‘Go Shop’ Can Be a Fig Leaf for a Deal to Hide Behind

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The “go shop” on Wall Street is quickly becoming a “no shop.”

After an acquisition is announced, the target company often has the opportunity to solicit higher bids from potential suitors, in what’s known as the go-shop process — as in “go shop” for a better deal. The buyer is supposed to act as a stalking horse, attracting other, more lucrative offers.

The go-shop provision, a relatively new phenomenon in the last few years, has been heralded by governance experts as a best practice for boards. Ideally, the directors, having already guaranteed a minimum price tag, run an auction for the company, seeking a better price.

But as the recent sale of J. Crew and other management-led buyouts show, the go-shop process looks more like window dressing — a way to subvert a true auction and enrich management. Boards also see it as a way to shield themselves from shareholder lawsuits. After all, directors, hiding behind a go-shop, can always say: “We tried to get a higher price, and this was the best offer available.”

Just look at J. Crew. Millard S. Drexler, the “merchant prince” behind the resurrection of the preppy retailer, arranged a management-led buyout with two private equity firms, TPG Capital and Leonard Green & Partners. By the time Mr. Drexler, known as Mickey, notified other directors weeks later, the deal was a fait accompli.

The board blessed the buyout in November. But it also inserted a go-shop clause to protect itself.

No bidders submitted binding offers over the next 85 days.

J. Crew’s shareholders are supposed to vote on the deal on Tuesday. Institutional Shareholder Services, the proxy advisory firm, has recommended that shareholders block the buyout, suggesting there are “serious issues in the sales process that gave TPG a significant advantage.” The advisory firm also called the go-shop provision “questionable.” As of late Monday, investors seemed ready to reject the sale unless the buyers raised their bid.

In many deals, the go-shop process is looking like a fake effort at good governance. Last year, 20 management-led buyouts included such a provision, according to Capital IQ, a firm that tracks deal data. Higher offers rarely emerged.

One exception: The Hardee’s and Carl’s Jr. fast-food chain spurned a deal with THL Partners in favor of a richer offer from Apollo Management. Apollo paid $12.55 a share in cash; THL had bid $11.05 a share.

But in most cases, the structure of the deals may be spooking potential bidders. Incumbent managers, said Guhan Subramanian, a Harvard professor who studied the effectiveness of a go-shop period, have "a significant advantage over other potential buyers."

The case of J. Crew makes it clear why. The retailer's chief, in a cloud of secrecy, teamed up with TPG and Leonard Green to make a deal. Mr. Drexler relaxed his stance and agreed to consider other suitors, after shareholders sued J. Crew.

But the die was cast at that point. What buyers would want to work with a chief executive who clearly didn't want to work with them?

In fairness, one defense of the go-shop process is hard to ignore. The buyers tend to pay higher premiums upfront, making it harder for an interloper to intercede. According to Capital IQ, deals that included a go-shop provision had a 39 percent premium compared with deals without such a provision, which had only a 16 percent premium.

"The premiums are so high, who wants to bid even higher?" said Richard Peterson, director of valuation and risk strategies at Standard & Poor's.

Ultimately, it comes back to whether the bidding process is competitive and shareholders get the best deal.

A Delaware Chancery Court judge called that into question in the management-led buyout of Del Monte. In November, the food maker's board agreed to a deal with a private equity giant, Kohlberg Kravis Roberts & Company. The terms included a go-shop period that ended in early January. Not surprisingly, no other suitors stepped forward.

The judge, Vice Chancellor J. Travis Laster, criticized the cozy deal in a recent ruling. The Barclays bankers advising Del Monte, he said, "had a keen desire to see the deal close with K.K.R." The British bank was also providing financing to the private equity buyer.

The judge declared that Barclays had "secretly and selfishly manipulated the sale process."