Public to Private

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So You Want to Buy A Public Company? Select Legal Issues in Public M&A

Private equity funds and hedge funds are more active than ever in the acquisition of public companies. The increasing costs and regulatory burdens of remaining a public company, combined with the increasing market power and liquidity of private equity and hedge funds, generate attractive acquisition opportunities.

Frequently, one or more private equity funds already own significant stakes in public companies, having invested before the companies' initial public offering. These funds often will have continuing representation on the board of directors, which gives the funds an inside track on acquisition feasibility and opportunity.

The acquisition of a public company involves a substantial number of legal considerations that are not present in the run-of-the-mill private company buyout transaction. This is particularly true for a fund that is already a significant shareholder of the public company or that intends to accumulate shares in advance of the proposed acquisition. The growing trend of "club" or "consortium" deals, where multiple private equity funds join forces to acquire larger public companies, can further complicate the legal analysis. This article will briefly touch on some of these legal issues. While this article refers primarily to private equity funds, the same considerations
will apply to hedge funds.

Schedule 13G / Schedule 13D issues

The U.S. Securities and Exchange Commission requires holders of more than 5% of public company equity securities to file beneficial ownership reports on either Schedule 13G or Schedule 13D. This reporting scheme is intended to alert public shareholders to accumulations of public company equity securities that may signal an impending acquisition or change of control of the company, which may affect shareholders' decisions as to whether to buy, sell or hold shares in the company.

Schedule 13G is a streamlined reporting form that provides only the most basic information about the identity of the shareholder and the amount of its holdings. It is available for use by pre-IPO shareholders, with no upper limit on the shareholders' ownership percentage and no requirement that the shareholders possess only a passive investment intent. A private equity fund that already beneficially owned more than 5% of the equity securities of a company at the time the company went public will likely be entitled to reflect its beneficial ownership on Schedule 13G and continue to use that reporting form. This would be the case notwithstanding minor increases in ownership by the fund in the years since the company went public.

Schedule 13G is also available for shareholders that acquire equity securities after the target company goes public, resulting in the shareholder owning more than 5% but less than 20% of the public company's stock, provided that the shareholder does not hold the securities with the purpose or effect of changing or influencing control of the public company.

For purposes of Schedules 13G and 13D, beneficial ownership is defined broadly to include any shares with respect to which the fund has or shares control over the decision to vote or dispose of the shares. Additionally it includes the right to acquire the shares within 60 days, such as pursuant to a contract or upon exercise, conversion of warrants, options or convertible or exchangeable preferred equity or debt securities. In addition, shares held by any member of a group of shareholders which agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities will be deemed to be beneficially owned by each member of the group.

In contrast to Schedule 13G, Schedule 13D requires a substantial amount of disclosure concerning the purpose of the acquisition of the securities and any plans or proposals that the shareholder has concerning additional purchases or sales of securities. A merger or other takeover of the company, a change in control of the board of directors, a sale of the company's assets, or delisting of the company's securities from a stock exchange or from SEC reporting.

In addition, Schedule 13D requires the shareholder to describe all arrangements and understandings between the shareholder and any other person with respect to the company's securities, to disclose the source of funds for previous and planned purchases of equity securities, and to provide a detailed itemization of all purchases and sales of company securities in the past 60 days.

How is all of this relevant to a private equity fund considering an acquisition of a public company?

One scenario involves a private equity fund that owns less than 5% of the company's equity securities or has held more than 5% of the company's equity securities since before the company went public, with no significant post-IPO additions to its holdings. If a fund in this situation acts on its own to acquire the company without partnering with any other stockholders and with no roll-over of equity by management stockholders, then the fund should not have to make any Schedule 13G amendment or file a Schedule 13D until the acquisition agreement is signed.

Another scenario involves a fund that will not be partnering with other stockholders in the acquisition, where no management equity roll-over will take place and where the fund owns more than 5% of the company acquired after the company was already public. If the fund owns less than 20% of the company's common stock and acquired the stock at a time when it did not have any intention to influence or change the control of the company, it may be reporting its beneficial ownership on Schedule 13G. When the fund changes its intentions concerning its holdings and decides to pursue a takeover of the company, the "passive investment" condition of eligibility for its Schedule 13G filing status will be lost; the fund will have to file a Schedule 13D within 10 days and disclose its plans and intentions concerning the takeover.

Another scenario involves a fund that desires to accumulate shares on the public trading market in anticipation of an acquisition where the stock accumulations will push the fund's ownership over 5%. Schedule 13D was designed for this classic case. Once the 5% threshold has been exceeded, Schedule 13D must be filed within 10 days.

The existence of an agreement, arrangement or understanding concerning an acquisition of a public company could result in the fund being deemed to have acquired beneficial ownership of the shares owned by the other participants in the acquisition. This could occur where the fund will be part of a club deal with other private equity funds which own shares of the public company; or where management stockholders will be rolling over some or all of their equity in the acquisition. Depending on the number of shares already owned and the number of additional shares deemed acquired, the fund may be required to file a Schedule 13D to report the formation of this "group," the arrangements between the group, and the group's intentions concerning the buyout.

Typically, acquirers prefer to maintain the confidentiality of their intentions until a definitive acquisition agreement is signed and publicly announced. Early disclosure has the potential to disrupt the trading market for the target company's stock, with the anticipation of a takeover leading to a spike in the public trading price, thereby making an acquisition more difficult to achieve.

Because of the potential requirement for premature disclosure of the possible acquisition and the harm to the acquisition process that would likely result, care must be taken to evaluate the requirements concerning Schedule 13D reporting in connection with any decision to acquire a public company.

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Section 16

Section 16 of the U.S. Securities Exchange Act of 1934 is intended to deter insiders from misusing confidential information about their companies for personal trading gain. Section 16 generally operates to restrict trading activities of insiders by permitting recovery of any profits realized by the insiders on acquisitions and dispositions of equity securities that take place within a six-month period, and by requiring public disclosure of their trades.

Section 16 applies to private equity fund investors in public companies in a number of ways. A fund that beneficially owns 10% of a class of the public company's equity securities will be subject to Section 16, as will any representative of a private equity fund who serves on the public company's board of directors. If the designated board member has or shares control of the fund's voting or investment decisions concerning the securities that the fund owns in the public company, then the board member designee will be deemed to beneficially own all of the fund's shares in the public company. As a result, all of the fund's trading activities will become subject to Section 16 – even where the fund owns less than 10% of the public company's stock.

Section 16 can present some dangers in the context of the acquisition of a public company – not generally for the acquirer of the company, but more so for shareholders that are subject to Section 16 and that have recently acquired stock on the open market or otherwise. Consider the following example. A private equity fund decides to pursue the acquisition of a public company for which the fund is subject to Section 16 reporting requirements. In anticipation of the buyout process, it accumulates shares on the open market or from other institutional shareholders. The fund commences discussions with the public company, either initiating the discussion of a potential acquisition or as one of several bidders in an auction or other organized sale process. In the end, the fund determines not to pursue the acquisition and, because of an increase in the stock price, wishes to sell some or all of its shares.

Under Section 16, any open market sales of shares within six months of any open market purchase of shares will result in the fund being legally obligated to pay to the company any profit realized by matching the highest net sales price against the lowest net purchase price in the past six months. There is no tracing of shares, so liability will result even if the highest sale price resulted from the sale of different shares than those that were purchased at the lowest purchase price.

If another bidder winds up launching a tender offer to acquire the company and the fund tenders its shares into the tender offer, the same liability result will be obtained. This is because the sale in the tender offer is a voluntary act on the part of the fund and is not exempt under any of the Section 16 rules. If the fund winds up having its recently purchased public company stock converted into cash or shares as a result of the closing of a merger transaction with another bidder, the fund may be eligible for relief from liability under the so-called "unorthodox transaction" doctrine, but this result is not assured. In this type of situation, courts will look to both the fund's ability to control whether or not the merger takes place as well as the fund's access to inside information. This will determine whether the fund's disposition of securities in the merger could have resulted from speculative abuse.

Even if the private equity fund is not otherwise subject to Section 16 with respect to the target company, as soon as the fund becomes part of a club or consortium with other stockholders that are already subject to Section 16 with respect to the target company, the fund may find that it has become part of a beneficial ownership group. This will subject all of its subsequent activities in the target company's equity securities to Section 16 reporting and potential liability.

Section 16 is a complex area and contains many traps for the unwary. Caution should be exercised before engaging in any stock purchases in the run-up to a potential acquisition of a public company.

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State anti-takeover laws

In addition to the federal regulations administered by the SEC described above, acquirers of public companies must contend with a veritable patchwork of anti-takeover laws adopted by individual states. A private equity fund considering an acquisition of a public company must carefully consider the impact of any state anti-takeover laws before acquiring beneficial ownership of the company's stock or commencing any buyout process. State laws generally will apply by their terms only to public companies incorporated in the state in question.

Delaware is the most common state of incorporation for U.S. public companies, and its main anti-takeover law falls into the category generally referred to as "business combination moratorium" statutes. Any person who acquires ownership of more than 15% of a Delaware public company's voting stock, referred to as the "interested stockholder," is prohibited from acquiring the company or engaging in various types of transactions with the company for three years. This is unless either the board of directors of the public company approves the initial acquisition of the greater than 15% ownership, or the acquisition or other business combination transaction is approved by both the board of directors and the holders of two-thirds of the voting stock not owned by the interested stockholder. Public companies that are not listed on a national securities exchange or NASDAQ and not widely held are exempt from the law. Ownership is defined broadly for purposes of this Delaware law, not unlike the concept of beneficial ownership for purposes of Schedules 13D and 13G, but also includes any securities held by an interested stockholder's affiliates or associates.

A private equity fund that has owned more than 15% of a Delaware public company's voting stock since before the company became a public company is not subject to the limitations of Delaware's anti-takeover law. But if the private equity fund joins forces with other stockholders in order to pursue the buyout, the broad definition of ownership in the law will result in the other stockholders being deemed to acquire all of the stock held by the private equity fund; thus, the buyout group will become subject to the limitations of the law.

Other states' business combination moratorium statutes are more onerous than Delaware's. New York is one example. Whereas Delaware's moratorium for non-exempted business combinations is for three years, New York's law (which applies to 20% shareholders) contains a five-year moratorium. As discussed above, a business combination with an interested stockholder of a Delaware corporation may take place without waiting three years as long as the board of directors and two-thirds of the other stockholders approve the business combination transaction. In New York, however, no business combination between an interested shareholder and a New York corporation may take place for five years unless, before the interested stockholder becomes an interested stockholder, the company's board of directors approves the business combination or the interested stockholder's acquisition of 20% or more of the company's voting stock. Any business combination after such five-year period is required to be approved by a majority vote of shareholders other than the interested shareholder and its affiliates and associates, unless certain minimum price requirements are satisfied.

Other states' anti-takeover laws contain variations on these themes, and some states go much further in the types of anti-takeover laws that they impose. For example, Pennsylvania not only has a business moratorium statute that is similar in many respects to New York's, but it has a handful of other anti-takeover laws. This includes a law requiring any shareholder that acquires interested shareholders status (which, like New York, requires a 20% ownership level) without prior approval of the public company's board of directors must offer to purchase all of the remaining outstanding shares of the company at the highest price paid by the interested shareholder in the 90 days before it acquired interested shareholder status, or such higher amount as determined by an appraiser to represent the "fair value" of the shares. Pennsylvania's anti-takeover arsenal also includes a law that denies voting rights to shares held by an interested shareholder exceeding various percentage thresholds; another law requires an interested shareholder to disgorge any profits realized within 18 months after the interested shareholder acquired interested shareholder status. These laws will not apply if the public company has opted out of these laws according to the procedures laid out in the law or if certain other procedural hurdles are met.

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One general common thread of state anti-takeover statutes is an exemption from the restrictions imposed by the state law if the shareholder's acquisition of the threshold ownership level of voting shares, typically 15 or 20%, is approved by the public company's board of directors. An example of a state where this will not provide an exemption is New Jersey, where a stockholder that acquires 10% or more of a public company's voting stock is prohibited from engaging in a business combination for five years, unless the board of directors approves the business combination (not merely the acquisition of interested stockholder status) before the stockholder acquires interested stockholder status. Any business combination after such five-year period is required to be approved by the holders of at least two-thirds of the stock owned by stockholders other than the interested stockholder, unless the business combination satisfies certain minimum price requirements specified in the New Jersey law.

As with the Schedule 13D/13G and Section 16 issues, a private equity fund acting on its own in pursuit of the acquisition of a public company, and with no desire to accumulate additional shares prior to the acquisition, may be able to avoid significant limitations imposed by state anti-takeover laws. However, it the fund enters into any agreement, arrangement or understanding with other stockholders – including management stockholders – concerning the proposed acquisition, the fund may find itself entangled in unanticipated legal complications. A private equity fund considering a possible buyout of a public company is well-advised to make sure that applicable state takeover statutes are reviewed with legal counsel before joining forces with any other funds or stockholders and before accumulating shares on the open market.

Poison Pills

Shareholder rights plans, also known as "poison pills," are designed to deter hostile or unsolicited corporate takeovers or market accumulations of the public company's stock that do not take into account the long-range interests of the corporation and its stockholders. The acquisitions of more than a specified threshold beneficial ownership in the public company, typically 10 or 15%, without an amendment of the poison pill permitting this threshold to be exceeded by the triggering shareholder, will result in a series of events that will severely dilute the value of the triggering shareholder's holdings.

Poison pill plans typically use the same type of expansive beneficial ownership definition as discussed above with respect to Schedule 13D, and frequently use even more expansive definitions of the sort used in New York's anti-takeover law. The result of these expansive definitions is that the formation of a group of stockholders of a public company has the potential to result in the deemed aggregation of beneficial ownership of all of the group's members, which could trigger the poison pill.

Accordingly, before entering into any arrangement or agreement with respect to a consortium of private equity funds in connection with a public company buyout, any existing shareholder rights plan of the target should be taken into account.

Conclusion

Prudent private equity funds must be wary of a number of legal traps when considering a buyout of a public company. However, with a carefully mapped out acquisition strategy that deals with the requirements of federal and state laws and regulations and shareholder rights plans, significant legal roadblocks along the path to a successful public company acquisition can be avoided.

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