



CHADBOURNE  
& PARKE LLP

## Top-Up Options

Tender offers have become increasingly popular in negotiated merger and acquisition transactions in recent years. Nearly 23% of friendly public M&A transactions in 2010 employed tender offers, versus 7.6% in 2006.<sup>1</sup> Moreover, a substantial number of such friendly public M&A deals now utilize a feature known as top-up options. The Delaware Court of Chancery recently noted that 94% of two-step cash tender offers in 2007 involved top-up options as compared to 67% in 2005 and 2006.<sup>2</sup>

In a tender offer, a prospective buyer appeals directly to a target company's stockholders by inviting them to sell their shares to the buyer. If less than 100% of the target's stock is acquired (which is a likely scenario), then the buyer will presumably employ a second-step merger to "squeeze out" the target's remaining shares and prevent any minority stockholders from interfering with the buyer's intended control of the target.

The nature of this second-step merger depends upon how much stock the buyer has acquired in the tender offer. If the buyer acquires at least 90% of the target's shares (the statutory requirement in Delaware), it may then "squeeze out" the remaining shares with a short form merger. Unlike a traditional merger, a short form merger requires no further involvement by the target's board or stockholders. Therefore, it avoids the cost of organizing a stockholders' meeting and preparing a proxy statement, and thus reduces the overall time required to close a deal, except in cases where regulatory approval is necessary. Furthermore, in general, the more quickly a deal closes, the less likely a material adverse event or other circumstance will derail the transaction.

Pursuant to a top-up option, which can only be employed in a negotiated (non-hostile) M&A transaction, the target's board of directors grants an option to the buyer to purchase additional shares of the target's stock after the close of the tender offer in question. The buyer exercises the option and acquires the number of shares necessary to reach the 90% threshold, Delaware's statutory requirement to effect a short form merger.

Nevertheless, there are limitations on the use of top-up options. There must be a sufficient reserve of the target's authorized but unissued stock in place to cover the option. In addition, NYSE and NASDAQ rules require a target to obtain stockholder approval when issuing an amount of shares equal to 20% or more of the outstanding stock. Generally, for every 1% that the tender offer falls short of the 90% mark, a top-up option will require the target to issue an additional number of shares equivalent to 10% of its then-outstanding stock. As a result of these considerations, as a practical matter, a buyer should acquire at least 88% of the shares outstanding in a tender offer to successfully use a top-up option to "squeeze out" the remaining shares with a short form merger.

Not surprisingly, as top-up options are being used with increasing frequency, so too are lawsuits being launched against their use. In *In re Cogent, Inc. Shareholder Litigation*,<sup>3</sup> the Delaware Court of Chancery rejected the plaintiffs' various arguments against the use of top-up options in a case involving 3M Company's proposed acquisition of Cogent, Inc. In this transaction, 3M had the discretion to pay for any top-up shares with cash or with a promissory note due in one year.

Among the arguments considered by the court was the plaintiffs' contention that top-up options would undermine the appraisal rights of the applicable dissenting stockholders by diluting the value of their shares in any future appraisal proceeding. Appraisal rights are the rights of dissenting stockholders, in certain transactions, to demand a fair price for their shares. The plaintiffs' dilution concerns stem from the attendant increase in Cogent's outstanding shares (which would be the result of exercising the top-up option) as well as the possible use of a convertible promissory note as part of the consideration for the top-up option in question.

The court dismissed the plaintiffs' argument and stated that the merger agreement between 3M and Cogent, "which states that 'the fair value of the Appraisal Shares shall be determined in accordance with Section 262 [of the Delaware General Corporation Law, the statute governing appraisal rights] without regard to the Top-Up Option . . . or any promissory note,' is sufficient to overcome Plaintiffs' professed concerns about protecting [Cogent's] stockholders from the potential dilutive effects of the Top-Up Option."<sup>4</sup> However, the court acknowledged that it was unclear whether Delaware law permits merger parties to predefine the criteria for executing an appraisal under Section 262. Nonetheless, the court said there were indications from other Court of Chancery decisions that this practice is permissible as it benefits dissenting stockholders and is consistent with the intent of the Delaware General Corporate Law.

Based on the Cogent case, with respect to addressing the "dilutive effects" of utilizing a top-up option, transactional attorneys should as standard practice stipulate in the transaction agreement that the fair value of the appraisal shares will be calculated in accordance with Section 262 of the DGCL, without taking into account the effect of any top-up option (or consideration received in connection therewith).

<sup>1</sup> Steven M. Davidoff, Behind the Growing Number of Tender Offers, The New York Times DealBook, Oct. 14, 2010, <http://dealbook.nytimes.com/2010/10/14/behind-the-growing-number-of-tender-offers/>.

<sup>2</sup> *In re Cogent, Inc. Shareholder Litigation*, Cons. C.A. No. 5780-VCP (Del. Ch. Oct. 5, 2010).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

Visit [www.chadbourne.com/publications](http://www.chadbourne.com/publications) to read other Chadbourne & Parke articles, newsletters and client alerts.

If you received this email in error, or wish to be removed from this distribution list, please visit [www.chadbourne.com/publications/subscription.aspx](http://www.chadbourne.com/publications/subscription.aspx)

IRS Circular 230 Disclaimer:

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code; or (ii) promoting, marketing or recommending to another party any transaction or tax-related matter addressed herein." For more information about why we are required to include this legend in emails, please visit

[www.chadbourne.com/files/upload/circular230.pdf](http://www.chadbourne.com/files/upload/circular230.pdf)