PRACTICE NOTE

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Auctions: From the Bidder's Perspective

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A Practice Note that describes the mergers and acquisitions (M&A) auction process from the bidder's perspective. This Practice Note outlines the fundamental differences between an auction and a negotiated transaction, highlighting the unique challenges a bidder faces in an auction. It discusses the preliminary steps in an auction, from negotiating the confidentiality agreement to conducting due diligence. This resource also explores key strategies for preparing a competitive bid package, including how to approach the seller's bid-draft acquisition agreement. Furthermore, this Practice Note discusses the changing dynamics of later bidding rounds and negotiations, as well as considerations for teaming up with other potential buyers to submit a consortium bid.

An auction is the sale of a company or business where the seller solicits bids from potential buyers. The auction process creates a competitive environment in which potential buyers must submit bids that the seller can more easily compare. Accordingly, from the bidder's perspective, an auction has some fundamental differences from a negotiated transaction between a single buyer and a single seller (a negotiated transaction).

Unlike in a negotiated transaction, the seller controls the auction process. It will typically try to maximize its bargaining leverage by:

- Developing a timeline that requires potential buyers to submit bids on an expedited schedule (which allows the seller greater time to renegotiate more favorable terms from the bidder after it accepts a bid).
- Controlling the timing and scope of access to due diligence materials.
- Providing an initial draft of the acquisition agreement (bid-draft acquisition agreement) to each bidder for its review.
- Factoring the bidder's markup of the bid-draft acquisition agreement into its final decision (which incentivizes the bidder to make fewer changes).
- Keeping confidential the number and identity of bidders in the auction.

Another difference from a negotiated transaction is the timing for the involvement of counsel. The bidder should engage its counsel in the auction process from the beginning. Counsel can assist the bidder with several aspects, such as by:

- Formulating a negotiating strategy.
- Establishing a strategy for conducting legal due diligence.
- Preparing a markup of the bid-draft acquisition agreement or a memorandum summarizing comments and open items.

The seller may structure the auction as a closed auction or a public auction. During a closed auction, the seller will approach several potential bidders confidentially. This structure may benefit the bidder because there will likely be less competition if the seller has not effectively identified and contacted all likely bidders. However, it can be disadvantageous if there is no meaningful competition and the bidder submits a high purchase price believing that there are other bidders. During a public auction, the seller will make a public communication (such as a press release) that it intends to sell its company. Public auctions often attract more bidders.

In both types of auctions, the bidder is usually unable to determine the existence or identity of other bidders and must appropriately balance its desire to win the bid with its need for favorable terms. If the bidder emphasizes terms favorable to itself, it could lose the bid, which results in lost time and unreimbursed costs. Conversely, if the bidder focuses on winning the bid by proposing seller-friendly terms, such as a high purchase price or limited representations and warranties and indemnities, the bidder may not get the benefit of its bargain in the long run.

In addition to these differences from a negotiated transaction, there are other considerations and concerns for a bidder in an auction. This Practice Note describes the auction process from the bidder's perspective, including the:

- Preliminary steps that the bidder undertakes (see Preliminary Steps).
- Principal concerns of the bidder when reviewing and marking up the bid-draft acquisition agreement (see Review and Mark-Up of Acquisition Agreement).
- Strategies involved with preparing the bid package that the bidder submits to the seller (see Bid Package**)**.
- Changing dynamics that occur during later bidding rounds and negotiations (see Bidding and Negotiation Rounds).

Although similar considerations apply in auctions involving the sale of other entity types (such as limited liability companies) or particular business lines or assets, this Practice Note assumes that:

- The target company is a c-corporation.
- The auction involves a merger or the acquisition of all outstanding shares or substantially all the assets of the target company.

For information on the auction process from the seller's perspective, see Practice Note, Auctions: From the Seller's Perspective.

Preliminary Steps

The auction process begins with the seller (or an investment bank hired by the seller) conducting a search to identify potential bidders. Each bidder often receives a two to five page summary, known as a teaser, which describes the target company (often without identifying it), its business, and its strategic objectives. The teaser is usually accompanied by a confidentiality agreement that each bidder must enter into before it can continue with the bidding process.

Negotiate Confidentiality Agreement

The confidentiality agreement will be subject to negotiation between the seller and each bidder. When reviewing the confidentiality agreement, the bidder should consider limiting comments to essential substantive matters, avoiding unnecessary or stylistic changes. Otherwise, the seller might see the bidder as an undesirable or difficult negotiating partner.

The confidentiality agreement should contain standard restrictions on the disclosure and use of confidential information. In addition, it may contain certain provisions particular to an auction, such as provisions prohibiting a bidder from talking to other bidders or to certain financing sources or engaging in discussions regarding the target company with other companies. A strategic bidder in the same industry as the seller may have existing relationships with the other bidders as customers, suppliers, or as strategic partners, which may limit its willingness to agree to certain restrictions.

The confidentiality agreement may also prohibit a bidder from talking to the target company's customers and suppliers. Many of the target company's customers and suppliers may also be customers and suppliers of the bidder. As a result, the bidder should require the confidentiality agreement to permit continued interaction with these customers and suppliers in the ordinary course of business, provided that the bidder does not discuss the target company or its proposed transaction with the target company. If the bidder cannot secure these permissions, then the bidder may be restricted in how it operates its business.

For publicly traded target companies, the bidder may also be required to sign a standstill agreement that restricts the bidder's right to acquire the target company's securities and often restricts the bidder from taking other specified actions commonly carried out in hostile acquisitions. Sellers often incorporate the standstill provision into the confidentiality agreement so that the restrictions are in effect at the early stages of a transaction before the sellers' release of confidential information. Sellers typically want this agreement because it helps them stay in control of the deal process and prevents a bidder from using confidential information to facilitate a hostile takeover. Bidders typically resist signing because they want to remain flexible with how to structure the sale. For example, if the bidder cannot negotiate with the target company's board, it may want to go directly to its stockholders to acquire shares of the company. For this reason, standstill provisions are often highly negotiated.

For more information on confidentiality agreements in mergers and acquisitions, see Practice Note, Confidentiality Agreements: Mergers and Acquisitions.

For more information on standstill agreements, see Practice Note, Standstill Agreements in Public M&A Deals and Standard Document, Confidentiality Agreement: Mergers and Acquisitions: Standstill.

Review Confidential Information Memorandum and Bid Process Letter

After entering into a confidentiality agreement, the bidder will likely receive a confidential information memorandum (the CIM) and a bid process letter from the seller. The CIM provides more detailed information about the target company than the teaser to elicit meaningful bids. It usually contains the following information about the target company:

- A description of the industry, business, history, and principal assets.
- Current and historical financial information and projections.
- Information about management and employees, including the senior management team and board of directors.
- Information about major customers and contracts to the extent the seller is comfortable disclosing this information at this stage of the process.

The bidder should carefully review the CIM. While the CIM often states that the seller is not making any representations or warranties about the information provided, the seller's description of the target company's business, assets, and financial condition often alerts the bidder to potential due diligence issues that it must address later in the auction process.

The bid process letter sets the stage for the auction. It explains the rules and procedures of the auction, including:

- How the bidder may communicate with the seller and the seller's investment bank.
- The date when bids are due.
- The due diligence process.
- If and when there will be a management presentation and site visit.
- How many bidding rounds are expected and what each bid package must include, such as a full mark-up of the bid-draft acquisition agreement or an issues list based on the same.

The information contained in the bid process letter often gives the bidder a sense of how long the auction process will last, the degree of competitiveness that the seller anticipates, and the level of communication that bidders may have with the target company's management during the process. For multi-round auctions, the seller typically sends a new bid process letter at the start of each round (see Bidding and Negotiation Rounds). For more information on bid process letters, see Practice Note, Bid Process Letters.

Assemble Team

The bidder should engage legal counsel, financial advisors, accountants, and any other specialists whose expertise the bidder may require before submitting its initial bid, if possible. Later in the bidding process, it will be difficult for the bidder to revise any material terms of its bid based on further input from its outside advisors. Bidders can call out the need for such input in the initial bid, but that may adversely affect its perceived value.

The bidder must, however, balance the need for input from its advisors against a desire to limit costs associated with a transaction the bidder may not ultimately be able to close. Therefore, when engaging advisors, the bidder should identify the nature of the engagement as being in connection with an auction and set clear guidelines on the nature and scope of the services the bidder requires. The bidder could also consider limiting the review of its advisors to material areas within each advisor's purview to limit costs. The bidder should also ensure each advisor is aware of its area of responsibility to avoid costly duplication of effort.

Attend Management Presentation and Site Visit

The seller may arrange a presentation by the target company's management team for the bidder's key decision makers. The seller will likely seek to keep the bidders' identities secret by interacting with each bidder individually. The bidder and its counsel should prepare in advance for the presentation or call by identifying questions to ask the target company's management. Sellers often request that these questions be submitted in writing before the presentation or call. The bidder should ensure its questions are both insightful (and account for information the bidder already knows or has learned about the target company) and noncombative. In addition to considering the bidder's questions, the seller and its investment banker will often gauge the bidder's commitment by making note of the number of bidder representatives that attend and their rank within the bidder's organization.

The management presentation will typically include an overview of the following information about the target company:

- The history, market characteristics, key trends, and competitive landscape of the company.
- The products, brands, customers, research and development (R&D), pricing, and marketing.
- The board of directors, senior management team, and key employees.
- The current and historical financials, management's financial projections, and cashflow forecasts.

The management team may also give a tour of the target company's major facilities, conduct product demos, and afford the bidder an opportunity to ask questions.

Conduct Due Diligence Review

Before requesting due diligence materials from the seller, the bidder may be able to conduct an initial due diligence review from public information. This could include Securities and Exchange Commission (SEC) filings for a public company, company websites, litigation docket searches, US Patent & Trademark Office searches, UCC lien searches, and obtaining good standing certificates from secretary of state (or equivalent) offices. After the bidder conducts this initial due diligence, the seller typically posts certain due diligence materials in a virtual data room (VDR) for the bidder to review. Most due diligence is conducted through VDRs, so bidders no longer need to travel to the seller's location. This saves both time and expense for the bidder. Most VDRs, however, also allow the seller to easily limit access or restrict certain functions, such as printing documents, and to track access by each bidder and its representatives.

Over the course of the due diligence process, the seller may grant bidders access to the following documents and information relating to the target company:

- Financial and accounting information including audited financials, tax information, and accounting policies and procedures.
- Management and employee information including organization charts, employee policies and benefits, pensions, and employment contracts.
- Operating and facilities information including environmental reports, R&D activity, and management information systems.
- Supplier and customer information including lists of the most important suppliers and customers, supply contracts, and license agreements.
- Legal information including litigation matters, intellectual property registrations, board minutes, resolutions, stock records, and organizational documents.
- Other information including press releases, product brochures, and marketing information.

The level of access that a bidder has to due diligence materials will vary depending on the transaction. In some auctions, a bidder will have access to a limited number of documents in the initial bidding round. In other auctions, a bidder may not be permitted to make a due diligence request until after the seller has chosen that bidder's bid. The seller often allows the bidder only a short time to conduct due diligence before bids must be submitted. A bidder wishing to conduct a complete diligence review quickly may incur substantial costs resulting from the time and effort required of counsel, financial analysts, and other specialists. These cost constraints may limit the amount of due diligence that some bidders conduct, especially early in the auction process.

Due diligence can also occur in several phases. If the auction consists of multiple rounds of bidding, the due diligence review may become more extensive or delve into more sensitive information about the target company with each round. Other auctions may only allow expansive due diligence to be conducted by the winning bidder after its bid is chosen. The documents that the bidder should insist on reviewing in the preliminary stage are influenced by the structure of the sale. For example:

- With a stock purchase or merger, the bidder should request the target company's and any predecessor's governing documents, stock certificates, if any, and other capitalization records, stockholders agreements and other material contracts, financial statements, and any documents related to litigation and liabilities.
- With an asset purchase, the bidder should request recorded titles to property, lien searches, financing agreements, and any documents regarding potential encumbrances or security interests on the assets to be acquired. The bidder should also review financial statements and information regarding litigation and liabilities.

Some information may be less important in the asset purchase context depending on the terms of the acquisition agreement and particularly if the bidder intends to integrate only selected assets into its current operations.

In general, the bidder should ask to see any documents that could affect the purchase price or the bidder's general desire to complete the transaction and any material third-party consents or regulatory consents that may be required.

The bidder should be sensitive to the amount and nature of the due diligence requests that it makes. Burdensome or excessive requests by a bidder may indicate that it will be difficult to work with and may dissuade the seller from selecting that bidder's bid. The bidder should avoid standard due diligence checklists and instead should supplement the data room index prepared by the seller with its requests.

The due diligence process allows the bidder to demonstrate its interest by performing as thorough a review of the documents as time and resources allow. With VDRs being the standard disclosure method, the seller can easily monitor each bidder's access to the disclosed documents and may use this data as an indicator of a bidder's interest in the transaction.

Although the bidder may not have direct access to the seller during the early stages of the auction, it can sometimes solicit information from the seller's investment banker that is not formally disclosed to all bidders. In addition, conversations with the investment banker may indicate what level of preliminary interest the bidder should demonstrate to advance to further rounds of bidding. Conversations with seller's management, if feasible, may allow the bidder to identify other bidders against which it is competing and management's perceptions of those other bidders.

For more information on due diligence in mergers and acquisitions, see Practice Notes, Due Diligence for Public Mergers and Acquisitions and Due Diligence for Private Mergers and Acquisitions. For more information on VDRs, see Practice Note, Using a Virtual Data Room for an M&A Transaction.

Review and Mark-Up of Acquisition Agreement

The bid-draft acquisition agreement that the seller distributes to each bidder is similar to the initial draft of the acquisition agreement in a negotiated transaction. The bid-draft acquisition agreement in an auction, however, is always drafted by the seller, whereas the buyer commonly prepares the first draft of the acquisition agreement in a negotiated transaction. Therefore, it generally reflects the seller's positions on key transaction terms, such as the form of consideration, conditions to closing, the scope of representations and warranties, reliance on representation and warranty insurance, and limitations on indemnification. The terms of the bid-draft acquisition agreement can vary widely and may be favorable to the seller or more neutral.

Each bidder typically submits either a mark-up of the bid-draft acquisition agreement or an issues list regarding the bid-draft acquisition agreement as part of its bid package, depending on the bid procedures and, in a multi-round auction, the relevant bid round (see Bidding and Negotiation Rounds). If the bidder submits a mark-up of the bid-draft acquisition agreement, it should consider limiting its comments to substantive issues and refrain from making stylistic changes to the document. A heavy mark-up can signal to the seller that there will be a long and difficult negotiation if it moves forward with the bidder that submitted that mark-up, while a mark-up with fewer changes can signal a quick negotiation.

Typically, the two most important issues from the bidder's perspective are:

- The purchase price.
- Any risk allocation provisions, such as representations, warranties, indemnities, and insurance.

The successful bidder should focus on these aspects when making its mark-up and avoid adding burdensome or open-ended conditions to closing. Instead of sending a full mark-up of the bid-draft acquisition agreement, the bidder may be required to or may choose to submit an issues list indicating specific points that the bidder wants to negotiate. The issues list can be helpful to focus the bidder and seller on those aspects of the acquisition agreement that are of the greatest importance to each party.

Generally, the bidder must make a tactical decision on how aggressive it should be during negotiations. This decision can be difficult, especially if there is limited due diligence made available by the seller before the bidder must submit its mark-up of the bid-draft acquisition agreement or its issues list. The bidder should balance its desire to close the deal against its need to include certain terms and risk allocation provisions in the acquisition agreement. The bidder should attempt to achieve its goals in a way that simultaneously furthers the seller's interests. Substantially changing the scope of the seller's representations and warranties, for example, may require extensive and time-consuming changes to the disclosure schedules that the seller will want to avoid. The prudent bidder may accomplish the same objective by making limited but purposeful comments to indemnification provisions. An important caveat is that the bidder's behavior in an auction process may change significantly if it suspects that it is the only serious bidder in the auction. In that case, a bidder may have greater leverage, particularly if the seller has limited options beyond the sale of its business.

For more information on the various types of acquisition agreements, see Practice Notes:

- Asset Purchase Agreement Commentary.
- Stock Purchase Agreement Commentary.
- Merger Agreement Commentary: Public Mergers and Acquisitions.
- Merger Agreement Commentary: Private Company.

Bid Package

When making its bid, the bidder submits a bid package that typically consists of a bid letter and either a mark-up of the bid-draft acquisition agreement or an issues list, depending on the bid procedures and, in multi-round auctions, the relevant bid round (see Bidding and Negotiation Rounds). The bid letter is similar to a letter of intent in a negotiated transaction and usually describes:

- The proposed purchase price and type of consideration (including any proposed adjustments, such as a post-closing working capital adjustment, and any contingent or deferred payments, such as an earn-out).
- Any proposed financing, with evidence that the bidder will be able to receive the financing at closing.
- A list of closing conditions such as the completion of due diligence or the resolution of certain high-level issues.

An important tactical decision for the bidder is whether to fully comply with the bidding procedures, particularly when the seller requests a full and final mark-up of the bid-draft acquisition agreement based on limited due diligence. Submitting a full mark-up is virtually impossible without the acceptance of significant risk and the incurrence of substantial costs by a bidder. Therefore, many bidders opt to submit mark-ups or issues lists that focus on conceptual issues rather than specific language. The decision of how to comply with bidding procedures is often determined by the bidder's perceived leverage and desire to close the transaction. The bidder's legal and financial advisors should discuss the form the bid will take early in the process to avoid spending unnecessary time and expense.

The most important part of the bid letter is the proposed purchase price. The bidder should include a purchase price that is both attractive and credible from the seller's perspective. The seller may dismiss a low purchase price as economically unattractive, and it may question the seriousness of a bidder that submits an exceptionally high purchase price, suspecting that the high offer will be substantially reduced in later negotiating. The bidding procedures often require the bidder to include the methodology that it used to arrive at its purchase price, such as a multiple of EBITDA. The bidding procedures may also request a detailed calculation for the valuation. Bidders should resist including this type of information without extensive due diligence as sellers often use it to negotiate an increased purchase price later in the process.

The form of consideration is also an important factor in a seller's analysis of potential bids. Sellers may prefer a lower bid that makes an all-cash offer payable at closing to a higher one that offers forms of consideration that are contingent (such as earn-outs), potentially illiquid, have an uncertain valuation (such as equity), or pose a credit risk (such as promissory notes).

The seller will often focus on certainty of closing when evaluating competing bids. Sellers factor in various conditions to closing, including any regulatory, board, or shareholder approvals. Bidders have, therefore, historically sought to limit their reliance on financing contingencies and similar walk away rights, although these provisions are more common in times when there is general illiquidity in the credit market.

The bidder may wish to include information in its bid package concerning its plans for the seller's management and employees, as well as any requirements for rollover of equity or options. Additionally, bidders may specify whether representation and warranty insurance will be used.

Finally, the bidder should state in its bid package that the bid is non-binding and confidential. The bidder may also want to limit the time period that the offer remains open and require exclusivity if accepted.

Bidding and Negotiation Rounds

The auction process may include multiple rounds of bidding. The number of bidding rounds in an auction and how comprehensive the bid submissions are at each stage vary from auction to auction. Sometimes the first round of bidding is merely an indication of interest. This round is meant to eliminate bidders not serious about purchasing the target company. It can also eliminate bidders who are only interested in gaining confidential information of the seller or the target company. In this round, the bidder will typically submit a non-binding bid with its proposed purchase price, the type of consideration, any proposed financings, and conditions to closing. A bidder that takes an aggressive position on documents and due diligence is likely to get through to the second round if its price is in the right range.

The seller and its advisors consider each proposal, evaluating purchase price and any conditions. Typically, the purchase price is the main factor for deciding which bidders advance to the second round, although an offer with too many conditions may be rejected, regardless of the price. If the bidders raised issues or due diligence questions in their first-round bid proposals, the parties usually work to address those concerns before the second-round bid date.

In later rounds, the seller will often simultaneously negotiate with multiple bidders in an effort to elicit bids with a higher purchase price or more favorable terms by playing one bidder against another. The second round will typically start with another bid process letter and a bid-draft acquisition agreement (and sometimes draft disclosure schedules). The second round bids are significantly more comprehensive and less conditional than the first round bids. The bid should include a firm purchase price and type of consideration, proposed financing (if any), a limited number of conditions (if any), and a comprehensive mark-up of the bid-draft acquisition agreement and draft disclosure schedules (if applicable). If the winning bid is acceptable as is, the parties may execute a binding acquisition agreement with only minor changes. If further negotiation and due diligence are necessary, then the seller may agree to deal exclusively with the winning bidder and execute an exclusivity agreement (see Practice Note, Exclusivity Agreements). During the exclusivity period, the bidder continues to conduct due diligence and the parties continue to negotiate the bid-draft acquisition agreement until execution.

After the signing of the final acquisition agreement, an auction proceeds similarly to the typical negotiated transaction (see Practice Note, Signing and Closing M&A Transactions). If the target company is a public company, preparation for closing may involve, among other things, the filing of a proxy statement with the SEC and holding a stockholders' meeting (see Practice Notes, Public Mergers Disclosure: Overview and Proxy Statements: Public Mergers).

For more information regarding stages of bidding, see Practice Note, Auctions: From the Seller's Perspective: Bidding and Negotiation.

Teaming up With Other Bidders

A bidder might choose to team up with other bidders and submit a joint bid to the seller, called a consortium bid. Bidders may choose to combine their resources to submit an attractive bid with a higher purchase price than each bidder would individually be capable of making. However, some sellers explicitly require that potential bidders agree, as a condition to entering the auction process, not to team up with other bidders without the seller's permission. Sellers often include this condition in the confidentiality agreement. The seller may expressly prohibit each bidder from making any agreement to refrain from bidding against other bidders in an effort to lower the purchase price. In some circumstances, antitrust laws may also restrict bidders from teaming up in this manner.