

MEMORANDUM

TO: Nancy Ovuka
FROM: [REDACTED]
DATE: April 19, 2002
RE: Convertible Preferred Stock

Do you agree with the following analysis?

FACTS:

A private equity fund ("Fund") is purchasing 50,000 shares of Series A preferred stock (the "Preferred Stock") of a public corporation ("Issuer") in a private placement for \$1,000 per share. The aggregate purchase price is exactly \$50 million. No additional consideration in any form is being paid for the Preferred Stock. The Fund does not currently own any securities of Issuer. The size-of-person test and commerce test are met. The Preferred Stock is convertible into common stock of Issuer. The conversion ratio is set so that, at the time Fund acquires the Preferred Stock, the Preferred Stock will be "out-of-the-money" -- that is, the market price of the underlying common stock will be substantially less than \$50 million. The Preferred Stock is presently entitled to vote for directors of Issuer on an "as converted" basis. As a consequence, if the Preferred Stock were converted into common stock, the number of votes that the Preferred Stock could cast with respect to the election of directors immediately before such conversion would be equal to the number of such votes that the resulting common stock could vote immediately after such conversion. The common stock of Issuer is traded on the New York Stock Exchange; the Preferred Stock is not publicly traded.

Dividends on the Preferred Stock accrue daily at an annual rate of [6.5%] and will be payable [quarterly] (the parties are still negotiating the annual rate of the dividend and the frequency with which it will be paid). The dividends will be paid in common stock of the Issuer (priced at 95% of the average closing price of the Issuer's common stock on the 5 trading days prior to the dividend payment date). However, the Fund may elect to receive the dividend in Preferred Stock (instead of common stock) priced on a dollar-for-dollar basis (that is, one share of Preferred Stock for every \$1,000 of dividend).

ANALYSIS:Purchase of the Preferred Stock

The acquisition of the Preferred Stock is not exempt under Rule 802.31, because the Preferred Stock has present voting rights.

The Fund's initial purchase of the Preferred Stock does not meet the size-of-transaction test. The Preferred Stock is not publicly traded and the purchase price is determined. Thus, the Preferred Stock is valued pursuant to Rule 801.10(a)(2)(i) at the purchase price, which is exactly \$50 million. In order to meet the size-of-transaction test, the Fund would have to acquire in excess of \$50 million, and it is not doing so.



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Note: The value of the Preferred Stock is not treated as being equal to the value of the underlying common stock, contrary to what Question 121 of the ABA Premerger Notification Practice Manual might suggest.

Dividends Payable in Stock

The stock dividends on the Preferred Stock are not exempt under Rule 802.10 or under Section 7A(c)(10) of the HSR Act, because such dividends would increase the percent of the Issuer's voting securities held by the Fund.

After each stock dividend on the Preferred Stock, the Fund will be treated under Rule 801.13 as holding "as a result" of that dividend all voting securities of the Issuer held by the Fund immediately after the dividend (including the stock received by the Fund in that dividend and the stock already held by the Fund). For purposes of the size-of-transaction test, such voting securities will be valued as follows in accordance with Rule 801.13:

- If common stock is received in the dividend, it will be valued at market price under Rule 801.10(a) -- even though it is discounted at 95% of market price for purposes of calculating the number of shares to be included in the dividend.
- If Preferred Stock is received in the dividend, it will be valued at fair market value determined in accordance with Rule 801.10(c)(3). (The purchase price of Preferred Stock received in that dividend is treated as undetermined, so that Rule 801.10(a)(2)(i) does not apply.)
- The Preferred Stock already held by the Fund will be valued at fair market value determined in accordance with Rule 801.10(c)(3).
- If the Fund already has any common stock of the Issuer at the time of the dividend in question (for example, common stock received in a prior stock dividend on the Preferred Stock), then such common stock will be valued at market price.

Note: The value of the Preferred Stock would not be treated as being equal to the value of the underlying common stock, contrary to what Question 121 of the ABA Premerger Notification Practice Manual might suggest. Of course, the value of the underlying common stock would be a factor to be considered when determining the fair market value of the Preferred Stock.

Note: The market price in each case would be determined in accordance with Rule 801.10(c)(ii) for the full 45 day calendar period before the dividend in question. Neither the declaration of the dividend nor the Fund's election to receive the dividend in Preferred Stock would constitute a "contract, agreement in principle or letter of intent" with respect to the dividend that might shorten that 45 day period.

If the voting securities of Issuer held by Fund "as a result of" a stock dividend on the Preferred Stock have a value (determined in the manner specified above) in excess of \$50 million, then the stock dividend would be reportable unless an exemption is available. One possible exemption: after the first



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HSR filing, subsequent stock dividends might be exempt if they do not cause the Fund to exceed a higher notification threshold.

Conversion of the Preferred Stock.

The conversion of the Preferred Stock into common stock would not result in a change in the percentage of the Issuer's voting securities held by the Fund, because the Preferred Stock votes on an as-converted basis. Thus, no HSR filing is needed for the conversion. HSR Act, § 7A(c)(10).

4/22/02
agree w/ analysis
MV concurs

