Asia M&A / Private Equity Newsletter

DAVIS POLK & WARDWELL

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Acquiring a Minority Equity Stake in a U.S. Public Company

Acquisitions of minority stakes in U.S. public companies are attracting increasing interest from Asian investors, whether as stand-alone passive investments, as strategic stakes or as preludes to possible future business combinations. This heightened interest is driven by a number of factors, including the rise in recent years of well-capitalized and acquisitive multinational companies in key emerging markets in Asia. More recently, the ongoing global financial crisis has created a further boost in the number of potential opportunities for attractive investments in U.S. public companies, including as a result of volatile foreign currency exchange rates, sharply declining equity valuations, and pressing needs by a number of these companies for improved liquidity and additional capital.

Depending on the form and structure of the acquisition, these minority investments raise a variety of complex legal issues. Typically, acquisitions of minority stakes in U.S. public companies take one of two forms: the investor may purchase shares in the open market, or the investor may purchase shares directly from the company or one of its significant shareholders in a negotiated transaction. Open market purchases are often chosen because they are quick and easy to implement, especially if the investor thinks that its investment may not be welcomed by the target company. There are, however, commercial limits on how much an investor may purchase in the market at a given price, as well as legal limits on how much an investor may purchase without triggering certain approval requirements or legal obligations or consequences. A negotiated transaction, on the other hand, typically takes longer to execute, but can offer a number of benefits, including due diligence access and potential board representation and certain minority protection rights. However, an investor may be required, in exchange for such benefits, to agree to restrictions on disposition (referred to as a “lock-up”) or further investment (referred to as a “standstill”).

In this inaugural issue of our Asia M&A / Private Equity Newsletter, we have selected five things that we believe will be of interest to an Asian investor considering a minority investment in a U.S. public company.

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Five Things to Consider

» ***Poison Pill.*** A “poison pill” is a common and potent form of takeover defense utilized by public companies in the U.S. A poison pill typically takes the form of a shareholder rights plan under which the company issues “rights” to its existing shareholders to purchase equity securities of the company at a significant discount. These rights are generally attached to and traded with the company’s equity securities and may not be exercised until the occurrence of a triggering event. The triggering events for a poison pill generally include any person or group acquiring more than a specified percentage of the company’s equity securities (typically 15-20%) without first obtaining board approval. Once triggered, these rights will entitle every shareholder of the company, except the unsolicited acquirer, to purchase additional equity securities of the company at a significant discount, heavily diluting the acquiror’s stake and increasing the cost of the acquisition. Consequently, before acquiring a large amount of securities of a U.S. public company in the open market, it is important for an investor to discover whether the target company has a poison pill and, if so, to determine what ownership threshold and other factors trigger it. The target company board typically has the power to waive the application of the poison pill to a given acquiror, and obtaining this waiver is usually a precondition when acquiring securities directly from a target company in a negotiated transaction.

» ***"Creeping" Tender Offer.*** In many Asian jurisdictions the accumulation of securities of a listed company above a specified ownership percentage would require the purchaser to make a mandatory general offer to all of the listed company's shareholders. There is no such mandatory offer requirement in the United States. However, a different type of "mandatory" tender offer issue exists in the United States which may catch foreign acquirors unaware. Certain types of purchases of securities of a U.S. public company from the company's existing securityholders, whether through the open market or in negotiated transactions, can constitute a "tender offer" under the U.S. securities laws and require compliance with the U.S. tender offer rules, with the effect of imposing significant procedural and substantive requirements on the unwary acquiror. The U.S. securities laws do not define the term "tender offer", and the U.S. Securities Exchange Commission ("SEC") has taken the position that the term "tender offer" is to be interpreted flexibly and apply to accumulations of securities beyond the "classic" tender offer (which is usually thought of as an organized, public offer made simultaneously to all shareholders to purchase their securities at a uniform, specified price). The analysis of whether a given plan for accumulating securities constitutes a "tender offer" that must comply with the U.S. tender offer rules is highly fact-intensive. "Tender offers" can be deemed to have occurred in situations where bids are made that are too large to be filled in the regular auction market, purchases are made on the basis of widespread mailings, telephone calls or other types of solicitations, and any other purchases where the conduct of the person seeking control causes pressure to be placed on the company's securityholders similar to that attendant to a conventional tender offer. However, with appropriate planning, investors can usually make market accumulations with confidence that they will not inadvertently violate the U.S. tender offer rules.

» ***Schedule 13D or 13G Filings.*** The U.S. securities laws impose certain filing and disclosure requirements on any person or group that acquires beneficial ownership of more than 5% of a class of publicly traded equity securities, whether through open market purchases or negotiated transactions or otherwise. Generally speaking, an investor must file a Schedule 13D with the SEC within 10 days of crossing the 5% threshold, and thereafter report any material changes by filing an amendment within one business day of the change. Schedule 13D filings are intended to provide information to the issuer of the securities and to the public concerning accumulations of securities by persons who might influence or change the control or management of the issuer, and require disclosure of, among other things, the identity and background of the reporting person, certain information regarding its directors and executive officers, the source and amount of funds used to make the acquisition, the purpose of the acquisition, and any plans of the reporting person regarding the issuer (including plans to acquire additional securities or to change the board or management of the issuer). A shorter and less onerous Schedule 13G may be filed in lieu of Schedule 13D by certain institutional investors (such as banks and investment companies) and passive investors with less than a 20% holding in the publicly-traded class of equity securities that can certify that the investment is made in the ordinary course of business without any "control purpose or effect". If, however, the investor acquires more than 20%, or changes its investment intent so it does have a "control purpose or effect", the investor must file a Schedule 13D within 10 days and cannot purchase additional securities until the Schedule 13D is filed. Before acquiring 5% or more of a publicly-traded class of equity securities, investors should carefully evaluate the disclosure and strategic implications of becoming a Schedule 13D or Schedule 13G filer.

» ***Section 16 Implications.*** Any person that acquires beneficial ownership of more than 10% of a class of equity securities of a U.S. public company will become a "Section 16 insider" subject to the same rules and regulations under Section 16 of the U.S. Securities Exchange Act that apply to every officer and director of the company.[1] These rules require, among other things, that the "insiders" publicly disclose, through SEC filings, their ownership of securities in the company and promptly disclose any changes in ownership. A Section 16 "insider" must also comply with certain restrictions on the "short selling" of such securities. In addition, under Section 16, an "insider" will be forced to disgorge any profits from "short-swing" transactions (i.e., any purchase and sale, or sale and purchase, of the company's securities or any security-based swap agreement involving the company's securities, within any six-month period). This is the case regardless of the intention of the Section 16 insider in entering into these transactions. For the typical minority investor, these restrictions can impose significant and unexpected restrictions on the investor's ability to, among other things, hedge or exit from its investment.

» ***U.S. Regulatory Considerations.*** Depending on the nature and size of the investment, certain acquisitions of U.S. securities may require U.S. regulatory reviews or approvals before they can be consummated. These include antitrust approval, as well as review of transactions that may threaten to impair U.S. national security interests. Under the U.S. Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act"), acquisitions of U.S. voting securities or assets exceeding US$63.1 million must generally be notified to the U.S. Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice, as well as the target company, and cannot be consummated prior to the expiration or early termination of an applicable waiting period. Under the Exon-Florio statute (as amended by the Foreign Investment and National Security Act), the U.S. President has the authority to suspend or prohibit any acquisition of "control" of a U.S. business by a foreign buyer that threatens to impair U.S. national security interests. An inter-agency U.S. government body, the Committee on Foreign Investment in the United States ("CFIUS"), conducts national security reviews of transactions that may be subject to Exon-Florio. These reviews may be initiated voluntarily by the parties or by CFIUS or any of its member agencies. A successful CFIUS review means that, except under unusual circumstances, the transaction will not be subsequently blocked or unwound under Exon Florio – as a result, investors should voluntarily submit proposed transactions to CFIUS for review where there are any potential national security concerns. Apart from antitrust and Exon-Florio reviews, investments into certain regulated industries (such as aviation, banking, public utilities, insurance, communications, railways and trucking, shipping, and liquor producers and distillers) may face foreign ownership or other additional restrictions and regulatory review processes. Before acquiring any U.S. securities or business, an investor should consult with legal counsel regarding potential foreign ownership restrictions, antitrust, national security or industry-specific regulatory requirements that may apply to the proposed investment, and inquire as to the existence and nature of any exemptions that may apply, in particular for minority investments. To provide two relevant examples, the HSR Act offers a potential exemption for an acquisition involving less than 10% of the voting securities of a company if the investment is passive in nature. Likewise, under proposed regulations issued by CFIUS, passive investments of less than 10% may be exempt from Exon-Florio.

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If you have any questions regarding this newsletter, please call your regular Davis Polk contact.

[1] But note that Section 16 does not apply to equity securities issued by a company that is organized under the laws of a jurisdiction outside of the United States and that qualifies as a "foreign private issuer" under the SEC's rules.