

THE MICHEL/SHAKED GROUP

RESEARCH FROM OUR EXPERTS

Major Equity and Asset Transactions: The Enhanced Standard for Minimizing Litigation Risk

Traditionally, companies have applied a great deal of care and scrutiny to merger and acquisition transactions, as well as to other selected major strategic undertakings. Today, investors and regulators are implicitly demanding that same level of review be applied to a broader category of undertakings, especially material and frequently complex transactions linked to the common stock or assets of the company. I will refer to this group as “equity-based transactions.”

A sizable equity-based transaction is a major corporate event. Companies should show that sufficient thoughtfulness underlies their decision-making process and the weighing of alternatives. Whereas the mechanism for effecting the transaction may (or may not) be straightforward, the related analysis and structuring are often varied and complex. For instance, a large share repurchase can be simple in its execution. However, it can be challenging to measure the impact on the company’s credit, to assess the fundamental value of the shares retired and to foresee what other corporate opportunities must be forgone.

In the case of major strategic / M&A transactions,

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The opinions expressed in this article are those of the author and do not necessarily reflect those of The Michel/Shaked Group.



boards of directors have typically relied in good faith on the corporation's officers or employees, and additionally upon professionally competent outside financial experts that have been selected with reasonable care. Recent high-profile situations have broadened the range of potential transactions subject to scrutiny. Such situations have also placed increased duties upon the company's CEO and CFO. Any failure to satisfy their obligations can lead to significantly increased legal exposure.

Common stock and other equity-related securities, measured by market value, generally form the great bulk of a company's capital structure. These junior securities are also the company's most expensive capital source, and the same may be said for equity participations in corporate assets. As a result, the potential economic benefit or loss from an equity-based transaction is high.

In practice, structuring and understanding equity-based transactions is an imprecise undertaking requiring experience and sound judgment. While modern financial theory, such as the Black-Scholes option pricing model, has made great strides in this area, such forms of analysis constitute the beginning, and not the end, of a comprehensive evaluation of the appropriateness of such a transaction. Unlike debt, and especially unlike investment-grade debt, equity-based transactions often lack a widely understood and accepted basis for sophisticated analysis. Also unlike the situation with debt, the burden of review typically falls upon the most senior officers of the company, who are at a disadvantage in their ability to analyze, given both the demands of their other duties and the less-straightforward nature of the analysis required.

In order to avoid subsequent criticism, the CEO, CFO and the board of directors need to be properly advised. Such advice is most credibly provided by a third-party financial advisor, with length and breadth of experience, whose compensation, unlike that of the investment bankers executing the transaction, is not directly tied to closing a deal. Such advice may or may not call for an official fairness opinion. However, the process should reflect due care taken in a disciplined review of key considerations,

A Letter From Our Managing Directors

Dear Friend:

We are pleased to bring you Rob Brokaw's insights into minimizing litigation risk in major equity and asset transactions. He has had a distinguished career as an investment banker at Bear Stearns, Merrill Lynch and PaineWebber. In addition he has served as an adjunct professor at New York University's Stern School of Business.

As a Managing Director responsible for the design and execution of a wide variety of equity and asset transactions, Rob Brokaw describes many topics relevant to all those involved in structuring deals and litigating issues related to those transactions. Whether the transactions involved are seemingly straightforward equity issues or more complex convertible offerings, spin-offs, recapitalizations or acquisitions funded with equity, this piece provides useful advice on the evolving standards associated with major transactions in today's environment.

We hope that you find his article insightful and helpful to your practice.

Best Regards,



Allen Michel



Israel Shaked

taking into account the circumstances known at the time.

Specific examples of controversial transactions may be useful. For instance, some speculative-grade issuers that had access to the long-dated convertible market chose a shorter maturity to save a few basis points. A few years later, they found their share prices much lower; and lenders were unwilling to extend credit beyond the impending maturity of the convertibles. Elsewhere, the press has been full of stories about complex partnership arrangements that the CEOs did not understand and for which no disinterested financial advice had been sought. Acquisitions that could have been financed with equity are instead funded with borrowings, combining increased financial leverage with the uncertainties of merger benefits. Forward stock purchase contracts are settled at future dates, by which time stock prices may have fallen substan-

tially, meaning shares must then be acquired at large premiums to market.

The process of transaction approval should demonstrate “*appropriateness*,” as well as clear evidence that those involved are acting in good faith, untainted by self-interest, in the honest belief that the transaction is in the company’s best interests. An outside advisor may bolster the company’s defense should subsequent litigation give rise to questions regarding (1) business purpose and likelihood that transaction will achieve its objectives, (2) reception of the transaction by the market, (3) competitiveness of the proposed terms and (4) availability and advisability of alternatives and their potential time frames.

Material equity-based transactions can fall in a broad range of categories, including the following:

- Common stock offerings
- Convertible securities offerings
- Sales of assets in complex arrangements, such as joint ventures, leases or special-purpose entities (excluding asset-based financing that functions as a lower cost of borrowing)
- Share repurchases
- Use of equity in acquisitions
- Dividend policy
- Use of stock options, and policy regarding disposition of the underlying shares
- Employee equity investment vehicles
- Use of special classes of stock – high/low vote structures, “tracking” shares, etc.
- Sale of substantial equity interests to major private investors, including special forms of convertible securities and warrants
- Spin-offs
- Recapitalizations
- Rights offerings

Equity-based transactions are increasingly subject to criticism after the fact. With the kind of third-party review I have in mind, some such deals will not be undertaken. Others will still go forward but with a stronger record to defend against the Monday-morning quarterbacks.

While there is no universal checklist that can be provided in judging material equity-linked transactions, the following 12 items may serve as a general guide.

1. Accounting

What are the financial-reporting impacts? Is the treatment potentially controversial?

2. Appearance

Cosmetics are important. What will be the reaction of various parties, including analysts, the Board, investors, employees and the press?

3. Capacity

Is the transaction well within market capacity? Is the transaction unnecessarily large or targeted to an overly narrow investor group, thus raising questions about competitiveness of terms?

4. Credit

To what extent will lenders, rating agencies, analysts and shareholders respectively view the transaction as absorbing borrowing capacity or, alternatively, providing “equity credit?”

5. Economics

What are the true costs, both from a security-specific perspective and in terms of impact on overall corporate cost of capital? What will the Board, analysts, investors and other interested parties think the costs are? Are there any special implications for employee incentives?

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6. Execution

How certain is it that closing will occur on a timely basis in the amount and under the terms sought? What elements pose the greatest uncertainties?

7. Regulation

What constraints do corporate and securities laws, as well as

the company’s charter, impose on format? Will the transaction be controversial?

8. Stewardship

Does the transaction satisfy the fiduciary obligations of senior management and the Board? Is the transaction reasonable and appropriate? Does it rise to the level where it must pass a test of “fairness” (to the company and its shareholders)? If so, is it fair?

9. Resources

Does the transaction increase or decrease (1) assets under control and/or (2) future availability of financing?

10. Strategic Position

How does the transaction affect the issuer's competitive position? How does it impact overall corporate control? How does it impact the actual or potential disposition of parts of the business?

11. Taxes

Do any corporate tax benefits more than offset any related disadvantages — e.g., complexity or increased scrutiny by tax authorities?

12. Trading

What are the impacts on liquidity and ability to achieve full valuation in the market? How important is the quoted market in the common stock?

Not all 12 items will be important in every situation, but generally a number are. Understanding the potential relevance of each is important to overall due diligence, especially if events play out adversely in ways that could not readily be predicted. The company management, guided by appropriate outside advice, that has demonstrated a careful assessment of relevant factors may bolster defenses against subsequent criticism. On the other hand, after-the-fact critics of company policy may be emboldened to the extent the prescribed process is not followed.

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