



Federal Securities Law Disclosure Requirements - Corporate Transactions

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The issue of disclosure requirements inevitably arises when the board of directors of a publicly traded company contemplates a significant corporate transaction, such as a sale of the company, a sale of a substantial portion of the assets of the company or other strategic transaction. This memorandum summarizes securities law obligations to disclose the fact of a potential transaction in certain circumstances and the timing requirements for such disclosure. In addition, it provides practical guidelines for adoption and enforcement of a no-comment policy.

1. Disclosure Obligations of Public Companies

1.1 Duty to Disclose

In general, a publicly traded company has only a limited duty to disclose information to the general public, analysts or the press, even when that information is material. Courts have consistently held that the existence of material information is not, by itself, enough to create a disclosure obligation under federal securities law and have specifically applied this principle in the context of preliminary merger negotiations.¹ With the adoption of the Sarbanes-Oxley Act of 2002,² however, the disclosure obligation of public reporting companies has been heightened to a standard of real-time disclosure of material developments. As a result of this Act's directive, the SEC has adopted rule changes requiring issuers to provide disclosure on Form 8-K of most current material

developments affecting the issuer within four business days.³

Federal securities law obligates a company to disclose information only where there is some independent duty to speak.⁴ A duty to disclose might arise because of the following:

- Reporting requirements imposed by the Securities Exchange Act of 1934 (the "Exchange Act"), including the new real-time reporting rules;
- Purchases or sales by the company of its own securities;
- Rumors or leaks that can be attributed to the company;
- Trading by corporate insiders;
- Prior disclosures made by the company; or
- In certain circumstances, prior forward-looking statements.

The company must generally disclose the information immediately once it has determined that information is material and that a duty to disclose exists under the securities law. Courts have upheld a few very narrow exceptions to this general rule and allowed limited delays where (a) the information is not yet "ripe" (i.e., management is not confident of its accuracy) or (b) immediate disclosure would cause more harm than good to the company and its stockholders.

¹ See *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2^d Cir. 1993); see also *Weiner v. Quaker Oats Co.*, 928 F. Supp. 1372, 1382 (D.N.J. 1996).

² Section 409 of the Act.

³ See SEC Release No. 33-8400 dated March 16, 2004.

⁴ *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985); *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990).

1.2 Duty of Accuracy

Once the company has chosen to speak, it must disclose all material non-public information related to the subject of the disclosure. Any information disclosed by the company, whether voluntarily or involuntarily, must be complete, accurate and not misleading.⁵ An issuer can be held liable under Section 10(b) of the Exchange Act and Rule 10b-5 where it has either made a material misstatement or failed to disclose any material facts that are necessary in light of the circumstances to make its other statements not misleading. In addition, Section 12(a) of the Securities Act of 1933 (the “Securities Act”) imposes liability on an issuer, in the context of a registration statement, for untrue statements of material fact and failures to state material facts necessary to prevent the statements made from being misleading.

1.3 Duty to Correct or Update

An issuer may have the duty to correct disclosure made publicly or to an analyst, even though such disclosure was accurate when made, if subsequent events have made the disclosure inaccurate or reveal that such information was incorrect at the time the statement was made.⁶ A fact that might not alone be considered material can therefore become so if its existence renders a previous public disclosure by the company inaccurate. The duty to update continues so long as the prior disclosure remains “alive,” meaning: for as long as investors could be expected to rely on the disclosure.

An issuer that does not wish to assume a duty to disclose information on a continuous basis can issue a statement to the effect that it will not issue any further statements until a specified future event has occurred. For example, an issuer that has obligated itself, through prior statements, to provide ongoing disclosure about merger negotiations, might issue a statement that it will not speak again on the subject until an agreement has been signed. An issuer that chooses this approach must adhere consistently to its stated policy.

⁵ *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987).

⁶ *Ross v. A.H. Robbins Co.*, 607 F.2d 545 (2^d Cir. 1979).

There is no duty to correct or verify market rumors, unless those rumors can be attributed to the company.⁷ However, if the rumors originated with the company, the company may be obliged to comment on the rumors. In addition, if the company typically responds to analysts’ reports or rumors, or issues voluntary interim statements, it could be found to have established a “course of performance” on which the market relies that obligates it to respond even at an inopportune time.

1.4 Periodic Reports

The reporting obligations imposed on the company by the Exchange Act also create a duty for the company to disclose certain material information.

The entry into material definitive agreements and the completion of certain types of major corporate transactions, including significant acquisitions or dispositions of assets, trigger an Exchange Act requirement to file, within four business days of such occurrence, a current report on Form 8-K.

In addition, in its Exchange Act periodic reports, the company must respond to the specific line-item disclosure requirements contained in Regulation S-K. Further, Rule 12b-20 (under the Exchange Act) requires disclosure of “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”

Item 303 of Regulation S-K calls for discussion in the MD&A of certain information necessary to an understanding of the registrant’s financial condition, with a particular emphasis on its future prospects. This includes known trends or uncertainties that are (a) reasonably likely to come to fruition and, assuming they do come to fruition, (b) reasonably likely to have a material effect on the registrant’s financial condition or results of operations.⁸ The SEC has explicitly

⁷ *State Teachers Retirement Bd. v. Fluor*, 654 F.2d 843, 849 (2^d Cir. 1981).

⁸ SEC Release Nos. 33-6835 and 34-26831, Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures (May 24, 1989).

and consistently advised issuers that Item 303 should not be interpreted as creating a duty to disclose otherwise undisclosed preliminary merger negotiations.⁹

2. Determining the Materiality of Information about Corporate Transactions

Information is considered material if a reasonable stockholder would consider it important in making an investment decision.¹⁰ Courts determining in hindsight whether undisclosed information was “material” will evaluate whether there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor as having significantly altered the total mix of information available.¹¹ Issuers have long struggled with the difficulty of determining when the possibility of a major corporate transaction becomes material information. The current standard was articulated by the Supreme Court in *Basic Inc. v. Levinson*.¹² *Basic* involved an issuer that had engaged in merger negotiations for two years and issued several public statements denying the existence of such activity before publicly announcing the completion of the merger.

In its decision in *Basic*, the Supreme Court rejected a bright-line “agreement in principle” test¹³ and adopted a subjective balancing test for determining whether the merger negotiations became material. This test requires a fact-based assessment of both (a) the indicated probability that the event will occur and (b) the anticipated magnitude of the event, should it occur, in relation to the issuer’s other activities.¹⁴ Thus, whether a proposed transaction is material at any given moment depends on a combination of the transaction’s impact on the issuer and how likely it is, at that moment, that the transaction will occur.

2.1 Probability of Occurrence

In assessing probability of occurrence, the *Basic* test requires that a court assess “indicia of interest in the transaction at the highest corporate levels,” including, but not limited to, board resolutions, instructions to investment bankers and actual negotiations between the parties’ principals or their intermediaries.¹⁵ Courts interpreting the *Basic* test have implied that the probability of completing a corporate transaction increases along a continuum and that reaching certain milestones can render a proposed transaction likely. In previous cases applying the *Basic* test, the following milestones were held to be insufficient to render a major corporate transaction material:

- One party decided to undertake or pursue a major transaction before contacting the other party;
- One or both parties retained an investment bank to explore possibilities;
- Initial expressions of interest or “routine discussions” between two potential parties that “may or may not give rise to an agreement;”
- Parties commenced negotiations and exchanged confidential information, but believed they were too far apart to reach agreement; and
- Negotiations between the parties broke down.

On the other hand, courts have determined that the following milestones reflected sufficient certainty that a potential merger had become material:

- Formal offer by one party presented to the board of the other party; and
- Agreement as to price and terms.

The probability of occurrence of a proposed corporate transaction is a factual determination to be decided on a case-by-case basis. However, the company can draw some guidance from the above list of milestones and from the general principle that as the discussions and negotiations regarding the

⁹ *Id.*

¹⁰ *TSC Indus., Inc. v. Northway, Inc.*, 426, 445 U.S. 438 (1976).

¹¹ *In re Adams Gulf, Inc. Sec. Lit.*, 2004 U.S. App Lexis 18030 (2004); *First Virginia Bankshares v. Sandberg*, 559 F.2d 1307 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978).

¹² 485 U.S. 224 (1988).

¹³ The “agreement in principle” test, which had been adopted by the Third and Sixth Circuits, deemed merger negotiations immaterial until the parties had reached an agreement on price and structure.

¹⁴ *Basic*, 485 U.S. at 238, quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2^d Cir. 1968).

¹⁵ *Basic*, 485 U.S. at 239.

transaction become more specific, the transaction more closely approaches the materiality threshold set by the *Basic* test.

2.2 Magnitude of Event

For “small corporations,” “a merger in which it is bought out is the most important event that can happen in its life,” and therefore information about a potential merger “can become material at an earlier stage than would be the case as regards lesser transactions.”¹⁶ The Supreme Court in *Basic* did not define what it meant by “small corporation” and subsequent decisions have indicated that acquisition overtures made to, or negotiations for the purchase of, public companies do not by themselves constitute material information.¹⁷ In determining whether such information is material, a court would consider the relative size of the parties involved and the potential premium over stock price.

3. No Comment Policy

Basic reiterated that a “no comment” statement is the functional equivalent of silence.¹⁸ However, an issuer which selectively exercises the right not to comment (that is, which truthfully denies rumors that are untrue, and issues “no comment” statements when there is a grain of truth to them) exposes itself to the danger that its “no comment” statement is actually a disclosure because it alerts the inquirer to the fact that a significant development is underway or is being considered. In these circumstances, a statement of “no comment” triggers a duty to make such disclosure complete and accurate.¹⁹ However, an issuer who establishes and consistently follows a policy not to comment does not face such a risk. A “no comment” policy is the most advisable approach from a securities law perspective in a scenario involving a possible corporate transaction if it is adopted well before the process begins and if the company can maintain consistency

among all public statements. Such a policy is not the best approach to adopt, however, if prior disclosures have been inconsistent with that policy.

¹⁶ *Basic*, 485 U.S. at 238, citing *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-49 (2nd Cir. 1976).

¹⁷ *Glazer v. Formica Corp.*, 964 F.2d 149, 155 (2nd Cir. 1992).

¹⁸ *Basic*, 485 U.S. at 239, citing *In re Carnation Co.*, Exchange Act Release No. 22214, SEC Docket 1025 (1985).

¹⁹ *Basic*, 485 U.S. at 239, citing *Flamm v. Eberstadt*, 814 F.2d 11659, 1178 (7th Cir. 1987).