Don’t Stub Your Toe(hold)

The decision whether or not to acquire a minority or “toehold” stake in a public company as a prelude to future M&A requires a nuanced assessment of the tactical benefits and detriments of this approach.

Whether or not to acquire a minority or “toehold” stake in a public company as a preliminary step towards a future business combination has been the subject of tactical debate for many years. Proponents argue that a toehold can be used by a potential bidder to convey its serious intent or, if necessary, as a platform to quietly or publicly put the target in play. In addition, the position could advantage a buyer in a subsequent sale process by reducing its average cost (by acquiring shares before a deal premium attaches) or acquiring a meaningful voting position in the target; at the very least, the profit on the toehold that the acquirer can collect if another buyer succeeds with a higher bid may cover, or exceed, the costs the acquirer incurs in pursuing the target. On the flip side, demurrers point out the risk of being perceived as employing strong-arm tactics when a velvet glove approach is more likely to win over the “hearts and minds” of the target. Moreover, many a target board may reflexively react in an unduly defensive manner, for example by enacting a poison pill, complicating an attempt to reach a negotiated outcome at a desirable price.

The debate has recently sharpened with comments from at least one Delaware judge who has taken the view that the failure to acquire a stake before approaching a target conveys a lack of seriousness about making a potential bid and is evidence of being a “stupid acquirer.” A small stake (even as little as 100 shares) in a potential target represents a low-cost option for better positioning the acquirer in the event of litigation if a sale process does not unfold in the way the buyer would like (e.g., the target board refuses to engage with the buyer or agrees to a sale to another buyer). Only by owning a stake will the buyer have “standing” as a shareholder of the target to bring legal claims against the target or its board, a need that may not become apparent until it is too late to rectify.

Conceding that there is no “right” answer to this question, dealmakers must approach this issue on a facts-and-circumstances basis, focusing on the specifics of a situation including the personalities of the parties and the likely competitive landscape for a possible transaction. An informed decision about employing this tactic also requires an understanding of a number of regulatory, legal and process considerations attaching to taking a toehold position as a prelude to potential M&A activity. Below is a brief, and very simplified, summary of a number of those key considerations:

Regulatory Considerations

SEC Filings - A public 13D filing is required within 10 days of crossing the 5% ownership threshold, while additional Section 16 filings will be required (along with exposure to “short-swing” profit disgorgement) at and above the 10% level. Under recently enacted SEC rules, a confidential Form 13H filing is required for any person who acquires more than $20 million or 2 million shares in one calendar day or $200 million or 20 million shares in any calendar month. Importantly, this nonpublic filing obligation could be triggered by rapid toehold activity short of the well-known 13D or even HSR thresholds.

Insider Trading - A purchaser cannot acquire shares of a company while in possession of material non-public information regarding the target. That said, the general view is that a buyer’s knowledge of its own intentions with respect to a company (e.g., a unilateral plan to pursue an acquisition of the target) is not information that precludes purchases of the target’s securities.

Antitrust Filing - Any acquisition of more than $68.2 million of voting shares, regardless of the percentage of the target that monetary threshold represents and subject to somewhat quirky calculation rules, requires a filing under the HSR Act. The target, but not the public, is notified of the filing and expiration of a waiting period (usually up to 30 days absent substantive concerns) is a condition to further purchases. For large targets, the HSR filing threshold will be an important inflection point in trying to quietly build a meaningful stake.

National Security/Foreign Ownership/Regulated Industry Restrictions- Acquisitions of stakes in companies in certain industries or by foreign buyers may trigger filing/review requirements or ownership restrictions under national security and other industry-specific regulations.

Antitakeover Statutes - Many companies are subject to state-law business combination statutes. While varying considerably, these laws usually present significant obstacles or disclosure obligations for acquirers who

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cross certain ownership thresholds without board or shareholder approval. For example, Section 203 of the Delaware corporate statute restricts, for a period of three years, certain back-end transactions designed to further increase ownership by an acquirer who crosses 15% without board approval.

Target Company Considerations

Poison Pill- Some companies have standing stockholder rights plans that threaten prohibitive dilution to the ownership of a person who acquires a stake beyond a stated threshold (often 10-20%, but sometimes as little as 5%) without board approval. In addition, a target company can quickly enact such a plan to halt ongoing accumulations of which it becomes aware as a result of market activity or regulatory filings (e.g., an HSR or 13D filing).

Charter Provisions - Certain companies have additional ownership limitations set forth in their organizational documents (often in regulated industries or, as in the case of REITs, where there are tax consequences to certain ownership levels being crossed), while others may have additional "fair price" or "business combination" provisions that supplement state-law restrictions that kick-in at fixed ownership levels.

NOLs - If a company has significant net operating loss carryforwards (NOLs), an acquirer should be thoughtful about the impact its purchasing activity may have on this valuable target asset under IRS rules that limit the ability to utilize NOLs in future periods if the company undergoes an "ownership change", with those complex rules focusing on activity by "5%+ shareholders".

Employee Arrangements/Debt Instruments - Especially when a sizeable stake on a percentage basis is being contemplated, buyers should review the governing documents for employee arrangements such as equity plans and credit agreement or bond indentures to ascertain whether the acquisition could trigger "change of control" provisions in those instruments and result in the accelerated vesting of employee benefits, stripping them of their retention value, or a repayment obligation on the debt.

Tactical/Process Considerations

Standstills - In the context of negotiating a confidentiality agreement (a prerequisite to gaining access to due diligence), most target companies will seek a "standstill" from a potential buyer under which the buyer will be prohibited from acquiring shares for an agreed period of time. A buyer should anticipate that its ability to acquire or increase its toehold stake may be limited after a confidentiality agreement is reached as a result of either an agreed standstill or concerns about possession of material non-public information. In addition, even a toehold stake that the acquirer wanted to keep hidden may need to be disclosed to the target in the context of negotiating a confidentiality agreement as a target may seek a representation that the buyer does not currently own any shares.

Use of Derivatives- In the aftermath of some high profile cases involving the use of derivative instruments in stake-building exercises, some buyers have explored whether they can enhance their toehold execution by utilizing these securities to delay application of some of the regulatory requirements described above (e.g., by possibly not counting towards antitrust filing thresholds) and/or to quickly increase their economic exposure to the target's stock where there is insufficient liquidity to facilitate a rapid or quiet accumulation of actual shares. Buyers should approach use of these instruments with caution, as the regulatory treatment of the securities is not always clear, not least because of the very complex nature of some of the more exotic derivatives.

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While financial investors and activists have long appreciated the value of toehold stakes to advance their agendas, strategic acquirers have largely avoided this tactic, often failing to appreciate the potential benefits or fearing the possible negative reputational or tactical consequences. Acquiring a stake in a public company can be an important and powerful first step in pursuing an acquisition of a target, whether the ultimate intent or outcome is hostile or friendly. While the decision must take account of various regulatory and legal considerations and consequences summarized above, a nuanced assessment of the tactical benefits and detriments of this approach in the situation at hand is at least as important. Failure to comply with the requirements or to appreciate the tactical ramifications can turn a potent opening move into a fatal misstep; equally, a failure to employ this approach in appropriate circumstances can be an irretrievable missed opportunity.

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