

Client Alert

A report
for clients
and friends
of the firm June 2005

Recent SEC Section 21(a) Report Focuses Attention on Proxy Statement Disclosure of Representations in Merger Agreements

On March 1, 2005, the SEC issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 to provide guidance concerning potential liability under Sections 10(b) and 14(a) of the Exchange Act for disclosure of false or misleading material contractual provisions in SEC disclosure documents. The Report was issued in connection with a settlement of an enforcement action against The Titan Company involving allegations of violations of the Foreign Corrupt Practices Act of 1977, or FCPA. The SEC stated that the Report is not intended to change the way issuers engage in mergers, but the implications of the report could have an effect on practices relating to public company merger agreements and merger proxy disclosures.

Titan Complaint and Settlement

On September 15, 2003, Titan entered into a merger agreement pursuant to which it was to be acquired, subject to certain conditions. In the merger agreement, Titan made a specific representation that:

To the knowledge of the Company, neither the Company nor any of its Subsidiaries, nor any director, officer, agent or employee of the Company or any of its Subsidiaries, has...taken any action which would cause the Company or any of its Subsidiaries to be in violation of the Foreign Corrupt Practices Act of 1977, as amended, or any applicable law of similar effect.

Titan's proxy statement, which was filed with the SEC and mailed to its shareholders, disclosed and disseminated the FCPA representation in two respects: the proxy statement contained a summary of the FCPA representation and the merger agreement was appended to the proxy statement as an exhibit. SEC rules do not mandate that an issuer append a merger agreement to its merger proxy statement, but doing so is common practice.

After Titan filed and distributed its proxy statement, Titan issued a press release disclosing meetings with the SEC and the Department of Justice regarding certain payments made in foreign countries. Subsequently, the SEC and DOJ commenced investigations of Titan for potential violations of the FCPA. Without admitting or denying the allegations against it, Titan settled the complaints with each governmental entity. At various times between the first announcement by Titan regarding the potential liability for FCPA violations and settlement of the complaints, Titan amended the merger agreement and proxy statement to add disclosure regarding the investigations being conducted against it, but the FCPA representation in the merger agreement itself was not amended or qualified.

The SEC Report

The SEC stated that it was not alleging liability of Titan under Sections 10(b) and 14(a) of the Exchange

Act, but was using the Titan matter to provide guidance concerning potential liability for materially misleading disclosures of contract provisions in SEC filings, whether it be through summaries in a disclosure document, attaching contracts as exhibits, incorporating contracts by reference or otherwise. Even though shareholders of Titan were not third-party beneficiaries of the FCPA representation and the merger agreement was not prepared as a disclosure document, the Report concluded that the inclusion of the representation in Titan's proxy statement constituted a disclosure to investors. Therefore, since a reasonable investor could determine that the representation described the actual state of affairs of the company and such information could be found to be material, Titan was potentially liable for disclosure of false or misleading information to investors.

Implications

The SEC's warning in the Report is likely to have lasting implications on public company merger agreements and merger proxy statement disclosures. Representations, typically a matter of private contract, could now lead to liability under Sections 10(b) and 14(a) of the Exchange Act. Representations serve different purposes—disclosure and/or risk allocation. Where representations serve only the latter function as between the contract parties, reliance by shareholders may be misplaced. As a result of the Report, issuers must have a heightened sensitivity to how contract provisions are drafted and summarized in SEC filings. Additionally, issuers should ensure that disclosures made are internally consistent within the filing or with disclosures in other filings. This was not done by Titan—while the merger agreement and proxy statement were revised to reflect the complaint against Titan, the FCPA representation remained unchanged.

Additionally, disclaimers in merger proxy statements aimed at avoiding liability for representations in merger agreements are likely to become commonplace. Below is a sample disclaimer from a document recently filed with the SEC:

The description of the proposed Merger described in this report does not purport to be complete and is qualified in its entirety by reference to the Merger Agreement, which is filed as Exhibit 2.1 to this report and incorporated herein by reference. The Merger Agreement has been included to provide investors and security holders with information regarding its terms. It is not intended to provide any other factual information about [the issuer]. The Merger Agreement contains representations and warranties the parties thereto made to and solely for the benefit of each other. The assertions

embodied in those representations and warranties are qualified by information in confidential disclosure schedules that the parties have exchanged in connection with signing the Merger Agreement. Accordingly, investors and security holders should not rely on the representations and warranties as characterizations of the actual state of facts, since they were only made as of the date of the Merger Agreement and are modified in important part by the underlying disclosure schedules. Moreover, information concerning the subject matter of the representations and warranties may change after the date of the Merger Agreement, which subsequent information may or may not be fully reflected in [the issuer's] public disclosures.

Nevertheless, issuers should be aware that the Report indicated that such a general disclaimer may not be sufficient to exculpate issuers in possession of material information that is contradictory to representations made. In addition, the SEC staff is likely to comment on such disclaimers where they suggest that not all material information is included in a disclosure document. Over time, a form of disclaimer that satisfies both issuers and the SEC is likely to be developed.

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