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Securities Law Aspects of Business Combinations and Acquisitions

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A careful look at the securities law issues to be considered in a business combination or acquisition transaction.

Counseling a party involved in the sale of a business requires familiarity with a number of disciplines, including, among others, tax, state corporation and employment law. In addition, the sale of a business frequently requires an analysis of federal and state securities law, even in transactions in which the acquiring and the acquired company are privately held. In transactions in which a publicly traded company uses its stock to acquire a private company, counsel to the company being acquired must be familiar with the securities law implications of the transaction in order to provide effective advice to the client. This article focuses on some of the securities law issues which must be considered in representing parties to a business combination or acquisition transaction.

Does the Transaction Involve the Sale of a Security?

Inasmuch as the focus of this article is on the purchase and sale of a privately owned corporate business, we would be remiss if we did not address the issue of whether stock transferred to effectuate the sale of all or part of a business is a security within the meaning of the Securities Act of 1933, as amended[1] and the Securities Exchange Act of 1934, as amended.[2] There had been considerable debate of this issue over the years and, for some time, a split among the federal circuits on how to resolve the issue. The United States Supreme Court silenced the debate in 1985 when it held that the sale of stock of a corporation is a securities transaction subject to the anti-fraud provisions of the federal securities laws.[3]

As lawyers involved in the sale of a privately held business structured as a *stock* deal, it is important to understand that although the sale of stock to, for example, one or a limited number of purchasers does not appear to have the same characteristics as a public offering of securities, the federal securities laws will apply to the sale. We cannot rely upon the so-called sale of business doctrine, which had been embraced in certain jurisdictions for some time, suggesting that a business rather than a security was being sold, rendering the federal securities laws inapplicable. The sale of business doctrine will not apply where the sale of all or a part of a business is effectuated through the sale of stock. Accordingly, it is of critical importance to provide the purchaser of stock with material information relative to the business being acquired, and to be sure that information is not omitted and that the information provided is accurate and complete in all respects. Anything less leaves the seller vulnerable to a claim under the anti-fraud provisions of the federal securities laws.[4]

It is interesting to note that while the law is clear regarding the application of the federal securities laws to a private sale of an ownership interest in an operating business where the transaction is structured as a sale of stock, there is no legal authority suggesting that the federal securities laws should apply to a business sale structured as an asset transaction where the consideration paid for the assets is cash rather than stock or some other security. As a result, it is not uncommon for the purchaser of assets to include in its agreement a provision commonly known as a 10b-5 representation, where the seller represents, among other things, that all information relating to the business disclosed to the purchaser is accurate and complete, and that no information has been omitted which would render the information furnished false or misleading. With such a provision, liability normally associated with the anti-fraud provisions of the federal securities laws is imposed by contract upon the seller.[5]

From the purchaser's perspective, in a transaction structured as either a stock or an asset purchase, there may be a promissory note issued by the purchaser to the seller. The question which arises under these circumstances is whether the federal securities laws apply to the issuance of the note, particularly as it relates to the anti-fraud rules. If the term of the note is for nine months or less, the statutes themselves are clear in stating that any such note constitutes a security exempt under the federal securities laws.[6] Nonetheless, inasmuch as debt instruments issued by a purchaser to a seller in connection with the private acquisition of a business generally are for a longer term, further analysis is warranted to determine if the purchaser is issuing a security covered by the federal securities laws. Regrettably, that analysis is somewhat complex.The factors to be considered in determining whether or not a promissory note or other debt instrument is a security are set forth in *Reves v. Ernst & Young.*[7]

The United States Supreme Court determined in *Reves* that there is a rebuttable presumption that a note with a maturity in excess of nine months is a security unless it fits within a list of the types of promissory notes that are not viewed as involving a security. In addition, it embraced the so called family resemblance test, setting forth the types of notes that would not be considered securities, and then announcing factors to consider in determining whether a note had a family resemblance to and fit within the type of note included on the list.

The first factor considered is the motivation of the parties to the transaction. The second factor is the plan of distribution for the notes. The third factor is the reasonable expectation of the investing public, and the fourth factor is whether there is another regulatory scheme to protect the noteholder which makes the protection provided by the federal securities laws unnecessary. Space limitations do not permit a further analysis of the *Reves* tests; however, suffice it to say that a note secured by a lien on a small business or some of its assets is identified by the court as the type of note not covered by the federal securities laws.

Another fact pattern frequently encountered involves a transaction in which the former shareholder of the acquired corporation agrees to accept a contingent right to receive stock in an acquiring corporation in consideration for the transfer of the stock or assets of the acquired corporation. Courts have held that the contingent contractual right is within the coverage of the federal securities laws, and that the recipient of the contingent contractual right has standing to bring a securities fraud claim against the acquiring corporation under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.[8] Therefore, as parties utilize contingent earn-out arrangements to bridge gaps in negotiating positions, it is important to understand that the federal securities laws may apply to the deal structure, even though stock is not issued upon the close of the transaction but is issued thereafter upon the achievement of a prescribed objective.

Federal and State Registration Requirements

In recent years, many public companies have adopted growth strategies focused on expansion through acquisitions, including the acquisition of privately owned businesses. Securities of the acquiring company often are a principal or the sole component of the consideration paid to the target company shareholders. The use of securities as acquisition consideration requires consideration of a number of factors by both the acquiring company and the company to be acquired.

Rule 145 has been adopted by the Securities and Exchange Commission (SEC) so the protections provided by the registration provisions of the securities act are available to persons who are offered securities in business combinations. As noted in the preliminary note to Rule 145, the thrust of the rule is that an offer or sale occurs when there is submitted to security holders a plan or agreement pursuant to which the holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security. As a result, if securities of an acquiring company are to be issued to a company being acquired or its shareholders, federal securities laws must be examined to determine whether an exemption from the registration requirements of the securities act is available. Because each state has its own securities laws, the *blue sky laws* of each state in which the securities are being offered or issued must also be reviewed to determine whether state registration is required.

The federal exemptions most often relied upon are those provided by Section 4(2) of the securities act and Regulation D. Section 4(2) applies to transactions "not involving a public offering," and Regulation D provides a series of exemptions having specific guidelines which can be relied upon to ensure a transaction qualifies as a transaction not involving a public offering. Although the SEC has provided some guidance regarding the factors which should be considered to determine whether an offering qualifies for a Section 4(2) exemption, no specific guidelines have been established. Due to the potential uncertainty in relying upon Section 4(2), most practitioners will attempt to structure a transaction so it qualifies under one of the exemptions provided under Rule 505 or Rule 506 of Regulation D.[9]

A full discussion of Section 4(2), Rule 505 and the Rule 506 exemptions is beyond the scope of this article; however, the availability of these exemptions depends upon, among other things, the aggregate value of the securities offered and the number and sophistication of the target company shareholders. If any of the shareholders do not qualify as accredited investors, as defined in Rule 501 of Regulation D, a detailed disclosure document must be prepared and distributed. In addition, Regulation D requires Form D to be filed with the SEC in connection with a Rule 505 or 506 transaction.

The steps which must be taken to comply with state blue sky requirements vary from state to state. The National Securities Markets Improvements Act of 1996 (NSMIA)[10] preempts state blue sky laws in transactions involving covered securities. Covered securities include, among others, securities listed on the New York Stock Exchange, American Stock Exchange or Nasdaq Stock Market, and securities issued in Rule 506 transactions or to a qualified purchaser, as defined by the SEC.[11] Despite this preemption, most states, as permitted by NSMIA, impose notice and fee requirements on private offerings of covered securities. As a result, the applicable blue sky laws must be reviewed, even if an acquisition transaction involves the issuance of a covered security.

Reselling Securities: The Significance of Registered or Restricted Securities

If an exemption from the registration requirements cannot be identified, the acquiring company will be required to register the securities issued in the acquisition transaction under the securities act. Generally, this is accomplished through the filing of an S-4 registration statement with the SEC, pursuant to Rule 145 of the securities act. Whether the securities being issued in the transaction are registered significantly affects the ability of the acquired company's shareholders to dispose of the securities they acquire following the transaction. If the securities are not registered, shareholders of the acquired company will hold restricted securities, and thus may resell the shares they receive in the public markets only in accordance with procedures set forth in Rule 144 promulgated under the securities act.

- the shares must be held for one year before the sale;
- the number of shares which can be sold during any 90-day period is limited;
- the shares must be sold in a brokers' transactions or in transactions directly with a market maker;
- the issuer of the securities must have current public information on file with the SEC; and
- the shareholder must file a notice with the SEC.

After the shares have been held for two years, a shareholder who is not an affiliate[12] of the acquiring company can sell them freely without compliance with Rule 144.[13] Unregistered shares issued to a shareholder who is an affiliate of the acquiring company after the transaction must always be sold publicly in accordance with the requirements of Rule 144, unless registered under the securities act.[14]

If the shares issued in an acquisition transaction are registered, a person who is not an affiliate of either the acquiring or acquired company can sell the shares publicly without restriction.[15] During the one-year period following the closing of an acquisition transaction, a person who was an affiliate of the acquired company must comply with the resale provisions of Rule 144 in selling shares registered in connection with the transaction, except that the one-year holding period requirement does not apply.[16] After the one-year period following the transaction, a person who was an affiliate of the acquired company can resell the shares freely, provided the issuer has current public information on file with the SEC. After two years, the current public information requirement does not apply.[17]

A person who is an affiliate of the acquired company and who becomes an affiliate of the acquiring corporation must comply with all of the resale provisions of Rule 144 when reselling shares registered under an S-4, except that the one-year holding period does not apply.[18]

In situations where the securities issued to the acquired company shareholders have not been registered under the securities act, counsel should recommend that the company being acquired negotiate registration rights which require the acquiring company to file a resale registration statement with the SEC following the transaction. This way the shareholders of the acquired company can resell their shares without having to wait for the expiration of the one-year holding period set forth in Rule 144. In situations where an S-4 is filed in connection with an acquisition transaction, consideration should also be given to requiring the acquiring company to include S-3 reoffering information in the S-4 prospectus so persons who become affiliates of the acquiring company can use the S-4 prospectus for resales, and thus avoid the restrictions of Rule 144.[19]

Proxy Rules

Business combinations and acquisition transactions generally require approval by the shareholders of the company being acquired under state corporation law. In New Jersey, the approval of the shareholders of an acquiring or surviving corporation in an acquisition or business combination is required if the number of voting shares of the acquiring or surviving corporation outstanding immediately after the transaction, plus the number of voting shares issuable on conversion of other securities or upon the exercise of rights or warrants issued pursuant to the transaction, will exceed by more than 40 percent the total number of voting shares of the corporation outstanding immediately before the transaction.[20] In addition, the rules of the New York Stock Exchange, American Stock Exchange and Nasdaq Stock Market require listed companies to obtain shareholder approval of transactions involving an increase or potential increase in outstanding common shares of 20 percent or more.[21]

Companies whose securities are registered under Section 12 of the exchange act are subject to the proxy rules set forth in Regulation 14A of the act. In order to obtain the votes required to approve an acquisition transaction, these companies generally solicit proxies from their shareholders. The proxy rules require the preparation of a proxy statement which must contain a description of the proposed transaction and other detailed information required by Schedule 14A if proxies are to be solicited.[22] Preliminary copies of the proxy materials must be filed with the SEC at least 10 days prior to the date the proxy materials are first sent or given to shareholders.[23] The final proxy materials must be filed no later than the date they are first sent or given to security holders.[24] In situations where securities of the acquiring company are being registered under Form S-4, the S-4 prospectus is used to provide the required disclosure to shareholders and no separate proxy materials need be filed.[25]

Companies that are not subject to the SEC's proxy rules should consider supplying information similar to that required by the proxy rules to shareholders who are voting on the transaction. Because a vote on a business combination is, in substance, an investment decision, federal and state securities laws which impose liability in connection with the sale or purchase of securities for misstatements of material fact or omissions of statements necessary to make other statements not misleading apply. The furnishing of information which allows shareholders to make an informed voting decision can reduce the risk of liability being imposed under the anti-fraud rules described above.[26]

In negotiating an acquisition transaction, it is not unusual for the acquiring company to seek commitments from the principal or controlling shareholders of the company being acquired to vote in favor of the proposed transaction when it is submitted to a vote of shareholders. If the voting securities of the target company are registered under Section 12 of the exchange act, the acquiring corporation must adhere to the proxy rules because, under Rule 14a-1, the term proxy includes any proxy, consent or authorization within the meaning of Section 14(a) of the exchange act. Rule 14a-2, however, provides that the proxy rules do not apply to any solicitation made otherwise than on behalf of the registrant if the total number of persons solicited is not more than 10. As a result, in soliciting voting commitments, the acquiring company should limit the number of parties from whom it seeks voting commitments to 10 or less persons. ǿ

Endnotes

1. 15 U.S.C. § 77a *et seq.*
2. 15 U.S.C. § 78a *et seq.*
3. *Landreth Timber Company v. Landreth, et. al.*, 471 U.S. 681, 105 S. Ct. 2297 (1985); *Gould v. Ruefenacht, et. al.*, 471 U.S. 701, 105 S. Ct. 2308 (1985).
4. *Harsco Corp. v. Segui*, 91 F.3d 337 (2d Cir. 1996). The court in *Harsco* addresses the effect of certain contract provisions on the availability of claims under Section 10-b of the exchange act to a purchaser of stock. The authors have focused on the anti-fraud provisions of the federal securities laws in this article. It should be noted that claims

for violations of state securities laws, as well as state law claims for fraud or negligent misrepresentation, may be available to the parties to a transaction. The anti-fraud provisions of the New Jersey Uniform Securities Law are set forth in N.J.S.A. 49:3-71. *See also Kaufman v. i-Stat Corp.*, 165 N.J. 94 (2000).

5. A sale of a limited partnership interest is a security, while the sale of an interest in a general partnership is generally not viewed as involving the sale of a security. In reaching the conclusion that general partnership interests are not securities, the courts have placed emphasis upon the fact that general partners are normally actively involved in the business. An opposite conclusion would likely be reached if the general partners are passive investors in the business. Similar analysis should apply with respect to sales of interests in a limited liability company. In any event, because the analysis of whether or not an interest in a partnership or limited liability company is very fact sensitive, the authors suggest that each factual circumstance be reviewed against the applicable legal authorities before reaching a conclusion regarding the application of the federal securities laws.
6. Securities Exchange Act of 1934, as amended, § 3(a)(10).
7. 507 U.S. 170, 113 S. Ct. 1163 (1993).
8. *See Yoder v. Orthomolecular Nutrition Institute, Inc.*, 751 F.2d 555 (2nd Cir. 1985); *Griggs v. Pace American Group, Inc.*, 170 F.3d 877 (9th Cir. 1999).
9. Other possible exemptions are provided by Section 3(a)(11), the intrastate exemption, and Section 3(a)(10) of the securities act, which provides an exemption for exchange transactions in which the issue of fairness is passed upon by a state authority after a hearing.
10. Pub. L. 104-290, 110 Stat. 3416 (Oct. 11, 1996).
11. The SEC has proposed a definition of qualified purchaser to be contained in Rule 146 of the securities act that mirrors the definition of accredited investor in Rule 501. The proposed definition has not become final.
12. 17 C.F.R. § 240.144(k).
13. *See* 17 C.F.R. § 501(a) for the definition of affiliate.
14. 17 C.F.R. § 240.144(b).
15. Persons who are not affiliates of the acquired company or the issuer are not considered underwriters under Rule 145(c) (17 C.F.R. § 240.145(c)).
16. 17 C.F.R. § 240.145(d)(1).
17. 17 C.F.R. § 240.145(d)(2).
18. 17 C.F.R. § 240.145(d)(3).
19. *See* Item 7 of Form S-4.
20. N.J.S.A. 14A:10-3 and N.J.S.A. 14A:10-12.
21. *See* Section 312.03 of the New York Stock Exchange Listed Company Manual; Section 713 of the American Stock Exchange Listing Standards, Policies and Requirements; NASD Rule 4350(i).
22. 17 C.F.R. § 240.14a-3.
23. 17 C.F.R. § 240.14a-6(a).
24. 17 C.F.R. § 240.14a-6(b). *See also* 14a-12 (17 C.F.R. § 240.14a-12) which permits certain communications to be made to shareholders before the delivery of the proxy statement.
25. *See* Rule 14a-6(j) (17 C.F.R. § 240.14a-6(j)) and General Instruction E to Form S-4.
26. *See* Rule 10b-5 (17 C.F.R. § 240.10b-5) and N.J.S.A. 49:3-71.

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