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ABSTRACTS OF CURRENT ARTICLES IN BUSINESS AND FINANCIAL PERIODICALS

APRIL 2005

INVESTMENT BANKING

Skip The Block Party, Since Big Profits Await In Smaller Equity Deals

ABSTRACTED FROM: *Small Is Bountiful*
BY: Peter Koh
Euromoney, January 2005, Pgs. 38-40

Mind your table manners. Investment bankers keeping tabs on Europe's most profitable deal niches will need to look beyond the headline-grabbing, large-company block transactions. Those in 2004 involving small and mid-sized companies were far more lucrative. Peter Koh reports that the 41% surge in 2004 deal volume in Europe masks an undercurrent of low profitability created by cutthroat competition and league-table jostling among investment banks for the largest high-profile deals. At some banks, losses on a handful of secondary offering transactions may have decimated a sizable chunk of the revenues from smaller, profitable deals.

The bigger they come. League-table ranking and reputation seem to bear little relationship to profitability. In December 2004, Morgan Stanley's book-building efforts in TeliaSonera shares received a severe blow when the Swedish/Finnish telecom giant announced a writedown, sending its shares plunging. CSFB also suffered a year-end fiasco when it failed to sell a large block of ST Microelectronics shares on which it had bid aggressively. Perhaps the biggest blow came in January 2004, notes the author, when Citigroup suffered a huge loss on a block trade of 150 million shares in semiconductor manufacturer Infineon. Rivals estimate that during 2004, Citigroup lost three times more to block trades in Europe than its closest competitor, Morgan Stanley.

High profile, low profit. Investment bankers might find the losses from messy trades more palatable if other deals were yielding healthy profits. However, some of 2004's largest and most successful deals produced little or no returns. Many of these were privatizations, and European governments

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with budgetary constraints kept a tight rein on spending. Although government sellers put a squeeze on fees in the IPO market, a surge in volume over the prior year made the transactions profitable overall. Even though European governments may be difficult customers, the author points out, investment banks nevertheless continue to court them in the hope of securing future deals, and eager dealmakers can point to several bright spots on the horizon. The head of Europe's equity syndicate at Morgan Stanley maintains that observers should look at the overall return of a portfolio rather than at a few unprofitable deals. Even difficult trades are worth pursuing because they carry franchise value and clear the path for secondary volumes.

Smaller companies yield more profit. Deals involving small and mid-cap companies, where competition is less intense, have generally been more profitable than the large high-profile transactions. Marketed deals and those that have not been put out to competitive tenders earned bankers solid fees of 2% or more. The author observes that these deals are more profitable for a number of reasons. For example, because investors are unfamiliar with small and mid-sized companies, bankers are more likely to market these deals than those involving larger companies; smaller companies often agree to share more of a deal's upside with banks; and lower coverage for small and mid-cap stocks often means less competition for fees. Ironically, the profitability of small and mid-sized deals coincides with a move by investment banks to slash analytical coverage in this area and focus instead on large companies—the ones that generate the highest turnover.

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FINANCIAL REPORTING, TAXATION & ACCOUNTING

Establishing A New Internal Control Function: Tough But Essential Task

ABSTRACTED FROM: *Jump-Start Success*
BY: Bruce Caplain, First Marblehead, Boston, MA
Journal of Accountancy, February 2005, Pgs. 34-38

Improve management's view of internal audit. For an incoming chief internal auditor, creating and heading up a new internal audit team may require a corporate jump-start. The new chief auditor must first establish the department's independence and educate management on how a top-level internal audit department adds value to a company. A company seeking only to put up a good front and meet the mandates on internal control will likely fail to appreciate the chief auditor's position. The ideal leader will be able to convince management that internal audit is a vital part of the company and exists for reasons other than Sarbanes-Oxley compliance or stock-exchange listing requirements. CPA Bruce Caplain speaks from experience: he has led an existing corporate audit department and has started another one from scratch. When initially setting goals for the internal audit function, advise management that assessments take time and that opining on the company's internal control environment could take up to two years.

Looking for SWANs. Once the new internal audit chief is convinced that management values internal control, let executives know the department's mission, the type of work the staff will be doing, and the kind of reports they can expect. Jumping into the fray and showing rapid progress—within the first month on the job—is critical. Immediately get audits underway, the author advises. The best way to manage this? Hire experienced, top-notch staff. The most time-consuming but important job, recruiting the best auditors should be a search for SWANs: CPAs who are Smart, Work hard, and are Ambitious but Nice. The internal auditor must not only have technical competence but must

also be an effective representative of the important new department. Internal auditors are not just assistants to the outside CPAs, and they do more than monitor controls and undertake special projects.

Let the environment guide the priorities. The author notes that the chief auditor must understand the corporate environment and prioritize the audits accordingly. To assess the company's risks, meet with the top brass to determine the risks associated with transaction volume, management competence, and liquidity. Management may be looking for control testing while the new chief may see specific problems to attack. Once the internal audit team is in place, continue to expand the intelligence gathering and perform a control assessment evaluation. Alerting the audit committee to the company's control environment is meaningful and helps to establish the department's credibility with the committee.

Create value for the company. When the chief internal auditor has done a good job of educating management, the department's first audit report will carry weight and alert management to potential problems but not crises. Should the internal audits reveal an imminent crisis, management should be alerted well before the IA department issues the audit report. Another important task is to find the department's proper role in Sarbanes-Oxley compliance. The internal-audit team must be careful not to create a conflict by performing cradle-to-grave control functions. If the internal auditors are making control assessments, let management perform the testing and documentation for Sarbanes-Oxley.

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Sarbanes-Oxley Rule 404 Now A Costly, Time-Consuming Reality Show

ABSTRACTED FROM: *Section 404 Compliance: Telling It Like It Is*
BY: William Sinnett, Financial Executives Research Foundation
Financial Executive, January/February 2005, Pgs. 19-22

The curtain draws back. Rule 404 under the Sarbanes-Oxley Act is beginning to star in annual reports throughout the country. Beginning with annual reports published in 2005, investors will discover the issuer's evaluation of the effectiveness of its internal controls, as well as the auditors' opinion of that assessment. In particular, researcher William Sinnett emphasizes, the company must highlight any uncorrected control deficiency that impacts its ability to report its financial information accurately. The annual report must indicate whether the deficiency is significant and, if so, whether it is so compelling that it could cause the company to misstate the financial statements. The PCAOB's audit standards indicate that a company's failure to reconcile certain accounts on a regular basis would constitute a control deficiency, a minor infraction. However, if the company did not have a process in place to ensure that the reconciliations were performed, that would constitute a significant deficiency.

Dow and GM report a clean slate. Uncovering and then remediating significant deficiencies and material weaknesses is a time-consuming, expensive process, the author reports. Dow Chemical employees spent over 100,000 hours on meeting the Rule 404 mandates. The SEC has given issuers a little leeway, allowing an extra two weeks for companies to file their Form 10-Ks. The fortnight extension meant General Motors had enough time to correct the control deficiencies it uncovered and complete the necessary retesting. Neither GM nor Dow, which started its analysis in March 2003, will be reporting any deficiencies in their 2004 annual reports. By beginning so early, Dow's implementation team was able to document, test, correct, and retest the controls, eliminating reportable deficiencies. Both GM and Dow reported problems with their service providers issuing timely SAS 70 reports. These required reports provide assurance that the outsource agency (e.g., payroll service) has effective internal controls. One service provider told Dow it could not supply the 2004 SAS 70 until mid-2005. As a result, Dow is seeking a mid-year report that covers at least six months of the current reporting year.

Internal-control deficiencies impact credit reports. Moody's issued a special report in October 2004, describing how deficiencies in a company's internal controls might impact its credit report. Deficiencies that are specific and easily correctable will likely not affect the issuer's credit rating. However, the rating agency will consider acting if a company reports a material, systemic control weakness (given the difficulty of auditing around that kind of problem). One Moody's executive thinks the internal-control reports will improve reporting and restore the market's confidence. Companies certainly anticipate that Rule 404 compliance will confer some long-term benefits, because they are spending enormous amounts of money on the process. The author estimates that Dow spent over $5 million just for the compliance team's labor costs.

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Editor's Note: For insight on how investors might interpret internal-control deficiencies in 10-Ks, read "How Clean Are The Books?" by David Henry, *BusinessWeek,* March 7, 2005, Pgs. 108-110.

Sarbanes-Oxley 404 Software Helps To Bridge Compliance Gaps

ABSTRACTED FROM: *Looking For Gaps*
BY: John Goff
CFO*,* February 2005, Pgs. 53-58

Looming deadline. CFOs facing the deadline for implementation of Sarbanes-Oxley Section 404 may benefit from a new suite of software programs designed specifically for compliance purposes, reports John Goff. Companies face either a March 15th or April 15th implementation deadline. All are likely to spend significant sums in complying with the 404 mandate to identify key business processes and controls, as well as the vulnerabilities within those systems. Those with revenues of $5 billion or more could spend over $4.6 million in 2005 on such compliance, according to Financial Executives International. Even smaller companies are feeling the pain. Software maker Micros Systems, with revenues of $487 million, has spent about $4 million over the last two years on its Section 404 compliance program.

Software to the rescue. Although manpower accounts for most business expenditures attributable to the assessment of internal controls, more managers are relying on software to help automate and document the processes. Software companies, eager to rush their products to market, once answered the need with programs that did little more than spit out compliance best practices. More recently, vendors such as OpenPages, Axentis, Approva, Virsa Systems, and Hummingbird have revamped their internal controls offerings with new, improved software. Some of the software available will compare the company's internal controls to best practices and will then make suggestions for improvement. Other programs focus on documenting policies and procedures, creating electronic archives as they do so, while several flag suspicious-looking transactions. A number of companies are investing in e-mail archiving systems to ensure that 404-related documents are held for a "reasonable" length of time, as Sarbanes-Oxley requires. Companies use the software to meet a variety of goals. Micros Systems, for example, uses a web-based program from OpenPages called Sarbanes-Oxley Express to identify and store key internal controls and the policies governing them. The author mentions several programs featuring documentation systems to assess and house internal controls. For example, BizRights produces a report that analyzes an SAP system and compares internal controls against best practices; Firefighter lets managers log on to systems they do not access routinely; and Compliance Calibrator restricts access to sensitive areas such as accounts payable, even though such restrictions may be difficult to implement within a sizable company.

Playing to the auditors. At many companies, documentation is scattered throughout Excel spreadsheets or voluminous printouts, making it difficult for auditors to conduct an evaluation and suggest improvements. After helping their clients anticipate the Section 404 requirements, many auditors expect to see more clearly marked audit trails and consistent, reliable documentation systems. In-

creased guidance from the SEC regarding 404 documentation would help software companies tailor their programs more effectively and ease the burden for finance executives, but nothing has happened yet. In the meantime, the simple appearance of strong internal controls through some form of digital documentation can prove invaluable when the accountants start probing. Those auditors are less likely to question internal controls, the author supposes, if the controls are documented in digital form, rather than lying around in paper-stuffed boxes.

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EQUITY & DEBT OFFERINGS

Allowing The Use Of Unregistered Finders Would Help Small Businesses

ABSTRACTED FROM: *Finders Keepers*
BY: Ronald Fink
CFO, February 2005, Pgs. 63-65

Unregistered finders could help small businesses raise capital. In a world where registered securities representatives increasingly work for large firms reluctant to participate in small deals, owners of small public companies usually have trouble finding intermediaries to help them raise capital. Banks' risk-management policies often prevent them from making loans to small, not-well-known companies, and major investors also prefer larger enterprises. Even venture-capital firms, once the financial backbone of startups, now favor the somewhat-safer later-round investment. Ronald Fink reports that small businesses would happily use unregistered intermediaries to scout investors for relatively small issues. Unfortunately, a 70-year-old rule under the Securities Exchange Act of 1934 prohibits the use of unregistered finders.

Occasionally a no-action letter. The SEC has occasionally issued no-action letters to a few unregistered individuals, permitting them to receive fees for introducing investors to companies or partnerships, provided they do not make a profession of being an intermediary. For example, the author mentions that in 1991, the SEC permitted singer Paul Anka to accept fees for introducing his personal acquaintances to a general partner at a hockey team, who then solicited them as limited partners. The no-action letter states that the SEC would take no action against Anka if he did nothing beyond introducing people and did not make a living out of acting as an intermediary for securities investors. Since unregistered intermediaries must, by definition, be amateurs, the small-business owner needing help from a finder can look only at friends and their acquaintances. Small-business associations would like to see a modification in the regulations, allowing professional but unregistered representatives to fill the gap between major investment banks and personal social networks. The American Bar Association is also expected to recommend relaxing the prohibition against unregistered finders.

Change is an uphill battle. Despite the lobbying efforts of small-business associations, major changes seem unlikely. The SEC and the NASD believe that a reasonably priced registered representative is available for any size of deal and that broad relaxation of the rules is therefore unnecessary. The SEC points to numerous stock frauds perpetrated by unregistered intermediaries who promoted stocks with false claims. Vector Medical Technologies, for instance, defrauded mostly physician/investors of approximately $16 million a few years ago. Tyco's lead director and compensation committee chairman, Frank Walsh Jr., collected an unregistered-finder's fee of $20 million for recommending that Tyco buy CIT Group, which less than a year later it had to sell for half the purchase price. Proponents of relaxed rules point out that registered intermediaries also participate in fraud, but the numerous

recent corporate frauds have served to increase—not reduce—the impetus for regulatory oversight. The author also observes that the NASD is the organization which registers securities representatives, and both the SEC and the NASD are unlikely to approve changes that reduce their own power. Minor tweaks are possible in the pragmatic application of regulations governing unregistered finders, but major change is almost certainly a long way off.

Abstracted from ***CFO,*** published by CFO Publishing Corp., 253 Summer Street, Boston, MA 02210. To subscribe or to view back issues, visit *www.cfo.com;* for more information, call (800) 877-5416. **Editor's Note:** Angel investors have become a crucial source of capital for biotech startups. See "Where VCs Fear To Tread" by Arlene Weintraub, *BusinessWeek,* March 7, 2005, Pgs. 86-87.

Going Public With A Commercial Bank May Reduce IPO Underpricing

ABSTRACTED FROM: *The Effect Of Banking Relationships On The Firm's IPO Underpricing*
BY: Carola Schenone
Journal of Finance*,* Vol. 59, No. 6, Pgs. 2903-2958

Asymmetric information increases IPO underpricing. Initial public offerings are typically priced well below their actual market value. Although theorists disagree on the exact nature of information flow and structure, all agree that bankers—and the investors they solicit—know less about private companies on the brink of going public than they do about already public companies. The lower offering price compensates investors for the increased risk of buying into a company for which information is relatively limited. Therefore, anything that reduces information asymmetry should reduce underpricing. One factor that may reduce underpricing, researcher Carola Schenone theorizes, is the ability of commercial banks (since the 1998 repeal of the Glass-Steagall Act) to take clients public.

Lending banks have an inside track. When a private company has an existing banking relationship with a bank capable of taking it public, that bank presumably knows more about the company than a just-recruited bank; and the commercial bank that underwrites debt or lends money directly to a private client certainly knows more about the borrower than investment bankers brought in for the IPO. Furthermore, the lending bank has a greater incentive to monitor the company than does a bank which merely underwrites debt to be sold to investors. Thus, the author surmises, lenders normally have more information than debt underwriters. The private companies examined had chosen their banks before commercial banks were permitted to take them public, so there was no self-selection whereby stronger companies chose banks capable of underwriting IPOs.

Going public with an existing banker significantly reduces underpricing. Controlling for company size, age, and other characteristics, the companies that had an existing banker capable of taking them public collectively experienced 17% less underpricing than other IPO companies. Looking at the existence of a banking relationship, the author finds an increase in the underpricing differential: Companies that could and did go public with an existing banker enjoyed 37% less underpricing than those without a banker capable of taking them public. Companies that could have gone public with an existing banker but chose another bank instead paid for the switch; they faced 4% more underpricing than the firms that could and did go with their existing banker. Larger companies using existing bankers were less underpriced. Even leveraged companies were less underpriced, because the ability of a private firm to borrow signals that bankers and investors have already vetted the company and found it creditworthy. Conversely, a high cash-to-asset ratio produces higher underpricing, perhaps because investors distrust the motives for going public at all. Venture-capital-backed and Internet IPOs also have greater underpricing; however, the existing-banker relationship continues to influence the extent, regardless of industry or company characteristics.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Board Work Is Tougher These Days, But Precautions Can Minimize The Risk

ABSTRACTED FROM: *Whither Directors' Personal Liability?*
BY: Harvey Pitt, Kalorama Partners, Washington, DC
Compliance Week, February 2005, Pgs. 1, 40-41

Board seat has lost its luster. In times past, an invitation to join a board of directors spelled trips to scenic, exotic locations and the opportunity to mingle with other prestigious executives. That pleasant prospect has been altered dramatically by three high-profile cases of securities fraud, which turn on the issue of personal liability. In a Delaware Chancery Court case, the court held one director—who possessed specialized financial knowledge above and beyond that of the other directors—to a higher standard. The Emerging Communications board had approved a dubious two-step transaction, taking the company private. The court decided that the financially sophisticated director, unlike the rest of the board, could not rely on the business judgment rule. Two other cases, involving WorldCom and Enron, forced individual directors to contribute as much as 20% of their assets to a settlement, forestalling a public trial and a potentially adverse jury decision. In the aftermath, it is little wonder that directors are considering service on the board as something to be strictly avoided. Characterizing this response as an overreaction, former SEC chair Harvey Pitt suggests a set of proactive guidelines that, if followed, can minimize the risk of liability for outside directors.

Due diligence, knowledge, and a game plan. The author counsels potential directors to do a thorough job of due diligence, examining the company's operations, management, and governance practices. If possible, obtain an independent evaluation, seeking to understand the nature of the company's business, corporate culture, strengths, and weaknesses. Thoroughly examine the management team, and do not overlook the strengths and weaknesses of the other directors. Being the most knowledgeable or the hardest-working director may not prove an asset in the current climate. Directors need outside experts to help them make effective decisions. Determine whether the company is willing to invest in experts that will be readily available. Organization, planning, and time for evaluation are essential to successful directors, so ascertain that the board's scheduling allows the time for these activities.

Disclosure, information, and recordkeeping. Full disclosure—a critical element for responsible board service—requires a continuous flow of information from management to the board. If this information flow is effective, it will encourage directors to anticipate crises, ensuring a better response when the inevitable adversity arises. Evaluate the company's systems and procedures on a regular basis. Educating directors, officers, and employees about critical issues and changes in the business landscape will help the board as well as the company to function effectively. A paper trail, including accurate and detailed records of all board meetings and deliberations, is critical for documenting the board's good-faith efforts. The author also recommends that audit committees consider a forensic audit every two or three years. Review the company's D&O and E&O insurance, and ensure that protection for outside directors is comprehensive and solid.

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Canadians Consider National Compliance Guidelines

ABSTRACTED FROM: *Corporate Governance Disclosure In Canada: A National Approach...Finally*
BY: Simon Romano and Andrew Grossman, Stikeman Elliott, Toronto, ON
Wall Street Lawyer, Vol. 8, No. 7, Pgs. 11-15

Securities regulators draft compliance guidelines. America's neighbor to the north is at last catching up on compliance and disclosure requirements for public companies. The securities regulatory authorities in Alberta, British Columbia, Ontario, and Quebec recently issued proposals for regulating corporate governance disclosure for Canadian public companies. Two proposals, one on disclosure of corporate governance practices and the other on governance best practices, have been harmonized and melded into a single document, which is representative of separate initiatives undertaken by every securities regulator in Canada. Similar to the NYSE's corporate governance standards and to provisions in the Sarbanes-Oxley Act, the new Canadian best practices are meant to provide guidance for dealing with corporate governance issues. Canadian corporate lawyers Simon Romano and Andrew Grossman explain that the new national approach will ease the process of reviewing, monitoring, and enforcing corporate governance disclosure requirements in Canada. Not yet in force, the guidelines upon adoption will apply to public corporations, publicly traded income trusts, and limited partnerships.

Best practices follow stock exchange rules. The new proposal is designed to provide greater transparency of corporate governance practices. While the rules will require some mandatory filings on SEDAR (Canada's EDGAR counterpart), they actually reduce disclosure requirements for companies not listed on the Toronto Stock Exchange. One new element in the best practices section is the shift away from a negative focus—such as explaining compliance slips—and toward the positive—such as describing corporate governance practices. Where company policies and these best practices diverge, the company must describe what it is doing to bring its policies into line with the guidelines. The proposal incorporates the Toronto Stock Exchange's existing corporate guidelines, and it also resembles the new regulations and exchange rules governing post-Sarbanes America. Government officials hope that the proposal will lead to more effective enforcement of securities violations.

Independence and duties of the board. The authors have summarized some of the major best practices, pointing out which will be new to formal Canadian governance practices. For instance, in addition to the usual mandates that a majority of the board's directors and the chair be independent, boards will now be asked to create written acknowledgments of the directors' responsibility for stewarding the company, ensuring the integrity of the CEO, adopting strategic plans and communication policies, and identifying principal business risks. The board will also have to develop written job descriptions for its chair, each committee chair, and the CEO. It will be responsible for the orientation of all new directors and their continuing education, as well as for drafting and adopting a written business code. The code should cover conflicts of interest, proper use of corporate assets, compliance with regulations, and reporting of illegal or unethical behavior.

Focus on directors. The best practices include guidelines for nominating and recruiting directors and determining their skill sets. Any compensation committee should hereafter contain only independent directors, who will be responsible for determining compensation for the directors and officers of the company and for reviewing the compensation disclosure in any proxy materials. Along with the best practices, the authors write, the new harmonized proposal offers amendments to a prior law on audit committees, clarifying the term "independence" as it pertains to directors. A director is independent who has no direct or material relationship with the corporation. Independent directors may not be company employees and cannot work for the external auditor. They may not receive more than $75,000 in direct compensation for services other than board meetings and duties. While share ownership does not compromise independence, family relationships may do so.

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CORPORATE ENTITIES & STRUCTURES

Public To Private: The New Small And Mid-Cap Choice

ABSTRACTED FROM: *The Pros And Cons Of Going Private*
BY: John Sinnenberg, Key Principal Partners, Cleveland, OH
***Financial Executive**,* January/February 2005, Pgs. 24-27

Being a public company is expensive. New regulations have increased the cost of compliance by 130% since 2001, and that figure is expected to continue rising. Many small companies now spend between $1 million and $2 million a year to satisfy new regulations. Accounting and legal fees are up, and premiums for directors' and officers' liability insurance have more than doubled. In addition, the increased risk of personal liability for officers and directors now makes finding good candidates more difficult (and paying them more onerous). For many smaller companies, being public offers few advantages in today's market, concludes investment banker John Sinnenberg. Over half of the companies with a market capitalization of less than $50 million have no analyst coverage, without which it is difficult to attract institutional investors. Small public companies are often fairly illiquid and trade erratically. Stocks without analyst coverage are frequently underpriced, thus opening the door to hostile takeovers. Given all this, going private often looks like an attractive alternative.

Going private is not easy. Going private will give the public stockholders an opportunity to cash out at a reasonable price. Whether through merger, tender offer, or reverse stock split, a public company must buy back its public stock in order to go private, the author explains. The costs for advisors, legal fees, accounting fees, and special committees can run from several hundred thousand dollars to a couple of million. The SEC must approve the transaction and must be convinced that the shareholders' rights have been protected. The shareholders who aspire to own the newly private company must raise enough capital to buy all the company's stock, which normally means finding financing even if a majority of the insiders and the largest public stockholders intend to participate in the private company. The conversion process typically takes from six to 18 months. Although expensive to do, going private does eliminate the increasing and perpetual costs of compliance.

Only healthy companies make good candidates. To navigate the complexities of going private, clearly the company must be an attractive investment opportunity, blessed with good current income and market potential. The best candidates tend to have undervalued stock. Lenders and investors are also looking for the real possibility of continued profits, which will finance the going-private process and provide the private investors with a return on investment. To attract banks or other third-party investors, the candidate with a solid product, good cashflow, and ongoing potential in its marketplace will fare best. Relieved of the burdens of compliance and its associated costs, company managers can refocus on their core business and products, which will boost performance.

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MERGERS & ACQUISITIONS

Acquiror's Shareholders Tend To Approve Mergers, But Not With A Rubber Stamp

ABSTRACTED FROM: *Is Acquiring-Firm Shareholder Approval In Stock-For-Stock Mergers Perfunctory?*
BY: Prof. Timothy Burch, Prof. Angela Morgan, and Prof. Jack Wolf
University of Miami (TB); Clemson University (AM, JW)
Financial Management, Vol. 33, No. 4, Pgs. 45-69

A perfunctory process. Although stock acquisitions often dilute shareholder wealth, the overwhelming majority of shareholders at the acquiring companies vote in favor of them. Finance professors Timothy Burch, Angela Morgan, and Jack Wolf examined 209 merger-approving proxy votes conducted by acquirors and determined that the mean approval rate was an astounding 98%. Yet research has repeatedly shown that acquirors' shareholders often experience substantial ownership dilution in stock-for-stock deals, as well as erosion of stock value at the time of the announcement. Their behavior raises questions about why shareholders consistently approve such deals, even to their own potential detriment. The authors reviewed several explanations: The level of shareholder support may depend on the perceived quality of the deal or reflect the stock market returns surrounding the announcement; shareholders might study the details of a proposed merger; or perhaps they simply and perfunctorily accept management's seal of approval. If the latter holds true, shareholders may not add the checks and balances to management's acquisition policy that the voting process implies, making shareholder votes an ineffective monitoring tool.

Negative voters sit it out. The mean approval rate, when all shareholders with voting rights are included, is 73%. The authors compare this to the 98% mean approval rate when counting only the votes cast. They conclude that shareholders who would vote against a merger are more likely to sell their stock before the vote or to simply not vote at all. The quantum of vote, whether by voting rights or by number of votes cast, is generally a matter dictated by state law. Shareholders with negative views affect the outcome in voting rights, but not outcomes based on votes cast. Nevertheless, even though most shareholders who vote usually approve of a merger, reaching the quorum for a valid vote can prove difficult.

Firm characteristics important. The research shows that characteristics of the acquiror and the target, as well as of the proposed combination, affect approval rates. A tendency for institutions to rely on recommendations from managers or from their advisory service—which generally favor acquisitions—might explain increased approval rates at acquirors with high levels of institutional ownership. An alternative explanation, the authors suggest, is that companies with high institutional ownership carefully evaluate the deals they propose. Recent operating and stock market performance do not seem to affect approval rates, although shareholders apparently believe that a large cash stockpile could signal poor acquisition choices by management. Voters also consider other factors, including target size and cash included in the bid.

An indirect monitoring device. The authors' analysis shows that even with overwhelming acceptance, merger voting serves as an indirect monitoring device. The very threat of a failed vote appears to prompt managers to propose only acquisitions that they believe will receive approval, even if passage means campaigning for votes. The fact that some acquisitions pass by only a narrow margin indicates that managers may, at times, overestimate shareholder support. Five percent of the deals studied had an approval rate or voter turnout of less than 60%. These results should prompt managers considering a merger not to take shareholder support for granted.

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Structure Deals With Earnouts Clearly And Carefully To Avoid Future Trouble

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BY: Michael Frankel, General Electric Consumer Finance, Stamford, CT
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Resolving spreads, overcoming viewpoints. Need an original, powerful way to resolve the gap between the bid and ask valuations in an acquisition? Consider the earnout, suggests Michael Frankel, a corporate development and finance executive. The earnout is a payment resulting from performance after a deal is closed. Future performance may seem a simple criterion—giving the seller the benefit of post-closing earnings arising from its pre-closing efforts—but it can also stir intense disagreement between the parties. Earnouts are useful when an outcome is difficult to predict, for example, in deals involving startups and early-stage companies, firms with new products or technologies, and those in highly volatile industries. They are an attempt to resolve the contrasting viewpoints of the buyer (i.e., pessimistic) and the seller (optimistic) as to future performance. The higher a company's projected growth, the greater the valuation gap; the slower or more predictable the growth, the narrower the gap. Contingent payments—based on future revenues, profits, or cashflow—can bridge the gap and sometimes are the only way to get a deal done. However, view them as a last resort, remembering that deals with earnouts are complex, demand precise drafting, generally seem difficult to manage, and hold great potential for conflict.

The devil in the details. While earnouts offer a reasonable solution, they succeed only when the details, terms, and metrics of the deal are accurate. Using contingent payments to put off solving a disagreement can cause more problems than it attempts to fix. The rules must be clear and easy to carry out, the author warns, or else the parties will unhappily meet in court. The triggers must be specific, precise, and capable of easy measurement; ambiguity in terms, measures, or responsibility for performance just delays the inevitable disagreement. Problems can also occur when the earnout is a large percentage of the purchase price. Financial metrics (including revenues, EBITDA, and net income) and nonfinancial metrics (such as product development milestones) are sound criteria for contingency payments. Occasionally, even the metrics are subject to interpretation regarding calculation methods, data sources, and payment circumstances. Align metrics with the goals and expectations of both parties by identifying the variables that match the underlying goals.

Control is always an issue. After the deal closes, the buyer generally exercises complete control over the acquisition. This leaves the seller dependent on the new management to determine performance, and it raises a potential for conflict. Sellers must be aware of the buyer's adverse incentive bias, the author urges. While this bias should be offset by the desire to achieve successful performance, an especially large payment can certainly tempt the buyer to hinder the company's performance, thereby reducing or eliminating the payout. Another possibility is that the buyer might weight the financials away from the payout metrics. Avoid potential issues of control by permitting the seller either to retain some control over the business or to establish parameters for operation. Examples are requirements for minimum expenditures in marketing or adherence to the existing business model, until the payout is complete.

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