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Amendments to Delaware Merger Statutes: An Arrow in Your Quiver, Not a Silver Bullet

Highlights

- The Delaware legislature is currently considering amendments to the DGCL that would facilitate the use of the more efficient tender offer transaction structure for negotiated mergers.
- The proposed amendments would, in many cases, eliminate the need for stockholder approval of the second-step merger following a successful tender offer in which the "short-form" merger provisions of the DGCL otherwise are not available.
- We anticipate that both strategic and financial buyers will adopt this stockholder friendly transaction structure, saving substantial expense, eliminating delay associated with an SEC review of disclosure materials and facilitating financing for leveraged transactions.
- Despite the significant benefits expected from the proposed amendments, transaction planners should be mindful of certain ambiguities in the language that threaten to limit the amendments' effectiveness, particularly in situations in which one or more large stockholders are involved in the transaction (either as a buyer or party to a tender and support agreement) and situations in which management will "rollover" a significant equity stake.

Introduction

The Delaware State Bar Association recently proposed amendments[1] to the Delaware General Corporation Law (DGCL) intended to facilitate the use of tender offers in acquisitions of publicly traded corporations. If adopted, these amendments will, in many circumstances, permit the purchaser of a simple majority of a target's outstanding shares (as opposed to the current 90 percent threshold) to effect a short-form merger immediately, saving substantial expense, eliminating the delay associated with SEC review of disclosure materials and facilitating financing for leveraged transactions.

This M&A Commentary explores the intended benefits of the proposed amendments and why they represent a positive step in the recent evolution of tender offer practice. We also highlight why, absent clarification from the Delaware courts or revisions to the language by the Delaware legislature, the proposed amendments may not deliver all of the intended benefits.

Evolution of Tender Offer Practice

Following the 2006 amendments to the SEC's tender offer rules, tender offers became the transaction structure of choice for cash buyers who did not require financing or anticipate a lengthy regulatory review. According to Factset MergerMetrics, approximately 20.2 percent of the friendly cash deals in 2012 were structured as tender offers, as compared with only 6.4 percent in 2006. Speed is the primary advantage of a tender offer. Indeed, an uncontested tender offer can be completed in as little as six to eight weeks from public announcement, as compared to a minimum of 10 to 12 weeks (with a greater risk of additional delay) for a long-form merger.

The primary disadvantage of the tender offer is the need to complete a second-step or “back-end” merger to acquire any shares not tendered in the tender offer. The back-end merger can be completed immediately after the tender offer using the short-form merger provisions of the DGCL (thereby achieving a nearly simultaneous closing for the tender offer and the back-end merger),[2] if the buyer holds at least 90 percent of each class of the target company’s outstanding voting stock after the tender offer. If a buyer holds less than 90 percent, however, the target company must call a stockholder meeting to approve a long-form merger. The outcome of the vote is certain after the buyer acquires voting control in the tender offer, but the potential delay creates additional cost and complexity, including:

- The need to prepare and file a proxy or information statement for the second-step merger
- The need to negotiate corporate governance structures for the period prior to stockholder approval to afford the buyer the right to control the company, but also protect the stockholders’ right to receive the merger consideration in the second-step merger
- The potential need for “bridge” financing to fund the purchase of shares in the tender offer in advance of completion of the second-step merger

Driven in large part by the cost and risk associated with the required bridge financing, financial buyers have typically been unwilling to use a tender offer, absent certainty that the parties would achieve the 90 percent threshold necessary to complete a short-form merger immediately after closing the tender offer. All else being equal, a financial buyer’s reliance on a long-form merger may create a structural disadvantage to strategic buyers in competitive sales processes. However, use of both the “top-up” option and, more recently, “dual track” structures have facilitated tender offers by financial buyers, albeit with uncertainty as to timing and with the potential additional cost of a merger proxy.

Top-Up Option

Transactional planners developed the top-up option as a tool to assist a buyer seeking to achieve the requisite 90 percent threshold and eliminate any delay between the tender offer and the back-end merger, so long as the bidder received in the tender offer a number of shares sufficient to approve the second-step merger. A top-up option gives a buyer the right to purchase newly issued shares directly from the target to increase its ownership. As confirmed in the Delaware Court of Chancery’s decision in *In re Cogent, Inc. S'holders Litig.*,[3] the top-up option has been formally validated under Delaware law, subject to certain procedural requirements. In 2012, over 95 percent of the transactions structured as cash tender offers included a top-up option.

The top-up option is subject to a number of technical limitations, however. The top-up option cannot exceed the target’s authorized and unissued shares, and for that reason often does not allow a buyer to increase its ownership from a simple majority all the way to 90 percent. Accordingly, a buyer often must set the minimum condition in the tender offer at a level above the simple majority required in many cases to approve a long-form merger. This creates a supermajority approval requirement and increases transaction risk for both the buyer and the target company. For example, in a transaction in which the target company has 100 million authorized shares and 45 million shares outstanding, approximately 77 percent of the outstanding shares must be obtained in the tender offer to reach the short-form threshold via the top-up option. Consequently, the minimum condition for the tender offer would need to be set at 77 percent.

Dual-Track Structure

The dual-track structure was developed to retain the benefit of simple majority approval, but preserve the potential timing advantage of the tender offer.[4] In this structure, a buyer commences a tender offer in the hope of obtaining sufficient shares to achieve the 90 percent threshold, including by exercising the top-up option. The target also files a preliminary proxy statement with the SEC with respect to a traditional long-form merger. If the buyer fails to achieve the 90 percent threshold in the tender offer after giving effect to the top-up option, the parties can abandon the tender offer and seek to complete a long-form merger using the proxy statement that was previously filed. Although Rule 14e-5 under the Exchange Act has been interpreted by the SEC Staff to prohibit mailing a definitive proxy statement while the tender offer remains active, the early filing of the preliminary proxy statement can—if the SEC Staff reviews the filing while the tender offer is pending—save several weeks in the transaction timeline without losing the opportunity to close the merger on the abbreviated tender offer timeline.

The dual-track structure has been implemented in at least 20 going private transactions since 2010, but remains an imperfect solution. Some parties are reluctant to incur the additional cost associated with filing a proxy statement that may never be used or to suffer the additional delay in closing the long-form merger if the tender offer is ultimately unsuccessful. Interestingly, none of the dual-track transactions have had to use the long-form merger, as in each case sufficient shares were tendered to achieve the 90 percent short-form merger threshold, after giving effect to the exercise of the top-up option.

Proposed Amendments to DGCL

The proposed new subparagraph (h) of Section 251 of the DGCL would be available for transactions entered into on or after August 1, 2013 and would eliminate the requirement for a stockholder vote to authorize a second-step merger following a tender offer, if the following conditions are met:

1. The target company is a Delaware corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders.
2. The merger agreement expressly provides that the merger will be governed by Section 251(h) and will be effected as soon as practicable after consummation of the tender offer.
3. The buyer consummates a tender offer for any and all of the target's outstanding shares that would otherwise be entitled to vote on the adoption of the merger agreement.
4. Following consummation of the tender offer, the buyer owns at least the percentage of shares (typically, a majority) that otherwise would be required to adopt the merger agreement.
5. At the time the target's board of directors approves the merger agreement, no other party to the merger agreement is an "interested stockholder" (as defined in Section 203(c) of the DGCL) of the target.
6. The buyer entity consummating the offer merges with or into the target pursuant to the merger agreement.
7. The outstanding shares of the target corporation not canceled in the merger are converted in the merger into the same amount and kind of consideration paid for shares accepted in the tender offer.

Benefits of Proposed Amendments

Many practitioners believe the proposed amendments will increase the use of tender offers and render the top-up option and the dual-track structure obsolete. We hope this is true and, notwithstanding certain ambiguities we note below, we applaud the Delaware bar for their efforts to facilitate an efficient structure for the acquisition of public companies. We believe the proposed amendments will be particularly useful for target companies with a diffuse stockholder base and a limited number of authorized and unissued shares otherwise available to be issued under a top-up option. An acquisition of these target companies would otherwise require a dual-track structure. By eliminating the need to reach the 90 percent threshold, a tender offer for these target companies could now proceed with a customary minimum tender condition (consistent with the approval for a long-form merger) without the additional expense and risk of significant delay associated with the dual-track structure. The proposed amendments also facilitate acquisition financing by eliminating the need for tender "bridge" financing, and therefore should facilitate leveraged transactions by financial buyers, as well as transactions with strategic buyers funded with third party debt financing.

The proposed legislation would also revise Section 262 of the DGCL to make appraisal rights generally available for a merger effected pursuant to subsection 251(h). Notably, the proposed revisions to Section 262 would allow the parties to include an appraisal rights notice in the tender offer materials mailed to stockholders and require dissenting stockholders to provide notice of their intent to seek appraisal prior to the closing of the tender offer. This should allow buyers to, in appropriate circumstances, condition tender offers on a maximum percentage of shares exercising appraisal rights, thereby eliminating uncertainty regarding the exercise of appraisal rights after the closing of the tender offer.

Potential Ambiguities May Limit Effectiveness of Proposed Amendments

Absent clarification from the Delaware courts, or revisions to the language by the Delaware legislature, we are concerned that the proposed amendments may not deliver all of their intended benefits. Certain ambiguities are likely to limit their effectiveness in many situations, particularly situations in which one or more large stockholders are involved in the transaction (either as a buyer or a party to a tender and support agreement) and situations in which management is requested to "rollover" a significant equity stake. Accordingly, we view the proposed amendments as providing an important new tool for transactional planners seeking to structure tender offers, but are concerned that the proposed amendments may have limited benefit in many private equity transactions.

Exclusion for "Interested Stockholders" Overly Broad

The proposed amendments seek to prevent "interested stockholders" who are subject to the restrictions on business combinations under Section 203 of the DGCL from taking advantage of the expedited merger procedures. Absent this exclusion, new Section 251(h) could provide an easy path for an "end-run" around the protections of Section 203. However, many "interested stockholders" are exempt from the restrictions of Section 203 (and are permitted to undertake business combination transactions with the corporation) because (i) the board of directors pre-approved either the transaction in which the stockholder crossed the 15 percent threshold or the business combination itself or (ii) the interested stockholder became an interested stockholder at a time when the restrictions of Section 203 did not apply to the corporation (e.g. prior to the time when the corporation became publicly traded).[5] Unfortunately, the proposed amendments do not appear to recognize any distinction for "interested stockholders" that are exempt from Section 203. The proposed amendments refer specifically to Section 203(c), which defines the term "interested stockholder", but does not refer to the exemption language of Section 203(b). Therefore, notwithstanding any pre-approval or exempt status, the proposed amendment appears to preclude <u>any</u> person or group that holds more than 15 percent ownership from taking advantage of Section 251(h).

The definition of "owner" in Section 203(c) is very broadly drafted, in that agreements, arrangements and understandings between a buyer and one or more existing stockholders (including by way of customary tender and support agreements) may cause the buyer to be considered an "interested stockholder" under Section 203. Tender and support agreements with large stockholders (or a group of stockholders) are typically pre-approved by the Board (often in connection with a general exemption under Section 203), but if the arrangement is reached prior to board approval of the merger agreement, the buyer could be ineligible to use Section 251(h). Transaction planners may seek to address this concern by timing the board approval of the merger agreement to occur prior to signing any tender and support agreements. We believe, however, this strategy poses significant uncertainty; a buyer that enters into tender and support agreements shortly following board approval of the merger agreement could be viewed as having had an understanding related to those agreements prior to the merger agreement. Furthermore, we think that a buyer would not likely wait until after execution of the merger agreement to discuss these arrangements with significant stockholders, because the buyer would have no assurance that significant stockholders would sign a tender and support agreement at that time, and there would be little, if any, incentive for stockholders to do so. In addition, ambiguity remains regarding whether a buyer could enter into a tender and support agreement after the first public announcement of the tender offer, given the SEC rules prohibiting a buyer from purchasing or arranging to purchase target shares outside of the tender offer.[6] We do not believe the proposed amendments were intended to impact the customary practice of securing tender and support agreements from key stockholders. We are concerned however, that absent further clarification, relying upon the intent of the proposed amendments poses some risk. For the time being, the conservative approach would cap the number of shares subject to tender and support agreements at 14.9 percent, although we recognize this is undesirable where a large stockholder would otherwise support the transaction.

Ability to Count Equity Rollover Toward Minimum Condition

Financial buyers often require existing stockholders, including management to "rollover" equity in connection with the acquisition of a company. These stockholders' shares are generally not tendered in the offer, to mitigate the risk that value attributed to the rollover shares could implicate the SEC's best price rule.[7] Typically the shares are counted towards the minimum condition and for purposes of determining whether the 90 percent threshold has been achieved. These shares are contributed to the buyer or one of its affiliates, in exchange for buyer equity interests and/or cash, immediately after closing of the tender offer, but immediately prior to the back-end merger.

The proposed amendments require that buyers own at least the percentage of shares that otherwise would be required to adopt the merger agreement "following consummation of the offer," but do not specify whether shares acquired after the tender offer, such as rollover shares, can be counted. If the proposed amendments are interpreted narrowly to exclude shares acquired outside of the tender offer, buyers would not be permitted to count rollover shares and would face a higher *de facto* minimum condition (on a percentage basis) than would otherwise be required by the statute. For example, if the target company has 10 million shares outstanding, management has agreed to roll a total of 1 million shares, and a simple majority would be required to adopt the merger agreement (after excluding the rollover shares), a buyer would need to obtain approximately 56 percent of the remaining outstanding shares in the tender offer to satisfy the minimum condition. This is because the majority required to approve the merger agreement is calculated relative to the total shares outstanding, but the buyer could only count shares purchased from the public in the tender offer to achieve that majority. This interpretation does not appear to be consistent with the intent of the proposed amendments, but in the absence of clarification, buyers or their lenders may be wary of filing a certificate of merger following the completion of the tender offer in light of the statutory ambiguity and buyers may instead require a higher minimum condition.

Tender Offer Complexities for Financial Buyers

If the proposed amendments increase the use of tender offers generally, we anticipate increased competitive pressure on financial buyers to adopt the tender offer structure for public company transactions. Although buyers have become increasingly comfortable with the tender offer structure, certain SEC positions have resulted in increased complexity for tender offers by financial buyers, as compared to the long-form merger structure. The complexities include:

- The SEC's position that a financial buyer's fund entity should sign the tender offer disclosure documents, which creates the prospect for direct liability of the fund entity to target stockholders
- Uncertainty as to whether private remedies negotiated by the buyer and the target company in the merger agreement—including sole recourse reverse termination fees—will be effective to limit the liability of a financial buyer (and its fund entity) to target stockholders, absent triggering a specific tender offer condition
- The SEC Staff's recent interpretation of its tender offer rules that a five business day extension is generally required following the satisfaction or waiver of a financing proceeds condition (which requires that the buyer actually receive the funds pursuant to a previously disclosed legally binding third party commitment), which effectively requires that buyers either (i) draw their debt financing into escrow prior to the expiration of the tender offer or (ii) enter into definitive financing arrangements, or otherwise obtain appropriate assurances from their financing sources and waive the financing proceeds condition.

Transaction planners continue to seek creative ways to mitigate these risks for financial buyers. We would welcome further refinement by the SEC Staff with respect to these positions, consistent with the SEC's overall investor protection mandate and in light of evolving market practice.

Conclusions

We applaud the Delaware bar for their efforts to facilitate the tender offer structure for the acquisition of public companies and hope the proposed amendments will increase the use of tender offers. In that regard, the proposed amendments should facilitate shorter transaction timelines and simplify transaction structuring decisions by eliminating the need to reach a 90 percent ownership threshold. However, absent clarification with respect to certain ambiguities in the proposed legislation, we anticipate that Section 251(h) will be an additional tool in the transactional toolbox to be employed in the appropriate circumstances together with the top-up option and dual-track structures.

Endnotes

1 Corporate Council 2013 Amendments to the DGCL.
2 See Section 253 of the DGCL.
3 *In re Cogent, Inc. S'holders Litig.* (Consol. C.A. No. 5780-VCP); see also *In re Protection One, Inc. S'holders Litig.* (Consol. C.A. No. 5468-VCS).
4 For example, see 3G Capital's $3.27 billion acquisition of Burger King Holdings Inc. in October 2010, Golden Gate Capital's $454 million acquisition of California Pizza Kitchen Inc. in July 2011, and Centerbridge Partners LP's $1.09 billion acquisition of P.F. Chang's China Bistro Inc. in July 2012.
5 A corporation is also permitted to amend its organizational documents to elect not to be governed by the provisions of Section 203 of the DGCL. See Section 203(b)(3) of the DGCL.
6 See Rule 14e-5 under the Securities Exchange Act of 1934, as amended.
7 See Rule 14d-10 under the Securities Exchange Act of 1934, as amended.

If you have any questions about this *M&A Commentary*, please contact one of the authors listed below or the Latham attorney with whom you normally consult.

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