A Word Of Caution: Tender Offers And Appraisal Rights

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In acquiring a public company, a ″two-step″ acquisition structure comprised of a tender offer followed by a back-end merger provides a potentially faster acquisition alternative compared to a traditional ″one-step″ merger. But, as discussed below, due to the way a court might value shares of the target company in a state law appraisal rights proceeding, the tender offer structure presents a potential trap for acquirors looking to implement a new business plan for the target company following the acquisition of control but before the consummation of the back-end merger. Indeed, for these acquirors, a tender offer may not make much sense unless the acquiror is confident that target stockholders will tender the number of shares necessary to effect a short-form merger (*i.e.* , a merger effected without a vote of the target company′s stockholders) during the pendency of the tender offer.

Tender Offers Are Back

... courts in the interpretation of Rule 14d-10 of the Exchange Act - the SEC′s so-called all holders, best price rule. The split caused particular confusion regarding the applicability of the ″all holders, best price″ rule to compensation or retention arrangements with members of the target′s management who were also target stockholders. This confusion led to the possibility that, were a tender offer used, the acquiror could be required to pay far in excess of the agreed-upon purchase price to complete the transaction. In 2006, however, the SEC changed the ″all holders, best price″ rule to clarify that bona fide employee compensation or retention arrangements would not constitute part of the consideration paid for target shares in a tender offer. This clarification catalyzed the resurgence of tender offers for public company acquisitions. Between 2006 and 2009, the number of public company acquisitions structured as tender offers increased from less than 10 percent to nearly 25 percent. Thus far in 2010, nearly 24 percent of all public company acquisitions announced have been structured as tender offers.

Timing Advantage Of Tender Offers

Compared to a ″one-step″ merger, the principal advantage of structuring a public company acquisition as a ″two-step″ tender offer followed by a back-end merger is the speed with which an acquiror can obtain majority control and, in certain instances, total control of the target company.

In a ″two-step″ structure, the acquiror can obtain majority control of the target company at the expiration of the first-step tender offer, which can be as little as 20 business days after commencing the offer. Moreover, the full timing advantage of the ″two-step″ structure is realized if the acquiror obtains a sufficient number of target shares in the tender offer to effect a short-form merger under state law (*e.g.* , the short-form merger threshold under Delaware law is 90 percent of the outstanding shares of each class of target stock entitled to vote on a merger). A short-form merger is accomplished without a vote of the target′s stockholders, thereby enabling the acquiror to consummate the back-end merger (and obtain total control of the target company) within days of completing the tender offer.

If, however, the acquiror fails to reach the short-form merger threshold, the acquiror will need to consummate the second-step merger via a long-form merger, which can add weeks to the acquisition timetable. This resulting interim period can significantly erode, if not altogether eliminate, the timing advantage of the ″two-step″ structure. Importantly, this interim period also presents a concern in relation to dissenting stockholder appraisal rights, as discussed below.

The Concern Of Appraisal Rights In ″Two-Step″ Transactions

If the acquiror uses its majority control position to begin adding value to the target company during this interim period - by, for example, approving divestitures, providing new technology or taking other action to expand the target′s business - then such added value could be considered by a court in valuing the target′s shares in an appraisal proceeding, at least under Delaware law. This is due to the fact that under the Delaware appraisal statute, the value of the target′s shares is determined at the time of the back-end merger, not at the time the acquiror gained its controlling interest.

If a stockholder is dissatisfied with the terms of the back-end merger, then that stockholder may be entitled to exercise appraisal rights if available under state law. Assuming the stockholder properly perfects its appraisal rights, a court will determine the ″fair value″ of the stock of the target company. The court will then order the surviving company to pay that amount to the stockholder that exercised appraisal rights, which could be less than, the same as or *higher* than the price paid by the acquiror in the back-end merger.

Under current Delaware law, a stockholder in an appraisal action is entitled to receive its proportionate share of the target corporation′s ″going concern″ value on the date of the merger (determined as of the point in time immediately prior to the completion of the merger). In Delaware, valuation of the target company′s stock in an appraisal proceeding is governed by Section 262(h) of the Delaware General Corporation Law. Section 262(h) requires a court to ″determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger″ but taking into account ″all relevant factors.″

As part of the Section 262(h) ″all relevant factors″ analysis, Delaware courts have included elements of future value so long as those elements reflect the ″operative reality″ of the target company on the date of the merger. Courts have used the phrase ″operative reality″ to capture the often-quoted rule from *Weinberger v. UOP, Inc.* [1] that ″elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.″[2] Accordingly, if an acquiror acquires over 50 percent of the target′s stock but less than the amount needed for a short-form merger, there is a danger that any future value created by the acquiror before obtaining 100 percent of the target company will be added to the appraisal value. As the Delaware Supreme Court stated in *Cede & Co. v. Technicolor, Inc.* , ″value added to the going concern by the ′majority acquiror,′ during the transient period of a two-step merger, accrues to the benefit of all stockholders and must be included in the appraisal process on the date of the merger.″[3]

Acquirors eager to begin implementing their business plans following the completion of a tender offer should take heed of *Cede* and its progeny. In *Cede* , the acquiror gained control of a majority of the target company′s stock in a tender offer and instituted a plan to break up the target prior to completing the back-end merger. Once the court included this extra value in its analysis, the shares held by target stockholders asserting appraisal rights were valued at a price that was 24 percent higher than the tender offer price.

In *ONTI, Inc. v. Integra Bank* ,[4] Douglas Colkitt, the target′s majority stockholder, approved a ″one-step″ merger of the target company into an entity of which he was also the majority owner. Subsequently, the surviving corporation merged into a company exclusively owned by Colkitt, which then merged into Equivision, Inc., a public company of which Colkitt owned 30 percent. The Delaware Chancery Court held that these subsequent mergers were effectively in place at the time of the initial ″one-step″ merger because Colkitt, through his position as the majority owner of the various private corporations and as chairman of Equivision, Inc., had the ability to ensure that the various mergers occurred. As a result, while the target′s stockholders asserting appraisal rights would have received approximately $6 million under the terms of the merger, such stockholders were eventually awarded approximately $16 million in the appraisal proceeding.

Finally, in *Delaware Open MRI Radiology Associates, P.A. v. Kessler* , the Delaware Chancery Court held that unimplemented business plans can be deemed part of the ″operative reality″ of the target company so long as such plans were in place as of the date of the merger.[5] After finding that there were plans in place to expand the target company′s business to three additional facilities, the court concluded that the shares held by stockholders asserting appraisal rights had a fair value of approximately $33,000 per share, more than double the merger price of approximately $16,000 per share.

Conclusion

Though once out of favor, tender offers have returned as a popular structure for public company acquisitions because they provide a potentially time-saving alternative to traditional ″one-step″ mergers, particularly in the context of all-cash friendly acquisitions. If an acquiror can obtain enough shares during the tender offer to effect a short-form back-end merger, the time-saving advantage of the tender offer structure is clear. Before committing to a ″two-step″ acquisition structure, acquirors should analyze the target company′s stockholder profile (perhaps with the assistance of a proxy solicitation firm) to determine the likelihood of obtaining a sufficient number of shares during the tender offer to effect a short-form merger.

Failure to reach the short-form merger ownership threshold not only effectively erodes the timing advantage of the ″two-step″ structure, but also could create additional exposure in an appraisal proceeding. An acquiror should not assume that obtaining majority control in the first-step tender offer entitles the acquiror to operate the target company without consequence. Indeed, an acquiror should carefully consider whether any actions that it would like to take during the interim period between the tender offer and the back-end merger could be deemed to add value to the target company′s business in the context of an appraisal proceeding. [1]*457 A.2d 701, 712-713* (*Del. 1983*).

[2] See, e.g., Delaware Open MRI Radiology Associates, P.A. v. Kessler, *898 A.2d 290, 314* (*Del. Ch. 2006*) (quoting *Weinberger* , 457 A.2d at 713).

[3]*684 A.2d 289, 298* (*Del. 1996*).

[4]*751 A.2d 904* (*Del. Ch. 1999*).

[5] 898 A.2d 290, 314 (Del. Ch. 2006).

Published August 2, 2010.

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