Challenges and Approaches in Financing Consensual Tender Offers

In the past two years, we have seen a resurgence of tender offers in M&A transactions. These “two-step” acquisitions can provide buyers with an efficient method of purchasing the outstanding shares of a public target by making a conditional offer to the target’s shareholders, followed by a second-step merger. As tender offer structures continue to become more prevalent, clients (both borrowers and lenders) will need to be aware of the particular challenges associated with financing cash bids for two-step acquisitions.

Tender Offer Timing: A Double-Edged Sword

The primary advantage of a tender offer is speed: If a sufficient number of shares is tendered (Delaware requires 90 percent of outstanding shares; other states may vary), the buyer can close the offer and then file a short-form merger immediately thereafter, with the entire process from launch of the tender to closing of the merger lasting as little as 20 business days. This is a much shorter time frame than a typical one-step merger, which requires preclearance of a proxy statement by the SEC and a scheduled shareholder meeting and can take three to four months to close after the merger agreement is signed. Moreover, obtaining even 50.1 percent in a tender offer eliminates the risk of third-party competing bidders more quickly than a one-step merger.

Conversely, if the buyer fails to reach the short-form merger threshold, some of the timing benefits of the tender offer structure are lost. The parties still will be able to consummate the acquisition of control, provided the buyer has obtained enough shares in the tender offer. Usually, a simple majority of outstanding shares is enough for the buyer to be able to vote its (controlling) shares in favor of the merger, but the prolonged timing of a “long-form” merger process will prevent the parties from closing the merger on an expedited basis. (However, as noted above, the buyer will have minimized the risk of third-party competition.) From a lender’s perspective, the long-form scenario requires attention to a number of unique issues:

- Prior to consummation of the back-end merger, the lenders typically will not have access to the target’s cash and other assets due to the lack of 100 percent ownership of the target.
- During the gap period prior to consummation of the merger, the nontendering minority shareholders will be entitled to their pro rata share of any dividends and other distributions from the target (although the merger agreement will typically prohibit or strictly limit such payments).
- The parties also may need to refinance the target’s existing debt upon the closing of the tender offer, because the acquisition of a majority of the target’s shares likely will trigger change-of-control provisions in the target’s existing debt documentation.

Tender Offers and the Federal Margin Regulations

In both the short-form and long-form scenarios, the margin regulations of the Board of Governors of the Federal Reserve System will need to be considered. The federal margin regulations limit a lender’s ability to extend credit for the purpose of buying or carrying “margin stock” (which includes publicly traded securities) if the credit is secured, either directly or indirectly, by such stock. Moreover, by defining “indirectly secured” somewhat broadly, the regulations may be applicable to transactions that on their face do not appear to be within the scope of the regulations. The regulations currently require that the maximum loan value to the buyer with respect to margin stock not exceed 50 percent of the current
market value of such stock. As a result, to ensure compliance with the regulations, the security package for tender offer financings may exclude some or all of the shares of the target that are acquired.

Tender Offer Financing Strategies

Given the legal impediments and practical risks involved in the long-form scenario, how do lenders get comfortable with financing cash tender offers? There are a number of potential mitigating factors.

• **Top-up options.** In recent years, tender offers increasingly have included a top-up option from the target to the buyer to purchase newly issued target shares after the closing of the tender offer in order to obtain enough shares to reach the required statutory short-form merger threshold (e.g., 90 percent of outstanding shares in Delaware). The size of the top-up option is limited by the amount of authorized but unissued shares of the target, and the significant dilutive effect of the issuance (which increases the number of outstanding shares, thereby increasing the number of shares necessary to achieve short-form merger threshold) will, as a practical matter, require the requisite tender percentage to be relatively close to the statutory short-form merger percentage in many cases. Although shareholders may seek to challenge the dilutive effect of top-up options on the value of the remaining shares, such challenges have been rejected in recent Delaware cases.

• **Minimum tender conditions.** Lenders often will require, as a condition to funding a tender offer financing facility, that a minimum percentage of outstanding shares be purchased in the initial stage of the tender offer; usually, this is the same percentage required under the merger agreement (typically 50.1 percent, but may be higher for a particular transaction). Lenders still must wait for the second step to close to obtain security interests in the target’s assets to support the financing.

• **Mixed collateral loans.** If the buyer or its parent is a creditworthy entity, the collateral package can include not only the shares of the target (though the margin regulations still must be considered), but also the assets of the buyer or its parent. However, this structure is likely to be available only in the case of a strategic buyer, as the buyer in a private equity deal typically will be a newly created acquisition vehicle without material assets. Consequently, recent tender offer financings structured as true “two-step” financings have involved strategic buyers, rather than private equity sponsors. The high-profile private equity-backed deals occurring in 2010, such as GTCR/Protection One, Bain/Gymboree and 3G Capital/Burger King, required the consummation of the merger as a condition to funding. Generally, true tender offer financing facilities for private equity sponsors (i.e., where consummation of the merger is not a condition to funding) have been rare in recent years, an exception being the acquisition of Biomet by a consortium of private equity sponsors including KKR, Blackstone, TPG and Goldman Sachs Capital Partners.

• **Target financing.** Another option, although not frequently utilized, is for the target itself to provide financing to the buyer. This structure can be particularly useful in tender offers by private equity buyers, provided the target has enough cash on hand or has access to its own financing sources.

• **Joint tender offers.** A joint tender offer conducted simultaneously by buyer and target is another potential alternative. The financing for the self-tender is provided directly to the target, with the lender obtaining security in the target’s assets (as opposed to the target’s shares). The joint tender structure involves significant participation from the target’s incumbent board, which may be difficult to obtain. In addition, because the shares acquired by the target in the self-tender do not vote, the relative portion of the financing provided to the target is limited in amount.

These examples of alternative structures highlight several of the issues that arise in financing cash bids for two-step acquisitions. As tender offer activity continues to increase, we expect these structures to be used more frequently, and new approaches to be formulated, to address the unique issues presented in financing these deals.

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1 In examination of a tender offer structure, careful attention must be paid to domicile of target company and possible variations of Delaware law.