

Implications Of The Amended Best Price Rule: A New Era In Private Equity Deal Making

Summary

After many years of lobbying, the SEC has finally amended its Best Price Rule to revive the functionality of tender offers as a practical structural alternative to the conventional merger for the acquisition of public companies. While many will see the SEC rule revision as a modest, but long needed, correction of a dysfunctional misuse of the old rule by the plaintiffs' bar, the consequences of the amended rule have the potential to be farther reaching.

- Ironically, revitalization of the tender offer should not have much impact on hostile deal making, notwithstanding that hostile bids are often thought to be the principal function of tender offers.
- Rather, the rule revision's greatest impact will be on consensual deal making because the tender offer provides speed of execution which reduces exposure of buyers to topping bids and sellers to material adverse change and similar risks.
- Speed of execution will be most telling in deals lacking regulatory issues, such as corporate diversifications and, more important in today's market, leveraged buy-outs.
- For corporate buyers, the practical availability of the tender offer structure will allow for the first real test of the SEC's early commencement rule for offers involving the issuance of securities. If the implicit commitment of the SEC to process exchange offers on a 20 business day timetable is honored, the exchange offer will become competitive with the cash tender offer and will provide public company buyers greater structuring flexibility.
- The critical issue for cash buyers, particularly private equity sponsors, will be financing the tender offer in compliance with the Federal Reserve Board's Margin Rules. This, as we will see below, is likely to be the most important determinant of the ability of private equity (and smaller public company buyers) to utilize the tender offer as a means of achieving tactical equality and, in many cases, tactical superiority over other bidders for public companies.
- While financing cash tender offers in compliance with the Margin Rules is not without some cost and complications, there are a number of available financing structures (several of which have rarely been used but are eminently feasible) for cash tender offers. Accordingly, we believe tender offers will soon permeate LBO deals and become a dominant structural form for private equity purchases of public companies where regulatory approvals are not critical to the process.

Background

The saga of the SEC's Best Price Rule is well known and needs little explanation. The Best Price Rule is intended to ensure that all shareholders receive the same price for their shares in a tender offer—hardly a controversial principle. However, a seminal federal court decision in 1995 made application of the rule dependent on an intensely factual analysis into whether other aspects of a business combination (such as disparate forms of consideration to large shareholders, pre-and post-tender compensation payments to the target's management or ancillary business arrangements between the buyer and large shareholders of the target) actually constituted additional consideration for the tender of shares. If so, under this judicial construction of the Best Price Rule, all of the target shareholders would be entitled to receive the highest per share consideration paid to any favored shareholder.

The plaintiffs' bar quickly saw that claims based on alleged violations of the Best Price Rule could not be easily disposed of short of a jury trial because the factual nature of the claims made dismissal on the pleadings and summary judgment inappropriate. Given the out-sized value of the claims (often totaling billions or trillions of dollars because an "excess" payment to one shareholder would require the same amount of excess for all other shareholders), settlement was the only practical alternative open to the bidder. It didn't take too many of these "hold up" suits to convince the M&A community that the advantages of the tender offer were outweighed by the litigation and settlement costs. Absent special circumstances or a bidder with a very strong stomach for litigation risk, tender offers became a structure of the past for consensual deals.

Without delving into the interstices of the SEC policy and rule-making process, the SEC has finally amended its Best Price Rule expressly to deal with the factual quagmire created by the judicial decisions. The amendment clarifies that the Best Price Rule applies only to consideration paid to shareholders for securities tendered in the tender offer, not to employment compensation, severance or other employee benefit arrangements with shareholders of the target company. The amendment also provides for a "non-exclusive safe harbor" for arrangements approved by the compensation or other independent board committee of either the target company, regardless of whether the target company is a party to the arrangement, or the acquiring company.

We believe the revision will have the intended effect of relieving consensual tender offers from litigation threats under the Best Price Rule with respect to compensation, severance and other employee benefit arrangements, by far the most insidious and far reaching area of uncertainty under the old regime. As a result, the tender offer will once again become a practical and, we predict, widely used M&A structure.

Strategic Value of the Revitalized Tender Offer

- Conventional wisdom associates the tender offer with a hostile bid. While true, the Best Price Rule imbroglio has not had a significant effect on the utility of tender offers in a hostile context because differential consideration to shareholders and/or special compensation arrangements for management do not ordinarily factor into hostile bids. Reform of the Best Price Rule has been essentially irrelevant to hostile deal making.
 - The situation is starkly different for consensual deal making where compensation arrangements figure so prominently in deal dynamics. The Best Price Rule is explicitly being amended to make clear that, so long as certain well defined criteria are satisfied, compensation arrangements do not implicate the Best Price Rule. The result will be revitalization of the tender offer as a viable structure for friendly acquisitions of public companies.
 - One consequence of the Rule's revision will be the first meaningful opportunity to test the practicality of the SEC's regulatory reform in Regulation M-A permitting exchange offers to be commenced on the day of filing of the initial registration statement, rather than having to wait weeks until the registration statement actually becomes effective. If the SEC, in fact, is able to and does process early commencement filings within the normal 20-30 business day time frame of cash tender offers, its regulatory reform will permit exchange offers to compete in time with cash tender offers. This will obviously increase the utility of the exchange offer and make it a viable alternative to cash offers for corporate acquirers in many situations.
 - Particularly if exchange offers become as functional as cash tender offers, we expect the tender offer to become the structure of choice for corporate acquirers. In almost all cases, the tender offer format would reduce the deal's vulnerability to a topping bid and the target would deliver consideration to its shareholders with greater speed and less risk of intervening events, particularly material adverse changes. To be sure, use of the tender offer by corporate buyers would be limited to situations without significant regulatory hurdles that would undermine the otherwise short time frame of the tender offer structure. But many deals would not be subject to such delaying factors. As a consequence, the once familiar two-step acquisition structure of a merger agreement providing for a first step tender offer followed by a close-out merger (short-form or long-form) would again become common in corporate acquisitions of public company targets
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- We don't expect the shift to tender offers to be limited to corporate acquirers. The world of M&A has changed radically since the late '90s when the litigation risk attendant to the Best Price Rule effectively ended the use of the tender offer in friendly deals. In the former heyday of the consensual tender offer, private equity players rarely utilized the structure, and the deal form was largely the playground of corporate buyers. Since then we have witnessed the rise of private equity sponsors as leading buyers of public companies of increasingly large size. This change in the dynamic of the M&A marketplace signals a corresponding change in the use of the consensual tender offer structure.
- It is safe to predict that, following a brief digestion period for the new Rule, there will be a public company auction involving a number of corporate and private equity bidders where someone (be it the target or a corporate bidder) will suggest use of the consensual tender structure to gain a significant tactical advantage in the bidding process by offering a faster and less risky path to closing. The analysis is simple: assuming no regulatory delays, a bidder offering to close in 30-40 days through a first step tender offer followed by the certainty of a back-end merger will have a significant advantage over a bidder with the 90-120 day closing schedule of the one-step merger—an advantage that might be sufficient to warrant choosing a slightly lower bid and that would certainly prevail in the case of identically priced bids.
- The timing advantage of the tender offer structure for private equity bidders would not be limited to a defensive stance in those auctions where a strategic bidder offered to use a tender offer. There will be many situations where private equity bidders would not have antitrust or other regulatory issues and could use the tender offer structure to reinforce their timing and certainty advantages over rival corporate bidders that have antitrust or other regulatory issues.
- Nor would the desirability of the tender offer structure be limited only to those deals where corporate buyers were competing for the target. In auctions strictly among financial buyers, the ability and willingness of one private equity sponsor to offer the superior execution of the tender offer structure will inevitably drive all other competing bidders to the same structure.
- Indeed, if our crystal ball has any clarity, it should not be long before the tender offer structure becomes a ubiquitous feature of consensual deal making by both corporate and private equity buyers, so long as there are not regulatory issues that would diffuse the execution speed of the structure for all of the bidders.

Financing Issues and Answers

The possible opaqueness in our crystal ball involves financing issues for cash bids. Skeptics will be quick to point out that companies without large balance sheets and, more importantly, private equity buyers will not be able to finance cash tender offers in the same manner as one-step mergers because they will not have access to the target's balance sheet to support the tender offer financing. And, they will remind us, the target's stock is of limited usefulness as security, because the Margin Rules restrict borrowings secured by public company stock to 50% of its market value. But just as the LBO market has evolved since the '90s, leveraged finance has evolved with the result that today a number of financing structures are available for use in a tender offer, even those of the \$20 billion plus size of some of the recent block-buster LBOs such as HCA.

- The most obvious financing structure for a private equity buyer is an unsecured bridge loan for up to the entire debt financed portion of the purchase price of the target company. Conventional thinking has been that a bridge loan supporting a tender offer is too risky to be available, particularly in large size, and/or too expensive to be practical. However, if the underlying merger agreement provides for a minimum 50% tender as a closing condition for the tender offer and a no-out obligation by the bidder to close the back-end merger (subject only to injunction or other legal prohibition), the risk of the bridge facility will largely be confined to timing of the closing of the second step merger, at which point the assets of the target become available to support the permanent financing. This risk occurs only if the tender offer acceptances fall short of the required percentage ownership to enable a short-form merger. It is rare, perhaps unheard of, in today's equity market for a seller supported tender offer to fall short of the 90% ownership level required by Delaware and most other states for a short-form
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merger. Moreover, the timing risk can be virtually eliminated if the tender offer provides for a “subsequent offering period” following the initial tender offer closing, during which tenders are no longer subject to withdrawal rights, and the target grants the bidder a so-called “top up” option to acquire sufficient additional shares from the target at the deal price to reach the short-form percentage requirement.

- Those with an especially long memory or a working knowledge of the Margin Rules might raise the issue whether such an unsecured loan nonetheless runs afoul of the applicability of the Margin Rules to loans indirectly, as well as directly, secured by public company stock. At least in the case of the special purpose acquisition vehicles uniformly used in LBOs, a borrowing by a vehicle owning no assets other than stock being purchased in the tender offer could run afoul of the indirect security doctrine, even if the stock held by the vehicle were not formally pledged to support the loan. This was a burning issue in the 1980s when tender offer structures were first used by special purpose entities to acquire public companies. However, the Federal Reserve Board addressed this problem by issuing an interpretation to the effect that it would not deem a tender offer financing loan as indirectly secured by the stock of the target company if the bidder had entered into a merger agreement with the target prior to making the tender offer, the bidder acquired at least 50% of the target’s stock in the tender offer and the bidder neither pledged the stock nor agreed to a negative pledge covenant.
 - In short, the two-step merger agreement format dove-tails with the Margin Rule interpretation and makes bridge loans feasible, so long as lenders are willing to accept the risk of a delayed merger and the absence of a negative pledge clause.
 - There are a number of considerations that should offset concerns about the pricing of an unsecured tender offer bridge facility.
 - As noted above, it is rare, if not unheard of, for a consensual tender offer supported by the bidder (and by hypothesis not topped in the market) to fail to receive sufficient tenders to permit a short-form merger.
 - The presence of a “subsequent offering period” and a “top up” option in the deal will further reduce the practical risks of failing to achieve the ownership requirement for a short-form merger.
 - The time delay implicit in failing to achieve the short-form merger percentage is on the order of magnitude of 45-60 days that would be required to achieve a long-form merger.
 - Finally, at least in today’s leveraged loan market, private equity sponsors have significant leverage with lenders in deals small and large, making it unlikely that lenders would charge outsized fees for an unsecured bridge facility.
 - It is also important to note that there are at least two other financing structures that might be available which would eliminate the need for an unsecured third party bridge facility.
 - The first would be for the private equity sponsors to create internal fund based credit structures that could provide bridge financing for a tender offer internally within the private equity sponsors’ group of funds. One structural possibility would be for a private equity sponsor to raise a “mezzanine” fund that had the resources and authority to provide bridge loans for acquisitions by equity funds managed by the private equity sponsor. Another possibility would be for the private equity sponsor to create a generic credit facility with third party lenders that could supply bridge financing and would be supported by other assets of the private equity fund making the investment in the public company.
 - A second, and structurally more attractive, financing solution for many deals would be to have the target engage in a simultaneous self-tender along side and complementary with the third party tender offer. Such a structure would avoid some or all of the refinancing issues inherent in a conventional tender offer financing, since the debt could be located at the obligor ultimately intended to repay the credit facility.
 - Take, for example, a private equity acquisition where the permanent financing structure would be 25% equity and 75% debt. Rather than initially borrowing 75% (or close to that amount) at the acquisition vehicle and refinancing the
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debt at the target company level at or shortly after the merger, a simultaneous target self-tender offer would permit the private equity vehicle to tender for 25% of the shares with the equity it planned to inject in the merged entity, and the target to tender for 75% of the shares with the support of the target's assets as would be the case following the merger.

- The dual tender structure has been successfully used on several occasions, most notably in the Cox Enterprise going private tender offer for Cox Communications, and poses very few deal complications. The two tender offers are made in the form of a joint offer to purchase, with each party obligating itself to acquire an agreed number of shares at the same price and under the same terms and conditions. A single transmittal letter is also used. From the standpoint of tendering shareholders the identity of the buying entity is immaterial. While there are inter-company mechanics necessary to assure the appropriate end results in terms of allocating tenders, they are nothing more than mechanics.
- There is one obvious negative to the dual tender structure—the math of getting to the short-form merger percentage is adversely affected by the fact that most of the shares are being acquired by the target and will not count toward the ownership requirement of the buyer. A “subsequent offering period” and a “top up” option in favor of the buyer should reduce this concern. Moreover, the point of the dual tender structure is to utilize a financing structure that does not pose the credit risk of an unsecured bridge loan in the event that a short-form merger is not available.
- Another possible objection to the dual tender structure is that it requires more advance preparation and participation by the target to execute the simultaneous tender and, more particularly, the self-tender financing than would otherwise be the case. While extra effort is required by the target, its economic exposure can be eliminated by a reimbursement agreement by the buyer should the tender offers fail. Moreover, in the context of a friendly deal, targets are customarily required to cooperate with the bidder in obtaining both bridge and permanent financing and, in practice, the burdens of financing a self-tender are not likely to be much different from those of helping the bidder implement its merger financing.
- On balance, the financing advantages inherent in the simultaneous tender offer structure seem to more than offset its disadvantages. As a result, the dual tender offer structure may become a fixture of two-step merger technology because it facilitates a more efficient financing structure with less risk exposure than an unsecured bridge loan.

Conclusion

The SEC's reform of its Best Price Rule, while not as complete as many observers had urged or hoped for, seems adequate to reinvigorate the tender offer as a major structural device for public company acquisitions. This, in turn, will force private equity buyers to consider the tender offer as an acquisition structure, perhaps a preferred acquisition structure, because it will enhance the competitiveness of the private equity buyer in comparison to a strategic buyer burdened by any sort of regulatory delay.

The strategic and tactical advantages of the tender offer will require private equity buyers to deal with financing issues not present in the traditional one-step merger context. Although at first sight challenging, we believe that the financing issues are solvable without undue cost and there are effective precedents pointing the way. As a result, we expect that private equity sponsors will soon come to grips with and ultimately embrace the two-step tender offer structure.

If you have any questions about this M&A Deal Commentary, please contact [Chuck Nathan](#) in our New York office.

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