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Outside Counsel

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Dealing with Analysts After Regulation Fair Disclosure

By Maryann A. Waryjas

Regulation Fair Disclosure ("FD") requires that whenever an issuer, or any of its senior officials or other employees or agents who normally communicate with investors and analysts, discloses material nonpublic information to certain enumerated persons, such as securities analysts or institutional investors, the issuer must either (1) simultaneously (for intentional disclosures) or (2) promptly (for nonintentional disclosures) make public disclosure of that same information.

What Is "Material Nonpublic Information" Subject to the Regulation?

Regulation FD does not directly answer the fundamental question of what information is "material" and "nonpublic." Instead, it refers companies and investors to the following commonly used standards established by the courts:

- Information is considered "nonpublic" if "it has not been disseminated in a manner making it available to investors generally."
- Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision" or if it would have "significantly altered the 'total mix' of information made available."

The determination as to whether or not a particular piece of information is material must be made in light of the Securities and Exchange Commission's August 1999 pronouncement in Staff Accounting Bulletin No. 99 ("SAB 99") that assessments of materiality, for financial statement purposes, require consideration of "qualitative" as well as "quantitative" factors. SAB 99 indicates that, among other things, anticipated market reaction should be taken into account in considering whether information is material. Statements that did not seem significant when made, may appear material with the benefit of hindsight.

Analyst Guidance

The SEC specifically cites advance earnings warnings made on a selective basis as the type of situation it is attempting to address with Regulation FD. According to the adopting release:

> When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer will likely have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render

material information immaterial simply by breaking it into ostensibly nonmaterial pieces.

On the other hand, if a senior official provides a market professional nonmaterial information that the analyst uses to complete a "mosaic of information," the company would not, according to the SEC, be in violation of Regulation FD. The SEC claims that it does not intend to discourage analysts from "sifting through and extracting" information that may not be of interest to the ordinary investor. Nonetheless, it is clear that any guidance regarding financial forecasts or models should be considered material under the regulation. Moreover, based upon the SEC's statements in the release, a company official is likely violating Regulation FD even if he or she merely states "I am comfortable with street expectations" to an analyst without making the same statement publicly. As a result, companies will need to use caution in discussing with analysts their earnings models, whether in private conversations or at investor conferences, and in reviewing analyst reports, if they elect to do either.

Recommendations for Compliance with Regulation FD

Every company should review its current disclosure policy and practices, considering the types of information that previously have been requested by and provided to analysts and institutional investors.

We strongly urge companies that do not have written disclosure policies to adopt policies that are consistent with the requirements of Regulation FD.

We also suggest that companies consider regular public dissemination of information and data that are typically provided to analysts, such as monthly sales figures, financial forecasts, and general earnings guidance. To the extent that companies publish forecasts or other prospective information, they should be certain to take advantage of the "safe harbor for forward-looking statements." Any safe harbor language should be carefully crafted and tailored to the particular statements being made. Boilerplate language should be avoided.

We also recommend that companies:

- Limit who is authorized to talk to analysts and investors on behalf of the company.
- Limit the permitted scope of communications during private sessions with analysts or other market professionals or at investor conferences.
- Establish procedures to inform designated company officials if material information is inadvertently selectively disclosed and, in any such case, to rapidly make the requisite public disclosure.
- Require that more than one company representative participate in conversations with analysts and institutional investors.
- Require that, before any authorized representative discloses any information that is in a "gray area" as to materiality, the representative should review the proposed disclosure with designated company officials, including internal legal counsel and, where appropriate, outside counsel.
- Require that earnings calls and other conference calls with analysts and institutional investors be webcast and/or opened up to the public and media on a "listen only" basis with advance public notice of the calls and then be made available for replay on the company's website for a limited time period.
- Reevaluate their roles in reviewing (or not reviewing) drafts of analyst reports to avoid giving financial guidance or other material information that would have to be publicly disseminated.

Those individuals who administer the company's disclosure policy or are authorized to talk to analysts or instutitional investors on behalf of the company should be properly trained and should clearly understand the requirements of Regulation FD. ■

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Watch out for Low-Flying Tender Offers

By Herbert S. Wander

Most American publicly held companies are prepared to defend against hostile takeovers for control. Now, flying below the radar screen, are tender offers for less than 5 percent of the outstanding shares to make a quick buck known as "minitender offers." Virtually unknown bidders abusing the Depositary Trust Company are making minitender offers for listed or Nasdaq securities, such as Tellabs, without full disclosure, without notifying the issuer, and often at below-market prices. It's the Wild West revisited.

The Securities and Exchange Commission ("SEC") has recently

focused on these minitender offers and issued an interpretive release in late July raising serious concerns about these offers under the antifraud provisions of the Securities Exchange Act of 1934.[1]

Why Minitender Offers?

Tender offers were first federally regulated in 1968 when the Williams Act became part of the Exchange Act. Most lawyers are familiar with the following aspects of tender offers:

- Section 13(d), requiring the filing with the SEC of a Schedule 13D upon acquisition of more than 5 percent of the outstanding securities of a company registered under § 12 of the Exchange Act.
- Section 14(d), providing certain filing, disclosure, and procedural rules for offers to acquire more than 5 percent of the outstanding shares of a registered company.
- Section 14(e), imposing antifraud rules on all tender offers, even those for under 5 percent which are not regulated by § 14(d).

Until a few years ago, almost all tender offers were made to acquire control of the target and were thus subject to the full array of disclosure, filing, procedural, and antifraud rules of the Exchange Act. In the 1990s, however, a number of under 5 percent tender offers surfaced for the illiquid securities of public and private limited partnerships that had been syndicated in the early 1980s. These partnerships had largely failed to meet their financial goals, and thus their investors were stuck with their interests with no avenue to liquidate them. Realizing this predicament, a number of bidders made minitender offers to purchase these interests. These minitender offers were made cheaply, quickly, on a first-come, first-served basis, did not require filing with the SEC, and were generally short on disclosure. They raised a number of legal questions under both federal and state law and even spawned some state court litigation when bidders sought to obtain lists of limited partners. In many situations, moreover, the general partners did not know how or whether they should respond under state law fiduciary concepts or federal law securities regulation. Even though these minitender offers for limited partnership interests created many legal problems, they were not extensive and did not receive a lot of attention.

Recently, however, minitender offers have been made for the securities of publicly held corporations and closed-end funds that are traded on exchanges or quoted on Nasdaq. As the SEC revealed in its Interpretative Release (p. 4):

> "The offering documents in minitender offers frequently are very brief and contain very little information. Often, these minitender offers are made at a price below the current market price. However, frequently there is no disclosure of this fact in the offering documents or in any disclosure that the security holders ultimately receive. . . .
>
> Some bidders have devised schemes to confuse security holders about the actual offer price. For example, we have seen situations where a bidder makes an offer at a price above market price but never intends to purchase the shares in the offer at a premium. In these cases, the bidder holds the shares tendered and continuously extends the offer until the market price rises above the offer price. During this time, security holders generally are not permitted to withdraw their securities from the offer. Then the bidder purchases the shares at the offer price. In these situations, the bidder does not disclose this plan to security holders. . . .
>
> Disclosure in minitender offers is usually deficient in other respects that may harm security holders. For instance, since minitender offers are not subject to the specific requirements of Regulation 14D, these offers are generally structured as first-come, first-served offers without withdrawal rights and prorationing. . . ."

Furthermore, these minitender offers are not widely disseminated. In some instances, the bidders will simply deliver the written tender offers to the Depository Trust Company, which frequently passes on this information to broker-dealers and banks that, in turn, may or may not pass the information along to the beneficial owners. The issuers may not, in fact, become aware of these minitender offers for some time.

In response to these minitender offers, the SEC in the Interpretative

Release makes plain that these practices are often violative of the antifraud provisions of § 14(e). According to the SEC, bidders must disseminate the offer and make prompt payment, as well as clearly provide offerees accurate and complete information regarding the following types of information:

- Offer price.
- Price changes.
- Withdrawal rights.
- Pro rata acceptance.
- Identity of the bidder.
- Plans or proposals.
- Ability to finance the offer.
- Conditions and extensions.

Indeed, the SEC has already initiated enforcement actions against a number of bidders making minitender offers.

What Should Issuers Do?

First, companies should be alert and ready to react quickly if a minitender offer is made for their shares. Second, companies are required under the antifraud provisions of § 14(e) to make recommendations to their security holders to whom any tender offer is made, whether for more or less than 5 percent of the outstanding securities. The response should be made within ten business days of the offer or as soon as possible after the target becomes aware of the offer. The response should alert the target's stockholders to the minitender offer, should include the reasons for the target company's recommendation, and should describe any flaws inherent in the minitender offer.[2] ■

Notes

1. SEC interpretation: Commission guidance on minitender offers and limited partnership tender offers, Rel. No. 34-43069, July 24, 2000 ("Interpretative Release"). The Interpretative Release provides an excellent summary and analysis of the tender offer rules generally.
2. In this regard, the SEC has also published a helpful document called "Minitender Offers: Tips for Investors," Aug. 9, 2000, which is available at www.sec.gov/consumer/minitend.htm.

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SEC Proposes Additional Disclosures for Loss Contingencies to Address "Abusive Earnings Management" by Public Companies

By Lawrence D. Levin and Denise M. Orlinski

Consistent with its ongoing campaign to combat "abusive earnings management" by public companies and provide for "a more level playing field," the Securities and Exchange Commission ("SEC") earlier this year proposed new rules for disclosures concerning valuation and loss accrual accounts. The proposal would require detailed disclosure for such items as reserves for pending litigation, environmental remediation costs, contingent tax liabilities, and product warranty liabilities. The SEC intends for these added disclosures to provide sufficient analytical information so that changes in the amounts and activity in these accounts would be transparent to investors and would reduce the existing diversity in practice in this area.

Proposed New Disclosure Requirements

The proposal would create a new Item 302(c) of Regulation S-K to clarify and expand the supplemental disclosure requirements concerning activity involving an entity's valuation and loss accrual accounts. Information concerning changes in major classes of these accounts, including changes in the assumptions used for estimating various reserves, would be required for each period an audited income statement is required. The proposal would require that all reserve and loss contingencies be reported, separated by major class of loss accrual accounts. The list included in the SEC proposal is suggestive rather than all-inclusive and includes the following accounts:

- Probable losses from pending litigation.
- Liabilities for environmental costs.
- Contingent income and franchise tax liabilities.
- Product warranty liabilities.
- Allowance for doubtful accounts or notes receivable.
- Allowance for sales returns, discounts, and contractual allowances.
- Unamortized discount or premium.
- Excess of estimated costs over revenues on contracts (loss contracts).
- Inventory valuation allowance.
- Valuation allowance for deferred tax assets.
- Liabilities for exit and employee termination costs related to a restructuring or a business combination.
- Liabilities for costs of discontinued operations.

- Contingent income and franchise tax liabilities.

The proposed rules would reposition the required disclosures about activity in a registrant's valuation and loss accrual accounts currently furnished in a schedule to a separate item within Supplementary Financial Information. The proposed repositioning of these disclosures is intended to encourage registrants to provide a detailed narrative discussion about the assumptions underlying the recognition of a valuation or loss accrual account, along with the nature of any changes in those assumptions requiring adjustment to the account balance.

Essentially, the proposed rules would require registrants to provide a separate schedule showing each major class of valuation or loss accrual accounts, such as litigation reserves, with details of additions and deductions for the period. Accompanying the schedule would be a detailed narrative discussion of assumptions, estimations, and predictions.

The Public's Response

Although some people have applauded the SEC for its efforts in giving securities analysts and investors useful, expanded disclosure, many people have expressed grave concerns about the potentially harmful effects of this disclosure. Those critical of the proposal believe that the benefits of providing detailed information in such sensitive areas as probable losses from pending litigation or product warranty liabilities are strongly outweighed by the likely harm to companies and their shareholders from disclosing highly sensitive, proprietary information to financially interested parties and adversaries, as well as the additional costs of annually supplying this additional information.

Potential Harm

Many concerned about the new proposals argue that information of this nature could easily be used to strengthen the negotiating position of a party against the reporting company, most notably either as an admission against interest or as a starting point for negotiations. It could also act as an attractive inducement for frivolous lawsuits attempting to squeeze settlement money out of the company.

Loss of Attorney-Client Privilege

Companies providing detailed disclosures about loss accruals from pending litigation, environmental remediation, tax disputes, and certain other contingencies may also risk waiving their right to assert the attorney-client privilege. The proposed disclosures could in effect require corporate clients to disclose otherwise privileged information, thus arguably requiring their lawyers to waive the right to assert work product privilege with respect to the proposed disclosures of information underlying the basis for the reserves.

Competitive and Economic Harm

Whether or not the right to assert the attorney-client privilege is jeopardized by this proposal and depending on the level of detail required, information on specific cases could be discerned from the required disclosures. Such information could constitute an admission of liability and serve as a roadmap for plaintiffs' attorneys to use in discovery, thus severely harming a company's litigation posture. Moreover, the proposed requirement to disclose changes in assumptions used in estimating the reserve that have a material effect on the change could very easily be tied to specific litigation, further compromising a company's negotiating position.

In addition, these proposed new disclosures could affect the ability of reporting companies to pursue strategies in the company's best interests. For example, in establishing reserves for pending litigation or a class of litigation, factors to consider in determining the probability of liability and estimation of loss are a company's willingness to settle and the level at which a company might settle litigation. The proposed disclosures could have the unintended effect over time of driving reporting companies to a more adversarial strategy in dealing with litigation in order to avoid laying out their willingness to settle and at what price. The ultimate effect could then be that loss accruals for litigation would become less reliable and useful to investors.

Reporting companies have also expressed concern about the effect that additional disclosure concerning contingent income and franchise taxes could have on their ability to properly deal with these matters. A company's obligations to its shareholders include operating in a manner to obtain favorable tax treatment in accordance with existing law. Because of the uncertain nature of applicable statutes, rules, regulations, interpretations, and positions of taxing authorities, these proposed disclosures would necessarily involve issues in which taxing authorities could challenge a legitimate tax position of a company. The proposed disclosures could interfere with a company's ability to negotiate favorable tax settlements in the same manner that

they could affect the ability to settle pending litigation.

An Alternative?

A common sentiment among many opposed to the proposal is that current financial accounting standards, such as Statement of Financial Accounting Standards Nos. 5 and 109, more than adequately address both parameters for accrual and disclosure for a loss contingency. Instead of new disclosure requirements, many of those opposed to the proposal have recommended that the SEC focus more emphasis and education on the correct and consistent application of current standards.

Current Status

The comment period for this proposal has closed, and the Office of the Chief Accountant of the SEC is currently reviewing all comments and formulating final rules. The SEC has not indicated when it anticipates issuing final rules or the form that such rules would take. As a result of the adverse comments, the SEC may significantly reduce the application of these rules. ■

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Regulation of Communications Relating to Takeovers

By Bruce G. Wilson and Anthony J. Grzyb

The Securities and Exchange Commission ("SEC") adopted amendments to the registration, proxy, and tender offer rules relating to business combination transactions and security holder communications, effective January 24, 2000. The amendments permit more communications with security holders and update, simplify, and harmonize the rules and regulations governing business combination transactions.

Under these new rules, the SEC allows for more comprehensive and earlier disclosure in tender offers and mergers and puts acquisitions using the bidder's securities as currency on a more equal footing with cash deals. Both the acquiring company and the target can make oral and written communications with security holders at any time during the transaction, as long as any written communications are filed with the SEC upon first use and bear a specified legend.

In July 2000, the SEC Division of Corporation Finance issued interpretations of the new rules. Some of these interpretations, which can be found in the third supplement to the SEC's telephone interpretations manual,[1] are explained below, along with a few observations about what companies are doing under the new rules.

Early Commencement of Exchange Offers

Rule 162 was adopted under the Securities Act to allow for solicitations of tenders of securities in an exchange offer subject to Exchange Act Rule 13e-4(e) or 14d-4(b) before a registration statement is effective for the securities offered if no securities are purchased until the registration statement is effective and the tender offer has expired. The rule also says that a prospectus meeting the requirements of § 10(a) of the Securities Act need not be delivered to security holders in an exchange offer so long as a preliminary prospectus, supplements, and revised prospectuses (but not a final prospectus) are delivered in accordance with Rule 13e-4(e)(2) or 14d-4(b). The preliminary prospectus must contain all information necessary for investors to make an informed investment decision. A company using Rule 162 files its registration statement on the appropriate form under the Securities Act and a schedule under the Exchange Act incorporating the prospectus by reference to the registration statement. If, as a result of SEC review of the registration statement or otherwise, the offeror disseminates a prospectus supplement with material changes, Rule 14d-4 mandates minimum periods the offer must remain open, depending on the significance of the change.

Public Announcements

Parties to a business combination transaction typically make public announcements about the deal before definitive documents are sent to stockholders. Rule 165 creates an exemption from §§ 5(c) and 5(b)(1) of the Securities Act for public announcements and other written communications that offer to sell or solicit offers to buy securities in connection with or related to a business combination transaction as long as those communications are filed upon first use in accordance with Rule 425.

Amendments to the tender offer and proxy rules also allow public announcements of cash tender offers and cash mergers as long as

the material is filed on Schedule TO or under Rule 14a-12. A bidder can now make an announcement of a cash tender offer before the offer commences if the press release is filed on Schedule TO. There is no longer any requirement to commence the offer within five business days after the announcement.

Although "public announcement" is defined in Rule 165(c) and the revised tender offer rules, the specificity of the announcement is not addressed. The only communications that need to be filed are those in connection with or relating to the transaction. The SEC cautions that a statement may be a public announcement even if all of the terms of the transaction are not set. If the parties to the transaction are announced, that announcement should be enough to trigger a filing requirement. The more specific the announcement, the more likely that it will trigger a filing requirement. When in doubt, most companies should file the announcement.

If the offeror and target jointly issue a press release announcing a proposed merger in which the consideration is securities, the offeror must file the press release under Rule 425. Even if the offeror is participating in a proxy solicitation and the material is subject to the proxy rules, the offeror need not make a separate filing under Rule 14a-12, because Note 2 to Rule 425 provides that the filing is deemed filed under other applicable regulatory sections. The Rule 425 filing must, however, comply with the disclosure requirements of Rule 14a-12.

The target also has separate filing obligations and must make its own filings as a result of a joint press release. If the target's security holders are voting on the transaction, then any written statements by the target regarding the transaction may be soliciting material that must be filed under Rule 14a-12. A joint announcement of a cash merger would normally call for a filing under Rule 14a-12 by both parties.

In the context of negotiated cash tender offers, the prevailing practice under the new rules is for the joint press release announcing the deal to be filed by the bidder on Schedule TO and by the target on Schedule 14D-9.

Filing Written Information

As a condition to the Rule 165 exemption, offerors must file written communications in connection with or relating to a business combination. If, however, a communication is not an offer to sell or a solicitation of an offer to buy securities, the Rule 165 exemption will not be needed. The party to the transaction and its counsel should make this determination, based on the facts and circumstances, in accordance with traditional legal principles. A similar analysis also applies to the need to file material under the tender offer or proxy rules as a result of an announcement of a cash tender offer or a transaction calling for a proxy solicitation.

Written communications include electronic communications and other future applications of changing technology. Parties that use videos and CD-ROMs or use internet or telephone technology to make available video or audio materials in connection with a business combination transaction must file transcripts of those materials. The staff will not object if parties do not file live, "real-time" audio or video material whether made available over the internet or by telephone so long as the presentation does not continue to be made available after it is completed.

A dealer-manager that is retained by a bidder in an exchange offer would in most circumstances be viewed as acting on behalf of the bidder. There-fore, the dealer-manager should file any written materials it uses to solicit tenders, including scripts.

Articles

Media articles that quote company officials or that are based on interviews with company officials would not be viewed as a written communication by a party to the transaction or a person acting on its behalf. If, however, a party to a transaction controls, pays, or arranges for an article to be published or disseminates the article, then the article would be a written communication that must be filed under Rule 425.

If a party to a business combination posts an article discussing the transaction on its website, the article would be a written communication that must be filed under Rule 425. If the website provides a hyperlink to the article, a strong inference arises that the party has adopted that information, and accordingly, it must file the article under Rule 425. ■

Note

1. *Manual of Publicly Available Telephone Interpretations,* Third Supplement (July 2000), Regulation M-A, Part B.

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Katten Muchin Zavis

Securities Practice

Katten Muchin Zavis was formed in 1974 with the goal of providing comprehensive legal services and creative solutions to our clients. Because of our uniquely flexible and entrepreneurial culture, KMZ grew rapidly. Today, KMZ has more than 460 attorneys with offices in Chicago, Los Angeles, New York, and Washington, DC.

The breadth and depth of our securities practice enables us to provide value to our clients on a daily basis. KMZ has one of the most active, creative, and well-respected securities practices in the United States. This practice encompasses a wide spectrum of securities matters, including the representation of issuers and underwriters in a variety of complex public and private offerings of equity and debt securities, including complicated securitization and medium-term note offerings. Our practice also covers tender offers (both friendly and hostile), proxy contests, and going private transactions. By relying on our extensive experience, we are able to provide high-quality, cost-effective representation.

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For emerging growth and high technology companies, our broad experience, technical competency, industry knowledge and relationships, creativity, and common sense approach are invaluable. When the best alternative for our clients is an initial public offering, we assist in (1) selecting and negotiating with underwriters, (2) preparing the client to deal with the offering process, (3) structuring the offering, (4) counseling on corporate governance issues, (5) developing incentive compensation plans, (6) preparing the prospectus, and (7) managing the SEC process.

In addition to the transactional aspects of our securities practice, we actively counsel management, boards of directors, and special committees of boards with respect to all corporate and securities law issues, including fiduciary duty issues, obligations when buying or selling company securities, and ongoing securities compliance obligations. We also assist public companies with respect to antitakeover measures, including shareholder rights plans, proxy solicitations, compliance with stock exchange requirements, establishing corporate governance policies, and handling difficult disclosure issues.

In the litigation portion of our practice, we represent issuers, underwriters, and other market professionals in securities-related litigation and regulatory inquiries. KMZ represents clients in federal and state courts, as well as in arbitrations and hearings before regulatory authorities in enforcement proceedings. Cases have involved a variety of issues, including disclosures in initial and subsequent public offerings, marketing materials, and ongoing securities reporting obligations.

As the attorneys at KMZ strive to become trusted advocates and business advisors to our clients, we remain dedicated to the two fundamental principles the firm was built on: client service and legal innovation. We will do our best to become your trusted advocate and business advisor, as well.

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