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Insights into legal developments affecting mergers and acquisitions.



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Comment Period on Proposed Amendments to Rules 144 and 145 Ends

On June 22, 2007, the U.S. Securities and Exchange Commission (SEC) released proposed amendments to Rules 144 and 145 governing safe harbor exemptions related to the resale of unregistered securities. The proposed amendments demonstrate the SEC's continued focus on balancing market efficiency with investor protection. The proposed amendments to Rule 145, although not the focus of the SEC's proposals, are particularly important to the mergers and acquisitions (M&A) community, in light of its application to securities issued in connection with business combination transactions.

BACKGROUND

Section 4(1) of the Securities Act of 1933, as amended, provides exemptions from the registration requirements of the Act and the associated resale restrictions for transactions by any person who is not deemed an issuer, underwriter or dealer.¹ The Act defines an underwriter broadly, as any person who has purchased securities from an issuer with a view to distribution.² Rule 144 provides a safe harbor exemption from being deemed an underwriter if the transaction satisfies certain objective criteria. Rule 145 regulates securities issued in connection with business combination transactions and provides a narrower exemption from being deemed an underwriter.³ Both safe harbors are intended to balance investor protection against the need for market liquidity and capital formation.

RULE 144'S REDUCED HOLDING PERIOD

Currently, one criterion for exemption under Rule 144 is the expiration of a holding period, the length of which varies based on the type of securities and the status of the holder. In general, the proposed amendment to Rule 144 would shorten the holding period under Rule 144(d) from not less than 12 months to six months for restricted securities held by affiliates and non-

affiliates of SEC-reporting companies.⁴ The effect of the reduced holding period would be to enable small businesses to raise capital more efficiently through the issuance of unregistered securities, because purchasers of restricted securities expect, and receive, an illiquidity discount on restricted securities, thereby preventing companies from receiving full value on the securities issued. In this respect, it is expected that reducing the holding period to six months would limit the discount to be applied to unregistered securities.⁵ The proposed rules do not reduce the holding period for non-reporting companies, which remains at one year, due to the disparity of information available for non-reporting companies. The SEC's release explains that the lack of information on non-reporting companies increases risk to investors and, therefore, requires additional safeguards.⁶

With regard to securities hedged by a put-equivalent position (*e.g.*, a short position), the amendments provide that the holding period would be tolled (*i.e.*, suspended) for any period that such securities were hedged, up to a maximum of 12 months.⁷ In its release, the SEC expressed concern that certain hedging activities, designed to shift the economic risk from the security holder, make it more difficult to determine if the investor has held the security as an investment without a view to distribution. As a result, the SEC noted that the reduced six-month holding period would be insufficient to show that an investor has accepted the economic risk of an investment in unregistered securities.⁸

VOLUME, MANNER OF SALE, CURRENT INFORMATION AND REPORTING REQUIREMENTS

Currently, Rule 144 allows only limited resales by non-affiliates after one year, subject to volume, manner of sale, current information and reporting requirements. Free resales (*i.e.*, those not subject to these requirements) are permitted only after two years. The proposed amendments would effectively eliminate this distinction and permit free resales by non-affiliates after expiration of the applicable holding period, subject only to a one-

¹ 15 U.S.C. 77d(1)

² 15 U.S.C. 77b(a)(11)

³ 17 C.F.R. 230.145

⁴ Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, 72 Fed. Reg. 36,822 (proposed July 5, 2007) (to be codified at 17 C.F.R. pts. 230 and 239)

⁵ *Id.* at 36,838

⁶ *Id.* at 36,839

⁷ *Id.* at 36,823

⁸ *Id.* at 36,826

year current information requirement.⁹ Non-affiliate status is available to any person or entity that has not been an affiliate of the issuer for a period of three months from the date of resale.¹⁰

For affiliates, the proposed amendments would eliminate the manner of sale restriction after expiration of the applicable holding period with respect to fixed income securities but not equity securities, in general.¹¹ In addition, because of inflation the proposed amendments would raise the thresholds for triggering the reporting requirements applicable under Rule 144, from 500 securities or an amount more than \$10,000 over a three-month period, to 1,000 securities or an amount more than \$50,000 over a three-month period.¹² Note that due to the proposed reduction of Rule 144 requirements applicable to non-affiliates, this proposed amendment applies only to affiliates of the issuer that are otherwise subject to the reporting requirements of Rule 144.¹³

PROPOSED CHANGES TO RULE 145

Rule 145 provides a narrow safe harbor for the resale of restricted securities obtained in connection with business combination transactions. Rule 145 provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations or transfers of assets that are subject to shareholder vote constitute sales of securities subject to the registration requirements of the Act.¹⁴ Under Rule 145(c), any party to the transaction, other than the issuer, or any affiliate of such party at the time of relevant shareholder vote, is presumed to be an underwriter.¹⁵ In general, the proposed amendments would eliminate this presumption, except for shell companies that are not business combination-related shell companies, and permit securities held by certain of these parties to be freely transferable without restriction under Rule 145.¹⁶

In addition to these changes, the SEC proposes to harmonize the resale restrictions of Rule 145 with the new resale restrictions of Rule 144 with respect to shell companies.¹⁷

CONCLUSION

The proposed rules were subject to a 60-day comment period that ended on September 4, 2007. If adopted, the rules will allow for significantly broader application of the Rule 144 and Rule 145 exemptions. However, it is difficult to ascertain the extent to which the SEC will adopt the proposed amendments.

⁹ *Id.* at 36,823, 36,827-36,828

¹⁰ *Id.* at 36,827

¹¹ *Id.* at 36,823, 36,829

¹² *Id.* at 36,823, 36,830-36,831

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¹⁴ 17 C.F.R. 230.145(a).

¹⁵ 17 C.F.R. 230.145(c).

¹⁶ Proposed Rule, *supra* note 4, at 36,824, 36,833-36,834.

¹⁷ *Id.*

Nonetheless, the proposed amendments make clear that the SEC is moving in the right direction, easing the resale and manner of sales restrictions for capital raising and M&A transactions.

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NASD Proposed Rule

The National Association of Securities Dealers (NASD) is trying to resurrect its 2005 proposed rule establishing disclosure and procedural requirements regarding the issuance of fairness opinions.¹⁸ The revised proposed rule requires the following six items to be disclosed if a fairness opinion will be provided to a company's stockholders: (1) whether the investment bank has acted as a financial advisor to any party to the transaction; (2) whether the investment bank will receive any significant payment contingent upon the successful consummation of the transaction; (3) whether any material relationships existed during the past two years and whether there are expected future relationships between the investment bank and the company; (4) whether information used to form the opinion was supplied by the company and if so, whether the investment bank independently verified that information; (5) whether the opinion was approved or issued by an investment bank's internal fairness committee; and (6) whether the opinion discusses the amount or nature of compensation to the company's officers, directors or employees, or class of such persons relative to the compensation to public stockholders of the company. Only items 5 and 6 will result in a change from current practices. It is important to note that item 6 does not require investment banks to give an opinion whether compensation given to management as part of the transaction is fair. Item 6 merely requires that if an opinion does discuss relative compensation matters, then such discussion must be disclosed to the stockholders

Also of importance is the term "significant" in item 2. A "significant" payment is any payment that a reasonable reader of the opinion would have an interest in knowing about in order to assess whether the investment bank rendering the opinion had a potential conflict of interest. The NASD specifically chose not to set a precise amount because "significant" may vary based on the type and size of the transaction. Significant payments exclude *de minimis* payments, however, such as trading fees or other small incremental fees from account assets.

¹⁸ Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions, SR-NASD-2005-80, available at http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_019261.pdf

The NASD proposed rules intend to bring assurances to investors that the process resulting in an opinion is itself fair by increasing the transparency of the fairness opinion process and the relationships underlying that process. In doing so, the NASD may stymie a rush to the courts for similar situations as those found in several recent Delaware cases, such as *Caremark*,¹⁹ *Topps*²⁰ and *Ortsman*,²¹ in which plaintiffs alleged insufficient disclosure relating to the fairness opinions issued in those transactions.

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FINSA: Foreign Investment in the United States Comes Under Increased Scrutiny

U.S. policy encourages open foreign investment in the United States except when such investment threatens to impair U.S. national security. The Exon-Florio Amendment to Section 721 of the Defense Production Act, as amended,²² provides guidance to the president and the Committee on Foreign Investment in the United States (CFIUS) to evaluate whether a particular investment threatens national security and whether to block or take action against the transaction to minimize the perceived threat. Under Exon-Florio, a CFIUS review commences when the parties (or party) to a subject transaction submit a voluntary notice to the CFIUS staff chairman. A CFIUS review may also be started by a member's submission of an agency notice to the CFIUS staff chairman of a proposed or completed transaction that the member has reason to believe is subject to Section 721 and may have adverse effects on the national security.

Since September 11, 2001, Exon-Florio's effectiveness has been increasingly questioned. The Government Accountability Office (GAO) identified a number of weaknesses in the implementation of Exon-Florio.²³ The Exon-Florio process came under public and congressional criticism in 2005, when a Chinese government-owned corporation attempted to acquire a major U.S. oil company, and again in 2006, when a Dubai, United Arab Emirates-owned corporation acquired a U.K.-based international logistics and transportation company, thereby gaining control of six major U.S. ports.

The Foreign Investment and National Security Act of 2007 (FINSA), passed by Congress and signed into law by the president in late July, enacts a number of reforms to the CFIUS process in order to address many of the concerns raised by the GAO, Congress and the public, and directs the inspector general to investigate "each failure" of CFIUS to submit a periodic report to Congress, as required by Exon-Florio. The list below identifies FINSA's significant changes to Exon-Florio:

- The director of national intelligence, with the various intelligence agencies, has the responsibility to determine whether a proposed transaction would constitute a threat to national security, and advise CFIUS accordingly within 20 days of CFIUS's receipt of notice.
- CFIUS must consider a transaction's potential effects on critical infrastructure, including major energy assets; sales of military goods or technology to countries posing a regional military threat to the United States; critical technologies deemed essential to national defense; and the long-term projections of U.S. energy requirements.
- CFIUS must investigate any transaction that would result in a foreign government or a foreign government-controlled entity gaining control of a business in the United States, except where the CFIUS chair and lead agency jointly determine that the transaction will not impair national security. However, such a determination may be made only after evaluating whether the country adheres to nonproliferation regimes; the relationship of that country with the United States, specifically with respect to its record of cooperating in counterterrorism efforts; and the potential for trans-shipment or diversion of technologies with military applications.
- FINSA eliminates the permissive withdrawal of a voluntarily submitted notice, and CFIUS now must approve any withdrawal request. In addition, FINSA directs CFIUS to establish interim protections to address any specific concerns arising from the withdrawal or specific time frames for resubmission, and a process for tracking actions taken by a party to a covered transaction.
- FINSA grants Congress greater oversight of the CFIUS process. CFIUS now must brief Congress upon request and provide annual reports on all reviews and investigations completed by CFIUS during the 12-month report period. Further, CFIUS must notify Congress in writing at the completion of a review where no investigation is required or by a written report upon the completion of an investigation. Each notice or report must certify that there are no unresolved national security concerns with respect to the transaction that is the subject of the report. In addition, FINSA orders the secretary of the treasury to study foreign investments in the United States and report findings and conclusions within 150

¹⁹ *La. Municipal Police Employees' Retirement System v. Crawford*, 918 A.2d 1172, 2007

²⁰ *Upper Deck Co. v. Topps Co., Inc.*, 2007 Del. Ch. LEXIS 82 (June 11, 2007)

²¹ *Ortsman v. Green*, 2007 Del. Ch. LEXIS 29 (Feb. 27, 2007)

²² 50 U.S.C. § 2061

²³ *Defense Trade: Enhancements to the Implementation of the Exon-Florio Could Strengthen the Law's Effectiveness*, GAO-05-686 (Washington, D.C., Sept. 28, 2005)

days of the enactment of FINSA and with every annual CFIUS report submitted thereafter.

- FINSA obligates CFIUS to publish guidance on the types of transactions likely to raise national security issues—in particular, transactions that would result in foreign government control of critical infrastructure—no later than April 21, 2008.
- FINSA takes effect October 24, 2007. Regulations promulgated under FINSA must become effective no later than April 21, 2008, and must impose civil penalties for violations of those regulations.

The increased transparency of the CFIUS process is a double-edged sword for foreign businesses that wish to invest in the United States. On one hand, such businesses ultimately will gain a better understanding of the types of transactions that will be approved, require mitigation or be blocked. On the other hand, the increased transparency also could have a chilling effect on foreign investment in the United States, due to the increased level of scrutiny.

FINSA's requirement that CFIUS consider whether a transaction could have effect on "critical infrastructure and energy" clearly expands the scope of transactions that CFIUS now must review. Under Homeland Security Directive 7 (HSPD-7), issued by the president on December 7, 2003, U.S. critical infrastructures are identified as information technology, telecommunications, chemicals, transportation systems, postal and shipping services, agriculture, food, public health, drinking water and waste water treatment facilities, energy and electric power, banking and finance, and national monuments and icons.

FINSA does not change the voluntary submission of notice, a CFIUS member's ability to submit agency notice nor the timing for a CFIUS review process (30-day review with a potential subsequent 45-day investigation). However, FINSA's increased congressional oversight, which resulted in part from recent high-profile transactions, mandates that foreign investors in potentially high profile transactions develop both a CFIUS filing strategy and a political/congressional strategy in preparation for issues raised by a proposed transaction.

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Italy: Milan Courts Shape Case Law on Monetary Damages in Italian Takeover Law

The courts of Milan currently are developing case law on a significant issue in Italian takeover law: whether minority shareholders are entitled to claim monetary damages from majority shareholders who have failed to carry out their legal obligation to launch a public tender offer for all outstanding shares upon exceeding a holding of 30 percent of a company.

MANDATORY TENDER OFFERS UNDER ITALIAN TAKEOVER LAW

Under Italian takeover law, any purchaser who comes to own more than 30 percent of the voting shares of an Italian-listed company must launch a bid for all outstanding voting shares of that company. The rule aims to offer an exit right to minority shareholders on a change of control of a company and to allow them to participate in the "control premium" paid to the seller of a stake conferring on the purchaser more than 30 percent of the voting rights. The same obligation applies if the 30 percent threshold is exceeded jointly by the purchaser and another shareholder with whom the purchaser has made an agreement regarding the governance of the listed company (or *patto parasociale*). It often is a delicate question of facts and legal interpretation whether or not shareholders are acting in agreement (or "acting in concert," in takeover terminology) and if such agreement qualifies as a *patto parasociale*.

THE SAI-FONDIARIA CASE

In the *SAI-Fondiarria* case currently before the Milan courts, the dispute arose out of whether or not there was a *patto parasociale* or a concert party relationship between SAI and Mediobanca regarding the listed insurance company La Fondiaria. The background is as follows: Mediobanca held 14 percent of the share capital of La Fondiaria, and SAI held initially 7 percent and then acquired an additional 22 percent stake. If Mediobanca and SAI were acting in concert, the purchase of the 22 percent stake by SAI would have resulted in Mediobanca and SAI jointly holding more than 30 percent of La Fondiaria and, consequently, an obligation to make a mandatory bid would have been triggered under Italian law. Mediobanca and SAI rejected the allegation that they were acting in concert, and the matter went before the Italian stock exchange supervisory authority (CONSOB), the Italian antitrust authority and the Italian courts. However, by the time a decision had been made by the Italian courts that SAI and Mediobanca were acting in concert, La Fondiaria had merged with SAI, and it was too late for the mandatory bid, because the object of the bid was no longer the same. Minority shareholders were aggrieved at having been denied a control premium which

would have arisen on a mandatory bid and sued SAI and Mediobanca for the payment of monetary damages. There are currently 11 cases pending before the courts of Milan against SAI and Mediobanca, claiming an overall amount of €155 million in monetary damages.

THE QUESTION OF MONETARY DAMAGES

Italian law is silent on the right to monetary damages for loss arising from a failure to launch a mandatory bid. In fact, administrative sanctions aside, Italian law only provides for two express remedies for failure to launch a mandatory bid: the acquirer cannot vote any of its shares, and the acquirer is required to sell the shares exceeding the 30 percent threshold within 12 months.

In three rulings between June 2005 and October 2006, the Milan Tribunal ordered SAI and Mediobanca to pay monetary damages to minority shareholders, arguing that the failure to launch the mandatory bid was a tort *vis-à-vis* the other shareholders. Following an appeal by SAI and Mediobanca, in January 2007 the Milan Court of Appeals overruled the first of the Milan Tribunal's rulings, arguing that Italian law provided for no remedy other than the express sanctions of disenfranchisement and compulsory sale, and hence did not permit a remedy in tort.

RECENT DECISIONS AND OUTLOOK

The Milan Court of Appeals' overruling of the Tribunal of Milan's decision was not the end of the matter. In May and June 2007, the Tribunal of Milan made two new rulings ordering SAI and Mediobanca to pay monetary damages to minority shareholders on the basis of a breach of contractual or quasi-contractual obligations owed to other shareholders. The ruling builds on the general concept under Italian company law that all shareholders of a company are linked through a "contract of the company" (*contratto di società*) and argues that the obligation to comply with Italian takeover law is an implied obligation under that contract. Consequently, the failure to launch a mandatory bid is, at the same time, a breach of a contractual obligation *vis-à-vis* the other shareholders. The court calculated the amount of damages as the difference between the market price of the shares at the date the bid was due and the hypothetical price at which the bid should have been launched, multiplied by the number of shares held by the claimants at that time.

CONCLUSION

Whether or not the new concept of contractual liability owed to other shareholders is accepted as law, the recent decisions of the Milan Tribunal demonstrate a strong determination to uphold the case for individual minority shareholders' protection in Italian takeover law. In light of this development, large investors must

seriously consider the risk of minority shareholders' actions when planning their acquisition strategies, whether they are acting in concert or alone.

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