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MERGERS AND ACQUISITIONS

Disclosure Of Preliminary Merger Negotiations Just Say "No Comment"

Overview

In the preliminary stages of a merger, one of the most frequently asked questions is when must public disclosure be made of the potential merger. To answer this question, management of both the target company and the acquiror must take into account a number of factors.
Companies that are publicly held and report under the securities laws are required to file certain periodic reports with the Securities and Exchange Commission or, if a bank, with their respective primary federal bank regulatory agency. Examples of such reports are 10-Ks, 10-Qs, and 8-Ks and their federal bank regulatory agency counterparts. In this context, disclosure of material corporate developments is structured and entails little judgment as the disclosure is made in response to specific line items in the report. A far more difficult issue arises in the context of unstructured disclosure when a company contemplates communicating corporate developments to the investing public as those developments occur. Little guidance exists for unstructured disclosure and that which does exist has been developed through case law, always with the benefit of hindsight.

As the anti-fraud provisions of the federal securities laws apply to all securities, whether or not the securities are exempt from registration, executives of all companies must proceed with great caution when determining the timing and nature of corporate development disclosure.

Material Information

As a threshold issue, it should first be determined if the information is material. Information will be considered material if the reasonable shareholder would consider the information important in deciding how to vote (*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)) or whether to purchase or sell securities. (*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)). Also the total "mix" of information is important. To be material, there must be a "substantial likelihood" that the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc., supra* at 449.

In *Basic Inc., supra*, the U.S. Supreme Court specifically rejected a bright-line rule that preliminary merger discussions do not become material until an "agreement-in-principle" has been reached. Rather, the court developed a probability versus magnitude approach to materiality. This approach requires management to make a fact-specific inquiry to assess the materiality of merger negotiations. If the acquisition is meaningful to the company on all financial levels, then the probability of the transaction being consummated must be considered. If there is a low probability that the transaction will occur, the need for disclose decreases despite the significance of the transaction. Likewise, although the probability of a transaction may be high, if its impact on the company, i.e. its magnitude, is low, the need for disclosure is also low. As a practical guide, any information or news that is likely to have an impact on the price of the company's stock (that is, the news will result in a move in the price) should be considered material.

Timing of Disclosure

Once it has been determined that information is material, absent an affirmative duty to disclose, a company does not have an obligation to disclose material non-public information. In other words, a company is not required to disclose information as soon as it arises simply because it is material. "Silence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic Inc., supra* at 239n.17.
When no circumstances are present that require immediate disclosure, the timing for corporate disclosure of material information is left to the good faith business judgment of management. See *Kohler v. Kohler Co.*, 319 F.2d 634, 641 (7th Cir. 1963); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968).

Certain situations, however, may give rise to the need to make immediate disclosure of an impending corporate development. As mentioned above, there may be an affirmative requirement to disclose in response to structured disclosure requirements of the securities laws, such as disclosure in offering documents for the sale of the company's securities or disclosure in required periodic reports. Likewise, a company may be required to update prior public announcements that were accurate when made but became inaccurate as a result of later events or if secret information makes a prior public statement materially misleading. See *In re Time Warner, Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993). Unusual market activity may also trigger a requirement for immediate public disclosure. "This is particularly true where the company knows or has reason to believe that material non-public information has been made selectively available to certain market participants and that this selective availability may be the cause of unusual market activity." SEC Release No. 32-18271

(November 19, 1981). Thus, if rumors or unusual market activity indicate that information on impending developments has become known, a clear public announcement may be required, even though the matter may not have yet been presented to the company's board of directors.

"No Comment" Policy

When determining the timing for disclosure of material information on corporate developments, management must strike a balance between keeping its investors informed with protecting competitive information. This balance is possible to achieve if, before events occur which give rise to material information, management formulates and strictly adheres to certain policies and procedures.

The board of directors should consider adopting a formal policy of **always** responding **"NO COMMENT**" to inquiries on corporate developments. All market inquiries should be funneled to a designated company spokesperson who is familiar with the information on the company currently in the public domain, disclosure requirements under the securities laws and the concept of materiality, to assure that the company speaks with a single, consistent voice. The group involved in any preliminary merger negotiations should be kept as small as possible to decrease the likelihood of rumors or leaks that might trigger the need for disclosure. (It goes without saying, no member of management should trade in the company's stock while in possession of non-public, inside material information.)

These procedures will protect a company against claims of misleading or fraudulent statements only if the company aggressively implements the procedures and consistently follows them. In *Basic Inc.* the Supreme Court found the company liable under the securities laws for making misleading statements because it publicly denied there were any corporate developments that would explain the unusual activity in its stock at a time when the company was actively engaged in preliminary merger negotiations. In that decision, the Supreme Court observed that if the company had chosen to remain silent or stated "no comment", the functional equivalent of silence, no violation of the securities laws would have occurred. Once a company chooses to speak on corporate developments, however, it is under a duty not to make statements that are materially misleading or omit to state a material fact.

It is vital that a "no comment" policy be consistently and rigorously enforced if it is to be an effective tool. If a company responds fully to inquiries on corporate developments on some occasions and then states "no comment" to such inquiries on other occasions, the market place will quickly learn that the company uses "no comment" to signal that a major development is pending. This will defeat the very purpose for the policy and expose the company to potential liability under the anti-fraud provisions of the securities laws. Caution must also be taken not to make disclosure to select individuals in an attempt to be responsive to a shareholder inquiry or curry the favor of an influential stock analyst or market-maker.

Conclusion

As a general rule, publicly held companies should promptly disclose material information on corporate developments that may reasonably be expected to affect the value of its stock or influence investor decisions. A delay in making disclosure should be the exception to the rule and be done only for good cause: where, for example, immediate disclosure would prejudice the ability of a company to achieve its corporate objectives and the company is able to maintain confidentiality of those events.