What Japanese buyers need to know about US public deals

In this report we discussed the typical deal structure as well as the specific characteristics of US public M&A deals which Japanese buyers might need to consider.

Typical deal structure for a US public deal

There are, broadly speaking, two structures for US public deals – the one-step merger and the two-step merger. In a one-step merger, the buyer forms a subsidiary which then merges with the target. Thereby the target shareholders' shares are cancelled and converted into either cash or buyer stock. This structure requires majority vote of the voting stock to approve the merger. The remaining shareholders will then be "squeezed out" when the deal is completed. They do have an appraisal right to ask a court to determine the fair market value of their shares, but they cannot hold up the deal.

In a two-step merger, the first step is a tender offer from the buyer to all target shareholders to tender their shares essentially in escrow. The second step is a merger by which the buyer uses the control of the company already gained, in order to "squeeze out" the remaining shareholders. This is possible under the Delaware Statute. Again, their only remedy is the appraisal right mentioned above.

The main difference is the point in time when the interloper risk is cut off. This is especially important for public deals, as it is possible for third parties to come in once the deal becomes public. In a one-step merger, the risk is cut off at the time of the shareholder vote. Typically, the shareholder vote can be finalized two or three months after signing. On the other hand, for the two-step merger, the interloper risk is not cut off at the time of the tender offer, but at the time of obtaining all regulatory approvals, e.g., antitrust or CFIUS approvals, which could possibly take up to five or six months. Therefore, the one-step merger is often the preferred structure in cases where a lengthy regulatory review is expected. However, in cases where a quick regulatory approval can be obtained, the two-step merger is often preferred because control of the company can be gained relatively quickly.

Fiduciary duties and their impact on the sales process

Under Delaware law, except for the case of hostile takeovers, there are fiduciary duties for the board of directors of the target. The buyer needs to consider these when negotiating. The directors are subject to these fiduciary duties as they essentially act on behalf of the shareholders in the negotiation process. So, the two main fiduciary duties are the duty of care and the duty of loyalty. The duty of care requires directors to act prudently and diligently, e.g., consulting legal issues with a counsel, understanding the deal and its terms, reviewing the company's financial situation etc. The duty of loyalty requires the board to act in the best interest of the stockholders and free of conflict of interest. According to Delaware case law, this includes the duty to obtain the highest value possible for the shareholders, so called "Revlon duty". This does not necessarily mean the highest price. In some situations, other factors might also be considered, e.g., regulatory scrutiny, antitrust risks, requirement of foreign investment approvals etc. Furthermore, the Delaware Court has made it clear that there is no existing blueprint to carry out the Revlon duty and that it is left to the board to decide how they obtain the best value possible. In most cases the board would decide to run an auction, but in some cases the board might not do so, e.g., when they receive a great offer which was requested to be kept confidential.

Agreements between bidder and target and/or major shareholder?

There is usually an agreement between the buyer and the target, called merger agreement. Such agreement could govern a one-step merger or a two-step merger. In a two-step merger, some provisions would govern the tender offer step and other provisions the merger step. The contents of such agreement would usually include the consideration to be received by the shareholders and several covenants, e.g., regarding the regulatory approval, the provisions to fulfil fiduciary duties (e.g., a superior offer situation), termination

and termination fees etc. Exclusivity is rarely agreed upon due to the fiduciary duties. Sometimes, the buyer wants to secure the support for the transaction of the major shareholder by entering into a support/voting agreement.

Role of the board and the CEO during negotiations

Negotiations are typically conducted with the target's CEO, sometimes with another member of the management team or a representative of a transaction committee, if one exists. The CEO manages the process so that the directors have access to the information they need to fulfil their fiduciary duties.

Point in time of negotiating compensation and retention packages

It is important to ensure that the CEO has the support of his or her board at all times. In some cases, buyers negotiate a deal with the CEO and realize afterwards that the board has not been receiving the necessary information. Therefore, a buyer should repeatedly request the CEO to confirm the board's support with the terms and conditions being agreed. The negotiation of the CEO's compensation should be pushed off until most material terms of the deal itself have been agreed upon, surely until after the agreement on the share purchase price.

Breaches of fiduciary duties and risk of litigation initiated by shareholders

In the US, the process that a board goes through to sell control of the company is very important. Therefore, the process of a possible auction and negotiations with the buyer is included in the proxy statement in a section called "background to the merger". The target company thereby demonstrates to its shareholders that the board exercised its fiduciary duties. However, litigation is still common and might be considered a cost of doing public deals in the US. Some shareholders might file suits alleging that there are violations of security laws and/or breaches of fiduciary duties. Usually, the target company would settle these suits by agreeing to disclose additional information and pay the attorneys' fees. Although these suits are the target's issue, they ultimately become the buyer's issue, as in US public deals there is neither indemnity from the shareholders nor an adjustment to the purchase price. Therefore, it is also in the buyer's interest that the board runs a good M&A process, informed by the CEO on the process of negotiations and terms agreed, and fulfils the fiduciary duties.

Choice of the investment bank

It is advisable to choose an investment bank that is experienced in US public M&A transactions. The bankers know the required processes well. Often, they are not only helpful in negotiating key deal terms but also useful at ensuring a process in which directors and officers exercise their fiduciary duties.

Same strict standards of fiduciary duties for private M&A? Further differences?

In private M&A, the same fiduciary duties apply for the board of directors as in public M&A, except for deals through a share purchase where the buyer enters into an agreement with the shareholder directly and the board is not involved. However, if the target has many shareholders, a direct share purchase would be impractical and, therefore, the board would be subject to the same fiduciary duties as in the public context. Nevertheless, these fiduciary duties often do not underlie the same strict scrutiny as in the public context and there are a few important reasons for that. Firstly, in public transactions, everything that the board does during the sale process will eventually become public as it is part of the proxy statement mentioned above. Secondly, in the private context the shareholder base is relatively closed, whereas in the public context anyone can become a shareholder and any shareholder could eventually sue the board. So, the litigation risk for private transactions is generally lower. Thirdly, unlike for public transactions, purchase price adjustment and post completion indemnification are not uncommon for private transactions. Therefore, the litigation risk could be transferred back to the sellers. Adding up these reasons one can conclude that although the board is subject to the same fiduciary duties, it may be less concerned about them.

There are some further differences between public and private transactions. Firstly, the timeline for public transactions is often more compressed, as the concern about a leak is high. A leak could affect the stock price, which could even lead to a discontinuation of the whole transaction. Secondly, the due diligence concerning public targets is often less detailed and at a much higher level. The reason is that a public target is required to file periodic reports with the Securities and Exchange Commission, and it is expected that the stock price reflects the information available in the market. Thirdly, unlike public deals, many private deals include provisions on indemnification and purchase price adjustment. Furthermore, exclusivity is much more common for private deals and may be agreed upon for longer periods, e.g., one or two months, whereas exclusivity is very uncommon for public deals due to the fiduciary duties and, even if agreed upon, would be a matter of a few days.

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