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James C. Freund

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MERGERS AND ACQUISITIONS: THE QUINTESSENCE OF CHANGE

JAMES C. FREUND*

I can think of no area of legal practice where the need to cope with change is more accentuated than the one I specialize in—mergers and acquisitions, and more particularly, the frenetic world of hostile takeovers.

I wrote a book in the mid-'70's entitled *ANATOMY OF A MERGER*,¹ a guide to handling negotiated acquisitions. Looking back from the vantage point of a decade later,² I was struck by the tremendous changes that had taken place in terms of how acquisitions of public companies are accomplished.³ Today, the hostile takeover has so permeated the public company acquisition scene that it has entirely altered the way that lawyers and others who ply this trade accomplish their goals.

At the risk of oversimplifying, in the earlier decade, the attention of those of us who negotiated acquisitions was always directed inwardly. We worried about whether we were getting adequate representations and warranties, whether we had the requisite conditions to back out if the seller turned out to have flaws, and so on. Today, however, merger partners spend as much time worrying about what's going on "out there" as "in here." "It's not over 'til the fat lady sings," goes the refrain, and the overriding goal of the parties has now become to make it very difficult, or at least expensive, for anyone else to crash the party.

This has resulted in new acquisition techniques, such as negotiating straight through to a binding agreement without pausing for an agreement in principle; insisting on so-called "lock-up" options; using the tender offer vehicle and other piecemeal modes of purchase—all with the object of being able to put out an initial announcement that has the look of a "done deal." It has also changed the lives of lawyers completely, putting great pressure on them to negotiate quickly and quietly; to look

* Partner, Skadden, Arps, Slate, Meagher & Flom, New York, New York; Princeton University, A.B., 1956; Harvard Law School, LL.B., 1962.

¹ J. FREUND, *ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS* (1975)[hereinafter *ANATOMY*].

² See Freund, *A Turbulent Decade for Deals: Anatomy of a Merger Revisited*, NAT'L L.J., Nov. 11, 1985, at 13. (Article was later included in Freund, *The Acquisition Mating Dance and Other Essays on Negotiating*, LAW & BUS. (1987)[hereinafter *Mating Dance*]).

³ But not, interestingly enough, in terms of acquisitions of *private* companies, which have tended to stay much the same over the years and for which *ANATOMY*, *supra* note 1, is still valid.

for compromise solutions rather than standing pat in hopes that a long siege will bring the other side around; to forego kicking tires and taking other due diligence measures that were commonplace in the old days; and to use stripped-down forms of agreement with fewer lawyers' protective provisions and more reliance on public filings.

Another major difference can be found in the varied roles lawyers are forced to play in the takeover game. These roles go far beyond those of the traditional corporate/securities lawyer, litigator and negotiator.⁴ Today, we have to be something of a financial whiz, a public relations expert, and so on. However, the one role that epitomizes the need to cope with change is that of seer. The rules of the game used to be clearly designated and the lawyer's job was to lead the client by the hand while complying with these rules. Now the rules by which we play are not always as clear.

This became most apparent in 1986 in the realm of taxes. Everyone knew that there were changes in the wind which could greatly alter the shape of things, but no one was sure what would emerge from Congress, both on a substantive level, and also in terms of retroactivity. Everyone assumed the role of seer then, trying to peer into the future to figure out what was going to happen. The stakes were high. If the desired tax treatment was not going to be available (for instance, in the case of a company selling its assets in the course of what was formerly a Section 337 liquidation), the net difference could run into millions of dollars.

If we *knew* the old treatment was not going to be available, then perhaps we could have designed around it (at some financial loss, or decrease of flexibility, to be sure) or conducted negotiations to spread the damage around, so to speak. But the unknown left us in a state of uncertainty. All we could do was gather the best information available on the mood of the Congress and explain the situation to our client and have him say, "What do you think we ought to do?" Then, we could take a stab at a solution, gulp as we saw it implemented, and hold our breath, hoping the bill came out the right way.

This all goes to the issue of the lawyer's predictive function—traditionally, one of his strong points. Being able to tell a client how something is likely to come out separates the professional from the layman. While it is by no means the whole of lawyering, it furnishes a sturdy foundation on which to base considerations of strategy and approach. In today's fast-paced world, that foundation is eroding.

I might add that the lawyer's predictive function, vis-a-vis takeover litigation (again, one of his classic strong points), is also a bit shaky now in view of some surprising decisions and unclear judicial language. Put a group of lawyers together in a room, and try to get them to agree on just

⁴ See Freund, *M&A Lawyers Need Some Rather Unusual Skills*, NAT'L L.J., June 30, 1986, at 36 (later appearing in *Mating Dance*, *supra* note 2).

how the Delaware court is likely to come out on the *next* set of facts it is faced with and one will see exactly what I mean. And yet, this is precisely what we are required to do on a daily basis.

Our practice has certain characteristics which are not duplicated in any other profession. When taken together, these characteristics create a very unstable lawyering environment. The principal characteristics I have in mind are:

(1) The necessity for clients to take actions which have legal consequences to accomplish their business and financial goals. The lawyer's counseling function is absolutely essential to those actions.

(2) The knowledge that each step will likely be scrutinized by a court, under assault by an implacable, well-financed, intelligent adversary lawyer, poised to characterize your every move in apocalyptic terms as the ultimate depredation.

(3) The feeling of insecurity rooted in the fact that the "legal" issues tend to be broad ones, the considerations are highly fact-sensitive and the facts are almost never the same in crucial respects from case to case. No "bright lines" exist for appropriate conduct. We sit on the edge-of-the-law in which a new judicial decision or regulatory position is promulgated daily.

(4) The ever-present fear of either not going far enough to accomplish your purpose or going so far that you regret it in the courthouse.

Let me illustrate this with an example. A company (the "Target"), which is the object of a hostile takeover bid from another company the Target despises (the "Raider"), flees into the arms of a third company (the "White Knight"). To ensure that its merger agreement will survive the Raider's assault, the White Knight attempts to "lock up" the deal by having the Target issue the White Knight an option to acquire additional Target shares.⁵ The lock-up is not so much negotiated as it is shaped to what the traffic will bear—what a judge, called upon to invalidate the lock-up by the frustrated Raider, will endorse as being a reasonable step for the Target's board to take under all the circumstances.

In terms of clout, the most effective lock-up would be an option on shares which, when issued, would give the White Knight fifty-one percent of the Target's then outstanding shares to evidence clear control. But such an option, which has the effect of completely chilling the bidding for the Target, would run a high risk of being upset by the court since it is not hard to conceive of a judicial unwillingness to permit such a coercive and

⁵ As a matter of form, the lock-up is invariably presented by the White Knight as a *sine qua non* of its willingness to get involved in the deal at this price.

definitive step. On the other hand, an option for fifteen percent of Target's shares would probably sail through the courts—but will it serve to deter the Raider?

The White Knight depends on its lawyer for the strongest possible lock-up that will hold up in the courts. The lawyer is really operating by feel, by a sense of things and by whether the actions taken pass his "smell test." He is aware of a variety of concerns that other judges have considered important, such as whether the White Knight's offer would be there anyway without the option (i.e., was the option necessary to induce the White Knight "to play"); if not, how much of a price improvement does the offer represent; at what price will the option shares be purchased; under what circumstances is the option exercisable; what is the likely impact of the option on the Raider and other third parties; how did the Target's board of directors go about fulfilling its fiduciary responsibilities in terms of getting advice and exercising due care; is there reason to suspect management entrenchment as a dominant motive for the lock-up; and so on.

Now, for the lawyer advising on this subject, if the law were static, he or she could develop a refined sense of what is appropriate under the circumstances—how much is not too much. But the law is in constant flux; dozens of cases are winding their way through the courts at any given moment, with judicial judgments being pronounced weekly on lock-ups or on analogous fact patterns related to other defensive takeover tactics, any one of which could impact your particular case. For instance, assume that a judge somewhere decides that the fact of the option remaining exercisable after the White Knight terminates the merger agreement is a significant negative, a factor not previously stressed in the cases and which would not otherwise have been significant in the lawyer's list of key considerations. All of a sudden, everyone is back to the drawing board, rewriting lock-up options to take account of this judicial warning. It is a case of constantly looking over one's shoulder, and the time periods here are measured in days and hours, not months and years.

I am reminded of an analogous situation. In the "good old days," I and many other corporate lawyers used to counsel our clients to take minimalist minutes of their Board deliberations on the premise that it was impossible for something more than shorthand minutes to do justice to the entire discussion, while anything less risked omissions and possible misinterpretations at a later date. Then, along came the *Trans-Union* case,⁶ which threw corporate lawyers into a tizzy with its sweeping indictment of what the court considered inadequate corporate action. When the court pointed to the absence of adequate minutes to buttress

⁶ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

portions of its opinion, we all turned on a dime and now, as a bar, produce some of the most detailed, self-serving minutes known to man.

That capacity to turn on a dime, to adjust to changes in the law and to new interpretations by courts and regulators, is basic to the mergers and acquisitions game. A good example of this occurred several years ago in connection with Carl Icahn's takeover of TWA. Representing TWA, I remember quite well when Icahn surfaced, owning twenty percent of the TWA stock. The big question was "what would he do next?" According to his lawyer,⁷ that was Icahn's big question, too. He had a variety of choices. For instance, he could have made a partial offer, accumulating fifty percent of the stock and enticing tenders from people who did not want to receive securities on the back end.

But just then, on the day after TWA filed its inevitable litigation, the Delaware Supreme Court decided *Unocal Corp. v. Mesa Petroleum Co.*,⁸ holding that Unocal could make a discriminatory tender and exclude Mesa from participating, in order to protect its shareholders from a grossly inadequate and coercive front-end loaded tender by someone whose principal objective, the Board could have believed, was greenmail. After Icahn's lawyer convinced him that a judge might consider him in the same camp as T. Boone Pickens (and thus, under *Unocal*, prey to all sorts of tough responses from TWA), Icahn decided to make a cash offer for all TWA shares (not a junk bond in sight for the TWA shareholders), and to expressly disclaim any intention to seek greenmail. This changed the whole pattern of the takeover, affecting everything that came afterwards. It might not have gone that way at all, were it not for the unexpected intervention of the *Unocal* case.

Sometimes, change does not occur so dramatically, but rather, lawyers adapt to the passage of time, getting more comfortable with a situation. In the wake of the Supreme Court of Delaware blessing so-called "poison pills" in *Moran v. Household International Inc.*⁹ and the original pill's inability to block a stock accumulator who was willing not to trigger a merger transaction,¹⁰ venturesome lawyers began to include in their pills a "flip-in" provision (a feature *not* presented in the *Household* pill), creating a discriminatory dilution of a raider who acquired a certain percentage of the shares. At first, everyone set the flip-in percentage trigger at fifty percent of the shares on the obvious premise that it would be hard to argue that control does not shift at that level. Then, as time

⁷ See, Jacobs, *Case Study of a Contest: TWA*, in SEVENTEENTH ANN. INST. ON SEC. REG. (1986).

⁸ 493 A.2d 946 (Del. 1985).

⁹ 500 A.2d 1346 (Del. 1985).

¹⁰ This was exemplified by Sir James Goldsmith's takeover of Crown Zellerbach Corp., described in M. JOHNSTON, TAKEOVER: THE NEW WALL STREET WARRIORS: THE MEN, THE MONEY, THE IMPACT, 21-27, 196-200, 310-314, 376-378 (1986).

went by and the flip-in was not invalidated in the Delaware courts (albeit, not yet blessed by the Delaware Supreme Court), practitioners tampered with the number. In recognition of the obvious fact that working control can pass at considerably lesser percentages than a majority of the shares, practitioners began to drop the percentage feature of their flip-in provisions—first, a toe in the water to forty-five percent, then to forty percent or thirty-five percent, then to thirty percent, and now to twenty percent (or in some instances, where the acquiror has certain “bad man” characteristics, to even lesser percentages).

Often, the change requiring new directions has been brought on by the practitioners themselves (and their investment banking brethren), using egregious tactics which work and become the fad, but ultimately create countervailing pressures. Some years back, partial tender offers were all the rage, elevating coercive action to a high art form with front-end loaded deals, separate proration pools and the like. It became so confused, however, that the Securities Exchange Commission finally approved regulations¹¹ extending withdrawal rights for the duration of the tender offer and giving everyone an equal shot at proration. Consequently, the front-end loaded partial offer virtually disappeared from the acquisition landscape.

Coping with change also requires lawyers to find new loopholes in corrective actions taken to right a supposed wrong. Not long ago, the Internal Revenue Service introduced a prohibitive tax on “greenmail,”¹² which it defined in terms of a company buying off a shareholder who made or threatened to make a tender offer for company shares. Now, those who wish to be bought out by the issuer at a profit have been forced to mute their overt threats or, for example, to threaten just a proxy contest, which presumably is not embraced within the concept of “tender offer.”

Mergers and acquisitions therefore is a legal speciality that is constantly in a state of flux.¹³ Practitioners are forced to adapt to change, to structure new defenses and then devise novel routes around them by forging new methods of making deals. It is a fascinating practice; and while we often reach for the Roloids, most of us would not have it any other way.

¹¹ 17 C.F.R. § 240.14d-7 (1987).

¹² I.R.C. § 5881 (1986).

¹³ Fortunately, for those of us who ply this trade, the biggest potential change of all *has not* happened. I am referring to the imminent demise of the whole takeover movement, which, as each major development occurs—the Williams Act, state anti-takeover legislation, the new tax law, the poison pill—is the object of intense speculation in op. ed. pages across the land. But the resilient deal business has simply shucked these and other SEA changes off as little more than momentary aberrations as it plunges ever onward.