How does one sell a company? If you’re the generic drug maker Par Pharmaceutical Companies, you take a novel approach.

On Monday, Par Pharmaceuticals announced that it was being acquired by the private equity firm TPG Group in a deal valued at $1.9 billion.

As per convention, companies are normally sold in two ways. They negotiate exclusively with one or only a few bidders. Or, they run an auction and invite as many interested parties as possible to bid competitively.

The goal is obviously not only to obtain the highest price reasonably possible, but also to ensure that a sale actually occurs. A broken auction or sale process, particularly one that is out in the public arena, can leave the target company in a damaged state. Its stock price will fall to reflect the lack of takeover interest as those in the market and competitors reassess the company’s value.

The selling company’s goal is thus to run a sale process that draws as high a price as possible while maintaining the interest of potential buyers. Bidders will also leverage these concerns to demand exclusive negotiations or walk, preying on the target’s fears that the sale process will collapse.

It is the weighing of each of these factors that drives companies toward negotiations with a single or a small number of bidders, or a full-blown auction.

According to sources with direct knowledge of the matter, Par Pharmaceuticals, advised by the investment bank J.P. Morgan Securities, approached this dilemma in a new way by melding the two conventional approaches. Par invited five bidders — three strategic companies and two private equity firms — to a special V.I.P. round of bidding.

The process was intended to prevent the market from learning that the company was for sale. It also had a second goal. Private equity bidders are sometimes loath to become involved with a bid because of the expense and time it takes.

Private equity firms can sometimes spend millions of dollars on bids that go nowhere. By limiting the number of bidders, Par’s goal was to provide incentives to the private equity bidders, in particular, to participate and bid.

While we don’t yet have the full details of the sale process, since Par has yet to file a proxy statement detailing it, the plan appeared to work. TPG, one of the private equity firms, was the winning bidder, beating out the strategic ones.

The Par Pharmaceutical deal also contains a go-shop clause, meaning that Par will be able to solicit other bids through Aug. 24. If Par Pharmaceutical agrees to accept a third-party bid before that date, Par will have to pay a termination fee of only $24 million.
According to the source, the go-shop clause was part of the price of being included in the small bidding group. It was a way for Par to signal to the market that it had done an appropriate market check. And although the go-shop was not legally required, it does provide a more robust case for Par to argue that it did all that it was required to do to obtain the best price.

The deal is an interesting twist on the mechanics of how to sell a company. In their study published in 2007, Prof. Audra L. Boone, now at Mays Business School at Texas A&M University, and Prof. J. Harold Mulherin, at the Terry College of Business at the University of Georgia, examined how companies were sold in the 1990s.

They found that of 400 companies they looked at, 202 were sold by auction and 198 by negotiation. Contrary to popular wisdom that auctions were better for obtaining higher prices, the two found that the returns were largely the same, regardless of the method used.

Moreover, the size of the company being sold mattered more in deciding whether to pursue a sale through auction or negotiation. The bigger the target, the more likely there was to be a negotiation.

These findings are contrary to basic auction theory, which would say that having as many bidders as possible is the optimal strategy to achieve the highest price. The reason is that auction theory is based on the principle that the more bidders there are, the more likely it will be that the price goes higher.

The auction theorists Jeremy Bulow and Paul Klemperer have thus written that with risk-neutral bidders “an auction with N+1 bidders dominates any negotiation with N bidders.” N here is merely a symbol for any number of bidders; in essence, they say that the more bidders there are, the better theoretical price that can be achieved.

There is also comparative evidence in the M.&A. market to support this theory, though it is not as on point as Professor Boone and Professor Mulherin’s study. In Britain, where there is more of an auction-style system for merger deals, Prof. John C. Coates IV has found that premiums are higher but bids fewer than in the United States, where companies are allowed, within limits, to negotiate deals with termination fees and other deal protections.

But auction theory assumes that the auction is one in which all bidders have the same information and are on a level playing field, eager to participate. Prof. Guhan Subramanian, in his excellent book “Negotiauctions,” explains when negotiation may be better than an auction in selling a company.

For example, bidders may not want to participate in an auction, fearing they may overpay in a heated bidding war. A negotiation may also allow the bidder and the target company to trade information and produce a superior value-creating result. Finally, the need for secrecy and the value it creates may also tend toward a negotiation to better control the process. All of these factors may be more salient when the target company is bigger and can more easily know the universe of bidders to contact.

In truth, this means that today many companies run something close to what Par Pharmaceuticals has done. They run what Professor Subramanian calls negotiauctions.
Selling companies and their advisers run a mix of strategies. Companies devise their own strategies, running auctions, then often negotiating with a few select companies, or vice versa. The key is to employ a mix that preserves secrecy, bringing bidders on board to bid while pushing them to pay the highest price. Par Pharmaceuticals has simply extended this approach.

The downside to all of this is that sometimes companies and executives will prefer negotiations as an ostensible excuse to favor a preferred bidder at the expense of shareholders. The problem is that companies can too often come up with pretexts — like the need for secrecy — to provide the courts with justification for limiting the number of bidders through negotiation. This is where the law should come in, policing the process for signs of overt favoritism, something the Delaware courts have appropriately done in the past.

All of this means that selling a company is something that really is an art form, a process in which the expertise that investment bankers and lawyers provide is needed. It also means that Par Pharmaceutical’s experiment is something that other companies may mimic as the deal-making market continues to evolve.