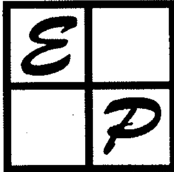

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What's the Big Deal? Why Some Seemingly Material Acquisition Agreements Might Never See the Light of Day

By Jim Moloney, Mike Titera and Kevin Hill of Gibson, Dunn & Crutcher LLP

Multi-billion dollar acquisitions often make headlines, but ever wonder why the terms of the related acquisition agreements are sometimes not disclosed, or the agreements filed with the SEC? For example, Microsoft announced via press release in May of 2011 that it had entered into an agreement to acquire Skype for $8.5 billion, yet the company did not file an Item 1.01 Form 8-K.[1]

This is not unusual for many large, acquisitive companies.[2] Below we examine how companies determine whether to disclose an acquisition agreement.[3] Item 1.01 of Form 8-K requires that, within four business days of entering into a material definitive agreement, a public company disclose certain information concerning that agreement, such as the date of the agreement, the identities of the parties, and a brief description of its terms and conditions. Similarly, subject to certain exceptions, Items 601(b)(2) and (b)(10) of Regulation S-K require that material plans of acquisition and material contracts not made in the ordinary course of business, respectively, be filed as exhibits to, among other things, registration statements and periodic reports.

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[1] Press Release, Microsoft, "Microsoft to Acquire Skype for $8.5 Billion" (May 10, 2011) *available at* http://news.microsoft.com/2011/05/10/microsoft-to-acquire-skype/ (announcing acquisition of Skype for $8.5 billion). (Note: As of June 30, 2011, Microsoft had total assets of $108.7 billion.) An announcement regarding the acquisition was disclosed by Microsoft under Item 8.01 of Form 8-K, but neither a description of the agreement nor the agreement itself was filed.

[2] See, *e.g.*, the following acquisitions where no disclosure of the acquisition agreements was made under Item 1.01 of Form 8-K: Press Release, Microsoft, "Microsoft to acquire Nokia's devices & services business, license Nokia's patents and mapping services" (September 3, 2013) (announcing acquisition of certain Nokia businesses for EUR 3.79 billion (approx. $5 billlion)); Press Release, Microsoft, "Minecraft to join Microsoft" (September 15, 2014) (announcing acquisition of Mojang and the company's Minecraft franchise for $2.5 billlion); Press Release, Cisco, "Cisco Completes Acquisition of NDS" (July 31, 2012) (announcing acquisition of NDS Group, Ltd. for approximately $5 billion); Press Release, PR Newswire, "Pfizer to Acquire King Pharmaceuticals, Inc." (October 12, 2010) (announcing acquisition of King Pharmaceuticals, Inc. for approximately $3.6 billion).

[3] While an acquirer may decide not to disclose an acquisition agreement, if the target is a public company, the acquisition agreement may be deemed material by the target and thus disclosed in an Item 1.01 Form 8-K filed by the target in any event.

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So, as a practical matter, what facts are relevant when companies must decide whether a multi-billion dollar acquisition agreement should be disclosed in a Form 8-K and later filed as an exhibit with the SEC? Both Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K are typically viewed as guideposts when evaluating whether the agreement is (1) material and (2) outside the ordinary course of business.[4]

The Materiality Analysis

So, how can a multi-billion dollar agreement not be material such that full disclosure is not required? Materiality, in a contract disclosure context, possesses the same elusive qualities as it does elsewhere in the securities laws. The term "material" is defined neither under Item 1.01 of Form 8-K nor under Items 601(b)(2) or (b)(10) of Regulation S-K. Thus, companies must look instead to general standards of materiality as defined in SEC rules, judicial decisions, and administrative guidance. Citing *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976) and *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988), the SEC Staff has stated that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[5] By its very nature this opaque definition ascribed to materiality precludes reliance on bright line rules or any precise formula, requiring instead a case-by-case analysis of both quantitative and qualitative factors.[6]

Although the SEC has not established a definitive formula to apply when determining whether a particular acquisition is material, companies can still use quantitative thresholds as a starting point in their materiality analysis.[7] It is helpful to note that the SEC has adopted some numerical value comparisons in certain contexts. Most importantly for a discussion of acquisition agreements, under Item 601(b)(10)(ii)(C), contracts for the sale or acquisition of any property, plant and equipment where the consideration exceeds 15 percent of the company's fixed assets must be included as exhibits even if they were made in the ordinary course of business.

Another helpful guideline, Item 2.01 of Form 8-K, provides that a completed acquisition of assets involves a "significant amount of assets" where the consideration exceeds 10 percent of the company's total assets.[8]

Also, Rules 1-02(w) and 3-05(b)(2) of Regulation S-X specify when an acquisition of a "business" is material for financial reporting purposes by applying three tests: an investment test, asset test and income test. The results of these tests are measured against specific thresholds of 20%, 40% and 50% to determine the periods for which financial statements of an acquired business must be filed.

Without going into too much detail on what constitutes a "business," and applying a similar logic, companies will often begin their analysis with these thresholds.[9] Of course, any such preliminary analysis should be supplemented by a thoughtful consideration of factors unique to the agreement and the company. Staff guidance, consistent with established case law, makes clear that no single fact is determinative of whether

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[4] The disclosure requirements in Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K are not identical. Yet, the adopting release for the 2004 amendments to Form 8-K states, "New Item 1.01 requires the disclosure of material definitive agreements entered into by a company that are not made in the ordinary course of business. The item parallels Items 601(b)(10) of Regulation S-K with regard to the types of agreements that are material to a company, a standard already familiar to reporting companies." SEC Release No. 33-8400, "Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date," August 23, 2004, available at *http://www.sec.gov/rules/final/33-8400.htm*. Except for a few minor differences between the two rules, practitioners generally view the standard for disclosure under Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K as comparable.

[5] SEC Release No. 33-7881 (Aug. 15, 2000).

[6] The Staff has specifically advised against making materiality determinations through the application of any single quantitative formula, stating that both quantitative and qualitative factors must be taken into account. SEC Release No. SAB 99 (Aug. 12, 1999).

[7] The SEC Staff has not objected to the use of such guideposts as an initial step in other contexts. *See* Securities and Exchange Commission, Staff Accounting Bulletin No. 99 (not objecting to the use of a 5 percent threshold in an accounting context).

[8] Instruction 4 to Item 2.01 of Form 8-K further states that "[a]cquisitions of individually insignificant businesses are not required to be reported . . . unless they are related businesses . . . and are significant in the aggregate."

[9] *See, e.g.* Exar Corporation, Correspondence to SEC dated August 5, 2013 (using a 10 percent threshold to determine materiality) *available at* http://www.sec.gov/Archives/edgar/data/753568/000143774913011185/filename1.htm, *see also* Debt Resolve Inc., Correspondence to the SEC dated February 06, 2012 (same) *available at* http://www.sec.gov/Archives/edgar/data/1106645/000147793212000214/filename1.htm.

information is material to investors.[10] A transaction, therefore, should not automatically be designated as material or immaterial simply because it lands above or below any of the thresholds mentioned above.

Qualitative questions to consider when evaluating the materiality of an acquisition agreement include:

1. How acquisitive is the acquirer?
2. Does the acquisition represent an expansion into a new line of business or a significant departure from the acquirer's strategic plan?
3. How similar are the assets of the target and acquiring company
4. Does the acquisition give rise to a new reporting segment for SEC and accounting purposes?

A company's materiality determination can come down to such tenuous qualitative factors, depending on the circumstances.

As one might expect, decisions not to file an acquisition agreement can subsequently be challenged after the fact by the Staff. For example, in a comment letter regarding a Form S-1 filed by Marketo, Inc., the Staff asked the issuer how it determined that an acquisition agreement was not a material definitive agreement, while at the same time the issuer was indicating (through an Item 2.01 Form 8-K) the transaction related to the acquisition of a significant amount of assets and that it intended to file financial statements and pro forma information pursuant to Rule 3-05 and Article 11 of Regulation S-X in connection with the acquisition.

Counsel's response illustrates the analysis the company undertook in determining that the acquisition agreement was not material. In addition to a quantitative comparison of relative size of the target and various key metrics, the issuer also analyzed qualitative factors, noting the following: (1) the target's product offerings were complementary to and expanded the reach of the issuer's existing products and services, but did not represent a new line of business for the issuer; (2) the acquisition was not expected to materially change the market segments in which the issuer competed; (3) the target's product offerings and pipeline were not critical to the future development of the issuer's products; (4) the acquisition was not a material departure from the issuer's pre-existing strategic plan; and (5) no members of the target's management team were expected to become directors or executive officers of the issuer.

Ultimately, the Staff did not require Marketo to file the acquisition agreement or make the disclosure that would have been required by Item 1.01 of Form 8-K.[11] As illustrated by this situation, while the Staff may scrutinize a company's decision not to disclose an acquisition agreement, at the end of the day, deference will often be given to companies and their counsel so long as the analysis is reasonable.

Accordingly, the factors described above, along with other qualitative factors specific to each individual company, should be assessed in determining whether a reasonable investor would find more detailed information regarding the acquisition agreement useful in making an investment decision. The inherent flexibility associated with this standard provides companies with at least some leeway to reach reasoned conclusions.

"Ordinary Course of Business" Analysis

Item 1.01 of Form 8-K states that a material definitive agreement must be disclosed if "not made in the ordinary course of business." Item 601(b)(10)(ii) further explains that contracts made in the ordinary course

[10] *See* SEC Release No. 33-7881, at 10 (Aug. 15, 2000) (citing Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988), in which the Supreme Court held: "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive.")

[11] *See* Marketo, Inc., Correspondence to the SEC dated January 24, 2014 (evaluating a number of qualitative factors in addition to applying a series of quantitative tests) available at http://www.sec.gov/Archives/edgar/data/1490660/000110465914004115/filename1.htm, *see also* Exar Corporation, Correspondence to SEC dated August 5, 2013 (arguing that an acquisition agreement was not material and did not need to be disclosed because (1) the acquisition was consistent with the company's historical practice of acquiring synergistic assets and complementary businesses; (2) the company's cash resources were not depleted and its common stock was only minimally diluted as a result of the acquisition; and (3) the company did not enter into a new line of business with the acquisition) available at http://www.sec.gov/Archives/edgar/data/753568/000143774913011185/filename1.htm.

of business are those that "ordinarily accompan[y] the kind of business conducted by the registrant and its subsidiaries." An ordinary course determination involves comparing the nature of the contract with the nature of the company's business. While a particular acquisition agreement may fall outside the ordinary course for a company that rarely engages in such transactions, it could very well fall within the ordinary course of business for a particularly acquisitive company.[12]

But the significance of this aspect of the analysis should not be overstated. The mere fact that a company engages in many acquisitions will not render an otherwise material acquisition immaterial or unworthy of disclosure. The fact remains, however, that the more acquisitions completed, the less significant the next acquisition will become, especially for large corporate conglomerates. A company's size and the scope of its operations could also render an agreement ordinary. Overall, a company must evaluate the conditions relevant to its business and differentiate between those contracts that ordinarily accompany the business and those that do not.

Conclusion

In determining whether to disclose the details of an acquisition agreement and file the agreement with the SEC, companies must exercise significant judgment in analyzing the materiality and nature of the transaction with the advice of their legal and financial advisors. The decision to file or not will generally turn on whether the acquisition agreement is (1) material and (2) outside the ordinary course of business for the particular company. These determinations must be made on a case-by-case basis, factoring in the specific circumstances of the situation. While the rules cited above may be used as general guideposts, a detailed examination of both quantitative and qualitative measures often will be critical to reaching the final reasoned determination of whether to report.

[12] It is not uncommon for large public companies to undertake numerous large acquisitions in a single year, especially in the technology and social media sectors. According to its 2013 Annual Report, Yahoo, Inc. made 26 acquisitions in 2013, the largest of which wherein the consideration was publicly announced was for $1.1 billion. Similarly, according to its 2013 Annual Report, IBM made ten acquisitions for a total of $3.1 billion in 2013, the largest of which was for $2 billion. Neither company disclosed a single acquisition agreement in an Item 1.01 Form 8-K during that year. Similarly, Valeant Pharmaceuticals is believed to have made two dozen acquisitions in 2013, and only its acquisition of Bausch and Lomb for approximately $8.7 billion was disclosed via Item 1.01 of a Form 8-k.

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