KIRKLAND **M&A UPDATE**

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Shaping Up Your Top-Up Option

Recent court proceedings and settlements relating to top-up option claims offer dealmakers a few practical pointers to reduce litigation risk in tender offers.

As we noted in an *M&A Update* last year, tender offers are an increasingly common feature of the M&A landscape. In conjunction with this uptick in tender offer activity, the use of "top-up" options has become nearly universal. Under a top-up option, the target company grants the buyer an option (sometimes mandatorily exercisable) to purchase at the deal price, upon successful completion of the tender offer at or above the minimum condition level (usually 50%), a number of newly issued shares of the target (assuming sufficient shares are authorized and unissued) such that in aggregate the buyer will own at least 90% of the target's shares. Crossing the 90% threshold (in Delaware) allows the buyer to complete the back-end squeeze-out as a simple short-form merger. Top-up options have been justified as merely representing an acceleration of a foregone conclusion as the buyer, having acquired more than 50% of the target's shares, is already assured of the ability to effect the back-end squeeze-out (if necessary, via a long-form merger). The accelerated short-form merger timetable benefits both the buyer and the target's remaining shareholders by hastening the now inevitable exchange of 100% control for cash.

As sure as the sun rises, plaintiff's lawyers have added expansive attacks on top-up options to their strike suits against deals involving tender offers. While we are not aware that any of these suits has resulted in a full decision on the merits, the preliminary proceedings and some recent settlements (including in the acquisitions of Protection One and EV3) offer dealmakers three simple practice pointers to mitigate the deal and litigation risk arising from some of the arguments that appear to have gained traction in Delaware proceedings:

- In Delaware, dissenting or objecting shareholders in a cash tender offer are entitled to seek a post-closing court appraisal of the fair value of their target shares (which may be more or less than the deal price). Plaintiffs have complained that, if the top-up shares are taken into account in determining the per share enterprise value at closing in an appraisal proceeding, dissenting shareholders will be severely prejudiced by the massive dilution resulting from the exercise (as well as the arguable difficulty of valuing the promissory note that is often used to pay the exercise price). Although the top-up option is not intended to result in such an increase in share count across which the appraised enterprise value is divided, parties would be well advised to nip that argument in the bud. Merger agreements for tender offer deals should include an explicit acknowledgment that none of the top-up option, the shares issuable upon exercise of the option or any promissory note used to pay for the option shares will be taken into account in the determination of fair value in any appraisal action. This provision may refute claims that the top-up option unfairly undermines the integrity of the appraisal remedy.

- While most merger agreements provide that the exercise price of the top-up option may be paid in cash and/or a promissory note, the parties should consider providing that the par value of the option shares will be paid only in cash and including in the merger agreement the basic terms of any promissory note (e.g., market interest rate, maturity, acceleration, etc.) that may be used to pay the balance of the exercise price. By doing so, parties may reduce the risk of claims that the target's board of directors did not validly grant the option (and/or issue the option shares) in accordance with the requirements of Delaware law governing the necessary consideration for such a grant or issuance.

- Parties should consider expanding the disclosure in the offer documents to more clearly address the mechanics and specific consequences of the potential exercise of the top-up option. For example, parties can include clearer disclosure of the math of reaching the 90% threshold via the top-up option and the practical results of an exercise (e.g., the ability to delist or deregister the target's share, to complete the short-form merger, etc.). While such disclosure may be repetitive of other typical disclosure about the consequences of the overall deal, it may mitigate the risk of disclosure-based claims relating specifically to the top-up option.

While there is no guarantee that the simple suggestions described above will successfully eliminate the plaintiff's claims to which they are addressed, buyers and sellers would be well advised to implement these strategies to narrow the injunction risk and hold-up value from these suits. Of course, as top-up options continue to proliferate, there remains the risk that a court will decide to undertake a broader review focusing on the doctrinal validity of, and justification for, the granting of such an option, which these suggestions clearly do not address.

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