Paul|Weiss

Private Equity Digest

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Sponsor Exits Part III – Public Company Transactions

In our last two editions of the Digest, we discussed issues faced by private equity sponsors when taking a portfolio company public and when executing a private company sale. In this edition, we focus on developments of interest to a sponsor engaging in an M&A transaction involving a publicly traded Delaware company.

Tender Offers

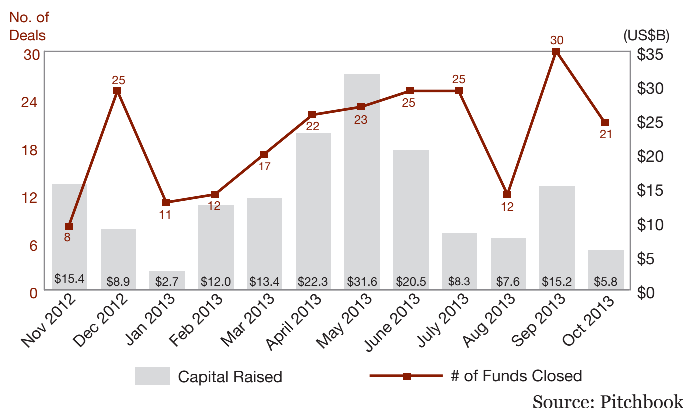
In August 2013, the Delaware General Corporation Law was amended to create a "medium form" merger procedure under a new Section 251(h). Parties completing a two-step transaction (a tender offer followed by a merger) may choose to be governed by the provision, which allows the acquirer to close the back-end merger without a stockholder vote. To qualify, the transaction must meet specified conditions including that:

- The parties expressly agree to be governed by DGCL 251(h);
- At least 50% of the outstanding voting stock (or whatever threshold would have been required to approve the merger) be tendered into the offer;
- The tender offer be for any and all outstanding target voting stock;
- No party be an "interested stockholder" as defined in the DGCL (generally a stockholder who holds 15% or more of the target); and
- The merger will be consummated as soon as practicable after the tender offer closes and for the same consideration.

DGCL 251(h) provides sponsors with clear benefits, including:

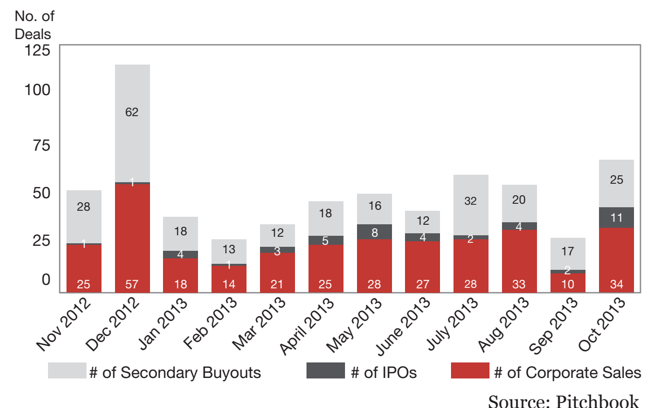
- The elimination of the need for a top-up option (where the target issues an option to sell shares to the acquirer to allow them to reach the 90% ownership threshold necessary to use the short-form merger procedure under DGCL 253) or other facilitating mechanism (such as a dual track tender offer/one-step merger structure);
- The ability to complete the back-end of a two-step acquisition contemporaneously, even where a traditional top-up option would not have been possible (such as when the target did not have enough authorized but unissued stock to issue to the acquirer to reach the 90% threshold); and
- The cost and time saved by avoiding a target stockholder vote.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

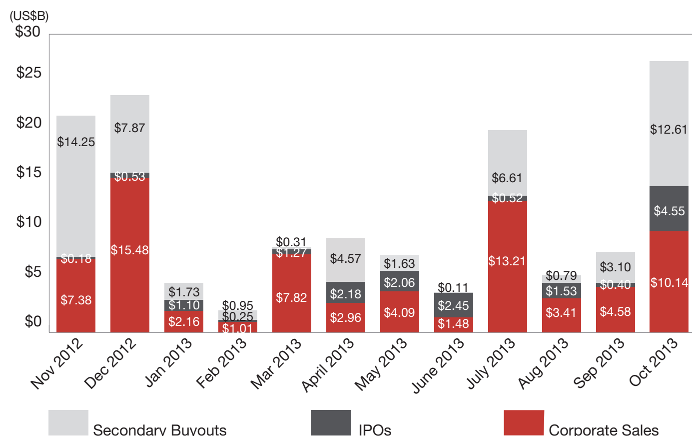
However, there continue to be limitations on the usefulness of DGCL 251(h) to sponsors, including the following:

- The requirement that all stockholders receive the same consideration in the transaction may preclude the use of DGCL 251(h) when management stockholders are receiving arguably disparate consideration for their shares (such as pursuant to a management rollover);
- The unavailability of DGCL 251(h) in transactions involving an interested stockholder party means that the procedure cannot be used in going-private transactions involving a sponsor that is an interested stockholder under DGCL 203 (even when the parties would have otherwise been able to proceed under DGCL 203). Where a sponsor is negotiating pre-signing agreements with management stockholders or entering into tender or voting agreements, this prohibition may also be implicated; and
- The lack of a practical workaround for the SEC staff position regarding waivers of funding conditions may continue to limit the usefulness of tender offer structures for debt financed acquisitions generally. SEC rules require that, when conducting a tender offer, the offeror must provide five business days' notice of material changes before closing the offer. The SEC staff has taken the view that the waiver of a funding condition is such a material change. The practical effect of this interpretation is that an acquirer must either hold the offer open for five business days after it waives the funding condition and risk that the funding may not materialize or fund the debt into escrow before it knows whether the tender offer is successful.

Claims Against Sponsors and Affiliates

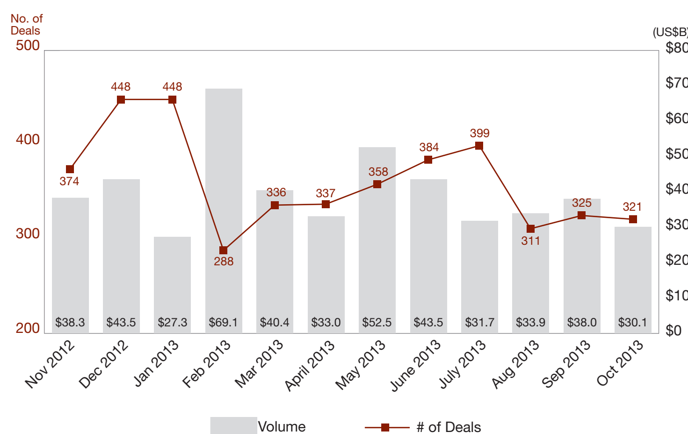
"*Trados*" Issues. A number of recent cases involve claims against large or controlling sponsor stockholders where the stockholder received disparate consideration in an M&A transaction. In the *Trados* case, the Delaware court found that a board comprised of a majority of directors appointed by venture capital funds holding preferred stock had acted entirely fairly to the common holders, notwithstanding the fact that the common holders received no consideration in the sale of the company. The result is both a comfort and a caution to directors appointed by holders of preferred stock. On the one hand, the decision establishes that when the common stock has no value, a well-founded decision to provide common stockholders with no consideration can withstand entire fairness scrutiny. On the other hand, the process required to show that the transaction was entirely fair can be daunting and require a great deal of time and expense. Importantly, the success of the process will be assessed in hindsight after the portfolio company in question has already been sold.

U.S. Sponsor-Backed Exits By Dollar Volume



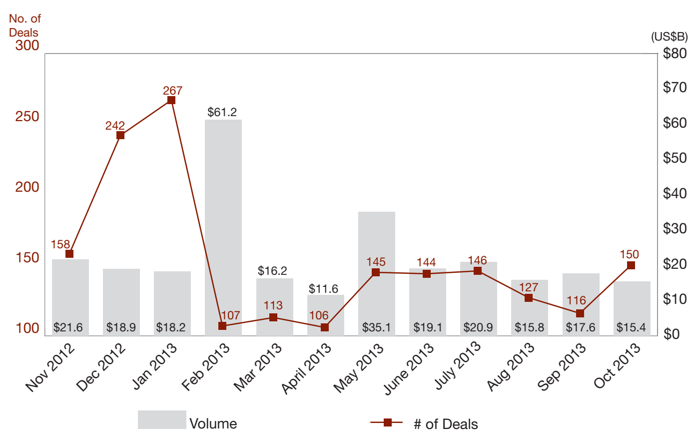
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

A sponsor may be able to avoid this burdensome judicial review with advance planning to implement certain structuring options. Sponsors should consider negotiating contractual drag-along rights with its co-investors at the outset of the investment. By having the ability to compel other investors to sell their entire stake, the sponsor would be able to deliver control of the target company without any board action and thereby avoid any judicial review in that regard. Similarly, a sponsor may consider converting the company into a limited liability company and explicitly eliminating all fiduciary duties. This waiver of fiduciary duties is permitted in Delaware, but may not be in other jurisdictions.

"Liquidity" Claims. So-called liquidity conflicts have been another recent popular claim made by plaintiffs. According to the theory advanced in these cases, sponsor stockholders who are nearing the end of their investment horizon exert undue influence on the board to sell the company via a faulty process or at an inopportune time. These claims have had mixed success with some judges dismissing them as implausible, e.g., because the sale process was in fact lengthy and belies the argument that the sponsors successfully pushed for a quick sale. Other judges appear to give the claims more attention if the facts support a showing that the board was unduly influenced by the sponsor's desire to exit. Depending on the situation, sponsors may want to consider certain measures to protect against these claims, including by carefully documenting the board process and forming a special committee of independent and disinterested directors to be actively involved in negotiations and determining deal terms.

Aiding and Abetting Claims. In nearly all public companies, directors are not liable for breaches of the fiduciary duty of care. However, a third party, such as a buyer, who knowingly participates in such a breach of the duty of care by a director still may face liability even though directors cannot be held liable. Arm's-length negotiations with fiduciaries generally show that there was no knowing participation in a fiduciary breach, including aggressively attempting to achieve a lower purchase price or demanding exclusivity. But overreaching methods of negotiation could backfire, leaving an overly aggressive buyer with an aiding and abetting claim without a clear settlement path. Some of the situations in which courts have noted might constitute overreaching are negotiating a deal with the CEO knowing that the board is not appropriately involved or informed, improperly using banking relationships or knowingly exploiting conflicts of interest among the target directors.

***Revlon* Claims.** There has been a resurgence of claims against target boards of directors that the process to sell the company was deficient because it focused on a single bidder. While these claims apply to both strategic and sponsor transactions, they are more prevalent with respect to the latter due to the clear, cash-out nature of most sponsor buy-outs and a sponsor's frequent desire for exclusivity. The factual nature of these cases make it impossible to delineate any sort of safe harbor for a single bidder sale process, but what is clear is that the board must have a well-supported and well-documented basis for choosing to focus on a single bidder and a robust understanding of the market and target company value.

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