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Corporate Governance Group

Client Alert

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FEDERAL COURT PROVIDES GUIDANCE ON THE TIMING FOR SECURITIES LAW DISCLOSURES IN CONNECTION WITH M&A NEGOTIATIONS

Dismisses Claims That Negotiations Were "Material" and Should Have Been Disclosed in Light of Statements Made by Target Company

One of the more difficult decisions that deal makers and their legal advisors must face in the course of negotiating an M&A transaction involving public companies is the proper timing for required disclosures under the federal securities laws. In *Levie v. Sears Roebuck & Co.*,[1] set against the backdrop of the 2005 merger between retail giants Sears and Kmart, the United States District Court for the Northern District of Illinois recently provided useful guidance for determining when such disclosures are required to be made, both by the constituent corporations and by significant stockholders.

Background of the Transaction

In February 2004, Sears Chief Executive Officer Alan J. Lacy began to explore the potential acquisition of his competitor, Kmart. To that end, Lacy engaged in discussions with Kmart's Chairman, Edward S. Lampert. Lampert, who also controlled ESL Partners, L.P., an entity owning more than five percent of Sears' stock, pointedly engaged in these discussions solely on behalf of Kmart, and not on behalf of ESL. By April 2004, after a series of discussions, both sides agreed that Sears would not acquire Kmart. Instead, the parties pursued an "alternative transaction" involving Sears' acquisition of certain stand-alone Kmart stores. On June 30, 2004, the companies announced that Sears would purchase 54 Kmart stores.

[1] *Levie v. Sears Roebuck & Co.*, N.D. Ill., No. 04 C 7643.

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On July 1, 2004, ESL filed a Schedule 13G with the Securities and Exchange Commission. The Schedule 13G disclosed ESL's ownership of Sears stock and, as required by that Schedule, certified that ESL "were not acquired and are not held for the purpose of or with the effect of changing or influencing control" of Sears.

Several months passed during which no discussions took place between the two companies. Then, on October 31, 2004, Lacy and Lampert (again, solely in his capacity as Kmart's Chairman) met to discuss – for the first time – the possibility of Kmart's acquiring Sears. Over the next two weeks, the parties retained financial and legal advisors and held internal discussions regarding possible strategic combinations. On November 10th, Sears and Kmart entered into a confidentiality agreement that allowed Kmart, for the first time, to examine confidential information pertaining to Sears. An initial draft of a merger agreement was sent to Sears by Kmart on November 12th, and a second draft was re-circulated a day later. The second draft contained the first mention of an agreement pursuant to which ESL would vote its Sears shares in favor of a Kmart-Sears combination. In the afternoon of November 15th, Lacy and Lampert reached a "handshake deal" to present to their respective boards of directors. On November 16th, both boards approved the merger. The transaction was publicly announced the following day and ESL filed a Schedule 13D with the Commission disclosing its agreement to support the merger.

The Class Action Lawsuit

Various Sears stockholders filed a class action lawsuit, alleging violations by Sears of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 promulgated thereunder.[2] The plaintiffs alleged that Sears and Kmart were engaged in merger negotiations from February 2004 until the merger was formally announced on November 17, 2004, and that this negotiation was a "material fact" which should have been disclosed in order to make certain statements made by Sears during the purported class period – from September 9 through November 16, 2004 – not misleading. Sears countered by arguing that the merger negotiations did not begin until October 31, 2004, well after the beginning of the class period, and further, that it was never under a duty to disclose the merger negotiations, even after they became material.

The plaintiffs also alleged that ESL violated Section 10(b) of the Exchange Act and Rule 10b-5 by failing to timely file a Schedule 13D disclosing that it "had formulated an intent to effect a change in control of Sears." The plaintiffs claimed that this filing should have been made prior to the commencement of the class period. ESL countered that its filing upon announcement of the transaction in November was sufficient.

Both sides moved for summary judgment after "extensive discovery." The Court granted defendants' motions on all counts.

[2] Section 10(b) of the Exchange Act and Rule 10b-5 make it unlawful, in connection with the purchase or sale of any security, for any person: (i) to make any untrue statement of material fact or (ii) to omit a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading.

The Court's Analysis

Claim Against Sears

The Court began its analysis by citing the landmark U.S. Supreme Court decision in *Basic Inc. v. Levinson*[3] for the proposition that "there is no general duty to disclose merger negotiations even when material" because "silence, absent a duty to disclose, is not misleading under Rule 10b-5." Accordingly, the Court explained, "plaintiffs' case is premised entirely on the omission to disclose the merger negotiations in order to make the statements made during the class period non-misleading."

The plaintiffs relied on five statements made by Sears as the bases for creating a duty on the part of Sears to disclose the merger negotiations under the Exchange Act. The Court noted that three of these five statements were made before October 31, 2004, the date on which Sears and Kmart first discussed the possibility of Kmart acquiring Sears. As such, the Court held that "these statements could not create a duty to disclose something that had yet to occur." Implicit in this ruling was the Court's rejection of the plaintiffs' contention that Kmart and Sears were engaged in continuous merger negotiations beginning in February 2004.

The Court then turned to two statements made by Sears after the merger negotiations began. On November 5, 2004, in response to an announcement by Vornado Realty Trust that it had acquired a 4.3% interest in Sears' stock, Sears announced that it was taking actions to "improve our full-line store performance … while simultaneously pursuing an aggressive off-mall growth strategy." This announcement did not mention Sears' negotiations with Kmart. The Court found that there was "nothing inaccurate or misleading in the statement with or without disclosure of the merger discussions." The Court explained that "the alleged material omission (the merger discussions) should relate directly to or be sufficiently linked to the express statements made so as to render them inaccurate or misleading." Because "nothing in the Vornado response refers to the merger negotiations or in any way implies that Sears was not engaged in such negotiations," the statement was found not to be misleading.

For good measure, the Court also observed that, at the time the response to Vornado was issued, the merger negotiations "had not yet become material." According to the Court, at this time "none of the factual or legal predicates for a merger were in place." For instance, "[t]here were no board resolutions, no actual negotiations and no instructions to investment bankers to facilitate or explore a merger." Although each company had mentioned the possibility of a merger with outside advisors and senior management of the two companies had engaged in discussions, "no structure had been reached and the parties had not begun due diligence." "In fact," the Court noted, "Kmart did not acquire the confidential information it needed to assess the prospect of a merger" until a week after the Vornado statement was issued. As a result, the Court characterized the merger negotiations at that time as "preliminary in nature" and, therefore, not material. According to the Court, "[t]o hold otherwise would result in endless and bewildering guesses as to the need for disclosure, operate as a deterrent to the legitimate conduct of corporate operations, and threaten to 'bury the shareholders in an avalanche of trivial information;' the very perils that the limit on disclosure imposed by the materiality requirement serves to avoid."

The final statement on which the plaintiffs relied was contained in Sears' third quarter Form 10-Q, filed on November 9, 2004. The MD&A included in the Form 10-Q stated that the "company's primary need for liquidity will be to fund the seasonal working capital requirements of its retail businesses and capital expenditures." At this

[3] 485 U.S. 224 (1988).

time, according to the plaintiffs, Sears was in reality "seeking to conserve and acquire additional capital to fund the planned merger." The Court found this argument to be "irreconcilable with the explicit mandate of the SEC that when disclosure of merger negotiations '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.'"[4] As a result, the Court concluded that Sears was under no duty to disclose the merger negotiations with Kmart in its Form 10-Q filing for the third quarter.

Claim Against ESL

Section 13(d) of the Exchange Act requires any person who acquires more than five percent of the outstanding voting securities of a company to report its ownership, and its plans for its investment, on a Schedule 13D filed with the SEC. However, a short-form Schedule 13G may be filed in lieu of the more expansive Schedule 13D if the investor can certify that the securities were not acquired for the purpose or effect of changing or influencing the control of the issuer. That was the path taken by ESL in July 2004. A person who discloses ownership of shares on a Schedule 13G must file a Schedule 13D within 10 days if circumstances change such that the stockholder comes to hold the securities with the purpose or effect of changing or influencing control of the issuer. The plaintiffs claimed that just such a change on the part of ESL in connection with its Sears investment occurred before commencement of the class period.

In analyzing this claim, the Court explained that there were two separate, discrete negotiations rather than, as the plaintiffs argued, a series of connected negotiations beginning in February 2004. The first set of negotiations, involving Sears' potential, but abandoned, acquisition of Kmart, terminated in April 2004 and did not contemplate a change in control of Sears. The second set of negotiations, involving Kmart's potential acquisition of Sears, began on October 31, 2004 and ended on November 16, 2004. Accordingly, "[t]he earliest possible date that ESL could have been required to file a Schedule 13D would be November 10, 2004, ten days after the start of the merger negotiations regarding Kmart's acquisition of Sears." However, because Lampert was initially acting in his capacity as Chairman of Kmart rather than on behalf of ESL, the Court determined that ESL did not become involved in the merger discussions until November 13th, when reference to an ESL voting agreement was added to the second draft of the merger agreement. Thus, ESL had 10 days from November 13th to file its Schedule 13D, a requirement that it satisfied.

Conclusion

The Court's decision in *Sears* should be welcome news to deal makers and their legal advisors. Not only did the Court provide helpful guidance for evaluating when disclosures need to be made under the federal securities laws in connection with a merger or other change in control transaction, but the principles that the Court relied on in reaching its decision support the view that, as a general matter, disclosures should not be required, even though active negotiations are under way and the parties are "kicking the tires" of a transaction, until definitive documentation is signed and the parties are required to file a Form 8-K. This would not be the case, however, if discussions have progressed to a point at which they would be considered "material" and a party to those discussions makes public statements that "relate directly" or are "sufficiently linked" to, or (as in *Basic Inc. v. Levinson*) are contradicted by, the merger discussions.

[4] The Court also observed that this argument was misplaced because it was Kmart, and not Sears, who would be required to obtain capital to consummate the transaction.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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