out upon the occurrence of certain adverse events. Usually, if the buyer opts out based on this clause, protracted litigation may ensue.

MERGER APPROVAL PROCEDURES

In the United States, each state has a statute that authorizes M&As of corporations. The rules may be different for domestic and foreign corporations. Once the board of directors of each company reaches an agreement, it adopts a resolution approving the deal. This resolution should include the names of the companies involved in the deal and the name of the new company. The resolution should include the financial terms of the deal and other relevant information, such as the method that is to be used to convert securities of each company into securities of the surviving corporation. If there are any changes in the articles of incorporation, these should be referenced in the resolution.

For the target company, this is the point in the deal process at which it is taken to the shareholders for approval. In deals where the bidder is financing the offer using 20% or more of its own stock, NYSE, AMEX, and NASDAQ rules require shareholder approval. Recent research shows that when bidders issue as much as 20% or more of their shares to acquire the target, they experience a 4.3% increase in their announcement returns.⁵ Presumably, this may be related to greater expected synergies and a lower likelihood of overpayment. The researchers found this effect was concentrated among acquirers with greater institutional ownership—investors who are in a better position to evaluate the deal.

Friendly deals that are a product of a free negotiation process between the management of the two companies are typically approved by shareholders. Following shareholders' approval, the merger plan must be submitted to the relevant state official, usually the secretary of state. The document that contains this plan is called the *articles for merger* or consolidation. Once the state official determines that the proper documentation has been received, it issues a certificate of merger or consolidation. SEC rules require a proxy solicitation to be accompanied by a Schedule 14A. Item 14 of this schedule sets forth the specific information that must be included in a proxy statement when there will be a vote for an approval of a merger, sale of substantial assets, or liquidation or dissolution of the corporation. For a merger, this information must include the terms and reasons for the transaction as well as a description of the accounting treatment and tax consequences of the deal. Financial statements and a statement regarding relevant state and federal regulatory compliance are required. Fairness opinions and other related documents must also be included. Following completion of a deal, the target/registrant must file a Form 15 with the SEC terminating the public registration of its securities.

Special Committees of the Board of Directors

The board of directors may choose to form a special committee of the board to evaluate the merger proposal. Directors who might personally benefit from the merger, such as when the buyout proposal contains provisions that management directors may potentially profit from the deal, should not be members of this committee. The more complex

⁵ Kai Li, Tingting Liu, and Juan (Julie) Wu, "Shareholder Approval in Mergers and Acquisitions," paper presented at the American Finance Association Annual Meetings, 2017.

the transaction, the more likely it is that a committee will be appointed. This committee should seek legal counsel to guide it on legal issues, such as the fairness of the transaction, the business judgment rule, and numerous other legal issues. The committee, and the board in general, needs to make sure that it carefully considers all relevant aspects of the transaction. A court may later scrutinize the decision-making process, such as what occurred in the *Smith v. Van Gorkom* case (see Chapter 15).⁶ In that case the court found the directors personally liable because it thought that the decision-making process was inadequate, even though the decision itself was apparently a good one for shareholders.

Fairness Opinions

It is common for the board to retain an outside valuation firm, such as an investment bank or a firm that specializes in valuations, to evaluate the transaction's terms and price. This firm may then render a fairness opinion, in which it may state that the offer is in a range that it determines to be accurate. This became even more important after the *Smith v. Van Gorkom* decision, which places directors under greater scrutiny. Directors who rely on fairness opinions from an expert are protected under Delaware law from personal liability.⁷ In an acquisition, the fairness opinion focuses on the financial fairness of the consideration paid by the buyer to the seller. In connection with a divestiture, the fairness opinion focuses on the fairness to the corporation as opposed to the stockholders of the company. Only if the shareholders directly receive the buyer's consideration will the fairness opinion focus on fairness to the holders of the seller's shares.

A fairness opinion could focus on fairness to the buyer in light of the amount it is paying. Like all valuations, fairness opinions are specific to a valuation date, and the issuers of such opinions generally disclaim any responsibility to update them with the passage of time and the occurrence of other relevant events.⁸

It is important to note that fairness opinions tend to have a narrow financial focus and usually do not try to address the strategic merits of a given transaction. Writers of such opinions also try to avoid making recommendations to shareholders on how they should vote on the transactions. They also avoid consideration of many relevant aspects of a deal, such as lockup provisions, no-shop provisions, termination fees, and financing arrangements.

The cost of fairness opinions can vary, but it tends to be lower for smaller deals compared to larger ones. For deals valued under \$5 billion, for example, the cost of a fairness opinion might be in the \$500,000 range. For larger deals, however, costs can easily be several million dollars. The actual opinion itself may be somewhat terse and usually features a limited discussion of the underlying financial analysis. As part of the opinion that is rendered, the evaluator should state what was investigated and verified and what was not. The fees received and any potential conflicts of interest should also be revealed.

⁶ *Smith v. Van Gorkom*, 488 A.2d 858, 3 EXC 112 (Del. 1985).

⁷ Delaware General Corporation Law Section 141(e).

⁸ *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, C.A. No. 961-CS (Del. Ch. Oct 14, 2011).

Voting Approval

Upon reaching agreeable terms and receiving board approval, the deal is taken before the shareholders for their approval, which is granted through a vote. For example, in 2016, 99% of Monsanto's shareholders who voted, representing 75% of all shares outstanding, approved the \$66 billion merger of the company with Bayer.⁹

The exact percentage necessary for stockholder approval depends on the articles of incorporation, which, in turn, are regulated by the prevailing state corporation laws. Following approval, each firm files the necessary documents with the state authorities in which each firm is incorporated. Once this step is completed and the compensation has changed hands, the deal is completed.

DEAL CLOSING

The closing of a merger or acquisition often takes place well after the agreement has been reached. This is because many conditions have to be fulfilled prior to the eventual closing. Among them may be the formal approval by shareholders. In addition, the parties may also need to secure regulatory approvals from governmental authorities, such as the Justice Department or Federal Trade Commission as well as regulators in other nations in the case of global firms. In many cases, the final purchase price will be adjusted according to the formula specified in the agreement.

SHORT-FORM MERGER

A short-form merger may take place in situations in which the stockholder approval process is not necessary. Stockholder approval may be bypassed when the corporation's stock is concentrated in the hands of a small group, such as management, which is advocating the merger. Some state laws may allow this group to approve the transaction on its own without soliciting the approval of the other stockholders. The board of directors simply approves the merger by a resolution.

A short-form merger may occur only when the stockholdings of insiders are beyond a certain threshold stipulated in the prevailing state corporation laws. This percentage varies, depending on the state in which the company is incorporated. Under Delaware law, the short-form merger percentage is 90%. This is the relevant percentage for most states although a few, such as Alabama, Florida, and Montana, have an 80% threshold.

A short-term merger may follow a tender offer as a second-step transaction, where shareholders who did not tender their shares to a bidder who acquired substantially all of the target's shares may be frozen out of their positions.

⁹ "Monsanto Shareowners Approve Merger with Bayer," Monsanto Newsroom Release, December 13, 2016.

FREEZEOUTS AND THE TREATMENT OF MINORITY SHAREHOLDERS

Typically, a majority of shareholders must provide their approval before a merger can be completed. A 51% margin is a common majority threshold. When this majority approves the deal, minority shareholders are required to tender their shares to the controlling shareholder, even though they may not have voted in favor of the deal. Minority shareholders are said to be frozen out of their positions. This majority approval requirement is designed to prevent a holdout problem, which may occur when a minority attempts to hold up the completion of a transaction unless they receive compensation over and above the acquisition stock price. This is not to say that dissenting shareholders are without rights. Those shareholders who believe that their shares are worth significantly more than what the terms of the merger are offering may go to court to pursue their shareholder appraisal rights. To successfully pursue these rights, dissenting shareholders must follow the proper procedures. Paramount among these procedures is the requirement that the dissenting shareholders object to the deal within the designated period of time. Then they may demand a cash settlement for the difference between the “fair value” of their shares and the compensation they actually received. Of course, corporations resist these maneuvers because the payment of cash for the value of shares will raise problems relating to the positions of other stockholders. Such suits are difficult for dissenting shareholders to win. Dissenting shareholders may file a suit only if the corporation does not file suit to have the fair value of the shares determined, after having been notified of the dissenting shareholders’ objections. If there is a suit, the court may appoint an appraiser to assist in the determination of the fair value.

Freezeouts can occur following tender offers as well as controlling shareholder closeouts in going private transactions. Prior to the 2001 *Siliconix* decision, all freezeout bids in Delaware were subject to the demanding “entire fairness” standard governing such transactions.¹⁰ In *Siliconix*, the Delaware Chancery Court decided that freezeouts in tender offers would not be subject to this standard. Subramanian analyzed a database of freezeouts in the years immediately following the *Siliconix* decision and found out that controlling shareholders paid less to minority shareholders in tender offers than they did in mergers.¹¹

Following an M&A, it is not unusual that months after the deal, as many as 10% to 20% of shareholders still have not exchanged their frozen-out shares for compensation. For a fee, companies, such as Georgeson Securities Corporation, offer services paid by the shareholders where they locate the shareholders and seek to have them exchange their shares.

¹⁰ *In Re Siliconix, Inc. Shareholder’s Litigation*, 2001 WL 716787 (Del Ch. 2001)

¹¹ Guhan Subramanian, “Post-Siliconix Freeze-outs: Theory, Evidence and Policy,” *Journal of Legal Studies* 36, no. 1 (2007): 1–26.

APPRAISAL ARBITRAGE

We have noted that shareholders who do not want to exchange their shares for the offered consideration can go to court (and this usually means Delaware Chancery Court) to pursue their appraisal rights. Here, the dissenting shareholders ask a court to judicially determine the value of their shares and to order that they be paid this value in cash. These dissenting shareholders have 120 days to file suit. Essentially, the potential appraisal payments are a post-closing obligation of the buyer. Certain hedge funds have pursued this appraisal process as an investment strategy—appraisal arbitrage.

The legal appraisal system allows hedge funds that own shares to pursue their alleged higher value in court and ultimately get their higher appraised value or accrued interest on the original deal price less appraisal costs. The plaintiffs in these matters forgo the payment by the bidder while they seek a higher appraised value. The law then allows them to receive interest on the amount they are ultimately awarded.

The interest rate is set at 5% above the Federal Reserve's discount rate, which can be attractive in a low interest rate environment such as what prevailed in the post-subprime crisis years. Hedge funds are also allowed to purchase shares in the market after the deal announcement date, and also after the record date for voting on the offer, and up to the effective date of the deal. This is a very controversial issue, but it has not yet been corrected in Delaware law. In addition, it is rare for courts to determine a value less than the offer price, so it is likely that those seeking appraisal rights will get the offer price or more and then also interest on what they receive—hence the term *appraisal arbitrage*. The fact that the appraised values determined by the court are usually at least equal to the deal price is somewhat surprising, in light of the fact that the Appraisal Statute (Section 262) states that the value should be one that is derived from stock prices prior to the deal announcement and, therefore, theoretically might not include any additional premium reflecting synergies.

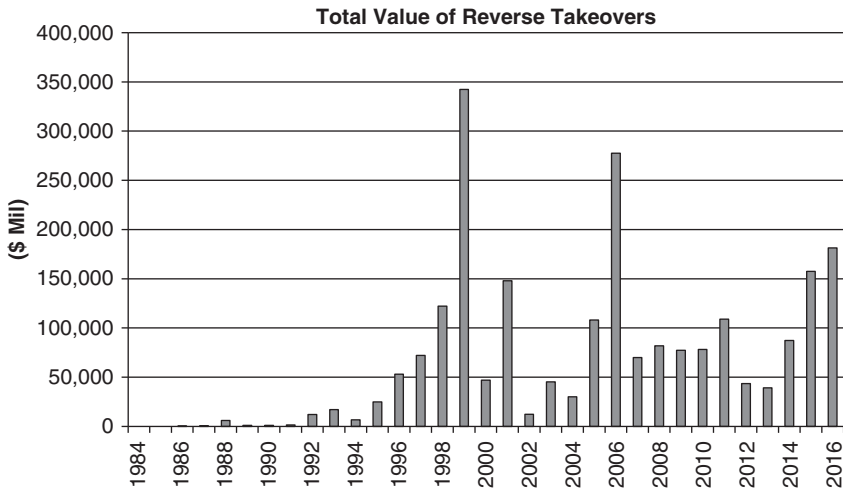
In recent years, the Delaware legislature has tried to rein in the abuses on appraisal arbitrage by the *de minimis* exception, which barred small claims by requiring those who want to seek appraisal rights to own more than 1% of the target or at least \$1 million worth of stock.¹² This did not really slow down hedge funds—especially when we note that it is highly likely the appraised value would be at least the offer price and they could get attractive interest. The rules were also changed to allow for cutting off the running in the interest payments by allowing defendants to prepay the interest up to the date of their payment. So, for example, in a deal where the per share offer price was \$20 and the plaintiffs are seeking \$25, the defendant could pay \$18 and have the interest on the \$18 stopped while the ultimate value gets decided by the court at some later date. The interest on the difference between \$18 and the value set by the court would have interest run for the full length of time until the decision came down from the court.¹³

¹² The *de minimis* exception does not apply to short form mergers.

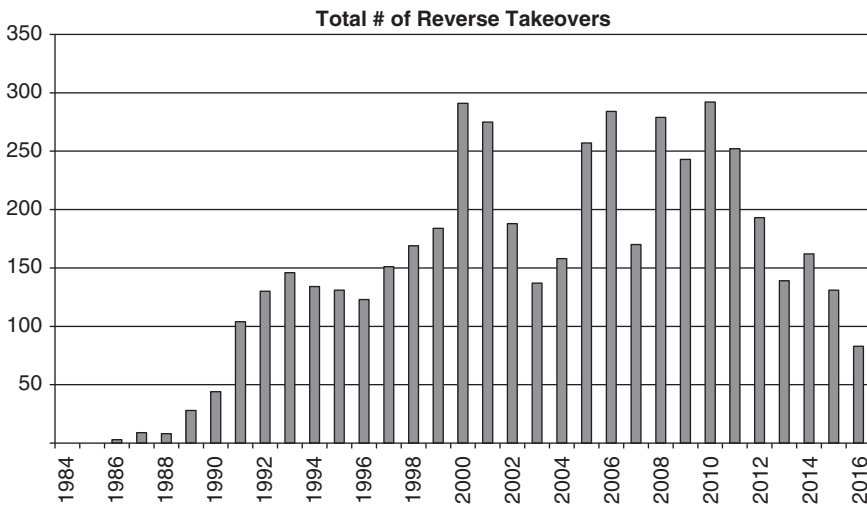
¹³ The law does not provide for any clawback of any of the payments and related interest. Sticking with the example discussed in the text above, if the company paid \$18 but the court decided on a lower appraised value such as \$16 (unlikely), there would be no refund required.

REVERSE MERGERS

A reverse merger is a merger in which a private company may go public by merging with an already-public company that often is inactive or a corporate shell. A shell company is a company that went public in the past but no longer conducts business operations and has few, if any, physical assets and its assets consist mainly of cash and cash equivalents. The combined company may then choose to issue securities and may not



(a)



(b)

FIGURE 1.7 (a) Value of reverse takeovers; (b) volume of reverse takeovers. *Source:* Thomson Financial Securities Data, January 12, 2017.

have to incur all of the costs and scrutiny that normally would be associated with an initial public offering. The private-turned-public company then has greatly enhanced liquidity for its equity. Another advantage is that the process can take place quickly and at lower costs than a traditional initial public offering (IPO). Instead of working with an underwriter to help with an IPO, the private operating company works with a “shell promoter” who will help it find a suitable nonoperating shell. Shell promoters often get control of defunct public companies by buying enough of their shares to get control. The private operating company merges with the shell, or a subsidiary of the shell, and its shareholders exchange their shares for shares of the shell. After the deal, the shell contains the assets and liabilities of the private operating company and its shareholders are the former private operating company shareholders. The shell promoters charge a fee for their services and often retain an ownership interest in the new operating company.

A reverse merger may take between two and three months to complete, whereas an IPO is a more involved process that may take many months longer.¹⁴ Reverse mergers usually do not involve as much dilution as IPOs, which may involve investment bankers requiring the company to issue more shares than what it would prefer. In addition, reverse mergers are less dependent on the state of the IPO market. When the IPO market is weak, reverse mergers can still be viable. For these reasons, there is usually a steady flow of reverse mergers, which explains why it is common to see in the financial media corporate “shells” advertised for sale to private companies seeking this avenue to go public.

While reverse mergers and IPOs have certain aspects in common there are also important differences. One key difference is that a reverse merger is not a capital raising event, whereas the traditional IPO is. In a reverse merger shares are exchanged but usually not cash. Typically, the only cash that is exchanged are monies the private operating company pays to the shell promoter (several hundred thousand dollars). Another significant difference is that in an IPO, an underwriter may be active in trying to make a market for the IPO shares. However, with reverse mergers, the shares are usually very thinly traded after the deal. Because of this, insiders usually cannot use a reverse merger to cash out their ownership in the firm, whereas in an IPO this may be possible. Due to the low liquidity of reverse merger shares, they often trade with a marketability discount. In light of these differences, reverse mergers bring few benefits from being public but, nonetheless, carry with them the same costs and requirements that public companies face. One way, though, that a reverse merger may enable a company to raise capital is through later transactions involving private investments in public equity (PIPE). Here the company may be able to work with specialized investment bankers to raise capital through the sale of debt and also the now public shares.

The number of reverse mergers generally increased from 2003 to 2010 but fell over the period 2011–2016. In terms of value, the business greatly declined after a banner year in 2006 until 2014, when it began to rebound (see Figure 1.7). In terms

¹⁴ Daniel Feldman, *Reverse Mergers* (New York: Bloomberg Press, 2009), 27–33.

of deal value, however, 2006 was the banner year and the value of these deals generally declined over the years 2008–2013 but rebounded significantly over the years 2014–2016.

For many companies, going public through a reverse merger may seem attractive, but it actually lacks some of the important benefits of a traditional IPO—benefits that make the financial and time costs of an IPO worthwhile. The traditional IPO allows the company going public to raise capital and usually provides an opportunity for the owners of the closely held company to liquidate their previously illiquid privately held shares. This does not automatically happen in a reverse merger. If the company wants to sell shares after the reverse merger, it still has to make a public offering, although it may be less complicated than an IPO. Being public after a reverse merger does not mean the shares of the combined company are really liquid. It all depends on how attractive the company is to the market and the condition of the market itself.

One advantage of doing a reverse merger is that it gives the company more liquid shares to use to purchase other target companies. Prospective targets might be reluctant to accept illiquid shares from a privately held bidder. Shares from a public company for which there is an active market are often more appealing. Thus if the goal is to finance stock-for-stock acquisitions, a reverse merger may have some appeal.

Reverse mergers have often been associated with stock scams, as market manipulators have often merged private companies with little business activity into public shells and tried to “hype” up the stock to make short-term fraudulent gains. The SEC has tried to keep an eye out for these manipulators and limit such opportunities.

Special Purchase Acquisition Vehicles

Special purchase acquisition vehicles (SPACs) are companies that raise capital in an IPO where the funds are earmarked for acquisitions. This is a very different type of IPO as most IPOs raise capital to grow a business as well as to create liquidity for the closely held shares. SPACs are sometimes also referred to as blank-check companies, or cash-shells.

There were SPACs in the 1990s, but they were not successful. The person who is considered the creator of the SPAC is David Nussbaum, who founded an investment bank called EarlyBirdCapital. He filed an S-1 in 2003 to take Millstream Acquisition Corporation. This company raised over \$20 million to acquire NationsHealth in 2004.

In 2008, NASDAQ and the New York Stock Exchange began to list SPACs, and this gave a great boost to their popularity. SPACs were particularly popular between 2006 and 2007 but have generally declined since then. In terms of capital raised, the business improved in the years 2015–2017 but remains well below the 2007 peak levels. This decline was caused by the fallout from the subprime crisis and the Great Recession that followed (see Figure 1.8). However, in recent years, especially in 2017, the business has rebounded.

SPACs start off life as a corporate shell. The founders of the SPAC purchase the shares of the shell at a nominal price, such as a few cents, and then these shares are used for the IPO. Like other IPOs this requires a filing of a Form S-1. In that filing, the founders may provide information on the nature of the acquisition targets they will seek. This information may specify a target industry or country.

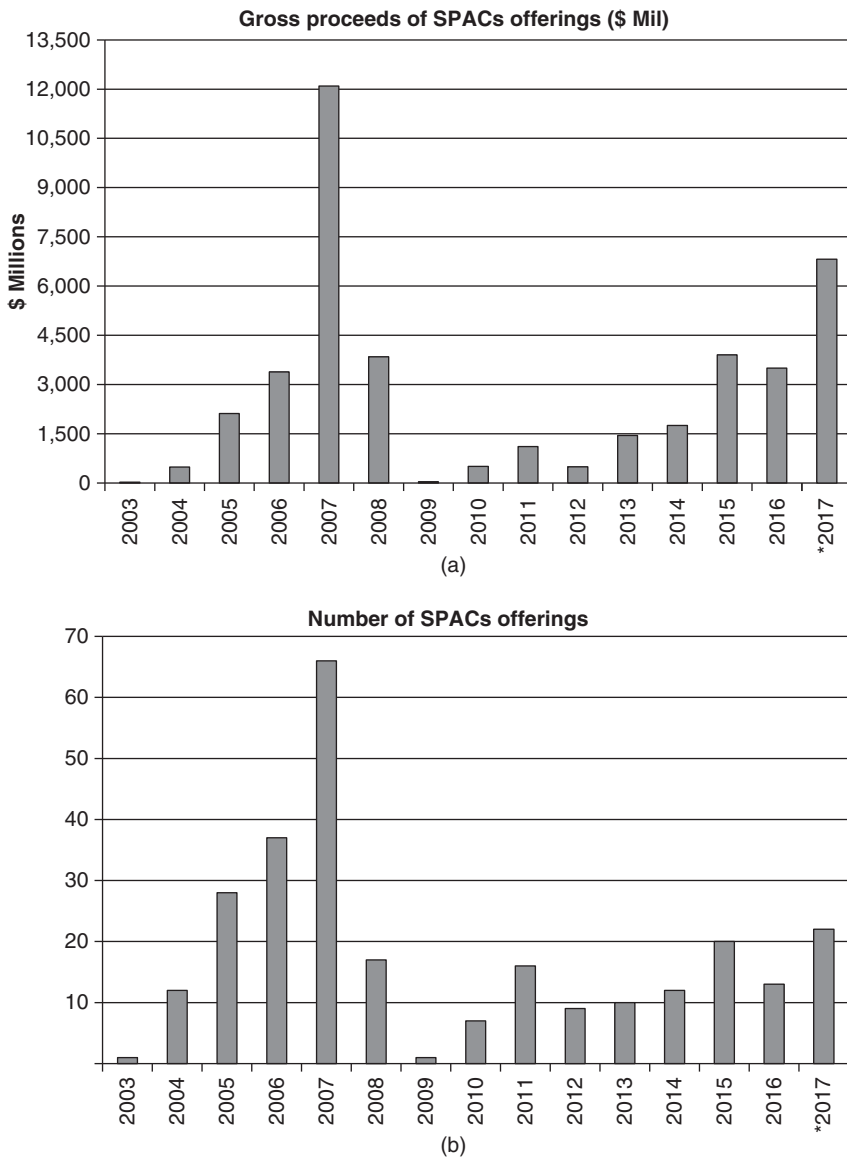


FIGURE 1.8 (a) Gross proceeds of SPACs offerings, (b) number of SPACs offerings. *Through Aug. 2017. Source: SPAC Analytics, August 17, 2017.

Usually, particularly for SPACs regulated by the listing requirements of the New York Stock Exchange (NYSE) or NASDAQ, 90% of the funds raised in the IPO are placed in an independently overseen trust account which earns a rate of return, such as the T-bill rate, while the company seeks to invest the monies in acquisitions. The percentage that ends up being placed in the account is affected by factors such as underwriting fees. The remainder of the monies can go toward expenses.

In March 2017, the New York Stock Exchange (NYSE) updated its rules governing SPACs so as to be more competitive with NASDAQ, which had been the leader in such listings.¹⁵ Up until the changes in the NYSE SPAC rules, the NYSE had not listed an SPAC in a decade. The new NYSE rules included the aforementioned requirement governing the placement of 90% of the funds raised in a trust account as well relaxing corporate governance rules on approval of an acquisition and also lowering the minimum listing size of an SPAC from \$200 million to \$80 million. Later in 2017, NASDAQ also relaxed its rules in an effort to maintain the competitive advantage in SPAC listings over NYSE. For example, while the NYSE's requirement for the minimum number of round lot shareholders is 300 (down from 400), NASDAQ lowered its minimum from 300 to 150. These lowered listing requirements help boost SPAC volume in 2017 (see Figure 1.8).

SPACs usually provide for a *no-vote threshold*. This is the maximum percentage of voting shareholders who can vote against a deal and have it still go forward. Typical percentages are 20% to 30%.

SPACs are risky investments as it is possible that the company may not complete an acquisition. If that is the case, investors could get back less money than they originally invested. Even when the company does complete deals, they do not know in advance what targets will be acquired.

The IPO offerings of SPACs are unique and differ in many ways from traditional IPOs. In addition to the differences in the nature of the company that we have discussed, they usually sell in units that include a share and one or two warrants, which usually detach from the shares and trade separately a couple of weeks after the IPO. Because the market for these shares can be illiquid, they often trade at a discount—similar to many closed-end funds. The post-IPO securities can be interesting investments as they represent shares in an entity that holds a known amount of cash but that trades at a value that may be less than this amount.

SPACs are somewhat similar to private equity investments. Lewellen referred to them as “single-shot” private equity funds.¹⁶ Private equity is mainly available only to institutional investors. For smaller investors, they can enjoy some of the same characteristics as private equity when they invest in SPACs.¹⁷ Also, SPAC investments are more transparent than private equity investments, which have more hidden fees—an issue that has become more controversial in recent years.

Founders of SPACs benefit by receiving a share, usually 20%, of the value of the acquisition. Normally, other than this ownership position, the founders of the SPAC do not receive any remuneration. Their shares usually are locked up for a period, such as three years, after the IPO date.

¹⁵ Securities and Exchange Commission, (Release No. 34-80199; File No. SR-NYSE-2016-72), March 10, 2017, Self-Regulatory Organizations; New York Stock Exchange LLC; Order Granting Approval of a Proposed Rule Change Amending Initial and Continued Listing Standards for Special Purpose Acquisition Companies.

¹⁶ Stefan Lewellen, “SPACs as an Asset Class,” Yale University working paper, March 2009.

¹⁷ Carol Boyer and George Baigent, “SPACs as Alternative Investments,” *Journal of Private Equity* 11, no. 3 (2008): 8–15; and Lora Dimitrova, “Perverse Incentives of Special Purpose Acquisition Companies: The Poor Man's Private Equity Funds,” *Journal of Accounting and Economics* 63 (2017): 99–120.

In Chapter 4 we discuss the various factors that lead to a value-destroying M&A strategy. With SPACs, however, there is little strategy, as investors are seeking to convert their liquid cash into an equity investment in an unknown company. Not surprisingly, in a study of 169 SPACs over the period 2003–2010, Jenkinson and Sousa found that over half of the deals immediately destroyed value.¹⁸ They compared the per share value of the SPAC at the time of the deal with the per share trust value. They reasoned that if the market value is equal to or less than the trust value, the SPAC should be liquidated and the acquisition should not go forward.

In spite of the disappointing results of Jenkinson and Sousa, there is an explanation for SPACs' continued popularity. The investments are liquid and the shares have been sold to the market in the initial IPO. This compares favorably to private equity investments, which are not very liquid. In addition, as we have noted, SPACs are more accessible for non-institutional investors.

Research by Vulcanovic explored which types of SPACs fared better.¹⁹ He found that SPACs that were more focused and had a management team from a given industry with a track record of some success tended to not fail. On the other hand, foreign SPACs did not do as well.

In spite of the fact that the market prices as of the acquisition approval date indicated *ex ante* that the deals would be value-destroying, more than half of the deals were nonetheless approved by investors. Jenkinson and Sousa found that investors who went along with the recommendations of the SPAC founders in spite of a negative signal from the market suffered –39% cumulative returns within six months and –79% after one year. The fact that the founders recommended the deal is not surprising, given that they derived their compensation by receiving 20% of the capital value of any acquisition. Therefore, they want the investors to approve an acquisition, as that is how they get their money. The deal may cause investors to lose money, but it can still make the founders a significant return. In light of the poor performance of SPACs, it is surprising that SPAC investors approve roughly three-quarters of deals.

¹⁸ Tim Jenkinson and Miguel Sousa, "Why SPAC Investors Should Listen to the Market," *Journal of Applied Finance* 21, no. 2 (September 2011): 38–57.

¹⁹ Milos Vulcanovic, "SPACs: Post Merger Survival," *Managerial Finance*, Vol. 43, no. 6 (2017): 679–699.

