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When an Acquisition "Plan or Proposal" Requires a Schedule 13D Amendment

US securities laws may impact the ability of an acquiror to maintain the confidentiality of its acquisition plans. Schedule 13D requires a principal shareholder of a US public company to disclose, among other things, its "plans or proposals" to acquire additional securities of the subject company. Understanding when a "plan or proposal" exists should enable a principal shareholder to support the timing of its acquisition disclosure obligations under US securities laws.

by Stephen D. Bohrer

Keeping discussions about a potential acquisition of a US-publicly traded company (a Public Target Company) confidential is often an essential element for a purchaser to complete its deal in a timely and cost effective manner. Early disclosure of a potential business acquisition may be unfavorable to a purchaser as such information can alert others to join the race to buy the Public Target Company and can increase the Public Target Company's stock trading price, thereby raising the acquisition costs to the purchaser. US securities laws, however, are not necessarily aligned with the interests of a purchaser that is also a principal shareholder of the Public Target Company to maintain its proposed business acquisition confidential until a deal is agreed by the parties. Pursuant to the requirements of Schedule 13D, a purchaser that beneficially owns 5 percent or more of a class of a Public Target Company's equity securities (a Principal Shareholder Acquiror) is required to promptly disclose its "plans or proposals" to acquire additional securities of the Public Target Company or merge with the Public Target Company. As a result, the Schedule 13D disclosure obligations could require a Principal Shareholder Acquiror to disclose prematurely its intentions to privatize a Public Target Company. Failure to adhere to the Schedule 13D disclosure obligations can lead to transaction delays and costly litigation against the Principal Shareholder Acquiror under US securities law. With careful planning and foresight, however, the Schedule 13D disclosure conundrum can be managed.

Stephen D. Bohrer is a counsel at Nishimura & Partners in Tokyo, Japan, and is the head of the Firm's Cross-Border Transactions Group.

Regulatory Background

The statutory requirements for a Schedule 13D are set forth in Section 13(d) of the US Securities Exchange Act of 1934 (Exchange Act), and the rules promulgated thereunder. Basically, any person, other than the issuer, who directly or indirectly acquires beneficial ownership of five percent or more of a class of equity securities registered under the Exchange Act, is required to file a Schedule 13D with the US Securities and Exchange Commission, regarding its share ownership no later than 10 days following such 5 percent acquisition.[1] The Principal Shareholder Acquiror must also provide a copy of the Schedule 13D to the Public Target Company and the stock exchange on which the equity securities of the Public Target Company trade.

The primary purposes of the Schedule 13D filing are to: (1) give an early warning to the investing public and the Public Target Company of the existence of a person or a group that may be in a position to exert control over the Public Target Company; and (2) alert the Public Target Company and the investing public of accumulations of a Public Target Company's stock, as such activities often impact the stock trading price of the Public Target Company.

A Principal Shareholder Acquiror should focus on when a potential transaction becomes an actual "plan or proposal."

Specified information must be disclosed in a Schedule 13D about the Principal Shareholder Acquiror and its acquisition of the securities of the Public Target Company. For example, a Schedule 13D requires the Principal Shareholder Acquiror to disclose background information about its officers and directors, its beneficial ownership level of securities of the Public Target Company, the source and amount of funds used to acquire the securities of the Public Target Company, and the Principal Shareholder Acquiror's future intentions regarding its control over the Public Target Company. In particular, Item 4 of Schedule 13D requires the Principal Shareholder Acquiror to disclose, in addition to other things, any "plans or proposals" which may or will result in (1) the acquisition by the Principal Shareholder Acquiror of additional securities of the Public Target Company, or (2) an extraordinary corporate transaction with the Public Target Company, such as a merger.

The disclosure requirements of Schedule 13D are not static. Rule 13d-2 of the Exchange Act states that all "material" changes to the information disclosed in a Schedule 13D should be filed "*promptly*." In general, information is considered material under U.S. securities laws if there is a substantial likelihood that disclosure of the omitted fact would be viewed by a reasonable investor as significantly altering the total mix of information available.[2] If a Principal Shareholder Acquiror that already has a Schedule 13D on file decides to purchase additional equity securities of the Public Target Company or merge with the Public Target Company, such information would be considered material under US securities laws.[3] As to the timeliness of the amendment, no bright line test has been adopted by the SEC in order to determine when a Schedule 13D amendment filing is prompt. The question of whether an amendment is prompt is determined based on all of the facts and circumstances surrounding both prior disclosures by the Principal Shareholder Acquiror and the market's sensitivity to the particular change of fact triggering the obligation to amend. Given the ability to electronically gather and file information with the SEC, a Principal Shareholder Acquiror would be hard pressed to explain why a material amendment to its Schedule 13D was not filed with the SEC within two to four business days after its occurrence.[4]

The Schedule 13D Conundrum

Schedule 13D's requirement to disclose promptly any "plans or proposals" to acquire additional securities of the Public Target Company or merge with the Public Target Company has various ramifications. For example, a pre-deal announcement by a purchaser of its intentions to accumulate shares of a Public Target Company or merge can be extremely costly for the purchaser and could even cost the purchaser its deal. Information about business acquisitions often drives up the price of a Public Target Company's securities. Because a purchaser usually pays a premium based on the Public Target Company's closing share price on the full trading date immediately prior to the public announcement of the proposed transaction, an increase in the Public Target Company's share price prior to the deal's announcement could add to the premium that the purchaser pays for the Public Target Company's securities. With news of a potential transaction, arbitrageurs also may start accumulating the securities of the Public Target Company and engage in various hedging activities, which could inflate the stock price of the Public Target Company. In addition, a pre-deal announcement increases the interloper risk, as other potential bidders are alerted about the transaction, and they may make a similar determination concerning the desirability of controlling the Public Target Company.

A Principal Shareholder Acquiror's failure to make a timely amendment to its Schedule 13D also could lead to increased costs to the Principal Shareholder Acquiror through litigation expenses. For example,

the SEC could bring an enforcement action against the Principal Shareholder Acquiror for failing to comply with the Schedule 13D filing requirements. In addition, shareholders could claim that they sold Public Target Company securities at prices lower than they would have sold their securities had the Principal Shareholder Acquiror properly filed an amended Schedule 13D announcing its intentions to consolidate its control over the Public Target Company. Shareholders or the SEC could seek preliminary injunctive relief until corrective disclosures are made, which may increase the inter-loper risk.[5]

To avoid the Schedule 13D amendment whipsaw, a Principal Shareholder Acquiror should focus on when a potential transaction becomes an actual "plan or proposal" regarding the acquisition of additional Public Target Company securities or a merger with the Public Target Company. An understanding of this concept is pivotal, because once a determination is made that a "plan or proposal" exists then the Principal Shareholder Acquiror's Schedule 13D must be amended promptly to disclose this new material information.

When Is a Plan or Proposal Formed?

There is no clear formula to determine whether a "plan or proposal" exists. Instead, US courts have used broadly defined concepts to determine when a "plan or proposal" requires disclosure. For example, one court ruled that "disclosure is required of definite intentions and matters fully determined, and not predictions of future behavior, or of tentative or inchoate plans."[6] Courts may be inclined not to provide concrete steps for determining when a "plan or proposal" exists, as a Principal Shareholder Acquiror could use such information as a roadmap to conceal its intentions in order to circumvent the Schedule 13D disclosure obligations.

Case law suggests that the determination of whether a "plan or proposal" exists is a highly fact-specific inquiry and requires a fact-finding investigation. The following provides some guidance on the type of evidence courts have used to determine whether a "plan or proposal" exists:

- In *Azurite*,[7] the court relied on testimony from a Principal Shareholder Acquiror's advisors that discussions were still preliminary and on a memorandum that merely offered proposals as to a potential proxy contest to conclude that a plan or proposal did not exist. The court noted that a plan is "something more definite than vaguely formed thoughts for the future."[8]
- In *Todd Shipyards*,[9] plaintiff alleged that a Principal Shareholder Acquiror failed to adequately disclose its purposes and intentions with respect to its share acquisitions of the plaintiff. The court examined evidence (including certain meetings at which discussions and negotiations took place) to conclude that defendant's disclosures were sufficient and that no plans had reached a level of definiteness as to warrant disclosure. The *Todd Shipyards* court suggested that meetings must reflect "firm fixed plans" before they will trigger disclosure requirements. Moreover, with regard to allegations that the defendant had intentions to take the plaintiff private, the court found that memoranda prepared to evaluate the investment potential of the Public Target Company did not represent "fixed plans."[10]
- In *Transcon*,[11] the court rejected plaintiff's claim that a Schedule 13D disclosure was inadequate and misleading in describing the Principal Shareholder Acquiror's intent to take control of the plaintiff, citing the lack of evidence that the Principal Shareholder Acquiror viewed the Public Target Company as a suitable investment vehicle and the fact that Principal Shareholder Acquiror lacked a history of taking equity positions as an initial step towards ultimately acquiring control of companies. The court also examined the facts and circumstances, including the plans of the Principal Shareholder Acquiror's management and the non-existence of finance arrangements to fund a takeover of the Public Target Company. The *Transcon* court noted that a Principal Shareholder Acquiror ". . . is not required to make predictions of future behavior, however tentatively phrased, which may cause the offeree or the public investor to rely on them unjustifiably . . ."[12]

These cases demonstrate that US courts look closely at the facts of each case to determine if there is a material change in the Principal Shareholder Acquiror's plans or proposals concerning the Public Target Company's securities. Unless a course of action is decided upon or intended, preliminary

or exploratory discussions concerning the potential acquisition of a Public Target Company are conjecture that should not give rise to a Schedule 13D disclosable event.

Recommendations

While the determination of when an amendment to a Schedule 13D should be filed is often made in hindsight based on all the facts and circumstances, as a matter of best practice a Principal Shareholder Acquiror may wish to (1) include language in its initial Schedule 13D regarding its potential plans or proposals to consolidate control over the Public Target Company, and (2) implement procedures to support the timing of its amended Schedule 13D filing.

Control Intentions in Initial Schedule 13D

A Schedule 13D containing statements regarding the Principal Shareholder Acquiror's control intentions over the Public Target Company could support a Principal Shareholder Acquiror's assertions that it is not obligated to update its Schedule 13D until a complete proposal (*i.e.*, one that includes all of the material terms of the offer, such as price and conditions to the transaction) has been submitted to the Public Target Company. By disclosing in a prior Schedule 13D that it may at any time attempt to exert control over the Public Target Company or engage in discussions with management of the Public Target Company regarding future acquisitions or sales of the Public Target Company's securities, the Principal Shareholder Acquiror could argue that the investing public was already on notice of its potential influence over the Public Target Company and the Principal Shareholder Acquiror is not required to amend its Schedule 13D until a complete proposal is submitted to the Public Target Company.

Although it is not feasible to draft disclosure applicable to the investment objectives of every Principal Shareholder Acquiror, the following Item 4 of Schedule 13D disclosure could be used as baseline language that can be modified to match the objectives of a particular Principal Shareholder Acquiror:

> [*Acquiror*] intends to review its holdings in the Company on a continuous basis and, depending upon:
>
> - the price and availability of the Common Stock;
> - subsequent developments affecting the Company;
> - the business prospects of the Company;
> - global and US stock market and economic conditions;
> - tax considerations;
> - other investment and business opportunities available to the [*Acquiror*];
> - changes in law or government regulations;
> - the costs associated with maintaining the public listing of the Company; and
> - other factors deemed relevant by the [*Acquiror*],
>
> may at any time determine to acquire additional shares of Common Stock, sell all or part of its holdings in the Company, or engage or participate in a transaction or series of transactions with the purpose or effect of influencing control over the Company.
>
> Such transactions may take place at any time with or without prior notice and may include, without limitation, (1) entering into one or more privately negotiated transactions for the purchase or sale of Common Stock, (2) effecting open market purchases or sales of Common Stock, (3) making a tender or exchange offer for some or all of the Common Stock, (4) waging a proxy contest for control of the board of directors of the Company, (5) seeking a merger or other form of business combination involving the Company, or (6) taking other actions that could have the purpose or effect of directly or indirectly influencing control over the Company. [*Acquiror*] has engaged, and/or may in the future engage, legal, accounting and other advisors to assist it in evaluating strategic alternatives that are or may become available with respect to its holdings in the Company.
>
> Except as set forth in this Schedule 13D, [*Acquiror*] does not have any plans or proposals that relate to or would result in any of the matters described in subparagraphs (a) through (j) of Item 4 of this Schedule 13D.

If a Principal Shareholder Acquiror has entered into a shareholders' agreement or other arrangement that allows it to control the Public Target Company, influence

the management of the Public Target Company or acquire additional Public Target Company securities, then the preceding form of disclosure should describe in detail such matters or cross-reference the disclosures made elsewhere in the Schedule 13D.

Support the Timing of the Amended Schedule 13D Filing

A Principal Shareholder Acquiror may wish to implement the following procedures to support the position that a "plan or proposal" did not exist until the latest possible moment:

- All preliminary communications from the Principal Shareholder Acquiror (and its advisors) to the Public Target Company regarding the potential transaction should clearly indicate the tentative nature of the discussions, and all written materials should be reviewed by legal counsel prior to distribution to the other side;
- Interim evaluations regarding the terms of a potential transaction should be made verbally or in undistributed slide presentations, to the extent practicable;
- All internal communications by the Principal Shareholder Acquiror (and its advisors) prior to the public announcement of the transaction should indicate that no firm or fixed plan or proposal has been adopted by the Principal Shareholder Acquiror;
- The board of directors of the Principal Shareholder Acquiror should thoroughly deliberate the merit and timing of the potential transaction, with some points renegotiated after submission to the board;
- The board of directors of the Principal Shareholder Acquiror should not approve the potential transaction until just prior to its public announcement;
- The board of directors of the Principal Shareholder Acquiror should base its decision, in part, to proceed with the potential transaction on one or more of the reasons set forth in its Schedule 13D (*e.g.*, the price and availability of the subject security, subsequent developments affecting the Public Target Company, the business prospects of the Public Target Company, etc.);
- Active discussions between the Principal Shareholder Acquiror and the Public Target Company should take place regarding the potential transaction to support that no meeting of the minds occurred prior to the proposed transaction's submission to the Public Target Company; and
- Good faith alternatives to effect the potential transaction should be considered by the Principal Shareholder Acquiror and the Public Target Company, and such discussions should be ongoing until the latest possible date.

In sum, until a Principal Shareholder Acquiror determines to amend its Schedule 13D, the Principal Shareholder Acquiror should not take any actions that could later be deemed to be definitive or otherwise inconsistent with the handling of a proposal that is merely being explored.

Conclusion

The disclosures in Schedule 13D regarding any "plans or proposals" to acquire additional securities of the Public Target Company or merge with the Public Target Company are often the subject of US shareholder litigation. Once a complete proposal is submitted by the Principal Shareholder Acquiror to the Public Target Company, regardless of whether it is binding or not, the Principal Shareholder Acquiror will normally amend its Schedule 13D to reflect the terms of its proposed deal and the Public Target Company will issue a public statement. There is no SEC guidance that expressly takes the position that a "plan or proposal" exists only on being approved by the Principal Shareholder Acquiror's board of directors or upon the transaction being formally submitted to the Public Target Company for consideration. As a result, it is during the period prior to such submission, while the Principal Shareholder Acquiror is considering whether to consolidate its ownership position over the Public Target Company and is conducting preliminary discussions with its advisors and members of the Public Target Company that uncertainty exists whether such activities rise to the level of a disclosable event.

The typical Schedule 13D lawsuit involves a Principal Shareholder Acquiror who states in its Schedule 13D no present plan with respect to an enumerated item, but in fact had or subsequently formed that intention and failed to promptly disclose this material information in an updated Schedule 13D. Class action plaintiff lawyers in the United States often make it their business to file lawsuits on behalf of shareholders shortly after a business acquisition is announced.[13] While it is not possible to avoid all

shareholder litigation in a takeover transaction, the practices and procedures suggested herein should assist the Principal Shareholder Acquiror in resolving any Schedule 13D-related litigation at an early stage on more favorable terms.

NOTES

1. By virtue of Rule 13d-1(b) and (c) of the Exchange Act, certain types of investors that otherwise would be required to file a Schedule 13D may qualify for a short form Schedule 13G if they own less than 20 percent of the particular class of the company's outstanding securities and they do not intend to change or influence the control of the company.

2. *TSC Industries, Inc. v. Northway, Inc.*, 426 US 438 (1976).

3. *See* Beneficial Ownership Reporting Requirements Amending Release, Exchange Act Release No. 39,538 (Jan. 12, 1998) (stating that changes in purpose of an acquisition are a "material change" in the information disclosed in a Schedule 13D).

4. This suggested timeframe is based on SEC submission requirements for a (1) Form 4, which requires updated beneficial ownership information be filed with the SEC within two business days after the execution date of the transaction, and (2) Form 8-K, which requires information relating to most of the specified reportable events be filed with the SEC within four business days after the occurrence of the particular event. As the Form 4 relates to securities acquisitions and dispositions and the Form 8-K relates to significant corporate events, the submission requirements under these forms are a useful reference.

5. Because there is no private cause of action for damages under Section 13(d) of the Exchange Act, shareholder plaintiffs often phrase their Schedule 13D failure to amend cause of actions in terms of a violation of the anti-fraud provisions of US securities laws. *See, e.g.*, *Seagoing Uniform Crop. v. Texaco, Inc.*, 705 F. Supp. 918 (S.D.N.Y. 1989) (action for damages for violation of Section 13(d) can be maintained under Section 10(b) if allegations establish essential elements of Section 10(b) claim); *Stern v. Leucadia Nat'l Corp.*, 644 F. Supp. 1108 (S.D.N.Y. 1986) (false Schedule 13D may support a Rule 10b-5 action, but complaint dismissed for failure to state cause of action); *Sanders v. Thrall Car Mfg. Co.*, 582 F. Supp. 945 (S.D.N.Y. 1983) (courts have consistently refused to imply private rights of action for damages under Section 13(d)).

6. *Rosen v. Brookhaven Capital Mgt. Co., Ltd.*, 113 F.Supp. 2d 615, 630 (S.D.N.Y. 2000).

7. *Azurite Corp., Ltd. v. Amster & Co.*, 52 F. 3d 15 (2d Cir. 1995).

8. *Id.* at 18.

9. *Todd Shipyards Corp. v. Madison Fund, Inc.*, 547 F. Supp. 1383 (S.D.N.Y. 1983).

10. *Id.* at 1390.

11. *Transcon Lines v. A.G. Becker, Inc.*, 470 F. Supp. 356 (SDNY 1979).

12. *Id.* at 377.

13. Because the offer document that the Principal Shareholder Acquiror will file with the SEC in connection with the potential transaction will contain a section detailing the history of the discussions between the parties regarding the potential transaction, plaintiff's lawyers often review this section in relation to the timing of the Schedule 13D amendment filing in order to formulate a lawsuit.

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