Smoother squeeze-outs

Delaware law changes are set to change US take-privates. Purchasers and lenders will both be affected

Recent changes to the Delaware General Corporation Law (DGCL) facilitate tender offers, and simplify and expedite take-privates, of US publicly-listed Delaware corporations (targets). As these acquisitions are typically financed (at least partially) using debt, US and non-US strategic acquirers, private equity funds and other buyers – as well as the lenders financing such acquisitions, should be aware of the impact of US margin regulations on such financings. Among other requirements, the margin rules may limit the amount of credit extended to purchase US publicly-listed securities (margin stock) to 50% of the value of the acquired securities. Violations of US margin rules can result in criminal sanctions (including fines of up to $25 million for entities or $5 million for individuals and/or imprisonment), injunctive relief (including a bar on the underlying transaction) or the voiding of the offending financing documentation, leaving the lender unable to recover on its credit. Fortunately, through careful transaction structuring the same Delaware corporate changes may expand the availability of merger-related exceptions to the US margin regulation requirements for both bond and loan transactions.

What's changed

On August 1 2013, section 251(h) was added to the DGCL to streamline the acquisition of publicly-listed Delaware corporations through a tender offer. This section permits, in certain circumstances, a squeeze-out merger immediately following the tender of a majority of the outstanding shares. What constitutes a majority is mandated by the corporation's constitutional documents, but this is typically a simple majority. With more than half of US publicly-traded companies (and 64% of the Fortune 500) organised in Delaware, this change to the DGCL will facilitate the acquisition process for many targets.

How to squeeze-out

The two most common means of acquiring US publicly-listed companies are a so-called long-form merger and a tender offer coupled with a squeeze-out merger. A long-form merger is a single-step transaction whereby, following stockholder approval, the target and purchaser's merger subsidiary (bidco and, together with the purchaser, the purchaser parties) are combined. The shares of the target are converted into rights of the target's pre-merger stockholders to receive the merger consideration (usually cash and/or bidco stock) which is paid within three days following consummation of the merger. To consummate a long-form merger, majority stockholder approval is obtained via a proxy solicitation, which takes 60-90 days. Upon such consummation, the target files a Form 25 with the SEC to de-list its shares from the applicable national securities exchange (which is effective 10 business days later).

By contrast, a tender offer coupled with a squeeze-out merger is a two-step transaction. The purchaser parties make a direct offer to all of the target's stockholders to purchase all or a portion of their shares, with the purchase price paid to tendering stockholders once the offer is completed. Any non-tendering stockholders must then be squeezed out through a second-step merger. This second-step was historically completed by way of a long-form merger. This is subject to a proxy solicitation delay of 60-90 days, unless the purchaser parties acquire 90% of the target shares, which triggers the right to merge through a squeeze-out procedure that takes one to two business days (short-form merger) under DGCL section 253. The adoption of DGCL Section 251(h) means that the purchaser parties may now effect a short-form merger if, at the end of the relevant tender offer (which must be open for at least 20 business days), the purchaser parties acquire the majority of the target shares and satisfy certain other conditions. Upon consummation of the Short-form Merger, the target also files a Form 25 with the SEC.

The intent of US margin rules

The US margin regulations regulate debt used to purchase margin stock, if that debt is secured directly or indirectly by margin stock and no exception or exemption applies.

The US adopted these rules in response to the Great Depression, to reduce stock market volatility by restricting leveraged speculation in the stock market. In the context of the financing of a tender offer, the most relevant regulations are Regulation U, which applies to US lenders, and Regulation X which applies to US borrowers.

Regulation U governs US bank and non-bank lenders (other than broker-dealers, which are governed by Regulation T), including any US bank and its domestic and overseas subsidiaries, and any US agency or branch of a non-US bank (each, a US lender). Unless an exception or exemption is available, Regulation U restricts US Lenders from extending credit used to buy or refinance margin stock (purpose credit) that is secured directly or indirectly by margin stock (being stock pledged as collateral to the lenders or subject to an arrangement that restricts disposal thereof) in excess 50% of the current market value of the acquired margin stock (a burdensome limitation for many purchasers and lenders). It also imposes certain reporting and filing requirements. Collectively, these are referred to as the margin limitations. Critically, Regulation U applies to any financing in which a US Lender participates in a syndicated loan (be it originally or through primary syndication) or purchases privately-placed notes. Publicly-listed bonds are not regulated by the US margin regulations.

Regulation X imposes requirements on US borrowers obtaining purpose credit that will be secured directly or indirectly by margin stock. Under Regulation X no US person, non-US person controlled by a US person, or person acting on behalf of or in conjunction with any US person (each, a US borrower) may borrow purpose credit from any lender to purchase or refinance US margin stock anywhere (or non-US margin stock within the US), if the credit would be prohibited if it had been made by a US lender. If no lender is a US Lender, but one or more of the purchaser parties is a US borrower and the credit is purpose credit secured directly or indirectly by margin stock, the margin limitations will apply (unless an exception or exemption is available).

If any lender is a US lender or any purchaser party is a US borrower, the US margin regulations will apply, even if all parties are located outside the US. In this situation, the next determinations to be made are whether the credit is purpose credit, whether it is secured directly or indirectly by margin stock, and whether any exception or exemption applies.

In the take-private context, because the target shares are delisted only after the relevant merger, any credit used to finance the transaction likely constitutes purpose credit. As such, the focus of the analysis is on whether the credit is directly or indirectly secured by margin stock. Typically in a tender offer context, the target stock is not pledged to the lenders, but the financing documentation contains negative covenants (such as a negative pledge and a restriction on disposition) applicable to the borrower's assets (including the target shares being purchased). In this sense, the credit is presumed to be indirectly secured by such margin stock, unless an exception or exemption applies.

25% cap exception

Notwithstanding any negative covenants in the financing documentation, under Section 221.2 of Regulation U, the credit will not be considered to be indirectly secured by margin stock if, after applying the proceeds of the credit, not more than 25% of the value of the assets of the consolidated borrower group subject to such covenants (relevant assets) constitute margin stock. If the target is much smaller than the consolidated borrower group, such that the value of the target represents 25% or less of the relevant assets, this exception may be available organically. However, if the value of the target exceeds 25% of the relevant assets, the relevant negative covenants in the financing documentation can be drafted not to apply to any margin stock owned by the borrower valued in excess of the 25% threshold. Many lenders and borrowers historically have relied on the 25% cap exception in tender offers because it provides bright-line compliance, through either organic calculations or tailored negative covenants that by their terms do not apply to margin stock in excess of the 25% cap.

Outside the US exemption

Credit (whether directly or indirectly secured) that is extended outside the US by a foreign branch or foreign subsidiary of a US bank is exempt from Regulation U under section 221.6(c). To qualify for this exemption, the negotiation and execution of the financing documentation, the disbursement of the credit and, if applicable, the maintenance of collateral must all occur outside the US. Only a limited US nexus is permissible – credit approval may be obtained in the US and the credit may be denominated in US dollars (so long as the funding and recipient accounts are both outside the US). The outside the US exemption has the unfortunate disadvantage of reducing liquidity by limiting syndication to US lenders until the acquisition completes and the target is delisted. It can also be difficult to apply, with little guidance available on what minimal US contacts may be permitted. Accordingly, if a credit is not directly secured by margin stock, the 25% cap would ordinarily be preferable, but the outside the US exemption is the only available option for most directly-secured transactions.

"Careful transaction structuring may expand the availability of merger-related exceptions to US margin requirements

Junk bond interpretation and exceptions

If there is neither direct security nor any negative covenants that trigger indirect security, credit extended to a shell company (including a bidco) is still presumed to be indirectly secured under guidance delivered by the Federal Reserve in 1986 (FFRS 5-903). This presumption is based on the assumption that the lenders are implicitly relying on the acquired margin stock, which is the only asset of the borrower. However, the guidance helpfully provides that this presumption does not apply if:

- the credit is guaranteed by an entity with substantial non-margin stock assets;
- a merger agreement is entered into between the shell company and the target before the credit is advanced; or
- the obligation to advance the credit to the shell company is conditioned upon the shell company acquiring the minimum amount of the target's stock necessary under applicable law to complete a short-form merger of the shell company and the target (short-form merger exception).

Under the guidance, these three exceptions apply largely if the take-private financing is achieved via a bond or note issued by a bidco, because a loan agreement typically includes negative covenants that trigger the presumption that the margin stock indirectly secures the credit. Still, in the case of a financing via qualifying bonds or notes, DGCL section 251(h) makes the short-form merger exception more usable in a tender offer context.

Good-faith non-reliance exception

If none of the other exceptions or exemptions are available, section 221.2 of Regulation U provides that a credit is not indirectly secured by margin stock if the lender can demonstrate in good faith that it has not relied upon the margin stock in extending or maintaining the credit. This exception is entirely fact-dependent and, in the absence of substantive guidance on proving good faith non-reliance, lenders and borrowers have been reluctant to apply this exception to tender offers. However, where DGCL section 251(h) facilitates the more efficient consummation of a Short-form merger following a tender offer, there appear to be legitimate grounds for good-faith non-reliance. As with the Short-form merger exception to the so-called Junk bond interpretation, if funding under a loan agreement is conditioned upon the purchaser parties purchasing the majority of the target stock, a compelling case can be made that lenders in good faith have not relied upon the margin stock in extending the credit. This is because it is clear that the borrower will be able to complete the short-form merger required to take the target private.

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