FUNDAMENTAL CORPORATE CHANGES: FEDERAL DISCLOSURE ASPECTS

By Donald A. Scott *

I am going to deal with the federal security law aspects of fundamental corporate changes. As mentioned previously, there is a common thread running through the Delaware and the federal cases. For example, the Delaware courts in determining what is "germane" under the complete candor test seem to have adopted the materiality test in *TSC v. Northway*,[1] which was a United States Supreme Court opinion interpreting the federal proxy rules.

Similarly, in *Weinberger III*,[2] there is quite a bit of discussion about misrepresentations in the proxy material under Delaware law which deals with exactly the same issues as would be dealt with in a federal court under the federal laws.

In looking over my outline I became a little concerned that if someone from another planet came in cold, or even if it was someone fresh out of law school, it would be very difficult to see why we are where we are without having grown up with the gradual development of the disclosure regulations and rules of the SEC. I would like to take a few minutes, then, to briefly present a federal securities law road map so that perhaps you will better understand the S-14s and S-15s, etc.

I will start with the Securities Act of 1933.[3] This was designed to regulate the sale of securities by issuers, underwriters, and dealers. It deals with the sale of securities, and for that reason a cash merger is not covered by the Securities Act of 1933. Basically the issuer of securities is required to file a registration statement and to deliver a prospectus to a purchaser of the security. Liabilities under the Act attach for failure to file a registration statement, for misleading prospectuses, and for fraud and deception in the sale of securities.

The principal Form under the Securities Act is Form S-1, which is the full registration statement. The SEC has adopted additional forms which I will get into after I discuss the Securities Exchange Act of 1934.[4]

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1. TSC Indus., Inc. v. Northway, 426 U.S. 438, 449 (1976).

2. Weinberger v. UOP, 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58-1981 (Del. Feb. 9, 1982).

3. 15 U.S.C. §§ 77a-77*ll* (1933 & Supp. III 1979).

4. 15 U.S.C. §§ 78a-78hh (1934 & Supp. III 1979).

Regarding mergers, prior to 1973, even if securities were being issued in a merger, the SEC took the position that under rule 133[5] no "sale" was involved because the operative event in determining whether the merger should go ahead was a vote of the shareholder body and not individual investment decisions.

That rule was rescinded in 1973 by the adoption of rule 145,[6] which recognized that a shareholder, in determining how to vote, was making an investment decision on whether he or she wanted to receive securities in the merger.

There is one exception to rule 145[7] which is mentioned in Steve Rothschild's outline:[8] that a registration statement is not required for a merger which simply changes the domicile of the corporation. As Steve points out, this has been quite liberally interpreted by the staff of the SEC to include a number of fundamental changes in connection with change of domicile.[9]

The Securities Act applies, as I say, to all sales of securities by an issuer. If I am going to acquire somebody else's corporation, and there is only one shareholder and I am issuing securities, that, by its terms, would be covered by the Securities Act of '33. But there is an exemption, which is the private offering exemption, and if the purchaser of the securities is sophisticated, then you do not need a registration statement in that type. I would simply refer you to rule 146[10] that has been adopted by the SEC which sets up procedures which they regard as complying with the private offering exemption.

The Securities Exchange Act of 1934 is designed to regulate transactions in securities. As originally enacted, it dealt primarily with the securities markets (the stock exchanges), with the professionals who operate in those markets (the broker/dealers), and with the companies whose securities are listed on those markets.

In the 1960's, the scope of the Act was enlarged to go beyond listed companies to what are called 12(g) companies, which are companies with more than 500 shareholders and more than a million dollars in assets. This reflected the development of the over-the-counter market which supplemented the stock exchanges.

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5. 17 C.F.R. § 230.133 (1981).

6. 17 C.F.R. § 230.145 (1981).

7. *Id.*

8. Rule 145(a)(2) provides an exception by allowing such statutory mergers, consolidations, and other plans of acquisitions to be accomplished without registration under the 1933 Act "where the sole purpose of the transaction is to change an issuer's domicile." 17 C.F.R. § 230.145(a)(2) (1981).

9. *See* SEC Release No. 33-5463 (Feb. 28, 1974), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 3058.

10. 17 C.F.R. § 230.146 (1981).

The purpose of the '34 Act with respect to these companies was to make sure that there is sufficient information in the market so that investors can make informed decisions about buying and selling their securities.

The structure of the '34 Act is that a company registers its securities under section 12.[11] This then leads to the requirements that the company comply with the reporting requirements of section 13,[12] the proxy requirements of section 14,[13] and, with respect to directors and officers, the short-swing profit or insider trading provisions of section 16.[14]

Section 14(a) [15] refers only to securities registered under the '34 Act, so if a company does not have securities registered under the '34 Act, it does not have to comply with the proxy rules. It may have to comply with state law provisions, the complete candor idea, and the entire fairness idea, but it does not have to comply with the proxy rules.

Secondly, section 14(a) [16] refers only to soliciting proxies or consents with respect to any securities. If there is a sufficient concentration of stock so that there is no need to solicit proxies because the vote is already in hand, you are not under section 14(a).[17] However, you get caught under section 14(c),[18] which requires the sending of an information statement (which is basically the same as a proxy statement) twenty days before the meeting or before the effective date of the consent, if action is being taken by the prospectus set forth in some detail the type of information that is required in the proxy statement. In the old days there were a number of disparities between the requirements of the proxy rules, the requirements of the reports under section 13, and the requirements under the '33 Act. The SEC has made tremendous strides in the last ten years in trying to eliminate these disparities.

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11. 15 U.S.C. § 78*l* (1976).

12. 15 U.S.C. § 78m (1976 & Supp. III 1979).

13. 15 U.S.C. § 78n (1976).

14. 15 U.S.C. § 78p (1976).

15. It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title.

15 U.S.C. § 78n(a) (1976).

16. *Id.*

17. *Id.*

18. 15 U.S.C. § 78n(c) (1976).

The first example is that there is now a Regulation S-K[19] and this details types of information required in all types of disclosure documents: information with respect to directors and officers, business, remuneration, exhibits, etc. Then the items in the S-K are incorporated by reference in the pertinent instructions for the other documents. It's very confusing if you do not know the road map because you go through the proxy rules and when you get to item 7, which is remuneration, it says to give the information in item 4 of S-K. But once you understand it, it's not so confusing.

Secondly, the SEC changed its rules to permit the use of one disclosure document to meet the requirements of another. The prime example of this is the registration statement of Form S-14, which is applicable to mergers. It says that a proxy statement meeting the requirements of the proxy rules can also be used as a registration statement and prospectus under the '33 Act.

Thirdly, and this is a quite recent occurrence, the SEC has reorganized the three basic disclosure documents under the '34 Act: the annual report on Form 10-K, the annual report to shareholders, and the proxy statement for the annual meeting of shareholders. What the SEC has done is to require greater specific information in the shareholders' annual report, so that it can be used as the basic disclosure document with the proxy statement. The Form 10-K then incorporates by reference the items that have been required to be put in the shareholders' report.

Finally, the SEC has adopted on an experimental basis Form S-15, which, again, is for mergers and is what would be called a short-form registration statement. The impact of S-15 is that, if the acquiring company is registered under the '34 Act, it can omit the information with respect to business, financial statements, etc. as long as there is delivered with the proxy statement the annual report to shareholders. If the acquired company is also subject to the '34 Act, the same thing can be done for it.

You end up with a proxy statement which is relatively short and which discusses the terms of the transaction, the voting requirements, and the conflicts of interest; hooked onto it are the shareholders' report and the proxy statements.

The availability of this form is limited to acquistions which do not result in more than a ten percent change in the revenues, net income, assets, and shareholders' equity of the issuer; furthermore, the purchase price must not exceed ten percent of the assets. The stated

19. 17 C.F.R. § 229.20 (1981).

reason for this limitation is that the SEC wants to ensure that the form will not be used for transactions that have a substantial effect on the issuer.

In addition to the proxy rules, there have recently been adopted what are called the going-private rules—rule 13e-3.[20] A going-private transaction is defined as a transaction which will result in shares being held by less than 300 shareholders (the significance of which is that the company can then terminate its registration under the '34 Act) or which will result in shares previously listed being delisted or not authorized for trading on an interdealer quotation system.

The information that is to be provided in a 13e-3 transaction is set forth in Schedule 13E-3.[21] Schedule 13E-3 contains requirements which are often complied with in a normal proxy solicitation anyway, but which are required here as well because of the inherent conflict of interest in a going-private transaction.

I might just mention that the SEC has recently proposed amendments [22] to rule 13e-3 and the Schedule under it, and has published staff interpretations of them.

Finally, there is the all-encompassing rule 10b-5 [23] under the Securities Exchange Act of 1934. The rule applies not only to securities which are registered under the '34 Act, but to all securities. Rule 10b-5 basically prohibits fraud or deception in the purchase or sale of a security.

Rule 10b-5 [24] applies to a merger in two possible respects. The first is that if securities are being issued in a merger—the key point being that 10b-5 is tied to the purchase or sale of a security—there is a sale of the security by the issuer to which 10b-5 would apply.

In addition, the cases generally have held that, even in a cash merger, the acquired company's shareholders are selling their shares, and 10b-5 [25] therefore would apply. I say the cases generally have

20. 17 C.F.R. § 240.13e-3 (1981). Rule 13e-3 regulates going-private transactions, including mergers, sales of assets, dissolutions, recapitalizations, and reverse stock splits.

21. Information required for Schedule 13E-3 includes: contracts, transactions, and negotiations between the issuer and any affiliate which is a party to the going-private transaction (Item 3); future plans of the issuer or affiliate (Item 5); source of funds (Item 6); purposes, alternatives, reasons, and effects (Item 7); fairness of the transaction (Item 8); reports, opinions, and appraisals (Item 9); projections (Item 11); and intentions of directors and officers with respect to approval of the transaction (Item 12).

22. *See* [1981] SEC. REG. & L. REP. (BNA) No. 599, A-17.

23. 17 C.F.R. § 240.10b-5 (1981).

24. *Id.*

25. *Id.*

held such. There is another line of cases, which has been developing quite recently, which state that an acquisition of a business is not subject to rule 10b-5 even though securities may be transferred in connection with the acquisition. I would cite to you the most recent case in this line which collects the other authorities: *Anchor Darling Industries v. Suozzo.*[26] Therefore, 10b-5 might be found not to apply in a cash merger.

In the last seven or eight years, the United States Supreme Court has been cutting back quite severely on the rather expansive interpretations of rule 10b-5.[27] I think you are all aware of the *Ernst & Ernst v. Hochfelder*[28] case, which held that scienter is required under rule 10b-5. Steve [Rothschild] mentioned the *Santa Fe v. Green*[29] case in which the Court held that the allegation of breach of fiduciary duty without any claim of deception or manipulation does not state a claim under rule 10b-5. The exact parameters of that case are still being explored, as you can see from reading the *Goldberg v. Meridor*[30] and *Healey v. Catalyst Recovery*[31] cases.

Actions attacking merger proxy statements are normally brought both under 10b-5[32] and under section 14,[33] the proxy rules. The question is whether there is any difference between the two. There is one area in which the courts have found a difference. The Second Circuit in *Gerstle v. Gamble-Skogmo*[34] and the Third Circuit in *Gould v. American Hawaiian*[35] have held that scienter is not required under the proxy rules.

On the other hand, the Sixth Circuit in the *Adams*[36] case required scienter at least with respect to the outside accountants. It did not have to decide whether scienter was also required for insiders. In the *Adams*[37] case, the petition for *certiorari* was denied by the

26. 510 F. Supp. 659 (E.D. Pa. 1981).

27. 17 C.F.R. § 240.10b-5 (1981).

28. 425 U.S. 185 (1976).

29. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

30. 567 F.2d 209 (2d Cir. 1977).

31. Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641 (3d Cir. 1980).

32. 17 C.F.R. § 240.10b-5 (1981).

33. 15 U.S.C. § 78n (1976).

34. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973).

35. Gould v. American Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976).

36. Adams v. Standard Knitting Mills, 623 F.2d 422 (6th Cir. 1980), *cert. denied sub nom.* Adams v. Peat, Marwick, Mitchell & Co., 449 U.S. 1067 (1980).

37. *Id.*

Supreme Court in December, so the conflict between the circuits, if there is one, will have to wait for a later day to be resolved.

There may also be a difference in the borrowing of the state statute of limitations. The circuits are split as to whether you borrow the fraud statute or the blue-sky statute, and if there are differing tests to be made under the two sections you may end up borrowing a different statute under the two. Again, this is a developing area of the law.

I would like to go over a few specific disclosure points in the context of a sample proxy statement. The sample happens to be about 100 pages, and I just want to mention some of the headings. Normally, the document that is on top is the letter to shareholders. Although not required by any of the rules, it is usually done because management may have a rather cynical belief that most shareholders will not read past the cover page. Therefore, they like to explain to the shareholder in brief terms what the transaction is all about, and also to put in a pitch for affirmative votes on the merger.

Here you run into what is referred to as the "buried-fact" doctrine or the "equal-prominence" doctrine. An example would be a statement in the letter to shareholders such as, "The Board of Directors unanimously recommends approval of the merger." Then you get to the proxy statement, and it turns out that there is an interlocking board of directors, and all the directors who recommended the merger are also directors of the acquiring company. *Kohn v. American Metal Climax*[38] found no violation, but *Gould v. American-Hawaiian*[39] did find one in that type of situation.

Obviously, it is helpful to have in the letter to shareholders something like, "You should read the accompanying proxy statement carefully," but that will not solve a buried-fact problem. A cross-reference would help, but not if you only say, "See Board of Directors inside," and then, when you get to the heading "Board of Directors" inside,

38. Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972). In this case, the court found: (1) a violation where the benefits of the transaction to the acquiring company were scattered throughout and were not given the same emphasis as the board's approval of the merger; (2) no violation where conflicts of interest of directors were set forth immediately following the statement of board approval even though the statement of board approval was in bold face and the conflicts of interest information was cross-referenced to an appendix; and (3) a violation where fact that investment advisor's opinion was not based on an independent survey of the assets and operations was included in their opinion in the appendix but not at the beginning of the proxy statement. *See also* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974).

39. Gould v. American Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976). The court found a proxy rule violation where facts concerning directors' conflicts of interest although included in the proxy statement were scattered throughout and were not given the same emphasis as the board's approval of the merger.

it turns out that everybody has a conflict. On the other hand, if you say, "For conflict of interest of the Board of Directors, see 'Conflict of Interest' inside," that might well be enough to put the shareholder on notice that the approval was not entirely dispassionate.

Following the letter to shareholders normally is the notice of the meeting, which is a state law requirement.[40] Then, if securities are to be issued in the merger, you will find a cover page that looks like a prospectus. This is to meet the requirements of the '33 Act for delivery of the prospectus.

Then there is the general introduction about shares entitled to vote, etc., and finally you get to the meat of the proxy statement, which is a description of the transaction. The heading for the first topic is "Background and Reasons for the Merger" or "Purpose of the Transaction" or something like that. This is probably the most important section in the proxy statement because it provides the springboard for future litigation.

One of the things that a Delaware court is going to examine is the entire fairness of the merger and whether the purpose of the merger fits within that. This frequently provides the opening gun or the first act in the litigation that follows.

I might also mention that Schedule 13E-3, when talking about stating the purpose of reasons for the transaction, warns that conclusory statements will not be acceptable.[41]

An example of the failure to properly state the purpose is the *Parklane*[42] case, where the court found that the proxy statement should have disclosed that the purpose was to enable the president to discharge his personal debts from the company treasury.

Another item which might be important, particularly where there are conflicts, is the question of who did the negotiating of the deal. This is an issue which came up under state law in *Weinberger III*.[43]

If there had been other offers which a shareholder might have deemed better than the transaction proposed, these should be disclosed. The question then becomes how firm the offer has to be in order to have it disclosed. This is a very difficult question.

You normally put in the factors that have been considered. A boilerplate disclosure has been developed which lists "earnings and dividend record, financial conditions, business, assets, management of

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40. *See, e.g.,* DEL. CODE ANN. tit. 8, § 251(c) (1974).

41. *See* note 21 *supra.*

42. SEC v. Parklane Hosiery Co., 558 F.2d 1083 (2d Cir. 1977).

43. Weinberger v. UOP, 426 A.2d 1333 (Del. Ch. 1981), *aff'd,* No. 58-1981 (Del. Feb. 9, 1982).

each company, and the recent stock market prices." You should make sure, because there has been litigation over this, that the board of directors has, in fact, considered each one of the factors that is listed.

The next heading is usually "Conflict of Interest", and here you start with the obvious ones of interlocking directors, stock ownership of directors in the other company, employment arrangements after the merger which might affect the judgment of the director/officers who will continue, special treatment of stock options and, finally, relationships with the financial advisors.

We then go to fairness opinions. These are the investment bankers coming in and saying, "We believe this is fair from a financial standpoint to the shareholders of X company." This disclosure should include the compensation of the financial advisors and any relationships they may have with the corporation. There has been a fair amount of litigation over the scope of the investigation. *Denison Mines*[44] held that there was a violation because the proxy statement did not disclose that the investment bankers had not inspected the assets of the company. *Kohn v. American Metal Climax, Inc.*[45] also found a violation.

The scope of the investigation of the investment bankers is usually included in their opinion. In the *Denison Mines*[46] case, the investment banker's opinion was not in the proxy statement. In the *American Metal Climax*[47] case, the banker's opinion was attached as an exhibit in the appendix, but the court, nevertheless, held this to be a buried fact.

A lot of people have adopted the procedure of including the text of the fairness opinions up front under the heading "Fairness Opinions" rather than referring to an appendix or exhibit at the back.

After you get beyond a description of the transaction, most of the remainder of the proxy statement is the financial statements and the business of the company. The statement of the business of the company is a very delicate balancing act because you are dealing with two entirely different constituencies. The acquiring company that is issuing securities to the shareholders of the acquired company would want to be somewhat gloomy about the prospects of the company in order to forestall a suit that the shareholders of the acquired company had been misled into agreeing to the merger. On the other hand, the acquiring company also has the constituency of its own shareholders

44. Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812 (D. Del. 1974).
45. 458 F.2d 255 (3d Cir. 1972). *See* note 38 *supra*.
46. 388 F. Supp. 812 (D. Del. 1974).
47. 458 F.2d 255 (3d Cir. 1972).

to take into account, and it says to these shareholders, "We regard this as a good deal for the company," so that the nondisclosure of any hidden assets or future developments might produce a lawsuit from the other end.

So this is, as I say, a very difficult balancing act which I am not going to get into because each one presents its own problems, but it is interesting to read the cases on projections[48] and see how this is developed.

Finally, what happens if a new event occurs between the time the proxy statement is mailed and the vote is taken on the merger, such as a new major lawsuit or perhaps an adverse determination of a lawsuit which was described in the proxy statement?

The first thing that has to be done is to make a judgment as to whether this event is material to the shareholders. We have mentioned *TSC v. Northway's* definition of materiality.[49] It is always a very difficult determination to make. But assuming you decide that it is material, there are three approaches.

The first would be just to send a letter to the shareholders describing the new event. This probably will not work unless the letter is sent so close to the mailing of the proxy statement that it can be assumed that no one has yet read the proxy statement and submitted his proxy before he receives the supplemental letter.

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48. Prior to 1976, Note (a) to Rule 14a-9 also listed predictions as to earnings and dividends as examples of misleading statements. The SEC has changed this policy by adopting guidelines for projections and a safe-harbor provision for reasonable calculations. *See* SEC Release No. 33-5992 (Nov. 7, 1978), Release No. 34-15,305 (Nov. 7, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,756; SEC Release No. 33-6084 (June 25, 1979), SEC Release No. 34-15,944 (June 25, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,117.

Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), relied on Note (a) to Rule 14a-9 before the change to find that projections were not required. *See also* Marsh v. Armada Corp., 533 F.2d 978 (6th Cir. 1976). Post-change cases have continued to conclude that projections are not required, since the SEC guidelines are permissive, not mandatory. *See* Margolis v. Masters, Inc., No. 80 C 3176, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,855 (E.D.N.Y. Jan. 29, 1981); Dower v. Mosser Indus., Inc., 488 F. Supp. 1328 (E.D. Pa. 1980).

49. TSC Indus., Inc. v. Northway, 426 U.S. 438 (1976). The Supreme Court defined materiality as follows:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

426 U.S. at 449.

The second approach is to send out the letter, but to send with it a proxy card saying, "If you want to change your vote, send in the proxy card; if you don't, you don't have to do anything."

The final approach is to have a complete resolicitation of proxies, which would involve scrapping the ones that have already come in, sending out a different color proxy card, and starting all over again. Of course, here you run the risk that the meeting will have to be adjourned in order to get the necessary votes.

You will find that the SEC staff may have very strong ideas about which alternative should be selected.

As a summary for this portion of my presentation, I was really tickled when I found this quote from the *Margolis* case. You will be reassured to know that, "It is not illegal under Sections 10(b) or 14 of the Securities Exchange Act to present meaningless information that is not also misleading to shareholders." [50]

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50. Margolis v. Masters, Inc., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,855, at 90,289 (E.D.N.Y. Jan. 29, 1981).