Traps to Consider: Delaware's Merger Statute and Ratification Amendments

Amendments to the Delaware General Corporation Law are now formally before the legislature:
http://legis.delaware.gov/LIS/lis147.nsf/vwLegislation/HB+127/$file/legis.html?open

Two provisions – one relating to defective corporate authorizations and the other to mergers –will be of particular interest, as will the potential traps that may arise in connection with the merger statute amendment.

1. Proposed DGCL Section 204 would formalize and streamline a ratification process for curing defective corporate acts (i.e., corporate acts purported to have been validly taken but which turn out to have been defectively authorized, including issuances of shares in excess of the number authorized in the charter and equity issued where the acquirer or grantee believes the issuance to be valid but there was a defect in the authorization process). One important qualification: Stockholders must receive notice of all Section 204 ratifications and thereafter would be permitted to bring actions in Chancery Court to challenge Section 204 ratifications as inequitable.

2. Proposed paragraph (h) of DGCL Section 251 (the merger statute) would permit an immediate second-step merger (no stockholder vote, no proxy statement, no need for a top-up option; just the quick filing of a certificate of merger) immediately following any negotiated tender offer or exchange offer for a public company's shares that results in the bidder owning at least the number of shares necessary to approve a merger (typically 50.1%). This provision may well change the landscape of M&A structuring by pushing many more deals to the two-step structure (where, significantly, ISS and Glass Lewis normally do not make recommendations). Three potential traps to consider:

    (a) Relationships Between the Bidder and Significant Stockholders May Limit Use of Section 251(h). To be eligible for new Section 251(h), the bidder may not be an "interested stockholder" under DGCL Section 203 at the time the target board approves the merger agreement. This restriction is broader than a provision that merely states that the second-step merger may not be with a party that is subject to Section 203. Most insiders that own at least 15% of an issuer's shares are exempt from

CLEARY
GOTTLIEB

Section 203 due to the board's pre-approval of their acquisitions of shares. But these 15% holders, notwithstanding their exemption from Section 203, still fall within the definition of "interested stockholder" and therefore would not be entitled to take advantage of Section 251(h). Moreover, most practitioners (due to the dearth of Section 203 case law and the breadth of the statutory language) have typically adopted a broad reading of the concept of "ownership" for purposes of the definition of "interested stockholder" under Section 203. As a result, understandings and arrangements between the bidder and a 15% stockholder may result in the bidder itself being an "interested stockholder." Even though these understandings and arrangements may be pre-approved by the target board and therefore exempt the bidder from Section 203, the bidder's transaction would still be rendered ineligible for Section 251(h) if any of these understandings or arrangements were to arise before the target board's approval of the merger agreement. Although a support agreement between the bidder and a 15% stockholder (where the stockholder would make undertakings relating to voting, transferring and tendering for the benefit of the bidder) could cause the bidder to itself be an "interested stockholder," Section 251(h) should still be available so long as the support agreement is not signed prior to the target board's approval of the merger agreement and prior to that time there was no understanding between the bidder and the stockholder that resulted in the bidder being deemed an interested stockholder .

(b) Equity Rollovers under Section 251(h). In some merger structures, certain stockholders will have their shares converted into different consideration than the other stockholders. This is common, for example, in connection with financial sponsor transactions where all stockholders other than management receive cash consideration and management "rolls over" its equity into shares of the sponsor's acquisition vehicle. To avoid risks under the SEC's "best price rule" (which requires that the same consideration per share be paid in tender offers, but not in second-step mergers), rollovers may be done in a second-step merger when a two-step, all-cash tender offer structure is employed. But one of the requirements of the new Section 251(h) will be that the second step merger must squeeze-out the untendered shares for the same per share consideration as paid in the tender offer. Thus, a "best price rule"-compliant exchange or other alternative to a second step merger will have to be relied upon for implementing rollovers in an otherwise all-cash transaction if the parties are to preserve access to the expedited Section 251(h) structure.

(c) Funding Conditions. We've seen a number of heavily leveraged acquisitions by relatively small-cap acquirers in recent months. If these acquirers, as well as financial sponsor LBO buyers, are pushed toward the two-step structure as result of Section 251(h), there may be renewed pressure from the SEC staff, based on recent informal statements, to require bidders to hold tender offers open for five business days after satisfaction of a funding or disbursement condition to the tender offer (which condition is often included in highly leveraged tender offers). The staff's purpose in putting forth this position would be to protect those holders who were waiting to see whether this condition would be satisfied before tendering (by giving those holders the opportunity, during these extra five business days, to tender once they have learned that this funding condition to the offer would be satisfied). Despite the good intention of the SEC staff here, such a requirement may not be workable since it would require that the bidder assume the risk that the lending banks would fail to fund the debt financing for some reason that would not also permit the bidder to refuse to close the tender offer. More importantly, given that the non-tendering holders will be cashed out pursuant to the new Section 251(h) promptly after the closing of the tender offer, and at the tender offer price, this requirement is not needed to protect the non-tendering holders. Nonetheless, this is an issue for leveraged acquirers (and their targets) to consider carefully before committing to a two-step structure using the new Section 251(h).

In connection with these matters, please do not hesitate to reach out to your regular contacts at Cleary Gottlieb or any of the U.S. M&A lawyers listed and linked below.

Laurent Alpert	Christopher E. Austin	Richard J. Cooper
Robert P. Davis	David I. Gottlieb	William A. Groll
Ethan A. Klingsberg	David Leinwand	Jeffrey S. Lewis
Victor I. Lewkow	Paul Marquardt	Glenn P. McGrory
Filip Moerman	Benet J. O'Reilly	Michael L. Ryan
Matthew P. Salerno	Paul J. Shim	Neil Whoriskey

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099