United States
Treasury Shares Guide
IBA Corporate and M&A Law Committee 2012

Contact

Ellisa Opstbaum Habbart

The Delaware Counsel Group, Wilmington, Delaware

ehabbart@delawarecounselgroup.com

Samuel A Nolen

Richards, Layton & Finger, PA, Wilmington, Delaware

Nolen@RLF.com

Steven A Cohen
Victor Goldfeld

Wachtell, Lipton, Rosen & Katz, New York, New York

SACohen@wlrk.com
VGoldfeld@wlrk.com

Contents

Page

INTRODUCTION

The following is a high-level guide to the principal legal considerations relating to treasury shares in the United States. The rules applicable to any particular company arise primarily under the law of the state in which the company is incorporated, as well as US federal law. This guide generally focuses on the rules that are most relevant for publicly traded corporations incorporated in Delaware or New York. This guide is only a summary, and local counsel should be consulted in connection with any particular questions that may arise.

GENERAL OVERVIEW

Is the buy-back of shares permitted in your jurisdiction?

Yes, buy-backs of shares generally are permitted by state and federal law, subject to the restrictions discussed below.

What are the characteristics (maximum holdings, voting rights and other rights) of treasury shares?

Under the law of some states, including Delaware and New York, a company that repurchases its own shares has two main options: (1) hold them as treasury shares (ie, shares that have been authorised and issued but generally are not considered outstanding), or (2) retire the repurchased shares (some states, such as New York, use the term ‘cancellation’ to express a concept similar to that of ‘retirement’ under Delaware law). Generally speaking, retirement of shares results in them resuming the status of shares that are authorised for issuance but not issued. In certain circumstances, such as where the certificate of incorporation prohibits the reissuance of retired shares, when shares are retired the number of authorised shares must be accordingly reduced by making an appropriate filing with the Secretary of State. The concept of treasury shares does not exist in some states, such as California, the laws of which provide that repurchased shares automatically are restored to the status of authorised but unissued shares (unless the company’s organisational documents prohibit their reissuance).

Treasury shares do not have voting rights or dividend rights. When a corporation sells treasury shares, there often is no requirement to receive consideration at least equal to the par value of the shares, whereas the sale of newly issued shares does carry such a requirement (although in all cases the decision of the board of directors to authorise the sale must still be made in accordance with applicable fiduciary standards). In addition, in states that provide for pre-emptive rights in connection with share issuances, the sale by the corporation of treasury shares may be exempt from pre-emptive rights.

The applicable rules may be somewhat different when shares of a company are purchased by its subsidiary or controlled affiliate, though they often lead to similar results. For example, Delaware law prohibits a corporation from voting its own stock belonging to it. Stock of a parent corporation belonging to a subsidiary corporation may also not be voted where the parent corporation owns directly or indirectly a majority of the voting stock of the subsidiary corporation. In circumstances where the voting power of a company’s shares held by a controlled entity is not ‘sterilised’ by statute, companies occasionally enter into voting arrangements pursuant to which the shares must be voted in proportion with the vote of public shareholders. In addition, general fraudulent conveyance concerns should be considered in connection with the purchase of a company’s shares if the purchasing entity (whether it is the company itself or another entity) is near insolvency or the purchase would render it so.

What are the main reasons to acquire treasury shares?

It is important to separate this into two questions: (1) What are the reasons for repurchasing shares? (2) What are the reasons for retaining the repurchased shares as treasury shares rather than retiring them?

Companies may repurchase their shares for a variety of reasons, including:

- returning capital to shareholders (as an alternative to paying a dividend, which is payable to all shareholders whether or not they wish to receive cash and also has different tax consequences than a repurchase);
- Reducing the number of shares outstanding, in order to increase earnings per share (EPS) and/or reduce the aggregate amount of cash needed to fund future dividends at a certain amount per share;
- the company may view its shares as under-priced, and therefore a good investment;
- offsetting the dilutive impact of option exercises; and
- providing additional liquidity in the market for the company's shares

For most companies, there is not much practical importance to the decision of whether to retire reacquired shares or hold them as treasury shares (to the extent the company has a choice; even in states that generally recognise treasury shares, the company may be required to retire repurchased shares in some circumstances). As noted above, treasury shares, unlike newly issued shares, need not be sold for at least par value, but this requirement usually is not problematic for new issuances in any event, as par values often are set at nominal amounts (commonly US$.01 per share). In addition, in some states, stated capital can be reduced in connection with a retirement of shares, which frees up additional surplus – defined as net assets (total assets minus total liabilities) minus stated capital – to be used for dividends and repurchases. But because stated capital usually is a relatively small amount (for many companies, it is equal to par value per share multiplied by total issued shares), reduction of stated capital in connection with retirement of shares often is not likely to significantly increase the surplus available for dividends and repurchases.

REGULATORY FRAMEWORK

As noted above, the rules applicable to any particular company arise primarily under the law of the state in which the company is incorporated, as well as US federal law. As discussed elsewhere in this guide, the principal aspects of the legal framework include:

- state statutes governing treasury shares, share repurchases, share issuances and legal capital requirements;
- state law doctrines of candour and fairness;
- state law fiduciary standards;
- state statutes that can be the basis of market abuse claims;
- federal securities laws establishing:
  - (i) tender offer rules;
  - (ii) anti-market manipulation and anti-fraud rules;
  - (iii) registration requirements relating to offers and sales of securities; and
  - (iv) periodic disclosure requirements; and
- stock exchange rules on notification and shareholder approval.

ACQUISITION OF TREASURY SHARES

How can a company acquire treasury shares?

Generally, any shares reacquired by a company that are not retired are treasury shares.

Shares can be acquired from public shareholders in four principal ways:

Self-tender offer

This can take one of two forms:

FIXED PRICE

The company sets in advance the price and the maximum (and, if it so chooses, the minimum) number of shares that it is seeking to purchase. Shareholders then have the option to tender all or some of their shares during the offer period at the given price.

MODIFIED DUTCH AUCTION

The company fixes in advance the quantity of its shares it is willing to purchase and sets a relatively narrow (10–15 per cent) price range within which shareholder tenders will be accepted. During the offer period, shareholders may tender all or a portion of their shares at a price chosen by them within the price range set by the company. Based on the offers it receives, the company determines the lowest share price necessary to acquire the number of shares it initially specified and pays this same, market-clearing price for all of the shares that it purchases.

Open-market share repurchase programme

The company acquires shares on the open market from time to time.

As compared to open-market repurchasing, a self-tender usually results in the purchase of a larger number of shares within the period of the offer. Combined with the fact that the tender offer is almost always priced at a premium to the prevailing market price, this often results in a more pronounced effect on the trading price of the shares over the short term. Conversely, an open-market repurchase programme may be preferable for shareholders who do not sell, as the price paid for repurchased shares tends to be lower in open-market transactions than in a self-tender. A self-tender affords the company less flexibility than it has in open-market programmes to respond to declines in the share price, but if the company expects the market for the shares to rise in the near future the self-tender may provide a more efficient means of repurchasing as well as a way to signal confidence to the market.

Privately negotiated transactions

The company may enter into agreements with individual shareholders to repurchase their shares. Depending on the circumstances and the nature of the seller or sellers, such privately negotiated transactions can include a wide variety of terms, and can be effected at the market price, or above or below it.

Accelerated share repurchase

In an accelerated share repurchase (ASR), a company arranges with an investment bank to purchase a desired quantity of its own shares from the bank at a fixed price on a specified date. The shares sold by the investment bank are borrowed from the market, leaving the bank with a large short position that it covers by repurchasing shares on the open market over time (typically a year or less). There is generally a make-up payment between the company and the investment bank based on the difference in the price that the investment bank paid to repurchase the shares in the market and the price the company initially paid to the investment bank, in some cases subject to a cap, floor or collar. ASRs allow companies to repurchase large blocks of shares quickly; however, the disadvantages include not knowing the ultimate cost of the programme, given the make-up payment.

Are there any restrictions in acquiring treasury shares? (eg, purpose-wise; accounting-wise?)

State legal capital requirements

Some states provide that shares generally may be acquired only out of surplus, or out of stated capital if the shares will be retired upon acquisition and the capital account reduced. Some states impose additional or alternative minimum capital restrictions on repurchases.

Federal securities laws applicable to repurchases

The federal securities laws impose various requirements on share repurchases, depending on the manner of repurchase.

Tender offer

If a company makes a tender offer for its own shares, it must comply with section 14(e) of the US Securities Exchange Act of 1934 (the 'Exchange Act') and Regulation 14E thereunder (which applies to all tender offers), as well as Rule 13e-4 under the Exchange Act (which applies to tender offers for equity securities of an issuer with a class of equity securities listed on a US securities exchange or held by at least 500 people, or that has sold securities in a transaction registered under the US Securities Act of 1933 (the 'Securities Act'), made by the issuer or an affiliate thereof). These rules impose a number of disclosure, timing and other procedural requirements on tender offers, including, among others:

– The tender offer must be open to all shareholders for at least 20 business days, during which tendering shareholders must have withdrawal rights, and the company must extend the offer in certain circumstances.
– The company must file with the US Securities and Exchange Commission (SEC) a tender offer statement on Schedule TO disclosing certain information on the date the tender offer commences, and must file an amendment to Schedule TO reporting promptly any material changes in the information set forth in the schedule previously filed. The company also must file all written communications it makes relating to the issuer tender offer, from and including the first public announcement, on the date of the communication. In addition, certain disclosure and dissemination requirements apply to issuer self-tenders.
– The consideration paid to any security holder for securities tendered in the tender offer must be the highest consideration paid to any other security holder for securities tendered in the tender offer.
– If the number of shares tendered is greater than the number being sought in the tender offer, shares must be accepted for purchase on a pro rata basis.
– The company may not purchase shares otherwise than pursuant to the tender offer until at least ten business days after the date of termination of the issuer tender offer.

The tender offer rules also include a number of anti-fraud provisions, in addition to those discussed below.

Open-market repurchase programmes

As noted below, share repurchases raise concerns under anti-manipulation and anti-fraud provisions of the federal securities laws. Rule 10b-18 under the Exchange Act provides an issuer with a 'safe harbour' from liability for manipulation under Exchange Act section 9(a)(2) and Rule 10b-5 solely by reason of the manner, timing, price, and volume of its repurchases when it repurchases its common stock in the market in accordance with the rule's conditions. The basic requirements of Rule 10b-18 are:

(1) manner of purchase: the purchases generally must be made from or through only one broker or dealer on any single day;
(2) time of purchase: the purchases must be made within certain time frames during the day;
(3) purchase price: the price generally must not exceed the highest independent bid or the last independent transaction price, whichever is higher, quoted or reported in the consolidated system at the time the purchase is effected; and
(4) volume of purchases: the volume of shares purchased on any single day must not exceed 25 per cent of the average daily trading volume for the four calendar weeks preceding the week of the purchase; however, once each week the issuer may effect one block purchase (in lieu of purchasing under the 25 per cent limit) if no other Rule 10b-18 purchases are effected that day and the block purchase is not included when calculating a security's four-week average daily trading volume.

While Rule 10b-18 provides a safe harbour from liability for market manipulation, it does not provide protection from liability if the issuer violates anti-fraud laws restricting purchases or sales while in possession of material non-public information. To address these concerns, companies often conduct repurchases in accordance with Rule 10b5-1 under the Exchange Act. That rule provides an affirmative defence against claims under Rule 10b-5 if, among other requirements (and among other alternatives), the company provides an instruction to another person to repurchase the shares for the company's account or adopts a written plan for purchasing shares that:

(1) specifies the amount, price and date of the repurchases;
(2) includes a written formula or algorithm for determining amounts, prices and dates for the repurchases; or
(3) does not permit the company to exercise any subsequent influence over how, when or whether to effect the repurchases.

Rule 10b5-1 plans permit repurchases to occur pursuant to the plan even during times when repurchases would otherwise be prohibited because the company has material non-public information, so long as the company was not in possession of material non-public information at the time of the execution of the plan. A drawback of using a Rule 10b5-1 plan is that the company would give up substantial discretion as to how and when repurchases are effected. In addition, some public companies have been concerned with potential negative investor reaction if the company makes 10b5-1 purchases at a time when it does in fact have material non-public information, even where lawful to do so, because the company (and the other shareholders) essentially benefit to the potential detriment of the selling shareholder.

Privately negotiated transactions

In privately negotiated transactions, the company must take care to conduct the repurchases in a manner that does not inadvertently trigger the tender offer rules, a task that is made somewhat difficult by the fact that the federal securities laws do not define the term 'tender offer'. Whether a series of purchases constitutes a tender offer is determined by a series of judge-made rules that examine, in addition to other factors, the size of the purchase, the time period within which shareholders must respond, and the ability of the shareholders to negotiate with the offeror. Note that privately negotiated (off-market) purchases are outside the Rule 10b-18 safe harbour.

Accelerated Share Repurchase Programme

ASRs fall outside the purview of the disclosure, timing and other process requirements of the tender offer rules, and do not qualify for the Rule 10b-18 safe harbour from liability under the anti-manipulation provisions of the Exchange Act. ASRs also raise issues about agency and disclosure under securities laws that should be carefully considered.

State law doctrines of candour and fairness

There are also state law doctrines of candour and fairness that may apply to transactions between a corporation and its shareholders. For example, some plaintiffs have argued, particularly in the private company context, that the corporation has a duty to disclose all material facts relating to the business (including potential strategic alternatives that are under consideration) to the shareholder before repurchasing shares. In addition, in some states the question of 'improper purpose' may be raised, if, for example, the purpose of the repurchase is to eliminate a dissident stockholder. Likewise, repurchases may not be undertaken to entrench directors in office or for other reasons inconsistent with the fiduciary duties owed to shareholders. In addition, as noted below, state statutes can be the basis for market abuse claims. Accordingly, the method of repurchase, the disclosure to be made and the totality of factual circumstances should be considered with counsel in connection with any assessment of attendant risks.

Which authorisation is needed?

Generally, the board of directors will approve share repurchases. Shareholder approval of share repurchases typically is not required. In the case of open-market repurchase programmes, the board generally approves the broad parameters of the programme, such as the maximum dollar amount to be spent, and number and/or percentage of shares to be repurchased, and delegates either to a board committee or to management the authority to determine terms such as the times and specific prices at which shares are to be purchased.

What are the publicity requirements in the event of acquisition of treasury shares?

Issuer tender offers must be disclosed as discussed above.

If an issuer is buying significant amounts of its own securities, this may be considered material to investors, and thus should be disclosed.

In the case of a share repurchase programme, the company typically would announce the programme in a current report on Form 8-K and/or press release.

In addition, the company must disclose information on all repurchases (including number of shares purchased and average price paid), whether or not pursuant to publicly announced programmes (and must describe any such programmes), in the issuer's quarterly reports on Form 10-Q and annual reports on Form 10-K.

Stock exchange rules may also require notification of the exchange in the event a listed company acquires its own shares.

The number of treasury shares is reflected on a company's balance sheet. In addition, treasury shares are disregarded for purposes of calculating EPS, such that they are equivalent to retired shares for this purpose.

Put and call options – do they count as acquisition of own shares?

It is uncommon for shareholders of public US companies to have put options against, or be subject to call options by, the issuer. Such put and call options are, however, generally legally permissible, and may be granted in appropriate circumstances.

UTILISATION OF TREASURY SHARES

Are there any statutory obligations to resell or redeem treasury shares?

There generally are no statutory obligations to resell treasury shares.

'Redemption' generally refers to the reacquisition of a company's outstanding shares pursuant to their terms as set forth in the company's organisational documents. The concept of redemption therefore is inapplicable to treasury shares, which are held by the company itself rather than shareholders, although, as noted above, a company has the option of retiring repurchased shares (in states that recognise the concept of treasury shares).

How are treasury shares redeemed?

As noted above, the concept of redemption is inapplicable to treasury shares, although treasury shares generally can be retired by a board resolution.

SALE OF TREASURY SHARES

How can the company sell treasury shares?

Sales of treasury shares can be effected in the same manner as sales of newly issued shares. They can be sold by public offering or private placement, and can also be used for employee compensation purposes and as acquisition currency in M&A transactions.

Are there any restrictions for selling treasury shares?

The restrictions for selling treasury shares generally are the same as those for selling newly issued shares. Any offer or sale of securities must, absent an applicable exemption, be registered under the Securities Act. In a registered offering, the issuer must file a registration statement with the SEC, which may be subject to SEC review. The Securities Act also includes anti-fraud provisions.

As noted above, under Delaware and New York law, there is no minimum consideration that must be received by the company for a sale of treasury shares; and, in states that provide shareholders with pre-emptive rights over issuances of new shares, a sale of treasury shares often would not trigger pre-emptive rights.

Which authorisation is needed for selling treasury shares?

Generally, only the board approves the sale of treasury shares, although stock exchange rules require shareholder approval of the issuance of shares in certain circumstances, including where shares representing greater than 20 per cent of the outstanding shares are being sold, subject to certain exceptions. The same generally is true for the sale of newly issued shares that are within the company's authorised share capital. By contrast, where newly issued shares in excess of the number of authorised but unissued shares are to be sold, an amendment of the company's certificate of incorporation requiring approval of both the board and shareholders typically is required.

Can treasury shares be sold other than via the stock exchange or by public tender offer?

Yes, they can be sold in a private placement as noted above.

What are the publicity requirements in the event of a sale of treasury shares?

When securities are sold in a transaction that is not exempt from registration under the Securities Act, a registration statement must be filed with the SEC as noted above. In addition, when a company sells equity securities in a transaction that is not registered under the Securities Act, information relating to the sale (including the amount of securities sold and the consideration, among other things) must be disclosed in the company's periodic reports under the Exchange Act.

Stock exchange rules also may require notification of the exchange in the event a listed company issues shares from treasury.

What legal restrictions are there in order to avoid market abuse?

The federal securities laws include two principal sets of market abuse provisions:

- Anti-market manipulation rules in section 9(a)(2) of the Exchange Act, section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act; and
- Anti-fraud rules in section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Some states, including New York, also have their own statutes that can be the basis for market abuse claims. In addition, as noted above, state law doctrines of candour and fairness should be considered in connection with repurchases.

TREASURY SHARES AND TAKEOVER LAW

What are the general implications of treasury shares under the applicable takeover law regime?

Generally speaking, holding repurchased shares as treasury shares, as opposed to retiring the shares, does not have significant takeover implications. Because treasury shares generally are not considered outstanding, they typically are disregarded for purposes of statutory provisions (which both Delaware and New York have) restricting business combinations with interested stockholders (ie, who own above a specified percentage of outstanding shares), as well as shareholder rights plans.

Share repurchases and issuances, however, may have takeover implications. A share repurchase can affect the company's cash balance and share price, thereby affecting a bidder's calculus as to the desirability of acquiring the company. Likewise, an issuer may engage in a 'street sweep' intended to reduce the number of shares on the market that a hostile raider might otherwise acquire. Moreover, some states (including New York), have statutory 'anti-greenmail' provisions that restrict companies from buying back shares from raiders at a premium (and whether or not there is a specific statutory restriction on greenmail, it may be subject to challenge on fiduciary grounds).

Treasury shares as defence measures?

In some cases, the issuance of shares (whether newly issued or from treasury) in response to a specific takeover threat may be characterised as a defensive measure, particularly when issued in a block to an approved party (a so-called 'white squire' defence). Under Delaware law, defensive measures may be subject to enhanced judicial review under the *Unocal* case and its progeny. Under *Unocal*, when a board adopts a defensive mechanism in response to a perceived threat to corporate control or policy, the board must show that it has reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and that the defensive measure chosen is reasonable in relation to the threat posed, that is, that the action is not 'coercive or preclusive' and otherwise falls within the range of reasonableness. Note that the original *Unocal* case involved a discriminatory self-tender, that is, a tender offer from which the hostile bidder was excluded, a tactic that is no longer permissible under Rule 13e-4.