Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Riding The BDC Consolidation Wave

Law360, New York (January 26, 2016, 2:28 PM ET) --


William J. Bielefeld


William J. Tuttle


Kenneth E. Young

The past 18 months have seen a wave of consolidation among business development companies (BDCs). Oak Hill Advisors LP took over the advisory role for NGP Capital Resources Co. (now OHA Investment Corp.) after the BDC ran a process to pursue strategic alternatives, PennantPark Floating Rate Capital Ltd. acquired MCG Capital Corp., and, as has been well publicized, TICC Capital Corp. has received advances from no fewer than three suitors.

If consolidation is coming to the BDC space, how will it work, and what do market participants need to know? Below, we seek to answer these questions for participants in the BDC arena and asset managers monitoring the space.

We believe there are several external factors that may make consolidation attractive to BDCs and asset managers in the current environment:

- ***Low Interest Rates.*** The low interest rate environment continues to compress yield margins for BDC investments. One way for a BDC to maintain a high level of net income in a low interest rate environment is to lower its overall cost structure. Consolidation can result in increased scale, which may result in nonadvisory costs being reduced as a percentage of net asset value (NAV). Unlike waiting for advantageous market conditions to raise additional equity capital, an acquisition may allow an exchange-listed BDC to achieve greater scale quickly.

- ***Impact of BDCs Trading Below NAV.*** Shares of many exchange-listed BDCs have recently been trading at or below NAV. Under the Investment Company Act of 1940, as amended (the "1940 Act"), a BDC cannot issue shares below the BDC's then-current NAV, absent stockholder approval, except in certain limited circumstances. As a result, many BDCs are currently limited in their ability to grow through the issuance of new equity. In addition, BDCs trading below their NAV may be vulnerable to activists seeking to change or terminate the BDC's advisory agreement, obtain board representation, liquidate the BDC or agitate for a merger or other consolidation transaction.

- ***M&A Transactions May Be an Efficient Way to Enter the BDC Market.*** BDCs remain an attractive vehicle among asset managers. Many alternative asset managers, in particular, have expressed interest in the BDC market. Moreover, as the alternative investment market continues to evolve, many larger, traditional asset managers are seeking to diversify their business model and grow their assets under management. These factors may contribute to M&A activity in the BDC space. Acquiring a BDC, acquiring its investment adviser or entering into a new investment advisory agreement may be an attractive means to enter the BDC sector, rather than relying on organic growth strategies.

BDC consolidation can take a number of forms. Consolidation could take place through the acquisition of the BDC itself. Alternatively, consolidation could take place through the acquisition of a BDC's investment adviser or through entering into a new advisory agreement with a BDC. Each structure raises a complicated intersection of legal issues, issues under state law, federal securities law issues (including those related to the 1940 Act) and tax considerations that require careful attention and consideration. Below are the principal BDC consolidation transaction options and an analysis of certain key legal considerations that may impact such transactions.

Acquisition of a BDC Itself Through a Merger, in Exchange for Cash, Stock or a Combination of Cash and Stock

All of the acquisitions of BDCs to date have been acquisitions via merger with other BDCs in which stock of the acquiring BDC was issued. This type of transaction is the most logical way for an existing BDC to acquire the assets of another BDC to increase scale.

A threshold issue for a merger of a BDC with another BDC is the price at which shares of the target BDC and acquiring BDC will be exchanged, often called the exchange ratio. For a target BDC trading below its NAV, a potential acquirer may believe that an offer above the target's then-current trading price but below NAV offers the target stockholders value while at the same time providing a benefit to the acquiring BDC's stockholders through the ability to acquire assets at a discount to NAV. However, our experience has been that this position may be difficult for the board of the target to accept. The target board is responsible for approving the BDC's NAV and may not be willing to consummate a transaction at a ratio that values the target BDC's shares below NAV (i.e., the BDC's fair value).

The exchange ratio should also take into account the value of the acquiring BDC's stock, which too may be trading at a discount to NAV. Under the 1940 Act, as noted above, a BDC cannot issue shares below its NAV absent stockholder approval, except in certain limited circumstances. As a result, the NAV of the acquirer's stock could be higher than its market value at the time the target's stockholders ultimately receive the stock of the acquirer. While the issues raised by the price of the acquirer's stock are avoided if the merger consideration is cash rather than the acquirer's stock, the acquiring BDC instead will face the prospect of an exchange of cash for likely less liquid debt positions, which may not be appealing to the board of the acquiring BDC. In addition, acquisition of a BDC for cash would not increase the scale of the acquiring BDC.

A merger triggers state law requirements for the target BDC, including takeover fiduciary duties (often called "Revlon duties"), that are implicated by any corporate merger activity. A merger will require approval of the target's stockholders at the threshold required under state law of the target BDC. In addition to the required support of the target BDC's stockholders, in a transaction where shares equal to 20 percent or more of the outstanding stock of the acquirer prior to the transaction will be issued as consideration in the merger, the relevant stock market listing rules currently require the approval of the acquirer's stockholders. These approvals will have to be taken into account when planning a BDC merger.

To consummate a BDC merger, the target, and in some cases the acquirer as well, will need to solicit its stockholders to obtain the votes noted above. In order to solicit the stockholders, a proxy statement will need to be filed with the U.S. Securities and Exchange Commission. A registration statement on Form N-14 would be used to register securities to be issued in a merger and can also serve as a joint proxy statement/prospectus that solicits stockholder votes on the transaction.

From a tax perspective, a merger in exchange for stock may be tax deferred to the target stockholders, while a merger for cash would be a taxable event. There may be other regulatory or tax features of the target that need to be taken into account as well.

Acquisition of a BDC's Investment Adviser

It may possible to assume the advisory function of a BDC by acquiring the BDC's investment adviser. This type of transaction raises a set of issues that are different from the issues that arise in the acquisition of a BDC itself.

A transaction to acquire an investment adviser could take innumerable forms. The considerations are likely to run the spectrum of all the typical acquisition issues — tax considerations, type and form of consideration, change-of-control and assignment issues, a stock or an asset deal, etc. Each of those considerations will be highly fact dependent, so an acquisition of an investment adviser requires careful planning.

In addition to the structural considerations that need to be taken into account when seeking to acquire the investment adviser to a BDC, specific 1940 Act considerations will need to be carefully taken into account as a result of the investment adviser's contractual relationship with the BDC. Under the 1940 Act, investment advisory agreements with BDCs must be terminable on no more than 60 days' notice by a BDC's board or stockholders, without payment by the BDC of any penalty. In addition, as required under the 1940 Act, an advisory agreement must include a provision that it will terminate automatically upon its assignment. Under the 1940 Act, a change in control of an investment adviser (which has a lower trigger point than many corporate-focused change-of-control definitions) is deemed an assignment of the adviser's investment advisory agreement, and results in the automatic termination of the adviser's investment advisory agreement.

Where the transaction is structured as an acquisition of an investment adviser, the acquirer will obviously seek to maintain the adviser's existing investment advisory relationships. To accomplish this where an investment adviser to a BDC is acquired, it is necessary to seek shareholder approval of a new investment advisory agreement with the BDC. The vote required to approve a new investment advisory agreement is a "vote of a majority of the outstanding voting securities," which is defined in the 1940 Act as a vote of at least 50 percent of the outstanding voting securities or 67 percent of the securities voting if 50 percent of the outstanding voting securities are present or represented by proxy, whichever is less. This standard is generally higher than the standard vote required for other proposals put before shareholders under state law. An acquirer of an investment adviser to a BDC needs to take this into consideration and will frequently require this vote of the target before consummating the acquisition of a BDC's investment adviser.

When purchasing an investment adviser, acquirers generally seek to comply with Section 15(f) of the 1940 Act. Generally, Section 15(f) permits an investment adviser to a BDC or an affiliated person of the investment adviser to receive "any amount or benefit" in connection with a sale of interests in the investment adviser that causes the assignment of the adviser's contract with a BDC, provided certain conditions are met. The conditions to comply with Section 15(f) impose requirements with respect to the percentage of the BDC's board that is comprised of independent directors for three years after the sale of the investment adviser. Section 15(f) further requires that there be "no unfair burden" imposed on the BDC as a result of the transaction. This requirement may impact the terms of a new advisory agreement. What is an "unfair burden" is a facts and circumstances analysis that requires careful evaluation. In considering the purchase of an investment advisory agreement and subsequently entering into a new investment advisory agreement, these conditions of Section 15(f) are often important considerations to an acquirer.

Negotiation of a New Advisory Agreement with a BDC (By Negotiating Either with the BDC's Existing Board or Following a Solicitation to Seat a New Board)

Under the 1940 Act, advisory agreements must be terminable on 60 days' notice by a BDC's board of directors or stockholders, without penalty. The board of a BDC can always agree to replace the BDC's existing investment adviser with a proposed acquirer. Historically, however, the termination of incumbent investment advisers has been rare. It is unclear whether increased stockholder engagement, whether through letter writing campaigns or actual proxy contests, may increase the turnover of investment advisers to BDCs. While there is no requirement that a transaction resulting in a new advisory agreement must also result in a change of board leadership, that was the case in one recent transaction. After conducting a process of examining strategic alternatives, NGP Capital Resources Co. decided to enter into a new investment advisory agreement with Oak Hill Advisors LP. In connection with that change, the board of directors of the former NGP Capital Resources Co. was also reconstituted.

Another consideration in this structure is that a transaction that results in only a change of investment adviser provides no liquidity or other direct benefit to stockholders. As a result, we have seen transactions of this type, which sought to include an equity investment in the BDC by an affiliate of the proposed new investment adviser. This capital injection can help provide liquidity to the BDC to cover transaction expenses and will increase the size of the BDC, with the potential benefits of scale mentioned above.

—By William J. Bielefeld, William J. Tuttle, Kenneth E. Young and Olumide A. Onafowora, Dechert LLP

William Bielefeld is a partner in Dechert's Washington, D.C., office. He is a former attorney-adviser in the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations.

William Tuttle is a partner in the firm's Washington office.

Kenneth Young is a partner in the firm's New York and Philadelphia offices.

Olumide Onafowora is an associate in the Philadelphia office.