

# Client Alert

March 2014

## **SEC Brings Enforcement Action for Public Company's Disclosure Violations During Defense Against Hostile Takeover Bid**

The Securities and Exchange Commission (SEC) recently brought a settled administrative enforcement action against Lions Gate Entertainment Corp. charging it with failing to make full and accurate disclosure to investors as part of its efforts to repel a hostile takeover bid. In addition to paying a substantial financial penalty, Lions Gate also consented to cease and desist from future violations of the federal securities laws. The case serves as a reminder that the SEC polices the disclosure practices of public companies instituting defensive measures when activist investors and hostile bidders emerge.

According to the SEC's order,<sup>1</sup> Lions Gate's management participated in a set of extraordinary corporate transactions in 2010 in order to issue a significant amount of common stock to a management-friendly director. The purpose of the stock issuance was to defeat a hostile tender offer by a large shareholder who had been locked in a long-running battle with Lions Gate for control of the company. Lions Gate did not disclose to investors that the stock issuance was part of a defensive strategy to ensure incumbent management retained control. Instead, Lions Gate stated in SEC filings that the transactions were part of a previously announced plan to reduce debt. In fact, the company had made no such prior announcement. Lions Gate also represented that the transactions were not prearranged with the management-friendly director, and failed to disclose the extent to which it planned and enabled the transactions with the expectation that the director would get the shares.

The large shareholder had made several tender offers and acquired more than 37 percent of Lions Gate's outstanding stock. Lions Gate management believed that allowing this large shareholder to control the company was not in the best interest of Lions Gate or its shareholders. The company put in place a poison pill, actively discouraged shareholders from tendering their stock to the shareholder, and sought a "white knight" to purchase available shares of Lions Gate stock. Moreover, Lions Gate commenced a three-part set of transactions that would begin by exchanging \$100 million in notes from a holder for new notes convertible to stock at a more favorable conversion rate. The note holder would then sell the notes to the management-friendly director at a premium, and the director would immediately convert the notes to shares.

According to the SEC's order, a special committee of the Lions Gate board of directors and the full board approved the transactions at meetings beginning on 12:01 a.m. on July 20—one minute after a standstill agreement with the large shareholder expired—while facing an imminent tender offer from the large shareholder. Completed in a matter of hours, these transactions allowed the management-friendly director to obtain control of approximately 9 percent of the company's outstanding stock, diluting the large shareholder and making it more difficult for the larger shareholder to acquire control through its tender offer.

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<sup>1</sup> The complete order is available at <http://www.sec.gov/litigation/admin/2014/34-71717.pdf>. Our description of the factual background to the Commission's investigation is derived from the narrative in this order.

The SEC's order found that Lions Gate failed to meet its SEC disclosure obligations to shareholders. First, Lions Gate stated in a July 20 press release and Form 8-K filing that the transactions were done to reduce the company's debt and improve near-term liquidity, and failed to disclose the effort to repel the hostile takeover bid, which Lions Gate viewed as a desirable benefit of the transactions. It also failed to disclose the steps Lions Gate took to incent the management-friendly director to purchase the notes and convert them to common stock.

Additionally, Lions Gate management knew that such a large, direct sale of stock by the company, commonly known as a "defensive recapitalization," would have required prior approval from its shareholders under a New York Stock Exchange (NYSE) rule. After the transactions, the NYSE contacted Lions Gate to inquire whether the transactions violated the NYSE rule requiring shareholder approval. In response to the NYSE inquiry, Lions Gate indicated it would disclose additional information to the public. In a Schedule 14D-9 filing made to the SEC in September, Lions Gate represented that the note exchange was not part of a prearranged plan to get shares to the management-friendly director, but the Schedule 14D-9 failed to disclose details that would have demonstrated the extent to which Lions Gate planned and enabled the exchange of notes with the note holder and sale of the new notes to the management-friendly director. It also failed to disclose that a purpose and expected effect of the July 20 series of transactions was to block the acquirer's takeover efforts and that Lions Gate viewed that outcome as a desirable benefit of the transactions. Furthermore, Lions Gate failed to include in its Schedule 14D-9 other required information concerning the management-friendly director's conversion of the notes to Lions Gate stock.

The SEC's order found that Lions Gate violated Sections 13(a) and 14(d) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-11 and 14d-9 thereunder. In addition to a financial penalty of \$7.5 million, the order requires Lions Gate to cease and desist from future violations. As part of its settlement, Lions Gate admitted to a number of facts supporting the SEC's case. This admission represents yet another departure from the SEC's historical practice of allowing defendants to settle on a neither-admit-nor-deny basis, and is consistent with a recent initiative to seek admissions of wrongdoing from defendants with greater frequency.

The SEC has long viewed disclosures about takeover defenses as potentially material information, although this is reflected mostly in the SEC's rules and regulations rather than in enforcement actions. For example, in a public offering of securities, issuers are required by Regulation S-K to describe charter or bylaw provisions that might have the effect of delaying, deferring or preventing a change in control. Similar rules apply to certain solicitations to amend a charter or change the terms of existing securities.

Although the SEC's investigation of Lions Gate focused solely on disclosure issues under the federal securities laws, companies should also be aware of state law disclosure obligations. Under Delaware law, a board of directors' fiduciary duties requires that it disclose all material information reasonably available when seeking stockholder action. It also requires that communications with stockholders be candid. These obligations can be triggered in the context of adopting takeover defenses. For example, in *ODS Technologies, L. P. v. Marshall*,<sup>2</sup> the Delaware Court of Chancery held that a company's proxy statement was "affirmatively misleading" in its description of proposed charter amendments to classify the company's board of directors and implement a supermajority voting requirement for future charter amendments. In granting a preliminary injunction enjoining the company's stockholders meeting, the court found that the disclosures gave the false "impression that the Amendments are merely routine measures adopted on a 'clear day' " rather than in response to a specific threat. The court also rejected the company's argument that information identifying the specific threat was incorporated by reference to prior SEC filings, noting that the board of directors' failure to disclose the information was not "cured by reason

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<sup>2</sup> 832 A.2d 1254 (Del. Ch. 2003). See also *Sherwood v. Chan Tze Ngon*, C.A. No. 7106-VCP, 2011 WL 6355209 (Del. Ch. 2011) (enjoining annual shareholder meeting due to insufficient disclosure).

that it could be uncovered by an energetic shareholder reading” prior disclosures. Thus, companies should remain mindful of state common law as well as federal securities law obligations.

**Contacts**

**Steven M. Haas**  
shaas@hunton.com

**Scott H. Kimpel**  
skimpel@hunton.com