Go-shop provisions under the spotlight

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During the boom M&A years, it was widely agreed that the M&A environment in the US was significantly less seller friendly than in Europe. However, one US market development, which was originally designed to favour buyers, may prove to be a boon to sellers in this tougher environment and may also find its way into more general use in Europe. That development is the use of a "go-shop" provision instead of the more traditional pre-sale auction process.

The go-shop provision came to prominence in Europe last year, when it formed an important part of the purchase contract CVC signed with Barclays Global Investors for the acquisition of the iShares business.

CVC exchanged contracts with Barclays Global Investors on 9 April 2009 to acquire iShares. In the period between exchange and completion Barclays Bank continued to market or "shop" the iShares business and the larger division, Barclays Global Investors, which owned iShares. On 12 June 2009 BlackRock, Inc. announced that it had signed a purchase contract to acquire Barclays Global Investors, triggering a termination fee payment to CVC.

What it is and how it works

Introducing a go-shop provision is like starting a public auction but with a fully underwritten reserve price already locked in place. It allows a seller to continue to market an asset post signing a sale agreement, with the original buyer being compensated if its offer is trumped.

The go-shop period will start on the date the original sale contract is signed and typically lasts between 30 and 60 days. During this period the seller will be permitted to solicit and encourage inquiries regarding any type of transaction involving the target business. The seller will also be permitted to enter into negotiations with a prospective buyer, supply confidential information about the target business and have the right to disclose the terms of the purchase contract it has entered into with the original buyer.

The original buyer will require notice of any new offer from a prospective buyer that is acceptable to the seller. That notice may include a copy of the agreement entered into with the new buyer and a detailed explanation of the reasons why the seller deems the new offer to be preferable. The original buyer may also require the right to match the new offer.

Typically, that will be achieved by the seller agreeing to give the original buyer a period of exclusivity - usually one week commencing on the date it is informed of the preferable offer - during which to negotiate modifications to the original purchase contract in order to address all of the reasons why the seller considers the new offer preferable.

If, for whatever reason, the seller decides to terminate the original purchase contract a termination fee will be payable by the seller to the original buyer.

In Europe the go-shop termination fee should be contrasted with the break fee that is the norm on public takeovers. A break fee is seen in the public company M&A arena and is payable by the target and usually capped at 1 per cent of the offer price. By contrast, a go-shop provision is seen in the private company M&A arena, is payable by the seller and can be a higher percentage of the offer price (with the actual amount a matter of straight negotiation, unlike break fees which, in the UK at least, are capped as a matter of law).

US experience

In the US, go-shop provisions are mainly seen in the public M&A arena; but they have on occasion also been seen in private company M&A.

The whole area of go-shops, no-shops and the like is a product of state law, and specifically the law in Delaware where most businesses of substance, and probably most start-ups, are incorporated. Delaware state law requires a board selling a company, as an aspect of its fiduciary duty, to seek the highest price reasonably available; and requiring a period to seek higher offers or at least to be open to receiving them is an aspect of fulfilling that duty.

Go-shops gained popularity in the robust M&A market that preceded the US credit

crisis in 2008. In particular, private equity firms viewed the go-shop as a mechanism by which they could avoid an auction process and become the de facto pre-emptive bidder, whilst providing the target's board of directors with an ability to satisfy its fiduciary obligations to the target shareholders.

The US courts closely scrutinise transactions involving the acquisition of public companies by financial sponsors (called "going private" or "public-to-private" transactions), and more often than not have found a target board's sale process that utilised a go-shop to be reasonable.

However, the US courts have been careful to state that there is no specific formula that a board must follow in seeking to obtain the best price reasonably available to shareholders in connection with a sale process, and have held that a go-shop by itself cannot cleanse a deficient process.

In addition, the courts in a number of cases have been critical of the terms of the go-shop. Following the onset of the economic crisis in the US and the corresponding depressed levels of M&A activity, and, in particular, the lack of going private transactions, go-shops have been used less frequently in US M&A.

In the US, go-shops have had a range of attributes. The solicitation period typically ranges from 20-50 days. Following the expiration of the solicitation period, the go-shop reverts to a traditional no-shop, i.e., until the meeting of shareholders at which the transaction will be considered for approval, the target is permitted only to respond to unsolicited proposals that it determines may lead to a superior transaction.

When a go-shop is employed in a US transaction, there often is a bifurcated approach to the termination fee, with a lower fee for the original buyer if a superior proposal results from discussions with a party that is solicited by the target during the go-shop period. The go-shop fee is usually in the range of 1-2 per cent of the equity value of the transaction and following expiration of the go-shop period reverts to a traditional no-shop termination fee in the 2-4 per cent range.

Other common characteristics of US go-shops include whether they are "open" or "closed" and whether they provide for broad or narrow matching rights. "Open" go-shops permit the target to continue its negotiations with a competing bidder that was solicited during the go-shop period even after the go-shop period expires and pay a reduced termination fee if the target and competing bidder ultimately enter into an agreement.

In contrast, under a "closed" go shop, the reduced fee is only available where the competing bidder and the target enter into an agreement within the go-shop period. "Closed" go-shops have been criticised by US courts because of the pressure they put on the competing bidder to reach agreement with the target within the go-shop period.

Most go-shops in US transactions also provide the original buyer with a matching right in order to permit the original buyer to improve its terms so that it can remain the winning bidder. Matching rights are common features of go-shops and no-shops, but they can exacerbate the criticism levelled on "closed" go-shops because they further limit the amount of time available for a competing bidder to agree to a superior proposal with the target.

Pros

Using a controlled auction process in difficult market conditions is significantly less attractive for sellers. Uncertainty over price and availability of finance means that the outcome of an auction is similarly uncertain, and sellers find that they can lose control of the auction process.

Putting assets on the market and having an unsuccessful auction can significantly impair the value of the assets to be sold. In the current market it is arguably a better strategy for the seller to identify an interested buyer, agree terms but also agree a go-shop provision.

This allows the seller to run the auction process at a point where the ultimate success of the sale is no longer in doubt; in addition, other buyers' confidence in the asset is enhanced by knowing that the original buyer has committed to acquire it.

There is also one key advantage for the original buyer. By agreeing to include a go-shop provision a bidder avoids engaging in a potentially costly auction process and, even if they are not ultimately successful, unlike with an auction there is a meaningful termination fee in place to defray the costs of the bid.

The original buyer also has a protection, as mentioned above, because sellers have generally been willing to provide the original buyer with the right to match any competing bid made during the go-shop period.

Cons

There are inevitably disadvantages for the seller, the original buyer and the new buyer. Go-shop provisions are expensive for both the seller and for the new buyer. They are expensive for the seller because, in the UK at least, termination fees are in the region of 2-4 per cent of the purchase price (in an auction the seller would not have this expense). That deters new buyers who know that in order to make the new offer attractive enough for the seller to pursue, the new buyer will have to offer at least 10-15 per cent higher than the original buyer's offer given that a portion of the increased purchase price will be paid over to the original buyer.

The new buyer also knows that the original buyer will have a contractual right to match; or if there is no such contractual right there is still the risk that the original buyer will make a counter proposal.

By lengthening the period between exchange and completion the seller exposes itself to the risk that the buyer, for whatever reason, fails to complete.

Go-shop provisions are bad for the original buyer for two reasons. First, during the go-shop period the original buyer may find it very difficult to achieve any progress towards completion because the seller will be soliciting new buyers and, if the seller finds interested buyers, then the management team will be required to meet with and attend to all requests from those interested buyers in priority to any requests from the original buyer.

Second, the original buyer's offer could be trumped, and whilst it will receive a termination fee, during the period that it worked on the acquisition it may have had to forego other opportunities to acquire similar businesses.

Conclusion

For all these reasons, in this difficult market the go-shop provision could prove to be a useful tool for sellers. By allowing a seller to run an auction process at a point where the ultimate success of the sale is no longer in doubt, it really does allow a seller to test whether "a bird in the hand is worth two in the bush". It could therefore also help boost activity levels.

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