PRESENTED AT

11th Annual
Mergers and Acquisitions Institute

October 15-16, 2015
Dallas, Texas

Maximizing Seller Leverage: Update on Pivotal Processes, Practices and Provisions

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Auctions: From the Seller's Perspective

PRACTICAL LAW CORPORATE & SECURITIES

This note describes an auction from the seller's perspective including, the advantages and disadvantages of an auction to the seller, the differences between an auction and a single buyer transaction and an overview of the auction process.

An auction is the sale of a company or business where the seller seeks competing bids. Although an auction has all of the same components as a single buyer transaction, there are additional steps and considerations because the seller is dealing with multiple bidders. This Note describes the auction process from the seller's perspective, including:

- The advantages and disadvantages of an auction to the seller.
- The differences between an auction and a single buyer transaction.

For more information on single buyer transactions, see the following Practice Notes:

- *Stock Acquisitions: Overview (http://us.practicallaw.com/4-380-7696).*
- *Asset Acquisitions: Overview (http://us.practicallaw.com/6-380-7695).*
- *Private Mergers: Overview (http://us.practicallaw.com/0-380-9145).*
- *Public Mergers: Overview (http://us.practicallaw.com/4-382-2164).*
- *Tender Offers: Overview (http://us.practicallaw.com/1-382-7403).*

ADVANTAGES AND DISADVANTAGES OF AN AUCTION TO THE SELLER

There are certain advantages and disadvantages the seller should consider before deciding to auction the target company.

ADVANTAGES

The seller seeks a number of the following benefits from the auction process:

- The seller can usually reach more potential buyers through an auction.
- The competitive process maximizes the price by encouraging potential buyers to bid against each other.
- The seller can negotiate more favorable deal terms if there are competing bids.
- The seller controls the sale process and drafts the transaction documents.
- The seller controls the due diligence process, including the number and scope of the documents disclosed and amount of time bidders have to investigate the target company.
- A well run auction functions as a market check (see *Box, Revlon Duties and Auctions*).
- The seller can gain leverage by keeping confidential the number and identity of the bidders.

DISADVANTAGES

- Not all businesses are suitable for sale by auction. If the market sector is limited and there are only one or two potential buyers, an auction may not be appropriate.
- If a potential buyer has already approached the seller with an offer for the target company, starting an auction process may drive that party to withdraw its offer.
- The cost to the seller is usually higher than in a single buyer sale. The seller typically engages an investment bank and may incur higher legal fees because its lawyers are responsible for drafting documents for and negotiating with multiple parties.
- A prolonged auction process with multiple bidders interrupts daily operations of the target company. Key management may become distracted from their duties because they must participate in due diligence and the drafting of the disclosure schedules for multiple bidders.
- It is often more difficult to prevent employees from learning the company is for sale if senior management is engaged in a complex auction process.
- The seller may have less control over the effect of the sale on management. For example, whether or not management is retained after completion of the sale.
- Some bidders may not be serious about acquiring the target company and are interested only in finding out information about a competitor. Sellers often try to minimize this problem by withholding competitively sensitive information (such as customer contracts) until late in the auction process.
- If the auction process does not result in a sale, the market (including the target company's competitors, investors, customers and other potential buyers) may think the target company is overvalued or in financial trouble.

REVLON DUTIES AND AUCTIONS

In the context of a change of ownership or the break-up of a corporation, the Delaware courts apply a higher standard when reviewing the conduct of directors (see *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)*). In this context, the Delaware courts have held that the board of directors has the burden of achieving the highest value reasonably available to stockholders (known as *Revlon* duties). Usually, the highest value is interpreted to mean the highest purchase price, but the board of directors can consider other factors such as certainty of completion and the likelihood of obtaining required governmental consents (such as antitrust clearance). If the directors fail to meet these *Revlon* duties, they must show the sale transaction was entirely fair to the corporation.

Although an auction may seem like a good way to achieve the highest value for the stockholders, the board of directors must also make sure they:

- Market the company to a wide enough pool of prospective buyers (for example, market the target company to both private equity and strategic buyers).
- Remain involved in the negotiations.
- Employ a reasonable and informed decision making process.

For more information on the fiduciary duties of the board of directors, see *Practice Note, Fiduciary Duties of the Board of Directors (http://us.practicallaw.com/6-382-1267).*

TIMING OF AN AUCTION

In an auction, multiple bidders submit an offer to purchase the target company. The auction can last from a couple of weeks to several months depending on factors such as:

- **The number of bidders.** If there is a large number of bidders, the process becomes more complicated because the seller conducts the due diligence process and negotiates the transaction documents individually with each bidder.
- **Whether or not the auction is competitive.** If the auction is competitive, the seller has greater control over the process and can demand a shorter time period for due diligence and negotiation.
- **If the transaction is complicated.** Sometimes there are deal-specific issues involving time intensive planning or negotiations such as complicated financing, internal reorganizations or required governmental or regulatory consents. For example, if the target company is part of an interrelated company group, the seller may need to move assets around or arrange to provide certain services to the buyer for after the transaction is completed.
- **Whether the target company is a public company.** If the target company (or the seller or buyer) has an obligation to make public disclosures, then the pre-closing process includes the preparation, filing and review (including the SEC's review) of the necessary disclosure documents (see *Practice Note, Public Mergers Disclosure: Overview (http://us.practicallaw.com/0-382-1406)*).

TRANSACTION STEPS: SELLER'S ROLE IN THE AUCTION

The number of steps in an auction differs from transaction to transaction, but almost invariably include the steps set out below. For an illustration of the auction process see *Auction Timeline (http://us.practicallaw.com/9-381-0700).*

PRELIMINARY PREPARATION

In an auction, the seller controls the sale process. Since it is conducting negotiations with multiple parties, the seller needs to take additional steps and use additional resources. As described below, there are certain preliminary preparations every seller should make before contacting the bidders.

Decide to Put the Company Up for Sale

Sometimes an auction is initiated when the board of directors (or the majority stockholder(s)) decides it is in the best interests of the target company to pursue a sale. Other times, a potential bidder submits an unsolicited indication of interest which causes the seller to look for other competing offers. In either case, the board of directors must make an informed decision whether or not to pursue a sale and how to achieve the highest value for its stockholders.

If the board decides to pursue an auction sale, it must also decide whether to structure the auction as either a public or closed auction. During a closed auction, the seller will approach several potential bidders confidentially. On the one hand, this structure may be disadvantageous to the seller because there will likely be less competition. On the other hand, it can be advantageous if there is no competition and the bidder submits a high purchase price believing that there are other bidders. During a public auction, the seller will make a public communication (such as a press release) that it intends to sell its company. The public auction approach often attracts more bidders.

As discussed above, the board of directors has enhanced fiduciary duties when the company is for sale (see *Box, Revlon Duties and Auctions* and *Practice Note, Fiduciary Duties of the Board of Directors (http://us.practicallaw.com/6-382-1267)*).

Engage Advisors

An auction is more complicated than a single buyer sale because the seller is simultaneously negotiating with multiple parties. The seller needs to engage additional advisors to ensure a smooth process. The seller must assemble its team and set out clearly each member's responsibilities at an early stage. Typically the seller's team includes:

- An investment bank as its financial advisor.
- Legal advisors.
- Accountants.
- Key managers of the seller and the target company.

Because the team can be large and includes multiple organizations, it is important to have a point person to organize and coordinate the process. The point person may be the seller, but often the seller delegates this responsibility to its investment bankers. Although deal teams may be organized in various ways, the following is a typical allocation of responsibility:

- **Investment bankers.** Usually play a key role in auctions. They:
  - solicit bidders;
  - draft marketing materials;
  - field requests for access to management;
  - arrange conference calls or visits; and
  - handle due diligence requests, questions about the process and price negotiations.