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Black & Decker II: The Death of Black & Decker

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[This commentary is based on public filings concerning the proposed merger of The Stanley Works and Black & Decker Corporation as well as other publicly available information on the two companies. A companion piece to this commentary was published by Citybizlist on December 4, 2009.]

The nagging question about the "merger" of **Black & Decker Corporation** (NYSE: BDK) and **The Stanley Works** (NYSE:SWK) is, "Why is this happening?" Why is Black & Decker disappearing (becoming a division of Stanley) at the beginning of an upturn in the market? Why is the company selling for a modest premium? Why are shareholders content to receive the lower end of the range that Black & Decker traded at for four of the past ten years?

The Black & Decker board would suggest that this makes "excellent financial and strategic sense."

Strategic, yes. Financial, maybe. Premiums are paid in order to gain control of the target company---in this case Black & Decker. The implied 22.1% premium for Black & Decker shareholders is far from stellar. The long-term market average for M&A premiums is approximately 25%. But premiums in the past year have been well above the long-term average, precisely because stock prices have been so depressed. A buyer can afford a high premium on a slumped stock like Black & Decker's and still make a good financial return on the acquisition. Stanley's investment bankers, in a joint presentation to Stanley directors as reported in the Form S-4 filing, showed this spike in premiums in 2009 to be 33.8% for companies the size of Black & Decker. That was surely welcome news during Stanley's deliberations.

The Form S-4 or "joint proxy statement/prospectus" was filed with the Securities and Exchange Commission by Stanley on December 4th. As M&A filings go, this is an extraordinary one, containing a long narrative on the history of two simultaneous negotiations and transactions.

Yes, two transactions.

The first deal described is the purchase of Black & Decker by Stanley through the conversion of Black & Decker shares into Stanley shares. The second deal is the tortuous one cut by Black & Decker Chairman and CEO Nolan Archibald as he helps to move the transaction forward, negotiates away control of his own company, recommends the deal to his board, and finally secures his compensation packages. Packages is plural, because Mr. Archibald, and Mr. Archibald alone among Black & Decker executives, exacts terms and/or compensation from both companies.

To be clear, the S-4 reveals that Mr. Archibald abstained from the final board vote authorizing the sale of Black & Decker, and nothing in the S-4 or elsewhere indicates that Mr. Archibald did not act in accordance with all applicable laws and market regulations. What the S-4 does show is that Mr. Archibald, through his negotiations with Stanley and his own board, stood to gain a great deal of money if the transaction was approved. My concern is, "Why is this in the best interests of the company and

shareholders to have a CEO in a position in which he himself concedes could be seen as a conflict of interests?" There is nothing new under the sun. These situations arise all the time in the sale of U.S. corporations. That doesn't mean that they should not be questioned.

The merger transaction, despite its average reward and outcome for Black & Decker shareholders, is going to happen---and it probably should happen. Stanley has the more aggressive and forward-thinking board of directors and management team in place. Stanley appears to have the bench of executives who will execute on a strategy to make the combined companies more efficient and competitive. Wall Street loves this deal and has bid up both stock prices in anticipation of these cost savings. In a small global marketplace, where tool companies from Asia have made significant inroads into the U.S. market, there may be room for only one U.S. survivor---and Stanley it will be.

But could a better deal have been struck for Black & Decker's shareholders? This is impossible to answer, but I believe that shareholders would be better served in this transaction and others if those involved in the negotiations were independent and free from financial incentives to do the deal.

In my opinion, the die was cast for Black & Decker's demise many years ago when Mr. Archibald consolidated his power base on this board. He has been CEO and Chairman of his own board of directors for almost twenty-five years. He has no challengers or successors in sight. How does an organization refresh and revitalize itself when it has one leader for 25 years? On July 16th, as negotiations with Stanley were heating up, one wonders what the Black & Decker board saw and heard in the annual strategic business review and planning session. Was the company still competitive? Was there growth in sight? Was there a realistic plan as a standalone company to get the stock price back to $60 to $90 per share?

The Black & Decker board itself has three problems when it comes to governance that make it particularly weak and less than fully credible. First, like many U.S. boards, it appears to be handpicked by the chairman, including on it the chairman's friends and associates. Of the ten members other than Mr. Archibald, at least three have personal ties to the chairman. Two of these are former colleagues from his food industry days at Beatrice Companies. A third board member is the president of a university which is owned by a major religious group, a religion in which Mr. Archibald is a senior, nationally recognized leader.

A second related concern is the convoluted connections that exist on this board. It is enough to make your head spin. Besides the members mentioned above, another director is a highly respected former chairman and CEO of Lockheed Martin who was appointed to the Black & Decker board in 1997, the year that he retired from Lockheed Martin. Five years later, Mr. Archibald was appointed to the Lockheed Martin board where he remains a director. This same board member is listed as one of sixteen elite advisors on the Deutsche Bank Americas Advisory Board. Another Black & Decker board member with a financial background is a former Deutsche Bank executive and is also on this same elite Deutsche Bank board. Deutsche Bank, along with Goldman Sachs, is an investment banking advisor to Stanley in this transaction and expects to receive a substantial fee if the transaction is successful. There is no reference in the merger prospectus to the Deutsche Bank connection nor is there any mention of this affiliation in

the Deutsche Bank fairness opinion. These are just the connections you find by reading the filings and researching the Internet.

The stocking of a board with people that you know and trust is common U.S. corporate practice. But the practice is coming under increasing fire from shareholder organizations and institutional investors, including the U.S government which ran up against this problem when it recently became a shareholder of banks and automobile companies.

The problems with this practice are many and easy to understand. First among them is, "Who is going to challenge the CEO in times of crisis?" 'He's an old friend, I know his family, he's been a big donator to my organization, I would not normally have a seat on a board like this without him….' How do you remain objective and potentially cross swords with your CEO/benefactor in years when there is poor performance or a crisis? The board hires and fires the CEO and other senior executives. The board approves strategy and key operating decisions such as acquisitions and capital budgets. The board establishes a successor. And in this case, the board had to approve the total and definitive end of a 100 year-old corporation, which it did on November 2nd.

The final concern with this board is lack of experience. Nobody on the Black & Decker board, save for Mr. Archibald, has tool industry experience and only a couple have manufacturing experience.

How can you tell the CEO that his strategy is flawed or his arguments for a merger are weak if he is the only member with direct industry knowledge and experience? Besides the above-mentioned members, the remaining directors consist of a former media executive, a former information industry executive, a former healthcare CFO, a retired rental industry CEO, and the current head of 3M. Of the ten, only the CEO of 3M and the retired CEO of Lockheed Martin have manufacturing industry experience. Now compare that set of biographies with the Stanley board. Seven out of eight non-executive Stanley directors come from manufacturing companies, including one from the tool industry.

I believe that the key to Stanley winning Black & Decker was in winning the support of Mr. Archibald. When Stanley came calling, negotiations started with Mr. Archibald and ended with him. From the narrative account in the prospectus, you can imagine the Stanley directors questioning their CEO as he time and again brings back demands from Mr. Archibald. In the beginning, they are Black & Decker demands for operating control and board seats and better terms for shareholders. By the end of the transaction run-up, these demands are rejected and Mr. Archibald is negotiating for two things---a slightly better share conversion ratio and his personal contracts. As the board meetings increase in frequency before the final November votes, every documented board meeting on both sides of the transaction includes a discussion of the deal and a discussion of Mr. Archibald's contracts and terms.

You can read in the S-4 how Stanley struggles to find a way to get Mr. Archibald aligned with Stanley's interests. On June 9th, Mr. Lundgren, the Stanley CEO, and Mr. Archibald have their now-famous lunch where Mr. Lundgren puts forward his proposal. By the end of June, the two CEOs are talking about their respective roles in a combined company. By the end of July, Stanley has proposed the clever tactic of making Mr. Archibald the Executive Chairman of the combined companies. Executive Chairman is relatively new nomenclature for differentiating a chairman who just oversees periodic board meetings

from one who is at a desk and helping to promote and run the company. It is often employed in publicly-held companies to politely move a CEO out of operating control and into a holding position pending retirement.

In this case, the Executive Chairman title would help build the façade of a "merger of equals" (terminology used at the time), as if Mr. Archibald had negotiated for Black & Decker the top executive position. In reality, the Stanley board would know that by retaining control of the combined board of directors and investing operating control of the combined companies in Stanley management, it was not much of a give-up in negotiations to offer Mr. Archibald the title of Executive Chairman. Experience shows that this relationship is inherently unstable. I would not be surprised if Mr. Archibald does not last the full three years of his new contract and that he eventually negotiates an early retirement with full payouts and benefits.

Eventually, with negotiations between the two companies stalled, the S-4 record indicates that sometime in September, a Stanley financial advisor comes up with an idea that only an investment banker's mother could love. Why not offer Mr. Archibald a rich bonus (between $15 million and $45 million) based on the combined companies achieving "cost synergies"? This was a genius maneuver. In one fell swoop, it accomplished several objectives. First of all, it spelled out in dollars for investors exactly how much the deal would benefit them. Public companies are loath to make predictions about future performance, but here you could describe to investors a hypothetical pay package based on achieving $350 million of cost cuts. No promises---just targets. Secondly, it provided a smoke screen for delivering a huge payment to Mr. Archibald, presumably providing a rationale for the payment by assigning Mr. Archibald the task of taking costs out of the combined businesses. Finally, and perhaps most importantly, it offered Mr. Archibald a large personal incentive to complete a transaction. Negotiations moved forward.

I find it hard to believe that Mr. Archibald as Executive Chairman will be spending his days pouring over spreadsheets and wringing $350 million of costs out of the new Stanley. This work is typically a function for operating management, which will be headed by the Stanley team. That team is probably already hard at work drawing up plans and making pink slip lists. This work gets done whether Mr. Archibald is in the Executive Chairman's seat or not.

In my opinion, this "cost synergy bonus" is simply designed to put additional money into the hands of Mr. Archibald to win his support for the deal. It is a payment that both boards should be embarrassed for having endorsed.

A key question in this transaction is how much is Mr. Archibald worth and how much more will he be worth if he recommends this transaction with Stanley? As you can now understand with this Black & Decker board, if there is no support from Mr. Archibald, then there is likely no transaction. We know that Black & Decker shareholders are supposed to receive a 22% premium in the stock exchange. Let's examine, as best as possible, Mr. Archibald's economic incentive to effect a transaction versus 'stay the course' with Black & Decker.

At this point, it gets tricky to present all of the facts accurately. The SEC and even FINRA try to create rules and regulations that encourage full and accurate disclosure, but corporate America pay packages for executives are, by design, very complex. To understand the holdings, payouts, equity grants, salary, benefits, perquisites and other money components of a typical CEO like Mr. Archibald requires forensic accounting training, benefits-management experience and a metal detector. The information is spread across multiple filings, and there are time and information gaps. You should not need two decades of finance experience and an MBA to pull back the curtain.

In his almost 25 years as CEO, Black & Decker has made Mr. Archibald a very rich man. At today's stock price, my calculations suggest that Mr. Archibald's current realizable Black & Decker holdings are worth over $110 million. This would consist of approximately $26 million in common shares, $31 million of "in the money" options, $3 million of vested restricted stock, $35 million of Accumulated Pension Benefits and $15 million in a Supplemental Savings Plan. In addition, he received approximately $10 million of salary, stock and perquisites in 2008, not including the $3.5 million value of options awarded him at the time. Not included in this $110 million estimate are $12 million worth of restricted stock that will vest in coming years and 600,000 "out of the money" stock options, some or all of which will have value if the new Stanley 's stock price grows.

Going forward, Mr. Archibald is guaranteed by a combination of both boards a full 2009 pay package of at least $13.75 million. When he becomes Executive Chairman of Stanley, he will receive in future years the same base salary of $1.5 million plus a yearly bonus up to $1.75 million plus a yearly equity award for his three year contract of $6.65 million plus a continuation of his perquisites such as a car, driver and private jet travel for him and his family, all of which add up to approximately $11 million of compensation a year for three years.

But Mr. Archibald can do the same or better by maintaining his Black & Decker employment, so he should be indifferent at this point.

The payments that could influence Mr. Archibald's objectivity are a grant of one million Stanley options at the time of the transaction as well as the infamous "cost synergy bonus". Think of the stock options in this way. They are nominally worth nothing at the time they are granted, but for every dollar that the stock price of the new Stanley rises after the transaction is completed, Mr. Archibald gains one million dollars.

Finally, there is the notorious cost synergy bonus that ranges from zero to $45 million, the latter achieved if the combined company can reduce costs by $350 million. With the cost synergy bonus and the one million of options, Mr. Archibald could reasonably hope to achieve $70 million or more in additional wealth in the coming years if the new Stanley achieves the cost cutting goals and the stock price grows at a market rate.

The questions are clearly framed in the end. When presented with these incentives, can Mr. Archibald be impartial and objective in assessing the merits of this transaction? Should he, or any executive or director, be allowed to lead negotiations when the buyer puts this level of financial incentive on the table? Why should an executive profit any more than shareholders from the sale of a company? As it

stands, Mr. Archibald, by far, is the largest individual shareholder of Black & Decker and will reap a substantial reward from the current share exchange.

Here is how the prospectus describes the end of the Black & Decker board meeting where the company is voted into oblivion. "After each of the presentations had been given, Mr. Archibald advised the Black & Decker board that he had given a great deal of thought to the proposed transaction and believed that the transaction was both strategically and financially compelling from the perspective of Black & Decker and its stockholders and that he was very supportive of the transaction. Mr. Archibald indicated that in light of the position he would have as Executive Chairman of the combined company and the interest he would have by virtue of his employment arrangements following the closing, he intended to abstain on the vote on the transaction." It is no surprise to me that Mr. Archibald found it compelling.

And with that, the plug was pulled in Towson.

[One last irony and twist of the knife for Baltimore. According to this Form S-4 filing, Deutsche Bank was in the room and presumably whispering in the ear of Stanley CEO Lundgren when the idea for this transaction was first revived in February of 2009. This is the same Deutsche Bank that was the ultimate buyer of Alex. Brown & Sons. As such, Deutsche Bank was the one that shuttered the Alex. Brown headquarters and moved the remaining functions to New York. And they wonder why Wall Street has such PR problems these days.]

Mr. Schmidt is CEO & Managing Director of Chessiecap, Inc., a financial services and information company. Chessiecap publishes a monthly financial newsletter entitled the "Mid-Atlantic Deal Review" found at www.midatlanticdealreview.com. Chessiecap is also the parent company of Chessiecap Securities, Inc., an investment bank raising capital and providing M&A and strategic advisory services to growth and technology companies in the Mid-Atlantic region. See www.chessiecap.com.
