VEDDER PRICE

Finance & Transactions Group

Corporate M&A Advisor

Spring 2002

RECENT TRENDS IN M&A ACTIVITY - AN INCREASINGLY HOSTILE ENVIRONMENT

After a significant decline in hostile activity in 2000, attempted hostile acquisitions in 2001 increased 135% over 2000. While M&A activity dropped nearly 60% in 2001 from the previous year's levels,[1] announced hostile acquisition activity increased from $39 billion[2] to over $94 billion during the same period.[3] By comparison, in 1988, at the peak of corporate raider hostile acquisitions, $81 billion in hostile deals took place.[4] Despite the sharp increase, the $94 billion in hostile acquisitions in 2001 may actually understate the increased use of the hostile takeover strategy. While significant hostile activity continued at a rapid pace through the third quarter of 2001, nearly all hostile activity promptly ceased after the events of September 11th. Takeover specialists believe that the cessation of unsolicited bids occurred because the public would perceive such hostile takeovers as taking advantage of a national tragedy and profiteering in a temporarily shocked marketplace.[5] Remarkably, November 2001 was the first month since May 1997 that no unsolicited bids were announced.[6]

Corporate raiders historically wielded hostile takeovers as financial weapons to break up or restructure companies. Today, industry leaders turn to hostile takeovers to implement strategic acquisitions after friendly overtures are rebuffed or ignored, particularly where the target company has valuable assets and is financially distressed. In fact, nearly 60% of all hostile activity during 2001 involved distressed telecommunications and technology companies, with technology and assets snapped up by hostile acquirers at depressed prices.[7]

Notwithstanding the temporary downturn in the fourth quarter of 2001, hostile activity is again on the rise. High profile deals such as Comcast's $72 billion unsolicited acquisition of AT&T Broadband, Northrop Grumman Corp.'s $6.0 billion unsolicited bid for TRW, Inc. (which has been rejected as of the date of this article) and Weyerhaeuser Co.'s successful $7.8 billion hostile acquisition of Willamette Industries have been prominently reported on and scrutinized in the past few months. Given the current economic landscape and continued stock market turbulence, the outlook for 2002 indicates that hostile activity will continue to increase and suggests that this activity could be concentrated in industries currently undergoing consolidation, including banking, financial services, energy and utilities.[8] Increased hostile activity presents a unique opportunity for potential hostile acquirers and increased risks for vulnerable companies attempting to remain independent. This article will (i) briefly review the background and

> ***Given the current economic landscape and continued stock market turbulence, the outlook for 2002 indicates that hostile activity will continue to increase and suggests that this activity could be concentrated in industries currently undergoing consolidation, including banking, financial services, energy and utilities.***

use of hostile acquisitions, (ii) examine the reasons for the increased levels of hostile activity and (iii) review key issues for both potential hostile acquirers and targets to consider.

Background

A hostile takeover involves a change of control which the board of directors and management of a target company do not support. The takeover usually involves an unsolicited tender offer for the stock of the target for cash, the stock of the hostile acquirer or a combination of the two, and/or a proxy fight to control the target's board. If successful, the target's stockholders tender their shares in support of the hostile offer, despite its rejection by the target's board and arguments raised by the target's board to the effect that the target company is worth more than the proposed offer and the target has greater business prospects as an independent company.

...once "in play" via an unsolicited offer, the target will likely be acquired in the near term by the original hostile bidder or an alternative acquirer, and its continued independence will become increasingly difficult to maintain.

In the recent past, hostile takeovers were generally leveraged financial acquisitions designed to break up or restructure target companies, and were practiced by corporate LBO raiders such as Carl Icahn. Today, industry leaders are trying to secure their market positions through strategic acquisitions in their industry, turning to hostile takeovers only after friendly acquisition overtures are rejected or ignored. Indeed, due to the potential duration of a hostile takeover,[9] the lengthy distraction of acquirer's management from its core business and the additional costs associated with pursuing a hostile takeover, a strategic buyer will often regard a hostile takeover as a fall-back position rather than a primary strategy. Additionally, merely making the first offer to purchase a target company does not ensure that the hostile bidder will be successful in acquiring the target. In the past 5 years, approximately 200 unsolicited bids have been announced, of which approximately 30% to 40% of the bids were successfully completed by the hostile bidders, 30% to 40% of the bids were successfully defended against by the target and 20% to 30% of the companies targeted by a hostile bid ultimately were acquired by alternative third parties.[10]

Hostile takeovers also involve greater social ramifications than a friendly deal. Potential acquirers should be particularly concerned if the target's employees are valuable assets to the continued success of the target (as in high technology companies). The possibility that such valuable assets could walk out the door if dissatisfied with the hostile nature or economic terms of the acquisition, or the integration of the target into the acquirer's structure, presents a real concern for the potential hostile acquirer.

Notwithstanding the risks of pursuing a hostile transaction, a well-financed acquirer willing to pay a premium on the target's current stock price stands a solid chance of successfully acquiring the company. From the target's perspective though, once "in play" via an unsolicited offer, the target will likely be acquired in the near term by the original hostile bidder or an alternative acquirer, and its continued independence will become increasingly difficult to maintain. However, anti-takeover protective measures (discussed below) have successful track records and can, at the very least, give the target's board time to find strategic alternatives to the hostile acquisition and provide negotiating leverage against the hostile bidder.

Reasons for the Increase in Hostile Activity

The Economy. The main catalyst and driver behind the increase in hostile activity has been the weakness of the U.S. economy. While the recession did not

technically begin until March of 2001,[11] softness in the economy was evident as far back as the third quarter of 2000. For corporate America, an economic downturn means weakened or negative profits, excess capacity and depressed share prices (the S&P 500 was down 13% in 2001 and, as of the date of this article, NASDAQ is down more than 65% from its 2000 high). All of these elements can motivate companies, particularly industry leaders, to reinforce their market position by consolidating the industry.[12] Additionally, the abundance of distressed companies in a depressed market provides ample opportunity for leading companies to purchase valuable assets at a substantial discount, and an acquirer's underlying fear that the employees of a target will depart due to a takeover is substantially eased as employment opportunities dwindle in the weakened economy. This has been evidenced by the dramatic increase in hostile acquisitions of technology and telecommunications companies in 2001.[13]

Historically, increased hostile activity has occurred when stock markets experience rapid and wide shifts in valuations.[14] Hostile activity increased after the 1987 stock market crash, the 1991 Gulf War and the Russian financial crisis in the mid-1990s.[15] Given the recent rapid decline of market capitalizations of various companies—particularly many companies listed on NASDAQ—the outlook for increased hostile activity seems likely. Where a company has tangible assets or cash on hand worth more than its current market capitalization, the potential exists for the company to become the target of a hostile takeover.[16]

Historically, increased hostile activity has occurred when stock markets experience rapid and wide shifts in valuations.

SFAS 141 and SFAS 142—Elimination of Pooling Accounting. The combined effect of two new statements from the Financial Accounting Standards Board (the "FASB") significantly changed the accounting of acquisitions by (a) eliminating the use of "pooling" accounting for all business combinations and (b) changing the treatment of goodwill (the difference between the purchase price of the target and book value of the target's assets) from amortization over a forty-year period to expensing such goodwill only upon permanent impairment. Statement of Financial Accounting Standards ("SFAS") No. 141, entitled "Business Combinations," went effective on June 30, 2001, and replaced Accounting Principles Board Opinion No. 16. On January 1, 2002, SFAS 142, entitled "Goodwill and Other Intangible Assets," went effective, replacing Accounting Principles Board Opinion No. 17.

SFAS 141 and SFAS 142 provide all acquirers, both hostile and friendly alike, with the benefit of eliminating the amortization of a target's goodwill, which positively impacts the earnings of the acquirer. Additionally, while the benefit of pooling accounting for business combinations was unavailable to financial acquirers (*i.e.*, LBO funds and the like), the benefits of SFAS 141 and SFAS 142 are available to any acquirer, whether strategic or financial.

In the past, acquirers accounted for business combinations under one of two methods—purchase or pooling accounting. Under purchase accounting, the acquirer recognized the goodwill of the target and was required to amortize the goodwill over a forty-year period. This annual amortization expense posed an impediment to any acquisition that involved a significant amount of goodwill, as the required amortization expense would adversely affect the acquirer's earnings for a forty-year period. Under pooling accounting, if the target and acquirer were successful in properly structuring the acquisition as a pooling transaction, the goodwill of the target was not recognized by the acquirer and would not appear on the financial statements of the acquirer. The pooling transaction would combine the financial statements of the target and acquirer, without recognizing the purchase price paid by the acquirer. This financial combination would allow an acquirer

to completely avoid the recognition of a target's goodwill, the annual amortization expense and the corresponding negative impact on the acquirer's earnings. In other words, recording the same acquisition under two different accounting methods could create dramatically different earnings for the acquirer, a particular concern for any publicly held acquirer. Not surprisingly, before SFAS 141 and SFAS 142 went effective, companies structured their business combinations to fulfill the prerequisites of pooling accounting to avoid the goodwill expense whenever possible. In some cases, pooling treatment became a condition precedent to closing. Indeed, from 1992 through 1999, while only 7% of all acquisitions were accounted for under the pooling method, pooling transactions represented 38% of the total dollar amount of all acquisitions.[17]

Although SFAS 141 eliminated the use of pooling accounting for business combinations entirely, SFAS 142 removed the primary motivation for pursuing a pooling transaction by implementing a new treatment of a target's goodwill. Under SFAS 142, the acquirer recognizes the goodwill of the target, but such goodwill stays on the acquirer's financial statements as a permanent asset, similar to real property. Goodwill is no longer subject to amortization and, correspondingly, there is no impact on the acquirer's earnings as a result of the goodwill recognition (unless such goodwill is permanently impaired, as discussed below). FASB recognized that many forms of goodwill do not depreciate, are not consumed over time and should remain on the balance sheets of the acquirer as a permanent asset. In addition to the positive impact on earnings, the larger asset base from goodwill recognition can lower an acquirer's debt/asset or debt/equity ratios, two additional performance metrics relied upon by investors.

Under SFAS 142, goodwill is expensed only when permanently "impaired." "Impairment" occurs when the fair value of such goodwill indefinitely falls below its book value. Upon determining that goodwill is permanently impaired, the entire value of the goodwill impairment must be expensed by the company on the current year's financial statements.[18]

In addition to easing the way for acquisitions and providing equal accounting treatment of business combinations between strategic and financial acquirers, the FASB statements are meant to discourage overpaying for acquisitions (acquirers will be motivated to reduce the risk of large future goodwill write-offs and the incurrence of significant goodwill expense), to encourage strategic acquisitions and to provide disclosure to the investing public of how much the acquirer initially paid for the acquired assets.

Revisions to SEC Tender Offer Rules. Under new SEC regulations, exchange offers may commence as soon as the underlying registration statement is filed with the SEC. Previously, exchange offers could not commence until after the relevant registration statement became effective with the SEC. This made exchange offers a lengthier and less desirable hostile takeover method as compared to cash tender offers because cash tender offers could commence the day a tender offer statement was filed with the SEC. The changes in the SEC regulations do not affect the inability of bidders in an exchange offer to purchase tendered stock prior to the effectiveness of a registration statement, but they do provide some parity between cash and stock offers in terms of commencing a tender offer for a target's stock.

Selected Hostile Takeover Issues

The following issues and defenses should be considered by both acquirers (in examining a potential target) and potential targets (in preparing against a possible hostile bid):

State Anti-Takeover Laws. Some states have enacted anti-takeover laws in response to losing their domestic companies to hostile out-of-state acquirers. The laws of the state of incorporation of the target

should be reviewed for any such anti-takeover laws. State anti-takeover laws range from explicitly allowing a target's board to consider the effect of a takeover on its employees and the local community to limiting the ability of a bidder to vote its target's shares at a meeting if such shares were acquired within an abbreviated time frame. For instance, Ohio has enacted some of the most stringent anti-takeover measures.[19] Such measures prevent the removal of any board member without cause, require both a proxy vote and a tender offer in a takeover and delay the closing of a takeover by up to three years if the target's board does not support the proposed acquisition.[20]

Corporate Charter and Bylaws. A target's charter and bylaws can also provide defenses to a hostile takeover. In most cases, the board may alter a target's bylaws without the approval of its stockholders, but the stockholders must approve any change to a target's charter. The most common defenses include the following:

(i) *Staggered Boards*. Implementing a staggered board provision prevents a hostile acquirer from staging a successful proxy fight by preventing the acquirer from removing the target's entire board of directors at a single stockholders meeting. Staggered board provisions allow only a certain number of the target's directors to be reelected in any given year. This forces the hostile acquirer to wait years before gaining control of the target's board.

(ii) *Process and Notice*. The charter and bylaws may be amended to prevent stockholders from calling a special stockholders meeting, to prevent stockholders from acting by written consent, or to extend the period during which a stockholder must provide notice of a director nomination or business proposal for the next stockholders meeting. These protections prevent a hostile acquirer from forcing a vote, controlling business proposals or the director nominations and generally allow the target to control the timing of a strategic transaction.

(iii) *Additional Provisions*. Additional defensive protections in the charter or bylaws include the absence of cumulative voting, limiting how a director may be removed, the authorization of "blank check" preferred stock, specifying how board vacancies are to be filled and supermajority provisions with respect to altering the bylaws or charter.

Poison Pills. Stockholder rights plans, or poison pills, make hostile takeovers prohibitively expensive by creating a flood of target's stock available for purchase at a significant discount by the existing stockholders of target, other than the hostile bidder. Poison pills do not require stockholder approval to implement. To avoid or lessen the likelihood that the implementation of a poison pill will subject a company to litigation, a poison pill should be put in place prior to a hostile bid. It is important to note that a target's board may terminate or redeem the pill to permit an approved transaction, thus motivating a would-be acquirer to negotiate with the board to achieve a friendly deal. The number of companies adopting poison pills increased by approximately 35% in 2001 over 2000.[21] Companies such as Yahoo, Gateway, Scient, Palm and Inktomi all adopted poison pills in 2001.[22]

The number of companies adopting poison pills increased by approximately 35% in 2001 over 2000.

Although some institutional stockholders do not support stockholder rights plans, it has been demonstrated that poison pills do not prevent takeovers, but rather increase the value of the target by forcing the acquirer to pay a higher premium to complete the deal.[23] On average, the premium paid by a hostile acquirer for a target jumps approximately 4% where the target has a poison pill in place.[24]

Defenses Generally. The defensive measures and protective provisions described above cannot wholly prevent hostile takeovers from successfully occurring. They can, however, give the target's board and management valuable time to evaluate a hostile bidder's offer or to seek out an alternative strategic transaction. These defenses may also provide the target with negotiating leverage vis-à-vis the hostile bidder and the ability to extract a higher premium in the deal.

While M&A activity has generally slowed, the number of hostile takeovers (or transactions initiated by hostile offers) has increased. The combination of the weakened economy, the depressed stock market and various alterations to the regulatory landscape presents unique opportunities for financial and strategic acquirers and unique risks to financially distressed companies and companies in certain consolidating industries such as financial services, banking, energy and utilities. While defensive measures can offer some level of protection and negotiating leverage for targets in a hostile environment, market forces and stockholder motivations will continue to drive whether a company remains an independent entity.

Footnotes

[1] *Business Week*, January 14, 2002, "The Bids Sure Are Getting Hostile – Unsolicited Offers Are on the Rise and Market Ripe for Consolidation."

[2] *CFO.com*, January 22, 2001, "Is Your Company Shark Proof?"

[3] *Business Week*, *supra* note 1.

[4] *Business Week*, *supra* note 1.

[5] *Wall Street Journal,* November 29, 2001, "Resumption of Hostile Takeover Bids is Likely after an Unusually Quiet Period since Attacks."

[6] *Id.*

[7] *Business Week*, *supra* note 1.

[8] *Business Week*, *supra* note 1.

[9] Weyerhaeuser's hostile bid for Willamette lasted more than 14 months.

[10] *CNet News.com*, April 20, 2001, "Tech Companies Warding Off Takeovers."

[11] *National Bureau of Economic Research*, November 26, 2001, "The Business-Cycle Peak of March, 2001."

[12] *Wall Street Journal*, *supra* note 5.

[13] *Business Week*, *supra* note 1; see for example, Comcast's unsolicited acquisition of AT&T Broadband, Alltel Corporation's unsolicited bid for CenturyTel, Inc. and DMC Stratex Network's hostile bid for Western Multiplex.

[14] *Wall Street Journal*, *supra* note 5.

[15] *Id.*

[16] Consider a company such as Viant Corporation, currently trading on the NASDAQ National Market with a market capitalization below its cash reserves. In response to its depressed market capitalization and concern over the possibility of an unsolicited bid, Viant recently implemented a stockholder rights plan (a poison pill) and staggered its board (see anti-takeover discussion above).

[17] *Commercial Lending Review*, Fall 2001 "FASB Rethinks Accounting for Goodwill."

[18] *American Bankruptcy Institute Journal*, December 2001, "New Rules for Business Combinations, Intangibles and Goodwill Accounting."

[19] See Ohio Senate Bill No. 110, passed November 21, 2001, by the General Assembly of the State of Ohio.

[20] *Bloomberg News*, February 26, 2002, "Northrop's Hostile Bid for TRW Faces Strict Ohio Laws."

[21] *Wall Street Journal*, *supra* note 5.

[22] *Business World*, February 13, 2002, "Fast Forward; an Invitation for Hostile Takeover."

[23] *Wall Street Journal*, *supra* note 5.

[24] *Id.*

Corporate M&A Advisor is published by the law firm of Vedder, Price, Kaufman & Kammholz. It is intended to keep our clients and interested parties informed on developments in the Corporate M&A industry. It is not a substitute for professional advice.

© 2002 Vedder, Price, Kaufman & Kammholz. Reproduction of this bulletin is permitted only with credit to Vedder, Price, Kaufman & Kammholz. For an electronic copy of this newsletter, please contact Mary Pennington at her e-mail address: mpennington@vedderprice.com.

If you have any questions regarding material in this issue of *Corporate M&A Advisor* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Michael A. Nemeroff *(practice group leader)* at 312/609-7858 or at mnemeroff@vedderprice.com.

Contributing Author: Joseph H. Kye
Editor: Dana S. Armagno

VEDDER, PRICE, KAUFMAN & KAMMHOLZ

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with more than 200 attorneys in Chicago, New York and New Jersey.

The Finance & Transactions Group

The Finance & Transactions Group of Vedder Price actively represents publicly held and private corporations, financiers, leveraged buy-out firms, private equity funds, venture capitalists, lenders, and related parties in a broad range of matters, including mergers and acquisitions; equity and debt financing; mezzanine financing; venture capital; private equity investments; and related transactions.

Chicago
Vedder, Price, Kaufman & Kammholz
A Partnership Including Vedder, Price, Kaufman & Kammholz, P.C.
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005

New York
Vedder, Price, Kaufman & Kammholz
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799

New Jersey
Vedder, Price, Kaufman & Kammholz
354 Eisenhower Parkway, Plaza II
Livingston, New Jersey 07039
973/597-1100
Fax: 973/597-9607

www.vedderprice.com

Principal Members of the Finance & Transactions Group:

Chicago:
Michael A. Nemeroff
Robert J. Stucker
Thomas P. Desmond
John T. McEnroe
Daniel O'Rourke
Jonathan H. Bogaard
Michael G. Beemer
John R. Obiala
Jennifer R. Evans
Robert J. Moran
Dalius F. Vasys
Guy E. Snyder
Daniel T. Sherlock
Douglas J. Lipke
Douglas M. Hambleton
Dean N. Gerber
Richard L. Williams, III
Thomas E. Schnur
Steven J. Gray
Timothy W. O'Donnell
Lane R. Moyer
Jeffrey C. Davis
Geoffrey R. Kass
William J. Bettman
Paul R. Hoffman
John T. Blatchford
Dana S. Armagno
Matthew T. O'Connor
Mark J. Kosminskas
Maxwell N. Barnes
Eric S. Prezant
Jospeh H. Kye
David C. Blum
David P. Kaminski
Nathan D. Koch
Adam S. Lewis
Jennifer Durham King
George W. Hoffman
Donal M. O'Brien
Megan E. Groves
James W. Morrissey
Meeghan O'Donnell
Leslie Allen
Jennifer R. Thornley
Jacob C. Pond

New York & New Jersey:
Ronald Scheinberg
Donald A. Wassall
Denise L. Blau
Barry J. Bendes (NY/NJ)
Stewart Reifler
Van Z. Krikorian
Sara Stewart Champion
Kathleen R. White
Nelson A. Ferreira