Lock-Ups: When Can They Give Rise to "Affiliate" Status & Potentially Implicate Rule 13e-3?

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Lock-ups are quite common in business combination and similar transactions, but when can such arrangements lead to questions about whether the transaction is subject to Rule 13e-3? This is an issue that most deal practitioners do not consider until they receive comments from the SEC Staff (the "Staff") asking for their Rule 13e-3 analysis.

As many practitioners know, a "going private" transaction is, simply put, one in which a publicly-held company, or an affiliate of such company, seeks to acquire a registered class of the company's outstanding securities, thereby taking the company private and excluding public shareholders from continued equity ownership in the company. Rule 13e-3 defines a going private transaction as any one or a series of transactions (involving a securities purchase, tender offer, or specified proxy solicitation) by an issuer or an affiliate of the issuer, which has a reasonable likelihood or purpose of directly or indirectly (i) causing any registered class of equity securities to be eligible for termination of registration, or eligible for termination or suspension of reporting obligations; or (ii) causing any listed class of equity securities to cease to be listed on a national securities exchange.[1] Due to the potential for abuse and overreaching by the issuer and/or its affiliates, who may be viewed as having roles on both sides of the transaction, and the significant impact that such transactions can have on minority shareholders,[2] Rule 13e-3 imposes certain filing, dissemination, heightened disclosure, and antifraud requirements on issuers and their affiliates engaged in these types of transactions.

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1 Exchange Act Rule 13e-3.

2 See Exchange Act Release No. 17719 (April 13, 1981) ("Because a going private transaction is undertaken either solely by the issuer or by the issuer and one or more of its affiliates, standing on both sides of the transaction, the terms of the transaction, including the consideration received and other effects upon unaffiliated security holders, may be designed to accommodate the interests of the affiliated parties rather than determined as a result of arm's length negotiations.") (hereinafter "Release No. 17719").

A person engaging in a transaction will be viewed as an "affiliate" if such person directly or indirectly "controls, is controlled by, or is under common control with" the issuer.[3] The element of "control" is fundamental to the concept of "affiliate," and the Staff has stated that "[t]he determination of whether a person is in control of an issuer, of course, depends on all of the facts and circumstances."[4]

As noted above, it is not unusual for acquirors to purchase securities and/or enter into lock-ups (*e.g.*, voting, tender or support agreements) in order to increase the likelihood the transaction will be successful. Such agreements are often negotiated and entered into with significant shareholders at or near the time that the merger or other acquisition agreement is signed with the target company. Of course, the timing of these events and disclosures related to the parties' ultimate intentions with respect to the target company will vary from transaction to transaction.

Still, it should come as no surprise that the Staff closely scrutinizes business combination transactions, often probing into whether the facts of a particular transaction involve one or more affiliates, thereby triggering the application of Rule 13e-3.[5] Therefore, careful planning and structuring is important to limit the potential application of those heightened disclosure requirements that are better suited to a truly "affiliated" transaction. For example, where an acquiror has sought to lock-up a deal, the Staff may question whether the acquiror has in fact become an affiliate prior to or during the course of the transaction, such that Rule 13e-3 should apply to the deal.[6]

Depending on the facts, including whether shares are purchased in advance, optioned, or subject to a voting, tender, or support agreement, the specific terms of the arrangement can influence whether Rule 13e-3 is implicated. Of course, where the acquiror purchases a significant amount of target securities well before the business combination transaction, the likelihood of Staff inquiry regarding affiliate status, and risk of Rule 13e-3 applying, is at its greatest. Whereas a plain vanilla lock-up entered into at the same time as the merger or other acquisition agreement is signed, without other indicia of affiliation or control, presents less of a risk. But there are many scenarios that fall in between these two ends of the spectrum that can raise red flags for a Staff member seeking to uncover a hidden going private transaction.[7] Accordingly, acquirors will want to take steps to ensure that the terms, timing and disclosures surrounding their lock-ups and business combinations do not implicate Rule 13e-3, especially when the transaction started out as an otherwise unaffiliated arm's-length negotiated deal.

When entering into lock-ups and signing up deals, few stop to consider the legal basis for why such arrangements generally do not implicate the Rule. The key provision here is paragraph (g)(1) of Rule 13e-3 which generally excludes transactions by a person "that occur within one year of the termination of a tender offer in which such person was the bidder and became an affiliate of the issuer as a result of such tender offer," from application of the Rule so long as certain so-called "unitary transaction" requirements

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[3] Rule 13e-3(a)(1).

[4] See Exchange Act Release No. 16075 (Aug. 2, 1979). While share ownership is a factor in the "control" determination, the Staff has also stated that the ownership of any specific percentage of securities is not dispositive of whether a shareholder controls, and is therefore an affiliate of, an issuer.

[5] See Shane de Búrca, The Definition of Affiliates under the SEC's Going Private Rule, Insights, Vol. 18 No. 8, August 2004 (detailing the extent to which the Staff will sometimes go to find an affiliation with the issuer when seeking to apply Rule 13e-3).

[6] See, *e.g.*, Turbosonic Technologies Inc. Response to SEC Comment Letter (Dec. 6, 2012), available at http://www.sec.gov/Archives/edgar/data/900393/000089109212007277/filename1.htm (voting agreements with company founder and executive officers with approximately 21% addressed in Rule 13e-3 analysis); Icahn Enterprises Holdings L.P. Response to SEC Comment Letter (Jan. 6, 2011), available at http://www.sec.gov/Archives/edgar/data/1034563/000119312511002613/filename1.htm (bidder's ownership of approximately 15% prompting comments on application of Rule 13e-3); American Community Properties Trust Response to SEC Comment Letter (Nov. 27, 2009), available at http://www.sec.gov/Archives/edgar/data/1065645/000114036109027623/filename1.htm (voting agreements with shareholders holding approximately 47% triggering Staff comments regarding application of Rule 13e-3 to transaction); First Montauk Financial Corp. Response to SEC Comment Letter (Jul. 14, 2006), available at http://www.sec.gov/Archives/edgar/data/83125/000008312506000028/filename1.txt (buyer's acquisition of shares and lock-ups covering approximately 49% triggering Staff comments regarding affiliation and application of Rule 13e-3 to transaction). See also Release No. 17719, Question and Answer No. 8.

[7] Even the mere reservation of the right to purchase target company shares has given rise to Staff inquiry regarding the availability of Rule 13e-3(g)(1). SEC Comment Letter Issued to Immucor, Inc. (Jul. 26, 2011), available at http://www.sec.gov/Archives/edgar/data/736822/000000000011045311/filename1.pdf (bidder reserving right to purchase target company shares on the open market in a two-step transaction triggering Staff comment regarding availability of Rule 13e-3(g)(1)); SEC Comment Letter Issued to Pyramid Breweries Inc. (Jul. 14, 2008), available at http://www.sec.gov/Archives/edgar/data/1001917/000000000008034738/filename1.pdf (same); SEC Comment Letter Issued to Digimarc Corporation (Jul. 14, 2008), available at http://www.sec.gov/Archives/edgar/data/1089443/000000000008034743/filename1.pdf (same); SEC Comment Letter Issued to Onyx Software Corporation (Jul. 18, 2006), available at http://www.sec.gov/Archives/edgar/data/1014383/000000000006033386/filename1.txt (buyer indicating uncertainty as to whether second-step merger would be consummated giving rise to Staff comment regarding applicability of Rule 13e-3(g)(1)).

are met.[8] More specifically, the various no-action letters extrapolating paragraph (g)(1) provides that an unaffiliated acquiror that negotiates at arm's-length an acquisition transaction and locks-up a controlling block of target company shares may avoid being deemed an "affiliate" for purposes of Rule 13e-3 so long as the transaction satisfies all of the following criteria:

- **The acquiror is not an affiliate of the issuer prior to the initial acquisition of the securities by the acquiror.** The acquiror and issuer must not have an affiliate relationship prior to the initial acquisition of the securities.[9]
- **The initial and "second-step" transactions are made pursuant to an agreement for the acquisition of all of the securities at the same price.** The acquiror who locks-up a significant amount of the issuer's shares must acquire all of the issuer's securities at the same price.
- **The intention of the acquiror to engage in the second-step transaction is publicly announced at the time of the initial acquisition, including the form and effect of such transaction and the proposed terms of the transaction, if known.** The acquiror's plans for the entire transaction must be unequivocally and publicly disclosed at the *commencement* of the first-step transaction to ensure that the second-step transaction is indeed based upon arm's-length negotiations and not upon the use of any control position resulting from the completion of the first step.[10]
- **The second-step transaction is effected within one year from the expiration of the tender offer.**
- **The acquiror does not change the management or the board of directors, or otherwise seek to exercise control, of the issuer prior to the completion of the second-step transaction.** The acquiror must not subsequently exercise control over the issuer by virtue of its newfound "affiliate" status as a result of the first step, and instead must ensure the transaction proceeds on an arm's-length basis.

Unfortunately, the conditions of (g)(1) are not always squarely met, or the facts of a transaction may play out in a way that precludes reliance on the exception to the Rule. For example, there are circumstances where the acquiror purchases securities from a controlling shareholder *prior to* commencement of the tender offer (or signing of the merger agreement), and in those situations, the Staff has generally concluded that it would not be eligible to rely on the (g)(1) exception.

Similarly, where the acquiror enters into a lock-up agreement and the issuer or controlling shareholder has granted the bidder an option (which is immediately exercisable) to purchase a significant amount of securities, the Staff will generally view such acquiror as an affiliate for Rule 13e-3 purposes. The one exception to this position is where the lock-up agreement is subject to substantial conditions beyond the control of the parties (*e.g.,* a top-up option with the issuer to reach the short-form merger threshold or an option with a controlling shareholder that a majority of unaffiliated shareholders vote in favor of the transaction or tender their shares in the offer). In those situations, the agreement is unlikely to render the acquiror an affiliate.

All important considerations to take into account before rushing to lock-up that next big deal.

Conclusion

It is important to keep in mind the conditions in (g)(1) and the various Staff no-action letters[11] when structuring business combination transactions (*e.g.*, how and when lock-ups are entered into and securities acquired) as well as the related disclosures regarding any intentions of the acquiror to take the target company private or engage in subsequent securities acquisitions. Through careful structuring of lock-ups and drafting of disclosures related to future intentions,[12] otherwise unaffiliated acquirors can avoid, or at least minimize, Staff inquiries into the potential application of the "going private" provisions of Rule 13e-3. Certainly, one clear path is to ensure the transaction satisfies the conditions of Rule 13e-3(g)(1), so that the acquisition will be viewed as a single, unitary transaction by a non-affiliate, and thus fall safely beyond the reach of Rule 13e-3.

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[8] Rule 13e-3(g)(1). See Release No. 17719, Question and Answer No. 8. The Staff has also taken a no-action position that the transactions set forth in paragraph (g)(1) do not trigger Rule 13e-3's heightened disclosure obligations when the unitary transaction conditions are present. See no-action letters re. Federal-Mogul Corp. (avail. Sep. 29, 1980) and HM Acquisition Corp. (avail. Mar. 2, 1981), where the Staff took a no-action position with respect to the applicability of Rule 13e-3 to merger transactions in which the acquiror had concurrently purchased target shares via a stock purchase agreement for the acquisition of all target shares at the same price, the merger was expected to be consummated within a relatively short time, and the acquiror would not change the management or otherwise exercise control over the target company in the interim period.

[9] See SEC Division of Corporation Finance Manual of Publicly Available Telephone Interpretations, Question No. 9, available at http://www.sec.gov/interps/telephone/cftelinterps_goingprivate.pdf. SEC Division of Corporation Finance, Compliance and Disclosure Interpretations of Going Private Transactions (Jan. 26, 2009), Question 211.02 available at http://www.sec.gov/divisions/corpfin/guidance/13e-3-interps.htm.

[10] SEC Division of Corporation Finance, Compliance and Disclosure Interpretations of Going Private Transactions (Jan. 26, 2009), Question 111.01 *available at* http://www.sec.gov/divisions/corpfin/guidance/13e-3-interps.htm.

[11] *See supra* note 8.