

# Services Provided By Investment Banks (Advisor) in an M&A Deal

## Advice

- ❖ Investment banks provide advice and deal opportunities;
  - **Screen** potential buyers and sellers;
  - Make **initial contact** with a seller or buyer; and
  - **Negotiation** support, **valuation**, and deal **structuring** guidance.

## Capital Market Services.

- ❖ The “universal or top-tier banks” can also provide capital markets funding (**bond, equity, hybrid, asset backed**) leaving the **loan component** of financing to **commercial banks** and other financial firms.
- ❖ Investment bankers also derive income from so-called **fairness opinion letters**. They often are developed as legal **protection for members of the boards** of directors against possible shareholder challenges of their decisions.
- ❖ **In selecting an investment bank**, acquirers and target firms focus far more on a bank’s **track record in generating high financial returns for their clients** than on its size or market share.
- ❖ Due to **perceived conflict of interest**, **boutique advisory firms** (normally founded by ex-executive large investment bank) have become popular choices for many of the M&A clients. About **25%** merging firms tend to hire so-called boutique knowledge.

# Investment Bank Fees in M&A Transactions

## ❖ Retainer Fees

- ❖ Often, and sometimes surprisingly, one of the most hotly debated fees in at least the lower mid-market.
- ❖ This fee can either be charged **up front as a standard flat fee or is often drawn-out** and invoiced on a monthly basis, with at least **some larger portion of the fee due upfront**.
- ❖ **It helps to cover the intermediary's fixed costs**. Despite what the seller may think, the intermediary typically has his own high fixed costs inherent in prepping and working each deal.
- ❖ Most advisors and **bankers do not make their money by charging retainers**, it just helps them not to lose it.

## ❖ Success/Back-end Fees

- ❖ The success fee, ranges and typically is most **dependent on the valuation** and/or size of the company.
- ❖ Some firms will actually **deduct any previous retainers (or a portion of previous retainers)** from the final success fee from the business, but this is extremely rare.
- ❖ **The success fee** is usually calculated as a percentage of the company's **Enterprise Value**, and is contingent upon completion of the deal.

# Mistakes Made By Sellers In Mergers And Acquisitions

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- ❖ **Not being prepared for the extensive effort and time the deal will take.**
- ❖ **Failing to create a competitive sales process.**
- ❖ **Not having an appropriate NDA.**
  - A well-drafted nondisclosure agreement (NDA) is essential to protect the company's secrets and proprietary information, particularly when the bidders are strategic competitors.
- ❖ **Hiring the wrong legal counsel.**
  - You must have a lawyer who primarily or exclusively handles M&As. mergers and acquisitions.
- ❖ **Not hiring a qualified financial advisor or investment banker.**
- ❖ **Having an inadequate understanding of competitors and market comparables.**
  - ❖ To avoid having unrealistic selling price expectations, the seller needs to understand how other comparable companies are being valued in the marketplace.
- ❖ **Having incomplete books, records, and contracts.**
  - Due diligence investigations by buyers frequently find problems in the seller's historical documentation process, which may cause a potential buyer to walk away.

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- ❖ **Not having a complete disclosure schedule far in advance.**

- ❖ A disclosure schedule is the document attached to the acquisition agreement setting forth a great deal of required disclosures relating to outstanding key contracts, intellectual property, related party transactions, employee information, pending litigation, insurance, and much more.

- ❖ **Not negotiating the key terms of the deal in a letter of intent.**

- ❖ A selling company's bargaining power is greatest prior to signing a letter of intent (LOI). Once the LOI is signed, the leverage typically swings to the buyer. This is because the buyer will typically require a "no shop" clause or exclusivity provision prohibiting the seller from talking to any other bidders for a period of time.

- ❖ **Not appreciating that time is the enemy of all deals.**

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- ❖ **Failing to negotiate and agree upon a favorable acquisition agreement.**

- The conditions to closing (a seller will ideally want to limit these to ensure that it can actually close the transaction quickly).
- The adjustments to the price (a seller ideally wants to avoid downward adjustment mechanisms based on working capital adjustments, employee issues, etc.).
- The triggers for earnouts or contingent purchase price payments.
- The nature of the covenants applicable between signing and closing (a seller wants these to be limited and reasonable).
- Provisions for termination of the acquisition agreement

# Mistakes Made By Sellers In Mergers And Acquisitions – cont.

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## ❖ **Not appreciating that time is the enemy of all deals.**

- ❖ The longer an M&A process drags on, the higher the likelihood that the deal will not happen or terms get worse. The seller and the seller's lawyer must have a sense of urgency in getting things done.

## ❖ **Not having an experienced M&A negotiator lead the negotiations.**

- ❖ It's critical to have an experienced M&A negotiator leading the negotiations. That can be the CEO if he or she has relevant M&A experience. The CEO or the Board may then determine that it will be more appropriate for the lead negotiator to be a representative from the Board.

## ❖ **Negotiating the deal without regard to tax considerations.**

- ❖ Buyers often prefer to do **asset purchase** deals as those can provide a “**step up**” in **tax basis** (and may mitigate the potential of **taking on unknown liabilities of the seller**). But **sellers will usually prefer a stock sale**, as this eliminates the risk of “double taxation” present in many asset deals.

## ❖ **Failing to communicate the vision and strategic fit.**

- ❖ The selling company's CEO must be able to effectively communicate to bidders the company's vision and significant growth prospects.

# Mistakes Made By Sellers In Mergers And Acquisitions – cont.

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- ❖ **Not considering change of control provisions in key contracts.** If the selling company has key contracts, licenses, or leases that require consents from third parties in connection with a change in control of the company, it is critical that these consent requirements be identified early on in the process.
- ❖ **Not adequately taking into account employee-related issues.** Transactions will typically include a number of employee issues. The questions that frequently arise in M&A transactions are the following:
  - What is the acquirer's plan for retention and motivation of the company's employees?
  - How will the company's stock options be dealt with?
  - Does the company need to establish a "carve out" to pay employees at the closing.
  - Finally, the most important issue: Culture. Without a cultural compatibility with the buyer's values and principle, the deal will eventually fail.
- ❖ **Not carefully negotiating earn-out provisions.** What are the realistic financial milestones to be achieved before the earn-out is payable? **Buyers tend to prefer profit or EBITDA metrics**, whereas **sellers prefer metrics** that have less chance to be manipulated, **such as gross revenues**.

# Tips to a Successful Merger and Acquisition

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- ❖ An M&A deal is a rigorous process with a required degree of detail. A myriad of processes have to go right for this sort of business dealing to be successful.
  
- ❖ Whatever the reasons for a merger, the entire process starts and ends with strategy. You have to be willing to look at everything from culture fit, geographic location and product to the market, the industry and business perspectives. No one deliberately plans to enter a bad deal, but unfortunately, it does happen.
  - Systematic approach.
  - Clear definition of value creation logic.
  - Comprehensive screening.
  - Clear analytical framework.
  - In-depth analysis of industries and targets.
  - Understand integration issues.
  - Realistic synergy expectations.
  - Thoroughly evaluate your liquidity and financial capability.
  - Be sure that you can handle the added strain and responsibility.
  - Unless you can handle a sufficient amount of debt and access equity-capital funding strategies to provide you with the perfect balance sheet, you will need to hold off on that M&A.
  - Put together the perfect team. Almost every company has these three divisions: finance, sales and marketing and operations.

# Tips to a Successful Merger and Acquisition – cont.

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- ❖ Establish your goals and measure for success:
  - Is your objective to boost your market share?
  - Are you seeking to bring in new products, services and intellectual property under your corporate wing?
  - Are you trying to break into new and contiguous markets?
  - Are you trying to eliminate a competitor or to achieve vertical integration?
  
- ❖ The strategic rationale for an acquisition that creates value typically conforms to at least one of the following six archetypes:
  - Improving the performance of the target company.
  - Removing excess capacity from an industry.
  - Creating market access for products.
  - Acquiring skills or technologies more quickly or at lower cost than they could be built in-house.
  - Exploiting a business's industry-specific scalability.
  - Picking winners early and helping them develop their businesses.



# Tips to a Successful Merger and Acquisition – cont.

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- ❖ In summary, to execute a successful M&A transaction, after considering the above points, make sure:
  - **Leadership:** Every transition requires the presence of strong leadership, whose members will be chosen to define the tone and set a precedent for the direction and efficiency of the new entity. Importantly, these transition team leaders must be chosen from both sides of the deal. These people will already understand the workings and culture of their respective companies and understand their employees.
  - **Assessing the strategic fit:** It's not just about how attractive a target company is, but how well it fits. How complementary are its operations to those of the acquirer, its geographic footprint, its set of customers, its suppliers.
  - **Synergy:** The acquirer must be able to gauge the significance of the cost or revenue synergies that a particular purchase might generate.
  - **Plan and anticipate:** In any merger, there will definitely be compatibility and integration issues, no matter how hard you've worked to reduce the risk of that happening.

The key is advanced preparation, plan, and a bidding strategy.

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# A Sample of Laws Affecting M&A in the U.S.

- ❖ Federal antitrust laws exist to prevent individual corporations from assuming so much market power that they can limit their output and raise prices without concern for any significant competitor reaction.
- ❖ The **Department of Justice (DoJ) and the Federal Trade Commission (FTC)** have the primary responsibility for enforcing federal antitrust laws.
- ❖ In 2001, the **EU antitrust** regulators were able to thwart the attempted takeover of **Honeywell by General Electric (\$45 billion)**—two US corporations with operations in the European Union. Remarkably, this **occurred following the approval** of the proposed takeover by **US antitrust authorities**.
- ❖ In 2014, EU antitrust authorities **blocked United Parcel Services'** bid to **acquire Dutch shipping company TNT** because of concerns about reduced competition in the continent wide delivery of small packages.

## ❖ **The Sherman Act**

- ❖ Passed in 1890, the Sherman Act makes illegal all contracts, combinations, and conspiracies that restrain trade “unreasonably.” Examples include agreements to fix prices, rig bids, allocate customers among competitors, or monopolize any part of interstate commerce.
  - **Section I** of the Sherman Act **prohibits new business combinations** resulting in monopolies or in a significant concentration of pricing power in a single firm.
  - Section II applies to firms that **already are dominant** in their targeted markets.

# A Sample of Laws Affecting M&A in the U.S. – cont.

## ❖ The Williams Act

- ❖ Regulation of Tender Offers Passed in 1968, the Williams Act consists of a **series of amendments to the Securities Act of 1934** intended to protect target **shareholders from fast takeovers in which they do not have enough time** to assess adequately the value of an acquirer's offer.
- ❖ The Act requires **more disclosure** by the bidding company, **establishing a minimum period during which a tender offer must remain open**, and authorizing targets to sue bidding firms.
- ❖ The Williams Act requirements **apply to all types of tender offers**, including those negotiated with the target firm (i.e., **negotiated or friendly tender offers**), those undertaken by a **firm to repurchase its own stock** (i.e., **self tender offers**), and those that are unwanted by the target firm (i.e., **hostile tender offers**).

## ❖ The Clayton Act

- ❖ Passed in 1914, the Clayton Act was created to outlaw certain practices not prohibited by the Sherman Act and to help government stop a monopoly before it developed.
- ❖ The act made price discrimination between customers illegal, unless it could be justified by cost savings associated with bulk purchases. Tying of contracts—in which a firm refuses to sell certain important products to a customer unless the customer agrees to buy other products from the firm—also was prohibited.
- ❖ It prohibits one company from buying the stock of another company if their combination results in reduced competition.
- ❖ **Acquirers soon learned how to circumvent** the original statutes of the Clayton Act of 1914, which applied to the purchase of stock. **They simply would acquire the assets**, rather than the stock, of a target firm.
- ❖ **Under the Celler–Kefauver Act of 1950**, the Clayton Act was amended to give the FTC the power to **prohibit asset as well as stock** purchases.

# The Consent Decree

- ❖ Consent decrees limits potential increases in business pricing power following a merger by creating viable competitors.
- ❖ A typical consent decree may consist of both **structural and behavioral remedies**.
  - **Structural Remedies.** This usually involves the sale of assets or businesses in areas where they compete directly.
  - **Behavioral Remedies.** Designed to regulate the future conduct of the relevant party or parties (e.g., by regulating the prices which a party may charge). Behavioral remedies may require significant monitoring by regulators to ensure compliance.
- ❖ **Example 1.** In late 2015, **General Electric won US and EU antitrust approval** to buy French-based **Alstom's electric power generation equipment** unit by agreeing to a structural remedy involving the **sale of Alstom's subsidiary that provides aftermarket parts and services**. Regulators reasoned that this divestiture would give customers a viable alternative to GE in buying spare parts and maintenance services.
- ❖ **Example 2.** As a condition of approving the January 2011 acquisition of NBC Universal (NBCU) by Comcast, Comcast agreed to several behavioral remedies that would impact its future conduct of the combined businesses.
  - Comcast committed to arbitrate disputes with other cable systems concerning their access to NBCU's cable channels.
  - In addition, Comcast assured regulators that it would adhere to so-called “**net neutrality**” conditions by licensing its content to competing Internet sites at competitive rates.
- ❖ If a **potential acquisition is likely to be challenged by the** regulatory authorities, an acquirer may seek to **negotiate a consent decree in advance of the deal. In the absence of a consent decree, a buyer often requires** that an agreement of purchase and sale includes a provision **allowing the acquirer to back out of the transaction** if it is challenged by the FTC or the DOJ on antitrust grounds.

## Antitrust Guidelines for Collaborative Efforts

- ❖ Collaborative efforts are **horizontal agreements** among competitors, including **joint ventures, strategic alliances**, and other competitor agreements.
- ❖ Regulators are less likely to find a **collaborative effort to be anticompetitive** if:
  - The participants have **continued to compete through separate**, independent operations or through **participation in other collaborative** efforts;
  - The **financial interest** in the effort by each participant is **relatively small**;
  - Each participant's **ability to control** the effort is **limited**;
  - Effective **safeguards prevent information** sharing; and
  - The **duration** of the collaborative effort is **short**.

# Business Alliances As Alternatives To M&A

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- ❖ In addition to M&As, businesses may combine through:
  - Joint ventures (JVs),
  - Strategic alliances,
  - Minority investments,
  - Franchises, and
  - Licenses.
- ❖ The term business alliance is used to refer to all forms of business combinations other than M&As JVs are business relationships formed by two or more parties to achieve common objectives.
- ❖ While the JV is often a legal entity such as a corporation or partnership, it may take any organizational form desired by the partners. Each JV partner continues to exist as a separate entity; JV corporations have their own management reporting to a board of directors.
- ❖ A strategic alliance generally does not create a separate legal entity and may be an agreement to sell each firm's products to the other's customers or to co-develop a technology, product, or process. Such agreements may be legally binding or informal.
- ❖ Minority investments, those involving less than a controlling interest, require little commitment of management time for those willing to be passive investors. Such investments are frequently made in firms that have attractive growth opportunities but lack the resources to pursue them. Investors often receive representation on the board or certain veto rights in exchange for their investment. A minority investor can effectively control a business by having veto rights changes in strategy, capital expenditures over a certain amount of money, key management promotions, salary increases applying to senior managers, and when the business would be sold.
- ❖ Licenses enable firms to extend their brands to new products and markets by permitting others to use their brand names or to gain access to a proprietary technology.
- ❖ A franchise is. a specialized form of a license agreement that grants a privilege to a dealer from a manufacturer or franchise service organization to sell the franchiser's products or services in a given area. Under a franchise agreement, the franchiser may offer the franchisee consultation, promotional assistance, financing, and other benefits in exchange for a share of the franchise's revenue. Franchises represent a low-cost way for the franchiser to

# Motivations For Business Alliances

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- ❖ **Risk Sharing.** Risk often is perceived to be greater the more money, management time, or other resources a company has committed to an endeavor and the less certain the outcome.
- ❖ **Sharing Proprietary Knowledge.** Given the pace at which technology changes, the risk is high that a competitor will be able to develop a superior technology before a firm can bring its own new technology to market.
- ❖ **Sharing Management Skills, Information, and Resources.**
- ❖ **Sharing Substantial Capital Outlays.** Regional and foreign cellular phone carriers were encouraged to join forces to achieve the scale necessary to support the creation of national networks. Vodafone and Verizon Communications joined forces in 1999 to form Verizon Wireless, with Verizon eventually buying out Vodafone in early 2014.
- ❖ **Securing Sources of Supply.** The chemical industry is highly vulnerable to swings in energy costs and other raw materials. Chemical companies such as Dow, Hercules, and Olin have used JVs to build new plants throughout the world.
- ❖ **Cost Reduction.** In the 1980s and 1990s, retailers and financial services firms outsourced such back-office activities as information and application processing to such firms as IBM and EDS.
- ❖ **Gaining Access to New Markets.** Accessing new customers is often a highly expensive effort involving substantial initial marketing costs, such as advertising, promotion, warehousing, and distribution expenses. .
  
- ❖ **Globalization**
- ❖ The dizzying pace of international competition increased the demand for alliances and JVs to enable companies to enter markets in which they lack production or distribution channels or in which laws prohibit 100% foreign ownership of a business.



# A Sample of Laws Affecting M&A in the U.S.

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- ❖ The U.S. has the longest tradition of antitrust regulation, starting the Sherman Act of 1890.
- ❖ **The Sherman Act (1890)**
  - ❖ Passed in 1890, the Sherman Act makes illegal all contracts, combinations, and conspiracies that restrain trade “unreasonably.” Examples include agreements to fix prices, rig bids, allocate customers among competitors, or monopolize any part of interstate commerce.
    - ❖ **Section I** of the Sherman Act **prohibits new business combinations** resulting in monopolies or in a significant concentration of pricing power in a single firm.
    - ❖ **Section II** applies to firms that **already are dominant** in their targeted markets.
  - ❖ **The Sherman Act was not particularly suitable** for the prevention of prospective M&As, **especially in the form of acquisition of stock** to gain control of companies.
- ❖ **The Clayton Act 1914**
  - ❖ The Act was passed to overcome the shortcomings of the Sherman Act, and was subject to later amendments to make it a more effective mechanism for dealing with mergers.
  - ❖ **The Federal Department of Justice (DOJ)** enforces the various statutory rules as well as the **Federal Trade Commission (FTC Act of 1914)**. Both agencies investigate and, if necessary, initiate proceedings in federal courts.
- ❖ **Hart-Scott-Rodino Antitrust Improvements Act of 1976**
  - ❖ The Hart-Scott-Rodino (HSR) Antitrust Improvements Act of 1976 requires large companies to file a report **before completing** a merger, acquisition or tender offer. Specifically, HSR is generally known as a "**premerger notification report**." The report is meant to alert DOJ and FTC to the intent of companies to merge.

# Antitrust Regulations in the United Kingdom and European Union

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## ❖ **United Kingdom (1973)**

❖ There are three principal authorities involved :

- The Office of Fair Trading (OFT);
- The Competition Commission; and
- The Secretary of State for Trade and Industry.

❖ The main tasks of these authorities are as follows: •

❖ **The OFT** - it is a first stage filter for mergers that meet the jurisdictional ‘qualifies for investigation’ thresholds. Acting on the Director General’s advice, the Secretary of States, decides whether or not a transaction raises sufficient competition concerns as to merit fuller investigation by the Competition Commission.

❖ **Competition Commission** - it is an independent body consisting of members drawn from industry, commerce and academic life. The Commission does not instigate the inquiries that it conducts. Cases are referred to it for in depth review by the Secretary of State.

# Antitrust Regulations in the European Union

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## ❖ **European Union Merger Regulations (1990)**

- ❖ Mergers of enterprises operating within the European Union are, since 1990, subject to European Union - level merger regulation.
- ❖ This **regulation was promulgated** with the aim of **achieving the ‘one-stop shop’ clearance of mergers**.
- ❖ This means that the merged **companies deal with just one authority instead** of review by **various national authorities**, which can lead to **confusion and uncertainty**.
- ❖ The result is that there is now a hierarchy of merger regulation in the European Union:
  - Very large mergers having European Union-wide impact being examined within the European Commission (EC).
  - Smaller mergers with their impact within a single member state are investigated by that state’s own antitrust regulator.

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# Business Judgment Rule (BJR)

- ❖ The BJR, **the most prominent and important standard of judicial review under corporate law**, protects a decision of a corporate board of directors from a fairness review **unless a well pleaded complaint provides sufficient evidence** that the Board has **breached its fiduciary duties** or that the decision making process is tainted, such as with a lack of independence or interestedness.
- ❖ To challenge the actions of a corporation's board of directors, a plaintiff assumes "the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their Fiduciary Duty: Good Faith, Loyalty or Due Care .
- ❖ **‘Fiduciary’** refers to trust and confidence. A fiduciary agrees to act for, or on behalf of, or in the interests of, another person in the exercise of a power or discretion that will affect the interests of that other person in a legal or practical sense.
- ❖ **Good faith**—directors and other officers .
- ❖ A director or other officer of a corporation must exercise their powers and discharge their duties:
  - In good faith in the **best interests of the corporation**; and for a proper purpose.
  - In Good Faith with the **care that an ordinarily prudent person in a like** position would exercise under similar circumstances; and
  - In a manner the directors reasonably believe to be in the best interests of the corporation
- ❖ Given that the directors **cannot ensure corporate success**, the BJR specifies that **the court will not review the business decisions of directors** who performed their duties **in good faith**.

# Business Judgment Rule (BJR) – cont.

## ❖ Duty Of Care And Duty Of Loyalty

- ❖ Duty of Care, Due of Loyalty is often evaluated by courts in certain **cases dealing with violations by the board**. While the **BJR is historically linked particularly to the duty of care** standard of conduct, **shareholders who sue the directors** often charge both the **duty of care and duty of loyalty violations**.
- ❖ Violations of the **duty of care are reviewed under a Gross Negligence standard**, as opposed to simple Negligence.
- ❖ Consequently, over time, one of the points of review that has entered the BJR was the prohibition against self-interest transactions. Conflicting interest when a board member:
  - A party to the transaction.
  - Has a beneficial financial interest in, or closely linked to, the transaction.
  - Is a director, general partner, agent, or employee of another entity with whom the corporation is transacting.

## ❖ Standard Of Review

- ❖ The following test as a guideline for satisfaction of the BJR. Directors in a business should:
  - Act in good faith;
  - Act in the best interests of the corporation;
  - Act on an informed basis;
  - Not be wasteful;
  - Not involve self-interest (duty of loyalty concept plays a role here).

# The Consent Decree

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- ❖ Consent decrees limits potential increases in business pricing power following a merger by creating viable competitors.
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# Comcast's Attempted 2015 Takeover Of Time Warner in 2015.

- ❖ Combining the biggest and second-biggest cable companies in America to create a single conglomerate would only make their already-bad customer experiences even worse.
- ❖ Media content providers, including **Netflix and Dish Network**, lobbied regulators relentlessly arguing that the combination would enable Comcast to discriminate against content providers.
- ❖ **Post merger, Comcast would control more than one-half of the broadband market** and would be in a position, so the regulators argued, to determine who would get access to its customers.
- ❖ **FCC's Net Neutrality Rule in 2015** is the principle that Internet service providers (ISPs) should enable access to all content and applications regardless of the source, and without favoring or blocking particular products or websites.
- ❖ **Calculating HHI For the Proposed Merger**
- ❖ There were about 100 million U.S. homes with some form of paid TV service (a category that includes cable, satellite, and Internet-based services).
- ❖ Comcast and TWC have about 22 million and 11 million subscribers, respectively.
- ❖ Using some relatively recent statistics about **the top eight pay-tv providers**, we come up with a very rough **pre-merger** estimate of the nationwide pay-tv industry's **HHI of 1,815**. That means that the pay-tv industry, as it stands, is only **moderately concentrated**.
- ❖ But if you merge Comcast and TWC, and reduce the combined company's number of subscribers by 3 million (as Comcast has promised it will do), the pay-tv industry's nationwide **HHI shoots way up to 2,454** – an **increase of 639 points**, putting it close to the level at which it would be **deemed highly concentrated**.
- ❖ **Comcast argued that because it doesn't compete head-to-head** with TWC in many cities, its HHI should be calculated differently – **using city-by-city statistics instead of nationwide ones**. That's the same kind of argument AT&T made when it wanted to acquire T-Mobile. And in both cases, it makes some amount of sense but was not sufficient to turn down the ruling.

# Friendly and Hostile Takeover Tactics

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## ❖ **Friendly Takeovers Are Most Common**

- ❖ The **potential acquirer initiates an informal dialogue with the target's top management**, and the acquirer and target reach an **agreement on**:
  - The key issues early in the process.
  - The long-term business strategy.
  - How they will operate in the short term.
  - Who will be in key executive positions.
- ❖ **Often, a standstill agreement** is negotiated in which the acquirer agrees not to make any further investments in the target's stock for a specific period.

## ❖ **Hostile Takeovers Are More a Threat Than a Reality**

- ❖ An acquirer may choose to adopt more aggressive tactics, including:
  - The **bear hug**,
  - The **proxy contest**,
  - The **tender offer**.
- ❖ However, **relatively few deals reach this stage**.
  - ❖ **Firms are more efficient today than in the 1980s** when highly diversified firms offered **corporate raiders opportunities** to reap huge profits **by breaking up such firms** and selling them in pieces.
  - ❖ **The proliferation of corporate takeover defenses** has made hostile takeovers more **problematic and expensive**.
- ❖ **Sometimes, the threat of an unsolicited offer** turning hostile **increases the likelihood that target** firm's management will ultimately negotiate a settlement.

## Friendly and Hostile Takeover Tactics – cont.

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### ❖ **The Bear Hug**

- ❖ A bear hug is an offer made by one company to buy the shares of another for a much higher per-share price than what that company is worth in the market and often entails mailing a letter containing the proposal to the target's CEO and board without warning and demanding a rapid decision. It's an acquisition strategy that companies sometimes use when there's doubt that the target company's management or shareholders are willing to sell.
- ❖ It usually involves a public announcement to **put pressure on the board**.
- ❖ **Directors voting against** the proposal may be subject to **shareholder lawsuits** alleging they are not working in the best interests of their shareholders.
- ❖ **Once the bid is made public**, the company is likely to attract additional bidders. **Institutional investors and arbitrageurs** (arbs) add to the pressure by lobbying the board to accept the offer. **By accumulating target shares**, they make purchases of **blocks of stock by the bidder** easier, for they often are quite willing to sell their shares.

# Alternative Takeover Tactics

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## ❖ Proxy Contests in Support of a Takeover

- A proxy contest occurs when the acquiring company **attempts to convince shareholders** to use their proxy votes to install new management that is open to the takeover. The technique allows the acquirer to **avoid paying premium for the target**.
- It can also **be used to eliminate takeover defenses**, as a precursor of a tender offer, or to oust recalcitrant target-firm board members.
- *Implementing a Proxy Contest*
  - ✓ The bidder's attempt to call a special shareholders meeting and put a proposal to replace the board at a regularly scheduled shareholders meeting.
  - ✓ Before the meeting, the **bidder opens an aggressive public relations campaign**, with direct solicitations sent to shareholders and **full-page advertisements in the press** to convince shareholders to support the bidder's proposals.
  - ✓ **The target often responds with its own campaign.**
  - ✓ Once shareholders receive the proxies, they may choose to sign and send them directly to a designated collection point such as a brokerage house or a bank.
  - ✓ **SEC regulations** must see all materials distributed to shareholders **for review at least 10 days** before they are distributed.

## ❖ The Hostile Tender Offer

- ❖ A hostile tender offer circumvents the target's board and management to reach the target's shareholders directly with an offer to purchase their shares.
- ❖ Such hostile offers are undertaken for several reasons:
  - **As a last resort** if the bidder cannot get the target's board and management to relent,
  - **To preempt another firm** from making a bid for the target, and
  - **To close a transaction quickly if the bidder believes that time is critical.** A common hostile takeover strategy involves the bidder's acquiring a controlling interest in the target and later completing the combination through a merger.

# Alternative Takeover Tactics: Implementation

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## ❖ Implementing a Tender Offer

- ❖ A tender offer is a type of public takeover bid.
- ❖ The tender offer is a public, open offer or invitation (**usually announced in a newspaper advertisement**) by a prospective acquirer to all stockholders of a publicly traded corporation to tender their stock for sale at a **specified price during a specified time**, subject to the tendering of a **minimum and maximum number of shares**.
- ❖ In a tender offer, the bidder contacts **shareholders directly**; the **directors** of the company **may or may not** have endorsed the tender offer proposal.
- ❖ For example, if a target corporation's stock were trading at \$10 per share, an acquirer might offer \$11.50 per share to shareholders on the **condition that 51%** of shareholders agree.
- ❖ **Cash or securities may** be offered to the target company's shareholders.
- ❖ A tender offer in which securities are offered as consideration is generally referred to as an **"exchange offer."**

## Alternative Takeover Tactics: Implementation – cont.

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### ❖ **Implementing a Tender Offer**

#### ❖ **Multi-Tiered Offers**

- ❖ A bid can be either a one- or two-tiered offer.
- ❖ In a one-tier offer, the acquirer announces the same offer to all target shareholders, which provides the potential to **purchase control of the target quickly and discourage other possible bidders** from attempting to disrupt the deal.
- ❖ In a two-tiered offer, the **acquirer offers** to buy a number of **shares at one price and more at a lower price** at a later date.
- ❖ The form of payment in the **second tier may be less attractive**, consisting of **securities rather than cash**.
- ❖ Once the bidding firm accumulates enough shares to gain control of the target (usually 50.1%), the bidder may initiate a **so-called back-end merger by calling a special shareholders meeting seeking approval for a merger, in which minority shareholders are required to accede to the majority vote**.

# Hostile Takeovers: Bid Premium

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- ❖ In any hostile takeover process, a bid comes at a premium to the **current market price (based on the average price of target's price during past week or maximum past month)** of the stock of the target.
- ❖ The **size of this bid premium** ideally depends on:
  - **How badly the acquirer** wants the target company. **Strategic** or tactical transaction.
  - The **expected amount of synergies** the acquirer hopes to generate.
- ❖ This premium can range from **15-30%** in some markets whereas it can be **as high as 30-45%** in some others.
- ❖ **Other factors** impacting the premium bids are:
  - The **recent** premium paid for **hostile acquisitions** completed during **past 2 years**.
  - The **historical** premium going back as much as past 20 years.
  - The breakdown of various paid **premium in terms of the industries**.
  - The **composition of the target shareholders**. What percentage institutional versus retail. The latter tend to demand higher premium based on (sometimes erroneous) assumptions and projections.
- ❖ **Goodwill**. Acquisition premium is recorded as Goodwill on the acquirer's balance sheet. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology acquired from the target company are factored into goodwill.

# Defense Tactics: Dual Class Stock

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- ❖ A dual class stock structure can consist of Class A and Class B shares, for example. Shares can differ, based on distinct **Voting Rights** and **Dividend Payments**.
- ❖ Normally:
  - One share class is offered to the general public. Limited or no voting rights
  - The other is offered to company founders, executives and family. More voting power and often provides for majority control.
- ❖ Example:
  - **Ford Company** has dual class stock structures, which provide founders, executives, and family with 40% of the vote, while owning 4% of the company total equity.
  - **Facebook** has two classes of shares — Class A, which is mostly held by everyday investors; and Class B, which is mostly held by Zuckerberg. Each Class B share comes with 10 times more votes than each Class A share. What that means is that even though Zuckerberg owns or controls about 15% of Facebook's total outstanding shares, he gets about 60% of its votes.
  - **Google: Alphabet Inc.**'s predecessor Google has issued second Class B shares to founders with 10 times the amount of votes as ordinary Class A shares, sold to the public
- ❖ **In recent times**, the number of companies opting for a dual-class structure during listing has multiplied.
- ❖ In particular, **technology startups** listing on public markets use this strategy to retain control over their outfits.



# Defense Tactics

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- ❖ **Anti-takeover measures share two things in common.** They are designed to:
  - ❖ **Raise the overall cost** of the takeover to the acquirer's shareholders and
  - ❖ **Increase the time required for the acquirer** to complete the transaction to give the target additional time to develop an anti-takeover strategy.
- ❖ **Problem With Anti-Takeover Defenses**
- ❖ Many anti-takeover defenses (such as poison pills, golden parachutes, etc.) have **a tendency to protect management as opposed to the shareholder.**
- ❖ Consequently, **companies with anti-takeover defenses usually have less upside potential** with valuations as opposed to companies that lack anti-takeover defenses.
- ❖ Additionally, **most studies show that anti-takeover defenses are not successful in preventing mergers.** They simply **add to the premiums** that acquiring companies must pay for target companies.

# Shark Repellent

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- ❖ The poison pill is arguably the **most significant corporate financial innovation of the 1980s** and certainly the most controversial.
- ❖ The pill has raised fresh controversy about the relationships **among managers, directors, shareholders, and fiduciaries.**
- ❖ **The pill's proponents say:**
  - Every company should have a stated threat pill.
  - There is no economic basis to oppose the implementation of rights plans.
- ❖ **The pill's opponents are equally emphatic:**
  - How is it useful for a management to make a commitment that could force actions that aren't in either the shareholders' or the company's interest?
  - The pill **favors the established management.**
  - The pill may **cap the upside price** of the stock.
- ❖ **When Triggers**
- ❖ Poison pills represent rights or options **issued to shareholders and bondholders.**
- ❖ When a merger occurs, **the rights are detached from the security and exercised**, giving the holder an opportunity to buy more securities at a deep discount.
- ❖ The rights **cannot be exercised unless a tender offer of 20%** or more is made by another company.

# Other Defense Tactics

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## ❖ White Knight

- ❖ If the target company wants to avoid a hostile merger, one option is to seek out another company for a more suitable merger. **Usually, the Target Company will enlist the services of an investment banker to locate a "white knight."** The White Knight Company comes in and rescues the Target Company from the hostile takeover attempt. **In order to stop the hostile merger, the White Knight will pay a price more favorable** than the price offered by the hostile bidder.

## ❖ Pac Man Defense

- ❖ As a last resort, the **target company can make a tender offer to acquire the stock of the hostile bidder.** This is a very extreme type of anti-takeover defense and usually signals desperation.

## ❖ Put Options

- ❖ They are used with bondholders, allowing them to sell-off bonds in the event that an unfriendly takeover occurs. By selling off the bonds, large principal payments come due and this lowers the value of the Target Company.

## ❖ Macaroni defense

- ❖ The macaroni defense allows the company to sell a **large number of bonds that must be redeemed at a future date** when an acquirer attempts a takeover against the company. **The bonds are redeemed at a high price to make it less attractive** for the acquiring entity to proceed with the takeover.

## Other Defense Tactics –cont.

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### ❖ **Greenmail**

- ❖ **If the acquirer is an investor or group of investors, it might be possible to buy back their stock at a special offering price.** The two parties hold private negotiations and settle for a price. However, **this type of targeted repurchase of stock runs contrary to fair and equal treatment for all shareholders. Therefore, green mail is not a widely accepted anti-takeover defense.**

### ❖ **Golden parachute**

- ❖ A Golden Parachute involves including a provision in the executive's contract that gives them a fairly large compensation in the form of cash or stock if the takeover attempt succeeds.

### ❖ **Supermajority**

- ❖ 70%-80% instead of 50% if an acquirer accumulate 20% of target company.

### ❖ **Staggered board of directors**

- ❖ The tenures of all the directors of the company are staggered over several years such that, the director of the company are elected at different periods. Some directors are elected every two years while others serve for a period of four years. Staggering the directors' tenures makes it difficult for an acquirer to influence a majority of the directors at the same time since the company will elect new members of the board every two years.