Deal for J. Crew Allows It to Go Shopping

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J. Crew is on sale for the holidays.

The retailer's agreement to sell itself includes a go-shop provision, which allows it to solicit other bidders even though its $3 billion deal with two private equity firms has been announced. In other words, J. Crew can go shopping for a higher bid.

The provision's purpose in an acquisition agreement is to compensate for a company's failure to fully canvass other possible third-party bidders prior to the transaction's announcement. A company will perform a post-announcement market check of the price through a go-shop as part of the board's effort to satisfy its Revlon duties under Delaware law. These duties require the company to sell itself for the highest price reasonably available. Though Delaware courts have said that go-shops are not required, boards still negotiate them to show that they are trying to fulfill their sale obligations.

Go-shop provisions are fairly common in private equity deals. According to Factset Mergermetrics, go-shops were used in about 50 percent of the private equity deals announced so far this year with a transaction value greater than $100 million. This compares with 3.3 percent of the deals that did not involve private equity.

The go-shop is somewhat suspect among market participants. It is viewed as primarily cosmetic. It provides cover for the fact that the chosen buyer has a head start but does not do much more. But in one study of private equity go-shops, Guhan Subramanian, a Harvard business professor, found that despite the conventional wisdom, go-shops were generally effective and did indeed result in subsequent bids. The one exception he found was when management was part of the buying party. In those cases, he found go-shops to be largely ineffective, possibly because of management's ability to unduly influence the sale process.

Unfortunately for J. Crew shareholders, management is involved in this deal. Not only is the company's chairman and chief executive, Millard S. Drexler, part of the buyout group, but so is the private equity firm TPG. TPG previously owned the company. So, there is a clear advantage to both bidders in terms of knowledge and relationships. (The other private equity firm involved in the deal is Leonard Green & Partners.)

The terms of the go-shop can also matter. In many go-shops there is a reduced termination fee if an agreement is reached with a third-party bidder during the go-shop period. We do not know if that is the case here because J. Crew has yet to file the acquisition agreement.

Some agreements allow the lower termination fee to be paid only if a third-party deal is reached during the go-shop period, while others allow negotiations to exceed that period so long as an initial bid is made. This nuance can also result in a less effective go-shop and can cost companies millions, as it did in the bidding for Diedrich Coffee.

J.Crew has called the go-shop "robust," so look to see if these more seller-friendly go-shop terms are part of the agreement.

Meanwhile, there is the question of how quickly people can actually move under a go-shop provision during the holidays. Forty days should be sufficient time for bidders to be fleshed out, but the holidays may make things slower and the go-shop less effective.

The go-shop, though, is merely cover here for the real issue surrounding this buyout — which is management involvement. Why is Mr. Drexler, as chief executive, involved in buying the company here? Can't he simply stay in his role and provide this value to shareholders instead of himself?

There may be good reasons for taking a company private. It can result in a more efficient operation that cannot be replicated in a public company. However, in these transactions there is always suspicion that management is trying to "steal" the company.

But one thing to focus on is the procedures that the independent directors have adopted to protect shareholders and try to limit management's undue involvement in the process. In a recent paper that I wrote with Matthew D. Cain, a Notre Dame finance professor, we examined buyouts with management participation. We found evidence of this finding that when management proposed a buyout in partnership with private equity, it resulted on average in lower premiums for shareholders. This was partly counteracted when the independent committee of the board negotiated provisions, like a go-shop, that allowed shareholders to vote down noncompetitive transactions.

We don't yet know the process used to sell J. Crew or the full terms of the go-shop. But in these provisions may lie the clue to whether this is a good deal for J. Crew shareholders.