

A Behind the Scenes Look at an \$860 Million Transaction

What was involved in the process? How did the deal team manage the various aspects of the sale?

The acquisition of Ceradyne, Inc. by 3M Company was one of the largest deals in Orange County in 2012. Interviewer, Samantha McDermott, connected with three of the people at the center of the transaction: Jerry Pellizzon, CFO of Ceradyne, Bob Rich, Shareholder of Stradling and lead corporate counsel who represented Ceradyne during the negotiations and transaction, and Marc Schneider, Shareholder of Stradling and lead litigation counsel who defended Ceradyne against litigation seeking to enjoin the sale.

Sam McDermott: Gentlemen, thank you for taking the time to contribute to this piece. As we all know, this was a huge deal. Tell me about the process. What are the first steps a company should take when it gets an offer?

Bob Rich: Companies should put in place Change in Control Agreements for key executives before they have an offer—even before a decision is made to sell the company. That's because you never know when an opportunity is going to present itself. The sale process creates a great deal of stress and uncertainty for management, and Change in Control Agreements help to ensure the retention and commitment of key executives through completion of the transaction. Also, buyers want a smooth transition and often will make the retention of key executives a condition to closing.

Jerry Pellizzon: Having Change in Control Agreements in place helped mitigate any uncertainty and allowed management to focus on the transaction while still maintaining their focus on our business, which is particularly important since there's always a real chance a deal will not happen. Once we received the inquiry from 3M, then the first step was to get the right team in place. This proved to be very instrumental to the success of this transaction. We retained Citi as a financial advisor to the Board, which had a long history with the company and significant experience in these types of deals. We also had experienced M&A corporate and litigation lawyers working with us which was key.

Marc Schneider: As a litigator, it's always helpful to be brought in early. With any public deal, particularly one of this size, there is a substantial likelihood the plaintiffs' bar will file a lawsuit to enjoin the merger. A litigator that has seen a number of these cases will have a good eye for the types of process and disclosure issues that plaintiffs focus on. By sharing those insights with the deal team, the litigator can help improve the process - which in turn helps insulate the deal from legal challenges.



Sam McDermott: What were some of the first steps taken by you and your team after 3M expressed interest in acquiring Ceradyne?

Jerry Pellizzon: We weren't looking to sell the company. But when 3M approached us earlier this year, we recognized the unique opportunity—a company who understood and appreciated our technologies, a company with the financial strength to pay all cash, and, because of the significant potential synergies, we believed 3M would be willing to offer a great price to our shareholders. So we listened to 3M's proposal. After some preliminary discussions, we got our deal team in place and focused on implementing an appropriate process for a possible transaction.

Bob Rich: Process becomes tremendously important. That being said, there isn't a one-size-fits-all process. The Board does not have any "Revlon" duties while it is still exploring the possibility of a sale. Once it commences negotiations with a potential buyer, there is a duty to maximize the price paid to shareholders. But the Delaware courts have made it clear that there is "no single blueprint" that a board must follow to fulfill its Revlon duties to maximize value for shareholders.

Marc Schneider: Good process is important, not only to achieve the best result for shareholders, but because it will be a central focus of any shareholder litigation alleging that the directors breached their fiduciary duties. It's important to have an active board that is well-informed. And you need to keep your eye out for possible conflicts—steps like having the bankers take the lead on negotiations and creating a special committee of the board may go a long way towards cleansing any perceived taint on the process.

Sam McDermott: Did the company engage in an auction?

Jerry Pellizzon: When 3M first expressed interest in purchasing Ceradyne, we were not looking to sell the company. Although it could be tempting to immediately start soliciting offers from other potential buyers, that can jeopardize negotiations with the existing bidder. In this case, the Board didn't want to risk losing a potentially great offer from a strategic, cash buyer that expected exclusivity, when our knowledge of the market suggested that there likely were no better buyers.

Bob Rich: Buyers typically seek deal protection provisions, such as a breakup fee, matching rights, and voting and tender agreements, so they have some assurances that the deal will close if they invest the time and money to pursue the deal. But here, since there was no broad market check, it was important to make sure that other potential buyers had an opportunity to put in a superior bid after we announced the 3M deal. We focused heavily on negotiating limitations to the deal protection terms. We ended up with an effective "fiduciary out," which would have allowed the Ceradyne Board to consider proposals from other bidders offering a better price. We negotiated a below-market breakup fee, limited 3M's matching rights, and extended the time of the tender offer, so motivated third parties wouldn't be deterred from making a topping bid.

Marc Schneider: This is another example of how the best business practices can double as the best defenses to litigation. Delaware law does not require every company to conduct a pre-signing market check or initiate an auction process. Sometimes an auction makes sense. But sometimes a company gets an attractive unsolicited offer from a party who insists on exclusive negotiating rights. Courts will generally uphold a transaction without a market check as long as the deal protection provisions do not unreasonably deter other parties from making a superior offer and the directors of the target company have made reasonable efforts to fulfill their obligation to obtain the best available price. In this case, those were easy arguments to make. Ceradyne's management knew their market inside and out. They were confident that a better offer was unlikely and that they had negotiated for the best price they could get from 3M. And Bob and his team did a great job of structuring a merger agreement that allowed Ceradyne to entertain a better offer, if one were to come along.

Sam McDermott: While you're negotiating the deal, how important is confidentiality?

Bob Rich: The company and the potential buyer should sign a confidentiality agreement before any non-public information is disclosed. As a recent Delaware Chancery court decision has noted, it is important to include a "standstill" provision in the confidentiality agreement if you want to prevent the buyer from using confidential information to make a hostile bid if negotiations break down.

Jerry Pellizzon: Absolutely, confidentiality is crucial. It is important to limit the working group on a strict need-to-know basis. Leaks about the deal can cause angst and uncertainty among employees. You don't want to lose employees during the deal process, both because that may undermine the deal and because there's always a real chance that the deal won't close and it will return to business as usual. Additionally, if there are leaks and for some reason the deal doesn't get completed, the market would wonder why, and we might be perceived as "damaged goods," which could lower future potential interest in the company.

Marc Schneider: Confidentiality is also key from a litigation perspective. Confidentiality limits the risk of insider trading and other securities law violations. And you should expect FINRA or even SEC inquiries on public deals like this. I urge clients to tell only the employees who need to know, and make sure they understand the importance of confidentiality.

Sam McDermott: What happens once the merger agreement is signed? What did each of you do once the deal was announced?

Bob Rich: The sale process is intense, stressful and places a huge burden on management, particularly on the CFO. During the course of the 3M transaction, Jerry was essentially working two jobs. He was responding to the demands of the deal, and at the same time he was still helping to run the company.

Jerry Pellizzon: As you can imagine, this event in a company's life cycle is extremely intense and filled with pressure. It's your focus and goal to get everything right; not just for the shareholders but also for the Board, the acquiring company, and the employees. Before the announcement, working with 3M on their diligence requests essentially became a second full time job. After the announcement, I worked with Bob and Citi's team on the financial and other disclosures to our shareholders. And post-closing, I have been working with 3M to assure a seamless transition. Part of that was making Ceradyne's employees comfortable, and explaining how this transaction would affect them and what they could expect under 3M's ownership.

Marc Schneider: Predictably, once the deal was announced, it was only a matter of days until the first shareholder lawsuits were filed in California and Delaware. Since we had been involved early in the process, we were ready to hit the ground running. That's important because the timeline for M&A litigation is compressed. In fact, we made sure that our defense was in motion before the first lawsuit was filed. That allowed us to resolve the litigation on favorable terms so the deal could close, for the benefit of Ceradyne's shareholders.



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