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CLIENT MEMORANDUM

SEC Releases Updated Guidance Regarding Going Private Transactions

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INTRODUCTION

The Securities and Exchange Commission (the "SEC") recently issued updated Compliance and Disclosure Interpretations (the "Q&A") regarding the application of Rule 13e-3 under the U.S. Securities Exchange Act of 1934 to transactions in which a publicly traded issuer or its affiliates engage in certain transactions that cause the issuer to "go private." Although some have suggested the possibility that the Q&A expands the current application of Rule 13e-3 to strategic transactions as well as to certain leveraged buyouts even where management's equity participation is not agreed, the Q&A is substantially a confirmation of prior interpretations.

BACKGROUND

Purchasers generally prefer to avoid triggering Rule 13e-3 because they are then required to file a Form 13E-3. The disclosure requirements of Form 13E-3 are more onerous than the customary disclosure requirements for a proxy, including disclosure with respect to the purpose of the transaction, post-transaction plans for the issuer, and the bidder's view as to the fairness of the transaction to public shareholders. The required exhibits include the filing of financial advisor presentations (e.g., board books) that are materially related to the going private transaction prepared for the issuer or even the bidder. Although practitioners have sometimes focused on written reports relating to fairness, the Q&A makes it clear that the disclosure requirements extend to oral reports and reports and opinions that address matters other than the fairness of the consideration. Form 13E-3 also contains historical information about the issuer and the filer may be liable for material errors or omissions in that information. Finally, the filing of a Form 13E-3 increases the chance of SEC review and is usually a more time consuming review process than a non-13e-3 transaction

WHO IS AN AFFILIATE?

- *Management.* Consistent with the SEC's historical position, the Q&A confirms that the SEC will treat

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members of senior management of an issuer that is going private as affiliates of the issuer. If deemed to be "engaged" in a going private transaction involving the issuer, management will be subject to 13e-3 obligations separate from the issuer.

- *Purchaser*. Also historically consistent, management's "engagement" in a going private transaction such that it is on "both sides" of the transaction may cause a previously unaffiliated purchaser to be deemed an affiliate as well, thereby triggering Rule 13e-3 requirements for both management and such purchaser. This is the classic basis for acquisitions effected by private equity firms becoming subject to Rule 13e-3.

WHEN IS MANAGEMENT "ENGAGED" IN THE TRANSACTION RESULTING IN THE TRIGGERING OF RULE 13E-3?

- *Management Engagement in the Transaction*. The Q&A confirms prior telephone interpretations that have taken the position that members of senior management still may be engaged in the going private transaction where the transaction will be effected through the merger of the issuer into the purchaser or that purchaser's acquisition subsidiary, even though:
  - management's involvement in the issuer's negotiations with the purchaser is limited to the terms of each manager's future employment with and/or equity participation in the surviving company; and
  - the issuer's board of directors appointed a special committee of outside directors to negotiate all other terms of the transaction except management's role in the surviving entity.

An important aspect of the staff's analysis has been that the issuer's management would hold a material amount of the surviving company's outstanding equity securities. In addition, the staff analyzes other factors such as whether management will occupy seats on the board of the surviving company or hold senior management positions with the surviving company, and whether management will otherwise be in a position to control the surviving company.

- Extent of Agreement or Understanding. The Q&A addresses the extent to which contacts or negotiations have progressed with respect to management's equity participation in order to trigger a Rule 13e-3 filing obligation.
  - While traditionally practitioners have focused upon whether there is an agreement or understanding between management and the buyout group as to the amount of management's equity deal, the Q&A says that management can be deemed to be engaged in a going private transaction where it is generally understood that they would be equity holders in the surviving entity after the acquisition closed. This statement is made in the context of a specific example of a transaction in which a financial purchaser planned to issue to target's senior management a 20% stake in the surviving company, even though the terms of the target's management future participation were not finalized.
  - Although there is a suggestion in the Q&A that the mere understanding that equity will be received by management is sufficient to create a 13e-3 transaction, the Q&A could be read as simply making clear, as practitioners currently understand, that a "plan" as to management's

equity participation need not be documented or finalized for a transaction to be subject to Rule 13e-3.

  - Although the SEC is not explicit on this point, we do not believe that a general understanding that management will receive some undetermined amount of equity pursuant to a buyout, which may or may not be material, will in and of itself subject the transaction to Rule 13e-3, so long as any negotiation as to specific amounts and other terms are deferred until after the transaction closes.

- *Material Amount of Equity*. The Q&A does not establish any bright line test as to the threshold amount of management's equity participation that will be deemed material and give rise to a Rule 13e-3 transaction.
- The Q&A indicates by way of example that a transaction in which target's senior management will receive a 20% stake in the surviving entity pursuant to a separate agreement will trigger Rule 13e-3 obligations for a previously unaffiliated purchaser.
- The Q&A does not say whether a lower percentage of equity would trigger Rule 13e-3, but historically the SEC often has required compliance with Rule 13e-3 if management owns 10% or more of the surviving entity or the purchaser. The 10% is neither a formal trigger nor a safe harbor. Facts and circumstances could result in a lower or higher percentage giving rise to a Rule 13e-3 transaction.
- Equity is not defined, but in the absence of further SEC guidance we would assume it includes "roll-over" equity, new equity and both time and performance options measured on a fully diluted basis.

APPLICATION OF RULE 13E-3 TO STRATEGIC INVESTORS

While the filing of a Form 13E-3 by an unaffiliated strategic buyer has been rare, the Q&A cites to a 1979 release to remind buyers that Rule 13e-3 may require a filing by even a strategic buyer where continuity of management exists. The Q&A notes that the SEC will look at various factors to determine whether Rule 13e-3 obligations will apply including increases in consideration to be received by management, alterations in management's executive agreements favorable to such management, the equity participation of management in the acquiror, and the representation of management on the board of the acquiror. The SEC, however, rarely questions the absence of a Rule 13e-3 filing by an unaffiliated strategic buyer and we do not expect that to change absent special circumstances.

FOR MORE INFORMATION

This memorandum is for general informational purposes and should not be regarded as legal advice.

Please contact your relationship partner if we can be of assistance regarding the application of securities laws to going private transactions. The names and office locations of all of our partners, as well as additional memoranda regarding recent securities law and mergers and acquisitions developments, can be obtained from ourwebsite, www.simpsonthacher.com.

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