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## Corporate Disclosure Obligations

### *Introduction*

The legal sources of disclosure obligations with respect to public announcements are threefold: (1) federal securities laws; (2) stock exchange rules; and (3) state laws. The timing and nature of such publicity present many pitfalls for both prospective acquirers and prospective targets. On the one hand, failure to make full and prompt disclosure of merger plans can result in a party to an acquisition transaction being held liable under the federal securities laws. On the other hand, a premature public announcement can also result in liability. Each party's strategic considerations will also influence the timing of the public announcement.

### *Duty to Disclose Under Federal Securities Law*

The federal securities law requirements with respect to corporate disclosures are reflected in the policy of the Securities and Exchange Commission and Rule 10b-5. Corporate disclosure is required by SEC Release No. 34-8995 (10/15/70), which provides: "Notwithstanding the fact that a company complies with such reporting requirements, it still has an obligation to make full and prompt announcements of material facts regarding the company's financial condition." If either party to a material transaction is publicly held, an affirmative duty exists to disclose the transaction to the public. A transaction is material if it presents "a substantial likelihood that a reasonable shareholder would consider it important" (*TSC Industries, Inc. v. Northway*, 426 US 438, 1976).

**Timing:** If an acquisition is material to a publicly owned acquiring corporation or a publicly held target corporation, the general rule is that the deal must be disclosed when an agreement in principle has been reached. (However, under some circumstances disclosure may be required earlier). If a large publicly held corporation acquires a small closely held firm

and the transaction is not material to the public entity, there is no duty to make an announcement. If both corporations are privately held, there is no need to make a public announcement until the closing, when the target would, in the ordinary course of business, notify its suppliers and customers.

**Updates:** A corporation's duty to disclose continues until the transaction is completed. So even if a public announcement has already been made, it is important to announce (1) any change in the material terms of the transaction; (2) any material change in the business or financial condition of either of the parties; or (3) the termination of a proposed transaction. Failure to follow up creates the same potential liabilities as an initial breach of the disclosure duty because previously disclosed information may leave a false or misleading impression with investors if it is not updated.

A corporation has a duty to correct previously disclosed information that has become inaccurate, if the market would logically attach credence to such uncorrected information (*Ross v. AH. Robins Ha, Inc.*, 465 F. Supp 904, SD N.Y., 1/8/79). If a prior report issued by the corporation is erroneous and materially misleading, the corporation should correct the report (*Fischer v. Kletz*, SD N.Y. 266 F. Supp. 180, 1967; *Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc.*, CA-2, 425 F.2d 842, 1970).

Rule 10b-5 is the most important securities rule with respect to corporate publicity. The Securities and Exchange Commission can seek an injunction against corporations and individuals who violate Rule 10b-5. Violations of Rule 10b-5 also give rise to an implied private right of action by securities purchasers or sellers. Rule 10b-5 reaches not only a corporate insider who engages in a securities transaction when in possession of material nonpublic information, but also a corporation and its officers who promulgate a materially misleading press release

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(*SEC v. Texas Gulf Sulphur Co.*, CA-2, 401 F. 833, cert denied, 394 US 976; *Mitchell v. Texas Gulf Sulphur Co.*, CA-10, 446 F. 2d 90, 1971, cert and rehearing denied 404 US 1004). Although no case had mandated corporate disclosure under Rule 10b-5, in (*Financial Industrial Fund Inc. v. McDonnell Douglas Corp.*, CA-10, 474 F. 2d 514, cert denied 414, 1973), the court, in dictum, indicated that liability might be imposed under Rule 10b-5 solely on a nondisclosure theory, at least where the corporation in bad faith refused to disclose or unduly delayed the release of material information. The court stated: "It is equally obvious that an undue delay not in good faith, in revealing facts, can be deceptive, misleading, or a device to defraud under Rule 10b-5."

## **Duty to Disclose Under Stock Exchange Regulations**

As noticed earlier, stock exchange rules also require prompt corporate disclosure. For example, the *New York Stock Exchange Manual* provides that "a corporation whose securities are listed on the New York Stock Exchange, Inc. is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." The *AMEX Company Guide* provides that, "A listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances." Mergers and acquisitions are specifically included in the guidelines for transactions requiring prompt disclosure.

Violation of exchange regulations may result in a suspension of trading or a delisting of the securities. To date, a violation of stock exchange rules with respect to timely disclosure has not been held to give rise to an implied private cause of action. (See *State Teachers Retirement Board v. Fluor Corp.*, CA-2, 654 F. 2d 843, 1981; *Jablon v. Dean Witter & Co.*, CA-9, 614 F. 2d 677, 1980, but compare *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CA-7, 410 F. 2d 135, 1969).

Stock exchange rules generally require public disclosure to be made as soon as any

disclosure is made to persons other than top management and their confidential advisors. If the acquiring corporation or the target corporation is listed on the New York Stock Exchange or the American Stock Exchange, the public-announcement rules apply if the acquisition would materially affect the stock of either corporation. If the parties' discussions have been kept confidential, the best time to release the information is when the parties reach an agreement in principle, whether or not a letter of intent is executed. This general standard should also be used for corporations whose stock is traded in the over-the-counter market.

## **Exceptions to Prompt Disclosure Rule**

Material, nonpublic information must be disclosed, but only when the information is "ripe" for disclosure. It may be appropriate to delay issuing a public announcement when disclosure would endanger the attainment of a legitimate corporate objective. (See, e.g., *Matarese v. Aero Chatillon Corp.*, SD N.Y., 12/22/71), in which the court said that non-disclosure was justified until the target corporation's shareholders approved the merger transaction because premature disclosure might have jeopardized the acquisition. In this situation, courts have used a business-judgment rationale to temper a corporation's prompt-disclosure obligation. In *SEC v. Texas Gulf Sulphur Co.*, (CA-2, 401 F. 2d 833, 1968 cert denied, 394 US 976, 1969), the Court stated "We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC." In another case, a court ruled that the duty to disclose does not arise until the corporation gathers enough information to issue an accurate release, verifies the information sufficiently for management to have confidence in its accuracy, and determines that there is no valid business reason for non-disclosure (*Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, CA-10, 474 F. 2d 514, 1973, cert denies, 414 US 874).

The *AMEX Company Guide* provides the following two exceptions to the general rule of prompt corporate disclosure: (1) when immediate disclosure would prejudice the ability of the company to pursue its corporate objectives (however, the unfavorable result to the corporation must be balanced against the undesirable consequences of nondisclosure); and (2) when the facts are in a state of flux and a more appropriate moment for disclosure is imminent.

If the corporation decides not to make immediate disclosure, counsel should double-check whether any disclosure of the transaction is required under any other disclosure

requirement—e.g., formal SEC filing, periodic SEC report, or proxy statement. If the corporation is making ongoing periodic purchases of its own shares (e.g., through regular purchases for the benefit of its pension plan), this would be an additional factor encouraging immediate disclosure.

## **Premature Disclosure**

Disclosure of preliminary discussions that will affect the market value of the stock of either party may result in liability under Rule 10b-5, even in the absence of insider trading, because the premature release of information may be materially misleading. Due care must be taken so that the information remains confidential until announced and insiders do not improperly trade on or tip the information.

From a practical standpoint, it is important to avoid premature disclosure, that is, disclosure prior to reaching an agreement in principle. Premature release of information with respect to merger or acquisition negotiations before any firm commitments are obtained may prejudice the corporation in its dealings. After such an announcement is made, other potential acquiring corporations may attempt to outbid the purchaser, knowing that the target is for sale and an agreement has not yet been reached. The principals may be besieged by analysts and shareholders.

## **Duty to Correct Rumors**

What should a party to an acquisition do when news of a planned merger has been "heard on the street" before a public announcement has been made? The corporation should attempt to determine whether information on impending developments has been leaked. If rumors of an impending acquisition are circulating, a corporation may have to announce its plan prior to reaching an agreement in principle.

Stock exchange rules provide that a listed corporation has an obligation to disclose information in response to materially misleading information from outside sources. For example, the New York Stock Exchange rules provide that a corporation should "act promptly to dispel unfounded rumors which result in unusual market activity or price variations." If it is apparent that the transaction is not going to remain confidential, the New York Stock Exchange rules state, "If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified . . . If rumors are correct or there are developments, an immediate, candid statement to the public as to the state of

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negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration."

The *AMEX Company Guide* provides that "Whenever a listed company becomes aware of a rumor or report, true or false, that contains information that is likely to have, or has had, an effect on the trading in its securities, or would be likely to have a bearing on investment decisions, the company is required to publicly clarify the rumor or report as promptly as possible."

If the rumors pertain to the acquiring corporation or the target corporation and its stock starts to move, the corporation will usually receive a call from the stock exchange's stock-watch committee asking if the company has any comment on any material pending events. To deal with this contingency, the acquiring corporation should have an announcement ready during the interim period, prior to the striking of a deal. (However, if an acquisition-minded corporation is subject to constant rumors that it is discussing a potential acquisition, it is not required to respond to each of these rumors).

A company's obligations under Rule 10b-5 to correct rumors vary depending on the source of the rumors. If the rumors are not attributable to the corporation, it has no obligation to correct or verify rumors in the marketplace (see *State Teachers Retirement Board v. Fluor Corp.*, CA-2, 654 F. 2d 843, 1981; *Electronic Specialty Co. v. International Controls Corp.*, CA-2, 409 F. 2d 937, 948, 1969). However, if the rumors originated from a corporate source and were materially misleading when published or have become materially misleading in light of subsequent events, the corporation is under a duty to correct the information. A duty to correct exists if there is an agency relationship between the maker of the misstatements and the corporation and the statements are within the scope of the maker's employment. There is no duty to correct statements made by low-level employees whose positions within the corporation would not normally authorize them to disclose such information.

If a listed corporation determines that unusual activity or price fluctuations are attributable to a rumor and that corrective action is mandated, it is advisable to arrange for a suspension of trading. This is especially true if the disclosure is likely to have a substantial impact on the price of the corporation's stock.

### Contents of the Public Announcement

The public announcement should be accurate, complete, and as up-to-date as possible to ensure that it contains no material misrepresentations and makes no material omissions. The information must be "in a manner making it generally available to the investing public" (*Faberge, Inc.*, SEC Release No. 33-10174, 5/25/1973). Disclosure should be made by means of a press release to the major financial services and the national wire services, and that release should be distributed to trade publications and newspapers in cities where the corporation has its headquarters, its major facilities, or significant security holder concentrations. The *AMEX Company Guide* recommends that such announcements be balanced, fair, complete, and written in a factual, clear and succinct language that is comprehensible to investors. Basic facts that should be disclosed include the identity of the parties and the principal terms of the transaction. If any basic terms remain undecided or any facts are in flux, the release should note that fact and affirmatively state which material terms have not yet been agreed on. The *AMEX Company Guide* (§ 403) states that "review of press releases and other public announcements by legal counsel is often desirable and necessary, depending on the importance and complexity of the announcement."

The release should also indicate the amount of consideration to be paid as well as the form of the consideration. If the target is privately held, the release should attempt to indicate the size and operations of the target (i.e., sale and net earnings for the most recent fiscal year and perhaps for subsequent interim periods) and the target's net worth as of a recent date.

The release should state whether an agreement in principle has been reached. It should also specify whether the consummation of the transaction is subject to the execution of a contract of sale, board and shareholder approval, or other significant conditions. If a corporation must announce a pending acquisition prior to reaching an agreement in principle, the release should state that the parties are engaged in preliminary negotiations but that no agreement in principle has been reached. In addition to exercising due diligence in the preparation of the press release and carefully weighing the method of dissemination, the corporation should follow up on the media's treatment of the release to ensure that information is not edited in a misleading fashion and that incorrect information is not attributed to the corporation. If the media distorts or wrongfully attributes information, the corporation should immediately issue a corrective release.

### Impact of Other Federal Securities Regulations

If, as part of the transaction, the acquiring corporation is planning to issue new securities requiring registration under the 1933 Act, the timing or manner of disclosure of information may be affected by the corporation's obligations under § 5(c) of the 1933 Act (which prohibits any written offerings of a security during the period prior to the filing of a registration statement). If a corporation must disclose information publicly, such public disclosure may run afoul of § 5(c). The prohibition of § 5(c) has been interpreted broadly by the SEC to include any communications made as part of a sales campaign prior to the effective date of the registration statement. In *Loeb, Rhodes & Co.* (38 SEC 843, 1959), the Commission stated: "The statute prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, conditioned the public mind or aroused public interest in a particular security."

Thus, the acquiring corporation must avoid communications designed or having a tendency to generate shareholder interest in the transaction. (See, e.g., *Chris-Craft Industries Inc. v. Bangor Punta Corp.*, CA-2, 426 F. 2d 569, 1970 (*en banc*), *rev'd on other grounds* 430 US 1977), in which an announcement was held to constitute improper "gun-jumping" because it exceeded the preregistration effective information permitted and it encouraged [the reader] to form a premature opinion of value without benefit of full set of facts contained in a prospectus." For examples of activities which may be deemed "gun-jumping," (see *SEC Release No. 33-5180*, 8/16/71, and *SEC Release No. 33-5009*, 1/07/69; see also *SEC v. Arvida Corp.*, SD N.Y., 169 F. Supp. 211, 1958).

If a registration statement is to be prepared in connection with the merger or acquisition transaction the release should include nothing that could be construed as priming the market in order to avoid a gun-jumping situation under § 5(c). In this situation, the announcement should only set forth the bare outline of the proposed transaction.

A specific exception, Rule 145(b) (promulgated under the 1933 Act), permits the public announcement of a merger before filing a registration statement. Rule 145(b) allows for a press release to be issued identifying the parties and their respective businesses; the date, time, and place of the meeting of shareholders; and a brief description of the transaction and the basis on which it was made (see also Rule 135, which provides for notice of proposed public offerings generally). Thus, when an agreement in principle is reached, a public announcement may, if

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carefully prepared, be made without violating the 1933 Act. A public announcement may also be made before an agreement in principle is reached (e.g., at the beginning of the negotiations, provided the requirements of Rule 145(b) are adhered to).

The 1933 Act restrictions on publicity and communications apply to the acquiring corporation and its affiliates. In a Rule 145 transaction, the target (if not subject to the proxy rules) and its management are subject to the same restrictions as are imposed on the acquiring corporation because § 5 of the Act prohibits premature offers or communications by any person involved in offering or selling securities. The target and its management may be deemed underwriters (§ 2(a)(11) of the 1933 Act) because they are persons participating in a distribution of the securities of the acquiring corporation.

After the filing of the registration statement, § 2(a)(10) of the 1933 Act and Rule 134 (promulgated under the 1933 Act) permit the dissemination of certain limited information identifying the issuer and the offering terms.

If the target is subject to the proxy rules and a joint prospectus/proxy statement

(Schedule 14a) is used, the target will be subject to restraints on publicity and communications under the proxy rules. Dissemination of the preliminary prospectus cannot be made before the delivery of the proxy statement. Rule 14a-3 (promulgated under the 1934 Act) prohibits any solicitation of proxies, written or oral, prior to the furnishing of the required proxy statement to a corporation's shareholders. Thus, management of the acquiring corporation cannot personally contact the target's shareholders in a transaction subject to the proxy rules prior to furnishing a proxy statement to the target's shareholders. Also, a press release should not include information not reasonably expected to be included in the proxy statement; otherwise, the release may be construed as a premature proxy solicitation under Rules 14a-2 and 14a-1.

Note that an exception exists pursuant to Rule 14a-2(g)(6) for a newspaper announcement that identifies the issuer and the proposals to be acted on for the security holders. This makes possible a public announcement of the impending transaction prior to furnishing the proxy statement.

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