SEC STAFF PROVIDES WELCOME GUIDANCE ON POST-IPO STOCKHOLDER ARRANGEMENTS

November 18, 2010

To Our Clients and Friends:

Following an IPO, it has become increasingly common for the persons who were stockholders prior to the offering to seek to maintain in effect various voting, tag-along and drag-along provisions of the stockholders agreement that governed their relationship when the company was private. This holds particularly true where a private equity fund will maintain a significant equity interest following a portfolio company's IPO. There has been an open question as to the securities law implications of certain of these provisions. In a response to a request for interpretive relief we recently obtained,[1] the Securities and Exchange Commission staff has provided guidance on several key aspects of this issue. Specifically, the SEC staff confirmed what we and other counsel had previously hoped – that tag-along rights and irrevocable proxies would not result in the creation of a "group" for purposes of Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). At the same time, the staff made it fairly clear that similar relief would not be provided with respect to drag-along rights and mutual voting agreements.

Section 13(d) and 16 reporting. Persons who beneficially own 5% or more of an issuer's publicly traded equity securities or who are members of a "group" that collectively holds 5% or more of such securities are subject to the reporting requirements under Section 13(d) under the Exchange Act. A "group" is formed when stockholders agree "to act together for the purposes of acquiring, holding, voting or disposing of equity securities of an issuer." If the members of the group collectively hold more than 10% of the issuer's equity securities, the SEC takes the position that all members of the group also become subject to the reporting and short-swing trading rules under Section 16 of the Exchange Act. Having a large number of small stockholders subject to these obligations can be burdensome and particularly problematic for employee stockholders who are not executive officers but receive equity securities from the issuer.

Interpretive Relief. In the facts presented by the request for interpretive relief, following the IPO, current and former non-executive employee stockholders of an issuer were parties – along with a majority stockholder (an affiliate of a private investment firm) and the executive officers of the issuer – to a stockholders agreement that included restrictions on transfer without the issuer's consent, registration rights for the majority stockholder,

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[1] *See Booz Allen Hamilton Holding Corporation, SEC Interpretive Letter (November 12, 2010), available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2010/boozallen111210-13d.htm.

piggyback registration rights for the other stockholders and certain issuer repurchase rights. Certain other provisions in the stockholders agreement that were in effect prior to the IPO, including drag-along rights (allowing the majority stockholder to force the minority stockholders to sell shares when it did) and voting agreements (requiring the minority stockholders to vote as directed by the majority stockholder), ceased to apply to non-executive officers upon completion of the IPO. For technical reasons, under the stockholders agreement, each of the current and former employees separately granted the majority stockholder an irrevocable proxy to vote each individual stockholder's shares with respect to specified matters following the IPO – including the election and removal of directors and change in control transactions – and were granted a tag-along right by the majority stockholder giving each the right to participate in certain third-party sales by the majority stockholder.

The SEC staff confirmed our interpretation that none of the continuation of the remaining provisions of the stockholders agreement, the grant by each individual stockholder of an irrevocable proxy to the majority stockholder or the grant of tag-along rights by the majority stockholder to each other stockholder created an agreement "to act together for the purposes of acquiring, holding, voting or disposing of equity securities of an issuer." In reaching this determination, the SEC staff noted, in the case of the proxy, that each individual stockholder had divested itself of voting power and was thus not able to "act together" with the majority stockholder or any other stockholder with respect to the vote. In the case of the tag-along right, the SEC staff noted that the majority stockholder would make all decisions with respect to the sale of its shares in its sole discretion and had no control over any other stockholder's determination to sell in the tag-along offering, while no minority stockholder had the ability to influence or control the majority stockholder's determination to sell.

Although the letter was limited to an interpretation under Section 13(d) of the Exchange Act, because Section 16 imports the definition of beneficial ownership in Section 13(d) for purposes of determining whether a person is a 10% holder subject to Section 16 of the Exchange Act, no employee stockholder should be subject to the reporting obligations and potential "short-swing profit" liability under Section 16 solely by reason of being a party to a stockholders agreement and tag and proxy arrangements.

Please feel free to contact us with any questions.

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