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Court Rejects Claims That Merger Negotiations Must Be Disclosed

BY DEYAN SPIRIDONOV AND REBECCA A. BROPHY

Introduction

One of the more difficult tasks that face deal makers in the context of public company mergers and acquisitions is the decision whether or not to disclose pending negotiations for ongoing transactions. A recent case involving merger negotiations between Sears and Kmart reaffirmed the general practice not to disclose merger negotiations.

In *Levie v. Sears Roebuck & Co.*,[1] the United States District Court for the Northern District of Illinois ("Court") reiterated several key principles originally developed in the 1988 landmark case *Basic v. Levinson*[2] that are useful guidelines when a public company considers the necessity of disclosing merger negotiations:

- Even if material, there is no general duty to disclose merger negotiations.
- Merger negotiations must be disclosed if the merger is material and non-disclosure makes other disclosures misleading.
- The materiality of a merger depends upon the probability that the transaction will occur and the significance of the transaction to the issuer.

In addition, the Court illustrated the application of these key principles in two practical situations involving a public company merger, thereby providing useful guidance for public companies engaged in merger negotiations. Of particular note was the Court's finding that Sears' non-disclosure of merger negotiations in its Form 10-Q quarterly report was not actionable. This holding provides comfort that there is ***no per se obligation*** that arises under Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 promulgated thereunder[3] to disclose merger negotiations in periodic reports.

The Facts and Analysis in *Levie v. Sears Roebuck*

It has long been established that there is no general duty to disclose merger negotiations, even when the negotiations are material.[4] In *Levie v. Sears Roebuck & Co.*, however, the plaintiffs alleged that Sears misled investors by omitting to disclose merger negotiations with Kmart in the context of several statements made by Sears prior to the announcement of the merger.[5]

In the course of dismissing the plaintiffs' claims and granting summary judgment to Sears, the Court analyzed two specific statements made by Sears and in doing so illustrated in some detail the exercise a public company should perform when determining whether it must disclose merger negotiations.

The court first considered Sears' public acknowledgement that a third party had acquired an equity interest in Sears. The plaintiffs alleged that this acknowledgement created a duty to disclose the merger negotiations with Kmart in order to make the acknowledgement non-misleading. The Court reiterated that the applicable standard for determining if merger negotiations must be disclosed is when: (1) non-disclosure of negotiations makes a statement misleading; and (2) the merger is material.

With respect to the first component, the Court found that Sears' statement was not misleading because the alleged material omission regarding the merger negotiations was neither related directly, nor sufficiently linked, to Sears' statement acknowledging the acquisition of an equity interest by a third party. Accordingly, the court concluded that Sears' was not required to disclose merger negotiations based on the content of Sears' statement acknowledging the third party's ownership, even if the merger was material. While the Court's judgment as to the lack of a duty of disclosure arising from Sears' public acknowledgement would alone have been dispositive, the Court analyzed the materiality of the merger negotiations.

The Court reiterated the key principle that, in the merger negotiation context, materiality is a fact-specific determination based on both the probability that a transaction will be consummated and the significance of the merger to the issuer of the securities. In this case, the Court stated that the merger negotiations were not yet material based on the facts at hand because none of the factual or legal predicates for a merger were in place. Specifically, although Kmart and Sears had discussed the subject of the merger with outside advisors and their senior managements had held discussions regarding strategic combinations, the merger negotiations in question were not yet material because of the lack of board resolutions, actual negotiations, instructions to investment bankers to explore a merger, any basic general agreement on structure, and the performance of due diligence.[6]

The Court then turned to the plaintiffs' argument that statements made by Sears in its Form 10-Q quarterly report created a duty to disclose the merger negotiations. Public companies that have elected to pursue strategic alternatives or expand through mergers and acquisitions will often be confronted with periodic report filing requirements at the time these activities are ongoing. The Court's analysis of Sears' disclosure duty in light of the Form 10-Q quarterly report filing provides important guidance for companies in the midst of exploring or negotiating mergers at the time they are required to file a periodic report such as a Form 10-K annual report or Form 10-Q quarterly report. In these situations, questions often arise as to whether the negotiations must be disclosed in the periodic report for Rule 10b-5 compliance purposes in the face of genuine concerns that premature disclosure of ongoing merger negotiations could very likely have a negative impact on the probability of consummating the transaction.

Sears' Form 10-Q quarterly report contained a discussion in the Management's Discussion and Analysis of Financial Condition and Results of Operations section ("MD&A") which stated that Sears' "primary need for liquidity will be to fund the seasonal working capital requirements of its retail business and capital expenditures."[7] The plaintiffs argued that this statement was misleading and that Sears committed securities fraud by not disclosing the merger negotiations in order to make the statement non-misleading. The Court dismissed this argument, noting that there was no inaccurate or misleading statement in the MD&A because it was Kmart that needed the capital to purchase Sears, not vice-versa. Further, the Court specifically noted that the Securities and Exchange Commission ("SEC"), in interpreting the MD&A disclosure requirement of Regulation S-K,[8] specifically

acknowledged that when disclosure is not otherwise required and has not otherwise been made, disclosure of the impact of undisclosed merger negotiations in the MD&A is not required when a company believes that doing so would jeopardize the completion of the transaction.[9] Since non-disclosure of the merger negotiations clearly did not make the Form 10-Q quarterly report statement identified by the plaintiffs misleading, the Court concluded that it was not necessary to analyze whether the merger was material at the time the Form 10-Q quarterly report was filed.[10]

Conclusion

The Court's analysis is significant because it reiterates that disclosure of merger negotiations in a periodic report or elsewhere is not a *per se* legal requirement. While it remains critically important for public companies and their advisors to assess all relevant facts and circumstance when considering whether merger negotiations are material and, if so, whether non-disclosure of material merger negotiations would render any statements in periodic reports or elsewhere misleading, *Levie* provides public companies a tangible example of why in most instances there should be no requirement to disclose merger negotiations in periodic reports, particularly when disclosure would jeopardize the completion of the transaction.

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:

Atlanta
Elizabeth H. Noe
404-815-2287
elizabethnoe@paulhastings.com

Jared M. Brandman
404-815-2276
jaredbrandman@paulhastings.com

Hong Kong
Neil Torpey
852-2867-9902
neiltorpey@paulhastings.com

Joseph A. Sevack
852-2867-9920
josephsevack@paulhastings.com

Los Angeles
Robert R. Carlson
213-683-6220
robcarlson@paulhastings.com

Robert A. Miller, Jr.
213-683-6254
robertmiller@paulhastings.com

New York
Jeffrey J. Pellegrino
212-318-6932
jeffreypellegrino@paulhastings.com

Keith D. Pisani
212-318-6058
keithpisani@paulhastings.com

Scott R. Saks
212-318-6311
scottsaks@paulhastings.com

Mark Schonberger
212-318-6859
markschonberger@paulhastings.com

William F. Schwitter
212-318-6400
williamschwitter@paulhastings.com

Michael L. Zuppone
212-318-6906
michaelzuppone@paulhastings.com

Orange County
Stephen D. Cooke
714-668-6264
stephencooke@paulhastings.com

John F. Della Grotta
714-668-6210
johndellagrotta@paulhastings.com

Palo Alto
Robert A. Claassen
650-320-1884
robertclaassen@paulhastings.com

Paris
Joel M. Simon
33-1-42-99-04-45
joelsimon@paulhastings.com

San Diego
Carl R. Sanchez
858-458-3030
carlsanchez@paulhastings.com

Deyan P. Spiridonov
858-458-3044
spiri@paulhastings.com

San Francisco
Jeffrey T. Hartlin
415-856-7024
jeffhartlin@paulhastings.com

Thomas R. Pollock
415-856-7047
thomaspollock@paulhastings.com

Gregg F. Vignos
415-856-7210
greggvignos@paulhastings.com

Tokyo
Kenju Watanabe
81-3-6229-6003
kenjuwatanabe@paulhastings.com

[1] *Levie v. Sears Roebuck & Co.*, 2009 WL 5096401 (N.D. Ill.).

[2] *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

[3] Section 10(b) and Rule 10b-5 make it unlawful for any person to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in connection with the purchase or sale of any security. 17 C.F.R. Section 240.10b-5(b).

[4] *Basic Inc. v. Levinson*, 485 U.S. 224, 239 (1988).

[5] The Court quickly dismissed three of the statements on which the plaintiffs relied on the factual basis that they predated the October 31st start of the merger negotiations and accordingly could not create a duty to disclose something that had not yet occurred. The Court also dismissed allegations against an investment firm headed by Kmart's chairman regarding Schedule 13D filings. *Levie v. Sears Roebuck & Co.*, 2009 WL 5096401 (N.D. Ill.).

[6] *Id.*

[7] *Id.*

[8] Item 303 of Regulation S-K requires, among other things, that an issuer discuss its "financial condition, changes in financial condition and results of operations . . . [and] such other information that the [issuer] believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." 17 C.F.R. Section 229.303.

[9] *Levie v. Sears Roebuck & Co.*, 2009 WL 5096401 (N.D. Ill.). *See also*, SEC Rel. No. 33-6835 (May 18, 1989). "While Item 303 [MD&A] could be read to impose a duty to disclose otherwise nondisclosed preliminary merger negotiations, as known events or uncertainties reasonably likely to have material effects on future financial condition or results of operations, the Commission did not intend to apply, and has not applied, Item 303 in this manner. As reflected in the various disclosure requirements under the Securities Act and Exchange Act that specifically address merger transactions, the Commission historically has balanced the informational need of investors against the risk that premature disclosure of negotiations may jeopardize completion of the transaction . . . Accordingly, where disclosure is not otherwise required, and has not otherwise been made, the MD&A need not contain a discussion of the impact of such negotiations where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction. Where disclosure is otherwise required or has otherwise been made by or on behalf of the registrant, the interests in avoiding premature disclosure no longer exist." *Id.*

[10] On the date that the Form 10-Q quarterly report was filed, there was a general agreement that any transaction would involve a combination of stock and cash although no structure had been reached and the parties had not begun due diligence, nor had they executed a confidentiality agreement or received the corresponding confidential information necessary to assess the prospect of the merger. The Court further noted that as of the morning of the day the agreement by which Kmart would acquire Sears was reached, which was nearly a week after the Form 10-Q quarterly report was filed, the chances of the deal's consummation were assessed at only 50-50 by Sears' financial advisors. *Levie v. Sears Roebuck & Co.*, 2009 WL 5096401 (N.D. Ill.).