Novel Maneuvers in Battle for Quest Software

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The battle for Quest Software highlights a board's quandary when a chief executive makes a play for the company. Not only that, it's also a fun takeover battle in the midst of a slow summer deal market featuring some novel deal-making.

On March 9, Quest Software announced that it had agreed to be acquired by Insight Venture Partners and Quest's chief, Vincent C. Smith, for $23 a share in cash in a deal valued at about $2 billion. Mr. Smith owns about 34 percent of the company.

Quest's proxy statement discloses that the company's board did not run a full auction for the company before the deal was announced. Instead, Quest's acquisition agreement contained a fairly typical, though longer than normal, "go-shop" clause. This go-shop period allowed Quest to solicit other bidders for 60 days. If a competing bid emerged and was accepted, Quest would have to pay Insight a termination fee of $4.2 million if a deal was reached during the go-shop period or $6.3 million thereafter. The lower termination fee is somewhat typical and intended to encourage a more robust bidding process to make up for the lack of one before the deal was announced.

But Insight and Mr. Smith most likely thought that the chances of a competing bid emerging were low. Mr. Smith is the chief executive and controls a large stake that could almost block another bid. In many other deals, like the buyout of J.Crew, executives have used their positions and share ownership to frighten off competing bidders who fear a disadvantage in the bidding process. This finding has been confirmed empirically by Guhan Subramanian at Harvard, who found that go-shop periods are less likely to produce competing bids when management is part of the buyout group.

Sure enough, Quest's go-shop period expired without a competing bid. But on June 14, Quest announced that it had received a bid from an unidentified strategic bidder, which Reuters later reported was likely to be Dell. This unidentified bidder had submitted an offer for $25.50 a share.

The existence of a competing bid was a bit novel, but the special committee of the Quest board did something in connection with this bid that was even more unique. Quest announced it would agree to unusual provisions to incentivize the unidentified bidder and place it on a more level playing field with Insight and Mr. Smith.

Quest said that if it accepted the competing bid, it would agree to issue an option to the new bidder to acquire 19.9 percent of Quest's shares, the maximum Quest could issue without running afoul of Nasdaq rules that require a shareholder vote for share issuances above this threshold. These shares could be used by the unidentified bidder to offset Mr. Smith's 34 percent stake and make it more likely that a competing deal would get shareholder approval even if Mr. Smith opposed it.

To further incentivize the unidentified bidder, Quest also said it would pay a breakup fee of 2 percent of transaction value if shareholders voted no on the deal and 3.5 percent if the deal was subsequently trumped. These types of no-vote termination fees, also known by the ungainly term "naked no vote termination fees," are relatively rare, and only about 1 percent of deals since 2011 have included them, according to Factset MergerMetrics. They are avoided because the fee penalizes shareholders for exercising their right to disapprove a transaction.

While the fee may be problematic, Quest's issuance of these shares may be illegal. Delaware law provides that controlling shareholders have value in their shares and cannot be forced to sell. This right is balanced with so-called Revlon duties, which require the Quest board to get the highest price reasonably available in a sale. The question is, which right trumps the other here – Smith's right to exercise his near-blocking vote freely or the board's duty to get the highest price reasonably available for all shareholders?

Prior cases appear to come out on the side of Mr. Smith. In the 1994 case of Mendel v. Caroll, Chancellor William T. Allen wrote that a board could not issue a dilutive option to force a controlling shareholder who sought to buy the company to sell to another party where the price being paid by the controlling shareholder was not coercive. In the Quest case, the big difference is that Mr. Smith is not a controlling shareholder, though his large stake may effectively constitute a blocking position. The question is whether this difference is enough to justify the board's maneuvers.

The Quest board is doing something admirable in trying to keep an open bidding field and counter Mr. Smith's advantage. Yet, this arguably conflicts with Mr. Smith's rights as a shareholder to sell his shares to whomever he pleases.

It's a thorny issue, and I suspect the outcome in any litigation will depend on how egregious his conduct is. And this issue is likely to come up again as other special committees consider the Quest case. The tactic could also be considered in a first bid, where, for example, a bidder puts an attractive offer on the table but is unwilling to proceed in the face of opposition from a large shareholder.

But for now, the issue is moot as Insight has returned with a higher bid. Under its arrangement, Quest granted Insight the right to match a competing bid. Insight exercised this right, and raised its bid $2.75 a share, or 25 cents a share above the competing bid. This type of nickel-and-dime bidding is par for the course in many bidding wars as initial bidders use matching rights to their advantage in an effort to not overbid. It's likely that Insight's increased bid was also intended to get it an increase in the termination fee, which Quest acceded to by raising it to $25 million.

The ball is now in the unidentified bidder's court. Given that the Insight bid is only 25 cents higher, I would suspect another raise is coming. Dell after all bid furiously when it competed with Hewlett-Packard to acquire 3Par in 2010.

But Dell or whoever this bidder is has time. Its best route may be to bump up the bid by a dollar or two to eliminate the game-playing associated with Insight's matching right and any further increases in the termination fee. If I were this mysterious bidder, I would just wait for the merger proxy and the record date and then bump up my bid.