

CHAPTER 12

Securities Laws

Acquisition review with respect to the possible liabilities of the target company (Company) under securities laws is quite narrowly focused in the context of an acquisition of all of the outstanding shares of stock of a closely held corporation. Even if the prior issuance of such shares by the Company had presented a possible issue of material misrepresentation or nondisclosure under the Securities Exchange Act of 1934 (or, much less likely, of failure to register in violation of the Securities Act of 1933) or any of their state counterparts, the acquisition transaction itself generally would moot such issues, either by direct releases from the selling shareholders or by operation of the warranty and indemnification provisions of the acquisition agreement. Thus, the exposure of the Company, after the acquisition, to liability for violations of securities laws occurring prior to the acquisition is limited to two kinds of situations: (1) liability as a controlling person (or possibly as a statutory "underwriter") for securities issued by other entities and (2) liability to persons who are no longer securityholders of the Company at the time of the acquisition but may have claims respecting their purchase or sale of such securities that are not yet barred by the applicable statute of limitations.

Although analysis of the Company's possible liability in the foregoing situations may implicate a number of the frequently litigated issues under the securities laws, it is not necessary here to attempt to summarize, for purchaser's counsel's application, the substantive securities laws that may be applicable to such transactions. The acquisition of a privately held corporation with subsidiaries or affiliates that have security holders who are not parties to the transaction is relatively rare. It is perhaps more common for claims of former security holders of the Company to remain viable, but from the standpoint of the purchaser the Company's exposure is more effectively and conveniently addressed by indemnification and escrow arrangements with the sellers than by a full factual investigation of the underlying transaction by the purchaser's counsel. If, for example, the purchaser's acquisition review uncovers a redemption of a former shareholder's entire interest in the Company one month before the present acquisition for a price significantly less than the price to be paid by the purchaser, a claim by that former shareholder against the Company is highly likely, and the purchaser should concentrate on the reliability of the sellers' indemnification for the cost of disposing of such a claim rather than on an expensive and necessarily inconclusive investigation by the purchaser's counsel into the validity of such a claim.

The following paragraphs discuss several inquiries by purchaser's counsel designed to identify circumstances that reveal a possible exposure of the Company to a claim based upon securities laws.

____ Review the Company's Minute Book and financial statements to determine

(1) whether the Company has any subsidiaries other than wholly owned subsidiaries (or entities that will become wholly owned subsidiaries in connection with the acquisition transaction), (2) whether the Company or any subsidiary has any indebtedness that is intended to survive the acquisition, and (3) whether the Company is a general partner of any partnership having limited partners. If the Company has publicly issued debt securities or a publicly owned subsidiary, or is general partner of a publicly held limited partnership, it is likely that the transaction will be treated from its inception as an acquisition of a publicly held entity. On the other hand, if relatively few persons may be in a position to assert securities claims against the Company, purchaser's counsel should discuss with the purchaser the strategy to be employed with respect to such security holders. In respect to some such security holders, counsel may be able to determine quickly that the statute of limitations is a bar to the assertion of any securities claims. As to other security holders, the purchaser may determine for business reasons to deal directly with them on business issues, and any agreements with such security holders almost always will dispose of any potential claim.

___ Review the Company's stock ledger and stock transfer book to determine whether any of the Company's stock was repurchased or redeemed by the Company during the five years preceding the acquisition transaction. If any shares were repurchased or redeemed from a person who is not a selling shareholder in the acquisition transaction, determine whether there is any realistic risk that a claim with respect to such transactions is not barred by the applicable federal (maximum three years from the date of the repurchase) or state statute of limitations. If claims in respect of the repurchase may still be asserted, purchaser's counsel should determine whether the repurchase was conducted pursuant to a contract that eliminated the shareholder's discretion as to the fact of the repurchase and the repurchase price. If all material aspects of the repurchase were contractually beyond the discretion of the shareholder and could not be manipulated by the Company, the likelihood of a claim by the shareholder is significantly reduced. On the other hand, if the shareholder retained any discretion in the transaction and if the repurchase price is out of line with the price paid in the instant acquisition, the issue of adequate indemnification for the claim must be addressed. A similar analysis should be made respecting any purchase made by controlling shareholders of the Company before the acquisition. Although the Company may be able to establish that it is not liable for any securities law violation by a controlling shareholder, the likelihood that the Company could become implicated in litigation should be taken into account by the purchaser in dealing with indemnification issues.