RULE 10b-5 AS APPLICABLE TO NEGOTIATED M+A TRANSACTIONS

This informal memo collects some relevant sources on the application of Rule 10b-5 to M+A transactions.

1. Common law fraud differs from state to state but essentially consists of five elements, as follows:

> (1) a false representation, usually one of fact, made by the defendant;
> (2) the defendant's knowledge or belief that the representation was false, or was made with reckless disregard of the truth;
> (3) an intent to induce the plaintiff to act or to refrain from acting;
> (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and
> (5) damage to the plaintiff as a result of such reliance.

2. Securities fraud under Section 10b-5 of the Securities Exchange Act of 1934 is less demanding than common law but still requires scienter of the seller and reliance by the buyer. It states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> > (b) *To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading*, or
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3. 10b-5 applies to all sales of securities, including privately negotiated transactions and the sale of all the stock of a company. It does not apply to sales of companies structured as the sale of assets.

4. Section 29(a) of the '34 Act states:

> any condition, stipulation, or provision binding any person to waive compliance with any provision of this Act or of any rule or regulation thereunder….shall be void.

15 USC Sec. 78cc. This is also in Section 14 of the Securities Act of 1933 and Section 10(5) of the UK's The Companies Act.

5. Until about 2000, purchasers regularly waived the application of 10b-5 by inserting in the stock purchase agreement ("SPA") a statement by the buyer that it was not relying on statements or representations by the seller not contained in the SPA. Since reliance is an essential element to proving 10b-5 fraud, giving that statement effect would defeat a claim at least to the extent it was based on a statement by the seller.

6. Some writers take the position that the "non-reliance" language should be ignored completely due to the language of Section 29(a). Jonathan P. Altman, Rule 10b-5 and Reasonable Reliance: Why Courts Should Abandon Focus on Non-Reliance Clauses. 68 Pitt LR 747 (2007).

7. The courts seem to be [still] split on whether the non-reliance language is effective to waive claims based on seller's statements not contained in the SPA. In particular the 1st, 2nd and 7th Circuits take different views.

8. The cases seem to all focus on affirmative statements of the seller not contained in the SPA. They do not go to the other two possibilities of 10b-5 - affirmative statements made in the SPA leaving out facts material to the buyer's decision and affirmative statements which are misleading. Even the non-reliance on extra-contractual statements would not cover seller's material omissions.

9. Besides "non-reliance" statements, sellers also try to include statements by the buyer that (a) it has had ample opportunity to conduct full due diligence and ask all questions material to it and (b) the contract contains all agreements between the parties.

10. Adding 10b-5 language (see 12 below) to a SPA or asset purchase agreement ("APA") deviates from the Securities Exchange Act language in two ways, making it more dangerous to seller:

A. It may not require seller's scienter. So buyer may not have to prove seller's knowingly having left out material information or having misled buyer.

B. It may not require buyer to prove that it reasonably relied on the omission or misleading effect of the statements.

Whether or not seller needs to intend to mislead buyer depends on the language of the representation. Likewise, whether or not the buyer needs to have relied on the misleading statement or omission depends on the language of the APA.

11. Reliance in contractual breach claims is closely related to sandbagging. Must the buyer have cared about the information? Must it have believed it to be true? This is where the due diligence opportunity language comes in. If buyer did not care enough to get an affirmative statement from seller, could it be relying on the omission? If it had ample opportunity to study all the documents and disclosures in the due diligence documents and ask for more, how can it now claim it relied on the omission or misleading statement?

12. A standard 10b-5 contract insert reads:

> No representation or warranty or other statement made by [Target] in the Agreement, the Disclosure Letter, any supplement to the Disclosure Letter, the certificates delivered pursuant to Section ____ or otherwise in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them in light of the circumstances in which it was made, not misleading.

13. A standard "full disclosure" formulation reads:

> Seller does not have Knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition or results of operations of Seller that has not been set forth in the Agreement or the Disclosure Letter.

14. In 2006, 68% of all privately negotiated M+A transactions contained one or both of the statements. [Was this for asset deals??] In 2011, the percentage had changed to 30+%. Was this a significant trend, a blip or a change in the relative bargaining strengths of buyers and sellers?

15. PLC notes: Buyer wants a full disclosure representation with no knowledge qualifier. Buyer wants seller's knowledge to be "constructive" - i.e. a reasonable investigation by seller would have disclosed it. Seller wants this limited to actual knowledge so no investigation is needed and no comparison to a reasonable man is permitted. [Key Negotiating Points in Private Acquisition Agreements Comparison Chart. Howard T. Spiko, Kramer Levin.]

In “Eliminating Securities Fraud Class Actions Under the Radar” by Professor Barbara Black (2009) states: “…it is well established that Section 29(a) does not permit provisions that weaken investors’ ability to recover under the federal securities laws, no matter what form they take: “no-reliance” clauses in stock purchase agreements, “no-action” clauses in indentures, clauses that provide for an alternative remedy, and clauses that specify indemnification as the sole remedy. The only situation where some courts have enforced no reliance clauses is in negotiated contracts among sophisticated investors or corporate insiders where the written agreement contains specific representations and the no reliance clause serves the purpose of barring representations not contained in the agreement. While the judiciary’s creation of a parole evidence exception to Section 29(a) is questionable, it is of limited scope. P. 23 citing

> AES Corp. vs. Dow Chemical Corp; Caiola v. Citibank, N.A.,; Rogen v. Illikon Corp., Roll v. Singh; MBI Acquisition Partners, LP v. Chronicle Publ. Co.
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> Citibank v. Itochu Int’l.
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> Rissman v. Rissman
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> Harscho v. Segui.

RULE 10b-5 and RELATED CONSIDERATIONS IN ACQUISITION AGREEMENTS by Mark Betzen (Jones Day, June 2004)

A typical insertion states "neither the representations and warranties *set forth in the acquisition agreement nor the related disclosure schedule* contain any misstatement of a material fact or omit to state a material fact necessary to prevent the statements made therein from being misleading."

A broader form extends to material misstatements and omissions in connection with the transaction – so beyond the acquisition agreement.

Contractual representations do not depend on culpability or reliance (which is presumed or unnecessary). But contractual representations may well be subject to limits on recovery (unlike 10b-5).

Two important effects: 1) it includes omissions as well as misstatements and may cover misstatements and omissions outside the acquisition agreement; 2) a presumption that the statements or omissions were reasonably relied upon.

Re "non-reliance" – in 2nd Circuit (NY) and 7th (Illinois), non-reliance clauses should be given effect to bar Rule 10b-5 claims based on extra-contractual representations. [What about omissions or misleading statements?] See Harsco Corporation and Rissman.

In 1st Circuit (Massachusetts) and 3rd Circuit (Delaware) – giving absolute effect violates Section 29(a). See Rogen and AES Corp.

In Harsco there as a non-reliance clause and 14 pages of representations and warranties with a sophisticated buyer, so it could not reasonably have relied on extra-contractual representations. Buyer did not indiscriminately waive 10b-5 protection but limited the representations to a reasonable degree.

In Rissman, the court said to disregard the non-reliance would mean the plaintiff could simply say it lied when it said it did not rely.

In Rogen, the court said it would not give literal effect to the clause. The clause can be taken as evidence. So the non-reliance clause is still important.

Re Integration Clauses (the contract contains all provision) - these are helpful to seller but not determinative.

Re Due Diligence Clauses - these tend to negate reasonable reliance. Some courts say if a sophisticated party has an opportunity to investigate pre-contractual disclosures or have them incorporated, it has willingly incurred the risk. But the cases do not involve omissions! Also, due diligence rooms are often a mess. Does the buyer have to tell the seller or the seller's investment banker that they made a mess of the disclosure process? Does this clause make a US style due diligence review like a Continental European investigation – where the buyer is charged with knowledge of everything included in the room?

Exclusive Remedy Clauses – these are not likely to preclude a 10b-5 claim. Citibank v. Itochu Intl. due to Section 29(a).

PRACTICAL OBSERVATIONS

1. Seller in a stock deal cannot foreclose a 10b-5 claim but can probably make proof of reliance by the buyer difficult by including language as to non-reliance, opportunity to investigate and completeness of the agreement.
2. Seller will do better by making the sole jurisdiction New York and not Delaware.
3. Buyers are wise to consider the offering memorandum and insert any representations of importance found in the memorandum into the Stock Purchase Agreement or Asset Purchase Agreement.
4. Reliance on representations made by seller buy not included in the APA or SPA will be difficult. But reliance on a belief that all material information has been disclosed may be easier. Also reliance on representations which seller knew to be misleading could be easier.
5. If a buyer in an asset deal wants protection, it must insert a 10b-5 like representation.
6. The issues in a 10b-5 representation are whether the seller must know a statement or omission is false or misleading and whether the buyer must prove its reliance on the statement.
7. Reliance becomes a factor when dealing with sandbagging. If the APA contains an anti-sandbagging provision, then the issue is whether the buyer really relied on the omission or the misleading statement.
8. If a seller intends to ask for a "full opportunity to conduct due diligence" representation, then buyer has an interest in controlling the disclosure process. It makes a difference in how buyer conducts the process.

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