

Locke Lord QuickStudy: Buybacks: How Companies Can Benefit From Undervalued Stock

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Corporate stock buybacks have been prevalent in recent years. However, due to COVID-19 and market volatility, many companies, because they are focused on liquidity and balance sheet strength, have suspended or terminated existing stock buyback programs. Despite falling out of favor, analysts estimate that companies will spend hundreds of billions of dollars on buyback programs in 2020. As companies grapple with COVID-19 and economic uncertainties, the market will present opportunities for those companies with strong balance sheets to implement stock buyback programs and make repurchases.

Important considerations when preparing for a stock buyback include:

- Relevant law of the state of incorporation;
- Organizational documents;
- Credit and other agreements that may restrict the ability to repurchase outstanding shares;
- Stock exchange requirements; and
- Potential tax and accounting treatment of repurchases.

Buybacks must comply with the antifraud and anti-manipulation rules under the Securities Exchange Act of 1934 (the "Exchange Act") and federal securities law disclosure requirements. For example, a company may have to disclose non-public information before repurchasing its shares. In addition, a company may need to comply with Regulation FD prohibiting selective disclosures of material non-public information. A company typically will disclose its adoption of a stock repurchase program prior to commencement of repurchases. Depending on timing, the announcement can be made by means of a press release or Exchange Act filing. The disclosure obligations do not end upon the repurchase of the shares; details of share repurchases must be disclosed pursuant to Item 703 of Regulation S-K in a company's next periodic report.

The new stimulus and government lending programs under the CARES Act can limit buybacks. With limited exceptions, businesses that receive funds are prohibited from repurchasing company stock for a period ending 12 months after the loan or guarantee is repaid.

When contemplating a buyback, companies should evaluate the impact of repurchases on the cash position of the company and its projected capital needs. They should consider other uses for their cash, such as potential alternative investments and the need to preserve liquidity. Well-positioned companies may borrow funds to take advantage of current market prices for their shares. Once the decision is made to proceed, a company's board of directors typically authorizes and approves a stock buyback plan. The board should consider and document its

attention to stockholders' best interests and proper discharge of fiduciary duties, with a particular focus on the company's liquidity and future cash needs, the effect of the buyback on its capitalization and the reaction of investors, understanding that there are various groups that are critical of company buybacks.

A buyback can be accomplished in several ways: open market purchases; privately negotiated transactions; accelerated stock repurchase agreements; and tender offers.

Open Market Stock Buybacks

The most common buyback plan involves purchasing shares in the open market. Rule 10b-18 under the Exchange Act provides a non-exclusive safe harbor from violation of anti-manipulation rules. To benefit from the rule's protections, the buyback must meet manner, time, volume, and price restrictions, designed to minimize the effect of the repurchases on the price of the shares.

Open market buyback programs involve a broker-dealer buying on behalf of the company in ordinary trading transactions. The company does not have to offer premium pricing, nor does the company have any obligation to complete the repurchase program. The open market repurchase method gives companies the most flexibility compared to other types of buyback plans. Conducting buybacks in the open market can be cost-effective, limiting repurchases to avoid driving price increases while taking advantage of lower stock values. A company can decide whether and when to buy back shares and can choose to terminate a buyback program.

Companies often comply with Rule 10b5-1 when establishing a buyback program. That allows them to continue making repurchases despite being in possession of material non-public information. To do so, the company adopts the plan at a time when there is no undisclosed material non-public information, and the repurchases are made based on a formula or set of advance instructions to the broker-dealer, so the company loses some degree of control over the timing and amount of the buybacks.

Privately Negotiated Buybacks

The company may approach one or more large stockholders to negotiate a repurchase of shares at the market price or at a premium. Using this method can allow the company to repurchase a sizeable block at one time. The number of stockholders the company may approach is limited to avoid the repurchases being considered a tender offer. Like all repurchase programs, privately negotiated transactions are subject to Rule 10b-5's prohibition on repurchases made while in possession of material non-public information and the need to comply with Regulation FD. It may be possible to use "big boy" letters with sophisticated sellers who disclaim reliance on the company for information in making their decision to sell so as to avoid disclosing additional information. If material non-public information might be revealed to potential selling stockholders, wall-crossing procedures and confidentiality agreements could be used while negotiations are on-going.

A variation of the privately negotiated buyback is sometimes used in connection with the issuance of convertible securities by the company. Because some convertible securities buyers short the common stock at the time of purchasing the convertible securities, a company can undertake a simultaneous share repurchase in order to alleviate downward pressure on the stock price caused by the issuance of the convertible securities.

Accelerated Stock Repurchase Agreements

In an accelerated stock repurchase agreement (“ASR”), the company enters into a forward contract with an investment bank for the purchase of its shares. The investment bank borrows shares from existing stockholders and delivers those shares to the company. The investment bank later satisfies its obligation to return the borrowed shares by purchasing shares in the open market during a pre-agreed time period. An ASR allows a company to retire shares upfront upon delivery from the investment bank, while purchases of shares in the market take place over time. ASRs can be tailored through the use of collars, caps, and knock-out days to limit the company’s exposure to future increases in stock price and to improve the buyback’s pricing.

While market purchases by the investment bank under an ASR do not fall within Rule 10b-18’s safe harbor, they are typically structured to meet the requirements of the rule. Also, ASRs are most often set up as Rule 10b5-1 plans, which provides the protective benefits referred to above.

Tender Offers

Another way for a company to repurchase shares is an issuer self-tender. A tender offer may be structured as a fixed price tender offer or a modified Dutch auction tender offer. In a modified Dutch auction tender offer, the company offers to repurchase a fixed maximum number of shares within an identified (approximately 15%) range of prices. In a fixed price tender offer, a company makes an offer to stockholders to purchase the company’s shares on a fixed date and at a fixed price. The price of the tender offer almost always includes a premium over the current market price. The stockholders who are interested in participating inform the company of the number of shares they are willing to sell. If a company intends to repurchase a significant portion of its stock, it may be able to complete the tender offer transaction more quickly than an open market buyback program. Choosing a tender offer allows for greater participation by stockholders compared to open market and privately negotiated buybacks.

Tender offers by a company for its own shares must comply with Rule 13e-4 under the Exchange Act. For example, the offer must remain open for at least 20 business days, and the company cannot repurchase any shares outside of the tender offer or for 10 business days after completion of the tender offer. In addition, companies must file with the SEC a tender offer statement on Schedule TO, as well as written communications relating to the tender offer.

Key Takeaways

Stock buybacks are an effective way companies can choose to return capital to stockholders and increase confidence in a company during times of financial hardship. In uncertain and volatile markets, companies with the financial resources to invest may have an opportunity to buy back stock at an advantageous price.

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