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Delaware Supreme Court Provides Important Guidance on Interpretation of "Boilerplate" Indenture Language

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The Delaware Supreme Court recently was asked to consider whether the Court of Chancery properly determined that a series of four divestitures—taking place over the course of seven years along with various asset acquisitions and swaps—should be aggregated for purposes of determining whether a corporation had sold "substantially all of its assets" under a bond indenture's successor obligor provision.[1] While affirming the Court of Chancery's conclusion that the four divestitures were not sufficiently connected to warrant aggregation, the Supreme Court also found that the Court of Chancery's adoption of the "step-transaction doctrine" as an analytical tool for determining whether a series of transactions should be aggregated for purposes of a successor obligor provision was not necessary, limiting the precedential impact of the Court of Chancery's decision.[2] The Supreme Court also took the opportunity to provide some useful guidance concerning the interpretation of so-called "boilerplate" language when used in a bond indenture.

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From the EDITOR

An Antitrust Autumn

In contrast to the relatively quiet past decade, when there were few government lawsuits that sought to block proposed mergers, the next six months will be a series of potentially decisive battles.

The U.S. Department of Justice's lawsuit challenging the proposed $39 billion merger of AT&T Inc. and T-Mobile USA Inc. is one of the biggest antitrust stories of the year. The DOJ is looking to block a deal that would unite the second- and fourth-largest cellphone providers in the U.S., with the DOJ arguing that the merger, if approved, could raise prices and could hamper innovation in the sector. The DOJ has described AT&T's target T-Mobile as a "maverick" that has helped spur competition and kept down pricing in the cellphone industry. DOJ officials reportedly have scoured thousands of internal documents in the hopes of finding emails and marketing tools to show that AT&T has considered T-Mobile a major competitor in the past.

There seems little chance of a settlement beforehand, with a trial provisionally set to begin on February 13, 2012 (AT&T competitors Sprint Nextel Corp. and Cellular South have also sued AT&T in the U.S. District Court for the District of Columbia over the proposed deal). Expected to head the DOJ's case are deputy attorney general Joseph Wayland and Claude Scott, who spearheaded the government's unsuccessful attempt to block the Oracle Corp./PeopleSoft merger. The DOJ is also reportedly hiring Glenn D. Pomerantz, a partner in the Los Angeles office of Munger, Tolles & Olson. AT&T is reportedly building a defense led by its general counsel Wayne Watts.

The court's decision may come down to the national vs. local implications of the deal: while the merger reduces the number of national cellphone companies to two, AT&T is expected to argue that competition remains plentiful at the local level. However, the DOJ's 21-page complaint is focused on the implications for national, rather than local, competition, which means trouble for AT&T. Mark Ostrau, a partner with Fenwick & West, told the *Wall Street Journal* that AT&T likely could have resolved concerns about its local market impact by divesting customers, spectrum and other assets in regions where it would have acquired a large market share via T-Mobile. But crafting an all-purpose remedy for the national market is a far different story.

Before its showdown with AT&T, however, the DOJ has been fighting to prevent H&R Block Inc. from buying 2ss Holdings Inc., the maker of TaxACT products, a merger that "totally lacks any redeeming features," Wayland said in his closing arguments in early October. U.S. District Judge Beryl Howell in Washington is expected to rule on the case by the end of the month.

While of lesser scope than AT&T/T-Mobile, the H&R Block case is crucial for the DOJ. It's the DOJ's first merger trial in seven years, and a loss in court here could set a troubling precedent for its upcoming fight with AT&T, analysts and lawyers said. And regardless of what happens with H&R Block, the AT&T case will likely take a number of unexpected twists before the trial begins next year.

CHRIS O'LEARY

MANAGING EDITOR

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Background

Liberty Media Corporation, led by cable TV giant John Malone, is a major distributor of entertainment, sports and other television programming. Liberty was created in 1991 by Tele-Communications, Inc. in reaction to a threat by federal regulators to separate its programming assets from its cable systems. After a series of corporate transactions engineered by Malone, Liberty emerged in August 2001 as an independent, publicly-traded corporation.

At that time, Liberty held assets characterized by the Court of Chancery as "a 'fruit salad' of assets, consisting mainly of minority equity positions in public and private entities." In addition, Liberty was party to an indenture for outstanding bonds containing a "successor obligor provision." This provision prohibited Liberty "from selling, transferring, or otherwise disposing of 'substantially all' of its assets unless the entity to which the assets are transferred assumes Liberty's obligations under the indenture...." Notably, the bond indenture, which is governed by New York law, does not define the term "substantially all."

Because many of Liberty's assets were minority investments that did not generate cash flow, Liberty management sought to acquire controlling interests in those businesses. If the path to control was blocked, management would "evaluate[ ] all possible alternatives for the asset." In furtherance of this strategy, Liberty "engaged regularly in acquisitions, dispositions, [and] complex swaps," as well as the following dispositive transactions:

1. *LMI:* In 2004, management engineered the spinoff to Liberty stockholders of a subsidiary, Liberty Media International, Inc., which held Liberty's international cable businesses in Europe, Latin America and Japan. This transaction removed $11.79 billion in assets from Liberty's balance sheet, representing 19% of Liberty's book value as of March 31, 2004.

2. *Discovery*: In 2005, Liberty dividended to stockholders its minority interest in the joint venture that owns the Discovery cable channel. This transaction removed $5.825 billion in assets from Liberty's balance sheet, representing 10% of Liberty's book value as of March 31, 2004.

3. *LEI:* In 2009, Liberty split off its interest in DirectTV (as well as certain other businesses) into a new entity called Liberty Entertainment, Inc. ("LEI"). This transaction removed $14.2 billion in assets from Liberty's balance sheet, representing 23% of Liberty's book value as of March 31, 2004.

4. *Capital Splitoff*: Finally, in June 2010, Liberty announced the "Capital Splitoff," pursuant to which it would split off its Capital and Starz Groups into a new public entity. This proposed transaction would remove $9.1 billion in assets from Liberty's balance sheet, representing 15% of Liberty's total assets as of March 31, 2004.

After learning of the Capital Splitoff, a lawyer acting for an anonymous bondholder sent a letter to Liberty claiming that it was pursuing "a 'disaggregation strategy' designed to remove assets from the corporate structure against which the bondholders have claims and shift the assets into the hands of Liberty's stockholders." Completion of the Capital Splitoff, the letter asserted, would result in a sale by Liberty of "substantially all of its assets." Accordingly, unless Liberty simultaneously arranged for the various successor entities to assume its obligations under the bond indenture, Liberty would be in violation of the bond indenture's successor obligor provision. On this basis, the lawyer's letter threatened Liberty with a declaration of an event of default under the bond indenture.

Faced with this threat, Liberty sought declaratory and injunctive relief in the Court of Chancery against Bank of New York Mellon in its capacity as Trustee under the bond indenture.

The Court of Chancery Decision

Aggregating Transactions: *Sharon Steel*

The Court of Chancery recognized that the "threshold question is. . .whether the Capital Spli-

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toff should be aggregated with the prior spinoffs of LMI and Discovery and the splitoff of LEI." To address this question, the Court of Chancery considered the Second Circuit's decision in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*,[3] which the Court of Chancery characterized as "the leading decision on aggregating transactions for purposes of a 'substantially all' analysis."

In *Sharon Steel*, the Second Circuit was confronted with a debtor corporation that transferred assets to multiple purchasers, including Sharon Steel, pursuant to a plan of liquidation. Sharon Steel asserted that it had acquired "all or substantially all" of the debtor corporation's assets and therefore was entitled to be recognized as the successor obligor under the indenture. Under the successor obligor provision contained in the debtor corporation's bond indenture, a successor could assume the debtor corporation's obligations only if the corporation was selling "all or substantially all" of its assets in the transaction. Certain debenture holders, however, claimed that the assets sold to Sharon Steel did not constitute "substantially all" of the debtor's assets and, therefore, the debtor was in default under the indenture. Focusing on the fact that the individual asset sales were carried out in furtherance of formal plan of liquidation, the Second Circuit declared that the assets transferred to Sharon Steel had to be measured against the totality of assets owned at the *inception* of the plan of liquidation. On this basis, the Second Circuit ruled that Sharon Steel was not entitled to assume the debtor's indenture obligations.

From the Court of Chancery's point of view, based on *Sharon Steel*, the independent transactions engaged in by Liberty over a seven-year period—and not pursuant to a specific plan—should not be aggregated.

Step-Transaction Doctrine: *Noddings*

While acknowledging that "[c]ourts applying New York law have recognized that, under appropriate circumstances, multiple transactions can be considered together when determining whether a transaction constitutes a sale of all or substantially all of a corporation's assets," the Court of Chancery observed that "[n]one of these sources…has articulated a clear standard for determining when transactions should be aggregated." Accordingly, the Court of Chancery applied "doctrinal hindsight" to add a "second layer of analysis": the step-transaction doctrine articulated by the Court of Chancery in *Noddings Investment Group, Inc. v. Capstar Communications, Inc.*,[4] 17 years after *Sharon Steel*.

Under *Noddings*, the Court of Chancery explained, the various "steps" in a series of formally separate but related transactions will be treated as a single transaction if any one of the following tests is satisfied:

1. Under the "*end result test*," the doctrine will be invoked "if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result."

2. Under the "*interdependence test*," separate transactions will be treated as one if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."

3. The "*binding commitment test*" requires "a series of transactions [to be] combined only if, at the time the first step is entered into, there was a binding commitment to undertake the later steps."

Employing each of the "three lenses of the step-transaction doctrine…as a doctrinal tool" to bring the picture created by the evidence at trial "into sharper focus," the Court of Chancery saw no basis to support invocation of the step-transaction doctrine to Liberty's four dispositive transactions.

The Supreme Court's Analysis

Trustee's Arguments on Appeal

The Trustee appealed to the Delaware Supreme Court, challenging not only the Court of Chancery's conclusion that the transactions should not be aggregated under *Sharon Steel*, but also its use of the step-transaction doctrine as an analytical

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tool in this context. Specifically, the Trustee complained that the Court of Chancery's "adoption of the legally irrelevant step-transaction doctrine is…inconsistent with the Indenture's actual language, which forbids disposition of substantially all of Liberty's assets through a 'series of transactions.'" In the Trustee's view, "there is no evidence indicating that the parties intended to incorporate the step-transaction doctrine into the Successor Obligor Provision… ." The Trustee asserted, moreover, that "even if *Sharon Steel* fits within [the step-transaction framework], it does not follow that the Second Circuit intended to apply a step-transaction *requirement* for aggregating transactions under an indenture."

Court of Chancery Correctly Applied *Sharon Steel*

At the outset, the Supreme Court agreed with the Court of Chancery's framing of the threshold issue,[5] as well as its reliance on *Sharon Steel* and acknowledgement that "as a theoretical matter, a series of transactions can be aggregated for purposes of a 'substantially all' analysis." Next, the Supreme Court affirmed the Court of Chancery's application of the *Sharon Steel* principles to the Liberty divestitures, noting that "the Court of Chancery carefully assessed whether the trial evidence demonstrated that Liberty had developed a plan or scheme to dispose of its assets piecemeal with a goal of liquidating nearly all its assets…" Crediting the Court of Chancery's conclusion that the evidence at trial did not establish a plan on the part of Liberty to engage in a series of distributions that would evade the bondholders' claim, the Supreme Court upheld the Court of Chancery's "legal conclusion rest[ing] on its factual finding that aggregating the four transactions is not warranted because each transaction was the result of a discrete, context-based decision and not as part of an overall plan to deplete Liberty's asset base over time."

In so ruling, the Supreme Court emphasized that the Second Circuit had been careful to distinguish the "piecemeal liquidation" at issue in *Sharon Steel* from situations in which a corporation disposes of assets over time and "not as a part of a preconceived plan of liquidation." Echoing this distinction, the Supreme Court observed that a "sale in the absence of a plan to liquidate is undertaken because the directors expect the sale to strengthen the corporation as a going concern." It then noted that "where assets are not piecemeal components of an otherwise integrated, preestablished plan to liquidate or dispose of nearly all assets, and where each such transaction stands on its own merits without reference to another, courts have declined to aggregate for purposes of a 'substantially all' analysis."

Application of Step-Transaction Doctrine Not Necessary

The Supreme Court was not prepared, however, to support the Court of Chancery's "second layer of analysis" incorporating the *Noddings* step-transaction doctrine. Rather, the Supreme Court noted that the Court of Chancery should have ended its analysis when it determined that Liberty's various dispositive transactions should not be aggregated under *Sharon Steel*. In light of the "near absence of any authoritative New York case law," the Supreme Court concluded that "the principles articulated in *Sharon Steel* are the proper basis for determining, under New York law, the nature and degree of interrelationship that will warrant aggregation of otherwise separate and individual transactions as a part of a 'series.'"

On this basis, the Supreme Court concluded that it was unnecessary for it to decide whether a New York court would adopt the step-transaction doctrine to determine whether to aggregate a series of transactions in a "substantially all" analysis. "Given the Court of Chancery's factual findings," the Supreme Court explained, "even if the Court of Chancery had not utilized '[t]he three lenses of the step-transaction doctrine,'" its ultimate conclusion "would have been the same under its independent reading of *Sharon Steel*."

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"Market-Facilitating Boilerplate Language" Requires "Uniform Interpretation"

The Supreme Court's opinion also provides important guidance concerning the interpretation of so-called "boilerplate" language used in an indenture—in this case, the successor obligor provision. The Supreme Court explained that "[c]ourts endeavor to apply the plain terms of such provisions in a uniform manner to promote market stability." Under such circumstances, "courts will not look to the intent of the parties, but rather the accepted common purpose" of non-negotiated boilerplate provisions.

With respect to the Liberty indenture's successor obligor provision, the Supreme Court noted that the indenture "was executed many years after…*Sharon Steel*. There is no evidence that the…language was included for any reason other than to clarify that the Successor Obligor Provision should be interpreted in the same manner as the one at issue in *Sharon Steel*." The Supreme Court also noted that "the Successor Obligor Provision was never a subject of negotiations between the parties… ." Accordingly, the Supreme Court pointed out that "[h]ad the parties to the Indenture intended to create an asset disposition covenant with a broader scope than the standard, boilerplate successor obligor covenant, it was incumbent upon them to include it in a separate, negotiated covenant." Quoting two commentators on the subject, the Supreme Court further explained that if parties to an indenture intend to change the meaning of a commonly used provisions, such provision must "be not only explicit but also distinct from boilerplate provisions. Modifications to common indenture provisions will unlikely yield additional rights as courts will not look to the intent of the parties, but rather the accepted common purpose of such provisions."[6] The reason for this seems straightforward enough: in the words of the Supreme Court, "[i]t is important to the efficiency of capital markets that language routinely used in indentures be accorded a consistent and uniform construction."

Continuing with this theme, the Supreme Court recognized that, if they so desired, the drafters of the Liberty indenture could have availed themselves of "more rigorous model provisions available that explicitly required consideration of prior asset dispositions in determining the legal effect of a later disposition of any substantial part of an issuer's assets." The Liberty indenture contained no such provisions, however. The Supreme Court also referenced the Court of Chancery's observations that the indenture contained "no covenant 'requiring Liberty to maintain a particular credit rating, a minimum debt coverage ratio, or a minimum asset-to-liability ratio,'" nor "any provision directly addressing dividends and stock repurchases, which are the corporate vehicles to effectuate a spinoff (stock dividend) and a split-off (stock redemption)." Given that "this Court has consistently held that the rights of bondholders and other creditors are fixed by contract…, it would be inconsistent with the concept of private ordering to expand the scope of the Successor Obligor Provision by rewriting the Indenture contract to include by implication additional protections for which the parties could have—but did not—provide by way of a covenant separate and apart from the boilerplate successor obligor provision."

Conclusion

The Supreme Court's opinion in *Liberty Media* provides helpful guidance to drafters of bond indentures on several levels:

First, although the determination whether and when separate corporate dispositions should be aggregated for purposes of a successor obligor provision is inherently fact-specific, it is clear that the temporal proximity or similarity of the transactions in question will not be determinative under a *Sharon Steel* analysis.

Second, the Supreme Court rejected the Court of Chancery's attempt to impose a perhaps more sophisticated doctrinal approach to the determination whether transactions of this nature should be aggregated. Especially in view of the fact that the Liberty indenture is governed by New York law and the only precedent available was the Second Circuit's opinion in *Sharon Steel*, the Supreme Court was not prepared to support the Court of

Chancery's incorporation of the step-transaction doctrine into the analysis.

Third, the *Liberty Media* opinion reinforces the proposition that non-negotiated boilerplate indenture provisions will be given the accepted meaning in the market. When it comes to interpreting such language, the actual words or the intent of the parties appear to be of little significance. Rather, they simply serve as a marker signaling that the prevailing market meaning should be applied, absent the negotiation of "explicit" and, more importantly, "distinct" contractual language that provides otherwise.

NOTES

1. *Liberty Media Corp. v. Bank of New York Mellon Trust Company*, N.A.; C.A. No. 5702-VCL (Del. Ch. Apr. 29, 2011).
2. *Bank of New York Mellon Trust Company, N.A. v. Liberty Media Corp.*; No. 284, 2011, C.A. No 5702 (Del. Sup. Ct. Sept. 21, 2011).
3. 691 F.2d 1039 (2d. Cir. 1982).
4. Del. Ch. Mar. 24, 1999.
5. In framing the threshold question on appeal, the Supreme Court noted that, "The answer... involves the construction of a boilerplate successor obligor provision in an indenture governed by New York law...The question presented has not been addressed by the New York Court of Appeals, nor, to our knowledge, by any lower New York state court. In the past, we have certified questions of first impression under New York law to the New York Court of Appeals. In this case, certification is not realistically possible because the parties have requested a decision within one week of the oral argument before this Court. Consequently, as did the Court of Chancery, we must predict what the law of New York would be on this important question of first impression."
6. In an interesting reference to a recent Supreme Court decision interpreting a corporate charter provision establishing a classified, or "staggered," board of directors, the Supreme Court noted that under *Airgas, Inc. v. Air Products and Chemicals*, 8 A.3d 1182 (Del. 2010), "practice and understanding in the real world are relevant and persuasive when interpreting similar language in a contractual provision."

Changes to the UK Takeover Code: A Hostile Regime for Hostile Bids?

BY RICHARD MAY

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On September 19, 2011 substantial changes to the UK City Code on Takeovers and Mergers ("the Code") came into force. These changes make takeovers significantly more difficult by, among other things:

- providing greater protection for target companies against "virtual bids";
- prohibiting most deal protection measures and inducement fees;
- requiring greater disclosure in relation to the financing of bids and in relation to related fees and expenses; and
- introducing measures intended to properly recognize the interests of a target company's employees in relation to a potential bid.

Background

Following the public controversy relating to Kraft Foods Inc.'s bid for Cadbury plc, in February 2010 the UK Panel on Takeovers and Mergers ("the Panel") announced that it intended to launch a public consultation on proposed changes to the Code. This consultation was launched in June 2010.[1] In October 2010 the Panel issued a response statement in which it indicated that it intended to implement several of the changes which had been proposed in that consultation paper.[2]

On March 21, 2011, the Panel published a further consultation paper[3] detailing the proposed

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rule changes and inviting further comments. In July 2011 the Panel issued a response statement[4] in which it outlined the results of that consultation. The new rules came into force on September 19, 2011.

New rules

Protections in Relation to "Virtual Bids"

Previously, statements by a potential bidder that it may make a bid did not require it to do so. However the Panel could, following a bid announcement which identified a potential bidder, impose a "put up or shut up" order requiring the potential bidder, within the period set by the Panel, to either make a bid or to announce that it does not intend to do so. In those circumstances the potential bidder would not be permitted to do so for six months.

In recent times, some potential bidders have made such statements in order to put pressure on the target board to open its books or to gauge likely market reaction. While the Panel normally required an announcement to be made of a possible bid approach (by the potential bidder if no approach to the target had been made, and by the target company if it had been) where there was rumor or speculation or a material movement in the target company's share price, there was no general obligation on a target company to identify the potential bidder when the announcement was made.

The new rules require:

- target companies to identify any potential bidder with whom the target is in talks or from whom it has received an approach (unless that approach has been unequivocally rejected); and
- potential bidders which have been publicly named, within four weeks of the relevant announcement, either (i) to announce a formal offer; (ii) to announce that they do not intend to do so (in which case, as previously, they will not be permitted to do so for six months); or (iii) to make a joint application with the target company to the Panel to extend the deadline.

The Panel has the power to grant a dispensation from these requirements where a potential bidder is participating in a formal auction process which has been commenced by the target company.

While it is clearly undesirable for target companies to be subject to protracted siege as a result of a virtual bid, these new rules may encourage target companies to announce the identity of potential bidders in order to make them subject to the four week "put up or shut up" requirement. This may, in turn, deter potential bidders from approaching target companies.

It is also doubtful whether the four week period is sufficient to allow potential bidders to carry out due diligence and, if required, to arrange bid financing.

Prohibition of Deal Protection Measures and Inducement Fees

It has become common practice in the UK for potential bidders to require target companies, in the context of recommended offers, to agree to various deal protection measures. These include break fees, exclusivity undertakings, matching rights and implementation agreements.

The Panel previously expressed concern that such measures may deter potential competing bidders.

The new rules introduce a general prohibition on "offer-related arrangements" of this sort. This prohibition also extends to other arrangements between the potential bidder and the target company in connection with a bid. These include arrangements relating to the purchase by the bidder of assets from, or to the provision by the bidder of finance to, the target company, which are not in the ordinary course of their respective businesses.

Confidentiality and non-solicitation undertakings, commitments to provide information for the purpose of obtaining regulatory clearances and agreements which only impose obligations on the potential bidder (*e.g.*, a "reverse break fee") do not constitute an "offer-related arrangement" for this purpose.

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The Panel has the power to grant a dispensation from this prohibition to allow a company to enter into a break fee arrangement:

- with a prospective "white knight," where the company is the subject of a hostile offer; or
- with a potential bidder who is participating in a formal auction process commenced by the target company, provided that the break fee does not exceed 1% of the value of the target company, calculated by reference to the value of the competing offer. The Panel has also indicated that it may grant a dispensation from this prohibition where the target company is in such serious financial distress that its board is actively seeking an offer for it and where a potential bidder is only likely to make an offer if such arrangements are entered into.

Where the offer is proposed to be implemented by means of a Court approved scheme of arrangement, the position is different. Unlike a conventional offer, a scheme of arrangement is a target company-driven process. The target company is required to propose the transaction to its own shareholders and to convene and hold the necessary Court and shareholder meetings. Previously, potential bidders commonly required the relevant target company to enter into an implementation agreement to regulate the implementation of the scheme of arrangement. Under the new rules, such arrangements are also prohibited as "offer-related arrangements." However, to address the bidder's legitimate desire to ensure that the bid is implemented in a timely and orderly manner, where the target company recommends the offer and it is to be implemented by means of a scheme of arrangement the target will be required to issue the scheme circular proposing the scheme to its shareholders within 28 days of the announcement of the offer and to implement the scheme in accordance with the timetable set out in that circular unless, among other things, it withdraws its recommendation.

Agreements relating to existing employee incentive arrangements are not subject to the general prohibition on the basis that the target company's board should be able to agree with the potential bidder how to exercise its discretion under such arrangements.

Disclosure of Financing Arrangements

Previously, offer documents had to include a general description of how the offer was to be financed, including details of the principal lenders or arrangers. Under the new rules, additional information will need to be disclosed, including in respect of any debt facilities which have been entered into to finance the offer, the amount of each facility, the repayment terms, interest rates, any security provided and details of the key covenants.

In this context, the Panel has however recognized that private equity bidders may have complex financing structures and that the way in which equity is to be provided to the relevant bid vehicle may be commercially sensitive. Detailed disclosure of the latter will not be required.

All documents relating to the financing of the bid will be required to be put on display once the offer is announced. Redaction will not be permitted.

Disclosure of Bid-Related Fees and Expenses

Under the new rules, the bidder and the target are required to disclose in the offer document their aggregate estimated fees and expenses in relation to the bid, and, separately, the estimated fees and expenses of each of their advisers (including financial advisers and corporate brokers, accountants, lawyers and public relations advisers).

Bidders will also be required to disclose details of any fees and expenses which are payable in connection with the financing of its bid. This will need to be done on the basis that the bid will complete and that the finance will be fully drawn down. Where there is a variable fee arrangement, estimates of the minimum and maximum amounts payable will need to be disclosed. When a fee is uncapped, the amount disclosed will need to reflect a reasonable estimate of the fees which are likely to be paid.

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Disclosure of Financial Information

Previously, less detailed financial information was required to be disclosed by a bidder in relation to a cash offer than a share offer.

Under the new rules, the same financial information will, essentially, be required to be disclosed by bidders in all circumstances, subject to an exception for cash offers relating to disclosure of details of changes in the bidder's financial and trading position. The latter will not be required.

Providing Greater Recognition of the Interests of the Target Company's Employees

Some of the most important new changes are intended to improve the quality of disclosure by the bidder in relation to its plans for the target and its employees. Specifically:

- a bidder will be required to disclose its intentions with regard to the continued employment of the employees and management of the target company (including any material change in their conditions of employment), and to the locations of its places of business and of its fixed assets, or to make an appropriate negative statement; and
- statements in offer documents regarding a bidder's intentions concerning such matters will be expected to hold true for at least one year from the date on which the offer becomes wholly unconditional (unless another period is stated).

The new rules also increase the ability of employee representatives to make their views known on the merits of a bid. These include requiring:

- the board of directors of the target company to inform employee representatives at the earliest opportunity of their right under the Code to circulate an opinion on the effects of the bid on employment;
- the target company to pay the costs associated with the publication of the employee representatives' opinion, including costs incurred by employee representatives in obtaining advice to verify the information in the opinion to the standards required by the Code; and
- the target company, if this opinion is not received by the target company in good time before its publishes its circular (in which case it will be appended to the circular in the normal way), to publish the opinion on its website and to announce that it has done so.

Conclusion

Taken together, these changes to the Code are the most significant for some time and represent a material shift in the balance of advantage between potential bidders and target companies. They are likely to make takeovers, and especially hostile takeovers, more difficult to implement. They pose particular challenges for private equity, and other debt financed, bidders.

Care will also be required to avoid potential bidders being prematurely identified. This is likely to mean even tighter controls on secrecy, and more detailed planning before any approach is made to a potential target company.

NOTES

1. PCP 2010/2.
2. Statement 2010/22.
3. PCP 2011/1.
4. RS 2011/1.

NYSE And Nasdaq Propose Additional Listing Requirements for Reverse Merger Companies

BY MICHAEL L. ZUPPONE, YARIV C. KATZ AND KEITH C. GARTNER

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Reverse merger companies, which are formed when a public "shell company"[1] survives a merger with a private operating company, have recently been subject to numerous federal securities fraud lawsuits and Securities and Exchange Commission enforcement actions and penalties due to concerns relating to accounting irregularities and other disclosure issues. As a response to these concerns, and in an effort to increase transparency and limit risks to investors, the New York Stock Exchange and The Nasdaq Stock Market LLC have each proposed additional listing application requirements for reverse merger companies seeking to list on their exchanges.[2] The proposed sets of rules effectively create a "seasoning" period prior to listing and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market or on a national or foreign exchange subsequent to the consummation of the reverse merger for a specified period of time prior to listing;
- file all required information regarding the reverse merger transaction with the SEC, including audited financial statements;
- maintain a minimum stock price of $4 per share for a certain period of time prior to listing; and
- file all required reports with the SEC subsequent to the reverse merger during the "seasoning" period, including certain specified periodic reports.

The NYSE and Nasdaq expect that the "seasoning" period will increase the integrity of the reverse merger company's financial and operations related reporting and allow auditors and company management to adequately evaluate and address accounting irregularities and internal controls deficiencies. In addition, this period would allow for additional market and regulatory scrutiny of these companies and provide time to identify concerns that could otherwise preclude listing eligibility. The SEC is currently reviewing the proposed listing requirements of each securities exchange and may act on each proposal by early November 2011.

Background

Reverse Merger Transaction Structure

In a reverse merger transaction, a privately-held company merges into a public "shell company" that survives the merger. After the merger, the former shareholders of the private company typically own a majority (or even a supermajority) of the public company's shares. In addition, the management and members of the board of directors of the private company generally assume such roles with the postmerger surviving public company, whose business operations and assets may be entirely those of the premerger private company. As such, reverse merger companies quickly gain access to the public markets, though the post-merger surviving company generally enters the trading market without having been subject to registration under the Securities Act of 1933, as amended (the "Securities Act"), at the time of the merger in marked contrast to companies that "go public" by undertaking a traditional initial public offering. Reverse merger companies are thus able to bypass the typical SEC review and underwriter

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diligence process that occurs in the context of an initial public offering. Since 2007, over 600 private companies have gone public through reverse mergers with shell companies, of which more than 150 companies are principally based in the People's Republic of China ("PRC").[3]

Recent Increased Scrutiny and Regulation

Such "backdoor registrations" involving reverse merger companies have led to increased scrutiny by investors, the SEC and other regulators, and self-regulatory organizations, such as the NYSE and Nasdaq, resulting in allegations involving accounting irregularities and disclosure issues in the SEC filings of such companies. At least 24 federal securities fraud class action filings related to Chinese reverse merger companies alone have been made thus far in 2011.[4] In a recent opinion, a federal district court rejected the reverse merger company's motion to dismiss a complaint that alleged that the company failed to disclose certain related-party transactions and materially misstated its financial information in two filings with the SEC.[5] The plaintiffs also alleged that the company's auditor had been disbarred and was unlicensed at the time of its audits. Finding that such allegations raised factual disputes, the court allowed the plaintiffs' case to proceed, in what appears to be the first motion to dismiss opinion in a reverse merger company class action.

The SEC, along with other regulators, such as the Public Company Accounting Oversight Board ("PCAOB"), has actively targeted reverse merger companies and their accountants in the past year. In recent months, the SEC has suspended trading of at least six reverse merger companies,[6] in many occasions based on the companies' failure to file certain periodic reports or due to the inaccuracy and incompleteness of reported financial matters. In addition, the SEC imposed sanctions in December 2010 against an accounting firm and one of its partners for, among other things, failing to conduct its audits and review of a reverse merger company's financial statements in accordance with PCAOB rules and standards.[7] The SEC has also revoked the securities registration of at least eight PRC-based companies that became domestic issuers through reverse mergers, as a result of their failure to file required periodic reports.[8] Demonstrating its concern and focus on these types of companies, the SEC released an Investor Bulletin regarding reverse mergers in June 2011, which discusses the risks associated with investing in such companies and describes recent enforcement actions. Furthermore, the PCAOB has identified problems with the audits of reverse-merger companies and issued a practice alert in July 2010 that cautioned accounting firms to adhere to specific auditing practices in this field.[9]

In addition, both the NYSE and Nasdaq have halted the trading of several reverse merger companies in 2011, in some occasions due to their failure to timely file required reports with the SEC.[10] Nasdaq has also identified situations in which promoters and others appeared to manipulate the price of company stock to meet initial listing bid price requirements or where companies have gifted stock to artificially satisfy minimum holder requirements.

Proposed NYSE Listing Requirements

On July 22, 2011, the NYSE submitted to the SEC a rulemaking proposal containing proposed additional listing requirements that would apply to any company that is formed by a reverse merger, which is defined as "any transaction whereby an operating company becomes an Exchange Act reporting company by combining with a shell company which is an Exchange Act reporting company, whether through a reverse merger, exchange offer, or otherwise." Significantly, a reverse merger under such proposed rules does not include the acquisition of an operating company by a listed company which qualified for initial listing as a special purpose acquisition company, commonly known as a SPAC.

The proposed rules establish a minimum one year "seasoning" period prior to a listing on the NYSE and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market, on another

national securities exchange, or on a regulated foreign exchange for at least one year following the consummation of the reverse merger and prior to a NYSE listing;

- file all required information regarding the reverse merger transaction with the SEC as follows: (i) in the case of a domestic issuer, the reverse merger company must file with the SEC a Current Report on Form 8-K ("Form 8-K") containing all of the information required by Item 2.01(f) of Form 8-K, including all required audited financial statements, or (ii) in the case of a foreign private issuer, the reverse merger company must file all of the information described in (i) above on Form 20-F;
- maintain a minimum stock price of at least $4 per share "on both an absolute and an average basis for a sustained period" (which period is undefined) through such company's NYSE listing; and
- timely file with the SEC all required reports since the consummation of the reverse merger, including the filing of at least one annual report on Form 10-K or 20-F "containing audited financial statements for a full fiscal year commencing on a date after the date of filing with the Commission of the filing" described in the second bullet point above.

The NYSE has also reserved the right to impose "more stringent requirements" on particular reverse merger companies "based on, among other things, an inactive trading market in the Reverse Merger Company's securities, the existence of a low number of publicly held shares that were not subject to transfer restrictions, if the Reverse Merger Company had not had a Securities Act registration statement or other filing subjected to a comprehensive review by the Commission, or if the Reverse Merger Company had disclosed that it had material weaknesses in its internal controls which had been identified by management and/or the Reverse Merger Issuer's independent auditor and had not yet implemented an appropriate corrective action plan." Finally, unlike Nasdaq, these proposed rules would not apply to a reverse-merger company if its listing is in connection with an "Initial Firm Commitment Underwritten Public Offering," as such term is defined in the NYSE Listed Company Manual, under certain circumstances.

On July 22, 2011, NYSE Amex (formerly the American Stock Exchange) also proposed its own set of additional listing application requirements for reverse merger companies. Such proposed rules are nearly identical to the NYSE proposed rules, but do not contain a $4 minimum stock price requirement.[11]

The SEC recently extended its review period of the NYSE and NYSE Amex proposed rules and is expected to act on them by November 8, 2011.[12]

Proposed Nasdaq Listing Requirements

On May 26, 2011, Nasdaq submitted to the SEC its revised rulemaking proposal containing proposed additional listing requirements for reverse merger companies. The proposed rule changes apply to any company that was formed by a reverse merger, defined as "any transaction whereby an operating company becomes public by combining with a public shell, whether through a reverse merger, exchange offer, or otherwise." To determine whether an entity is a "public shell," Nasdaq intends to analyze a number of factors, including, among others, "whether the Company is considered a "shell company" as defined in Rule 12b-2 under the Act; what percentage of the Company's assets are active versus passive; whether the Company generates revenues, and if so, whether the revenues are passively or actively generated; whether the Company's expenses are reasonably related to the revenues being generated; how many employees support the Company's revenue-generating business operations; how long the Company has been without material business operations; and whether the Company has publicly announced a plan to begin operating activities or generate revenues, including through a near-term acquisition or transaction."

The proposed rules establish a minimum six month "seasoning" period prior to a listing on

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Nasdaq and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market, on another national securities exchange, or on a foreign exchange for at least six months prior to listing;
- file with the SEC "all required information about the transaction, including audited financial statements for the combined entity";
- maintain "a Bid Price of $4 per share or higher on at least 30 of the most recent 60 trading days"; and
- timely file with the SEC all required reports as follows: (i) "in the case of a domestic issuer, its most recent two periodic financial reports with the Commission or Other Regulatory Authority (Forms 10-Q or 10-K) containing at least six months of information about the combined entity; or (ii) in the case of a Foreign Private Issuer, comparable information as described in (i) above on Forms 6-K, 20-F or 40-F."

However, it should be noted that even if a company meets these proposed requirements, Nasdaq may nevertheless deny listing based on its authority "to apply additional or more stringent criteria in order to maintain the quality of and public confidence in the market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest."

On September 12, 2011, the SEC instituted proceedings to determine whether to disapprove the proposed rule changes and was accepting written comments from interested persons until October 17, 2011.[13]

Rationale for Proposed Rules

The NYSE and Nasdaq believe that the "seasoning" period created by their proposed rules will reduce investor risk by providing increased scrutiny of reverse merger companies by the markets and regulators prior to listing. Such period will provide greater assurance that the reverse merger company's SEC reports are accurate and reliable since auditors and the company will have reviewed at least several quarters of the company's operating results prior to listing. In addition, a "seasoning" period will allow the company's auditors and management to identify and address financial irregularities or internal control problems before they are listed on these exchanges. Nasdaq suggests that during the "seasoning" period, the Financial Industry Regulatory Authority, Inc. and other regulators would be able to effectively review trading patterns of reverse merger companies to reveal potentially manipulative trading. Furthermore, a "seasoning" period would lead to an increased likelihood that a reverse merger company has "a more bona fide shareholder base" and will help assure that the initial listing bid price was not obtained through manipulative trading practices. Finally, the NYSE points out that that the new rules "will increase transparency to issuers and other market participants with respect to the factors considered by NYSE Regulation in assessing reverse merger companies for listing."

Conclusion

Given the growing concerns related to reverse merger companies that enter the trading market in the United States without the SEC's review and underwriters' due diligence that is associated with a typical initial public offering registered under the Securities Act, the NYSE and Nasdaq have each proposed listing requirements that are designed to better identify and correct financial irregularities and other disclosure issues often associated with these companies by requiring a "seasoning" period prior to listing. The exchanges expect that this period will permit regulators to identify issues that may preclude listing and allow the reverse merger companies to create reliable reporting track records that promote confidence among potential investors.

Private companies seeking to effectuate a reverse merger and list on the NYSE or Nasdaq should be mindful of these potential listing rule changes as well as the enhanced scrutiny surrounding reverse mergers, which often involves

extended SEC review of post-merger filings and regulatory inquiry into the trading of the securities of the reverse merger company, all of which suggest that the ostensible benefits of a reverse merger as an alternative to a traditional initial public offering may not outweigh the costs, particularly when ongoing compliance costs and the delay in listing associated with the seasoning period are factored into the analysis.

NOTES

1. A "shell company" is a public reporting company with few or no operations. *See* Securities Act Release No. 8587 (July 14, 2005).
2. *See* Exchange Act Release No. 65034 (August 4, 2011) and Exchange Act Release No. 64633 (June 8, 2011).
3. *See* Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010, Research Note # 2011-P1 (March 14, 2011), http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf.
4. Securities Class Actions Filings - 2011 Mid-Year Assessment, Cornerstone Research, at p. 1, http://securities.stanford.edu/clearinghouse_research/2011_YIR/Cornerstone_Research_Filings_2011_Mid_Year_Assessment.pdf.
5. *See Henning v. Orient Paper, Inc.* CV 10-5887-VBF (AJWx), 2011 U.S. Dist. LEXIS 79135 (C.D. Cal. July 20, 2011).
6. SEC Investor Bulletin: Reverse Mergers (June 9, 2011) at pp. 3-4, http://www.sec.gov/investor/alerts/reversemergers.pdf.
7. *In re* Moore Stephens Wurth Frazer and Torbet, Order Instituting Public Administrative and Cease-and-Desist Proceedings, Securities Act Release No. 9166 (December 20, 2010).
8. Letter from Mary L. Schapiro to Hon. Patrick T. McHenry, dated April 27, 2011, at p. 3, http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf.
9. *See* Public Company Accounting Oversight Board, Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm, Staff Audit Practice Alert No. 6 (July 12, 2010), http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.
10. *See, e.g.*, Press Release, NYSE Euronext, NYSE to Suspend Trading in Duoyan Printing, Inc. (March 28, 2011), http://www.nyse.com/press/1301307616164.html.
11. *See* Exchange Act Release No. 65033 (August 4, 2011).
12. *See* Exchange Act Release No. 65368 (September 21, 2011) and Exchange Act Release No. 65369 (September 21, 2011).
13. *See* Exchange Act Release No. 65319 (September 12, 2001).

SEC Will Not Appeal Proxy Access Decision; Shareholder Proposal Amendments Will Take Effect

BY DAVID M. LYNN AND SCOTT G. HODGDON

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On September 6, 2011, Mary L. Schapiro, Chairman of the Securities and Exchange Commission ("SEC"), issued a statement[1] indicating that the SEC would not seek rehearing of the recent decision of the United States Court of Appeals for the District of Columbia Circuit (the "Court") that vacated the SEC's "proxy access" rule, nor would the SEC seek Supreme Court review.[2] Chairman Schapiro also indicated that the amendment to existing Rule 14a-8, adopted with Rule 14a-11, which provides that companies may not exclude from their proxy materials shareholder proposals for proxy access procedures, will go into effect when the Court's decision is finalized, which was expected to be on September 13, 2011. The amendment subsequently became effective on September 20, 2011, upon publica-

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tion of the notice of effective date in the Federal Register.

Rule 14a-11—the Vacated Proxy Access Rule

As adopted, Rule 14a-11 would have provided qualifying shareholders or groups holding at least three percent of the voting power of a company's securities, and who have held their shares for at least three years, with the ability to request that public companies or investment companies include the shareholder or shareholders' director nominees in their proxy materials, upon meeting certain other requirements. The rule would have applied to public companies and investment companies.

Rule 14a-11 was adopted shortly after Section 971 of the Dodd-Frank Act clarified the SEC's authority to promulgate the rule. In September 2010, the Business Roundtable and Chamber of Commerce of the United States of America filed a petition with the Court seeking judicial review of the changes to the SEC's proxy access and related rules. In October 2010, the SEC granted a stay of the rules pending resolution of the petition for review by the Court.

In its July 22, 2011 decision, the Court held that the SEC was arbitrary and capricious in adopting the rule and indicated that the SEC failed to adequately address the economic effects of Rule 14a-11. The Court expressed significant concerns about the conclusions that the SEC reached and the agency's consideration of comments during the course of the rulemaking.

The SEC confirmed that it would neither seek a rehearing of the decision that vacated Rule 14a-11, nor would it appeal the decision to the U.S. Supreme Court. In her statement, Chairman Schapiro reiterated her support for proxy access, noting that "it is a process that helps make boards more accountable for the risks undertaken by the companies they manage." She noted, however, that she wants "to be sure that we carefully consider and learn from the Court's objections as we determine the best path forward." While the statement does not foreclose the possibility of the SEC revisiting the issue of proxy access, it appears that the SEC staff will spend some time reviewing not only the Court's decision but also comments the SEC had previously received from commenters.

Rule 14a-8 Amendments—"Private Ordering"

The Court's decision did not address the SEC's amendment to Rule 14a-8(i)(8), which was adopted at the same time as Rule 14a-11 but was not a subject of the litigation. These amendments to the existing shareholder proposal rule permit the type of "private ordering" for proxy access through the shareholder proposal process that many commenters had supported in the course of the proxy access rulemaking. Under the amendments to Rule 14a-8, a company may no longer exclude a proposal that would amend or request that the company consider amending governing documents to facilitate director nominations by shareholders or disclosures related to nominations made by shareholders, as long as such proposal is not otherwise excludable under some other procedural or substantive basis in Rule 14a-8. The SEC also codified some of the Staff's historical interpretations of 14a-8(i)(8) which permitted exclusion of a shareholder proposal that would: (1) seek to disqualify a nominee standing for election; (2) remove a director from office before the expiration of his or her term; (3) question the competence, business judgment or character of a nominee or director; (4) nominate a specific individual for election to the board of directors, other than an applicable SEC provision, an applicable state law provision, or an issuer's governing documents; or (5) otherwise affect the outcome of the upcoming election of directors. As a result of the SEC's amendment of Rule 14a-8(i)(8), shareholders will have the opportunity to establish proxy access standards on an individual company-by-company basis, rather than the "universal" approach that had been contemplated by Rule 14a-11.

The status of the amendments to Rule 14a-8 was unclear following the Court's decision to vacate Rule 14a-11. In the wake of the Court's decision, the SEC issued a statement from the Di-

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rector of the Division of Corporation Finance indicating that the SEC staff was disappointed with the Court's decision and stating that they were considering their options. The statement also noted that the amendments to Rule 14a-8(i)(8), adopted at the same time as Rule 14a-11, were unaffected by the Court's decision.

The SEC's October 2010 stay order provides that the stay of the effective date of Rule 14a-8 and related rules will expire without further SEC action when the Court's decision is finalized, which the SEC expected would be on September 13, 2011. The SEC indicated that, absent further action by the SEC, the Rule 14a-8 amendments would go into effect and a notice of the effective date of such amendments would be published. The notice of effective date was subsequently published in the Federal Register on September 20, 2011.

What's Next

Prior to Chairman Schapiro's statement, the future of proxy access was unclear. Now that the SEC has confirmed that it will not appeal the Court's decision on Rule 14a-11, there is no longer uncertainty about whether the Rule 14a-11 approach could potentially be revived in time for the upcoming proxy season. Even though Chairman Schapiro's statement demonstrates that she remains committed to proxy access, her request that the SEC staff continue reviewing the Court's decision and the previously received comments indicates that it will likely be some time before the SEC revisits the issue of proxy access.

Chairman Schapiro's statement also clarifies the future of the amendments to Rule 14a-8, left unclear following the Court's ruling. As these amendments will become effective shortly, the "private ordering" approach to proxy access should be on every public company's list of significant issues for the upcoming proxy season. Shareholders who have expressed disappointment in the Court's decision to vacate Rule 14a-11 may use the mechanism provided by Rule 14a-8(i)(8) to seek to establish a proxy access regime at individual companies. Companies gearing up for the proxy season should plan accordingly.

NOTES

1. *See* Statement by Chairman Schapiro on Proxy Access Litigation, available at http://www.sec.gov/news/press/2011/2011-179.htm.
2. *See* our "SEC Proxy Access Rule Vacated," *The M&A Lawyer*, July-August 2011.

Corporate Governance Feature: 500 and Counting—Proposed Law Would Make It Easier to Stay Private

BY MATTHEW E. KAPLAN AND JONATHAN F. LEWIS

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On June 14th, a bill was introduced in the House of Representatives which, if enacted, would reshape the public/private company landscape and would allow large private companies to remain private for longer periods than under current law, and potentially indefinitely. While it is too early to see whether this legislation will gain the support necessary to become law advisors to private companies should monitor its progress.

Background

Private companies are generally not subject to public-company registration and disclosure requirements under Federal securities laws or compliance with Sarbanes-Oxley. This is one of the primary advantages of private ownership, as it results in private companies not being required to file Forms 10-K and 10-Q and being exempt from proxy and tender offer rules as well as Sarbanes-Oxley's independence requirements for

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audit committees and outside auditors. However, under Section 12(g) of the Securities Exchange Act of 1934, a private company that has more than 500 shareholders (and more than $10 million in assets) would find itself required to comply with these requirements. It is a perception in the business community (in particular in the venture capital world, but less so with respect to private equity) that this 500 shareholder rule can effectively force large private companies (such as Google and Facebook) to go public earlier than they might otherwise choose. A private company that inadvertently allows itself to have too large a base of shareholders might become "accidentally" public and subject to public company disclosure and compliance obligations without having used the event as an opportunity for capital-raising. For example, Facebook has reported that it expects to have more than 500 shareholders by the end of 2011, thus leading to speculation of a need to begin complying with public company requirements by April of 2012. If this is the case, then it would be reasonable to expect a Facebook IPO before then.

In the context of employee options, the SEC has granted limited relief from the 500-shareholder rule. This limited relief included no-action relief on a case-by-case basis prior to 2007, and, since 2007, private companies have been able to rely on Rule 12h-1(f) under the Exchange Act to exclude employees who hold options granted as compensation. The rule includes several restrictions, including transferability restrictions and a requirement that employees be provided with periodic financial and other information. Most importantly, however, the exemption applies only to options. Once an employee exercises his or her options and acquires the underlying shares, the rule is no longer available for those shares.

H.R. 2167: Relief for Private Companies from the Requirement to Go Public

The bill, H.R. 2167—named the Private Company Flexibility and Growth Act—would have two effects: First, it would double the number of investors necessary to trigger the public company

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» **The Forzani Group Ltd.** on its C$771-million acquisition by Canadian Tire Corporation, Limited.

» **Capstone Mining Corp.** on its proposed C$725-million acquisition of Far West Mining Ltd.

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disclosure requirements, from 500 to 1,000. Second, and more importantly, accredited investors and employee equity would not be included in determining whether the 1,000-investor threshold has been reached.

The combination of the exclusion for accredited investors and employees would be a significant development in the securities laws, as these two groups may be the only shareholders in many private companies, or at least may predominate over unaccredited, non-employee investors. Certainly in private equity, and even in the venture capital context, it is often the case that the shareholder base consists only of accredited investors and employees. Thus, if adopted, the bill would almost certainly achieve the goal of permitting private companies to exercise greater control over the timing of their becoming public. And, with the development of the private trading platforms such as SecondMarket, some private companies could conceivably choose to side-step the public markets altogether.

Opposition to the bill will likely center around two clusters of issues. The first of these relates to disclosure and investor protection. Would allowing large private companies to remain private (likely coupled with the growth of less regulated private trading platforms) result in less protection to investors? Would investors have access to disclosures necessary to make prudent investment decisions? The bill's implicit answer to these questions is that accredited investors are sophisticated enough to take care of themselves, and that transactions between companies and their employees require less scrutiny than capital-raising transactions. There is support for both of these propositions under existing regulations relating to securities offerings, especially with respect to employees: offers and sales to employees that are not capital raising transactions are treated more leniently as a general rule under the securities laws, for example by requiring far less disclosure than other offerings.

The second cluster of issues is likely to involve access to investment opportunities by small individual investors, *i.e.*, issues that are more macroeconomic than legal. If the bill became law, it would be possible for markets to develop in which only accredited investors (or investors with greater sophistication) could buy and sell securities. Currently, most investment opportunities on private trading platforms are limited to qualified institutional buyers, or QIBs, which require much higher levels of net worth or assets under management than accredited investors. Would the development of these alternative platforms and their extension to accredited investors, potentially to the exclusion of unaccredited investors, limit the investment opportunities of the average (unaccredited) individual investor? Or would the mutual fund markets be viewed as providing sufficient access for this group? Would accredited investors be able to participate effectively in the same unregulated markets as QIBs? Private equity sponsors might well be interested in the development of robust private trading platforms, as these platforms could result in new exit opportunities, although potentially at less than true public company valuations.

It will also be interesting to see how the SEC responds to the bill. In an April letter to Congressman Darrell Issa, the SEC's Chair, Mary Schapiro, disclosed that the 500-shareholder rule and related issues are under review by the SEC, but, since the 500- shareholder rule is a statutory requirement, revolutionary changes are unlikely to be established through SEC rulemaking. Rather, these changes are likely to occur only through changes to the statute itself. And while it is premature to speculate on whether the bill will pass in its current form, or at all, investors in private companies would be well-advised to focus on how the discussion of these issues develop in 2011 and 2012 in light of a looming Facebook IPO and the explosive growth of social buying sites such as LivingSocial.

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