



M&A Alert

January 2010

Recent News

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- DIRECTV in its \$28.5 billion combination with Liberty Entertainment, Inc.

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- #1 in 2009 Global Announced Bankruptcy Liquidation M&A
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- #5 in 2009 US Announced M&A

Locking Up the Public Deal: Seeking Certainty in Uncertain Times

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When a buyer signs up a deal to acquire a public company, the buyer wants as much certainty as possible that the deal will close on the terms negotiated. One of the best ways to enhance this "certainty of closing" is to obtain commitments (known as lock-up agreements) from large shareholders of the target to vote for, tender shares into, or otherwise support, the deal. Lock-up agreements help the buyer protect its deal from being "jumped" by a competing offer from an interloper or turned down by shareholders for other reasons.

Many acquisitions of U.S. publicly companies announced in the past year had lock-up agreements, including the \$3.9 billion acquisition of Marvel Entertainment (lock up of 37% of the shares), the \$3.6 billion acquisition of Perot Systems (lock up of 21% of the shares), the \$2.9 billion acquisition of Metavante Technologies (lock up of 25% of the shares), the recently announced agreement to acquire Bare Escentuals in a transaction valued at \$1.6 billion (lock up of 16% of the shares), and the pending \$6.4 billion acquisition of Affiliated Computer Services discussed later in this article.

In light of recent market volatility, lock-ups are as important as ever. A swing in a party's stock price can quickly change a deal that was priced at a premium into a below market deal. These dynamics create fertile ground for an interloper to come off the sidelines and challenge a deal or for shareholders to turn down the deal in the hope of getting a better offer. Below are legal considerations that are brought into play by the use of lock-ups.

SEC Rules

"Gun Jumping"

In a public company acquisition structured as a share exchange offer, the public offer and sale of the buyer shares to target shareholders must be registered under the Securities Act of 1933. If lock-up agreements to tender into the exchange offer are executed before the filing of the registration statement with the SEC, the SEC may object to the filing on the grounds that the lock-ups constitute a private offer by the buyer to the locked-up shareholders, and once an offering has commenced privately it must be completed privately.

However, the SEC recently confirmed¹ that it will not object to the filing of a registration statement after lock-up agreements are signed if:

1. the lock-ups involve only executive officers, directors, affiliates, founders and their family members, and holders of 5% or more of the target's shares;

2. the persons signing the lock-ups collectively own less than 100% of the target's shares;
3. the persons signing the lock-ups do not actually tender their shares (for example, by signing a letter of transmittal) before the registration statement is filed with the SEC;
4. the exchange offer will be made to all target shareholders; and
5. all target shareholders will be entitled to receive the same amount and form of consideration.

This confirmation is consistent with prior SEC guidance² in the context of a one-step stock-for-stock merger. The SEC has said that it will not object to the filing of a registration statement after the execution of lock-up agreements to vote in favor of a stock-for-stock merger if conditions (1) and (2) above are satisfied and votes will be solicited from target shareholders who have not signed lock-ups and would be ineligible to purchase in a private offering. However, if the persons entering into the lock-ups also deliver written consents approving the merger, the SEC may object to the filing because offers and sales have already been made and completed privately, and again, once begun privately, the transaction must be completed privately.

Plans and Proposals Disclosure

Schedule 13D disclosure is required of any person or group that directly or indirectly beneficially owns more than 5% of any class of shares registered under the Securities Exchange Act of 1934 (the "Exchange Act"). Under the Exchange Act, a person who has the right to vote, or to direct the vote, of shares may be deemed to be the beneficial owner of those shares. Accordingly, a lock-up that grants the buyer a proxy to vote the locked-up shares would trigger a Schedule 13D disclosure obligation if

those shares (together with any shares otherwise beneficially owned by the buyer) represent more than 5% of the outstanding target shares.

By itself, disclosure of a lock-up generally is not an issue because the lock-up would be disclosed anyway in the public offer documents. In fact, the buyer specifically wants the lock-up disclosed in order to deter would be interlopers. However, the possible drawback is that Schedule 13D requires public disclosure of certain matters, such as future (including post-closing) plans or proposals for the target company, which, depending on the situation, might otherwise not be required to be disclosed.

Fiduciary Duties of the Target's Board of Directors

In 2003, the Delaware Supreme Court ruled in *Omnicare v. NCS Healthcare* that a target company's directors may not agree to a totally locked-up deal without an effective fiduciary out mechanism. Specifically, the court struck down a lock-up of enough shares to ensure the outcome of the shareholder vote, where the target committed to bring the deal to a vote even if a superior offer was received prior to the vote, thus making shareholder approval of the deal a *fait accompli*.

After *Omnicare*, dealmakers began to tweak their lock-ups, and some of these have been tested in the courts. Notably, in 2004 the Delaware Chancery Court in *Orman v. Cullman* upheld a lock-up that stopped short of guaranteeing completion of the deal at hand, but instead required the controlling shareholder to vote against any other sale for 18 months, thus effectively blocking any competing transaction for at least 18 months.

Written Consents

In some situations, an absolute lock-up can be achieved by obtaining,

concurrently with signing up the deal, written consents in favor of the transaction from the holders of a sufficient percentage of the target's shares to approve the transaction. This approach eliminates the time lag between the directors' approval of the deal and the shareholder vote, during which period *Omnicare* requires the target to have a way out of the deal to accept a superior proposal. This approach was validated by the Delaware Chancery Court in 2008 in *Optima International v. WCI Steel*. There, after questioning the continued vitality of *Omnicare*, the court ruled that nothing in Delaware law requires any minimum time period between the directors' approval of a merger and the shareholder vote. The court noted that its decision not to enjoin the deal at hand was influenced by the fact that the target had been shopped to other potential bidders, and that there were valid timing reasons (including a serious liquidity crisis) for the directors to agree to the written consent approach rather than take the time to call a shareholders' meeting to vote on the deal.

The written consent approach only works if the target's charter documents permit shareholders to act by written consent. Many public companies do not (as a defensive measure) permit action by written consent. In addition, the approach works best as a practical matter if voting control of the target is concentrated in a relatively small number of shareholders.

Parties considering written consents for a target whose shares are registered with the SEC should be aware that the Exchange Act requires filing with the SEC, and mailing to target shareholders, of an information statement on Schedule 14C, followed by a 20 day waiting period, before a merger approved by written consent may close. Also, if the buyer will be

paying with stock, then obtaining written consents before the filing of a registration statement raises the “gun jumping” issues discussed above under “SEC Rules.”

Litigation

Lock-ups, like any other “deal protection” device, are often challenged in the shareholder lawsuits that frequently accompany public M&A deals.

The case law teaches that a lock-up should withstand challenge if, *when considered together with the totality of all the other deal protection devices employed* (including the break-up fee and any “force the vote” provision), the deal protection package is not preclusive of the shareholders’ ability to prefer a competing, superior offer received before the time shareholders approve the deal.

Even so, dealmakers sometimes agree to amend the deal protection provisions post-signing in order to settle the shareholder lawsuits. A recent example is Xerox’s agreement to acquire Affiliated Computer Systems. In that deal, Xerox obtained a lock-up voting agreement from Affiliated’s chairman, who owns shares representing over 43% of the votes. However, to settle lawsuits brought by Affiliated shareholders, Xerox agreed that it would not enforce the lock-up if Affiliated received a superior acquisition proposal.

Bankruptcy and Financially Distressed Targets

In a sign of the times, the M&A market for financially distressed companies has been particularly active. Lock-ups are an important part of these deals as well. Buyers of financially distressed companies, and buyers in connection with “pre-negotiated” or “prepackaged” plans of reorganization under chapter 11 of the U.S. Bankruptcy Code, often seek lock-up agreements from creditors and other key stakeholders of the target to vote in favor of, or otherwise support, a plan that provides for their proposed M&A transaction. For example, the complex 2008 merger of American Color Graphics and Vertis Holdings was accomplished through prepackaged chapter 11 cases with lock-up agreements involving numerous stakeholders.

There are unique considerations for lock-ups in the bankruptcy context, which we will discuss in a future article.

- 1 See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question 139.30 (Nov. 16, 2009) at <http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.
- 2 See SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question 239.13 (Nov. 26, 2008) at <http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.

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