Securities Law Issues in Private Company M&A

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Safety Share: Communicating with Shareholders about Company Securities

Am considering taking Tesla private at $420. Funding secured.

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Securities Laws Implicated

- **Rule 14e-8** (Tender offer rules against market manipulation)
- **Rule 10b-5** (Fraud in connection with sale of a security)
- **Regulation FD** (fair disclosure)
- **Rule 17(a)** (negligence in a sale of securities that involved fraud or deceit on purchaser)

Learnings

Principles for communicating with Shareholders:

--Truth matters
--But so does:
  - Manner of communication
  - Timing
  - Intent
Securities Law Relevance in Private M&A

Cash Transactions
- No Section 5 Concerns
- Rule 10b-5 and general fraud considerations still applicable
- Fiduciary duties

Mergers, Recaps, and Debt Securities
- Section 5 Fully Applicable
- Need to find exemptions in private M&A transactions
- Rule 10b-5 and general fraud considerations still applicable
- Fiduciary duties
Rule 145, Business Combinations as Sales

- An acquirer that issues stock or other securities in any type of business combination that requires shareholder approval is considered to be selling securities.

- The Preliminary Note to the rule specifically references the exemptions contained in Sections 3(a)(9), (10), (11) and 4(a)(2).

- Types of Transactions Covered by Rule 145
  - Reclassifications
  - Mergers or Consolidations
  - Certain Transfers of Assets
  - Tender Offers (must comply with both the bender offer rules and the '33 Act registration requirements)

- Controlling persons of a target are free to resell any acquirer securities received in the transaction, unless they become controlling persons of the acquirer (assuming a shell company is not involved).
Consequences of Securities Law Violations (Private Actions)

Right of Rescission

- Purchaser has “put” right to exchange securities in return of purchase price. (Section 12(a)(1))
- State law rescission statutes typically also require payment of interest

Fraud Claims

- Rule 10b-5 provide for a private cause of action for violations involving false statements or omissions of material fact.
- For a successful cause of action, scienter must be shown.
- Purchaser often tries to require a 10b-5 representation in purchase agreement that does not include a scienter requirement.
Consequences of Securities Law Violations (Regulatory Actions)

SEC and the states may bring actions requiring payments of fines, cease and desist orders or prohibiting future actions.

Violations may make it harder to raise money in the future or do future acquisitions.

Google was required to conduct a rescission offer prior to its IPO for violating Section 5 in issuing compensatory equity.

US Department of Justice and State Attorney General can bring criminal claims.
## Most Useful Exemptions in Private M&A

<table>
<thead>
<tr>
<th>4(a)(2)</th>
<th>Rule 506</th>
<th>3(a)(10) Fairness Hearings</th>
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| - Transactions by an issuer not involving any public offering, aka the “private placement exemption”  
  - Ralston Purina Corp. (1953) | - Safe Harbor under Rule 4(a)(2)  
  - May only sell to up to 35 unaccredited investors | - Utah Division of Securities has a Fairness Hearing Process.  
  - Likely will provide a faster and cheaper alternative to full federal registration of the offering |
Other Exemptions

Intrastate Exemption (Section 3(a)(11) and Rule 147 and Rule 147A)
- Issuance must be sold only to persons resident within a single state.
- Does not limit the size of the offering or number of purchasers.

Rule 504
- Exempts offerings with an aggregate price of up to $5 million during 12 months
- Does not limit the number of investors or impose any sophistication requirements
- Does not preempt state law
- Not available for public companies

Regulation S
- Provides that, subject to certain conditions, offers and sales outside of the United States are not subject to Section 5 of the Securities Act
Using Rule 506

- Does not limit the amount of capital an issuer can raise
- Permits an unlimited number of accredited investors and up to 35 non-accredited investors
- Rule 506(c) amendments are not very helpful in an M&A context
- Rule 506 safe harbor is not available if any covered person has had disqualifying event in the past, unless a bad actor disqualification was obtained
Using Rule 506 (continued)

Extensive disclosure under Rule 502(b) required for non-accredited investors,

- Including much of what would be required in an S-4 Registration Statement

Rule 502(b) information needs to be provided a reasonable period of time prior to sale.

- For a stock purchase agreement, when the purchase agreement is signed
- For a merger agreement, when the agreement is submitted to a vote of security holders
Rule 506 (Great for Accredited Investors)
Strategies for Non-Accredited Investors

Don’t offer them securities

- Buyer pays cash
- Target accredited shareholder buys out non-accredited shareholder prior to the transaction
Either party to the transaction is a domestic business entity;

Either party to the transaction is a business entity whose headquarters or principal place of business is located in Utah; or

Thirty percent (30%) or more of the persons to whom it is proposed to issue securities or to deliver other consideration in the exchange are persons who are Utah residents.
3(a)(10) Fairness Hearings Benefits

- Quicker and cheaper than a Form S-4 Registration Statement
- Unlimited amount of securities and unlimited number of non-accredited investors
- Target shareholders typically get “unrestricted securities”
- In August 2012, Department of Corporations in California approved the acquisition of Instagram by Facebook following a fairness hearing
3(a)(10) Fairness Hearings Process

- Complete Application (Form 11 and Proxy Materials) (Approximately 30-45 days)
- Notice of Fairness Hearing (At least 20 calendar days)
- Fairness Hearing
- Finding and Order (Determination typically comes immediately or very quickly)
## Common Securities Law Alternatives

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<th>Private Placement</th>
<th>Form S-4 Registration Statement</th>
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<tr>
<td>Transaction Costs</td>
<td>Least Expensive</td>
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<tr>
<td>Time to Closing</td>
<td>15-30 days</td>
<td>90+ days</td>
<td>45-75 days</td>
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<td>Liquidity Timing</td>
<td>6 – 12 months</td>
<td>At Closing</td>
<td>At Closing</td>
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<tr>
<td>Best Use</td>
<td>Small number of sophisticated shareholders</td>
<td>Large, diverse group of shareholders</td>
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</tr>
</tbody>
</table>
State Securities Law Considerations

Common Exemptions

- Non-Public Offering
- Merger and Reorganization
- Limited Offering
- Isolated Transactions
- Fairness Hearing
- Exchange Listed Security
- Accredited Investor
Fairness Hearings are not “covered securities” under federal securities laws.

Fairness Hearings are exempt under Utah law

Fairness Hearings are not exempt under the laws of every state
Disclosure Issues

Rule 10b-5

It is *unlawful* to issue materially misleading statements or omissions, or use manipulative and deceptive devices.

General anti-fraud provision of the federal securities laws.

Applies to any transaction involving the sale of securities.
Who has 10b-5 Exposure in a Stock-for Stock Merger?

Company A?

Company A Shareholders?

Company B?

Company B Shareholders?
Rule 701 Issues (Post-Merger)

How do you determine the amount of securities the acquirer may sell in any consecutive 12-month period?

- Acquirer must include the aggregate sales price and amount of securities for which the target company claimed the exemption

How do you determine the amount of securities an acquirer can sell for purposes of the $5 million calculation?

- Acquirer must include any securities that the target company sold during the same period
Don’t Forget About Fiduciary Duties

Failure to preserve the Business Judgement Rule gives dissenting shareholders another claim to add onto their securities law claims.

Advise the Board

---duty of care means to “be informed”

---no conflicts of interest!!!
Hypothetical #1

- Big Chairs Inc. wants to acquire Indoor Swings Corporation to broaden its product offerings. It is proposing to acquire 100% of Indoor Swings’ outstanding shares by paying Indoor Swings’ shareholders a combination of cash and stock (50/50 mix) worth $25.0 million.

- Indoor Swings has 25 accredited shareholders and 20 unaccredited. The shareholders live in Utah, Wyoming, Idaho and California.

- Indoor Swings issued stock options to its employees six months prior to the merger date in an amount of $2 million in reliance upon Rule 701. In addition to wanting to know which exemption to rely upon, Big Chairs wants to know how these options will affect the deal.
Hypothetical #1 Answer

• Big Chairs can rely on Rule 506 of Regulation D for an exemption under the Securities Act

• No specified information must be supplied to accredited investors, although Rule 10b-5 still applies

• Information meeting the requirements of Rule 502 must be supplied to non-accredited investors a reasonable period of time prior to sale (good idea to provide some information to accredited investors since already prepared)

• State blue sky laws preempted, but there may still be a requirement to file a notice of offering

• Options granted to Indoor Swings employees must be aggregated with options granted to employees of Big Chairs pursuant to Rule 701
Hypothetical No. 2

• Beach Tacos, Inc. is based in Utah and wants to acquire Fourteener Enchiladas Corp (based in Colorado) in an all stock deal valued at $4 million.

• One of the directors of Fourteener Enchiladas will become a director of the combined company. The remaining directors will retire.

• Fourteener has 10 accredited investors and 25 non-accredited investors. Its shareholders are located in Colorado and New Mexico.

• In addition to the appropriate exemption to rely upon, the directors of Fourteener want to know if the stock they receive from Beach Tacos will be freely tradable.
Hypothetical No. 2 Answer

• Beach Tacos (issuer) can rely on Rule 506 of Regulation D for an exemption under the Securities Act (same as in the prior example).

• Beach Tacos must prepare disclosure required by Rule 502.

• Beach Tacos can also rely on Rule 504 of Regulation D for an exemption under the Securities Act (less than $5 million)

• No specified information must be supplied to non-accredited investors, though be mindful of Rule 10b-5

• State blue sky laws not preempted, so you’ll need a separate state law exemption

• Under Rule 145, the stock of the directors of Fourteener Enchiladas who did not become directors of Beach Tacos will be freely tradable (assuming neither entity is a shell company)
Hypothetical #3

• Soda Cookies proposes to acquire FroYo King through an all-stock merger valued at $15 million.

• Soda & Cookies will issue new shares representing 50% of the post-merger outstanding shares. Both Soda Cookies and FroYo King are based in Utah, as are all shareholders. Ten of FroYo King’s shareholders are accredited, and the other 15 are non-accredited.
Hypothetical #3 Answer

- Soda Cookies can rely on Rule 506 of Regulation D for an exemption under the Securities Act
- Soda Cookies may also be able to rely on Section 3(a)(11)/Rule 147/ Rule 147A for an exemption under the Securities Act
- State blue sky laws not preempted, so you'll need a separate state law exemption
- Soda Cookies will also need shareholder approval under Utah law and, if publicly traded, under the laws of its securities exchange.
Hypothetical #4

- Funny Money is a public company and Crypto Boys is a private company.
- Funny Money is located in Utah; Crypto Boys is located in Idaho.
- Funny Money wants to acquire Crypto Boys through a merger of 50% cash and 50% stock. The value of the deal will be $50 million.
- Crypto Boys has 250 shareholders, most of whom are not-accredited.
- Stock ownership is dispersed (directors and officers together own 10% of the stock; there are no 5% or greater shareholders)
- Funny Money wants to “lock-up” at least 30% of the votes at the time the merger agreement is signed.
Hypothetical #4 Answer

- Rule 506 is not available.
- The issuer can utilize a fairness opinion in Utah.
- Funny Money can “lock-up” insiders, but should not lock-up others.