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REALIZING THE VALUE OF HOLDINGS IN U.S. COMPANIES

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As the mergers and acquisitions (M&A) cycle moves through its present phase, an increasing number of non-US private companies are being acquired by US companies with stock and non-US shareholders of these targets are finding their ability to realize on their investment constrained by the US securities laws. Institutional and other non-US investors may make a private investment in a US company or may place a representative on its board, and find themselves similarly constrained.

This article looks at the implications to shareholders of US companies that, by reason of how they received their shares or their relationship to the issuer, may not freely resell their securities. Holders of stakes, regardless of size, in US public companies may be subject to restrictions on their ability to sell their holdings if they received shares (referred to as restricted securities) from a US public company issuer in non-registered transactions. The most common examples of these would be private cash investments by such holders in an issuer or acquisitions by an issuer paid for in stock or a combination of cash and stock. Holders of large stakes in US public companies may be deemed affiliates of such companies and, as a result, will be subject to such restrictions, as well as disclosure obligations, even if they bought their shares in the open market.

US Securities Laws Generally

Any offer or sale of securities in the US must be made pursuant to an effective registration statement under the US Securities Act of 1933, or an available exemption. To register securities under the Securities Act, an issuer files with the Securities and Exchange Commission (SEC) a registration statement which contains information required by the Securities Act and the rules and regulations promulgated by the SEC, and registration is deemed to have occurred when the registration statement has been reviewed and declared effective by the SEC. A registration statement is a disclosure document consisting of two parts: (i) a prospectus (which is ultimately disseminated to prospective investors); and (ii) supplemental information provided to the SEC which is not required to be included in the prospectus.

These registration requirements apply to all transactions in securities — sales and resales. There are exemptions, however, among others, for private placements and for secondary market transactions. The key to understanding how securities can be resold requires identifying who the seller is and what type of securities are being resold. To assist in understanding some of these concepts, the following should be borne in mind:

A seller may be affiliated with an issuer or unaffiliated. Affiliates (like issuers themselves) are treated differently from other investors. They cannot rely on the exemption for secondary market transactions (even if they bought the securities in the open market) — only non-affiliates can rely on this exemption.

Securities may have been issued directly to an affiliate or a non-affiliate by an issuer in a private placement, or the securities may have been bought in the open market.

Securities sold in a private placement by the issuer or an affiliate are known as "restricted" securities. In the acquisition context, where a US public company is acquiring a private company in the US, it may well rely on a private placement exemption in order to issue the stock consideration to the target's shareholders. Where the target is a non-US private company, the acquiror is likely to rely on a combination of a private placement exemption and the offshore sale exemption (under Regulation S). Because the issuer is a US company, the shares received by US shareholders or non-US shareholders will be deemed restricted securities. Therefore, in the case of a non-US private target, shareholders will be subject to the resale rules notwithstanding the fact that they received their shares in a Regulation S transaction that was not subject to US registration. Unless there is a foreign market for the shares of the US acquiror, consideration must be given to resale in accordance with the US securities laws.

An issuer can always register its sales, including sales made in connection with acquisitions. In the acquisition context, however, registration requires disclosure about the target company as well, and given both the time and effort required to prepare the registration statement and the need for SEC review, issuers generally will rely on private placements and Regulation S where targets are private and those exemptions are available.

Any restricted securities can be freely resold in a registered public offering. If there is no way of causing an issuer to register securities for resale (and assuming that a private placement is out of the question because, in the hands of a buyer, such securities may still be restricted), an affiliate selling any securities and a non-affiliate selling restricted securities needs to rely on the exemption in registration provided by Rule 144 under the Securities Act. Non-affiliates selling non-restricted securities rely on the standard exemption for secondary market sales.

Resales of Securities

An investor who acquires shares in a private company which subsequently goes public or who acquires a block of shares in a public company in a private transaction directly from the issuer, and wishes to sell such shares, will need to sell pursuant to a registration statement or rely on Rule 144 in order to resell the securities. In addition, if such person is also in affiliate of the issuer and acquires shares in the open market, resales will be subject to the same limitations. Finally, a person who is an affiliate of one company that is subsequently acquired by another company in a stock-for-stock transaction, may be subject to the same limitations with respect to the resale of the shares received in the acquisition.

A word about Regulation S: although an issuer may rely on Regulation S to offer shares to offshore buyers, those shares will be deemed "restricted" and subject to a one-year lockup. Although those shares can continue to be sold offshore in Regulation S resale transactions, the offshore holder will be in the same position as a US holder. Offshore resales remain technically possible, but if the principal market is in the US, offshore resales are not a realistic option.

Set forth below are the principal methods by which these investors can obtain registered stock or meet the conditions for using Rule 144.

Registration Rights Agreements

Because the registration of securities can only be effected by the issuer of such securities, it is typical in the US in connection with a privately negotiated investment (which could be an investment for cash or a stock acquisition) to contractually obligate an issuer, if such issuer is a public company (or upon such issuer becoming a public company), to register such securities at some specified time or times to facilitate their resale. These rights are called registration rights and the document in which such rights are typically included is called a registration rights agreement. Registration rights may include all or a combination of demand registration, piggyback registration and shelf registration rights:

Demand Registration Rights. A shareholder with demand rights is entitled to obligate an issuer, upon instruction by such a shareholder, to prepare and file with the SEC a registration statement registering the securities held by such shareholder. There are variations of these rights but, generally speaking, an issuer is required to register all or a portion of such shareholder's securities at least one time, at the issuer's expense, in an underwritten firm commitment offering. In a firm commitment underwriting, one or more investment banking firms agree to purchase the securities for resale to the public at a specified offering price. This ensures that the offering is backed by selling efforts to maximize the offering price (which is especially useful if a shareholder desires to sell a large block of shares at one time).

While other shareholders with registration rights may be entitled to include (piggyback) their securities in the demand registration statement, if the managing underwriter advises the issuer that the number of shares proposed to be sold in the offering exceeds that which can be sold at an expected offering price, the shareholder initiating the registration may be entitled to sell its shares while other shareholders participating in the offering will be cut-back (required to reduce the number of shares each such shareholder wishes to include in the offering). In other cases, the cut back will be pro rata among a group of non-priority holders (as defined) or pro rata among all holders.

The registration rights agreement will often address "long-form" and "short-form" registrations. This refers to the different types of registration statements prescribed under the Securities Act. The same information is required to be part of all registration statements. The differences among the forms of registration statements reflect the SEC's determination as to: (i) when the required information must be presented in full in the prospectus delivered to prospective investors; (ii) when certain of the delivered information may be presented on a streamlined basis and supplemented by documents incorporated by reference; and (iii) when certain information may be incorporated by reference to other filings with the SEC, without delivery to investors.

A company that has been public for less than one year is required to register its securities on a Form S-1 or long-form registration statement. A Form S-1 requires complete disclosure in the prospectus and does not permit a company to incorporate information by reference to other filings. A company that has been public for more than one year generally will be entitled to register its securities on a Form S-3 or short-form registration statement for resales by selling shareholders. (To use Form S-3 for primary offerings, the issuer would also need a public float of more than $75 million.) A Form S-3 requires the least disclosure to be presented in the prospectus. Generally, the Form S-3 will present the same transaction-specific information as is presented in a Form S-1. However, issuer-oriented information can be incorporated by reference from Exchange Act filings. In theory, the Form S-3 prospectus is a relatively short document. In practice, it may be in the interests of the selling shareholders and the issuer for the Form S-3 to contain a full business section for marketing reasons. In this case, the issuer-oriented information is included in the Form S-3 prospectus, making it very similar to a Form S-1 prospectus.

Piggyback Registration Rights. A shareholder with piggyback registration rights is entitled to obligate an issuer, whenever the issuer proposes (either of its own accord or pursuant to a demand by one or more other investors) to register its securities under the Securities Act and the registration form so permits, to register all or a portion of the securities held by such shareholder, at the issuer's expense. Other shareholders with registration rights are typically entitled to include their securities in the piggyback registration statement, and if the managing underwriter requires a cut-back, the issuer generally will include all securities proposed to be sold by it in the offering, with the shareholders participating in the registration pursuant to piggyback registration rights being cut-back either on a priority or on a pro rata basis after the issuer. (As the issuer gives away piggyback rights to other shareholders, the issue becomes one of priority 6 where one ends up in the multiple levels of cut-backs.)

Shelf Registration Rights. An issuer may be obligated under a registration rights agreement to file a shelf registration statement under Rule 415 of the Securities Act, pursuant to which the issuer's securities are offered on a delayed or continuous basis. Shelf registration statements are registration statements that contain undertakings on the part of the issuer and are updated during any period during which offers and sales are made through post-effective amendments, prospectus supplements (stickers) or incorporation by reference to periodic reports filed under the Exchange Act (if such shelf registration statement is on a Form S-3). A shelf allows a shareholder to sell shares at any time during which the registration statement is effective. Maintaining and updating a shelf may be an onerous task for an issuer, particularly if the issuer is not eligible to use a Form S-3. The existence of the shelf can also create a market over-hang. Therefore, an issuer typically will only agree to file a shelf if it is Form S-3 eligible and will limit the period during which it is required to maintain the effectiveness of the shelf.

Securities registered on a shelf may end up being sold in an underwritten offering, with the issuer using the offering as an opportunity to increase liquidity and the sellers

having the benefit of an organized marketing effort. If holders negotiate for the shelf to be in place at the closing of the private transaction (such as an acquisition), they can obtain immediate liquidity.

Miscellaneous Features. Other typical features of a registration rights agreement include:

- the issuer is typically entitled to delay the filing of a demand registration statement for a valid business reason (*i.e.*, if such filing would interfere with a pending transaction). Generally, such a delay is limited to a specific time period and an issuer may not delay an offering more than once in any 12-month period;

- a shareholder generally will be obligated not to sell its shares within a specified time after an issuer effects a registered offering (whether or not it participated in the offering). This is often referred to as a "lock up";

- for underwritten offerings, an issuer will agree to enter into an underwriting agreement and to conduct a roadshow;

- an issuer will agree to indemnify a shareholder for misstatements or omissions in a registration statement (except with respect to statements supplied by the shareholder in writing to the issuer for inclusion in the registration statement), and a shareholder will agree to indemnify an issuer for its misstatements, but such liability generally will be limited to such a shareholder's net proceeds in the offering; and

- an issuer will agree to do all things necessary to enable a shareholder to sell its securities without registration under the Securities Act pursuant to the exemption provided by Rule 144 (see discussion below). Registration rights generally cease when a shareholder can freely resell all of its shares under Rule 144.

Rule 144

The most common exemption from the registration requirements of the Securities Act for resales by affiliates of any securities and by non-affiliates of restricted securities is that provided by Rule 144. Once a one-year holding period has elapsed for "restricted" (*i.e.*, non-registered) securities, or at any time if an affiliate is seeking to sell shares bought in the open market, sales under Rule 144 may be made under the following conditions:

- the issuer must have been subject to the reporting requirements under the Exchange Act for at least 90 days and must have filed with the SEC all reports required under the Exchange Act;

- affiliates selling any securities (including restricted securities and securities bought in the open market) and non-affiliates selling restricted securities may sell in any three-month period no more than a defined amount of the issuer securities;

- all sales must be sold in "brokers' transactions"; and

- except for certain small transactions, the seller must file a public notice of sale at or before the time of sale.

After two years, non-affiliates may sell restricted securities without limitation.

Affiliates. An affiliate is defined by Rule 144 to include, among other things, any person who directly or indirectly controls, is controlled by, or is under common control with, an issuer. Whether a person is an affiliate is ordinarily a question of fact. Typically, holders of 10% or more of any class of stock of an issuer, directors, certain executive officers, and other persons with the power to direct the affairs of an issuer may be regarded as affiliates. The effect of being deemed an affiliate is that all sales of an issuer's securities, whether restricted securities or securities acquired in the open market, will be subject to the limitations of Rule 144 unless such sales are made pursuant to a registration statement.

Public Information. In order for affiliates to effect any sales of securities or for non-affiliates (unless more than two years have elapsed since the shares were acquired from the issuer or an affiliate of the issuer) to effect sales of restricted securities, there must be presently available to the public adequate information regarding the issuer and its affairs. Rule 144 requires that an issuer must have been subject to the reporting requirements of the Exchange Act for at least 90 days preceding any sale under Rule 144 and the issuer must have filed all periodic reports required by the Exchange Act during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports).

Limitation on Amount of Securities Sold. Assuming that such information is available to the public, and all periodic reports have been filed, each shareholder, executive officer and director who is an affiliate or who holds restricted securities may sell, during any three-month period, an amount of shares not to exceed the greater of 1% of the shares then outstanding, as shown by the most recent report or statement published by the issuer (such as the issuer's annual and quarterly reports) and the average weekly reported volume of trading in the shares during the four calendar weeks preceding the filing of the notice of sale.

Non-affiliates are not required to comply with the volume limitation if at least two years — computed in accordance with the tacking rules described below — have elapsed since the later of the date the securities were acquired: (i) originally from the issuer; or (ii) from an affiliate of the issuer, and the person is not an affiliate at the time of sale. In computing the volume limitation, certain sales by others will be aggregated with the

affiliate's sales including, among others, sales by any corporation or other entity in which the affiliate owns 10% or more of the equity interest.

Manner of Sale. Sales may be made under Rule 144 only in ordinary brokers' transactions or in transactions directly with a market maker. The seller may not solicit or arrange for the solicitation of buy orders and may make no payments in connection with the sale other than to the seller's broker. A brokers' transaction is deemed to include transactions by a broker in which such broker does no more than execute the seller's order, receives no more than the ordinary and usual commission and neither solicits nor arranges for the solicitations of buy orders.

Brokers must make reasonable inquiry to determine whether any circumstances indicate that Rule 144 may be unavailable to the prospective seller. A person effecting a sale pursuant to Rule 144 may be asked by a broker to provide a representation letter to the effect that the sale will comply with all of the requirements of Rule 144. In addition, the issuer's transfer agent will customarily require an opinion of counsel to the effect that the transfer does not require registration under the Securities Act and that no legend need appear on the new stock certificate representing the transferred shares.

Notice of Proposed Sale. Concurrently with placing a sell order with a broker, a person selling under Rule 144 must mail to the SEC and to any national securities exchanges on which the securities are traded a notice on Form 144, unless the shares to be sold during a three-month period will not exceed 500 shares and the proceeds of sale will not exceed $10,000. Form 144 requires the name and signature of the seller, the securities to be sold, their aggregate market value, the date and manner of the seller's acquisition of the securities, information as to recent sales and the name and address of the broker selling the securities.

Holding Period for Restricted Securities. A sale of restricted securities must also comply with the holding period requirements of Rule 144. This is the reason why registration rights are so important. The length of time restricted securities have been owned (commonly referred to as the holding period), and whether they have been held by affiliates or nonaffiliates of the issuer, are important factors in determining how much flexibility is available under Rule 144. Generally, if a one-year holding period is established, sales of restricted securities under Rule 144 can take place subject to the volume, information, manner of sale and filing requirements discussed above. In the case of nonaffiliates, if a holding period of two years or more is established, sales under Rule 144 are free of such limitations.

In determining whether the one- or two-year holding period has been met, Rule 144 permits holders of restricted securities to add to their own holding period (or to tack) the holding period of prior holders unaffiliated with the issuer. The presence of an affiliate in the chain of title will trigger the commencement of a new holding period.

Questions may arise as to when the holding period commences. For example, in the case of a purchase of restricted securities, the purchase price must have been paid to the issuer or an affiliate of the issuer in full at least one year prior to sale.

Reporting of Beneficial Ownership

Any person (defined to include a group of persons acting in concert) who acquires beneficial ownership of more than 5% of any class of equity securities registered under the Exchange Act must file a Schedule 13D containing specified information with the SEC, the issuer and any national securities exchange in the US on which the class of securities is traded (though not to Nasdaq, in the case of securities quoted on Nasdaq).

Schedule 13D requires disclosure of information about the purchaser, its holdings in the issuer and plans for control of the issuer. The Schedule 13D must be amended promptly if any material change occurs in the facts set forth in the Schedule 13D, including any material change in the number of shares held by the purchase. Increases or decrease of at least 1% of the class of reported securities are deemed material.

A person will be deemed to be the beneficial owner of a security if such person has or shares the power to vote or the power to dispose of such security. Such person will also be deemed to be the beneficial owner of any security that such person has the right to acquire within 60 days, including through the exercise of options or warrants or conversion rights or the voluntary or involuntary termination of trusts. The reporting obligations apply only to beneficial ownership of voting securities; holdings of non-voting securities need not be reported.

A short form Schedule 13G is available for certain persons to file in lieu of Schedule 13D. Schedule 13G is available to any person who beneficially owned more than 5% of an issuer's equity securities prior to the registration of such securities under the Exchange Act (*i.e.*, prior to an initial public offering). However, if such a person thereafter acquires beneficial ownership of 2% or more of the issuer's registered securities in any 12-month period, the person must file a Schedule 13D in lieu of Schedule 13G. Schedule 13G is also available to certain institutional holders if they become 5% holders in the ordinary course of their business and not with the purpose or effect of changing or influencing control of the issuer. Schedule 13G must be filed within 45 days after the end of the calendar year in which the requirement to file the Schedule arose, and must be amended within 45 days of the end of each calendar year if there are any changes in the information previously reported.

Short Swing Profits

Section 16 of the Exchange Act imposes reporting and profit disgorgement requirements on directors, executive officers and 10% beneficial owners of equity securities registered under the Exchange Act. These persons must report beneficial ownership of equity securities as well as derivative securities, such as options and warrants deriving their value from equity securities. Purchases and sales, or sales and purchases, of any of these securities within a six-month period at a profit requires disgorgement of any profit on such transactions.

Insider Trading Considerations

Even though securities may be saleable under Rule 144 or under a registration statement, if the seller is in possession of material, non-public information, it will have to delay selling until the information is public. Although a seller may be able to conclude that all material information has been made public where the issuer has filed a registration statement for an underwritten offering, in cases where a shelf is available and the seller is taking its shares off the shelf, or is relying on Rule 144, it may find that it cannot sell because of the information that it possesses (for example, because of its designees on the issuer's board of directors).

Avoiding the Pitfalls

The foregoing should demonstrate that the rules governing resales of securities in the US are unique. Non-US persons who acquire shares outside of market transactions, be it as a result of an acquisition or a private investment, need to consider the implications on the short-term liquidity of their investments. If immediate liquidity is important, registration rights are critical.

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