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Recent Developments Relating to Hostile Deals in the US

By Spencer D. Klein, Jeffery Bell & Enrico Granata

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The "Pac Man" Defence Makes a Return Appearance

In November 2013, Men's Wearhouse made an unsolicited offer to acquire Jos. A. Bank, just weeks after rejecting a hostile offer from Jos. A. Bank. Jos. A. Bank initially rejected the "Pac Man" counteroffer, but ultimately agreed to a sweetened offer from Men's Wearhouse.

Besides Men's Wearhouse's counteroffer, there have been only a handful of cases where the Pac Man defence was actually employed, the most recent being in 1999.

Because of its limited use, courts have provided little guidance on the legitimacy of the defence. In the only two instances in which U.S. courts have ruled on the matter, they have upheld the use of the Pac Man defence under the business judgment rule. However, both cases pre-date the Delaware Supreme Court's decision in Unocal v. Mesa Petroleum, which first articulated the standard that defencive actions need to be reasonable and proportionate to the threat to the target company.

Of equal importance, the use of the Pac Man defence may hinder or even eliminate other viable defencive tactics. For example, the counter-bidder can't credibly question the business logic of the combination once it has made its own offer to put the companies together, or complain about its potential antitrust implications. Using a Pac Man defence is an implicit agreement that a combination makes sense.

The negotiated resolution of the Jos. A. Bank/Men's Wearhouse situation means that judicial clarity on the legal regime applicable to the Pac Man defence will have to wait. In the meantime, it will be interesting to see whether the tactic will become more widely used in light of this recent success.

SEC Provides New Guidance on Shareholder Proposal "Unbundling"

The U.S. Securities and Exchange Commission staff recently issued Compliance and Disclosure Interpretations providing guidance as to when it is permissible to group multiple matters in a single proposal to be voted on by shareholders. These C&DIs are important for a hostile bidder crafting proposals to present for a shareholder vote. Securities Exchange Act Rule 14a-4(a)(3) requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon, whether or not related to or conditioned on the approval of other matters." Rule 14a-4(b)(1) further requires that the form of proxy provide separate boxes to choose between approval, disapproval or abstention "with respect to each separate matter referred to therein as intended to be acted upon."

The rule does not define "matter." However, in the release adopting the current form of Rule 14a-4(a)(3), the SEC expressed that the purpose of this rule is to ensure that shareholders "not be forced to approve or disapprove a package of items and thus approve matters they might not [approve] if presented independently." Courts and commentators have determined that "what constitutes a 'separate matter' … is ultimately a question of fact to be determined in light of the corporate documents [of the registrant] and in consideration of the SEC's apparent preference for more voting items rather than fewer."[1]

In one new C&DI, the Staff indicated that multiple matters that are so "inextricably intertwined" as to effectively constitute a single matter need not be unbundled. For example, a single proposal submitted to holders of common stock to approve a charter amendment that would reduce the dividend rate on a series of preferred stock in exchange for extending the maturity date of the preferred need not be unbundled into separate proposals, such matters being inextricably intertwined "because each of the proposed provisions relates to a basic financial term of the same series of capital stock and was the sole consideration for the countervailing provision…."

At the same time, the Staff noted

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that it would not view two arguably separate matters as being inextricably intertwined merely because the matters were negotiated as part of a single transaction.

In another C&DI, the Staff concluded unbundling is not required where management sought to present to shareholders a proposal to amend the charter to: (a) change the par value of the common stock; (b) eliminate provisions relating to a series of preferred stock that was no longer outstanding; and (c) declassify the board of directors. The Staff noted that it would not ordinarily object to the bundling of any number of immaterial matters with a single material matter; in this case, while the declassification amendment would be material, "the amendments relating to par value and preferred stock do not substantively affect shareholder rights, and therefore both of these amendments ordinarily could be included in a single restatement proposal together with the declassification amendment." The Staff advised that "registrants should consider whether a given matter substantively affects shareholder rights."

In addition, the Staff noted that a registrant should unbundle an amendment if management knows or has reason to believe that shareholders "could be reasonably expected to wish to express a view ... separate from their views on other amendments," even if such amendment does not affect substantive shareholder rights.

Important Amendment to Merger Vote Requirements Under Delaware Law

In 2013, the Delaware legislature amended the Delaware General Corporation Law (the "DCGL") to eliminate the need to obtain stockholder approval for a second-step merger in a two-step transaction (i.e., an acquisition structured as a tender offer followed by a back-end merger). While commentators have focused primarily on how the proposed amendment changes how friendly acquirers, and in particular private equity sponsors, use tender offers to acquire public companies in negotiated transactions, the amendment would also provide similar timing and cost benefits to transactions that commence with an unsolicited tender offer, but end with a negotiated merger agreement.

New DGCL Section 251(h) resulted primarily from the recognition of the significant costs and delays (e.g., preparation of a merger proxy statement, conducting a special stockholders meeting, etc.) associated with voting on the merger agreement for a second-step merger when adoption is a fait accompli following consummation of the tender offer. Section 251(h) eliminates the need to obtain a shareholder vote (or to use top-up options to reach the 90% ownership threshold required for a "short-form" merger), and facilitates the financing of two-step transactions by ensuring that the second-step merger occurs immediately after the tender offer.

However, a hostile bidder would not be disqualified from employing Section 251(h) to consummate a second-step merger if the parties ultimately negotiated a merger agreement either because the target board agreed to sell to the hostile bidder or because the hostile bidder prevailed in a proxy contest and replaced the board with a new board that approved the merger agreement. This would enable a hostile bidder to potentially benefit from similar cost savings and timing efficiencies and facilitate the financing of hostile transactions.

In order to make use of Section 251(h), certain conditions apply. For example, the tender offer must be for any and all outstanding shares entitled to vote on the merger agreement, and the price paid for shares in the second-step merger must be the same as in the tender offer.

Special Compensation Arrangements with Dissident Director Nominees

Certain activist shareholders have offered special compensation (e.g., a fee for agreeing to be nominated on the activist's slate or performance-related bonuses after election) to their director nominees. However, such arrangements call into question whether the nominee is really representing all the target company's shareholders or just the activist,

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and have been criticized as:

- creating incentives to trigger the special compensation arrangements, even if not in the best interests of all shareholders;
- potentially sacrificing long-term value for short-term gain;
- creating a dysfunctional board by motivating directors differently;
- impacting dissident directors' abilities to satisfy their fiduciary duties; and
- undermining the board's ability to set compensation relative to corporate goals.

In response, some companies have adopted bylaws prohibiting nominees who have special compensation arrangements. Such a bylaw would not prevent an activist from nominating a director, reimbursing such nominee's expenses, or indemnifying such nominee in connection with the solicitation, or from providing compensation to a nominee for her efforts if she is not elected. Such a bylaw would also not disqualify a principal or employee of the activist fund from serving as a director merely because his compensation depends on the trading price of the target's shares.

Such a bylaw can generally be adopted without a shareholder vote. Note, however, that ISS and Glass Lewis believe that the better practice is to allow shareholders to vote upon the ratification of such a bylaw, and both have stated that they will recommend shareholders vote against governance committee members if the board has adopted such a bylaw without seeking shareholder approval.

A New Form of "Greenmail"

The much-maligned 1980s tactic of "greenmail" appears to have made a comeback. "Greenmail" has generally been defined as the practice of purchasing shares in a company to threaten a takeover, and then using that leverage to pressure the target company to buy those shares back at a premium in order to abandon the takeover. Today's variety of greenmail does not always involve the threat of a takeover, but instead typically involves the threat of a proxy contest that would effect major corporate change.

In just the last few months, several noted activist investors have profited handsomely by selling shares back to their target companies. In some cases, these stock repurchases may be the culmination of a legitimate effort by activist investors to drive corporate change. In other cases, they may result from the activists' attempt to turn a quick profit without any legitimate governance objective at all.

Market participants should be aware that, in response to the wave of greenmail in the 1980s, several states-including New York-adopted statutes specifically prohibiting corporations organized in those states from paying greenmail. Other states have statutes that require investors who engage in greenmail to disgorge their profits.

Moreover, the Internal Revenue Code imposes a 50 per cent excise tax on the profit derived from greenmail. However, due to the narrow definition of greenmail, the excise tax is not likely to be implicated by most activist strategies associated with the current version of the "greenmail" tactic, short of a tender offer. Similarly, given that the shares of the activist investor are not repurchased at a premium (as in the more traditional greenmail scenarios) but have generally been bought back at the previous day's closing price, the state anti-greenmail statutes will usually not come into play.

Of course, the absence of a premium does not mean the activist isn't receiving favorable treatment. In fact, because stock prices have tended to fall following such repurchases, an exit at the repurchase/market price will often be available only to the activist. A related concern is that because the activist may not have been able to divest its entire stake at the repurchase price on the open market, the target may be perceived as having overpaid for the activist's shares.

Either way, outsized returns for one

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investor at the expense of others may undermine the legitimacy of "constructive" activists and diminish the recently observed enthusiasm of large institutional investors in supporting activist efforts. Whether these "greenmail" practices persist may depend on whether activists are increasingly perceived as less than genuine in their claim to represent the interests of all shareholders as opposed to seeking an opportunistic short-term gain for themselves. In addition, considering the increasingly widespread criticism associated with this new type of "greenmail," companies may wish to evaluate whether such repurchases should be open to other shareholders through a Dutch auction tender offer or similar buyback arrangement.

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1 - Koppel v. 4987 Corp., 167 F.3d 125, 138 (2d Cir. 1999)

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