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When Bad Things Happen After A Securities Pricing

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The underwriters have priced the deal. The underwriting agreement has been signed. The issuer has returned its focus to running its business and the underwriters have moved on to the next deal. All that is left is for the lawyers to document the terms and to ensure that the underwriters are in a position to move money at closing. Then, a day or two after pricing, the plant unexpectedly blows up. What happens if an unforeseeable and materially adverse event[1] ("MAC event") occurs after the pricing of the securities but before closing?

In such a situation, a standard underwriting agreement would allow the underwriters to terminate the deal and all parties could walk away. That said, in certain circumstances, issuers, underwriters and investors may forgo the termination option and opt to stay in the deal.

Navigating an alternative to termination in a "plant blows up"-after-pricing scenario is particularly challenging because U.S. Securities and Exchange Commission rules and guidance are not always helpful and, given the infrequency with which these events occur, rarely do participants have a set of "best practices" to guide them.

Legal Framework

With Securities Offering Reform in 2005, the SEC focused the liability inquiry on the quality of disclosure at the "time of sale," which, according to the SEC, occurs when the investor becomes committed to purchase the securities.[2] In most investment-grade debt transactions, this commitment occurs roughly contemporaneously with pricing.

In practical terms, the SEC shifted the liability focus from the disclosure in the final prospectus to the combined disclosure in the preliminary prospectus and the term sheet, i.e., the disclosure package, because the disclosure package is available at pricing and the final prospectus only subsequently.

Section 12(a)(2) provides a private right of action for offers or sales by means of a prospectus or an oral communication that contains a material misstatement or omits a material fact. In Rule 159, the SEC makes it clear that if the time of sale disclosure package does not meet the 12(a)(2) standards, "any information conveyed to the purchaser only after such time of sale (including contract of sale) must not be taken into account."

In the "plant blows up"-after-pricing scenario, because the MAC event occurs after the securities have priced and commitments been obtained based on then-complete and accurate disclosure, no rights to recovery under Section 12(a)(2) will arise for failure to disclose such event.

Likewise with Section 11. Section 11 imposes liability for any part of a registration statement, if, when such part became effective, it contained an untrue statement of a material fact or omitted to

state a material fact required to be stated therein or necessary to make the statements included not misleading.

Under Rule 430B, the effective date for a shelf registration statement for Section 11 liability purposes (for both the issuer and underwriter) is the earlier of the date it is first used or the date and time of the first contract of sale. Because in the "plant blows up"-after-pricing hypothetical, the MAC event occurred subsequent to the first contract of sale, the issuer and underwriters would not have liability under Section 11 for failure to disclose such event.

Contractual Rights of the Underwriters and Investors

Despite the lack of Section 11 or 12(a)(2) liability at the time of sale,[3] the issuer could not proceed to closing without disclosing the MAC event. Every standard underwriting agreement requires the issuer to deliver an officer's certificate stating that no MAC event has occurred since the pricing disclosures and to "bring down" its representations, including its representations regarding disclosure, at the time of closing.

In addition, the 10b-5 negative assurance letters, provided by issuer's and underwriters' counsel, are required to address the adequacy of the disclosure package delivered not just at the time of pricing, but also at closing. This process is designed to compel both the issuer and counsel to perform diligence to confirm that no MAC event has occurred, which is a condition to closing enumerated in virtually all underwriting agreements.

If a MAC event occurs after pricing and prior to closing, the underwriters will have two options. The first would be to terminate the transaction based on the inability of the issuer to satisfy the conditions to close in the underwriting agreement. Termination of the underwriting agreement will also result in the termination of the contracts between the underwriter and its customers due to the fact that such contracts are on a "when, as and if" issued basis.

The second option would be to proceed with closing after updating the disclosure documents and the underwriting agreement appropriately. In so doing, the underwriters will need to be sensitive to investors' reactions to the MAC event. It would be highly unlikely that any underwriter would proceed to closing without obtaining most investors' consent and without releasing the investors who fail to do so.

In our experience, no underwriter (nor any issuer that would regularly need to access the capital markets) would want to override investors who balk at accepting securities of an issuer that suffered a MAC event. If most investors are willing to proceed and, despite the MAC event, accept the original pricing, then closing could proceed as originally planned. Of course, investors may ask to be compensated for the MAC event. In such case, it will be up to the issuer and the underwriters to determine how and whether the issuance can be successfully repriced.

What's the Applicable Time?

If the transaction moves successfully toward closing, participants need to consider if the "applicable time" set forth in the underwriting agreement should be revised. Although liability

under Section 12(a)(2) is evaluated as of the time of sale to each investor, issuers and counsel prefer to give representations and opinions as of a particular time. As a result, the practice has developed to have the issuer and underwriters designate a specific, "applicable time" in the underwriting agreement at which certain disclosure representations and opinions are provided.

It is generally set after pricing, when underwriters are first in a position to begin to obtain investors' commitments. If the securities are repriced or commitments reconfirmed after the MAC event, it seems clear that the original applicable time needs to be updated.

In the case of a repricing, the new commitments to purchase (i.e., "time of sale") will not occur until the new price is established. As such, an applicable time should be chosen that closely approximates the time at which the first sales are made after the new disclosure has been conveyed to investors.

Even if a repricing is not necessary, we believe that it still is preferable to amend the applicable time. This formality will serve as evidence of the investors' reevaluation of the transaction in the light of revised disclosure package and, in effect, documents the highly unusual fact pattern (i.e., the reconfirmation process).

What to Consider

When faced with this scenario, some (but certainly not all) issues to consider are set out below:

1. Get the facts. The issuer, book-running managers and both sets of counsel (internal and external) should schedule a call so that the issuer can explain the situation directly to the group.

2. Make an initial determination as to whether the deal can proceed. There will most certainly have to be some sidebar conversations amongst deal team members to make this initial recommendation, and it will clearly be made on inadequate information (e.g., predicting investor reaction) — but time will be of the essence. If there is a possibility that the deal can be saved, a number of crucial decisions will need to be made promptly, as discussed further below. If the deal is dead, consider the methods by which to inform the market and investors (Form 8-K, press release, Bloomberg or some combination thereof).

3. Underwriters need to determine how many accounts committed to buy the securities. The greater the number of accounts, the more difficult the process becomes.

4. The issuer should prepare disclosure on the event. Because a MAC event is material, an Item 8.01 Form 8-K is probably the appropriate method of disclosure. Underwriters and their counsel (internal and external) need to review and be comfortable with the language.

5. Prepare a script. Counsel, underwriters and the issuer should prepare a script that sales agents will use to inform accounts of the MAC event. The script should stick to the facts and generally match the issuer's disclosure regarding the event.

6. Determine the amount of time needed to talk to accounts. Underwriters need to predict the amount of time that they will need to contact accounts and explain the situation.

7. Sequence the events that need to happen to close. Depending on the number of accounts, the time needed to contact them, when the Form 8-K can be filed and whether the securities will need to be repriced, settlement may need to be extended. If so, the billing-and-delivering bookrunner's back office will need to coordinate with the Depository Trust Co. and the trustee/transfer agent, as appropriate.

8. Contact the rating agencies. The reaction of the rating agencies could be critical in either an equity or fixed income transaction. Standard underwriting agreements will have a termination event upon the downgrade (or placing on credit watch) of an issuer's credit rating between pricing and closing. Furthermore, if debt is to be issued, the rating agencies will need to be informed of the event and confirm that the event will not impact the delivery of the ratings letters (with the original ratings) at closing.

9. Reg FD should not be an issue. In a registered takedown and/or if a Form 8-K is timely filed, FD should not be an issue. If the transaction is a 144A issuance, however, issuers will not have the Reg FD exemption available to shelf takedowns and will have to file a Form 8-K to avoid any Reg FD concerns.

10. Revise documents. Counsel need to determine which documents need to be amended to reflect new pricing terms, new "applicable time" or any other terms that have changed due to the post-pricing event.

11. Staff appropriately. If there are multiple bookrunners, underwriters' counsel should consider staffing its team appropriately with seasoned securities lawyers to ensure that internal counsel at each bookrunner is engaged and kept informed in a timely and accurate manner.

Conclusion

Although the 2005 updates to the securities laws placed a greater focus on the time of sale disclosure, the practical effect of the securities laws has not changed. When a material negative event occurs after pricing, investors will need to be given an opportunity to both digest the new information and decide whether to remain in the transaction, whether at the original or some modified price.

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[1] A material disclosure is one to which there is a substantial likelihood that a reasonable investor would attach importance in making an investment decision because the disclosure would significantly alter the "total mix" of available information. TSC Industries Inc., v. Northway Inc., 426 U.S. 438 (1976).

[2] See Reform Release, Section IV.A.2.

[3] In a 144A offering, Section 11 and Section 12 do not apply. But there would remain the same need for the issuer to correct its disclosure under the parallel provisions contained in Rule 144A purchase contracts.