Execution and Legal

There are 2 ways to gain control of a company:

1. Acquire enough shares to constitute control **according to the laws of the state in which the target is incorporated**

    This can vary from 50.1% to 90%+ (some states don't want outsiders to control their companies)

    Typically executed via a **tender offer** to the public (e.g. Offer to pay $x/share in cash for y% of the outstanding equity)
    Or, a private offer to a major holder (e.g. an institution)
    Or, by acquiring shares in the open market quietly, using a **creeping tender offer**

2. Gain control of the Board of Directors (and then force the company to sell)

    Technically, you do not need to own shares in order to be a Director (beyond some token amount)
    Annual shareholders' meeting has elections for Directors
        Propose a **slate** of Directors at the annual meeting --> shareholders vote
        Practical considerations: staggered elections, different classes of Directors, etc.)

Having gained control of a company, there are 3 possible things can happen subsequently:

1. Election is made to do a statutory merger of the target with the acquirer (most exposure to unknown)
2. Make selected asset purchases and selected assumption of liabilities (implying **limited liability**)
3. Do nothing and keep as is --> target becomes a subsidiary of the acquirer (a **stock deal**) (least exposure to unknown)

A **merger** is a combination of the two companies terms of assets, liabilities and equity, referring to the **liabilities both known and unknown**

    2 old companies cease to exist, replaced by a new company
    All old contracts etc. of old companies revert to the new company
    Requires votes and approval of both sets of shareholders (generally, a simple majority)

        Minority squeeze-out: merger consideration is forced on a dissenting minority

            Some shareholders may object because they are being forced to surrender their economic interest in the target for a different economic interest in the merged companies

            Often goes to **state court**, minority arguing that they did not receive fair consideration

Miscellaneous:

1. The Williams Act of 1968 stipulates that tender offers have to be open for a minimum of 20 business days (30 calendar days)
2. If you own more than 80% of a target company, you can report its financial results as part of your consolidated financial statements
3. A **White Knight** is a third-party who intervenes on a target-friendly basis with a competing bid
4. **Rule of Tender:** You have until the last minute to revoke tender subscriptions
5. An **exchange offer** is an offer of stock-for-stock
    Non-taxable to shareholders of target as they transfer old share basis to new stock
    Non-taxable to target company since no realized P/L on assets
6. **Rule 16(b) - "No Flipping/Short Swing Rule":** Anyone who owns more than 10% of the stock is a constructive insider
    Insiders cannot buy and sell within 6 months
    If insiders trade, they must give back all profits and stand criminal trial
7. **Rule 13(d) - "D is for Disclosure:** Must disclose ownership and intention above 5%
8. **"Sweeping the Street"**: Getting block shares (typically from institutions or arbs) in a single day (or a short period of time)
9. A **Type C reorg:** asset purchase in consideration for 100% stock, after which target liquidates and goes out of business
10. A 338(h)(10) Election is as if the acquirer sells the acquired assets to himself on Day 1
    Assets are written up
    Tax payable (at ordinary rates)
    Used typically if acquirer has NOLs that it can monetize (I.e. by transforming into the step-up stream)
11. **Greenmail:** Money paid to a putative bidder to make him go away
12. Problem: How can you structure the deal in order to meet the interests of all of the parties?
13. **Conglomerate Theory:** Under sophisticated management, conglomerate forms an umbrella under which the companies can be operated more efficiently and access capital markets more efficiently
14. Every state has rules that preclude the Board of Directors from deals that would leave the firm with negative equity pursuant to an action by the board
15. A **triangular merger** is one in which one of the acquirer's subsidiary companies is merged into the target company

Statutory Mergers:

Generally structured as a **Type A reorganization** (from S. 368 (a)(1)(A) of the IRS Code of 1954

Requires that shareholders maintain their **continuity of interest**
Exchange **shares-for-shares** pursuant to the transaction
No taxes at the individual level
No taxes at the corporate level

Leveraged Buyouts

Use the target company's debt capacity to finance its acquisition, structuring the deal so as to take on as much debt as you think you can handle, so that you as you pay down the debt, your equity slice becomes more valuable

Typically, LBOs or MBOs are executed where the target company has the following characteristics:

Stable cash flows growing at the rate of inflation

Brand does the workd, not necessarily the steward
Profitable if you can fund with debt and earn a positive spread (**leverage**)

Lots of cushy overhead and a casual ex-ante management attitude

Trim fat and waste (**agency problem**)

Transaction Mechanics:

Example Transaction:

Kelly/KKR group want to do a LBO of Beatrice

Start with an acquisition vehicle P (a single purpose vehicle)

P borrows $6 bio from a syndicate of banks and investors
Kelly and KKR together contributed $400 mm in consideration for equity in P
This leaves them with a single asset of $6.4 bio in cash

Create a subsidiary S and put all the cash into the sub in consideration for stock

The subsidiary must guarantee P's loans (using an off-balance sheet item)

P makes a tender offer of $6.4 bio to Beatrice shareholders, conditional on receipt of Beatrice shares and a triangular merger of S into Beatrice
Approval required by both sets of shareholders (P's Board and Beatrice's shareholders)

P becomes the de facto owner of Beatrice
S* (S+Beatrice) has a clean balance sheet, carrying only Beatrice's ex-ante debt
Valuation Issues:

1. Will cash flows be able to service debt and with what cushion

2. Need an exit multiple (IPO, typically)
3. Possible to have huge swings in valuation, bigger than size of equity piece
4. How do you pick a WACC with a dynamic capital structure (becoming progressively less leveraged)

Unlevered β theoretically overestimates the riskiness of equity at high levels of debt because debt becomes like equity

FCF methodology is very poor in valuing highly levered transactions --> APV is better

Two-tiered offer: Make a tender offer at one price for 50.1% (or control) and a second tender offer at a second price for the remainder (often thought of as a coercive technique)

White Knight: A company that is friendly to the target company's management and that intervenes with a competing takeover proposal

Generally, if there is the potential for competitive bidding, the best chance for winning is with offering the best bid up front.

Incremental savings don't outweigh the risk of losing the first-mover surprise advantage

Anti-takeover techniques:

Staggered board election
Share buyback --> puts more shares in control of target firm and out of circulation
Issue of different classes of shares with voting rights contingent upon the period holding the stock
Reclassification of different classes of stock --> dilution of voting rights of potential acquirer
Make owning stock unattractive to the arbs
Share buyback premium --> pay exiting shareholders at the expense of those who are staying (since price will drop next day)
Sell the crucial asset in the target firm --> unattractive to the unwanted bidder