Will The Bidder-Activist Model To Buy Allergan Catch On?

*Law360, New York (May 30, 2014, 7:53 PM ET)* -- Now a persistent force in corporate America, activists continue to seek new areas and creative methods of influence. Their initial focus was on changing corporate governance, influencing business strategy and removing directors. When they expanded to M&A, they pressured target companies to dismantle defensive mechanisms and negotiate with bidders, and, in a few cases, acquired large equity stakes in companies either to put them in play or as a first step to acquiring them. The Pershing Square-Valeant collaboration* is different. Rather than the activist investor making its investment in a target and then working toward causing a value-creating event, the activist has partnered with a bidder at the start of the process, creating a kind of prepackaged transaction that adds momentum to the bidder’s unsolicited acquisition proposal.[1]

Prior to disclosure of any purchases of Allergan equity or Valeant’s intent to acquire Allergan, a newly formed Pershing Square-Valeant entity, managed and almost wholly funded by Pershing Square, acquired options exercisable into 9.7 percent of Allergan’s common stock.[2] The hallmarks of the Pershing Square-Valeant model are the very aggressive accumulation of over-the-counter options (in lieu of the traditional pre-announcement market accumulation of a much smaller stake of target company common stock), and the ability of the activist to convert those options more quickly than the bidder could (because, as a noncompetitor, it can obtain Hart-Scott-Rodino (HSR) clearance more quickly). While Valeant itself could have bought the options stake, the Pershing Square-managed entity’s purchase instead will result in a very large equity stake being available very quickly for a proxy contest to remove the Allergan board and redeem its shareholder rights plan — providing a convincing roadmap to a sale of Allergan (although, notably, not necessarily to Valeant if a competing bidder emerges with a superior offer).

In this collaboration, Pershing Square’s objective is, as always, to maximize its profit. Before Valeant’s interest in acquiring Allergan was public, Pershing Square had spent about $4 billion to buy the Pershing Square-Valeant equity stake in Allergan. The value of that investment increased by about $1 billion the day Valeant announced its acquisition proposal for Allergan. By contrast, Valeant’s objective is to acquire Allergan, and its objective in collaborating with Pershing Square appears to be to create both
momentum and substantive support for the acquisition (and, through its interest in the pre-announcement equity stake, to ensure that its expenses are covered in the event that its acquisition bid fails).

Corporate America has had a mixed reaction to activist investor activity, recognizing that some of the activity has been instrumental in creating real, long-term value for shareholders, but concerned that some has reflected a short-term self-interested focus to the detriment of other shareholders. The concern now is that the Pershing Square-Valeant collaboration reflects the development of a “perfect storm” in the M&A arena — activists are causing the dismantling of companies’ standard takeover defenses; they control large pools of capital; and they can maneuver within the existing regulatory framework to create what appears to be unfairness in the market and an unfair advantage over target corporations. The fear is that the Pershing Square-Valeant model will be followed by other bidders and activists, unleashing a new wave of unsolicited takeover attempts fueled by activists seeking to profit from the acquisition of a large equity stake in a company for which their corporate partner then makes an unsolicited bid.

**Key Takeaway**

Whether the model will be widely followed will depend on whether it produces the benefits that the bidder anticipates and, if so, at what cost. In our view, whether the model creates a net benefit to a bidder in any given case, and the nature and extent of the benefit, will depend on the facts and circumstances relating to the specific bidder, activist, target, bidder-activist arrangements, and underlying proposed transaction.

**Benefits to Valeant**

In the case of the Pershing Square-Valeant arrangement, arguably the collaboration, as structured, potentially provides the following benefits to Valeant: use of the 9.7 percent equity stake in the target as voting support for a proxy contest, that can be commenced soon after announcement of the bid, to remove the target’s board and redeem its shareholder rights plan; use of Pershing Square’s expertise in amassing options in the over-the-counter market to acquire the equity stake; Pershing Square’s assumption of all the downside economic risk on the equity stake; 15 percent of any upside economic gain on the equity stake in the event the Valeant bid loses to a competing bidder (at least enough to cover Valeant’s expenses in having made the bid); availability of $400 million of additional funding for the bid; added credibility and momentum for the bid; and, after the bid (if it is successful), the possible benefits of Pershing Square’s participation as a large shareholder of the resulting company. We discuss below the extent to which it appears that these benefits have been or will be provided to Valeant, and at what cost.

**Disadvantages of the Model**

Bidders in general will need to determine their view of the likely net benefit of this model, after taking into account that it appears that: there are significant economic costs to the bidder; there are inherent
conflicts of interest as between the bidder and the activist; depending on the specific circumstances; a bidder acting on its own (with an investment banker) may be able to achieve most or all of the things that can be achieved by acting with an activist; and the model itself (particularly if widely followed) may prompt regulatory changes that could limit its future use.

**What are the Potential Benefits of the Model to a Bidder?**

While the benefits of the model to the activist have already been proven (with Pershing Square’s one-day billion dollar gain), the benefits to the bidder are more nuanced and will vary based on the facts and circumstances.

- **Pershing Square’s voting support for a proxy contest.** If Allergan resists the Valeant proposal, Valeant and/or Pershing may elect to conduct a proxy contest to remove Allergan directors and replace them with new directors, who will be in a position to redeem the Allergan shareholder rights plan and approve the transaction with Valeant. Although HSR clearance is required for the exercise of options into voting stock, the clearance for the Pershing Square-Valeant entity (which is managed by Pershing Square) likely will be obtainable relatively quickly. By contrast, had Valeant acquired the options for its own account, their exercise likely would have been delayed by a longer HSR clearance process than would apply to an entity controlled by a non-competitor. Therefore, the collaboration permits Valeant to more quickly conduct a proxy contest, with 9.7 percent of the Allergan common stock in support. The extent to which a bidder in another situation will view the model as providing a significant benefit in this respect will depend on that bidder’s view of the likely difference (if any) in the time needed for HSR clearance for the bidder as compared to the activist; the likelihood of credible competing bids emerging; and the likelihood that the voting of the equity stake would make a difference in the proxy contest.

- **Extent of this benefit.** When evaluating this benefit, it should be noted, first, that a bidder who is not a direct business competitor (unlike Valeant here) may not have a materially different timeframe for HSR clearance than can be achieved by the activist-bidder entity. Second, while Pershing Square has committed to vote in support of the Valeant transaction and against other transactions, if a higher bid materializes, Pershing Square’s vote of the 9.7 percent stake in favor of Valeant’s bid will be irrelevant, as the higher transaction would be approved by Allergan’s other shareholders and would prevail.

- **Economic cost of this benefit.** Finally, the economic cost of this benefit to Valeant is high. If Valeant had itself purchased the options, the billion dollar gain on the options would have been for Valeant’s account. If competing bidders for Allergan emerge, Valeant will have been the only bidder who had the opportunity to acquire a significant stake in Allergan at prices well below the bid price. By permitting Pershing Square to take almost all of the economic benefit of the pre-announcement purchases — equal to at least 2-3 percent of the total deal value (assuming Valeant had bought the same 9.7 percent stake) — Valeant has relinquished the economic advantage it would have had over competing bidders. That advantage represents up to about $5 per Allergan share that could have been offered without additional cost to Valeant. While a quick proxy fight advantages a bid, the timing benefit must be compared with the benefit that could have been derived from Valeant’s having had an extra billion dollars with which to increase its bid price.
Go-it-alone alternatives potentially providing the same benefit. An alternative that bidders may want to consider is to acquire the pre-announcement equity stake for their own account, and then determine sometime after announcement of their acquisition proposal whether to collaborate with one or more activists for support. The decision then would be made after the bidder has more knowledge about the HSR timing, the target’s reaction, the emergence of other bidders, and so forth. Armed with the gain on the pre-announcement equity stake that arises from announcement of its proposal, if the bidder then believed that collaboration with an activist would be to its advantage, the bidder would be in a position to make very appealing offers to activists that might well not need to be as much as the 85 percent share of the gain on the Allergan equity stake in effect paid by Valeant to Pershing Square (or, indeed, the bidder could use the gain to increase its deal price).[3]

- **Pershing Square’s expertise in amassing options.** Activist investors have significant experience in maneuvering in the over-the-counter options market. In this case, Pershing Square was able to acquire a 4.9 percent stake in Allergan options over just six weeks, and an almost doubling of that amount in just 10 additional days. The question arises whether activists uniquely can acquire this large amount of options, particularly with the desired speed and confidentiality. Investment bankers will need to make bidders aware of their capabilities to effect options buying programs, so that a bidder can evaluate the benefits of one-stop shopping with an investment bank for investment banking advice, financing, and a pre-announcement options buying program, as compared with collaboration with an activist investor for the buying program. Further, there was much evidence that Allergan options were being bought up, and companies will need to review and update their systems for tracking activity not only in their stock but also in their options.[4]

- **Pershing Square’s funding; Pershing Square’s taking the downside risk on the equity stake.** While Valeant benefited from Pershing Square’s funding of the options buying program, and may benefit from the availability of additional funding for the bid through a sale of Valeant common stock to Pershing Square at a 15 percent discount to the then market price, presumably Valeant had the wherewithal to arrange financing on its own in the context of its over $50 billion acquisition bid. The terms of more traditional financing certainly would have been more favorable than the cost to Valeant of the collaboration with Pershing Square. Further, it appears that if Valeant could have purchased 9.7 percent of the common stock it would have done so and been prepared to take the downside risk. In any event, where a credible bid for the target company is made, the likelihood is high that the target will ultimately enhance value for its shareholders.

- **Pershing Square’s presence increasing the credibility of and momentum for the bid.** The involvement of a committed activist investor may well increase the credibility of and momentum for a bid. Before the Pershing Square-Valeant collaboration, Valeant had been trying for a year, to no avail, to persuade Allergan to enter discussions about a combination. Yet, instantaneously on announcement of the collaboration and the bid, the pressure on Allergan increased. The activist’s presence may also tend to discourage competing bids, as companies
may not want to antagonize the activist. However, the announcement of Valeant’s bid for Allergan itself (particularly if combined with a significant pre-announcement stake in Allergan), even without the presence of the activist, would have changed the dynamics for Valeant. One may question how much additional benefit is provided by the presence of the activist collaborator, when arbitrageurs and activists in any event will accumulate the target company’s stock after announcement of a credible bid and pressure the target company to generate value for the shareholders. Further, it is not clear that a competing bidder with a credible alternative transaction would be dissuaded by the presence of an activist collaborator since the target’s shareholders generally (and even the activist collaborator) will prefer the competing bid so long as it is superior.

- **Pershing Square’s presence providing value-added for the resulting company.** Pershing Square’s commitment to hold a significant amount of the resulting company’s stock for a year if the Valeant bid for Allergan succeeds may be viewed as a benefit for the resulting company. Many may view the inclusion of a value-focused activist investor as a major shareholder as additional impetus for value creation for shareholders after the acquisition is consummated. On the other hand, many may view the presence of an aggressive activist investor, who has not agreed to any standstill with respect to the resulting company, as a potentially destabilizing influence, putting the activist in a position to influence the company’s taking actions that will benefit the activist, potentially at the expense of the other shareholders. While Pershing Square may have no such intentions, and while one presumes that most activists will not want to develop a reputation for using their influence for short-term self-interested gain, the potential for problematic motives and actions presents a risk that must be considered.

**Conflicts of Interest as Between the Activist and Bidder**

Notably, there are significant conflicts of interest as between the activist and the bidder in the Pershing Square-Valeant model. For example, most fundamentally, the bidder’s objective is to buy the target company, while the activist’s objective is best achieved if a competing offer at a higher price succeeds instead.[5] A bidder may have concerns about partnering with a party whose interest is so clearly not aligned with the bid it is supposedly supporting.

Also, the activist’s interest is in acquiring the largest possible pre-announcement equity stake (since that is what will maximize the activist’s profit), while the bidder may have reasons to prefer a smaller pre-announcement acquisition program (for example, to lower the cost or ensure more confidentiality).[6] Note that, with a 15 percent interest in the upside economic potential of the pre-announcement stake, Valeant could have achieved the same economic result had it bought for its own account a stake as small as 1.5 percent.

**Possible Impetus for Regulatory and Other Changes that Could Limit Future Use of the Model**

The Pershing Square-Valeant model, by eluding disclosure requirements and market trading restrictions, may provide further impetus to the SEC to implement certain regulatory changes that have been under consideration for some time, with corporations generally having favored the changes and activist investors generally having advocated against them. These changes include reducing the Schedule 13D filing window period[7], and expanding the applicability of Rule 14e-3 to cover acquisition structures
beyond tender and exchange offers.[8]

In addition, a legislative amendment to HSR — requiring options and other derivatives to be considered in the calculation of an interest in voting stock when the derivatives are purchased as part of an effort to obtain control — may gain traction as a result of the Pershing Square-Valeant model. Finally, companies may turn to self-help measures such as the “window-closing shareholder rights plan” that was designed by this firm, which, in effect, prevents anyone from acquiring 5 percent or more of a company’s stock without immediately filing a Schedule 13D.[9]

Conclusion

While there is an advantage to a “coming out all guns blazing” approach when making an unsolicited acquisition proposal, the net benefits to a bidder of an upfront collaboration with an activist shareholder will depend on the circumstances and the terms of the collaboration. Ultimately, the questions in each case will be: Does the collaboration increase the likelihood of the bidder’s deal getting done; if so, at what cost; and how did the alternative ways the bidder could have proceeded compare?

Fundamentally, if a credible bid is made (and there is no compelling alternative), generally it will be likely that the deal will get done, with or without the activist’s participation. If a bid is made that is not credible (or a competing bid is made that is more compelling), then generally it will be unlikely that the deal will get done, with or without the activist’s participation. The incremental advantages the Pershing Square-Valeant model may provide will have to be evaluated in each case.

—By Abigail Pickering Bomba, Steven Epstein, Arthur Fleischer Jr., Peter S. Golden, Karl Groskaufmanis, Barry Nigro, Alyson Redman, Philip Richter, David N. Shine, John E. Sorkin and Gail Weinstein, Fried Frank Harris Shriver & Jacobson LLP

Abigail Pickering Bomba, Steven Epstein, Peter Golden and John Sorkin are partners in Fried Frank’s New York office. Arthur Fleischer Jr. is a senior counsel in the firm’s New York office. Karl Groskaufmanis is a partner in the firm’s Washington, D.C., office. Barry Nigro is a partner in the Washington and New York offices and is chairman of the firm’s antitrust department. Alyson Redman is special counsel in the New York office. Philip Richter and David Shine are New York-based partners and co-heads of the firm’s mergers and acquisitions practice. Gail Weinstein is senior legal counsel in the firm’s New York office.

*Fried Frank Harris Shriver & Jacobson LLP is involved in this matter on the target side.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Pershing Square, a hedge fund run by activist investor Bill Ackman, has teamed up with Valeant Pharmaceuticals to facilitate Valeant’s unsolicited bid to acquire Allergan. A new entity formed by Pershing Square and Valeant, and managed by Pershing Square, purchased $75.9 million of Allergan common stock (the HSR limit for a corporate buyer prior to obtaining HSR clearance), funded by Valeant. The entity then purchased options representing about 9.7% of Allergan’s common stock, for about $4 billion, funded by Pershing Square. Valeant will bear the economic downside risk only on its $75.9 million investment and Pershing Square will bear the risk on the rest of the stake. Valeant will be allocated all the upside economic potential on its $75.9 million investment, and will share 15% of the upside on the rest of the stake (with Pershing Square being allocated 85%). Pershing Square promptly
sought HSR clearance for the exercise of the options and disclosed on May 2nd that it had obtained clearance and exercised the options. Pershing Square will vote Allergan common stock it owns in favor of proposals that support Valeant’s bid and against proposals that disadvantage it. At Valeant’s election, Pershing Square will provide an additional $400 million of funding for the bid by buying Valeant common Stock, at a 15% discount to the then market price. Pershing Square will elect to receive all stock in Valeant’s cash-and-stock bid for Allergan. If Valeant’s bid is successful, Pershing Square will retain at least $1.5 billion of its shares in the resulting company for one year.

[2] The terms of the options (a nominal strike price, one year until expiration, virtually no options premium paid, and a purchase price that approximated the market price of the underlying common stock) make the options the functional equivalent of the common stock (but for their not carrying a vote) and ensure that they will be exercised, even though there is no obligation for Pershing Square to exercise them.

[3] Another alternative that might be considered is the acquisition by the bidder, acting alone, of target shares up to the HSR limit plus options coupled (if possible) with some contractual right to direct the vote on the underlying shares. Depending on the structure and terms of the voting arrangement, the acquisition may not be subject to HSR clearance. For example, for the bidder to acquire the options and voting rights without triggering an HSR reporting obligation, (i) the right to direct the vote could not be structured as an irrevocable proxy to vote the shares, and (ii) the options could not be coupled with the contractual right to designate one or more directors where the board is elected via cumulative voting. Thus, without the costs of collaboration with an activist, the bidder may be able to achieve the same equity stake and same voting support as in the Pershing Square-Valeant model, with even more certainty and speed for voting support in a proxy contest as no HSR reporting obligation may be triggered.

[4] The Allergan options trading volume was at an all-time record starting months before the date Pershing Square reports that it began its market accumulation program. Trading volume in the underlying common stock also was very high. It is not clear whether this trading related to Pershing Square-Valeant’s activities or not. There has been no disclosure as to who the counterparties to the options purchases were or how, when, or at what prices they purchased the underlying common stock to cover the calls.

[5] One might view the activist as being motivated by the potential increase in the value of its shares in the resulting company if the bid is successful. In the Allergan situation, for example, there are significant synergies anticipated from the combination, which should lead to an increase in value of resulting company shares held by Pershing Square. However, Pershing Square saw an increase in value of its equity stake in Allergan increase by roughly $1 billion just by virtue of announcement of Valeant’s bid. The potential increase in value resulting from deal synergies pales in comparison, even in the case of the most compelling of combination proposals.

[6] In any given case, the activist’s interests in structuring the options program may conflict with what would be optimal for the bidder. The bidder may be advantaged by buying a smaller amount of options, buying different types of options, or buying options on a different timetable than the activist prefers. For example, the activist, whose objective will be to amass as many options as possible in order to maximize profit, will have little sensitivity to bidding up the price of the options or the underlying common stock as its primary objective will be to amass as many options as possible since a profit will be realized on all of them. A bidder, on the other hand, may be disadvantaged by doing so (because of the higher upfront economic cost, greater downside risk, and reduction in the size of the premium its bid
SEC Rule 13D requires a filing and disclosure after acquisition of beneficial ownership of 5% or more of a company’s common stock. However, the filing and disclosure need not be made until ten days after the 5% threshold is crossed, and there is no limitation on further purchases during the ten-day filing window period. Pershing Square-Valeant almost doubled their equity stake in Allergan during the ten-day window filing period. The Dodd-Frank law authorized the SEC to shorten the Schedule 13D filing window and the SEC has been considering the issue for some time.

Under SEC Rule 14e-3, if a bidder has taken significant steps to commence a tender or exchange offer, a party (other than the bidder) having information about the bidder’s plans cannot trade in the target company’s stock. In the Allergan situation, if Valeant has not taken significant steps toward a tender or exchange offer, then Rule 14e-3 would be inapplicable as it does not extend to other acquisition structures. The SEC has been considering extending applicability of the Rule to other acquisition structures. It should be noted that the model treats Pershing Square as a “co-bidder” with Valeant, so that, even if Rule 14e-3 were deemed to apply (that is, if Valeant is deemed to have taken significant steps toward a tender or exchange offer), the parties would not have violated the rule so long as the co-bidder characterization is accepted. If Pershing Square is deemed not to be a co-bidder, there still would not be a violation of insider trading laws unless the information that Valeant consented to Pershing Square using (i.e., Valeant’s intent to make a bid for Allergan) had been “misappropriated”—which would have occurred only if Pershing Square or Valeant had a fiduciary obligation or duty of nondisclosure to any party with respect to that information. For example, if Pershing Square had shared the information that Valeant intended to make a bid with any other person, that would constitute insider trading because Pershing Square had a duty of nondisclosure to Valeant with respect to the information.

This shareholder rights plan (poison pill) would be triggered by the acquisition of 5% or more of a company’s stock if at the time the acquiror crossed the 5% threshold it did not file a Schedule 13D, even if by law the Schedule 13D did not have to be filed until a later time—in effect closing the ten-day filing window period. While proxy advisory firms and activist investors have not favored rights plans generally and have convinced companies to terminate them or not to adopt them, companies (and potentially others) may view the window-closing rights plan differently in light of the Pershing Square-Valeant experience. Please see our Memorandum here entitled “The Window Closing Pill – One Response to Stealth Stock Acquisitions,” by Peter Golden.