**Mergers and Acquisitions**

In this month's roundtable, our panel of experts analyzes the flurry of mergers and acquisitions in today’s corporate marketplace and discusses the best defenses for companies to include in their charters; how companies should best respond to activist hedge funds; and California’s fairness hearing process.

The panelists are Daniel Kelly of Davis Polk & Wardwell; Douglas Cogen of Fenwick & West; David Grinberg of Manatt, Phelps & Phillips; Robert Townsend of Morrison & Foerster; Celeste Greene of Skadden, Arps, Slate, Meagher & Flom; and Michael Ringler of Wilson Sonsini Goodrich & Rosati. The roundtable was moderated by Custom Publishing Editor Chuleenan Svetvilas and reported for Barkley Court Reporters by Krishanna DeRita.

**MODERATOR:** What’s driving all this merger-and-acquisition activity?

**COGEN:** There are a few factors. One, consolidation is part of the natural evolution and maturation of industries. So in Northern California, which is so focused on technology, there’s a natural maturation stage we are going through and that’s certainly playing itself out in acquisitions by large serial acquirers, who are expanding product sets and snapping up smaller companies.

**RINGLER:** Certainly something else we are seeing is the smaller capitalized company struggling to remain viable as a public company. Many of them are looking around for exit strategies. Sometimes that’s a going private transaction and sometimes that’s a sale to a larger acquisitive buyer. We are seeing that as a catalyst for many M&A deals.

**GREENE:** We cannot underestimate the influence of activism and the fact that there are a lot of people with money who require higher returns in mature markets. That phenomenon is forcing companies to take a hard look at buy-versus-build strategies. Managements of public companies are under increasing pressure to deliver not only quarterly, but also over the long term. As boards come under more pressure because of disclosure transparency, companies that historically took a longer view as to their viability are now looking at M&A transactions as their means of generating shareholder value.

**KELLY:** There is a huge amount of capital available to deploy. We think of hedge funds, but there are lots of other institutions with money right now and debt is relatively cheap. Another aspect is the internationalization of the market—foreign companies are looking here and our companies are looking abroad, so it’s a worldwide market with a lot of capital.

**GRINBERG:** The universe of companies that private equity funds are able to acquire is expanding because larger funds have been raised and private equity funds have become very skillful at joining forces to compete for even the largest transactions. In addition, strategic buyers were historically able to outbid financial buyers without undermining their long-term prospects because of synergies that could be achieved with existing businesses. However, financial buyers currently have access to cheaper capital and are accepting lower returns on transactions.

Another interesting factor driving M&A activity is that it’s been almost four years since the passage of Sarbanes-Oxley. After spending resources and time over the previous several years reorganizing and restructuring their internal controls and procedures, companies are now exploring acquisitions as a means of growing earnings as they realize that it is becoming increasingly more difficult to organically boost earnings either through an increase of revenues or reduction of costs in connection with their existing businesses. Furthermore, companies are spinning-off non-core divisions, products, and assets to focus on their core competencies.

**TOWNSEND:** If you look at the statistics, we are still 35 percent shy of the level of M&A activity witnessed in 2000. Look at the emergence of private equity buyers, who are probably at a ten-year peak in terms of their participation in M&A, the entrance of new hedge funds, and the internationalization of the market where we see more new entrants, particularly from Asia and Europe. Short of some dislocation in the stock market or some international economic problem, we can expect the same or greater M&A activity in the next couple of years.

**MODERATOR:** Are the additional reporting burdens of Sarbanes-Oxley driving companies to seek acquisitions rather than go public?

**TOWNSEND:** Absolutely. Last year, 25 percent of companies used IPOs as an exit strategy; 75 percent used M&A. The relative percentage of IPOs was...
the lowest in a decade. It’s particularly true in this region where we have a concentration of tech companies. The burden of Sarbanes-Oxley falls heaviest on small cap companies like tech companies. So today, when you have an emerging growth company filing a registration statement, it is also a statement that the company is up for sale and it starts not only a registration process but sometimes an auction process to sell the company.

COGEN: What you do see especially with the smaller public companies is that the costs associated with Sarbanes-Oxley, which a lot of companies thought would be a one-time heavy hit and then would steady out, has turned out to be just a basic increase in the cost of doing business. That, coupled with just the quarter-to-quarter pressure to deliver earnings, which often warps long-term planning, is putting an awful lot of pressure on public company management teams. The idea of being part of something larger and running a division or being part of a private-equity-controlled group is increasingly attractive. As the SEC starts to focus more pressure on executive compensation disclosure, that’s going to also snowball that.

RINGLER: It’s difficult enough to be a small public company and comply with all of the SOX regulations, but the real problem we’ve seen is when there is a misstep and they actually can’t comply with these regulations—the market is very unforgiving. Once that happens, it’s frequently the end of the story. That is another catalyst to M&A deals today because distressed companies frequently don’t have any other alternatives at that point.

GRINBERG: SOX and SEC compliance issues and costs are certainly driving some companies to explore the potential of being acquired rather than going public. Concerns relating to offering expenses, market-timing issues, and the onerous expectation of quarterly results are additional factors that are leading companies down the acquisition path. Companies are also realizing the advantages of being a part of a private equity family. Rather than going out to the public market to raise debt or equity, a company can look to its parent for support, both financial and otherwise.

MODERATOR: Do you see more M&A activity in certain industries? Energy, telecommunications, and health care, for example?

TOWNSEND: Those and media would be the four largest.

KELLY: It has become a seller’s market, too. The deal terms that we are seeing are much more seller-oriented, especially in auctions. The behavior of buyers in auctions has changed markedly over the last three or four years and they are getting away with a lot less. They are really trying to put their best deal forward on the initial bid. They are actually sending in mark-ups of the merger agreement, whereas you used to get some vague comments and leave it open for later. So sellers, especially in this auction process, are getting a much better deal than in the past.

TOWNSEND: The private equity funds are a main reason sellers are getting better terms these days. There is more than $150 billion in private equity funds today and so almost every sale transaction is an auction. The return hurdle for funds is coming down a bit and it’s a more competitive market, but people are trying to be disciplined in the price they pay and in the competitive returns that they offer.

RINGLER: We see a lot of buyers spend a great deal of energy trying to avoid auctions these days, and there is a great deal of thought now as to how to preempt that process as a strategic buyer. It’s challenging in every deal, but sometimes buyers can avoid an auction. Obviously price is often the mechanism that buyers use to preempt an auction, but many of them try other methods as well, like co-opting management.

GREENE: Another question that arises is what is the objective for the private equity funds? What does it tell us about the efficiency of some of these public companies that are sold to either private equity funds individually or in consortium? Typically, the motive of private equity firms is first to do due diligence, identify some inefficiency or risk, typically execution risk associated with a public company, to make some assessment about management and while the company is in their hands, to make it more efficient and sell it for more than they bought it for.

It’s probably a healthy phenomenon—that private firms are going in, improving the management, improving the long-term strategic objectives of these companies, and then selling them for greater value. Perhaps if you ask an academic or a market...
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GRINBERG: But it does raise the issue of the effect on a company’s other stakeholders, such as customers, suppliers, vendors, and the communities that it serves. How are those stakeholders affected when companies are bought and sold for short-term value?

MODERATOR: What defenses should a company have in its charter at the time of an IPO?

KELLY: I’m a strong believer in companies having at least two basic defenses: a staggered board and blank check preferred stock so that on a moment’s notice in times of trouble, they can adopt a shareholders’ rights plan. Those level the playing field in a contested situation. If you go back a long time, the playing field was not level and raiders were able to do midnight raids and coerce bust up deals that provided less consideration to shareholders on the back end.

These defenses allow a board of independent directors acting in good faith to at least negotiate and find another party at a higher price, if necessary. So defenses are quite legitimate and they are usually, in my experience, properly used.

TOWNSEND: Another value of having defenses in place is not just giving the board more time to consider its options, but giving alternative bidders more time to analyze the situation, come out of the woodwork, and create a competitive situation—that’s what maximizes shareholder value.

GRINBERG: A company can have numerous and sophisticated defensive mechanisms, but it’s not going to ultimately prevent a sale. Defensive mechanisms permit the board to conduct an orderly process, review all available strategic alternatives, and preserve the board’s bargaining power and flexibility in its dealings with a third-party acquirer to maximize value for all stockholders. In addition, defenses are designed to encourage third parties interested in acquiring a company to negotiate with its board and discourage investors who are simply interested in putting a company into play at a time when such action would not be in the best interests of stockholders and could be seriously disruptive and detrimental to the company and its business.

MODERATOR: How should companies respond to activist hedge funds?

TOWNSEND: I tell my clients there are four P’s in reacting to an activist hedge fund. The first is performance. You have to make sure your company is fundamentally performing. The second is preparation. You need to be meeting regularly with your advisors. You need to understand what your defenses are before they approach you. The third is proactive. You can’t sit back. Once an activist fund has your company in its sights, you may have a battle on
Different funds seek different results in different contexts and they may be looking to change management, they may be looking for a dividend, they may be looking for a sale of the entire company or a sale of part of the company. Part of what is required is proactively understanding what really is their goal. Finally you get to the fourth P, which is PR. You can’t let them capture the high ground in the public marketplace and convince people that they are the advocates of the shareholders and you are trying to resist what’s in the best interest of all the shareholders.

**GREENE:** The proper response to any unsolicited overture, be it from a hedge fund that's looking for an opportunity to engender an auction or any other potential acquirer, is to ensure that the process for the board's consideration of the bid is such that the board can do it in a timely but deliberate manner. A board is going to be evaluated by the courts on the basis of information that was made available to it at the time. The market is going to evaluate the board with 20/20 hindsight, but the courts generally will look at the context within which all of this occurred. So it is incumbent on the board to take whatever steps are necessary to have a defensible record, to make an informed decision and to do so in a disinterested manner.

**GRINBERG:** Opening the lines of communication and engaging the activist hedge fund to determine the advisability and feasibility of its ideas may be an appropriate response in many circumstances. That being said, a company does not have a duty to discuss or negotiate with the hedge fund. However, by ignoring its demands a company runs the risk of further agitating the hedge fund and other stockholders who support its position. Regardless of the approach, a company should attempt to shift the public debate back to actions and strategies that create long-term value as opposed to actions and policies that focus primarily on short-term value.

**GREENE:** In 2005, the market value for deals that were subject to the California fairness process totaled more than $3 billion. So it’s getting a fair amount of use and I think quite appropriately. What are its advantages? It can be a cost-effective means for an acquirer in a stock-for-stock acquisition in getting its shares to the target’s stockholders in a manner that complies with the requirement to either register the shares that will be issued or to obtain an exemption from registration. The federal process, which involves the filing of a registration statement on form S-4, is the most expensive and the most time-consuming process for registering shares.

The popular alternatives to that process are private placement of those shares to be issued or a fairness hearing conducted at the state level. There are only a half a dozen states that have this process and California probably has the most active process. The scrutiny by the examiner at a fairness hearing is such that you typically don’t get what can be troublesome accounting comments that you get occasionally from the Securities and Exchange Commission and the standard for review is whether the transaction is fair, just, and equitable.

**KELLY:** If you have employees who have private company stock, it is a very useful process. You need some sort of a California connection. I’m not sure the examiners really want strangers coming in and using it, although technically they could. But it’s a great process.

**RINGLER:** In our experience, buyers are becoming more aggressive on the indemnity and escrow terms of transactions and that has dissuaded many of them from using the California fairness hearing process because, for various reasons, aggressive indemnity provisions are not always looked upon favorably by the Department of Corporations. So I've actually seen a trend away from using the fairness hearing lately.

**COGEN:** The trend lines that show the numbers going down again are probably more a function of more cash than we were using five years ago. If it’s a stock deal and you have got a private target, it’s absolutely a superb process. The Department of Corporations has developed a good process for running the hearings and the documentation. When you have a public company target, while technically it might work, the board and stockholders are not going to be comfortable with it. So you have to have the right set of stars aligned. But if they are, it’s a terrific process.

What’s interesting is that as long as we’ve been doing it in California, other states where there are obviously an immense number of corporations show no interest in having a similar process. It should be part of your tool kit for any corporation with a nexus to California.