



Proposed Amendment to Delaware Law May Increase Pressure for Private Equity-Sponsors to Use Two-Step Merger Structures in Going-Private Transactions

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The Delaware State Bar Association has proposed an amendment to the Delaware General Corporation Law (“DGCL”) that may significantly change how acquirors, including private equity sponsors, use tender offers to acquire public companies. It is expected that the proposed amendment will be adopted by this summer and become effective August 1, 2013.

Typically, public company acquisitions are structured either as a one-step merger or as a tender offer followed by a back-end squeeze-out merger. The latter approach, a so called “two-step” merger, is used when front-end speed and deal certainty are at a premium. Under the two-step approach, the acquiror can use the tender offer “first-step” to achieve a control position as soon as it can close its tender offer—typically one month after launch assuming all necessary regulatory approvals are obtained. This can be substantially quicker than the date it would acquire control in a one-step merger process, which typically requires several months in order for the proxy solicitation and stockholder approval process to take place. One disadvantage of the two-step merger approach is the delay and cost of the second-step merger needed to acquire the non-tendered shares. Unless the first-step tender offer results in the acquiror owning at least 90% of the target corporation’s stock (permitting it to conduct a “short-form” merger without seeking stockholder approval), the second-step merger will require the filing of a proxy or consent statement with the SEC and be subject to the attendant delays inherent in a public company merger approval process. In addition, an acquiror using debt financing would not typically be able to obtain sufficient debt financing to consummate a two-step merger transaction unless the first-step tender offer closes on the same day as the second-step merger.

The proposed amendment would eliminate these disadvantages by allowing parties to a merger agreement to complete a second-step merger without stockholder approval if the acquiror owns a majority of the outstanding stock of the target following completion of the first-step tender offer. As a result, if the proposed amendment is adopted, we anticipate that target corporations may increasingly seek to structure going-private transactions by private equity sponsors as two-step mergers. Nevertheless, private equity sponsors should be mindful of the advantages and disadvantages of using two-step merger structures in public company acquisitions and should carefully assess whether a two-step merger structure will be consistent with their objectives given the particular facts and circumstances.

PROPOSED AMENDMENT

The proposed new subparagraph (h) of Section 251 of the DGCL, which is only available to Delaware corporations with exchange-listed shares or shares held by more than 2,000 record holders immediately prior to the execution of the merger agreement, provides that stockholder approval is not required if:

- (1) the acquiror and the target corporation enter into a merger agreement on or after August 1, 2013 that expressly provides that the merger will be governed by Section 251(h) and effected as soon as practicable after the consummation of the tender offer;
- (2) the acquiror consummates a tender offer for any and all of the outstanding stock of the target corporation that would be entitled to vote to adopt the merger agreement;
- (3) following consummation of the tender offer, the acquiror owns at least the required percentage (typically a majority) of each class or series of stock of the target corporation that otherwise would have been required to adopt the merger agreement;
- (4) at the time the target corporation's board of directors approved the merger agreement, no other party to the merger agreement is an "interested stockholder" (as such term is defined in Section 203 of the DGCL) of the target corporation;
- (5) the acquiror merges with or into the target corporation pursuant to the merger agreement; and
- (6) the shares of the target corporation that are not acquired in the tender offer are converted in the merger into the same amount and kind of consideration paid for shares of the target corporation in the tender offer.

CURRENT TWO-STEP MERGER STRUCTURES

While strategic acquirors often utilize a two-step merger structure in order to more quickly gain control of a public target, most going-private transactions by private equity sponsors are structured as a one-step merger due to a variety of considerations, including complications that can arise in obtaining debt financing in two-step merger transactions. In particular, unless lenders are able and willing to make a "margin loan" to fund the first-step tender offer (which can be challenging in this context), debt financing sources will not provide funding until the closing of the second-step merger because, until that occurs and the target becomes wholly owned by the acquiror, they do not have access to the target corporation's assets and cash flows.

To the extent private equity sponsors structure an acquisition as a two-step merger, in order to alleviate debt financing complications, they typically seek to consummate the second-step merger on the same day that the first-step tender offer is completed. This requires the sponsor to reach a 90% ownership through the tender offer (potentially in conjunction with the exercise

of a “top-up” option¹) so that it has the requisite 90% ownership necessary to complete a short-form merger without seeking stockholder approval.

Some recent going-private transactions have employed a dual track structure in which the acquiror commences a tender offer and the target corporation files a preliminary proxy statement, and seeks SEC clearance thereof, during the pendency of the tender offer. This structure provides the benefit of the speed of a tender offer (to the extent the tender offer conditions can be timely satisfied), with the safety net of obtaining stockholder approval required in a traditional one-step merger (without the loss of time) if the tender offer fails to be consummated quickly due to a high tender offer acceptance condition or otherwise. However, this structure typically is only viable when the target corporation has a relatively large number of authorized and unissued and unreserved shares available to allow for a top-up option.

IMPACT OF THE PROPOSED AMENDMENT

The proposed Section 251(h) would simplify the ability for acquirors, including private equity sponsors, to effect tender offers by eliminating the need for a high tender offer acceptance condition, top-up option and/or dual-track structure. As a result, following the approval and effectiveness of Section 251(h), we anticipate that target corporations may increasingly seek to utilize a two-step merger structure in going-private transactions, particularly those involving private equity sponsors.

CERTAIN CONSIDERATIONS

Private equity sponsors should keep in mind certain considerations in determining whether to structure an acquisition as a two-step merger that exist today, and that will continue to exist if Section 251(h) is adopted, including, among others:

- Impact of Antitrust and Other Regulatory Approvals. The primary advantage of a two-step merger structure is that a tender offer can generally be completed much more quickly than a one-step merger. This timing advantage may not be available if the transaction will be subject to a regulatory review process that would extend beyond the typical one-step merger timetable. Examples include circumstances where antitrust approvals will take an extended period of time to obtain due to substantive delays or the extended approval process in certain non-U.S. jurisdictions and/or the target

¹ To assist acquirors in obtaining enough shares to reach the 90% short-form merger threshold, market practice has developed the use of “top-up” options whereby target corporations permit the acquiror to purchase through delivery of a promissory note and a nominal amount of cash, in addition to the shares acquired in the tender offer, the minimum number of newly issued shares from the target corporation that would be necessary for the acquiror to effect a short-form merger. Because of the dilutive effect of issuances under the top-up option, a significant number of authorized and unissued and unreserved shares of the target corporation are required. In many cases, a target corporation may not have a sufficient number of such shares. As a result, private equity sponsors often must require a minimum tender offer acceptance condition significantly higher than 50% of the outstanding shares of the target. For example, if a target corporation had a number of authorized and unissued and unreserved shares equal to the number of outstanding shares, 80% of the outstanding shares must be tendered in order for the top-up option to result in 90% ownership by the acquiror.

corporation operates in a regulated industry (e.g., utilities, communications, insurance, defense, gaming, banking, etc.) that would require a separate transaction approval.

- Longer Exposure to Interlopers and Intervening Events in Some Circumstances and Other Potential Limitations. In the event that the consummation of a transaction is subject to a protracted regulatory review process as described above or is otherwise delayed, a tender offer remains open and subject to the risk that an interloper will make a “superior proposal” or an “intervening event” occurs until the tender offer is consummated. However, in a one-step merger transaction, once stockholder approval is obtained, the target corporation typically cannot terminate a merger agreement to accept a superior proposal or due to the occurrence of an intervening event. In addition, in the event an interloper makes a superior proposal during the pendency of a first-step tender offer, any negotiations or discussions between the acquiror and the target corporation or third parties (to preserve its then-pending transaction or otherwise) must be promptly disclosed publicly under the tender offer rules; these disclosure obligations are generally not applicable in a one-step merger.
- Potentially Greater Liability Exposure. Because a tender offer is a direct offer by the acquiror to the target corporation’s stockholders to purchase their shares, the failure by the acquiror to close the tender offer when required after the tender offer conditions are satisfied could expose the acquiror to direct claims by the target corporation’s stockholders and these claims potentially would not be subject to any reverse termination fee, damages cap or other liability limitation provisions that are typically included in the merger agreement. In addition, the SEC has, in certain two-step merger transactions, required that the private equity fund entity directly sign the tender offer documents, thereby assuming any attendant securities law liabilities.
- Additional Pressure to Quickly Market Debt Financing. The emphasis of speed in a two-step merger transaction places additional pressure on the acquiror to be prepared to complete the marketing of the debt financing quickly and, if high yield financing is used, to potentially use more expensive bridge financing to close the transaction. With a shorter period of time to close the transaction, there may be fewer available marketing “windows” for the debt financing. The limited availability of marketing windows may increase the likelihood that the acquiror determines to close the debt financing into escrow, which will increase the financing costs, as well as the acquiror’s cost if the transaction does not ultimately close. In addition, if shortly after signing the target corporation’s financial statements will become “stale” for debt marketing purposes, or there are customary marketing “blackout” periods (e.g., late August, the December holiday period, etc.), the benefits of a two-step merger structure could be reduced because of the delay in preparing current financial statements or the inability to complete the marketing of the debt financing during any such blackout periods.
- More Limited Period to Enter into Equity Rollover Agreements. Federal tender offer rules provide that acquirors generally may not purchase or arrange to purchase the target corporation’s stock outside of the tender offer. Therefore, any proposed equity

rollover (by management or otherwise) must typically be negotiated prior to the signing of the merger agreement in respect of a two-step merger transaction. These requirements also can make it impractical to effect a rollover of employee equity by anyone other than a small group of senior management of the target corporation.

- Potential Delays if Transaction Subject to SEC's "Going-Private" Transaction Rules. If the two-step merger transaction is deemed to be a "going-private" transaction subject to Rule 13e-3 of the Exchange Act, the first-step tender offer would require enhanced disclosure and be subject to increased scrutiny and comment by the SEC, which could delay the consummation of the tender offer and thereby reduce some of the benefit of a two-step merger structure, although typically not for a longer period than would be the case if a proxy statement were prepared in connection with obtaining a stockholder vote in a one-step merger.
- Tactical Considerations Should Be Evaluated. There may be certain tactical considerations related to stockholder participation in tender offers versus one-step mergers requiring stockholder approval that may favor or disfavor a two-step merger structure approach based on the particular transaction. As a result, private equity sponsors should carefully evaluate with the assistance of their counsel and outside advisors the particular facts and circumstances of any applicable public company acquisition and the potential advantages and disadvantages of a two-step acquisition structure that exist and/or may arise following signing.

If adopted, the proposed amendment to DGCL Section 251 will ease the ability for acquirors, particularly those using debt financing, to structure certain public company acquisitions as tender offers. Consequently, private equity sponsors may face increasing pressure to employ two-step merger structures in connection with public company acquisitions. Before agreeing to implement a two-step merger structure in a take-private transaction, private equity sponsors should carefully consider whether such structures are appropriate given their objectives and the applicable circumstances.

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