PAUL HASTINGS
STAY CURRENT
A CLIENT ALERT FROM PAUL HASTINGS

May 2014

Tender Offers: Past, Present and Future—the Evolution of Section 251(h)

BY CARL SANCHEZ, ELIZABETH RAZZANO & LAURA MCGURTY

Prior to August 1, 2013, deal lawyers generally had two ways to structure a public company acquisition of a Delaware corporation — a statutory merger, whereby a vote of the target stockholders was required to approve the transaction (i.e., a long-form merger), or a two-step tender offer, whereby the buyer would undertake a first-step public tender offer, followed by a second-step merger (in either the form of a long-form merger or a short-form merger[1]) to eliminate any residual outstanding interest, resulting in the buyer owning 100% of the target's outstanding shares. Absent regulatory concerns, a two-step tender offer generally was considered a faster route to completing an acquisition. However, buyers who did not acquire at least 90% of the outstanding shares of the target company in the first-step tender offer were then required to undertake a long-form merger, which necessarily required the preparation of a proxy statement and the holding of a stockholder meeting to approve the merger. The expense and additional time required to complete the acquisition was unappealing to most buyers. Any buyer or seller trying to fast-track a deal and any deal lawyer who has labored over a "top-up" calculation spreadsheet or navigated the drafting of a "dual track" merger has surely thought, "There has to be a better way."

Delaware lawmakers answered the call with the enactment of Section 251(h) of the DGCL,[2] which became effective on August 1, 2013. Subject to certain conditions, Section 251(h) allows buyers who, following the consummation of a tender offer, own at least such percentage of the target's stock that, absent Section 251(h), would have been required to adopt the merger agreement under the target's certificate of incorporation and the DGCL, to effect a second-step short-form merger without a vote of the target's stockholders.

Section 251(h) has already been warmly embraced by the deal community, with 28 of the 30 Delaware-governed tender offer deals executed between August 1, 2013 and April 7, 2014 opting in to Section 251(h). However, some practical questions have arisen regarding its implementation and Delaware lawmakers again responded to the concerns of practitioners with proposed amendments to Section 251(h) that will answer those questions and improve the statute's overall utility. The proposed amendments would, among other things, (i) clarify ownership and timing requirements, (ii) provide flexibility between the use of Section 251(h), Section 253 of the DGCL or a long-form merger, and (iii) eliminate the restriction against the use of Section 251(h) by an "interested stockholder." To gain a full appreciation for where the statute is headed, we must first take a brief look at the tender offers of old and examine the benefits of, and questions raised by, Section 251(h).

The Past: The Traditional Approach to Tender Offers

Prior to the enactment of Section 251(h), buyers who wanted to avoid the expense and delay of a stockholder vote to approve a merger had the option to pursue a two-step transaction with a tender offer followed by a statutorily permitted short-form (or second-step) merger without a vote of the target stockholders; however, this option was only available to buyers who could obtain the statutorily required minimum of 90% of the target's shares in the front-end tender offer. If necessary, buyers could close the front-end tender offer and use subsequent offering periods to achieve the 90% threshold requirement. In addition, buyers typically negotiated for a "top-up" option that enabled them to buy the shares needed to reach the 90% threshold directly from the target company, but this ace in the hole could only be played if the target had enough authorized and unissued shares to get the buyer to 90%. Buyers who were ultimately unable to achieve the 90% threshold necessary to bypass the stockholder vote and effect a short-form merger found themselves in the very position they were trying to avoid: filing a proxy statement and waiting for a vote of the target's stockholders to approve the transaction, despite the fact that they had obtained greater than a majority of the target's shares in the tender offer. Savvy deal lawyers used "dual track" structures in an attempt to eliminate some of the delay experienced when a first-step tender offer failed to reach the short-form merger threshold. The "dual track" structure, while providing an alternative path to completion of the merger in the event a 90% threshold proved too high, did no favors to the patience or the pocketbooks of transaction parties who found themselves headed toward a stockholder vote.

This begged the question: Why should there be an unnecessary delay to completion of the transaction while waiting to obtain a majority vote, when a majority of the target's shares had been tendered into the tender offer? Why should a buyer and target unable to reach the 90% threshold miss out on the advantages of a getting a deal done quickly even though the shares tendered represent the requisite percentage of shares necessary to approve the merger?

The Present: Section 251(h)—Bridging the Gap and Raising Questions

Section 251(h) was designed to bridge the gap that existed between the majority vote requirement of a long-form merger under Section 251(c) and the 90% threshold of a two-step tender offer and short-form merger under Section 253. The key feature of Section 251(h) is that it lowers the ownership threshold at which a buyer can effect a second-step merger without a vote of the target's stockholders. Specifically, Section 251(h) allows a buyer who, following consummation of a tender offer, owns a sufficient percentage of the shares (usually a simple majority) of its publicly held target as would be necessary to approve the merger agreement under Delaware law and the target's certificate of incorporation to effect a second-step merger without a vote of the target's stockholders.[3] By lowering the ownership threshold necessary for a second-step merger from 90% to a majority, Section 251(h) gives both parties the ability to complete the second-step merger as expeditiously as possible and enables target companies to get merger proceeds into the hands of their stockholders as soon as possible.

Section 251(h) also gives buyers who need to obtain third-party financing to complete a transaction an opportunity to compete with buyers that have readily available cash by allowing each of them to complete a transaction on the same timeline. Buyers that require financing to complete a transaction can face challenges in securing the necessary funds on desirable terms without having access to the target's underlying assets for use as collateral. Conducting a two-step transaction involving some interim level of majority ownership of the target, but less than the 90% necessary to effect a short-form merger, presented significant financing challenges for these financial buyers, who instead had to opt for a long-form merger and the added delay and expense that came with it. However, because of the reduced ownership threshold offered by Section 251(h), buyers requiring financing can now utilize a two-step tender offer structure and the advantage historically held by buyers not requiring financing has been reduced significantly. The resulting benefit to targets is that arguably they now have a larger pool of buyers able to deliver bid proposals structured as two-step tender offers, allowing them to focus on the more substantive terms of the proposals, such as price. In fact, 13 of the 28 Section 251(h) deals executed since the statute became effective contain a financing component. In the absence of Section 251(h), some of those bids would almost certainly have been structured as long-form mergers, perhaps making them uncompetitive where other bidders could complete a transaction structured as a two-step tender offer on a faster timeline.

Timing: Consummation and Ownership—When May a Buyer Proceed under Section 251(h)?

As is the case (or at least the goal) in most tender offers, the closing of the second-step merger occurs immediately following the closing of the first-step tender offer, often within minutes or hours. However, Section 251(h), while requiring that the tender offer be “consummated” before the buyer can proceed with the second-step merger, does not expressly state when consummation of the tender offer has been deemed to occur such that a buyer can proceed with the second-step merger. This has led buyers and targets to subjectively interpret when the tender offer has been “consummated.” Fourteen of the 28 merger agreements opting in to Section 251(h) since it became effective took the position that the consummation of the tender offer would occur when the tendered shares were accepted for payment, eight of the 28 agreements required acceptance *and* payment, and the remaining six agreements simply provided that the merger would be closed as soon as practicable after “consummation of the offer” without specifying when “consummation” was deemed to have occurred. If “consummation” requires acceptance *and* payment, closing of the second-step merger could be delayed, potentially by a few days, if the payment for shares in the first-step tender offer is not concurrent with the acceptance of the shares. Thus, the meaning of “consummation” is significant, as it marks the specific point in time at which a buyer must own the requisite number of shares to qualify for Section 251(h), which dictates how quickly a buyer can close the second-step merger.

Another issue with the completion of a two-step transaction under Section 251(h) arises with respect to the buyer’s “ownership” of target shares following consummation of the first-step tender offer. In order for a buyer to effect a second-step merger without a vote of the target’s stockholders, Section 251(h) requires that following the consummation of the tender offer, the buyer “owns” at least such percentage of the stock of the target that, absent Section 251(h), would be required to adopt the merger agreement under the DGCL and the target’s certificate of incorporation (i.e., usually, a majority of the *outstanding* shares,[4] which is consistent with the voting requirement of Section 251(c) of the DGCL). Similar to the “consummation” requirement, Section 251(h) is silent as to what shares are included in the calculation of ownership and whether convertible securities should be taken into consideration in calculating the requisite percentage of ownership. We note that, consistent with traditional two-step transactions, all 28 of the Section 251(h) deals executed since the statute became effective contain a minimum tender condition providing that the tender offer will not close until at least a majority of the target’s shares have been tendered into the offer and that, despite the language and intent of Section 251(h), 24 of those 28 deals based this majority threshold on the target’s fully diluted capitalization. If Section 251(h) is intended to mirror the voting requirements of a long-form merger under Section 251(c) (i.e., a majority of the “outstanding shares”), then shouldn’t ownership based on the fully diluted share count theoretically be irrelevant? Does a buyer need to be concerned that a holder of convertible securities might exercise or convert such securities in the time between closing of the first-step tender offer and closing of the second-step merger, thus decreasing the percentage of shares buyer then owns below the necessary threshold for Section 251(h)? And what about shares delivered via a notice of guaranteed delivery? Can a buyer count those shares toward the ownership requirement?[5] Each of these questions ties back into the meaning of "consummation" and ultimately the timing of the completion of the second-step merger.

Fear of Commitment: Opting In While Maintaining an Out

Parties who want to take advantage of Section 251(h) must specifically "opt in" via a statement in the merger agreement that "expressly provides that such merger shall be governed by" Section 251(h), and the merger agreement must provide that the merger will be effected as soon as practicable following consummation of the tender offer. Transactions that have opted in as of mid-April 2014 almost universally include the "opt in" language in the recitals of the merger agreement, with most agreements reiterating that the merger is to be governed by Section 251(h) in the provisions describing the timing for closing of the merger. While the mechanics for opting in to Section 251(h) are clear, exactly how the statute should impact the form and function of transactions is less clear, as reflected in merger agreements inked since Section 251(h) took effect. Parties crafting merger agreements under Section 251(h) have been reluctant to give up the safety net provided by certain features found in pre-Section 251(h) merger agreements, perhaps a reflection of deal makers' uncertainty as to how things will play out under the new statute. For instance, the accelerated transaction timeline facilitated by Section 251(h)'s lower tender offer threshold should obviate the need for merger agreement provisions allowing the buyer to appoint a pro rata portion of the target's board of directors during the interim period between the consummation of the tender offer and the closing of the merger (and, as a result, eliminate the target's obligation to file a Section 14(f) Information Statement along with its tender offer materials). However, 21 of the 28 transactions that opted in to Section 251(h) since it became effective still included pro rata board designation provisions in their merger agreements, and 11 of those targets went through the time and expense of preparing and filing an Information Statement with their Schedule 14D-9 even though there was seemingly no gap in time between the closing of the tender offer and the merger. Four of the 28 tender offers reviewed took the "kitchen sink" approach, including in their merger agreements a top-up option, a pro rata board designation provision and a covenant requiring the target to hold a stockholder meeting if required by the DGCL, despite the fact that each of these agreements expressly provided that Section 251(h) would govern.

If the parties have opted in to Section 251(h), why do they still feel compelled to include these seemingly unnecessary provisions in their merger agreements? If the merger agreement provides that the merger *shall be governed by Section 251(h)*, are the parties even permitted to change course and pursue the transaction via a traditional short-form or long-form merger?

Interested Stockholders Not Welcome

Unlike a traditional tender offer with a second-step short-form merger under Section 253 of the DGCL, Section 251(h) is not available for transactions involving a buyer that is an "interested stockholder" as defined in Section 203 of the DGCL, regardless of whether the target has opted out of Section 203 or an exemption to Section 203 would otherwise apply. This limitation has been perceived as prohibiting a buyer in an arms-length transaction from entering into tender and support agreements with target stockholders who collectively own 15% or more of the target's voting stock, which leaves buyers faced with a choice between the efficiency and cost-effectiveness of Section 251(h) and the security of locking up greater than 15% of the target shares. At least some commentary has suggested that because Section 251(h) represents such a significant change in the transactional landscape, lawmakers wanted to restrict its applicability, at least initially, to deals where conflicts were less likely to exist.[6]

The Future: Responding to Questions and Refining Section 251(h)

While revealing itself as a valuable transaction tool, the prevalent[7] use of Section 251(h) has raised several questions with respect to the statutory language, some of which could be clarified or revised in order to enhance the ability of the statute to serve its intended purpose. With less than a year of Section 251(h) experience in their rearview mirror, Delaware lawmakers have already taken steps to address the questions referenced above with proposed amendments to Section 251(h) that, if enacted, will take effect for merger agreements executed starting on or after August 1, 2014.[8] The proposed amendments would, among other things, (i) define "consummation" and clarify the ambiguity surrounding "ownership" requirements, (ii) provide flexibility between the use of Section 251(h), Section 253 of the DGCL or a long-form merger, and (iii) eliminate the restriction against the use of Section 251(h) by an "interested stockholder."

Timing: Consummation Defined and Ownership Clarified

As discussed earlier, the term "consummation" (and correlative terms) is not currently defined under Section 251(h), which has led to uncertainty as to when a buyer may proceed with effecting a second-step merger under Section 251(h). Reflective of the statute's purpose — to enable parties to expeditiously effect a second-step merger upon receipt of the requisite level of tenders — the proposed amendments define "consummation" as the irrevocable "*acceptance for purchase*" of the shares tendered, thus eliminating any uncertainty as to when the buyer may proceed with effecting the second-step merger, assuming buyer meets the requisite ownership threshold. By not requiring payment for the shares prior to effecting a merger, parties to a tender offer can further ensure an expedited closing of the transaction.

In addition, the proposed amendments also clarify when a buyer is deemed to "own" target shares (and which shares are counted) for purposes of allowing the buyer to proceed with the second-step merger. The proposed amendments provide that following the consummation of the offer, the stock *irrevocably accepted for purchase and received by the depository prior to the expiration of such offer, plus the stock otherwise owned by the buyer* equals at least such percentage of stock of the target that, absent Section 251(h), would be required to adopt the merger agreement under the DGCL and the target's certificate of incorporation. The term "*received*" is defined as the "physical receipt of a stock certificate in the case of certificated shares and transfer into the depository's account, or an agent's message being received by the depository, in the case of uncertificated shares." This proposed change makes clear that shares delivered via a notice of guaranteed delivery would not be deemed "owned" by the buyer for purposes of Section 251(h). In addition, because satisfaction of the ownership requirement is determined immediately following consummation of the tender offer and only those shares received by the depository plus those shares otherwise owned by the buyer are counted for purposes determining whether a buyer can proceed with a second-step merger under Section 251(h), the need for basing ownership calculations on a fully diluted share count should be unnecessary.

No Commitment Necessary: Maintaining a Backup Plan

The proposed amendments would also make it clear that the parties may draft the merger agreement to either *permit or require* the merger to be governed by Section 251(h), whereas the statute as originally drafted could be interpreted as obligating the parties to enter into a merger agreement that requires Section 251(h) treatment. A merger agreement that "expressly (i) permits or requires such merger to be effected under" Section 251(h) may take advantage of the statute's benefits, but a merger agreement drafted to *permit* rather than require the use of Section 251(h) also allows the parties to retain the option to pursue the merger under a different method (e.g., a long-form merger) if they become unwilling or unable to proceed under Section 251(h).[9] However, because the parties in this scenario may turn to a traditional tender offer structure or long-form merger, many of the provisions that could otherwise be trimmed out of a merger agreement in the Section 251(h) context will have to be retained, thus removing some of the simplicity offered by the statute. Regardless of whether the merger agreement merely permits or actually requires the use of Section 251(h), the revised statute would continue to require that "such merger shall be effected as soon as practicable following consummation of the offer … if such merger is effected under" Section 251(h).

Interested Stockholders: The Ban is Lifted

Perhaps the most significant change in the proposed amendments is the elimination of the restriction against the use of Section 251(h) by an "interested stockholder." This change would alleviate a buyer's fear that entering into arrangements with target stockholders could cause the buyer to become an "interested stockholder" and render the deal ineligible for Section 251(h). As a result, the market would likely experience a resurgence in the use of tender and support agreements between buyers and key target stockholders, which buyers were otherwise abandoning in favor of Section 251(h) treatment. In addition, this change would likely expand the use of the tender offer structure in "going private" transactions.

Additional Amendments

Additional revisions contained in the proposed amendments are aimed at the more administrative aspects of structuring the tender offer. The statute would be amended to clarify that the buyer's tender offer for "*any and all* of the outstanding stock" of the constituent corporation may exclude those shares owned by "(i) such constituent corporation; (ii) the corporation making such offer; (iii) any person that owns, directly or indirectly, all of the outstanding stock of the corporation making such offer; or (iv) any direct or indirect wholly-owned subsidiary of any of the foregoing." The revised statute's explicit reference to the exclusion of these shares more accurately reflects the mechanics already being employed by tender offer parties. In further clarifying which target shares are the subject of the statute, the proposed amendments provide that the shares that are "the subject of and not irrevocably accepted for purchase or exchange in the tender offer" must receive the same consideration in the second-step merger as those tendered into the offer. The foregoing two changes, taken together, reinforce the ability of the parties to essentially ignore shares associated with the constituent corporations for purposes of the tender offer and provide for the cancelation of those shares in the second-step merger.

Conclusion

It remains to be seen whether the proposed amendments, if enacted, will answer all of the questions raised by the implementation of Section 251(h) or if further refining will be necessary. What is clear is that Delaware lawmakers continue to be responsive to the concerns of practitioners and are determined to craft an effective statute. The market stands ready to take advantage of all the benefits Section 251(h) has to offer.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Reinaldo Pascual
1.404.815.2227
reypascual@paulhastings.com

Chicago

Thaddeus (Thad) J. Malik
1.312.499.6020
thaddeusmalik@paulhastings.com

Los Angeles

Claudia Simon
1.213.683.6199
claudiasimon@paulhastings.com

New York

Luke P. Iovine
1.212.318.6448
lukeiovine@paulhastings.com

Orange County

Brandon Howald
1.714.668.6239
brandonhowald@paulhastings.com

Palo Alto

Rob Carlson
1.650.320.1830
robcarlson@paulhastings.com

San Diego

Carl R. Sanchez
1.858.458.3030
carlsanchez@paulhastings.com

Elizabeth A. Razzano
1.858.458.3035
elizabethrazzano@paulhastings.com

Washington, D.C.

Eric D. Greenberg
1.202.551.1343
ericgreenberg@paulhastings.com

---

1 A short-form merger under Section 253 of the DGCL does not require approval by the target's stockholders. However, it can be used only if the buyer owns at least 90% of the target's outstanding shares after the first-step tender offer.

2 Section 251(h) of the DCGL provides that "Notwithstanding the requirements of subsection (c) of this section, unless expressly required by its certificate of incorporation, no vote of stockholders of a constituent corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the agreement of merger by such constituent corporation shall be necessary to authorize a merger if: (1) The agreement of merger, which must be entered into on or after August 1, 2013, expressly provides that such merger shall be governed by this subsection and shall be effected as soon as practicable following the consummation of the offer referred to in paragraph (h)(2) of this section; (2) A corporation consummates a tender or exchange offer for any and all of the outstanding stock of such constituent corporation on the terms provided in such agreement of merger that, absent this subsection, would be entitled to vote on the adoption or rejection of the agreement of merger; (3) Following the consummation of such offer, the consummating corporation owns at least such percentage of the stock, and of each class or series thereof, of such constituent corporation that, absent this subsection, would be required to adopt the agreement of merger by this chapter and by the certificate of incorporation of such constituent corporation; (4) At the time such constituent corporation's board of directors approves the agreement of merger, no other party to such agreement is an 'interested stockholder' (as defined in § 203(c) of this title) of such constituent corporation; (5) The corporation consummating the offer described in paragraph (h)(2) of this section merges with or into such constituent corporation pursuant to such agreement; and (6) The outstanding shares of each class or series of stock of the constituent corporation not to be canceled in the merger are to be converted in such merger into, or into the right to receive, the same amount and kind of cash, property, rights, or securities paid for shares of such class or series of stock of such constituent corporation upon consummation of the offer referred to in paragraph (h)(2) of this section. . . ."

3 In most cases, this will do away with the need for merger agreements to include a "top-up" option or subsequent offering period provisions, which existed almost entirely for the purpose of aiding the buyer in reaching the 90% threshold. As of April 7, 2014, only six of the 28 tender offers that have opted in to Section 251(h) since it became effective included a top-up option provision, and five of those merger agreements explicitly stated that the top-up option would only be exercisable if the merger could not be effected under Section 251(h).

4 In most cases, a "majority of the outstanding shares" was calculated using the target's fully-diluted capitalization as the denominator in the equation, typically resulting in a materially higher threshold of shares needed to close the first-step tender offer.

5 Only one of the 28 Section 251(h) deals executed since the statute became effective expressly permitted, at the buyer's option, the inclusion of shares subject to a notice of guaranteed delivery, while 20 of those deals specifically excluded shares subject to a notice of guaranteed delivery and the remaining seven deals were silent on the issue.

[6] Tender Offers Under the New Delaware Law (October 30, 2013), http://deallawyers.com/member/Programs/Webcast/2013/10_30/transcript.htm.

[7] A review of tender offer deals executed since Section 251(h) became effective revealed that only two of the 30 Delaware-governed tender offers did not "opt in" to Section 251(h).

[8] The proposed amendments to Section 251(h) are linked here. Please note that the link provided contains other proposed amendments to the DGCL, which are not addressed in this article.

[9] This can become important in the context of transactions where the parties find themselves in the midst of a lengthy regulatory review, in which case the advantages of Section 251(h) are lost because the parties are unable to close the merger until such time as the requisite regulatory approvals are obtained, and continuing to leave the tender offer open exposes the deal to the risk of a topping bid, material adverse change or other market risk. As long as a tender offer remains open, the target company's board of directors may choose to exercise a fiduciary out to accept what they determine to be a superior proposal. On the other hand, if the parties switch course and pursue a stockholder vote, which they may do prior to receipt of regulatory clearance, once the approval of the target's stockholders is obtained, the target company no longer has this fiduciary out. In order to mitigate the risks of a topping bid or the deal otherwise going sour during an extended tender offer period, parties may want to retain the option to switch to a long-form merger in the event they find themselves faced with an unexpected regulatory delay, or they may be well-advised to opt for a long-form merger structure at the outset if they are fairly certain to face lengthy regulatory review, as was the case with the almost inevitable 75-day CFIUS review and investigation period imposed on China-based Shuanghui International Holdings Limited's acquisition of Smithfield Foods, Inc. in 2013.