M&A Update

Ohio Federal Judge Blocks Controlling Stockholder's Tender Offer Based On Target Board's Conflicts and Stockholder Coercion

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In a March 14, 2014 decision that has received little commentary, an Ohio federal court in *Spachman v. Great American Insurance Co.* took the extraordinary step of enjoining a tender offer by Great American Insurance, a wholly-owned subsidiary of American Financial Group, for the 48 percent of National Interstate Corporation not already owned by AFG. The ruling provides important lessons to buyers and sellers in controlling shareholder tender offer situations.

Background

NIC shareholder, founder, and board member Alan Spachman contended that Great American's offer was coercive, a result of an unfair process led by conflicted NIC directors and replete with inadequate disclosures and back-end uncertainties. The decision is noteworthy both because it is rare (but not unheard of) for a tender offer to be blocked for violations of the Williams Act and because the court enjoined the transaction until an independent committee of the NIC board was formed and supported the deal. Although decided under Ohio law, the court relied heavily on Delaware precedent, including the *Pure Resources* line of cases governing controlling shareholder tender offers. The ruling ended AFG's bid, which was withdrawn three days later.

Takeaways

1. <u>Conflicted Directors Present Execution Risk</u>. Buyers can always proceed with a transaction without agreeing to subject the deal to minority stockholder protection mechanisms (such as a special committee and majority of the minority voting provision). However, in the event the transaction is challenged, the buyer would have to prove that the transaction was entirely fair. Even in situations where minority protections are not included, the risk to buyers (albeit large in extreme cases like *In re Southern Peru Copper Corp.*, where the court awarded damages of over $2 billion as well as over $300 million in attorney's fees) typically is having to pay money damages post-closing.

   The *Spachman* court went further. It found that NIC's board lacked independence and ordered that the tender not proceed unless supported by a truly independent and empowered special committee. The facts here appear to have been egregious: five of the NIC directors also held prominent positions with AFG; the conflicted directors shared confidential valuation information with Great American, allowing it to increase its bid just barely into the range of acceptable prices; and otherwise acted in the interests of the controlling shareholder. Controlling shareholders and sellers alike need to recognize the execution risk that follows where the seller's board lacks independence. Courts in Delaware and elsewhere will heavily scrutinize situations where it appears that the "fix is in" because the seller's board is aligned with the buyer to the detriment of selling shareholders.

2. <u>Supplemental Disclosure Will Not Always Salvage a Transaction</u>. The court also found that NIC's amended disclosure was too little–too late, being distributed only six days before the scheduled closing of the tender offer and still missing key financial projections. As a result, the court found the offer coercive notwithstanding the supplemental disclosure. Buyers and sellers alike should not view the availability of supplemental disclosure as a cure-all. To be effective, disclosure (including any supplements) needs to be provided early enough in the tender offer period that shareholders have adequate time to consider the information.

3. <u>Courts Will Not Tolerate Manipulated Valuations</u>. The court zeroed in on NIC's last minute changes to its financial projections. Only a few weeks after producing one set of projections, management issued new projections with significantly reduced performance assumptions that made the tender offer price appear more favorable. Shareholders only received the older projections a few days before the offer was scheduled to expire, and no financial advisor ever analyzed the bid using them. The court found that it was no coincidence that NIC issued these revised projections at the time of the tender offer, particularly in light of the directors' conflicts.

   A similar finding regarding a manipulated financial analysis led the Delaware Chancery Court in the recent *In re Rural Metro Corp*. decision to conclude that a shareholder vote based on a fairness opinion utilizing such projections was not informed and uncoerced. There, the court found the financial advisor liable for aiding and abetting breach of fiduciary duty because its manipulated financial projections caused the Board to approve the transaction without being fully informed.

   Buyers and sellers and their financial advisors should avoid last-minute changes to financial projections or analyses, particularly when those revisions make the transaction terms appear more favorable. Any late revisions need to be scrupulously supported and generally should not be the deciding factor for a conclusion that a deal is fair.

4. <u>Coercive Tender Offers are Never Acceptable, Even Outside of Delaware</u>. Great American had amended its deal terms by removing a condition that it would only consummate the deal if 90% of the outstanding shares it did not already own tendered in the deal (to be followed up with a short-form merger). Instead, Great American proposed to move forward if it gained roughly another 15% of NIC's stock, when it would reach ownership of 66% of the outstanding stock.

The court observed that once it achieved this level of ownership, Great American had the power to oppress remaining minority shareholders, including by discontinuing dividends or forcing them to sell at prices lower than the tender offer price of $30. As a result, the court found, the tender offer was structured to force buyers to tender rather than face an uncertain future and was therefore coercive.

While a long time has passed since a court last found a two-step tender offer coercive, in this case and in Royalty Pharma's failed bid for Élan Corporation last year, federal courts have reminded buyers that the Williams Act still has teeth. Buyers need to take care that their offers cannot be characterized as coercive, and targets should consider the entire structure of the proposed tender offer to determine whether it is unfairly coercive.

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