New SEC Advice on Rule 16b-3 Provides Broad Relief for Treatment of Securities in a Merger

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Skadden, Arps, Slate, Meagher & Flom LLP recently received a significant reply to its request for interpretative advice from the staff (the "Staff") of the Office of the Chief Counsel, Division of Corporation Finance, Securities and Exchange Commission, concerning the application of Rule 16b-3 ("Rule 16b-3"), issued under Section 16 of the Securities Exchange Act of 1934, as amended ("Section 16"). The reply applies to a wide variety of transactions in issuer securities occurring in connection with corporate mergers. The interpretative letter provides that, subject to the satisfaction of the specific conditions relating to issuer approval described below, Rule 16b-3 exempts such transactions from the short-swing profit rules of Section 16.[1]

Prior to the release of this letter, there was considerable uncertainty as to whether, under Rule 16b-3, the conversion of derivative or equity securities of a corporation ("Target") in a merger constituted an "exempt" sale of Target securities and whether the acquisition of derivative or equity securities of the acquiring corporation ("Acquiror") by Target insiders who were to become insiders of the Acquiror ("New Acquiror Insiders") constituted an "exempt" purchase of Acquiror securities. This uncertainty has been particularly troublesome in the following two contexts: (1) the disposition of Target securities in a merger where the Target insider had engaged in a nonexempt purchase of Target securities within the preceding six months; and (2) the acquisition of Acquiror securities in connection with a merger where the New Acquiror Insiders wished to diversify their holdings by disposing of Acquiror securities within the succeeding six-month period. The Staff's stated position, in greater detail, is as follows:

Dispositions to the Issuer. Rule 16b-3(e) provides that a transaction involving the disposition to the issuer of derivative or equity securities of the issuer will be exempt if: (1) such disposition has been previously approved by the board of directors ("Board") of the issuer or a committee of the Board that is composed solely of two or more "nonemployee directors" ("Committee"); or (2) such disposition has been previously approved by the holders of a majority of the securities of the issuer. The Staff has now advised that:

- The exemption for "dispositions to the issuer" under Rule 16b-3(e) generally applies to: (1) the conversion of Target shares into merger considera-

[1] Section 16(b) requires officers and directors of the issuer who are subject to the reporting requirements of Section 16(a) ("insiders") to disgorge to the issuer any profits realized from any "short-swing" trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer's equity or derivative securities within a period of less than six months).

tion (whether cash, Acquiror securities or other property); (2) the conversion in a merger of Target options into Acquiror options; and (3) the cancellation in a merger of Target options in exchange for cash and/or stock.

- For purposes of this exemption, it is not necessary for the Target to be the direct payor or for any payment to be made prior to the merger provided that the conversion or cancellation occurs prior to or simultaneously with the merger. (Both of these provisions have been included in merger agree ments for purposes of compliance with Rule 16b-3(e).)

- Mere approval of the merger by the Target Board or Committee will not be sufficient to satisfy the condition that the disposition be approved by the Board or Committee. Rather, in order to satisfy such condition, there must be additional, separate approval by the Target Board or Committee that specifically approves the disposition of shares or options (assuming stockholder approval of the disposition is not sought). This additional approval must specify (1) that the reason for the approval is to exempt the dispositions for purposes of Section 16, (2) the names of the Target insiders, and (3) the number of Target securities involved. Such additional approval need not be obtained when the merger agreement is approved, but may be obtained at any subsequent time prior to the merger.

Acquisitions from the Issuer. Rule 16b-3(d) provides that a transaction involving the acquisition from the issuer of derivative or equity securities of the issuer will be exempt if: (1) such acquisition has been previously approved by the issuer Board or Committee; (2) such acquisition has been previously (or, no later than the next annual meeting, subsequently) approved by the holders of a majority of the securities of the issuer; or (3) the acquired securities have been held for at least six months. The Staff has now advised that:

- The exemption for "acquisitions from the issuer" under Rule 16b-3(d) generally applies to: (1) the acquisition of Acquiror shares upon conver sion of Target shares in connection with a merger; (2) the acquisition in connection with a merger of Acquiror options in exchange for Target options; and (3) the grant of new options or other equity-based awards in connection with a merger.

- Once again, mere approval of the merger by the Target Board or Committee will not be sufficient to satisfy the condition that the acquisi tion be approved by the Board or Committee. Rather, in order to satisfy such condition, there must be additional, separate approval that specifically approves the acquisition of shares or options (or other equity awards) by New Acquiror Insiders (assuming stockholder approval of the acquisi tion is not sought). This additional Board or Committee approval must

specify: (1) that the reason for the approval is to exempt the acquisitions for purposes of Section 16; (2) the names of the New Acquiror Insiders; (3) the number of Acquiror securities involved; and (4) the material terms of the options (or other derivative securities) to be acquired. Such additional approval need not be obtained when the merger agreement is approved, but may be obtained at any subsequent time prior to the merger.

- It is not necessary for New Acquiror Insiders to have already attained such status at or prior to the time of Acquiror Board or Committee approval in order for the acquisition of Acquiror shares or Acquiror options (or other equity awards) to be exempt under Rule 16b-3(d).

The Staff has made it clear in the letter that its position applies not only to issuer equity securities acquired pursuant to employee benefit plans, but also to those acquired on the open market. Further, the letter has the effect of reducing if not eliminating the need to rely on the "unorthodox transaction doctrine" in the context of corporate mergers.

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If you have any questions concerning the Staff's position with regard to these matters or if you would like a copy of the Staff letter, please call your usual Skadden, Arps contact, or you may call Stuart N. Alperin at (212) 735-3920, Neil M. Leff at (212) 735-3269, or Regina Olshan at (212) 735-3963.