Corporate Secrecy, the Federal Securities Laws, and the Disclosure of Ongoing Negotiations

CORPORATE SECRECY, THE FEDERAL SECURITIES LAWS, AND THE DISCLOSURE OF ONGOING NEGOTIATIONS

J. Robert Brown, Jr.*

Few disclosure issues cause more trepidation and anxiety among corporate officials than the disclosure of ongoing negotiations, whether negotiations over prospective sales contracts, acquisitions, mergers, or other material developments. Most major arms length agreements are preceded by a period of negotiations that typically take place behind a veil of secrecy. Disclosure is often delayed until an agreement has been reached. Corporate officials fear that premature disclosure may result in a competitive disadvantage or may jeopardize continuation of the negotiations.¹

The often legitimate corporate predilection for secrecy, however, cannot be viewed in isolation; it must be juxtaposed against the disclosure philosophy of the federal securities laws.² These laws dictate that, under certain

* Assistant Professor of Business Administration, Franklin & Marshall College; Counsel, Stevens & Lee; B.A. 1978, College of William & Mary; J.D. 1980, University of Maryland School of Law; M.A. 1984, Georgetown University; Law Clerk 1981-1982, Honorable Frank M. Johnson, Jr., United States Court of Appeals for the Eleventh Circuit; Attorney, Office of the General Counsel, Securities and Exchange Commission, Washington, D.C., 1984-86. The views expressed in this Article are those of the author and do not necessarily reflect the views of the author’s colleagues, including those on the staff of the Commission. The author would like to thank Sherry Stephen for her many hours of typing and Beth Blechman for her long-standing support that helped make this Article possible.


2. A principal purpose of the federal securities laws was to ensure that investors had sufficient information to make informed investment decisions. See S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 8 (1933) (“The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited.”); see also 78 cong. rec. 2931 (1933) (“The theory upon which [the 1933 Act] has been drawn is to give the public complete information as to the security offered for sale . . . .”) (statement of Rep. Wolverton). Articulated another way, the laws were meant “to substitute a philosophy of full disclosure for the philosophy of caveat emptor.” SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); accord, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).


No investor, no speculator, can safely buy and sell securities upon the exchanges
circumstances, the public be apprised of all material developments. The concept of materiality is sufficiently broad to encompass ongoing negotiations.3

The difficulty in reconciling the disclosure requirements of the federal securities laws with the corporate need for secrecy has caused much judicial consternation. Some courts have shown a marked hesitancy to impose liability for nondisclosure of ongoing negotiations, even where the federal securities laws seem to so dictate.4 Viewing disclosure as potentially harmful to

without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity.


4. In fairness, part of the judicial hesitancy to require disclosure of speculative information may have been a similar hesitancy evinced by the Securities and Exchange Commission. Historically, the Commission prohibited the use of speculative information such as projections and appraisals in agency filings. See Guidelines for the Release of Information, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192 (Aug. 16, 1971) (companies should avoid making projections, forecasts, or predictions in any prospectus). See also Walker v. Action Indus., 802 F.2d 703 (4th Cir. 1986), cert. denied, 55 U.S.L.W. 3512 (U.S. Jan. 27, 1987) (No. 86-860) (“Historically, the Securities and Exchange Commission (SEC) has discouraged the disclosure of financial projections and other ‘soft’ information such as asset appraisals . . . .”); Flynn v. Bass Bros. Enter., 744 F.2d 978, 985 (3d Cir. 1985) (“The reasons underpinning the SEC’s longstanding policy against disclosure of soft information stem from its concern about the reliability of appraisals, [and] its fear that investors might give greater credence to the appraisals or projections than would be warranted . . . .”); Resource Exploration v. Yankee Gas & Oil, Inc., 566 F. Supp. 54, 63 (N.D. Ohio 1983) (“The rationale for omitting such information is that it is apt to create more potential for misunderstanding than enlightenment.”).

Contrary to the interpretation of some courts, however, the Commission did not consider projections and appraisals inherently misleading. Instead, the agency was concerned primarily with the use of soft information in documents filed with the Commission. See Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. ¶ 79,211, at 82,666 (Feb. 2, 1973) (“It has been the Commission’s longstanding policy generally not to permit projections to be included in prospectuses and reports filed with the Commission.”). While the Commission does not and cannot pass on the merits of any prospectus or filing or otherwise attest to its accuracy, see the Securities Act of 1933, Pub. L. No. 73-22, § 23, 48 Stat. 74, 87, 15 U.S.C. § 77w (1982), the mere fact that a document is filed with the Commission may give it added weight in the eyes of shareholders. By prohibiting the use of soft information in filings, it appears that the Commission was not trying to deny shareholders access to the information, but was trying to avoid attributing to such speculative information the added weight that might accrue from its inclusion in a filing.

By the mid-1970s, the Commission reversed its long-standing position with respect to the
Corporate Secrecy

shareholders and stressing the corporate need for secrecy, several recent decisions have, under the rubric of materiality, sought to severely curtail the instances in which ongoing negotiations must be disclosed. These courts have held that, absent an "agreement in principle," ongoing negotiations are immaterial as a matter of law. Moreover, the term "agreement in principle" has been narrowly construed. In the context of a merger or a change in control, an "agreement in principle" exists only if the parties have agreed upon the share price and the post-merger corporate structure. The effect of these decisions is to impose a rigid, bright-line test for determining the materiality of ongoing negotiations.

These cases contain faulty analysis and overbroad dictum. The courts go to great lengths to stretch and contort the federal securities laws in order to avoid imposing liability for nondisclosure. Typically, these courts accept without challenge the contentions that disclosure of the negotiations will damage the negotiation process and mislead investors. Although propitious sounding, these arguments are often incorrect. Moreover, even where correct, they do not always justify nondisclosure. While few would gainsay at least the occasional need for secrecy, secrecy must nevertheless sometimes give way to the need for disclosure.

Judicial unanimity on the subject, however, does not exist; not all courts agree with the use of a bright-line test. Instead, some courts use an analysis that examines the materiality of the ongoing negotiations on a fact-intensive,


6. Heublein, 742 F.2d at 757.

7. See infra notes 195-232 and accompanying text.
case-by-case basis. These courts balance the magnitude of the prospective agreement against the probability that an agreement will result. Using this type of analysis, negotiations may be material long before an agreement in principle is reached.

The materiality of negotiations issue has come under intense scrutiny by the Securities and Exchange Commission ("Commission"), the federal agency primarily responsible for administering and enforcing the federal securities laws. Through enforcement actions and participation in cases as amicus curiae, the Commission has taken an increasingly resolute stance with respect to the appropriate test for determining the materiality of ongoing negotiations. Among other things, it has reaffirmed the probability/magnitude test and expressly rejected the conclusion that negotiations preceding an agreement in principle are immaterial as a matter of law.

Judicial and administrative treatment of ongoing negotiations has sown considerable confusion. Moreover, as discussed in this Article, the Supreme Court recently has agreed to decide the appropriate standard for determining materiality of ongoing negotiations. The sensitivity of negotiations, the uncertainties imposed on companies seeking to conform to the disclosure requirements of the federal securities laws, the more aggressive posture by the Commission, and the consideration by the Supreme Court, all suggest the need for a thorough examination of this issue, a task to be undertaken in this article.

I. DUTY TO DISCLOSE

Most of the cases to date discussing liability for nondisclosure of ongoing

9. See infra notes 125-237 and accompanying text.
12. See Michaels Memorandum, supra note 11, at 2 n.1; Levinson Brief, supra note 11.
negotiations have focused on the materiality of the negotiations.13 Yet even if negotiations are material, liability for nondisclosure is not automatic. Instead, liability will attach only if a duty to disclose exists. The mere fact that information is material does not of itself give rise to a duty to disclose. Despite the longing of some commentators14 and the isolated musings of particular courts,15 it no longer can be seriously argued that publicly traded companies are subject to a general duty to disclose all material developments.16 The halcyon days when the imposition of a general duty to disclose under rule 10b-517 seemed a "small step" away have ended.18 Courts have rejected that notion and, despite past hints to the contrary, the Commission appears to have conceded that no such duty exists.19 The imposition of a general duty to disclose must now await action by either the Commission or Congress.20

20. See Brown, Corporate Communications and the Federal Securities Laws, 53 GEO.
Notwithstanding the absence of a general duty, the federal securities laws do require affirmative disclosures in certain specified circumstances. Broad disclosure obligations are imposed under the antifraud provisions. In addition, the Commission has adopted a myriad of specific disclosure requirements, some of which expressly mandate disclosure of ongoing negotiations.

A. Antifraud Provisions

By prohibiting fraudulent misstatements, the antifraud provisions in the Securities Act of 193321 and the Securities Exchange Act of 193422 to a large degree ensure the accuracy and completeness of public statements or filings. Moreover, the antifraud provisions also prohibit certain persons from trading while in possession of material nonpublic information. Persons with information obtained as a result of their position as a corporate insider or information misappropriated in breach of a duty of trust and confidentiality cannot trade until the information has been disclosed and disseminated to the market.24 The antifraud provisions, therefore, do not require informational parity, but rather focus upon informational disparities that are inherently unfair.

Under the antifraud provisions, companies are subject to a duty to disclose material developments in these general circumstances. First, under the duty to “disclose or abstain,”25 trading while in possession of material non-
public information is prohibited unless the information is first disclosed and disseminated to the market. As a result, whenever material negotiations are taking place, neither corporate insiders nor the issuer may trade in the securities of that company until the negotiations have been made public and the market has had sufficient time to react. Since the duty to disclose or abstain is triggered by a purchase or sale, the definition of these terms is critical. Courts have construed the terms expansively, defining them to include transactions not usually considered to be a purchase or sale.

A duty to disclose under the antifraud provisions also exists when necessary to prevent a statement, in light of the circumstances under which it is made from being so incomplete as to be misleading. As one court explained, "The disclose or abstain rule is derived from an interpretation of the antifraud rules, particularly rule 10b-5. The Commission's classic articulation of the principle appears in In re Cady Roberts, 40 S.E.C. 907 (1961)."

26. Under the principle of "disclose or abstain," the duty to disclose exists as long as the person to whom the duty is owed retains some investment discretion over whether to consummate the purchase or sale. The duty ceases once the parties to the transaction are committed "in the classical contracting sense." Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890-91 (2d Cir. 1972). In at least one case, a court found that the duty continued for almost a two year period. See Grigsby v. CMI Corp., 590 F. Supp. 826 (N.D. Cal. 1984), aff'd, 765 F.2d 1369 (9th Cir. 1985). There, plaintiffs executed contracts in 1980 to sell their shares in a subsidiary of defendant, CMI Corporation. Before closing the sale, CMI sued for rescission. The parties ultimately settled the case in 1982. The district court held, and the Ninth Circuit agreed, that the duty to disclose on the part of CMI continued through the 1982 settlement. Until then, plaintiffs had the option of confessing judgment and rescinding the agreements, "an option they could have exercised on the basis of information disclosed in 1982." Id. at 831; see Trecker v. Scag, 679 F.2d 703 (7th Cir. 1982).

27. See Rathborne v. Rathborne, 683 F.2d 914, 920 (5th Cir. 1982) ("This court has consistently held that a statutory purchase or sale for the purposes of rule 10b-5 may in some cases encompass transactions that bear little resemblance to conventional common law purchases and sales."); Alley v. Miramon, 614 F.2d 1372, 1380 (5th Cir. 1980) ("Courts applying section 10(b) and rule 10b-5 have defined 'sale' broadly so as to extend the panoply of the 1934 Act to those who may not be sellers in the common law sense.").


Moreover, under the "buried facts" doctrine, a filing may disclose all material information but still be misleading if important information is not sufficiently highlighted. See, e.g., Gould
plained: "A duty to speak the full truth arises when a defendant undertakes to say anything." Avoiding an incomplete disclosure may sometimes require affirmative disclosures, including the disclosure of ongoing negotiations. Once disclosure occurs, obligations to ensure the continued accuracy of the statements may also arise. Courts have held that a duty exists to correct "alive" statements that become misleading, a duty which may sometimes necessitate additional affirmative disclosures.

Finally, a duty to disclose may arise where material information is disclosed to select individuals who trade on the basis of the information or tip the information to others who trade. Under these circumstances, an issuer may have a duty to disclose the information to the market as a whole. This duty arises, for example, whenever news about material corporate developments has leaked to the person in the marketplace and that leak can be traced to the issuer. Unusual activity in a company's stock at the same time material undisclosed developments are taking place may provide constructive notice that persons inside the issuer have leaked material nonpublic

v. American-Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603 (5th Cir. 1974); see also Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1297 (2d Cir. 1973) ("While 'corporations are not required to address their stockholders as if they were children in kindergarten,' it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts.") (quoting Richard v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967)).

The Commission recently brought an administrative proceeding against B.F. Goodrich for disclosures that, while arguably accurate as a factual matter, were materially incomplete and, therefore, misleading. See In re B.F. Goodrich, Exchange Act Release No. 22,792, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,958 (Jan. 15, 1986). Goodrich disclosed in a press release that it had repurchased over 1 million shares for, among other things, use in funding employee benefit plans. A similar disclosure was made in Commission filings, including an annual report filed on form 10-K and a proxy statement. Goodrich failed to mention, however, that the shares were repurchased from Carl Icahn, a noted greenmailer, at a substantial (25%) premium. The Commission concluded that omission of the amount of the premium and of the identity of the seller violated rules governing disclosures in form 10-K's and proxy statements. Id. See also Vartain, S.E.C. Signal on "Greenmail," N.Y. Times, Jan. 23, 1986, at D8, col. 1.


information to select individuals, thereby triggering an affirmative duty on the part of the issuer to make disclosures to the entire market.

The antifraud provisions, therefore, may sometimes compel disclosure of ongoing negotiations. When material negotiations are taking place, disclosure will normally be a precondition to any trading by insiders. Further, disclosure is required if a public statement would otherwise be misleading but for mention of the negotiations. For example, a statement by the target company about the yield of corporate debt instruments designed to promote the bonds as investments may be misleading absent disclosure of the merger negotiations; negotiations that if successful may cause a material drop in the value of the debt. Likewise, denial of negotiations while negotiations are underway will also be misleading. Finally, a loosely worded statement that negotiations are not taking place might continue to be considered “alive,” at least for a short time after issuance, and need to be updated or corrected once negotiations commence.

B. Commission Filing Requirements: Line Item Disclosures

Pursuant to rulemaking authority, the Commission has adopted broad line item disclosure requirements that require the disclosure of specified information under certain circumstances. Unlike the antifraud provisions,
the line item disclosure requirements imposed by the Commission are intended to provide a certain degree of informational parity among investors. These requirements essentially insure that all investors have certain specified information deemed necessary for informed decisionmaking, such as whether to buy or sell securities, execute a proxy, or tender in response to a tender offer. Of course, individual investors do not always read or comprehend the often arcane and technical jargon that appears in Commission filings. Nonetheless, the information is normally highly relevant to analysts and sophisticated investors and, in an efficient market, will be reflected in the price of a company's shares.

The securities laws provide the Commission with exceedingly broad, almost plenary, authority to impose affirmative disclosure requirements. Under the Securities Act, companies issuing securities registered are subject to substantial disclosure requirements. Similarly, under the Exchange Act, publicly traded companies generally must file annual reports, quarterly reports, and current reports reflecting certain material developments. In addition, substantial disclosure requirements attach in connection with the solicitation of proxies, the acquisition of more than five percent of the

forth in TSC Indus. v. Northway, Inc., 426 U.S. 449 (1976), see infra note 100, an argument can be made that because investors have an expectation of receiving the information, its omission would be material.


38. Current reports on form 8-K must be filed within 15 days after the occurrence of certain specified events. 17 C.F.R. §§ 240.13a-11, 240.15d-11, 249.308a (1986). These events are (1) a change in control of the registrant, (2) the acquisition or disposition of a significant amount of assets, other than in the ordinary course of business, (3) bankruptcy or receivership, (4) changes in the registrant's certifying accountant, and (5) under certain circumstances, resignation of the registrant's directors. In addition, item 5 of form 8-K requires a company to report any other event or development "of material importance to security holders." See Item 5, Form 8-K.

Corporate Secrecy

stock of a publicly traded company, and tender offers. The contents of the documents disclosing this information are carefully specified by the Commission.

The Commission has adopted a number of line items that expressly call for the disclosure of negotiations. In general, they arise in the context of a change of control. This information is generally deemed necessary to enable shareholders to make informed investment decisions about whether to tender their shares or approve a merger or leveraged buy-out. Such Commission-imposed disclosure requirements include:

**Item 3(b), Schedule 14D-1.** Bidders making a tender offer for publicly traded companies must make certain disclosures on Schedule 14D-1. Item 3(b) of the Schedule expressly requires disclosure of any "contacts, negotiations or transactions" between the target and bidder concerning a "merger, consolidation or acquisition; a tender offer or other acquisition of securities; an election of directors; or a sale or other transfer of a material amount of assets." In adopting this disclosure requirement, the Commission noted which directors are to be elected must be accompanied or preceded by an annual report. 17 C.F.R. § 240.14a-3(b) (1986); see also Ash v. GAF Corp., 723 F.2d 1090, 1094 (3d Cir. 1983) (annual report was sent by third class mail four days before proxy).

40. A statement containing the information required in a Schedule 13D must be filed with the Commission and delivered to the issuer within 10 business days of the acquisition of shares of any class of outstanding equity securities of a publicly traded company if, following the acquisition, the purchaser beneficially owns greater than 5% of the outstanding shares. 15 U.S.C. § 78m(d) (1982); 17 C.F.R. § 240.13d-1 (1986). In some instances, large shareholders may be eligible for the reduced disclosure requirements contained in Schedule 13G. See rule 13d-1(c), 17 C.F.R. § 240.13d-1(c) (1986); see also § 13(f), 15 U.S.C. § 78m(f) (1982) (requiring certain institutional investment managers to file reports disclosing share ownership within 45 days of the end of the calendar year).

41. A company making a tender offer for a publicly traded company must file a statement containing the information required in a Schedule 14D-1 as soon as practicable after the date of the offer. 17 C.F.R. § 240.14d-3(a) (1986); see Schedule 14D-1, 17 C.F.R. § 240.14d-100 (1986); see also infra note 43.


43. 17 C.F.R. § 240.14d-3(a) (1986). A Schedule 14D-1 need be filed only where the tender offer is for a class of equity securities described in § 14(d)(1) of the Williams Act. 17 C.F.R. § 14d-1(a) (1986). Section 14(d)(1) extends to any class of any equity security which is registered pursuant to section 78f of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78f(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940. . . .


44. Item 3(b), Schedule 14D-1; 17 C.F.R. § 240.14d-100 (1986) (special instructions for complying with Schedule 14D-1). In adopting this requirement, the Commission stated that
that the item "was intended to provide security holders with more meaningful disclosure concerning certain material events occurring prior to the tender offer which can have a material effect on a shareholder's investment decision concerning the tender offer."45

Item 3, Schedule 13E-3. An issuer or affiliate engaging in a "going private" transaction must file a Schedule 13E-3.46 If the Schedule is filed by an affiliate of the issuer, Item 3 of the Schedule requires disclosure of "any contacts, negotiations, or transactions" between the issuer and the subsidiary concerning a merger, consolidation, or acquisition; a tender offer for or other acquisition of securities of any class of the issuer; an election of directors of the issuer; or a sale or other transfer of a material amount of assets of the issuer or any of its subsidiaries.47 Disclosure must also be made of any contacts or negotiations concerning such transactions between affiliates of the issuer and between the issuer (or its affiliates) and any nonaffiliated person.

Item 3 recognized that a tender offer may not be an isolated event in the corporate histories of the bidder and the subject company. Disclosure concerning certain events which occurred, either directly or indirectly, between these parties in the recent past is material to an investment decision by a security holder in the context of a tender offer.


45. Tender Offers—Notice of Proposed Rules and Schedules, Exchange Act Release No. 12,676, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,659(III)(J), at 86,701 (Aug. 2, 1976) (proposing item 3 of Schedule 14D-1). The Commission did not adopt item 3 as originally proposed, but instead attempted to narrow the disclosure requirements. As the Commission indicated in the adopting release, "[t]he scope of the persons affected . . . by Item 3(b) was more precisely defined and the types of events within the purview of that sub-item was modified." Filing and Disclosure Requirements Relating to Tender Offer, supra note 44. The Commission further explained that:

The changes in item 3 were intended to reduce, to the extent feasible, the burden placed on the bidder by such disclosure, while at the same time furnishing sufficient information concerning past contacts, negotiations and transactions to the shareholders of the subject company to assist them in making an informed investment decision.

Id.


47. Item 3(b), Schedule 13E-3; 17 C.F.R. § 240.13e-100 (1986) (general instructions for filing Schedule 13E-3). The proposing and adopting releases contain little insightful discussion of the requirements. In the proposing release, the Commission noted only that:

The disclosure that would be required by proposed Item 3 would pertain to contacts, negotiations or transactions which occurred since the commencement of the issuer's third full fiscal year preceding the date of the initial filing of this schedule by the issuer or affiliate engaging in the rule 13e-3 transaction.

that would have a direct interest in the matters. The identity of the person that initiated the contacts or negotiations must also be disclosed.

Item 6, Form S-4 and Form F-4. With respect to certain mergers and other business combinations, a registration statement must be filed on Form S-4 or, in the case of a foreign registrant, on Form F-4.\textsuperscript{48} Item 6 of both forms requires disclosure of certain negotiations. Specifically, disclosure must be made of “any past, present or proposed material contracts, negotiations, transactions or similar contacts between the registrant and the company being acquired.”\textsuperscript{49} As the Commission noted in the adopting release, Item 6 “is designed to elicit information about: (1) possible conflicts of interest and (2) facts relating to transactions such as pretakeover transactions or purchases by the registrant of significant blocks of the securities of the company being acquired.”\textsuperscript{50}

Item 504, Regulation S-K. Issuers filing registration statements under the Securities Act generally must conform to the requirements of Item 504 of Regulation S-K.\textsuperscript{51} Under Item 504, registrants must disclose the purposed use of the funds from the sale of securities. In the event that the registrant intends to use such funds to acquire another business, disclosure must be made of the identity of the business and must include a description of the “status of any negotiations” with that business.\textsuperscript{52}

Item 7, Schedule 14D-9. Item 7 of Schedule 14D-9\textsuperscript{53} is the only line item requiring the disclosure of negotiations to generate an appreciable amount of interpretative lore and case law. Following a tender offer, the management of a target company normally recommends to its shareholders whether to accept or reject the offer. The recommendation must be made on a Schedule

\textsuperscript{48} Item 6, form S-4; 17 C.F.R. § 239.25 (1986); Item 6, form F-4, 17 C.F.R. § 239.34 (1986) (registration form for business combinations by foreign registrants).
\textsuperscript{50} Id. In proposing item 6, the Commission noted that “[t]he proposed item is substantially similar to information required by the Commission’s tender offer rules.” Business Combination Transactions—Proposed New Registration Form, Exchange Act Release No. 20,944, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,627, at 86,840 (May 24, 1984). Interestingly, merger proxy statements are not subject to the same disclosure requirements. Although a merger proxy must disclose substantial information about the merger, the instructions do not expressly require disclosure of either past negotiations between the merging companies or negotiations with other possible merger candidates. See item 14, Schedule 14A, 17 C.F.R. § 240.14a-101 (1986) (information required in Schedule 14A proxy statement).
\textsuperscript{51} 17 C.F.R. § 229.504 (1986). Registration statements filed on forms S-1, S-2, S-3, and S-18 must include a response to item 504 of Regulation S-K.
Item 7 of the Schedule requires disclosure of "any negotiation . . . being undertaken or underway . . . in response to the tender offer," if the negotiations relate to certain extraordinary events such as a merger reorganization, the purchase, sale or transfer of a material amount of assets, a tender offer, or a material change in the existing capitalization or dividend policy. In addition, the Schedule must be amended "promptly" in the event of material changes, effectively requiring management of the target to continually update the Schedule. The commencement of negotiations constitutes a material development that must be disclosed in an amendment.

As originally proposed, Item 7 called for a description of "any negotiation or transaction being undertaken" concerning certain extraordinary events. In proposing the requirement, the Commission explained that "[e]fforts by the subject company such as those described in proposed Item 7 can have a determinative effect on the outcome of a tender offer and therefore are material to a security holder who is faced with making an investment decision by a tender offer." Following the proposal, some commentators complained that the disclosure of ongoing negotiations might, in certain circumstances,
chill the bidding process and dissuade competing offers.59

Concluding that the "major developments referred to in item 7 can be one of the most material items of information received by security holders,"60 the Commission decided to retain the disclosure of ongoing negotiations. Nevertheless, reflecting the concern of commentators, the Commission indicated in adopting the disclosure requirement that companies could, under certain circumstances, withhold information concerning the identity of the parties to the negotiations or the terms under discussion. Under Item 7, a company may withhold the identity of the other party and the terms under discussion "[i]f no agreement in principle has yet been reached" and "in the opinion of the Board of Directors [of the target] such disclosure would jeopardize continuation of the negotiations."61 Nonetheless, even under these circumstances, the target company must disclose that "negotiations are be-


The proposal was criticized by commentators who were concerned that it would elicit premature disclosure of negotiations with competing bidders which could dissuade them from making an offer. Commentators argued that security holders would be prevented from obtaining the highest price for their securities. In addition, concern was expressed that such disclosure may, either innocently or fraudulently, induce security holders to reject a tender offer on the basis of an unjustified inference that a competing bid is imminent.

The Commission recognizes that premature disclosure of the matters contemplated by the proposal may be detrimental to the interests of security holders. The effective representation of the interests of security holders may at times require management to maintain confidentiality during the formative stages of negotiations.

Id. at 82,594.

60. Id.

61. Instruction to item 7, supra note 55. As the Commission explained in the release adopting item 7:

While the proposal would have required the subject company to describe negotiations in response to a tender offer which related to or would result in the specified events, new Item 7(a) requires a statement as to whether negotiations are being undertaken or are underway with respect to such events without requiring detailed disclosure. An instruction has also been added to Item 7(a) which clarifies the extent of the disclosure required with respect to negotiations. The instruction provides that, if an agreement in principle has not been reached, the possible terms of any transaction or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuation of such negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient. Thus, security holders will be apprised that such negotiations are being held without the subject company's having to furnish disclosure discouraging further negotiations. . . . It should be noted that Item 7 is not exclusive. Thus, in a particular case, requirements such as those imposed by Section 14(e) of the Act may dictate the disclosure comprehended by either paragraphs (a) or (b) of Item 7 at an earlier time or in greater detail than contemplated by the item.

ing undertaken or are underway and are in the preliminary stages." 62

Until recently, Item 7 represented a relatively dormant provision, generating little case law. The Commission had brought only a few injunctive enforcement proceedings under the provision, none of which contained any significant discussion of Item 7. 63 A pair of private actions were slightly more illuminating. In Gulf Corp. v. Mesa Petroleum Corp., 64 Gulf Oil Company vigorously resisted efforts by Mesa Petroleum Company to acquire the company. Following a tender offer by Mesa, Gulf had filed a Schedule 14D-9 recommending that its shareholders reject the offer and disclosing that its legal and financial advisors had been authorized to "explore all alternatives." 65 The Schedule did not reveal that Atlantic Richfield Co. (ARCO) had contacted Gulf over a possible business combination in the inevitable litigation arising from the attempted acquisition. Mesa contended that Gulf violated Item 7 by omitting the contacts with ARCO from the Schedule.

The district court acknowledged that contacts between the two companies had occurred. In the period immediately preceding Mesa's offer, ARCO had expressed interest in a possible merger with Gulf. Gulf initially informed ARCO that it had no interest in the proposal. Subsequently, however, Gulf became more amenable to the proposition but indicated that any merger would require detailed discussions. No such discussions or negotiations, however, had ever taken place. The district court concluded that, from the time of Mesa's offer through Gulf's filing of the Schedule 14D-9, nothing occurred that "could accurately be described as negotiation." 66 Moreover, even if negotiations could be said to have occurred, the discussions commenced prior to the Mesa offer and were not "in response" to the tender

62. Instruction to item 7, supra note 55.
63. See SEC v. Grumman Corp., Civ. Act. No. 81-3685, slip op. (E.D.N.Y. June 18, 1984) (concluding that failure to disclose merger negotiations violates rule 14d-9 notwithstanding defendant's protestations that the "discussions . . . were preliminary and inconclusive and not reportable under Schedule 14D-9."); In re Heights Fin. Corp., Exchange Act Release No. 20,354, 29 SEC Docket 106 (Nov. 7, 1983). In Heights, the Commission made an oblique reference to the failure of Heights to disclose, in a Schedule 14D-9, negotiations with a third party for a right of first refusal to the exercise of warrants for its stock. The release did not state that the nondisclosure actually violated the requirements in item 7, but simply noted that "[n]egotiations . . . of this kind are required to be disclosed in filings on schedule 14D-9 . . . if entered into in response to a tender offer." Id. at 107 n.1. Based upon the facts set forth in the release, an argument could be made that disclosure was not required. Discussion over the right of first refusal commenced in the fall of 1982, months before the January 1983 tender offer. Id. Thus, while negotiations were ongoing during the pendency of the tender offer, they do not appear to have been commenced "in response to" the offer and would, therefore, not seem to be subject to disclosure in item 7. See infra note 67.
65. Id. at 1115.
66. Id. at 1119.
offer.67

The breadth of Item 7 again arose in Starkman v. Marathon Oil Co.68 Following an unfriendly tender offer by Mobile Corporation, Marathon Oil Company filed a Schedule 14D-9 recommending that shareholders oppose the offer. The Schedule also disclosed that the board had considered "exploring and investigating" a number of possible responses to the tender offer, including "a business combination between [Marathon] and another company."69 At the time Marathon filed the Schedule 14D-9, however, the company had done more than just consider the possibility of a business combination. It had contacted thirty to thirty-five companies in an effort to locate a "white knight" and had in fact commenced negotiations with U.S. Steel. Approximately one week after Marathon filed the Schedule, U.S. Steel announced an agreement to acquire Marathon.70

Plaintiffs, representing the class of Marathon shareholders that sold shares after the filing of the Schedule 14D-9 but before announcement of the agreement to merge, brought suit alleging that Marathon had violated the antifraud provisions by not disclosing the negotiations with U.S. Steel. In determining the level of disclosure required under the antifraud provisions, the Sixth Circuit looked to the requirements of Item 7. Relying in part upon what it perceived to be Commission policy, the court held that Marathon's disclosure in Item 7 of the Schedule 14D-9, of the possibility of a merger or other business combination was adequate for purposes of the antifraud pro-

67. Id. Item 7 only requires the disclosure of negotiations that occurred "in response to" a tender offer. Neither the rule nor the proposing and adopting releases define the phrase. As a result, a number of interpretive issues may arise. First, an argument can be made that negotiations will be "in response to" a tender offer only if commenced after an offer has actually been made. Thus, negotiations commenced in anticipation of an offer would not be subject to disclosure. Alternatively, the phrase "in response to" may require disclosure of any negotiations commenced after the target becomes aware that a tender offer will be made, even though no offer has actually gone forward. Thus, for example, once a bidder communicates to the target its intent to make an offer by a certain date, any negotiations commenced thereafter would be "in response to" an offer and subject to disclosure.

Requiring the disclosure of negotiations commenced before a tender offer actually occurs may create some uncertainty. It will require analysis of whether the target knew or should have known that an offer was about to occur. Conceivably, negotiations commenced after a target was placed on notice of the bidder's intent to acquire control by the bidder's public statements would be treated as "in response to" a tender offer for purposes of item 7. A target could, therefore, have a duty to disclose negotiations anytime it becomes aware that the bidder has taken a "substantial step" towards a tender offer. See rule 14e-3, 17 C.F.R. 240.14e-3 (prohibiting trading by persons aware that the bidder has taken a "substantial step" toward a tender offer).

68. 772 F.2d 231 (6th Cir. 1985), cert. denied, 106 S. Ct. 1195 (1986).
69. Id. at 236.
70. Id. at 237.
visions.\footnote{71} As the Sixth Circuit concluded:

The SEC and the courts have enunciated a firm rule regarding a tender offer target's duty to disclose ongoing negotiations: so long as merger or acquisition discussions are preliminary, general disclosure of the fact that such alternatives are being considered will suffice to adequately inform shareholders; a duty to disclose the possible terms of any transaction... arises only after an agreement in principle, regarding such fundamental terms as price and structure, has been reached.\footnote{72}

Because the disclosure was considered sufficient for purposes of Item 7, it was considered sufficient for purposes of the antifraud provisions.

The court's reasoning, however, suffers from a number of weaknesses. First, the court's conclusion does violence to the plain language of Item 7, which explicitly requires the affirmative disclosure of negotiations commenced in response to a tender offer. The U.S. Steel/Marathon negotiations were "in response" to an offer; Mobil's bid apparently acted as the direct catalyst for the negotiations. Given the affirmative disclosure obligations, a laundry list of possible alternatives or actions was simply inadequate.

Second, in interpreting the provision, the court mischaracterized the Commission's position. The Commission had never indicated that a list of alternatives would suffice when actual negotiations were taking place. Indeed, while purporting to provide the Commission's views, the court cited no Commission pronouncements. The \textit{Starkman} court never cited or examined the proposing and adopting releases for Item 7. Rather, it cited only three inapposite cases decided \textit{after} the adoption of Item 7. These cases addressed the materiality of negotiations under the antifraud provisions, not the disclosure requirements of Item 7.\footnote{73} The court's failure to examine the proposing and adopting releases is particularly striking since the meaning of Item 7 is first and foremost a question of statutory construction. Had the court undertaken such an examination, it would have been clear that Marathon had a duty to disclose the existence of the negotiations and that a laundry list of potential alternative courses of action was insufficient.

The instructions to Item 7 did allow Marathon some discretion to withhold both U.S. Steel's identity and the terms under discussion. However, omission of these facts was predicated upon a finding by the target's board of

\footnotesize{\begin{itemize}
\item 71. \textit{Id.} at 243.
\item 72. \textit{Id.}
\item 73. The court cited Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), \textit{cert. denied}, 105 S. Ct. 1189 (1985); Reiss v. Pan Am. World Airways, Inc., 711 F.2d 11 (2d Cir. 1983); Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982). In all of these cases the courts determined the materiality of negotiations for purposes of the antifraud provisions.
\end{itemize}}
directors that such disclosure would jeopardize continuation of the negotiations. Nothing in the opinion suggests either that the board made such a finding or that disclosure would have caused the requisite harm. Indeed, an argument could be made that disclosure would have benefited shareholders.\footnote{4} Even had such findings been made, however, Item 7 mandated disclosure that negotiations were taking place, something Marathon failed to do.\footnote{5}

Following the \textit{Starkman} decision, the Commission issued an order in an administrative proceeding implicitly rejecting the Sixth Circuit's reasoning.\footnote{6} The proceeding arose out of the fiercely fought takeover contest between Revlon and Pantry Pride. In August 1985, Pantry Pride made an any-and-all tender offer for Revlon, offering $47.50 per share of common stock. Revlon's management filed a Schedule 14D-9 opposing the offer. In response to Item 7 of the Schedule, the company stated that it "may undertake negotiations" but that currently "no negotiations have been undertaken with third parties."\footnote{7}

In September, following an announcement that Revlon intended to repurchase ten million shares, Pantry Pride withdrew its initial offer and announced a new offer at $42 per share, contingent upon ninety percent of the outstanding shares being tendered. On September 24, Revlon's management issued a second Schedule 14D-9, again opposing the offer. In response to Item 7, the Schedule 14D-9 for a second time revealed that Revlon "may undertake negotiations,"\footnote{8} Revlon, however, omitted the statement contained in the earlier filing that no negotiations were currently taking place.

\footnote{74. Additional disclosure may have enticed other white knights to enter the fray. Additional competition among bidders for a target inevitably inures to the benefit of shareholders. \textit{See infra} note 217.}

\footnote{75. In general, the Commission has explicitly required the disclosure of negotiations in filings associated with a change of control. Yet, as noted, issuers and affiliates making an issuer tender offer and companies filing a merger proxy are not expressly required to disclose ongoing negotiations. \textit{See supra} note 50. Nor is such disclosure expressly mandated in a Schedule 13D. Item 4 of Schedule 13D requires disclosure of the purpose of acquisition of the shares and any plan or proposal concerning the target. Item 6 mandates disclosure of "any contracts, arrangements, understandings or relationships." Neither, however, expressly mention negotiations. \textit{See} \textit{17 C.F.R.} \$ 240.13d-101 (1986). The existence of ongoing negotiations relating to the target would seem to be highly relevant both to shareholders and to the market in assessing the significance of a Schedule 13D filing.}


\footnote{78. \textit{Revlon}, \textit{[Current]} Fed. Sec. L. Rep. at 88,144.}
Eight days later, on October 2, Revlon disclosed in a press release that it was considering a number of alternatives to the Pantry Pride offer, including a leveraged buy-out. The following day, Revlon amended the Schedule 14D-9 to reveal a definitive merger agreement with Forstmann Little & Company, a firm specializing in leveraged buy-outs, and a sale of its domestic beauty group to Adler & Shaykin. Undaunted by the announcement, Pantry Pride increased its offering price and, after a critical court victory, ultimately succeeded in acquiring control of Revlon.79

The Commission brought an administrative action against Revlon contending that Revlon had failed promptly to amend the Schedule 14D-9 once negotiations with Forstmann Little and Adler & Shaykin had commenced. The Commission found that negotiations among Revlon, Adler & Shaykin, and Forstmann Little had begun “as of the time period from the evening of September 26 to September 29.”80 As the Commission concluded, by September 26, the parties had established contact, had begun and concluded their initial reviews of confidential financial information, had retained counsel to discuss between and among themselves the structure and timing of the acquisitions, and had discussed the percentage of equity to be offered [Revlon's CEO] and the Revlon management group. Shaykin presented an offer to Revlon, Lazard and Forstmann Little on September 29 which, although rejected, became the basis upon which the parties negotiated, including discussions that night and the next day among counsel for the parties over the structure of the Shaykin proposal and the Forstmann Little LBO.81

Because the commencement of negotiations constituted a material change in circumstances, Revlon was required to promptly amend the Schedule 14D-

79. Pantry Pride succeeded after the Delaware Supreme Court reversed a decision by the chancery court invalidating certain lock-up options issued by Revlon to Fortsmann Little. See MacAndrews & Forbes Holdings, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,357 (Del. Ct. Nov. 1, 1985). In part, Pantry Pride’s efforts to acquire Revlon acted as a catalyst for the Federal Reserve Board’s decision to issue an interpretative ruling concerning the use of high yield debt instruments, more commonly called “junk bonds,” to finance a tender offer. Pantry Pride had originally intended to fund the acquisition of Revlon through a combination of junk bonds and bank loans. Revlon filed a petition with the Federal Reserve Board asserting that Pantry Pride’s financing package did not conform with the margin requirements contained in Regulation 6, 12 C.F.R. § 207 (1986). The Federal Reserve Board never acted on the petition, see 51 Fed. Reg. 1771 (1986), but did issue an interpretation of the margin requirements, concluding that “debt securities, issued by [a shell corporation] to finance the acquisition of [the] margin stock of a target company, are indirectly secured by [the] margin stock” for purposes of the restrictions on lending in the margin regulation. Id.
81. Id. at 88,147.
Although Revlon had amended the Schedule on October 3, the Commission concluded that, under the particular facts of the case, i.e., a fast moving, fiercely contested tender offer in a highly sensitized market, the amendment was not prompt. Instead, "Revlon should have disseminated the information [about the negotiations] at least before the market opened on September 30 and simultaneously amended its Schedule 14D-9 . . .".

While the reasoning in Revlon is somewhat terse, two important conclusions can be gleaned from the Commission's opinion. First, in contrast to the Sixth Circuit's reasoning in Starkman, the Commission implicitly concluded that ongoing negotiations had to be expressly disclosed in Item 7; a laundry list of possible actions would not suffice. Thus, consistent with the antifraud provisions, negotiations could become subject to disclosure in the Schedule before an agreement in principle is reached.

Second, the Commission clarified the definition of "prompt" for purposes of amending the Schedule. The Revlon release emphasized that, in filing an amendment, consideration had to be given to "the market's sensitivity to the particular change of fact triggering the obligation to amend, and the effect on the market of the filing person's previous disclosures." Given the fierceness of the contest for control and the sensitivity of the market, an amendment was required as soon as practicable. In Revlon's case, "as soon as practicable" meant three days after negotiations commenced and less than a day after one of the parties made an offer.

Although adding teeth to the disclosure requirements in Item 7, portions of the Commission's opinion seem inconsistent with the instructions to the Schedule. In connection with Pantry Pride's first and second offers, Revlon's board determined that, in connection with negotiations with other prospective bidders, disclosure of either the terms under discussion or the identity of the other parties would jeopardize continuation of the negotiations. As a result, in both the first and second Schedule 14D-9, Revlon indicated that even if negotiations commenced, the terms and identities would

not be disclosed until an agreement in principle had been reached.  

While the instructions to the Schedule permit companies to withhold information about terms and identity upon a determination by the board that disclosure will jeopardize the negotiations, the determination by the Revlon board was made in the abstract. At the time of its determination, no negotiations were underway. This interpretation allows a company's board to make a generic determination that disclosure of terms and identities before negotiations commence will jeopardize their continuation. Avoiding disclosure in this way appears inconsistent with the instruction to Item 7. As noted in the release adopting the Schedule, Item 7(a) and the instruction represented an attempt to balance the shareholders' need for information against the subject company's continued need for secrecy. Determinations that negotiations will be jeopardized by disclosure before negotiations commence assumes that disclosure will always be harmful. Item 7, however, appears to contemplate circumstances in which such disclosure will not be harmful. Thus, the determination of harm normally would need to be made on a case-by-case basis, once negotiations have commenced or at least appear imminent. Absent extenuating circumstances then, Item 7 does not appear to permit the type of generic finding of harm made by the Revlon board prior to the commencement of negotiations. Nevertheless, the order in Revlon seems to have accepted the board's determination of possible harm in the abstract.

C. Commission Requirements: Other Material Information

In addition to specific line item disclosure requirements, Commission rules contain a catch-all provision that requires the inclusion in filings of any additional information "necessary to make the required statements, in light of the circumstances under which they are made, not misleading." Thus,

87. Id.
88. See supra notes 57-62 and accompanying text.
89. As the Commission concluded: Compliance by Revlon with Rule 14d-9(b) required the filing of an amendment and the public dissemination of information disclosing the fact that negotiations were underway and were in preliminary stages (but not the terms of the possible transactions or the parties thereto) as soon as practicable after negotiations had commenced. Revlon, [Current] Fed. Sec. L. Rep. at 88,147 (emphasis added).
90. 17 C.F.R. § 230.408; 17 C.F.R. § 240.12b-20 (1985); see 17 C.F.R. § 240.14a-9 (1985) (prohibiting solicitations with proxy material that omit "any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communications . . . which has become false or misleading."). The Commission has defined "material" under the 1933 and 1934 Acts as information "to which there is a substantial likelihood that a reasonable investor would attach importance." 17 C.F.R.
even where no line item specifically requires disclosure, Commission filings
may still, under some circumstances, need to include a discussion of ongoing
negotiations if a filing would otherwise be misleading absent disclosure.

For example, a merger proxy showing assets at book value may be consid-
ered misleading if negotiations concerning the sale of assets show that they
have appreciated substantially. In *Gerstle v. Gamble-Skogmo, Inc.*,91 General Outdoor Advertising Company had entered into negotiations for the
sale of several plants and had received a number of “firm offers” at prices
substantially more than book value. A merger proxy filed by General Out-
door disclosed the book value of the assets but omitted information relating
to their appreciated value. Noting that the securities laws imposed no duty
to disclose asset appraisals, the Second Circuit acknowledged that negotia-
tions and “ ‘firm offers’ [to acquire plants] may well stand differently.”92
Disclosure of the firm offers would have indicated to shareholders that the
book value of the plants was a substantial underestimation of their true fair
market value.93

Similarly, in *Friedlander v. Barnes*,94 Dorchester Gas Corporation’s man-
agement, although considering a possible leveraged buy-out,95 issued a proxy
statement disclaiming “knowledge at the present time of any specific effort to
accumulate the Company’s securities or to obtain control of the com-
pany.”96 Ten days later, the company issued a press release acknowledging
that a private company was considering the acquisition of Dorchester
through a leveraged buy-out and that discussions had taken place with
Dorchester’s management over possible participation in the acquisition.97

Plaintiffs, persons who had sold Dorchester’s stock after issuance of the
proxy statement, filed suit alleging that the proxy statement and the subse-

---

91. 478 F.2d 1281 (2d Cir. 1973). *See also* United States Smelting, Refining & Mining Co.
June 17, 1968) (failure to disclose second merger offer violated rule 14a-9).

92. *Gerstle*, 478 F.2d at 1294. The court discussed only the omission of “firm offers.”
Although discussions occurred that did not rise to the level of firm offers, see *id.* at 1294 n.14,
the court apparently did not treat them as subject to disclosure.

93. Although clearly troubled by the omission, the court did not actually hold that the
omitted information was material. Instead, it found the proxy misleading for failing to disclose
the company’s plan to aggressively sell the General Outdoor plants following the merger. *Id.*
at 1295.


96. *Id.* at 631.

97. *Id.*
quent release were misleading. In analyzing the issue on a motion to dismiss, the district court appeared to agree that the proxy statement may have been misleading. The district court held that the press release, acknowledging the possibility of a leveraged buy-out, did not necessarily cure the misstatements in the proxy. The court noted that the press release failed to disclose the extent of management’s participation in, or sponsorship of, the leveraged buy-out. Because this failure may have amounted to a material omission, the court denied the defendant’s motion for summary judgment.

In summary, under the federal securities laws, no obligation exists to provide the public with information concerning ongoing negotiations absent a duty to disclose. Moreover, the instances where a duty arises are limited. Through foresight and care, therefore, a company can often prevent occurrence of the particular circumstances that would trigger a duty to disclose.

II. MATERIALITY

The antifraud provisions of the federal securities laws only require disclosure of material information. Thus, even where a duty to disclose exists, liability for nondisclosure will not exist if the ongoing negotiations were immaterial. Determining the materiality of nonspeculative information involves a relatively straightforward analysis. Information is material if there is a “substantial likelihood” that “a reasonable shareholder would consider it important” in making an investment decision.

98. Id. at 631-33. Similarly, in SEC v. Parklane Hosiery Co., 422 F. Supp. 477 (S.D.N.Y. 1976), the failure to disclose negotiations rendered a proxy statement misleading. Parklane had leased property from the Federal Reserve Board (FRB). Desiring to regain use of the property, the FRB offered Parklane $500,000 to terminate the lease, an offer later increased to $800,000. Parklane counter-offered for $1.2 million, but the offer expired without any action by the FRB. Id. at 482-83. Some months later, Parklane issued a proxy statement in connection with a “going private” transaction, id. at 481, stating that “there are no negotiations at present” with respect to the FRB lease. Id. at 482. Two weeks after the proxy was issued and ten days before the shareholders meeting, Parklane and an agent for the FRB met. The agent indicated that he would recommend to the FRB that it accept Parklane’s $1.2 million offer. Id. at 483. The court agreed that the single meeting constituted material negotiations and that Parklane had an obligation to amend the proxy and disclose the negotiations. Id. at 485-86.

99. The antifraud provisions speak only to material information. Whether the line item disclosure requirements are always material is unresolved. See supra note 34.

100. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The lower court in TSC Indus. had defined materiality to include “all facts which a reasonable stockholder might consider important.” Northway, Inc. v. TSC Indus., 512 F.2d 324, 330 (7th Cir. 1975). Other courts had defined the term to include all facts that a reasonable investor would consider in making an investment decision. See, e.g., Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir.), cert. denied, 419 U.S. 873 (1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301-02 (2d Cir. 1973). The Supreme Court ultimately declined to adopt either defini-
only be important to an investor; it is unnecessary to determine how important.

Determining the materiality of speculative information such as ongoing negotiations, however, requires a more subtle analysis. The risk that an agreement will never be reached or a transaction never consummated increases the difficulty of the analysis. As an initial matter, the resulting agreement must be material. If the resulting agreement is immaterial, the negotiations likewise will be immaterial, regardless of how advanced.\textsuperscript{101} Whether an agreement is material may depend in part upon one's vantage point. A merger agreement, for example, will inevitably be material to the shareholders of a target company because it both spells the demise of the target and may involve the payment of a substantial premium.\textsuperscript{102} At the
same time, the agreement may not be material to the shareholders of the bidder, particularly if the bidder has a practice of acquiring companies and the target is relatively small. As a result, omission of such an agreement

(1983) ("The thirteen studies [discussed in the article] indicate that targets of successful takeover attempts release substantial and statistically significant increases in their stock prices.").

103. While target shareholders typically receive a substantial premium for their shares, see supra note 102, the advantage of a takeover to the shareholders of the bidder is less apparent. One study determined that the share prices of the bidder company increase an average of only three to four percent following the announcement of a tender offer. See Advisory Committee on Tender Offers, Report of Recommendations, at 7 n.6 (July 8, 1983). Other researchers have been even less ebullient about the return to shareholders of the bidding company, concluding that the "returns to successful bidding firms in mergers are zero." Jensen & Ruback, supra note 102, at 22 (emphasis in original) (although noting a "small positive abnormal return" for successful bidding firms in tender offers); see also Dodd, Merger Proposals, Management Discretion and Stockholder Wealth, 8 J. OF FIN. ECON. 105 (1980); Malatesta, The Wealth Effect of Merger Activity and the Objective Functions of the Merging Firms, 11 J. OF FIN. ECON. 155 (1983).

The lack of a premium for shareholders of the bidder may be explained by a number of factors. Acquisition of the target may generate no immediate gain to the bidder, particularly where competitive bidding drives up the price of the target. In addition, the absence of an increase in share price may sometimes be related, at least in part, to the relative size of the target and bidder. Bidders in the United States are typically much larger than the target. Gain to the bidder, if any, may be slight when measured as a percentage of the bidder's total market value. See Asquith, Bruner, & Mullins, Jr., The Gains to Bidding Firms from Merger, 11 J. FIN. ECON. 121, 138 (1983) ("Regression analysis indicates that the relationship between the bidding firm's cumulative excess return and the relative size of the target firm's equity is positive and statistically significant.").

A recent and provocative study of acquisitions in Canada supports the proposition that the premium on the bidder's shares is related to the bidder's market value in relation to that of the target. See Eckbo, Mergers and the Market for Corporate Control: The Canadian Evidence, 19 CANADIAN J. OF ECON. 236 (May 1986). The study of more than 1900 Canadian acquisitions noted that, unlike firms in the United States, "Canadian bidder and target firms are frequently of approximately the same asset size." Id. at 238. The study revealed that "target and bidder firms listed on the [Toronto Stock Exchange] on average earn large and significant gains from takeover activity." Id. at 258.

If the relative size of the target is an important factor in determining whether the acquisition will affect share prices of the bidder, smaller bidders acquiring larger targets might be expected to show large gains in their share prices. The successful acquisition by Pantry Pride of the substantially larger Revlon supports this hypothesis. Through early August, Pantry Pride closed at prices between $7 and $7.50. On August 14, the Wall Street Journal reported rumors of an impending offer by Pantry Pride for Revlon. The day the article appeared, Pantry Pride's share prices closed at $8, up five-eighths, an increase of more than 8%. Over the next three months, as Revlon resisted the attempted acquisition, Pantry Pride's closing share prices fluctuated between $5.87 and $7.62. In early November, however, Pantry Pride successfully overcame Revlon's resistance after the Delaware courts invalidated lock-up options issued by Revlon. At the end of November, Pantry Pride closed at $9. From the day before the article in the Wall Street Journal appeared announcing the impending offer through the end of November, Pantry Pride's share prices increased approximately 22%. See generally supra notes 76-86 and accompanying text.

Statistics demonstrating little movement in the price of a bidder's shares as a result of an acquisition do not, of course, support the proposition that a merger or tender offer is never
from a press release or filing may be a material misstatement for the target but not for the bidder.

Furthermore, the term "negotiation" itself can cause confusion.\textsuperscript{104} Generally, contacts not reaching the level of negotiations are treated as immaterial. Negotiations, however, often defy easy categorization and may take on a myriad of forms. Particularly in the change of control context, preliminary or exploratory contacts often precede actual negotiations. Bidders may make inquiries to determine whether a prospective target is interested in negotiating an agreement; a target may make available certain material, non-public information such as unreleased earnings or income forecasts to assist a number of prospective bidders in determining whether to go forward with the acquisition. In most circumstances, these types of preliminary contacts will not be treated as negotiations.\textsuperscript{105} The point at which these preliminary contacts become negotiations is, however, unclear. Nevertheless, that task often confronts the courts requiring them, as an initial step, to determine whether contacts rise to the level of negotiations.

Once both sides have indicated some interest in a possible agreement and
discussions proceed past the exploratory stage, the contacts generally have risen to the level of negotiations. Moreover, negotiations need not be evidenced by face-to-face bargaining sessions between high level officials of the target and bidder. Intermediaries are often used in the negotiation process. For example, an investment banker or other intermediary acting on behalf of the bidder may make the initial contact with a prospective target company. A target interested in a merger or friendly takeover may provide the investment banker with information necessary to assess the efficacy of the acquisition, including, in some cases, nonpublic information. In some cases, follow-up meetings between the target and the intermediary may occur that involve discussions of important matters such as price and post-acquisition structure. Conceivably, therefore, the parameters of an agreement, if not the agreement itself, can be negotiated without officials of the bidder and target ever meeting face-to-face. While preliminary contacts by an intermediary will normally not be considered negotiations, a bidder or target that uses an intermediary to advance the negotiating process may be treated as engaging in negotiations. The critical element is a mutual expression of interest in an agreement and that can be done either through an intermediary or directly.106

Even if the resulting agreement will be material and the contacts can be characterized as negotiations, the analysis is not complete. An inherently speculative concept, the materiality of ongoing negotiations requires a balancing of the magnitude of the final agreement against the probability an agreement will result.107 Under this balancing test, the more rudimentary

106. See Parklane Hosiery, 422 F. Supp. at 483 (negotiations between lessee and agent for lessor held material where lessor and lessee never met directly). As the Commission has noted: "[T]he term 'negotiations' includes not only final price bargaining, but also applies to substantive discussions between the parties or their legal and financial advisors concerning a possible transaction." In re Revlon, Exchange Act Release No. 23,320, [Current] Fed. Sec. L. Rep. ¶ 84,006, at 88,146 (June 16, 1986).


The Supreme Court has never specifically addressed the materiality of speculative information, although it recently considered whether to grant certiorari in a case addressing the issue. See Radol v. Thomas, 772 F.2d 244 (6th Cir. 1985) (materiality of asset appraisals), cert. denied, 106 S. Ct. 3272 (1986). At the request of the Court, the Solicitor General of the United States filed a brief expressing his view on the petition for certiorari. Because the case turned in large part on Commission regulations relating to the disclosure of oil and gas assets, and because cases were pending in other circuits that arguably presented "broader, yet more sharply focused, questions concerning the obligation to disclose soft information," the Solicitor General recommended "that the Court deny certiorari here and await a case of more general significance in which to consider such questions." Brief for the United States as Amicus Curiae at 9, Radol v. Thomas, 106 S. Ct. 3272 (1986) (No. 85-1030).

Notwithstanding any specific pronouncements by the Supreme Court, the test in TSC Indus. for determining materiality should be applicable to both speculative and nonspeculative infor-
the negotiations, i.e., the earlier their stage, the more important the final agreement must be before the negotiations will be considered material.

Although easily stated, the balancing test can be extraordinarily difficult to apply, at least with any certainty. Both "magnitude" and "probability" are elusive terms. Assessing magnitude requires some determination of the degree of importance of the resulting agreement, an imprecise task at best. Simply determining that the agreement would influence the investment decision of reasonable shareholders is not enough. Would investors consider the resulting agreement to be marginally, moderately or highly important? Only after the importance of the agreement has been assessed can it be balanced against the probability an agreement will occur.

Probability essentially requires examination of the stage of the negotiations to determine whether an agreement is likely. Stated another way, the issue turns upon the remoteness of a final agreement. Here again, difficult issues arise. Actually determining the likelihood of a final agreement would require a subjective inquiry into the minds of the negotiators. Unable to do this, courts must resort to objective indicia of an impending agreement. Thus, they focus on such factors as direct contacts between high level management of the parties, discussions of important terms, particularly price, the hiring of a third party such as an investment banker to provide assistance in assessing the viability of an acquisition, and efforts by one of the parties to acquire the necessary financing for an acquisition. Nonetheless, while objective factors provide some indicia of probability, the presence of particular factors and their relative importance vary from case-to-case.

An effect of the balancing test is uncertainty. Given its fluid and fact-intensive nature, court decisions provide practitioners with little guidance or comfort. The relevance of a particular holding may be limited because subsequent cases often involve different fact patterns. As will be explored, the uncertainty of the test has encouraged a number of courts to supplant this

---

108. See Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966).

109. One court has described materiality as an "elusive concept," noting that "whether or not any particular fact is material is a determination which clearly cannot be made in a vacuum. Each individual case must be viewed as a discrete set of circumstances and judged on its own unique facts." SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1233 (S.D.N.Y. 1976), aff'd, 565 F.2d 8 (2d Cir. 1977).
case-by-case, fact-intensive analysis with a bright-line test; a test that can present problems even more troublesome than vagaries of the balancing test.

A. Early Case Law

The materiality of ongoing negotiations has troubled the courts and Commission for over forty years. Ward La France Truck Corp., the first rule 10b-5 violation investigated by the Commission, involved persons trading while in possession of information regarding a prospective takeover. The issue also arose in one of the first private cases brought under the rule. These early opinions, however, contained little insightful discussion.

The first cases affording a more plenary treatment of the materiality of ongoing negotiations arose in the early and mid-1960's. List v. Fashion Park, Inc. and Rogen v. Ilikon Corp. illustrate the early judicial approach to the issue. In List, a union representative told the board of directors of Fashion Park, a financially troubled company, that an unidentified party was interested in buying the company. Following the union official's discussion with the board, the directors adopted a resolution authorizing corporate officials to "seek to negotiate a sale or a merger" of Fashion Park with the unidentified party. Ten days after the board meeting, the union official revealed the identity of the interested company and, shortly thereafter, negotiations were commenced between the two companies. Approximately one month after adoption of the board resolution, the companies reached a preliminary agreement to merge.

Plaintiff, a former shareholder of Fashion Park, sold 5,100 shares in the company to a director before any public announcement had been made about the merger. He filed suit alleging that the director had violated the antifraud provisions by failing to disclose that the board had resolved to merge or sell the company. The district court dismissed the suit and plaintiff appealed. The Second Circuit noted that the salient issue was whether the board resolution and the subsequent disclosure of the identity of the poten-


113. 361 F.2d 260 (1st Cir. 1966).

114. List, 340 F.2d at 460.

115. Id.

116. Id. at 462.
tial acquiror were "material facts that should have been disclosed to plaintiff."\textsuperscript{117} Declining to find them material, the court reasoned that, at the time plaintiff had sold his shares, the prospect of a merger was "too remote to have influenced the conduct of a reasonable investor."\textsuperscript{118}

That give and take negotiations had not occurred at the time plaintiff sold his shares was crucial to the court's reasoning. At the time the board had authorized the negotiations, it had received little more than an expression of interest, an inquiry, from an unknown acquiror. Even after learning the identity, corporate officials had no opportunity to assess the acquiror's interest in a merger or to determine whether a merger was practical or otherwise viable. Essentially, therefore, all the board had was an unsolicited expression of interest made indirectly through a union official. The Second Circuit had no difficulty concluding that, given the uncertain nature of any possible merger agreement and the lack of any actual bargaining, the board's resolution and the identity of the prospective purchaser was immaterial.

The situation in \textit{Rogen v. Ilikon Corp.},\textsuperscript{119} however, was markedly different. Defendant, Ilikon Corporation, had been trying to develop a method of fabricating aluminum cans. Plaintiff, the largest shareholder in, and an officer of, Ilikon, played an instrumental role in the early development of the aluminum can process. Plaintiff, however, had a contumacious relationship with the company causing the Ilikon Board to terminate his employment. Following termination, plaintiff decided to withdraw completely from the company and to sell his shares back to the company. Plaintiff, therefore, executed a purchase agreement with the company. Unbeknownst to plaintiff, Ilikon had begun negotiating a licensing agreement for the aluminum fabrication process with Reynolds Metal Company. By the time plaintiff had agreed to sell his shares, two meetings had been held between Ilikon and Reynolds and the terms of a possible agreement (although not the price) had been discussed. Officials of the two companies had also exchanged a number of phone calls and letters. The negotiations ultimately terminated when Reynolds insisted that the licensing agreement be exclusive.

Plaintiff filed suit, contending that the negotiations over the licensing agreement were material and that their nondisclosure violated the antifraud provisions. Reversing the district court's dismissal of the case, the First Cir-

\textsuperscript{117} Id. at 464.

\textsuperscript{118} Id.; see James Blackstone Memorial Library Ass'n v. Gulf, M. & O.R.R., 264 F.2d 445, 450 (7th Cir.) (finding negotiations over the sale of assets not material, the court stated that "the most that can be said of Gulf's situation at the time it purchased plaintiffs' shares ... was that it was anxious, as it had been for several years, to sell the ... property, and that it had hopes, perhaps with some reason, of consummating a sale"), \textit{cert. denied}, 361 U.S. 815 (1959).

\textsuperscript{119} 361 F.2d 260 (1st Cir. 1966).
Catholic University Law Review

The court of appeals noted that the negotiations had advanced considerably, with Reynolds evidencing a serious interest in the fabrication process. Moreover, the failure to reach an agreement resulted not from problems with the process but from the terms of the license. The Court deemed the discussions to be material both because they had advanced to the stage where an agreement was possible and because the negotiations tended to confirm the viability of the fabrication process.

In analyzing the materiality of the negotiations, the courts in Rogen and List did not resort to bright-line tests or other artificial constructs. Both performed fact-intensive analysis, carefully assessing the importance of the negotiations to the particular plaintiffs and the probability that the negotiations would culminate in a final agreement. In List, there had been no actual negotiations at the time plaintiff sold his shares, rendering the possibility of a final agreement complete conjecture. That a final agreement was eventually reached had no bearing on whether the negotiations were material at the time plaintiff sold. By contrast, in Rogen, actual give and take negotiations had taken place over a licensing agreement for the company's only significant asset. Although not by any means certain, some possibility of a final agreement existed at the time plaintiff sold his shares. The ultimate collapse of the negotiations did not alter the analysis or conclusion. Given the overall importance of a licensing agreement concerning such a critical asset, the court had little difficulty concluding that the negotiations had advanced far enough to be of interest to reasonable investors in determining whether to sell their shares.

List and Rogen, in some respects, however, represent easy cases. Both involved former officers who sold their shares back to the company or to a corporate insider. Given the preexisting relationship between the buyer and seller, the importance of the undisclosed negotiations (i.e., their materiality), was readily apparent. Intimately aware of the company's financial problems, the plaintiff in List seemed unlikely to be dissuaded from selling his shares at a premium over market by such vagaries as an unidentified company expressing some interest in merging with List Fashion. Rogen, however, involved a former president selling his shares back to the company. Aware of the technological deficiencies in, and the untried nature of, the fabrication process, the plaintiff would certainly have been influenced in determining whether to sell his shares and the selling price by information that a major company

---

120. Id. at 261-66.
122. Rogen, 361 F.2d at 266.
took the process seriously enough to engage in actual give and take negotiations over a licensing agreement. Moreover, the imposition of liability on Ilikon for nondisclosure would do little more than require the company to pay to plaintiff the true value of his shares and deprive the company of unfairly obtained profits. Involving only a single plaintiff that sold shares directly to the issuer, the amount of damages was limited and easily calculable.

Later decisions in this area would confront more difficult facts. With the advent of “fraud on the market” and the evisceration of the reliance requirements under the antifraud provisions, courts faced class action suits brought by large numbers of shareholders, shareholders that did not buy or sell directly to the company but had engaged in transactions in the open market. Companies were therefore exposed to the possibility of substantial liability in situations where they neither traded directly with the injured shareholders nor received any direct pecuniary benefit from the omission or misstatement. While in theory, the materiality analysis should not vary as the disclosing company’s financial exposure increased, nonetheless, subsequent courts seemed influenced by the awareness that a finding of materiality might lead to the imposition of substantial liability.

B. SEC v. Texas Gulf Sulphur Co.

List and Rogen presaged the seminal standard for determining the materiality of speculative information articulated by the Second Circuit in SEC v. Texas Gulf Sulphur Co. In that case, Texas Gulf Sulphur conducted exploratory drilling in eastern Canada. Early cores indicated a rich ore strike. Aware of the initial drilling results, a number of corporate insiders purchased Texas Gulf Sulphur stock. In response to rumors about a major ore strike, the company issued a press release stating that the results of drilling to date had not been conclusive and had uncovered only small or marginal ore deposits. In an enforcement proceeding brought by the Commission, the defendants argued that their trading did not violate the antifraud provisions because the information about the rich ore strike was speculative and “remote” and, therefore, not material.

The Second Circuit rejected that argument and reasoned that the mere fact that information was speculative did not automatically render it immaterial. Instead, materiality depended “at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated

123. Id. at 267.
magnitude of the event in light of the totality of the company activity."\textsuperscript{126} Applying that balancing test, the court concluded that the information relating to the ore strike, although speculative, may well have been material: "[K]nowledge of the possibility, which surely was more than marginal, of the existence of a mine of the vast magnitude indicated . . . would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold."\textsuperscript{127}

Although not addressing the materiality of ongoing negotiations, \textit{Texas Gulf Sulphur} did announce a test broad enough to reach ongoing negotiations. In the context of ongoing negotiations, the reasoning in \textit{Texas Gulf Sulphur} required a balancing of the magnitude of the final agreement against the probability of a final agreement. Such an analysis is necessarily fact-intensive. Materiality, the court stated, "must be determined on a case-to-case basis according to the fact pattern of each specific transaction."\textsuperscript{128}

The difficulty with the balancing test lies not in its formulation, but in its application. Reflecting discomfort with the disclosure of speculative information, some courts\textsuperscript{129} have placed substantial, if not exclusive, weight on the probability that the agreement will occur.\textsuperscript{130} To the extent the final agreement is speculative or remote, the tendency of these courts has been to find the ongoing negotiations immaterial, regardless of the magnitude of the agreement under discussion. While the speculative nature of the final agreement is obviously quite relevant, \textit{Texas Gulf Sulphur} did not make that factor the entire test. The stage of the negotiations must still be balanced against the importance of the final agreement.

With the notable exception of a line of cases from the Third Circuit,\textsuperscript{131} the decisions that followed \textit{Texas Gulf Sulphur} have in general implicitly or explicitly applied the balancing test to determine the materiality of negotiations. They did so in the contexts of both insider trading cases and cases involving misleading corporate disclosures.

\textbf{1. Insider Trading Cases}

Courts addressing the materiality of ongoing negotiations in insider trading generally have applied the \textit{Texas Gulf Sulphur} balancing test rigorously

\begin{itemize}
\item \textsuperscript{126} \textit{Id.} at 849.
\item \textsuperscript{127} \textit{Id.} at 849-50.
\item \textsuperscript{128} \textit{Id.}
\item \textsuperscript{129} See Greenfield v. Heublein, 742 F.2d 751, 753, 758 (3d Cir. 1984), \textit{cert. denied}, 105 S. Ct. 1189 (1985); Stafin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982).
\item \textsuperscript{130} See Radol v. Thomas, 772 F.2d 244, 253 (6th Cir. 1985) (speculative information such as projections and appraisals only material if "reasonably certain to hold").
\item \textsuperscript{131} See \textit{infra} notes 161-87 and accompanying text.
\end{itemize}
and accurately. To some degree, these cases present circumstances that facilitate the materiality analysis. The mere fact that insiders or their tippees traded on the basis of the information supports a finding of materiality. Moreover, the unfair trading advantage that accrues to the insider acquiring and using the information is often readily apparent. Corporate insiders aware of ongoing negotiations concerning a major development are in a position to acquire shares before the information generally becomes known to the market and to benefit from any increase in stock price when an agreement is consummated and becomes public information. Indeed, even if the negotiations end inconsequentially, insiders sometimes can benefit by selling their shares into the rising market that invariably occurs during the period preceding a major corporate development, perhaps as a result of leaks or rumors about the negotiations. Recognizing these unfair advantages, courts have routinely concluded that merger negotiations can be material at an early stage, typically once both sides have expressed serious interest and some actual discussions over principal terms have taken place.

SEC v. Shapiro is illustrative of the treatment of ongoing negotiations in insider trading cases. Defendant, a director of Ridge Manor Development Company, purchased shares in the company. At the time of the purchases, defendant knew that officials of Ridge Manor had (1) hired persons to arrange for merger discussions with a prospective acquiror, (2) supplied financial information to the acquiror indicating that a merger of the two companies would result in a sharp increase in earnings, (3) made a merger proposal to the acquiror that had been rejected, and (4) met with a director of the prospective acquiror who agreed to propose a merger to the board.

Applying the Texas Gulf Sulphur balancing text, the court conceded that the negotiations were at a formative stage but nevertheless found them to be material in light of the importance of the resulting merger agreement. As the court noted, "[a]lthough the negotiations had not jelled to the point where a merger was probable, the possibility was not so remote that, when considered in the light of a projected increase of at least 600% in [the acquiror's] earnings per share, it might not have influenced a reasonable investor."

Similarly, in SEC v. Geon Industries, Inc., the Second Circuit again addressed the materiality of ongoing merger negotiations in the context of an insider trading case and concluded that negotiations in the early stages were

132. See infra note 200.
133. 494 F.2d 1301 (2d Cir. 1974).
134. Id. at 1304.
135. Id. at 1306-07.
136. 531 F.2d 39 (2d Cir. 1976).
material. Geon Industries had hired an investment banker to arrange negotiations over a possible merger with a British oil company. Following preliminary discussions, Geon supplied the British company with various nonpublic forecasts and financial data. After digesting the information, the oil company indicated interest in a possible acquisition and Geon's president, Neuwirths, traveled to England to pursue the matter.

Before voyaging to England, Neuwirths informed a business associate about the possibility that Geon might be involved in a merger. On his return to the United States, Neuwirths spoke to a broker, who promptly began buying shares of Geon on behalf of the broker's wife and clients.\textsuperscript{137} About a month later, Geon publicly announced the merger negotiations with the British oil company and, shortly thereafter, disclosed a merger agreement. The agreement provided for the payment to Geon shareholders of a substantial premium over market price.

The Commission brought an enforcement action to enjoin Neuwirths from illegally tipping information about the merger negotiations to others. Among other things, Neuwirths argued that the information tipped was immaterial because the merger negotiations were in an "embryonic stage [to which] no reasonable man would attach importance."\textsuperscript{138} The Second Circuit, however, disagreed. Although acknowledging that "the mortality rate of mergers in such formative stages is doubtless high," the court emphasized that under the \textit{Texas Gulf Sulphur} balancing test, the probability of an agreement still had to be weighed against the magnitude of the agreement.\textsuperscript{139} The importance of a merger agreement to the target company was beyond peradventure. As the court stated:

Since a merger in which [a company] is bought out is the most important event that can occur in a small corporation’s life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions . . . .\textsuperscript{140}

\textsuperscript{137} \textit{Id.} at 43.

\textsuperscript{138} \textit{Id.} at 47.

\textsuperscript{139} \textit{Id.} In both \textit{Geon} and \textit{Shapiro}, the Commission took the position that the materiality of the information should be determined under the \textit{Texas Gulf Sulphur} test. See Brief of the Commission at 36, SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) (No. 72-1927); Brief of the Commission at 38, SEC v. Geon, 531 F.2d 39 (2d Cir. 1976) (No. 74-2614).

\textsuperscript{140} \textit{Geon}, 531 F.2d at 47. See Holmes v. Bateson, 583 F.2d 542, 550 (1st Cir. 1978) (although terms of possible merger not yet discussed, duty existed to disclose negotiations to selling shareholder; court noted that "we find it inconceivable that a reasonable shareholder would not think that the merger information concealed in this case was important and, therefore, material."). It bears reminding that, although these cases are correct, they do not stand for the proposition that negotiations are always material at such an early stage. That the persons traded acquired shares in a \textit{target} was critically important. The result might have been
Based upon the importance of the prospective merger agreement, the court concluded that the negotiations between Geon and the British oil company had advanced sufficiently to have crossed the materiality threshold.\textsuperscript{141}

Its holding notwithstanding, the court in \textit{Geon} was clearly troubled by the potential impact of its decision and admonished that its analysis was limited to insider trading cases: "In cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in a publicly disseminated press release."\textsuperscript{142} While the negotiations at issue in \textit{Geon} were material for purposes of insider trading cases, the court indicated doubt whether they would be material for purposes of the Commission's filing requirement.\textsuperscript{143}

different had the focus been on an insider purchasing or selling shares of the \textit{bidder}. See \textit{supra} note 103.

\textsuperscript{141} More recently, in SEC v. Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) \textsuperscript{12} \textsuperscript{14} \textsuperscript{16} \textsuperscript{18} 92,004, at 90,977 (S.D.N.Y. Apr. 15, 1985), the court held that merger negotiations were material. The court noted that discussions had advanced "beyond the exploratory stage to the establishment of preconditions, the existence of proposals . . . concerning price per share, and the existence of numerous meetings between [the two companies]." \textit{Id.}

\textsuperscript{142} \textit{Geon}, 531 F.2d at 48.

\textsuperscript{143} \textit{Id.} The court indicated that "the [nonpublic] information takes on an added charge just because it is inside information." \textit{Id.} At least one commentator has more or less taken the same position that the materiality threshold is lower where the information is used by insiders. \textit{See} \textit{Brudney, A Note on Chilling Tender Solicitations}, 21 \textit{RUTGERS L. REV.} 609, 622 n.32 (1967). Although superficially appealing, the "added charge" language seems inconsistent with the longstanding and conventional analysis used to determine materiality. In determining materiality, courts have focused upon the importance of the information to the mythical "reasonable" shareholder. \textit{See} \textit{supra} note 100. By using a more objective reasonable shareholder standard, courts need not perform a subjective inquiry into the particular knowledge of each person receiving the nonpublic information. The court in \textit{Geon} would deviate from the reasonable shareholder standards by taking into account the individual's status as an insider in determining materiality. Doing so arguably introduces subjective elements into the analysis, making an already elusive determination more difficult.

To contend that the "added charge" language in \textit{Geon} was wrong, however, does not render irrelevant the fact that an insider made use of the information. Insiders, who have a more complete understanding of the company, may be quicker to appreciate the value of particular information. As a result, courts have recognized that the use of the information by insiders may be one indication of materiality. \textit{See} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968), \textit{cert. denied}, 394 U.S. 976 (1969); General Portland, Inc. v. LaFarge Coppee S.A., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) \textsuperscript{12} \textsuperscript{14} \textsuperscript{16} \textsuperscript{18} 99,148 (N.D. Tex. Aug. 28, 1981).

At least one case in a different context has repudiated the argument that the standard of materiality is different where insiders are involved. \textit{See} Pavlidis v. New England Patriot Football Club, Inc., 737 F.2d 1227 (1st Cir. 1984). That case involved allegations that a proxy statement was materially misleading. In determining the materiality of certain misstatements and omissions, plaintiffs urged that "the standard of materiality should be less stringent in cases involving insiders." \textit{Id.} at 1231. The court rejected that approach, reasoning that "the fact that a proxy statement is drafted by insiders acting in their own interest does not change the standard of materiality. A fact does not become more material to the shareholder's decision because it is withheld by an insider, or because the insider might profit by withholding it."
The court cited no direct authority for the conclusion that the materiality of negotiations could vary depending upon whether the case involved insider trading or affirmative misrepresentations. Indeed, the analysis leads to anomalous, if not analytically indefensible, results. Admittedly, the materiality of information may depend in part upon the particular type document containing the disclosure. Information material in one type of document or filing may not be material in another. For example, information necessary to prevent a proxy statement from being misleading may not be necessary in a periodic filing, such as a quarterly or annual report. A proxy statement provides shareholders with information necessary to decide whether to execute a proxy. Information necessary in determining whether to execute a proxy may not be necessary to a prospective shareholder deciding whether to purchase the company's stock. Thus, a proxy statement proposing antitakeover charter amendments would be required to contain greater discussion of these provisions than may be required in other types of filings or disclosures. The materiality of information, therefore, will in part depend upon the particular disclosure document at issue and that document's purpose.

This is not, however, the type of reasoning employed by the Second Circuit in Geon. The court indicated that the materiality of the information depended upon whether the case involved insider trading or involved misleading disclosures. Both actions are typically brought under rule 10b-5. Geon, therefore, arguably stands for the proposition that the standard for materiality can vary in actions brought under the same provision of the securities laws. The decision neither points to any solid authority for that

---

*Id.* The court did not, however, consider the role of the insider in preparing the proxy statement to be irrelevant:

This is not to say, however, that court [sic] must ignore the interest of the parties who drafted the proxy statement in deciding whether they have met their obligation to disclose material facts. Certain facts might be material in the context of a one-sided transaction that would not be material in the context of an adversarial transaction. Therefore, although the same standard of materiality would apply to both kinds of transaction, the standard might identify different facts as material in each transaction. In addition, when the interests of the management conflict with those of the shareholders (and we note that this may happen in a hostile takeover, where the management seeks to preserve its endangered jobs, as well as in an uncontested merger), the court is entitled to regard the management's disclosures with a certain skepticism, and to resolve doubts in favor of the shareholders. Thus, although § 14(a) requires any party soliciting proxies, regardless of his status or interest in the transaction, to disclose all material information, a self-dealing insider may have a "heavier burden of disclosure" in the sense that he will find it more difficult to convince the court that he has met the requirements of § 14(a).

*Id.*

proposition nor provides any compelling reason for this conclusion.\textsuperscript{145} Moreover, at least one subsequent decision took precisely the opposite tact and concluded that the standard for materiality was lower in misrepresentation cases and, ipso facto, higher in insider cases.\textsuperscript{146}

What concerned the Second Circuit apparently was not the violation, but the remedy.\textsuperscript{147} As is typical in insider trading cases brought by the Commission, the sanction imposed on defendant in \textit{Geon} was an injunction and a possible disgorgement of profits.\textsuperscript{148} A company issuing a misleading press release, however, is subject to greater exposure. Under a fraud-on-the-market theory, a company may be liable to any person trading in the market at the time of the misleading statement, even if the company was not buying or selling its own shares or otherwise directly profiting from the misstate-

\textsuperscript{145} 17 C.F.R. § 240.10b-5 (1986). In at least one instance, the Supreme Court has rejected arguments that a securities law violation depends upon the nature of the parties or upon the relief sought. In \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185 (1976), the Supreme Court held that scienter was a necessary element of an antifraud violation under § 10(b) of the Securities Act, 15 U.S.C. § 78j(b) (1982) and rule 10b-5 in actions brought by private parties. The Commission took the position, however, that scienter was not necessary in Commission actions brought under the same provisions. The agency based its interpretation both on the nature of the relief sought—Commission actions typically involve injunctive relief and not damages—and on its special role as the agency designated to enforce the securities laws. In \textit{Aaron v. SEC}, 446 U.S. 680, 691 (1980), the Supreme Court rejected that reasoning concluding that "scienter is an element of a violation of § 10(b) and 17 C.F.R. § 240.10b-5, regardless of the identity of the plaintiff or the nature of the relief sought."

\textsuperscript{146} See \textit{Levinson v. Basic}, 786 F.2d 741 (6th Cir.), \textit{cert. granted}, 54 U.S.L.W. 2516 (U.S. Feb. 23, 1987) (No. 86-279). Admittedly, insiders often have a superior knowledge and understanding of a company's operations and they will be better able than other investors to recognize the importance, and take advantage of, nonpublic information. Indeed, empirical evidence indicates that investors recognize the superior knowledge of insiders. Trading by insiders often generates an increase in volume and price, as other investors purchase in their wake. See \textit{Givoly & Palmon, Insider Trading and the Exploitation of Insider Information: Some Empirical Evidence}, 58 J. Bus. 69, 86 (1985) ("the results also show that a significant abnormal return is produced in the wake of the trades [by insiders] themselves, lending support to the conjecture that (outside) investors accept the superior knowledge and follow the footsteps of insiders.").

\textsuperscript{147} As the Second Circuit noted in \textit{Geon}, "[w]hether such a violation [trading while in possession of material nonpublic information] would support relief more extended than that requested here—an injunction against future misconduct and a 'disgorgement' of profits—is a different question." 531 F.2d at 48.

This spectre of large scale liability no doubt influenced the court's reasoning.

Varying the materiality standard on the basis of the potential exposure is, however, not a concept that finds support in the securities laws. While liability for misleading statements may often seem harsh, a company can generally avoid such a result either by not making any public pronouncement or by making certain that the disclosure is accurate. Finally, the scienter element will obviate liability for misleading statements by companies unless such statements were recklessly or knowingly made.

2. Misleading Disclosure

Geon and Shapiro were, in essence, omission cases. In both decisions, the courts determined that insiders had contravened the duty to disclose the information or to abstain from acquiring shares before the information had become public. The materiality of ongoing negotiations also has been extensively litigated where companies engaged in negotiations have issued statements denying that any material developments are taking place. Publicly traded companies often receive inquiries, particularly from an exchange or the National Association of Securities Dealers (NASD) whenever their stock undergoes unusual increases in price and/or volume. If a company is unaware of a reason for the increase, it will typically issue a statement to the effect that it knows of "no developments" that would explain the unusual stock activity. If, at the time the "no developments" statement is issued, negotiations are taking place, the statement can be characterized as accurate only if the negotiations have not yet crossed the materiality threshold. Concomitantly, a "no developments" statement in the face of ongoing negotiations that are material will be misleading and violate the antifraud provisions.

In Schlanger v. Four-Phase Systems, Inc., for example, discussions between Four-Phase and Motorola over a possible merger commenced in late August and continued throughout the fall. Over the period, Four-Phase supplied Motorola with "increasingly detailed information regarding [the company], its finances, and its business projections." Both Four-Phase

---


150. See infra notes 229, 270-71 and accompanying text; see also Michaels Memorandum, supra note 11, at 2.


152. Id. at 131.
and Motorola retained investment bankers to assist in the negotiation process.

The stock in Four-Phase began to undergo dramatic activity, with price increasing almost six points in a single day and volume jumping from 39,800 shares the previous trading day to over 300,000. Officials of the New York Stock Exchange contacted Four-Phase to ascertain whether the company knew of any reason that would explain the unusual activity. A corporate spokesperson for Four-Phase issued a statement disseminated over the Dow Jones wire denying awareness "of any corporate developments which would affect the market of [sic] its stock." Eight days later, Four-Phase and Motorola announced a merger agreement.

Plaintiff sold shares between the time Four-Phase issued the "no developments" statement and the time the merger was announced. Plaintiff asserted that negotiations with Motorola over a possible merger would have explained the unusual activity in Four-Phase's stock, thereby rendering the "no developments" release materially misleading. Defendants moved for summary judgment, arguing, among other things, that no material omission or misstatement had occurred. Emphasizing that Motorola had not made a firm offer, defendants argued that, at the time the "no developments" release had been issued, the negotiations were not material. In declining to grant the motion, the district court concluded that the materiality of the negotiations was a factual matter which could not be decided on a motion for summary judgment. Moreover, if material, defendants could be liable for the misstatement.

While the federal securities laws do not impose a general duty upon an issuer to disclose material facts or new developments when it is not trading in its own securities, it does have a duty to make certain that any statement it does issue is truthful and complete, and does not materially misrepresent the facts existing at the time of the announcement. In this case, defendants did make an announcement, intended to be relied on by purchasers and sellers, and therefore had a duty to make a statement which was both truthful insofar as it went, and not misleading in light of the facts known at that time.

153. Id. at 129.
154. Id. at 130.
155. Id. at 133 (citations omitted). See also Rowe v. Maremont Corp., 77-C-2837 (N.D. Ill. June 3, 1986) ("Nonetheless, the rule entitling an issuer to keep silent about preliminary merger negotiations does not logically extend to the situation where a duty to disclose arises from other affirmative misstatements of a party or its agents."). The district court in Schlanger distinguished Reiss, see infra note 183, and Staffin, see infra notes 161-68 and accompanying text, by noting that these cases concerned whether the issuers had an affirmative duty to dis-
Implicitly refusing to follow the Second Circuit's suggestion in *Geon* that the standard for materiality could differ depending upon the nature of the offense, the *Schlanger* court in no way intimated that cases involving misleading press releases somehow necessitated a more rigorous materiality analysis than that employed in insider trading cases. If anything, the facts in *Schlanger* may have facilitated the materiality analysis. In insider trading cases, courts must assess the materiality of omitted information, a sometimes difficult and assiduous task. In *Schlanger*, however, Four-Phase did not omit information as much as it affirmatively misled the market through false disclosures. Bluntly speaking, Four-Phase lied and was seeking the district court's imprimatur for its actions. No matter how sympathetic a court may be to the sensitivity of the negotiations or the almost punitive liability that can result from misstatements, it cannot afford to absolve completely a company that affirmatively had misled the market, particularly when a more carefully worded announcement would have prevented the problem.

The reasoning employed in *Schlanger* also carried the day in *Etshokin v. Texasgulf, Inc.* In that case, Canada Development Corporation owned thirty-five percent of the outstanding stock of Texasgulf. Following unusual activity in Texasgulf's stock and rumors about an impending takeover, an official from Dow Jones called Canada Development for information about the unusual activity. Canada Development's public relations director responded in a statement carried over the Dow Jones wire that "the company hasn't [any] intention of selling its 35% interest in TEXASGULF," and that he was unaware of any reason that would explain the activity.

Before the announcement, however, another company considering the acquisition of Texasgulf entered into discussions with Canada Development concerning the terms that would induce Canada Development to sell its Texasgulf shares in the event of a tender offer. Plaintiffs filed suit alleging that the statement by the public relations manager was misleading. They contended that, as a result of the negotiations with the prospective bidder, Canada Development knew of reasons that would explain the unusual activity in Texasgulf's stock. In addition, the negotiations demonstrated, in contrast to the company's denial, that Canada Development in fact had an intention of selling its interest in Texasgulf. Although the district court did not treat the

---

157. *Id.* at 1227.
materiality of the omitted information at length, it did agree that a factual question existed as to whether the negotiations had been material at the time the company issued the release denying any intent to sell its interest in Texasgulf.\footnote{Etoshkin demonstrates the breadth of the disclosure requirements under the antifraud laws and the dangers that can befall persons or companies only tangentially connected to the acquisition process. In a change of control context, most cases addressing the materiality of negotiations have involved alleged omissions or misstatements by either the target or the bidder company. Canada Development was neither; it was simply a large shareholder of the target.\footnote{The size of Canada Development's interest, however, more or less dictated that any prospective bidder first approach the company to ascertain its willingness to sell and at what price.}

Given this situation, it was perhaps unsurprising that, following rumors of a takeover and the unusual activity in Texasgulf's stock, Dow Jones personnel turned to a substantial shareholder for information about the developments. At that point, Canada Development was confronted with the stark choice of either revealing that discussions were underway or issuing a "no comment" statement, a statement arguably tantamount to an admission that negotiations were taking place. Instead, Canada Development opted for a third course. The company provided misleading information to the market by issuing a blanket denial of any knowledge of developments about the unusual activity in Texasgulf. For this, the district court held the company could be liable under the antifraud provisions of the federal securities laws.}

\footnote{Id. at 1228.}

\footnote{An earlier case involving someone not affiliated with the target or the bidder arose in Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972). In that case, defendant purchased 6500 shares of Technical Research Group, Inc. (TRG) from plaintiff, Radiation Dynamics. Shortly thereafter, TRG agreed to merge with another company, generating substantial profits for the defendants. Plaintiff alleged that defendants were aware of the TRG negotiations and that they had a duty to disclose the information before purchasing the shares. The Second Circuit disagreed, concluding that the defendants had not apparently been aware of the negotiations. \textit{Id.} at 886. Even had defendants been in possession of information about the negotiations, it is not at all clear that they would have been under a duty to disclose to Radiation Dynamics. The decision predates Dirks v. SEC, 463 U.S. 646 (1983), and Chiarella v. United States, 445 U.S. 222 (1980), which established that silence may be the basis for liability only if a duty to disclose exists. As the Supreme Court stated, "[t]he duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them.'" \textit{Chiarella}, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). It does not appear that the defendants in \textit{Radiation Dynamics} had any duty toward plaintiff that required disclosure. Absent the requisite duty, defendants could have been liable only if they had received a tip about the negotiations from a TRG insider and the insider obtained a benefit from tipping the information. \textit{See id.} at 277 (tippee liability arises "from their role as a participant after the fact in the insider's breach of fiduciary duty"); \textit{see also} 17 C.F.R. § 240.14e-3 (1986).}
The standard for assessing the materiality of speculative information adopted in *Texas Gulf Sulphur* and subsequently accepted by courts suffers from an obvious difficulty. Because the balancing test involves a fact-intensive analysis, it provides practitioners and issuers with little certainty or comfort. Given the sensitivity of ongoing negotiations and the potential liability for inaccurate statements or omissions, this lack of certainty is a genuine cause for concern. A number of recent decisions—particularly in the Third Circuit—have attempted to assuage this concern by applying a more certain analysis. Deviating significantly from, and often without mention of, the test articulated in *Texas Gulf Sulphur*, these decisions have replaced the balancing test with a bright-line test that largely obviates the need to perform a case-by-case, fact-intensive analysis.

The Third Circuit first delved into these uncharted waters in *Staffin v. Greenberg*.

In that case, Bluebird Corporation commenced a self tender offer for a portion of its outstanding shares. Under the duty to abstain or disclose, Bluebird's acquisition of its own shares triggered a duty to disclose all material developments. During the pendency of the self tender offer, the chief executive officer of Bluebird contacted an official at Northern Foods, Ltd., to inquire about a possible merger. The two companies had previously explored a possible business combination. After the self tender offer closed, the two companies engaged in merger negotiations and ultimately executed a merger agreement.

Plaintiffs, representing the class of shareholders selling shares during the self tender, argued that Bluebird had violated the antifraud provisions by failing to disclose the contacts with Northern Foods. The Third Circuit rejected that contention, concluding that a single contact with a prospective merger candidate that had not been authorized by the board of directors was immaterial. Not content with this narrow holding, however, the court

162. 672 F.2d at 1199-1200.
163. *Id.* at 1200.
164. *Id.* at 1199.
165. *Id.* at 1201.
166. *Id.* at 1206-07. A single isolated contact between two companies generally would not be treated as "negotiations" and would not be considered material. *See, e.g.*, Bucher v. Shum-
provided additional analysis to support its decision. The court expansively concluded that “preliminary merger discussions” were “immaterial as a matter of law.” Thus, the materiality threshold would be crossed only if “an agreement in principle has been reached.”

---

67. Staffin, 672 F.2d at 1207; accord, Enterra Corp. v. SGS Assoc., 600 F. Supp. 678, 690 (E.D. Pa. 1985); Sulzer v. Associated Madison Cos., [1985 Tranfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,053, at 91,247 (M.D. Fla. May 10, 1985) (“Preliminary discussions do not fall into the category of firm offers and are, therefore, not material.”). The Commission has expressly rejected the court’s conclusion that negotiations preceding an agreement in principle are immaterial as a matter of law. See infra text accompanying notes 258-59.

The Staffin court cited a number of decisions interpreting the disclosure requirements in item 4 of Schedule 13D, 17 C.F.R. § 240.13d-101 (1986) as support for the conclusion that negotiations preceding an agreement in principle are immaterial, including Missouri Portland Cement Co. v. H.K. Porter, 535 F.2d 388, 398 (8th Cir. 1976); Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1084-86 (5th Cir. 1970). These cases, however, are inapposite. Item 4 of Schedule 13D requires disclosure of, among other things, certain “plans or purposes” concerning the issuer, including any plans for a merger. 17 C.F.R. § 240.13d-101 (1986). Most courts, including Missouri Portland Cement and Susquehanna, have concluded that only those plans and proposals relatively certain or “fixed” must be disclosed under item 4. See Missouri Portland Cement, 535 F.2d at 398; see also Sonesta Int’l Hotels Corp. v. Wellington Assoc., 483 F.2d 247, 254 (2d Cir. 1973); Susquehanna, 423 F.2d at 1084-86; Issen v. GSC Enters., 508 F. Supp. 1278, 1295 (N.D. Ill. 1981); Purolator, Inc. v. Tiger Int’l, Inc., 510 F. Supp. 554, 556 (D.D.C. 1981). As a result, prospective plans and negotiations about a possible merger need not be disclosed in a Schedule 13D unless they are far advanced and likely to occur. See Missouri Portland Cement, 535 F.2d at 398; Susquehanna, 423 F.2d at 1084-86. These courts do not purport to apply the general standard for materiality under the antifraud provisions, but instead are interpreting a specific disclosure requirement imposed by the Commission. Their relevancy to cases interpreting the antifraud provisions is, therefore, minimal.

68. Staffin, 672 F.2d at 1207. The holding, however, did not apply where the discussions “have not reached an agreement in principle but are in some sense the functional equivalents.” Id. In a similar vein, a number of earlier cases concluded that negotiations were immaterial absent a “firm offer.” See South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1273 (9th Cir. 1982) (no duty to disclose in proxy statement “inquiries or indications of interest that do not fall within the category of firm or definite offers.”); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294-95 (2d Cir. 1973) (failure to disclose “firm offers” may render proxy statement misleading); Berman v. Gerber Prods., Co., 454 F. Supp. 1310, 1318 (W.D. Mich. 1978) (“because such overtures [concerning a possible merger] were not firm offers they should not be deemed material information”); Scott, 386 F. Supp. at 65 (single telephone call constituted a “casual inquiry” and not a firm offer subject to disclosure in a proxy statement).
Staffin, taken at face value, excludes from the realm of materiality all negotiations preceding an agreement in principle. Under this reasoning, irrespective of the importance of the final agreement, negotiations preceding a talismanic agreement in principle would never be subject to required disclosure under the antifraud provisions. Absent such an agreement, Staffin not only obviates liability for a "no developments" statement issued while negotiations are taking place but arguably would allow corporate insiders involved in the negotiations to trade while in possession of the information and tip the information to others who trade without violating the antifraud provisions.

Staffin represented only part of the Third Circuit's efforts. The decision left open the definition of "agreement in principle." That issue was taken up in Greenfield v. Heublein. The Third Circuit in Heublein concluded that an agreement in principle existed in the context of a change of control only if the parties had agreed to the acquisition price and the post-acquisition corporate structure. In adopting the "price-structure" standard, the Third Circuit essentially opted for a rigid, bright-line test for determining the existence of an agreement in principle.

In Heublein, General Cinema Corporation acquired almost nineteen percent of Heublein's outstanding shares. Unable to get General Cinema to agree to a standstill agreement and fearing a hostile takeover attempt, Heublein entered into negotiations with R.J. Reynolds, a prospective white knight. A meeting between high level officials of both companies to discuss Reynold's acquisition of Heublein, however, did not result in any understanding or agreement. Five days later, General Cinema informed Heublein of the expected sale of certain assets; sales that would generate the funds necessary for General Cinema to resume open market purchases of Heublein's shares. That same day, Heublein's stock underwent a dramatic increase in volume and price. In response to a call from the NYSE, a Heublein spokesperson issued a release carried by Dow Jones stating that it "was aware of no reason that would explain the activity in its stock in trading on the NYSE today." The following day, another meeting occurred between the management of Heublein and Reynolds. Approximately two

170. Id. at 756-57.
171. Id. at 757.
172. Id. at 753.
173. Id. at 753-54.
174. Id. at 754. The volume increased from 32,500 shares on July 13, 1982 to 242,500 shares on July 14, 1982. The price during the same period increased from $40.25 to $43.00. Id. at 754 n.1.
175. Id. at 754.
weeks after the "no developments" announcement, Heublein and Reynolds announced a merger agreement that provided for the payment of a premium for Heublein's shares of thirty percent over market price.\textsuperscript{176}

Plaintiff alleged that the "no developments" release was materially misleading.\textsuperscript{177} In a somewhat obtuse and confusing opinion, a divided Third Circuit panel agreed with the district court that Heublein had not violated the antifraud provisions. The court first concluded that Heublein had no independent duty to disclose the negotiations until an agreement in principle had been reached.\textsuperscript{178} An agreement in principle arose only when the acquisition price and the post-merger structure had been agreed upon. Since no agreement on these terms existed at the time of the "no developments" release, no duty to disclose the negotiations existed.\textsuperscript{179}

With no independent duty to disclose, the Third Circuit turned to whether the "no developments" release was misleading. The majority appeared to conclude that the negotiations were immaterial absent an agreement in principle. Since no such agreement had been reached at the time of the "no developments" release, their omission did not render the statement misleading.\textsuperscript{180} The court also emphasized that plaintiffs had not established a causal connection between the unusual stock activity and leaks about the merger discussions. Thus, "[w]hile . . . Heublein executives[,] clearly knew of information that might have accounted for the increase in trading, there was no indication that any of this privileged information had been leaked . . . ."\textsuperscript{181}

As the dissent cogently noted, the majority confused the duty to disclose with the prohibition on misleading disclosures.\textsuperscript{182} To the dissent, whether

\begin{thebibliography}{9}
\bibitem{176} Id. at 754-55.
\bibitem{177} Id. at 755.
\bibitem{178} Id. at 756; see Enterra Corp. v. SGS Assocs., 600 F. Supp. 678, 690 (E.D. Pa. 1985) ("the Third Circuit has held that there exists no obligation . . . for a 'target' corporation to disclose the status of offers or negotiations . . . until an 'agreement in principal' . . . has been reached"). The \textit{Heublein} analysis has been followed by at least one state case. \textit{See} Eldridge v. Tymeshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986). In \textit{Eldridge}, the court relied upon the Third Circuit cases to conclude that directors of a corporation did not breach their fiduciary duty to shareholders by failing to disclose the existence of ongoing negotiations. "Accordingly, we conclude that as a matter of law corporate directors are under no duty to make a public disclosure of merger negotiations until an agreement in principle has been reached." \textit{Id.}
\bibitem{179} \textit{Heublein}, 742 F.2d at 756-57.
\bibitem{180} Id. at 758-60.
\bibitem{181} Id. at 759.
\bibitem{182} Id. at 760-61 (Higginbotham, J., dissenting). The majority seemed to confuse those issues throughout the opinion. The distinction is, of course, critical. A duty to disclose material information essentially casts aside corporate secrecy and requires companies to reveal undisclosed material developments to the public. Once the duty attaches, the discretion of corporate officials to determine the timing and contents of the disclosure is greatly circum-
Heublein had a duty to disclose the existence of the negotiations was not at issue. Rather, the only issue confronting the court was whether the "no developments" statement by Heublein was materially misleading. Heublein simply could not deny knowledge of any developments that would explain the unusual activity while engaging in merger negotiations with Reynolds and when aware of the actions of American Cinema. The absence of either a duty to disclose the negotiations or evidence that the information had leaked to the public did not in any way alter the misleading nature of the "no developments" statement.183

Unsurprisingly, courts generally have evidenced an unwillingness to intrude into corporate affairs in order to avoid expanding the instances in which the securities laws impose a duty to disclose material nonpublic information.

The prohibition on misleading disclosures, however, falls into a different category. Whether a duty to disclose exists is immaterial. Simply put, the prohibition on misleading disclosures proscribes false and misleading statements. See supra note 29. The focus, therefore, is not on the duty to disclose, but on the accuracy of the disclosure. It makes no difference whether the disclosure occurred because of a duty or was made voluntarily. Once a statement is made for any reason, accuracy and completeness are required.

183. Id. at 763. In addition to Staffin and Heublein, Reiss v. Pan Am. World Airways, 711 F.2d 11 (2d Cir. 1983) is often cited for the proposition that preliminary merger negotiations are immaterial as a matter of law. See, e.g., Kronfeld v. Transworld Airlines, 631 F. Supp. 1259, 1264 (S.D.N.Y 1986); Schlanger v. Four-Phase Systems, 582 F. Supp. 128, 131-33 (S.D.N.Y. 1984). In Reiss, Pan American authorized a call of convertible debentures at 110% of face value. The debentures were redeemable in cash or stock. Reiss, 711 F.2d at 12. On the day Pan Am's board approved the call, it also authorized negotiations with National Airlines over a possible merger. Id. at 13. Eight days after negotiations were authorized, Pan Am announced that it had made an offer for National. Id. Debenture holders that responded to the call before the announcement alleged that Pan Am had a duty to disclose the merger negotiations. Id. The Second Circuit disagreed, concluding that the failure to disclose the negotiations did not violate the antifraud provisions. Id. at 14.

The reasoning of the Second Circuit is not altogether clear. The court apparently concluded that no material negotiations had taken place between the time the debenture call occurred and the date Pan Am and National announced the offer. The court acknowledged, however, that negotiations did take place following the call for debentures. Id. at 13. Pan Am also obtained a loan commitment from Citibank to acquire National. Id. at 12-13. These facts, along with the Pan Am board's resolution authorizing negotiations with National, indicated a serious interest on Pan Am's part to acquire National. Prior Second Circuit decisions had found negotiations at even more rudimentary stages to be material. See, e.g., SEC v. Geon Indus., 531 F.2d 39 (2d Cir. 1976); SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974).

What distinguishes Reiss from Shapiro and Geon was not the stage of the negotiations, but the materiality of the underlying agreement. In both Geon and Shapiro, the courts had to ascertain the materiality of merger negotiations to the target's shareholders. The result in those case seems obvious. A merger that causes the demise of the target would almost certainly be material to that target's shareholders. See infra note 233 and accompanying text. The materiality of a possible merger to the bidder, however, is less clear. Particularly for acquisition-oriented companies, a tender offer for another company may be just another transaction in the ordinary course of business. Moreover, on the average, the bidder's share prices increase only minimally following an acquisition. Studies show minimal or no increase in the bidder's share prices following the announcement of an offer, see supra note 103, compared
The courts in *Staffin* and *Heublein*, as well as their progeny, provided two principal justifications for their conclusions. First, they were concerned that disclosure of negotiations would unnecessarily interfere with corporate secrecy, possibly jeopardizing the continuation of negotiations. Second, they feared that disclosure would harm or mislead shareholders. As one court stated: "The need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations . . . outweighs the right of shareholders to have notice of corporate developments important to their investment decision." The apparent logic of both lines of reasoning does not withstand close scrutiny.

---

with a much greater increase for the target's share prices. See supra note 102. Pan Am's negotiations with National may not, therefore, have been material to its debt holders.

184. See *Heublein*, 742 F.2d at 756; *Staffin*, 672 F.2d at 1205-07.

185. See *Staffin*, 672 F.2d at 1205-07; As one commentator noted:

The good served by disclosure must be weighed against other values to be preserved by silence, or against injuries to be inflicted by disclosure . . . . Disclosure obligations are curtailed in at least two kinds of circumstances—first, when disclosure of the information would harm the corporation because it would prevent the consummation of an advantageous transaction, and second, when by reason of the indefiniteness of the available information about existing conditions or uncertainty about the future occurrence of significant events, disclosure would cause uncertainty and confusion in the minds of security holders—and bring about market reactions for which there may ultimately turn out to have no justification.

Brudney, *supra* note 143, at 621.

186. Michaels v. Michaels, 767 F.2d 1185, 1196 (7th Cir.), *cert. denied*, 106 S. Ct. 797 (1985); Rowe v. Maremont Corp., 77-C-2837 (N.D. Ill. June 3, 1986) ("the policy underlying this rule [of nondisclosure] is not that merger negotiations are unimportant to investors but that until price and structure are agreed upon the disclosure of a tentative merger is likely to mislead the market."); see *Heublein*, 742 F.2d at 756. As the Second Circuit concluded in *Reiss*:

It does not serve the underlying purposes of the securities acts to compel disclosure of merger negotiations in the not unusual circumstance before us. Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned.

711 F.2d at 14 (citations omitted). The Commission has suggested that the reasoning in *Reiss* should be limited to its particular facts. See *Michaels Memorandum, supra* note 11, at 5 n.4.


187. In addition to the questionable materiality analysis, the decision in *Heublein* can be faulted on another score. Both *Heublein*, 742 F.2d at 756, and *Staffin*, 672 F.2d at 1207, held that once an agreement in principle is reached, a duty to disclose arises. See *Jordan v. Duff &
With regard to the fear of misleading shareholders, shareholders and other investors admittedly may sometimes overreact to the disclosure of speculative information such as ongoing negotiations. Yet, to suggest that speculative information would mislead is also to suggest that disclosure might violate the antifraud provisions. Prohibiting disclosure seems to be a dubious, if not improper, method of addressing the problems associated

Phelps, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,724, at 93,517 (N.D. Ill. Mar. 17, 1986) ("When at least one of the parties to acquisition negotiations is a publicly traded company, an agreement in principal [sic] to the acquisition by both corporations must occur before either corporation has a duty to disclose the fact of negotiations to a stockholder."); Revlon, Inc. v. Pantry Pride, Inc., 621 F. Supp. 804, 809 (D. Del. 1985) (quoting language in Staffin that a duty to disclose exists once agreement in principle reached). Until these decisions, no court had ever held that the existence of an agreement in principle automatically triggered a duty to disclose.

The rationale for the Third Circuit's conclusion is not readily apparent. At its most extreme, the court may have concluded that companies have a general duty to disclose all material developments. Because negotiations become material upon execution of an agreement in principle, the duty to disclose would only arise at that point. Such a holding would essentially subject companies to a general duty to disclose, something completely inconsistent with the trend in the case law. See supra notes 16, 19. More likely, the Third Circuit intended something far less expansive. The court may be attempting to create another exception to the rule that companies have no general duty to disclose material developments. Given the importance of a possible merger to target shareholders and other investors, the Third Circuit may have concluded that once negotiations reached an agreement in principle, disclosure should be required. Why this information is subject to required disclosure when other, equally material information, is not, is unclear.

A third possibility is that the Third Circuit considered disclosure required under the corporate duty to disclose or abstain, although nothing in the opinion indicates that this is what the court intended. When a company trades in its own shares, there is a duty to disclose all material developments. See supra note 25. The definition of purchase or sale under the securities laws has been interpreted expansively. See supra note 27. For a purchase or sale to occur, there need not be an actual settlement or transfer of title of the securities. A contract to purchase or sell constitutes a "purchase" or "sale" for purposes of the securities laws. See International Controls Corp. v. Vesco, 593 F.2d 166, 181 n.18 (2d Cir.), cert. denied, 442 U.S. 941 (1979); Davis v. Davis, 526 F.2d 1286, 1289 n.4 (5th Cir. 1976). Conceivably, the execution of an agreement in principle to merge constitutes a sale of securities, giving rise to a duty to disclose all material developments and an immediate duty to disclose the agreement may therefore arise. Moreover, if the bidder can be characterized as a temporary insider of the target once an agreement in principle is reached, the bidder, as well as the target, may be subject to the duty to disclose. See Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983). Of course, the final possibility is that the court had no underlying rationale and was simply incorrect in its reasoning.

188. Incredibly, at least one court has suggested that disclosure of preliminary negotiations may itself violate the securities laws. See Guy v. Duff & Phelps, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,828, at 94,029 (N.D. Ill. July 12, 1985). While many, including the Commission, see supra note 4, have on occasion expressed qualms about the disclosure of certain types of speculative information, such disclosure has never been equated with a securities violation. As long as the disclosure is accurate and complete, including a full explanation of the speculative nature of the information, it is difficult to see how it would contravene the antifraud provisions.
with over-reliance on speculative information. More in keeping with the purposes of the securities laws, shareholders could be adequately protected through accurate and complete disclosure; that is, disclosure accompanied by cautionary admonitions attesting to the speculative nature of the negotiations. In this manner, investors obtain the information and can independently assess the risk of a particular investment.

While not totally clear, the Third Circuit may be taking the position that even with a cautionary admonition, reasonable shareholders would still be unable to appreciate fully its speculative nature and would, therefore, be misled. This interpretation would effectively treat the information as inherently or substantively misleading, something that smacks of merit regulation, a concept antithetical to the intent of, and specifically rejected by, Congress in adopting the securities laws. Such “protection” of shareholders is inappropriate. By concluding that disclosure of speculative information...
tion may be misleading, the courts place themselves in a position of determining what information can be disseminated to, and considered by, shareholders in making investment decisions. The potential effect of this judicial posturing is to deny shareholders important information necessary for informed and intelligent investment decisions.

Moreover, the reasoning ignores the numerous other instances where investors are required to assess speculative information. For example, the acquisition of registered securities in an initial public offering can be an exceedingly speculative investment. Companies going public often have little or no operating history, rendering a reasonable prediction about future success well-nigh impossible. Yet, with adequate disclosure of the risks, these types of speculative investments can be sold without violating the securities laws. Adequate disclosure allows investors to assess the risks associated with the offering and to determine whether to acquire shares. It seems disingenuous, therefore, to suggest that investors can assess the speculative nature of an initial public offering while reaching the opposite conclusion with respect to ongoing negotiations.

Not only did the Third Circuit employ reasoning that could deprive shareholders and other investors of information necessary for intelligent investment decisions, but it also articulated a rationale that allowed companies affirmatively to mislead. As Judge Higginbotham noted in his dissent in *Heublein*:

> Although the majority's approach makes it easier to put together corporate deals and mergers, I do not believe that the holding of the majority protects sellers or purchasers of stock. If anything, it subjects the investing public to future voluntary misrepresentations by corporations in the midst of allegedly confidential merger discussions.

---

1971, did not know whether its officers would be able to devote sufficient time to the company, and that it might not be able to continue as a going concern. *Id.* at 3. While acknowledging the highly speculative nature of many offerings, Chairman of the Commission, John Shad, testified that the Commission had no authority to assess the merits of an offering but was limited to ensuring complete and accurate disclosure. *Id.* at 16-19.


193. Item 503 of Regulation S-K requires registrants to disclose risk factors associated with the offering. A company must set forth “under an appropriate caption, a discussion of the principal factors that make the offering speculative or one of high risk.” 17 C.F.R. § 299.503 (1986); see Woodland Oil & Gas, 38 S.E.C. 485, 493 (1958) (“We conclude, therefore, that full and accurate disclosure requires that the speculative features of [a] registrant's business and securities be set forth in summary fashion in one place in the early part of the prospectus under an appropriate heading.”).

The more cogent concern evidenced by Staffin and Heublein in adopting a restrictive test for determining the materiality of ongoing negotiations was the belief that disclosure could have a chilling effect on merger negotiations. 195 Arguably, for example, premature disclosure of merger negotiations might cause increases in the price of a target company’s stock, thereby making the acquisition more expensive and dooming the deal. While sometimes valid, however, this type of concern is often overstated.

To induce shareholders to tender shares in a tender offer or to vote shares in favor of a merger proposal, a bidder must generally offer to buy shares at a substantial premium over market price. 196 Aware of the possibility of such a premium, investors learning about the negotiations will often enter the market and acquire the target company’s shares, thereby increasing demand and driving up the share price. As a result, to pay the same premium (measured as a percentage of the share price) would require substantial additional expenditures by the bidder, expenditures that could render the acquisition prohibitively expensive. 197

There are problems with this scenario, however. First, speculative frenzies that drive the price of stock upward would seem more likely where the market is fueled by rumors and leaks and has inadequate hard information.

195. Courts have often acknowledged the need for secrecy to prevent disclosure of information that would jeopardize a legitimate business objective. See, e.g., State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981) (premature disclosure could jeopardize major contract); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (premature disclosure of major ore strike could interfere with corporation’s ability to acquire land for mine site), cert. denied, 394 U.S. 976 (1969).
196. See supra note 102.
197. See THE SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 1, at 2828 (1971) (“The advantages of secrecy are obvious: Public announcement of any intention to acquire a substantial position in a target company would almost certainly increase the market price of the target’s shares, making a bid more costly.”).

In connection with its acquisition of Campbell Taggart, Inc. (CTI), Anheuser Busch had alleged that premature disclosure of negotiations or an impending offer forced it to pay more than originally intended for the company. Paul Thayer, a director of Anheuser Busch, told a broker about Anheuser Busch’s plans concerning CTI. The broker purchased shares for himself and his clients and tipped the information to others. Between June 28 and August 3, CTI’s share prices increased from $24 to $30. Anheuser Busch ultimately made an offer for CTI for $37 per share. See SEC v. Thayer, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,718 (S.D.N.Y. Mar. 16, 1984). Anheuser Busch filed suit against Thayer and others, alleging that as a result of Thayer’s disclosures, the company was forced to pay more for CTI than it otherwise would have. See Anheuser Busch Cos. v. Thayer, CA-3-85-0794-R (N.D. Tex.). The Commission has taken the position that “[s]o long as the corporation defrauded by the misappropriator’s scheme otherwise satisfies the standing requirement for a private action . . . a private cause of action should be available.” Memorandum of the Securities and Exchange Commission, Amicus Curiae at 27-28, Anheuser Busch Cos. v. Thayer, CA-3-85-0794-R (N.D. Tex.).
to determine the correct price of a company's stock. Because the rumors may be inaccurate, the resulting value placed on a company by the market may likewise be inaccurate.¹⁹⁸ Public disclosure that negotiations are taking place as well as the price range under discussion might actually prevent speculative frenzies by providing the market with information needed to accurately value the shares. Indeed, disclosure, particularly of the approximate bid price, will often have a sedative influence on an upward, speculative-driven spiral in stock prices.¹⁹⁹

Second, the arguments for secrecy ignore the frequency with which information finds its way into the marketplace. A number of recent studies have shown that takeover announcements are often antedated by dramatic changes in share price.²⁰⁰ The thirty-three percent increase in the price of RCA's shares during the four days preceding General Electric's takeover bid was described by one influential periodical as "just another in a string of occurrences known on Wall Street as 'preannouncement run-ups.'"²⁰¹ As one judge noted, "[t]he truth of the matter is that material nonpublic information is leaked to some 'favorites' among the investing public and the suc-

¹⁹⁸. An example of market over-pricing in response to misinformation occurred when rumors flooded the market that the Texaco Board had approved a proposal to acquire Pennzoil for $100 per share in settlement of a $10.5 billion judgment. See Texaco’s Board Meets to Discuss Pennzoil Accord, Wall St. J., Jan. 7, 1986, at 3, col. 4. In a single day, Pennzoil’s stock jumped 20 points and, for a time during the following day, increased another eight points. After both companies denied the rumors, Pennzoil’s stock declined considerably. See Pennzoil’s Rise: A Case Study, Wash. Post, Feb. 16, 1986, at G4, col. 1; Behr & Vise, Wall Street Rumors, Wash. Post, Feb. 16, 1986, at G1, col. 2.

¹⁹⁹. For example, after unusual activity in Key Pharmaceutical's stock in early March 1986, Key disclosed ongoing negotiations over a possible merger with Schering-Plough. The transaction under consideration involved an exchange of .27 shares of Schering for each share of Key, an exchange valued at approximately $17 per share. The market was, therefore, made aware of the negotiations, the identity of the prospective bidder, and the price under consideration. Rather than a frenzied increase in the price of Key shares, the market reacted by falling one-half point to $15.125. See Ricks & Barnes, Schering Seeks to Acquire Key Pharmaceuticals, Wall St. J., Mar. 4, 1986, at 8, col. 1.

²⁰⁰. See Templeman, The Epidemic of Insider Trading, Bus. Wk., April 29, 1985, at 79-80. A study discussed in that article examined 229 takeovers, mergers, or leveraged buy-outs of exchange-traded companies, and determined that stock prices of the target increased in advance of the official announcement of the transaction in 72% of the cases. The study suggests that such information leaks into the market before the announcement is made. Indeed, in adopting the Williams Act, intended to regulate cash tender offers, Congress considered testimony suggesting that even diligent companies cannot prevent selective leaks of information about impending tender offers. See Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids. 1967: Hearings on S. 510. Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 75 (1967) (testimony of Donald J. Calvin). See also Metz, Use of Inside Data in the Takeover Game is Pervasive and Can Lead to Huge Profit, Wall St. J., Mar. 2, 1984, at 12, col. 1; Sterngold, Wall Street Crime and Its Dividends, N.Y. Times, April 27, 1986, at § 46, col. 3.

²⁰¹. Sterngold, supra note 200.
cess of many investors is not because they have the genius of an Einstein but solely because they have tidbits of information that the general public does not have." Thus, information about the negotiations may already have been disclosed to select individuals, with public disclosure to the remainder of the market often unlikely to cause much additional harm.

Moreover, as a practical matter, companies often disclose the existence of negotiations, including the terms under discussion, with no apparent untoward harm. In disclosing negotiations, a release can be carefully drafted

202. Heublein, 742 F.2d at 764 (Higginbotham, J., dissenting). That the word of an impending acquisition often falls into the hands of select individuals that trade on the information has been dramatized by a series of spectacular insider trading cases brought by the Commission. See, e.g., SEC v. Boesky, Lit. Release No. 11,288 (S.D.N.Y. Nov. 14, 1986) (injunctive action against arbitrageur Ivan Boesky for trading in securities while in possession of material nonpublic information about impending mergers and tender offers; as part of settlement of the action, Boesky required to disgorge $50 million and pay a penalty of an equal amount under the Insider Trading Sanctions Act); SEC v. Reich, Lit. Release No. 11,246 (S.D.N.Y. Oct. 9, 1986) (injunctive proceeding against Ilan K. Reich, a partner at the law firm of Wachtell, Lipton, Rosen & Katz for tipping material nonpublic information "relating to actual or contemplated tender offers, mergers, leveraged buyouts or other business combinations or extraordinary corporate transactions"); SEC v. Levine, Lit. Release No. 11,095 (S.D.N.Y. May 12, 1986) (injunctive proceeding against Dennis Levine, managing director of Drexel Burnham Lambert, for trading while in possession of material nonpublic information "concerning mergers, tender offers, leveraged buyouts and other extraordinary transactions"); see also SEC v. Levine, Lit. Release No. 1117 (S.D.N.Y. June 5, 1986) (settlement of injunctive proceeding requiring Levine to disgorge approximately $11.6 million).

203. While there appears to be no authority on point, inferential evidence supports the conclusion. A cursory review of the Wall Street Journal indicates frequent instances in which companies, almost as a matter of course, disclose ongoing negotiations or their intention to enter into such negotiations. Were disclosure so immediately and consistently harmful, it would seem unlikely that it would occur with such frequency. See, e.g., Ricks & Barnes, Schering Seeks to Acquire Key Pharmaceuticals, Wall St. J., Mar. 4, 1986, at 8, col. 1 (disclosure of discussions between Key Pharmaceuticals and Schering-Plough over possible acquisition; Schering would provide 27 shares for each share of Key); James River May Buy Some of Crown's Assets, Wash. Post, Oct. 18, 1985, at E1, col. 1 (Crown Zellerbach disclosed discussions with James River Corp. over sale of Crown assets); Phillips, Baxter Seeks Sale of 2 Units as Part of Merger Offer, Wall St. J., Aug. 2, 1985, at 3, col. 3 (acknowledging ongoing discussions to sell certain divisions but not identifying prospective purchaser or selling price); O'Boyle, National Intergroup Is in Talks To Sell First Nationwide, Its Big Thrift Unit, Wall St. J., July 30, 1985, at 2, col. 3 (price and identity of prospective purchaser not disclosed); Buss & Marcom, Burroughs Said to Set Deadline in Bid for Sperry, Wall St. J., June 17, 1985, at 2, col. 2 (disclosing that Burroughs and Sperry to resume merger discussions but noting that no agreement had been reached on the terms); Hall & Montgomery, Nabisco Holds Talks with R.J. Reynolds Amid Speculation Concerns Will Merge, Wall St. J., May 30, 1985, at 2, col. 3 (price and identity of prospective purchaser not disclosed); Landro, Storer Is Willing To Discuss Merger, But Debt Is a Factor, Wall St. J., April 16, 1985, at 27, col. 2 (Storer Communications disclosed that discussions with two companies over possible merger had occurred and expressed interest in a merger); On the Auction Block, Hughes Aircraft Looks Impressive to Bidders, Wall St. J., Mar. 27, 1985, at 1, col. 6 (GM, Boeing, and Rockwell all acknowledged interest in possibly acquiring Hughes Aircraft); Tharp, Castle & Cooke Is Discussing Merger
to minimize any potential harm to the negotiation process. Where necessary, companies will sometimes omit particularly sensitive information such as the identity of the other party or the terms under discussion. The inevitability of these leaks and public disclosures belies the notion that public disclosure is always harmful.

Third, the disclosure of ongoing negotiations will not necessarily cause substantial increases in share prices. The market's reaction to the disclosures will normally take into account a number of factors, including the likelihood that the merger will occur, the perceived value of the target company, and the possibility that other bids will occur. To the extent substantial risk and uncertainty exists, the price increase in an efficient market should adjust accordingly. The possibility that the negotiations might not culminate in a preliminary agreement and that a preliminary agreement once reached might never be consummated often dictates that the market value the target cautiously.

Even if share prices increase significantly following the disclosure of negotiations, a bidder will not necessarily be forced to pay a larger premium. Paradoxically, the increase in price may demonstrate market forces at work with Another Big Board Company, Wall St. J., Mar. 11, 1985, at 14, col. 1 (identity of possible merger candidate not disclosed).

204. In at least some circumstances, the Commission permits the omission of the bidder's identity and the terms under discussion. See item 3, Schedule 14D-9, 17 C.F.R. § 240.14d-101 (1986) (requiring disclosure of negotiations undertaken by the target in response to a tender offer; such information need not be disclosed where no agreement in principle has been reached and the board determines that disclosure would "jeopardize" continuation of the negotiations). Companies disclosing the existence of ongoing negotiations often omit discussion of the terms or identity of the bidder. See SEC v. Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,971 (S.D.N.Y. Apr. 15, 1985) (press release acknowledging preliminary merger negotiations with undisclosed concern; price under discussion "substantially in excess of the current market price."); Johnson, Quotron Discloses Talks with Firm It Won't Identify, Wall St. J., Oct. 17, 1985, at 2, col. 3 (disclosing "preliminary" discussions with a "major corporation" over a possible merger); Isikoff, General Foods Says It Has Takeover Bid, Wash. Post, Sept. 25, 1985, at F1, col. 3 (in announcing receipt of unsolicited takeover bid, bidder's identity and price not disclosed); Hall & Montgomery, supra note 203 (price and identity of prospective purchaser not disclosed); Tharp, supra note 203 (identity of possible merger candidate not disclosed).

205. See Samuelson & Rosenthal, Price Movements as Indicators of Tender Offer Success, 41 J. FIN. 481 (June 1986) (price movement in target's shares following announcement of a tender offer "represent the collective opinion of the market participants as to the success or failure of the offer."); Of course, there is some dispute that the market is, in fact, efficient. See Gibson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549 (1984); Kelsey, You Won't Find an Efficient Market on Wall Street, Wall St. J., July 18, 1985, at 25, col. 3; see also Rosenberg, Reid & Lanstein, Persuasive Evidence of Market Inefficiency, J. PORTFOLIO MANAGEMENT 9 (Spring 1985).

that actually facilitate an acquisition. The increase, in the change of control context, often results from shareholders selling to arbitrageurs and other speculators.\textsuperscript{207} By selling in the market to arbitrageurs, shareholders receive an immediate premium for their shares, and do not have to wait for consummation of the merger or completion of the tender offer, events that may be months away. Moreover, where an offer is for only a portion of the outstanding shares, shareholders selling to arbitrageurs avoid application of the pro rata provisions.\textsuperscript{208} Most important, however, by selling to arbitrageurs, shareholders avoid the risk that the merger or tender offer will be unsuccessful. Concomitantly, by purchasing the shares, arbitrageurs assume the risk that the deal will not go through.\textsuperscript{209} In return for assuming this risk, arbitrageurs receive the spread between the price they paid for the shares and the bidder's offering price.\textsuperscript{210}

As arbitrageurs purchase shares, the increase in demand will typically
cause the spread between the market price and the bid price to decrease.\textsuperscript{211} Indeed, shortly before consummation of a merger or completion of a tender offer, when there is minimal risk that the transaction will collapse, the spread may all but disappear.\textsuperscript{212} Even with a narrow spread, however, arbitrageurs can still profit by reason of the volume of their transactions.\textsuperscript{213}

The disclosure of ongoing negotiations may cause arbitrageurs and other risk takers to enter the market and begin acquiring shares. As demand for shares increases, so will the price. The resulting increase, however, does not necessarily force a bidder to pay more for a target. Arbitrageurs normally do not hold shares as long-term investments, but typically strive for short-term profits.\textsuperscript{214} As a result, arbitrageurs have an incentive to sell as quickly

\textsuperscript{211} See Hamilton, supra note 207, at 294 ("The consequence of arbitrage activity is to cause the market price of the target corporation's security to rise quickly to approximate the tender price . . . discounted by the possibility that the offer may not succeed."); see also Comment, Should Tender Offer Arbitrage Be Regulated?, 1978 DUKE L.J. 1000, 1005.

\textsuperscript{212} See Henry, supra note 207, at 470 (noting that shortly before consummation of an offer, spread is often "negligible"); see also Samuelson & Rosenthal, Price Movements as Indicators of Tender Offer Success, 41 J. FIN. 481 (June 1986) ("If the tender is successful, the target stock will trade at (or very near) the tender price before being delisted.").

\textsuperscript{213} See Henry, supra note 207, at 469 (although an arbitrageur's "profits per share on transactions undertaken at the narrower spread are smaller, he may trade in large volumes, thus making the overall transaction highly profitable."). Even if the final trading price actually exceeds the offering price, arbitrageurs can still profit. When H.K. Porter agreed to purchase all outstanding shares in Fansteel Incorporated for $23.50 per share, the company also offered brokers a solicitation fee of 45 cents for each share they tendered as an inducement to obtain the shares. Shortly before the offer closed, Fansteel's share prices climbed above the offering price to $23.75. Nonetheless, because of the solicitation fee, brokers could purchase the shares in the market, tender them to Porter, and still make a profit of 20 cents per share. See Ehrbar, How to Play the Arbitrage Game, FORTUNE, July 1976, at 84.

\textsuperscript{214} A number of factors militate against long term investments by arbitrageurs. By purchasing shares in a particular target, arbitrageurs tie up capital which becomes unavailable for use in other deals. They may also incur certain transaction costs the longer the shares are held. For example, borrowed funds represent an important source of capital for arbitrageurs. See Sterngold, Boesky Builds $1 Billion War Chest, N.Y. Times, March 13, 1986, at D1, col. 4 (reporting that Boesky stated in an offering circular that "he could quickly increase the $1 billion [in investment capital] to $3 billion of 'investable funds' through borrowings."). Assuming some type of revolving line of credit, interest charges will be greater the longer the funds are tied up in a particular deal. See Johnson, supra note 207, at 10.

In addition, raising investment capital from investors rather than through borrowing also generates costs. Raising such funds may necessitate payment of a fee to a broker or investment banker. See Anders, Top Arbitrageurs Are Increasing Capital, Raising Some Concern As Well As Money, Wall St. J., April 3, 1986, at 10, col. 1 (reporting that Merrill Lynch was to be paid annual fee of 1/2 of one percent of funds raised). Capital raised through the sale of high yield "junk bonds" may also generate considerable costs. See Sterngold, supra (in attempting to raise a pool of $1 billion, one arbitrageur sold almost $750 million in junk bonds; the bonds paid either 13% and a portion of the profits or 17% and a smaller portion of profits.). All of these costs require arbitrageurs to maximize returns. Finally, arbitrageurs need to keep profit levels high in order to attract sufficient investment capital. See Anders, supra (reporting that arbitrageur profits in excess of 50% "have made it easy to attract new clients").
Consequently, the premium necessary to induce an arbitrageur to sell need not be as high as the premium that must be paid to other shareholders. As long as the bid price is high enough to induce the remaining shareholders to tender and to create a sufficient spread for arbitrageurs to earn an adequate profit, the bid price normally will not need to be increased, notwithstanding the rising market.

This reasoning raises an obvious question. If disclosure is not generally harmful, why is secrecy so prevalent? While sometimes detrimental to the interests of shareholders, secrecy, at least in the change of control context, can benefit bidders by minimizing the likelihood of competitive bidding. Disclosure places the market on notice that a particular target is “in play,” thereby increasing the likelihood of competing offers and an auction market.

Advanced notice of a possible merger or friendly tender offer not only provides other prospective bidders additional time to study the viability of the acquisition and assess any synergistic benefits, but also affords additional time to obtain the resources and financing necessary for a competitive offer.

215. See Henry, supra note 207, at 468 (“Even if the defensive tactics [of the target] fail to block the takeover, the delay and uncertainty created may convince the arbitrageur that his capital can be more profitably invested elsewhere”); see also Dealers in the Know. THE ECONOMIST, May 24, 1986, at 14-15 (“Since the arbitrageurs will be more ready than the institutions to sell to the predator at a quick profit, the bid succeeds more easily.”). Even a short delay can have a substantial impact on the profits of an arbitrageur. Had the Macy’s offering, see supra note 213, remained open an additional month, the annualized profits of the arbitrageurs who purchased in early June at $66 5/8 would decline from 27% to about 13%. See Wall Street’s “Arbs” on the Hot Seat, supra note 210, at 41.

216. For example, Hanson Trust was able to induce arbitrageurs to sell their holdings in SCM Corporation by offering a premium of about one dollar over market price, notwithstanding a pending offer by Merrill Lynch and SCM’s management at an even higher price. In less than two hours, Hanson Trust acquired, primarily from arbitrageurs, about 25% of SCM’s stock. See Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985). Had Hanson not been enjoined by the district court, the company may have been able to acquire an even greater percentage of SCM’s shares.


218. Because time works to the detriment of the initial bidder, a target may engage in dilatory tactics or vexatious litigation, not so much in the expectation of the bidder withdrawing the offer, but in an effort to lengthen the time period of the offer in the hope that other, more acceptable bidders will enter the fray. See Giammarino & Heinkel, A Model of Dynamic Takeover Behavior, 41 J. FIN. 465, 466 (June 1986) (“target management resistance is justified...
An auction market is often detrimental to the original bidder's interests. Either the bidder will be unable to acquire the target or, if successful, will be forced to pay a higher price. The danger of an auction market to an initial bidder is not academic; a recent study found that once competitive bidding commenced, initial bidders failed to acquire control of the target in seventy-eight percent of the cases. Failure to acquire the target deprives the original bidder of the synergistic or other benefits expected from the acquisition. Moreover, the bidder may be further disadvantaged if the target is ultimately acquired by a competitor. Finally, the original bidder may also have incurred expenses in locating an appropriate target, expenses that may not be repaid if another bidder is successful.

Of course, even if disclosure is delayed until an agreement in principle has been reached, some opportunity exists for competitive bidding. In the case of a merger agreement, a period of time will elapse between the date the agreement is executed and the date that shareholders vote on the merger.
During this period, another bidder conceivably could make a tender offer at a higher price and acquire control of the target. Similarly, where an initial bidder seeks to acquire control through a friendly tender offer, the Williams Act and Commission rules require that the offer remain open for at least twenty business days. Thus, once an offer puts a target company “in play,” other prospective bidders have at least the twenty business days to make a competing bid.

Nonetheless, the earlier the negotiations are disclosed, the more time other prospective bidders will have to decide whether to make competing offers. As a result, the initial bidder has an obvious incentive to shorten the period in which competing offers can occur. Successfully enshrouding negotiations in secrecy will leave other potential bidders unaware that a particular target is in play. By withholding information about an impending tender offer or merger, the parties may also be able to negotiate an agreement containing terms designed to discourage competitive bidding, such as “crown jewel” and other lock-up options.

and Getty had previously announced an agreement to merge, Texaco made a more lucrative offer and acquired Getty. See Moffett, Petzinger & Stewart, Courting Disaster. How Texaco Turned Big Victory into Bigger Legal Loss, Wall St. J., Dec. 20, 1985, at 1, col. 6. Nonetheless, the existence of an agreement in principle to merge, particularly if coupled with some type of lock-up option, can toughen considerably the ability of an interloping bidder to acquire the target. Moreover, the legal difficulties incurred by Texaco in the wake of its acquisition of Getty have been said to have made some bidders wary of making an offer for a target once an agreement in principle has been announced. See Waldman, Cautious Talks, Texaco-Pennzoil Case Makes First Careful About Merger Moves, Wall St. J., April 15, 1986, at 1, col. 1.

222. Rule 14e-1(a), 17 C.F.R. § 240.14e-1(a) (1986). Shareholder withdrawal rights extend throughout the offering period. See rule 14d-7(a), 17 C.F.R. § 2140.14d-7(a) (1986); see also Exchange Act Release No. 23,421, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,016, at 88,196-97 (July 11, 1986) (amending rule 14(d)-7(a) to extend withdrawal rights throughout offering period). As a result, as long as the initial bidder’s offer is open, even shareholders that have already tendered can withdraw the shares and tender them to a competing bidder.

223. Once an offer is made, the risk of competitive bidding is substantial. The Commission’s Office of the Chief Economist conducted a study of the 148 successful tender offers from 1981 through 1983 and found that competitive bidding occurred in 62 cases. See supra note 102. Once competitive bidding begins, the initial bidder often loses. See supra note 219.

224. Unsurprisingly, therefore, it is often the bidder that insists on secrecy. See, e.g., In re Carnation, Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,593 (July 8, 1985) (prospective bidder, Nestle, informed target Carnation that discussions would cease if Carnation publicly disclosed negotiations); see also State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1982) (party awarding contract to Fluor placed “embargo” on publicity until specified date).

225. A lock-up may take the form of an option to buy a certain percentage of the target company’s shares. See Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), cert. denied, 465 U.S. 1052 (1984) (court upheld lock-up option issued by Datatab, the target, to a competing bidder to buy unissued shares equivalent to 200% of Datatab’s outstanding shares). A lock-up may also involve an option to buy important assets of the target, i.e., the crown jewels. See Mobile Oil Co. v. Marathon, 669 F.2d 366 (6th Cir. 1981), cert.
While secrecy is often in the interest of the bidder, secrecy may not necessarily be in the best interest of target shareholders. Shareholders gain from an auction market through increases in the offering price. To the extent that secrecy inhibits the auction market, therefore, shareholders may be forced to tender their shares at prices lower than would otherwise have been the case.

The debate on the need for secrecy aside, it can be conceded that at least in some instances, disclosure of the ongoing negotiations will prevent a particular transaction from going forward. The increase in share prices beyond the offering price may result from the market's perception that the target is worth more than what the bidder is willing to pay. The market thus expects either the open market price of the shares to increase or another bidder to offer a higher price.\(^2\)

If the market expects other bids and none material-denied, 455 U.S. 982 (1982) (In an effort to defeat a tender offer by Mobile Corp., Marathon gave U.S. Steel an option to buy its crown jewel, a 48% interest in oil and mineral rights in the Yates Oil Field, an option that could be exercised only if a third party acquired control of Marathon.). Whether in the form of an option to purchase stock or an option to purchase assets, lock-ups may make the target sufficiently unattractive so as to deter other bidders from making an offer. Of course, a crown jewel option may sometimes be insufficient to block a determined bidder, at least where the courts are cooperative. See Hanson Trust, 781 F.2d 264 (2d Cir. 1985).

As a general matter, fully disclosed lock-up arrangements do not raise concerns under the Williams Act. See Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985) (rejecting Sixth Circuit's reasoning in Marathon, that a fully disclosed lock-up arrangement can violate § 14(e) of the Williams Act); Kademian v. Ladish Co., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,764, at 93,745 (7th Cir. May 28, 1986) (concluding that after Schreiber, a fully disclosed lock-up arrangement did not violate securities laws); see also Lerner & Schwartz, Commentary—Lock-Ups and Lock-Ins, 51 BROOKLYN L. REV. 1103 (1985). Lock-ups issued during the pendency of contested takeovers have, however, been successfully challenged under state law. See Hanson Trust PLC v. SCM Corp., 781 F.2d 264 (2d Cir. 1985) (crown jewel option issued to Merrill Lynch declared invalid); see also MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1339 (Del. Ch.), aff'd, 505 A.2d 454 (Del. 1985) (per curiam) (enjoining lock-up options issued by Revlon).

In addition to lock-up options, a merger agreement can foreclose other prospective merger agreements by including a clause that expressly prohibits a target from selling assets or otherwise executing a merger agreement with other companies. In Jewel Cos., v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555 (9th Cir. 1984), the Ninth Circuit upheld an exclusive merger agreement in which the target agreed not to enter into merger agreements with other companies. Of course, such a prohibition does not prevent a third party from blocking the merger through a tender offer for the target.

226. See Samuelson & Rosenthal, Price Movements as Indicators of Tender Offer Success, 41 J. FIN. 481, 498 (June 1986) ("in competitive takeover bidding, it is common for the current stock price to rise about the initial tender offer in anticipation of (or in response to) higher competitive bids."). Where the market expects a competing offer, the trading price often exceeds the offering price. On September 19, 1985, Unilever announced that it was increasing the offering price for Richardson-Vicks, Inc. from $54 to $60 per share. Within several days after the announcement, Richardson-Vicks' stock price had jumped 10 points to over $63 in apparent expectation that a white knight would make a higher offer. See Vise, Richardson-Vicks Stock Soars on Rumor of Sale, Wash. Post, Oct. 1, 1985, at B1, col. 4. True to form, on
ize, the target's shares will often fall back below the bidder's offering price.\textsuperscript{227} Both expectations suggest the inadequacy of the original offering price and that preventing the initial merger agreement may be in the best interest of shareholders.

Even accepting the premise that increased disclosure will have a chilling effect on some negotiations in a manner detrimental to shareholders, a blanket rule of nondisclosure is not justified. The effect of cases such as \textit{Staffin} and \textit{Heublein} is to allow companies to issue false "no developments" press releases without fear of liability, a result antithetical to the purposes of the securities laws.\textsuperscript{228} While those favoring nondisclosure dwell on the potential harm to companies, they typically fail to address, or even to acknowledge, the harm to investors in the market. Nondisclosure allows companies to deprive investors of material information. This result conflicts with the

October 1, Richardson-Vicks announced that it had accepted an offer from Proctor & Gamble at $69 per share. See Williams, Waldholz & Solomon, \textit{Vicks Board Accepts Friendly Bid from P & G Totalling $1.24 Billion}, Wall St. J., Oct. 2, 1985, at 3, col. 1; see also Gilman & Tharp, \textit{MAXXAM Plans Bid to Acquire Pacific Lumber}, Wall St. J., Oct. 1, 1985, at 2, col. 2 (when MAXXAM Group, Inc. disclosed an impending tender offer for Pacific Lumber Co. for $36 per share, Pacific Lumber's stock price increased six points to $39, reflecting the market's reaction to the expectation that another company would top the MAXXAM bid). The market price may also exceed the offering price where the market believes that the initial bid is too low to succeed.

A higher bid may be necessary to entice a shareholder to sell and/or to win the support of the target's management. After Burroughs Corp. announced its intention to make an offer of $70 per share for Sperry Corp., Sperry's share prices jumped over 13 points in a single day to $71.25. See Buss, Hertzberg & Marcom, \textit{Burroughs Proposes to Buy Sperry Corp., Create New No. 2 Computer Maker}, Wall St. J., May 6, 1986, at 3, col. 1. The price exceeded Burroughs' offering price amid speculation that Burroughs would be forced to offer more in order to overcome the opposition of Sperry's management. See Hertzberg & Marcom, \textit{Sperry's Shares Surge to $71.25 on Speculation}, Wall St. J., May 7, 1986, at 2, col. 2. After Burroughs raised the offering price to $76.50 per share, Sperry's board of directors acquiesced to the acquisition. See Buss, Hertzberg & Marcom, \textit{Sperry Agrees To Be Acquired By Burroughs}, Wall St. J., May 28, 1986, at 2, col. 2.

\textsuperscript{227} For example, on July 1, 1986, Loral Corp. made an offer of $50 per share for Sanders Assocs. Lockheed Corp. followed with an offer for Sanders at $60 per share. In response to the second offer, Sanders' share price climbed more than two points above the Lockheed offer. The market apparently expected Loral to top the Lockheed offer. When Loral instead announced that it was withdrawing its bid, the share price slid back below Lockheed's offering price. See Hertzberg, \textit{Loral Withdraws Its $980 Million Offer for Sanders, Clearing Way for Lockheed}, Wall St. J., July 15, 1986, at 10, col. 1.

\textsuperscript{228} As the Commission has noted:

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.

overall purpose of the securities laws to encourage disclosure.\textsuperscript{229} Interference with ongoing negotiations and the prospect of harm does not justify complete absolution from liability for fraudulent misstatements by companies.\textsuperscript{230}

Moreover, a finding of materiality at relatively early stages does not ineluctably lead to the conclusion that disclosure of negotiation will occur with heightened frequency. As noted, an obligation to disclose material developments generally arises only in certain instances, such as when a company trades in its own stock or makes a public disclosure that would otherwise be misleading but for the disclosure of the negotiations. Companies, therefore, largely can prevent application of the duty to disclose by refraining from trading in their own shares or by remaining silent during the pendency of the negotiations.\textsuperscript{231}

In summary, requiring an agreement between the target and bidder on price and post-merger corporate structure as a precondition to a finding of materiality does not comport with the balancing test articulated in \textit{Texas Gulf Sulphur},\textsuperscript{232} appears inconsistent with the overall disclosure philosophy

\textsuperscript{229} See supra note 2.
\textsuperscript{230} As the Commission has noted, even if requiring disclosure might inhibit certain merger negotiations, "[i]n the final analysis, however, this concern cannot justify deceptive conduct." \textit{Michaels Memorandum, supra} note 11, at 9.
\textsuperscript{231} As the Commission has indicated:

\begin{quote}
[T]he concern [of the \textit{Heublein} Court] is, in effect, that it is impossible for a corporation accurately to disclose the existence of preliminary likelihood of success of merger negotiations, and that such disclosure would thus itself be misleading. The Commission does not agree with this reasoning. It should in fact be a relatively simple matter for a corporation to disclose that it is engaged in preliminary talks toward a possible merger, that there is no agreement to merge, and that the results of the talks cannot be predicted.
\end{quote}

\textit{Michaels Memorandum, supra} note 11, at 7. In some ways, the \textit{Texas Gulf Sulphur} analysis leads to an almost Hobson's choice. In response to inquiries, companies often have little choice but either to remain silent or to disclose otherwise nonpublic information. Moreover, silence may be tantamount to an affirmative disclosure. Nonetheless, the difficult choice does not justify a third alternative, a misstatement. As one court concluded:

\begin{quote}
Imposing a duty on \textit{[the target]} in these circumstances may, at first blush, appear unfair. \textit{Once [the bidder] approached [the target], [the target]'s choices were limited. "Should we have refused to speak with [the bidder]?" [the target] may ask. However, [the target]'s quandry [sic] was a foreseeable consequence of the scheme upon which it had embarked. This far-reaching consequence of its alleged wrongdoing evokes little sympathy. [The target] could have said nothing and avoided the difficulties entirely. It chose instead to speak in furtherance of its own interests and must suffer the consequences of its actions.}
\end{quote}


\textsuperscript{232} Not only is the \textit{Staffin-Heublein} line of authority a departure from the more conventional, longstanding analysis for determining the materiality of speculative information, but it also represents a departure from the type of analysis employed by the Third Circuit for other
of the federal securities laws and is derived from faulty reasoning. While the probability of an ultimate agreement may be particularly speculative during the period preceding an agreement in principle, the magnitude of the underlying agreement still must be considered. As noted, mergers result in the demise of the target company and, therefore, have been characterized as "the most important event" in at least a small corporation's life. Mergers also often involve substantial premiums, a fact of no small importance to reasonable investors. Under the Texas Gulf Sulphur balancing test, the magnitude of a possible merger weighs heavily in favor of materiality, even if the negotiations have not yet advanced to the level of a preliminary agreement.

The reasoning employed by the courts in Heublein and Staffin to support the price-structure test does not withstand scrutiny. Moreover, by permitting and perhaps even requiring companies to withhold information about negotiations preceding the price and structure determinations, the courts have adopted a position that is fundamentally inconsistent with the goal of the securities laws of ensuring full disclosure. Finally, while the Heublein-Staffin courts may have been motivated by the laudatory goal of bringing certainty to an uncertain area, certainty has a cost. A bright-line test is more susceptible to abuse. Companies far advanced in the negotiations process may be able to avoid disclosure by intentionally leaving elements of the price term or post-merger structure undecided until the last moment.

...
bright-line test would, therefore, enable companies to structure negotiations in a way that deprived shareholders of information of unquestionable materiality.\textsuperscript{237}

\textbf{IV. POST-HEUBLEIN: THE COMMISSION VIEW}

The Commission did not participate in the \textit{Heublein} appeal. The Third Circuit, therefore, confronted the materiality of ongoing negotiations without a clear expostulation of the Commission's views. Since that decision, however, the Commission has had a number of opportunities to articulate its views on the issue. The agency has addressed the issue in enforcement cases and amicus briefs. Through these pronouncements, the Commission has expressly disagreed with the Third Circuit's reasoning in both \textit{Staffin} and \textit{Heublein}.\textsuperscript{238}

The Commission's first recent comments in this area arose in \textit{In re Carnation Company},\textsuperscript{239} a report issued under section 21(a) of the Exchange Act.\textsuperscript{240} Officials of Carnation and Nestle commenced discussions about a possible

\textsuperscript{237} Perhaps an action could still be maintained against companies that intentionally delayed completion of the price-structure negotiations in order to avoid disclosure. Such cases, however, would be extraordinarily difficult to prove as they would require a detailed examination of the entire negotiation process and an analysis of the reasons and motivations of the parties in failing to agree sooner upon price or corporate structure.

\textsuperscript{238} \textit{See infra} notes 247, 257-60, 262-63, and accompanying text.


merger. Representatives of both companies met in mid-July, with Carnation agreeing to provide Nestle with certain information about its international operations. In early August, Carnation's stock began undergoing unusual activity, jumping over four points in a single day. In response to inquiries, Carnation's treasurer issued a statement disclaiming knowledge of any "corporate developments that would account for the stock action." 241

Negotiations between the two companies continued throughout August. At a meeting held on August 9, Nestle officials suggested a price of $75 per share, a price characterized by Carnation officials as "not in the ball park." 242 Meanwhile, the price of Carnation's stock continued the inexorable trend upward, hitting a twelve-month high on August 21. Again confronted by inquiries about the unusual activity, Carnation's treasurer issued a statement expressly denying that Carnation was negotiating with Nestle, and in fact stating that "[w]e are not negotiating with anyone." 243 At the time of the denial, Carnation's president and chief financial officer were in Switzerland actively negotiating with officials from Nestle. 244 Approximately two weeks after the second "no developments" release, Carnation and Nestle announced a merger agreement at $83 per share.

Following an investigation, the Commission issued a release characterizing Carnation's press releases of August 7 and 21 as "materially misleading" and "materially false and misleading," respectively. In both cases, Carnation knew of reasons that would explain the unusual activity in its stock—the discussions with Nestle. Issuing a blanket "no developments" statement was misleading and, at a minimum, should have been corrected. 245 As the Commission stated:

Whenever an issuer makes a public statement or responds to an inquiry from a stock exchange official concerning rumors, unusual

242. Id. The $75 was in fact "in the ball park." Nestle ultimately purchased the shares for $83. Id. at 87,594.
243. Id. The Dow Jones news wire study stated the following: Malone [the corporate spokesman and treasurer] said he had been informed of rumors in the market that Carnation is about to be acquired by Nestle S.A. or be taken private in a leveraged buyout by Kohlberg Kravis Robert. "But to the best of my knowledge there is nothing to substantiate either one of them" said Malone. "We are not negotiating with anyone."

244. Id. at 87,594. Stories in the press had also speculated about a possible merger between Carnation and Nestle. Id. at 87,594.
245. Id. at 87,596. The Commission made clear in the report that the existence of a duty to disclose was not at issue. The only question was whether Carnation's disclosures were misleading. Id.
market activity, possible corporate developments or any other matter, the statement must be materially accurate and complete. If the issuer is aware of nonpublic information concerning acquisition discussions that are occurring at the time the statement is made, the issuer has an obligation to disclose sufficient information concerning the discussions to prevent the statements made from being materially misleading . . . . Thus, in the Commission's view, an issuer statement that there is no corporate development that would account for unusual market activity in its stock, made while the issuer is engaged in acquisition discussions, may be materially false and misleading.\textsuperscript{246}

To the extent that the Third Circuit's decision in \textit{Heublein} indicated a contrary result, the Commission concluded "that \textit{Heublein} was wrongly decided."\textsuperscript{247}


The concern that arose from the legal principles enunciated in the release was unfounded. As the General Counsel to the Commission, Daniel L. Goelzer, explained in a letter to the \textit{Wall Street Journal}:  

Your July 10 second-front-page article describing the SEC's recent Carnation Co. release cited commentators who characterized the Commission's position as "impractical," and speculated that the release would "force more public disclosure about secret merger talks." In fact, the Commission's release breaks no new ground and imposes no additional disclosure obligations.

The Commission's release simply reiterates a well-settled proposition. The antifraud provisions of the securities laws prohibit companies from making materially false or misleading statements to the public—during merger negotiations or at any other time. While the release encourages companies to respond promptly to market rumors, it also makes clear that, in appropriate circumstances, a "no comment" response to press inquiries is permissible. These principles are hardly novel; rather, they are axiomatic.

The report contained no explicit discussion of the materiality of the negotiations; materiality was apparently presumed. The materiality of the August 21 negotiations seems beyond peradventure. By this time, Carnation had provided Nestle with financial information, the companies had been talking for over a month, officials of the companies had held a number of high level meetings, and price negotiations had begun.

The materiality of the negotiations on August 7 presents a more interesting case. Officials of the two companies had met only once, although another meeting was to be held in a few days. Telephone calls had been exchanged and Carnation officials knew that the company's largest shareholder was interested in selling its shares. No merger price, however, had been suggested. Despite the formative state of the August 7 negotiations, the Carnation release treated them as material. Rumors over a possible acquisition of Carnation by Nestle even at this early stage apparently caused Carnation's stock price to jump. Thus this case provides a telling example of how early in the process negotiations can be material.

Also interesting is the Commission's treatment of the need for secrecy. At one point, Nestle officials threatened to terminate the negotiations if public disclosure occurred. That Nestle would terminate discussions with a viable merger candidate simply because negotiations were publicly disclosed must questioned the propriety of an administrative ruling that expressly disagreed with the holding of a federal appellate court. Others asserted that the Commission was attempting to force earlier disclosure of merger negotiations, something that would hinder such negotiations. Neither criticism, however, is particularly well-founded. While the Commission historically has not made widespread use of § 21(a) reports to expressly disagree with an appellate decision, nothing precludes it from doing so. Other administrative agencies such as the Internal Revenue Service routinely acquiesce or disagree with decisions in the federal courts. See J. Grauer & M. Rothkoff, Fundamentals of Tax Research 3-29 (1977); see also Note, Agency Nonacquiescence: Implementation, Justification, and Acceptability, 42 Wash. & Lee L. Rev. 1233 (1985). The § 21(a) report simply placed issuers on notice about the Commission's interpretation of Heublein. The less satisfactory alternative would be for the Commission to articulate its view through the medium of an enforcement action, an alternative particularly unpalatable to the subjects of the investigation. The Carnation release at least provided advance warning, allowing issuers to modify their actions in a way that will avoid conflict with the Commission's interpretation and a possible enforcement action.

The second claim that the Commission was seeking to obtain earlier disclosure of merger negotiations is equally misplaced. In its bluntest terms, Carnation stands for the unremarkable proposition that a company cannot lie to the public. Carnation's spokesman denied that negotiations with Nestle were taking place. Had the Carnation spokesman said nothing or responded "no comment," there would have been no duty to reveal the existence of the negotiations with Nestle. The release does not expand the disclosure requirements under the federal securities laws; it simply restated the longstanding prohibition on misleading disclosures. Those decrying the Commission's position are, therefore, supporting the view that companies may issue misleading disclosures about merger negotiations without fear of an enforcement action. This view, rather than the Commission's, represents a radical departure from long established principles of the federal securities laws.
be viewed with some skepticism, although whether Nestle would have done so of course is unknown. Admittedly, publicity might have made the acquisition of Carnation more expensive to Nestle by either accelerating an upward trend in share prices or by attracting other bidders. Nestle, therefore, did stand to benefit from continued secrecy. Even with the ban on public disclosure, however, Carnation’s stock price increased significantly, apparently without affecting the merger. In any event, Nestle’s threat to terminate the negotiations received little attention in the Commission’s opinion. Nothing in the release suggested that Nestle’s threat of terminating the negotiations had any impact on Carnation’s duty to correct the misstatement.

Although the Commission concluded that both press releases were misleading, the report left unclear the precise nature of the antifraud violations. Arguably, Carnation violated the antifraud provisions ab initio by issuing the misleading press releases. To prevent such misstatements, Carnation arguably had a duty to keep its public spokesman apprised of all major developments, thereby ensuring the accuracy of releases when issued. Alternatively, Carnation should have had a system in place requiring pre-clearance from the appropriate corporate official before a public statement was made. Such policies would reduce the opportunity to disseminate false information, particularly when responding to calls from investors and analysts. Carnation also could have implemented a policy of responding “no comment” to all inquiries about merger negotiations or rumors, thereby avoiding the problem of misleading statements without necessarily revealing the negotiations to the corporate spokesman.248

Alternatively, the antifraud violation may have been Carnation’s failure to correct the misleading releases.249 A statement by the corporate spokesman is typically treated as a statement on behalf of the company. To the extent that the spokesman’s statements are false and not the views of the corporation, prompt correction, or at least prompt disavowal, would seem to be required. Perhaps a public statement indicating that the spokesman’s statement was unauthorized and not necessarily the views of the company would have been sufficient.250 Absent any such action, the corporation may fairly

248. In re Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 (July 8, 1985). The Commission made clear, however, that a “no comment” response to inquiries would not always be appropriate. Inquiries about rumors attributable to an issuer or prior statements that become incorrect or misleading might require a statement of the true state of affairs, rather than a noncommittal “no comment” response. The release seems to take the position that a “no comment” response will be inappropriate where there is inaccurate information in the marketplace and the source of the information was the issuer.

249. Id.

be treated as having ratified the corporate spokesman's misleading statement. 251

Finally, the release raises questions about the role of the corporate spokesman. Carnation's treasurer knew about rumors concerning a merger between Nestle and Carnation. Indeed, speculation about such a merger appeared in a number of publications. Given the unusual activity in Carnation's stock and the speculation concerning a possible acquisition by Nestle, the company's spokesman was arguably on notice about a possible development. Not to have investigated internally before issuing such emphatic denials to inquiries about the rumors may have been reckless. Had the spokesman made such inquiries, one of the other officers might have prevented the misleading denials. The Commission's release did not address the possible recklessness of the spokesman, however.

A more extensive analysis of the materiality of ongoing merger negotiations was undertaken in briefs filed as amicus curiae in Michaels v. Michaels 252 and Levinson v. Basic, Inc. 253 In Michaels, the parties owned a family business. Filial relations being less than harmonious, plaintiff decided to terminate his involvement and sell his interest back to the company. Before execution of the sales agreement, defendants, all relatives of plaintiff, contacted a broker about the possible sale of the business. The broker indicated that a number of companies might be interested in acquiring the business, including one that had previously shown interest in doing so. Plaintiff was not informed of these developments. Approximately six months after plaintiff agreed to sell his shares, defendants executed an agreement to sell the company at a substantial profit. 254

Plaintiff filed suit alleging that the nondisclosure of the negotiations violated the antifraud provisions and successfully obtained damages. 255 De-

(following quote over Dow Jones by spokesman that company knew of no reason to explain unusual stock activity, company "said the statement on the ticker had been reported incorrectly.") From a purely mechanical point of view, corporations seeking to disavow a spokesman's statement may have trouble disseminating the information. In Etshokin v. Texasgulf, Inc., 612 F. Supp. 1220 (N.D. Ill. 1985), the spokesman for Canada Development denied that the company had any intent to sell its shares in Texasgulf. See supra note 157 and accompanying text. According to the defendants, the company attempted to retract the statement but had been unable to do so. Dow Jones refused to issue the disavowal unless Canada Development was taking the position that the prior statement was false, something Canada Development refused to do. Notwithstanding these efforts to correct the statement, the district court refused to dismiss a suit alleging that the statement violated the antifraud provisions.

252. 767 F.2d 1185 (7th Cir. 1985), cert. denied, 106 S. Ct. 797 (1986). See supra note 11.
253. 786 F.2d 741 (6th Cir. 1986). See supra note 11.
254. Michaels, 767 F.2d at 1192.
255. Id. at 1191.
fendants appealed, contending that the information about a possible acquisition was immaterial as a matter of law. Noting that Heublein involved public shareholders, the Seventh Circuit agreed that disclosure of ongoing negotiations might mislead shareholders in the open market. The court therefore agreed that ongoing negotiations for publicly traded companies were immaterial absent an agreement on price and structure. Where, however, a publicly traded company was not involved, the possibility that disclosure might mislead shareholders was less of a concern. Negotiations could, therefore, be material prior to an agreement on price and structure.256 Because the company in Michaels was not publicly traded, the Seventh Circuit concluded that Heublein was not controlling and held that the omitted negotiations were material.

Defendants sought a rehearing. In connection with the petition, the Commission took the opportunity to comment on the Seventh Circuit's reasoning. The Commission filed a Memorandum, as amicus curiae, arguing that the Seventh Circuit's analysis concerning the materiality of ongoing negotiations for publicly traded companies should be treated as dictum and be deleted from the opinion.257 More to the point, the Commission took the position that the court's dictum on the issue was incorrect. Specifically, the Commission disagreed that the standard for materiality depended upon whether the negotiations involved a public or private company. Instead, for both publicly and privately traded companies, negotiations could be material well before the price and post-merger structure had been determined. The Commission pointedly criticized the Third Circuit's attempt to render negotiations preceding an agreement in principle immaterial, noting that the "Commission disagrees with the statement in Staffin that merger negotiations never become material prior to an agreement in principle."258 The Commission also labelled the price-structure test in Heublein as "far too rigid . . . [and] inconsistent with prior decisions in this area." The test would "deprive shareholders in publicly traded companies of important information relevant to their investment decisions."259 Eschewing a bright-line test for determining the materiality of ongoing negotiations, the Commission endorsed the case-by-case balancing test espoused in Texas Gulf Sulphur.

Although denying the petition for rehearing, the Seventh Circuit nonetheless issued an amended opinion. While not expressly adopting the Commission's reasoning, the court did delete the dictum endorsing Heublein.260

256. Id. at 1195-97.
257. Michaels Memorandum, supra note 11, at 1-2.
258. Id. at 2 n.1.
259. Id. at 2.
260. Michaels, 767 F.2d at 1196.
Instead, the court took note of the contrary views, including those espoused by the Commission, and declined to take a position as to the proper test.

The materiality analysis employed by the Third Circuit in *Staffin-Heublein* and initially supported by the Seventh Circuit in *Michaels*, provided the Commission with a relatively easy target to criticize. While a bright-line test had the advantage of certainty, the *Heublein-Staffin* decisions contained analysis completely at odds with existing case law and conventional notions of materiality. Indeed, the facts in *Heublein* illustrated the weaknesses in the Third Circuit's analytical approach. A bright-line "price-structure" test permitted Heublein to issue a "no developments" release notwithstanding the ongoing merger negotiations, thereby affirmatively misleading the market, a result inconsistent with the purposes of the federal securities laws. Furthermore, a bright-line test could be susceptible to manipulation. Companies might intentionally delay final agreement on either the price or structure until the last moment in an effort to avoid crossing the materiality threshold.

*Levinson v. Basic, Inc.*, another case involving an allegedly misleading "no developments" statement, presented a somewhat more difficult situation. Analysing the materiality of ongoing negotiations, the district court repeated the Third Circuit's conclusion that negotiations preceding an agreement in principle were immaterial. But, rather than adopt the price structure test espoused in *Heublein*, the *Levinson* court concluded that an agreement need be only "reasonably certain" for negotiations to be considered material.\(^{261}\)

The reasonable certainty test proposed by the district court in *Levinson* was arguably less rigid than the "price-structure" test and more amenable to flexible interpretation. A determination as to whether an agreement in principle was reasonably certain would have required a fact-intensive analysis, including an analysis of the particular stage of negotiations. Thus, the test did not completely disregard the Second Circuit's admonition in *Texas Gulf Sulphur* that materiality was to be determined on a case-by-case basis. Nonetheless, while perhaps more flexible than the *Staffin-Heublein* "price-structure" test, the district court in *Levinson* did seem to contemplate that negotiations would be material only in the most advanced stages. Under the *Texas Gulf Sulphur* test, however, negotiations can be material in less advanced stages where the resulting agreement was particularly important. The reasoning in *Levinson*, therefore, was inconsistent with *Texas Gulf Sulphur* and a substantial body of case law.

On appeal, the Commission, for a second time in a brief amicus curiae,

took the opportunity to express its views on the proper test for the materiality of ongoing negotiations. The Commission again objected to what it saw as another attempt to impose a bright-line test. The amicus brief argued that "[t]he correct test of materiality, and the one long accepted by other courts, is that the importance of preliminary merger negotiations to investors depends on the probability of a merger being concluded and the significance the merger would have for the company." Given the importance of the merger under discussion, the Commission asserted that the negotiations could be material "well before there is a reasonable certainty of agreement."

Reversing the district court, the Sixth Circuit in Levinson agreed that merger negotiations could be material before an agreement in principle had been reached. The court concluded that a "no developments" release and a release denying that negotiations were taking place were both misleading. Further, the court had little patience with Basic's contention that the contacts with the bidder had not risen to the level of negotiations. "The average investor does not necessarily know the technical and legal definition of [negotiations] . . . . A statement that 'no negotiations' were occurring could reasonably be read to state that no contacts of any kind whatsoever regarding merger had occurred." Recognizing that its reasoning conflicted with the reasoning employed by the Third Circuit, the court acknowledged that Heublein contained a holding "with which we are in disagreement."

The Sixth Circuit agreed that the district court's analysis was incorrect and correctly declined to adopt the faulty reasoning in Heublein. Had the opinion stopped there, the Levinson decision would have represented an unremarkable but accurate expostulation of the law. Unfortunately, the court went on to add yet another questionable wrinkle to the materiality analysis. The court made clear that its materiality analysis applied only to misleading statements, not to cases such as Staffin involving affirmative obligations to disclose.

In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because

262. Levinson Brief, supra note 11, at 7.
263. Id..
264. Levinson, 786 F.2d at 747.
265. Id. at 748.
they make the statement made untrue.266

The conclusion that a denial could somehow make immaterial information material is unsound. When Basic issued the "no developments" release, the company was implicitly denying that any material developments were taking place. So long as the negotiations were immaterial at the time Basic made the statement, the statement was accurate. It is difficult to see how a denial of material developments could change the result. This reasoning gives rise to a Catch-22 of sorts. Any time a company truthfully denies that material developments are taking place, it runs the risk that the denial itself will somehow cause developments to become material.267

The Sixth Circuit's reasoning conflicts with reasoning employed by the Second Circuit in Geon. There, the court took the position that materiality might be easier to establish in abstain or disclose cases and more difficult in cases involving misleading disclosures.268 The Sixth Circuit's reasoning in Levinson suggests the precise opposite; materiality is easier to establish in misleading disclosure cases. As a result, those who engage in insider trading have greater immunity than those issuing misleading statements that do not result in any direct pecuniary gain, an anomalous result at best.

Discontent with the results in the Sixth Circuit, Basic filed a petition for certiorari.269 Basic argued in its brief that Levinson and Heublein were in direct conflict and urged the Court to resolve the division among the circuits. Basic contended that the agreement in principle analysis employed by the Third Circuit best comported with the TSC Northway test for determining materiality.270

The Supreme Court requested the views of the United States on whether

266. Id. at 749; see SEC v. Parklane Hosiery Co., 422 F. Supp. 477, 485 (S.D.N.Y. 1976) ("Here . . . there is an affirmative misstatement rather than a non-disclosure. Had there been no falsity involved, the situation might have been different.").

267. The Sixth Circuit's curious reasoning in Levinson may have been motivated by a desire to avoid a conflict with the holdings in Starkman v. Marathon Oil, 772 F.2d 231 (6th Cir. 1985), cert. denied, 106 S. Ct. 1195 (1986) and Radol v. Thomas, 772 F.2d 244 (6th Cir. 1985), cert. denied, 106 S. Ct. 3272 (1986). In those cases, the Sixth Circuit had to determine the test for ascertaining the materiality of asset appraisals and other soft information. The court rejected the case-by-case balancing test articulated by the Second Circuit in Texas Gulf Sulphur in favor of a restrictive test, more closely resembling the type of reasoning employed by the Third Circuit in Heublein. In Radol, the Sixth Circuit held that appraisals of the target's assets were material in a tender offer only if the underlying projections were "substantially certain to hold." 772 F.2d at 252-53; see Starkman, 772 F.2d at 241 (appraisal material if underlying projections "virtually as certain as hard facts").

268. See supra notes 142-43 and accompanying text.


the petition should be granted. The request gave the Commission a specific opportunity to comment on the Sixth Circuit’s reasoning in Levinson and a more general opportunity to comment upon the correct standard for determining the materiality of speculative information such as ongoing negotiations. The Commission recommended in its brief that the Court grant the petition.\(^{271}\) The agency acknowledged that a split existed among the circuits and agreed that the materiality of ongoing negotiations represented “an issue of great importance to companies involved in such negotiations.”\(^{272}\)

In analyzing the issue, the Commission submitted a tightly reasoned, cogently drafted brief. The brief first made clear that the case did not involve a corporation’s duty to affirmatively disclose negotiations. Whether Heublein or Basic had an affirmative obligation to reveal that negotiations were underway was not at issue. Instead, the only issue was whether, by omitting mention of the negotiations, the companies had issued materially false and misleading statements. “While the federal securities laws do not impose upon a company any general obligation to issue a statement [revealing material developments], even in the face of unusual trading activity, a company that chooses to speak cannot make a materially false or materially misleading statement about ongoing negotiations.”\(^{273}\)

Consistent with its prior pronouncements, the Commission reiterated that the proper test for determining the materiality of ongoing negotiations was the “probability/magnitude” standard espoused by the Second Circuit in Texas Gulf Sulphur. The Commission also reiterated that the agreement in principle standard adopted in Heublein was inconsistent with this test.\(^{274}\) Turning to Levinson, the Commission expressed disagreement with the Sixth Circuit’s reasoning. Allowing negotiations to become material “by virtue of the statement denying their existence,”\(^{275}\) according to the Commission, “has no basis under Northway, and would appear to render any false statement, regardless of how trivial, per se material.”\(^{276}\)


\(^{272}\) Id. at 5-6.

\(^{273}\) Id. at 7.

\(^{274}\) Id. at 10-13.


\(^{276}\) Brief for the United States as Amicus Curiae on Petition for Writ of Certiorari, at 14, Basic, Inc. v. Levinson, 107 S. Ct. 267 (1986) (No. 86-279). The parties and the Commission all agreed that the materiality of ongoing negotiations was controlled by the Supreme Court’s reasoning in Northway. Id. at 9-10 n.11. Thus, the probability/magnitude test was not in lieu of the Northway formulation, but was simply the test for determining the materiality of speculative information such as ongoing negotiations under Northway. See supra note 107.
The Supreme Court has agreed to hear the case. Levinson represents an appropriate vehicle for clarification of the issue. With three circuits having weighed in on the issue, and a fourth taking the issue under consideration, the standard for determining the materiality of ongoing negotiations has become a morass of confusion. In some respects, the real conflict is between the fact specific, "probability/magnitude" standard of the Second Circuit and the more certain, "price/structure" standard of the Third Circuit. Each attempts to balance the harm of premature disclosure of negotiations against the need to protect the integrity of the marketplace. Under the price/structure test, the Third Circuit is, in order to protect perceived concerns about the negotiating process, willing to absolve from liability under some circumstances companies that mislead the market by issuing incorrect statements. The Second Circuit standard, on the other hand, errs on the side of ensuring accuracy in the marketplace, even if, as a result, there may be some incidental adverse impact upon the negotiation process.

The Sixth Circuit, perhaps trying to thread a line between the two tests, adopted something that bears no resemblance to conventional materiality analysis. Nor does the standard have any commending policy justifications. Moreover, if the problem with the "probability/magnitude" test is uncertainty, the Sixth Circuit's test exacerbates the problem. The Sixth Circuit standard does not obviate the need for a corporation to make the difficult determination as to whether (and under what test) negotiations are material. Instead, the Levinson court imposes the additional hurdle that even if negotiations are determined to be immaterial, they may be rendered material if a company expressly denies that negotiations or other material developments are taking place.

277. 54 U.S.L.W. 2516 (U.S. Feb. 23, 1987) (No. 86-279). In 1985, the Supreme Court had an opportunity to decide the appropriate standard for determining the materiality of speculative information such as projections and appraisals in another Sixth Circuit case. See Radol v. Thomas, 772 F.2d 644 (6th Cir. 1985), cert. denied, 106 S. Ct. 3727 (1986). In commenting on the cert. petition, the Commission suggested that the case was an inappropriate vehicle for deciding the issue. See supra note 107. Levinson does represent a cleaner set of facts than Radol. Perhaps more importantly, the harm and uncertainty that may result from leaving the Levinson decision intact is likely to be far greater than in Radol.

278. The Second, Third, and Sixth Circuits have all decided cases on this issue. See supra notes 133, 136, 161, 169, 253.

279. The Seventh Circuit expressly left the issue open in Michaels. See supra note 260 and accompanying text. More recently, the issue has again come before the court. See Jordan v. Duff & Phelps, Inc., Nos. 86-1611/1727 (7th Cir. 1986). The Commission filed a Memorandum as Amicus Curiae recommending that the Seventh Circuit reject the district court's adoption of the Staffin-Heublein test for determining the materiality of ongoing negotiations. See Memorandum of the Securities & Exchange Commission, Jordan v. Duff & Phelps, Inc., Nos. 86-1611/1727 (7th Cir. 1986).

280. See supra notes 99-124 and accompanying text.
For the sixteen years following *Texas Gulf Sulfur*, there was little controversy over the proper standard for determining the materiality of speculative negotiations such as ongoing negotiations. The 1984 *Heublein* decision represented an aberration that disagreed with a substantial and longstanding body of law without ever once mentioning *Texas Gulf Sulphur* or its progeny. The course of the case law could readily be returned to its proper path, the confusion could largely be alleviated through a brief decision by the Supreme Court affirming the probability/magnitude test and unequivocally stating that the *Levinson* and *Heublein* variations are inconsonant with the test.

V. ANALYSIS AND CONCLUSION

What advice can be given to corporate officials concerning the materiality of ongoing negotiations? First, until either an edict from the United States Supreme Court or a greater unanimity among the circuit courts, a company that adheres to the *Staffin-Heublein* analysis does so at great peril. The legal reasoning in those cases is dubious; the policy arguments are suspect. Other courts, including lower courts in the Third Circuit, have already begun to disagree with and limit the holdings in these cases. The likelihood of other circuits or the Supreme Court adopting the Third Circuit standard appears questionable.

Prudence, therefore, dictates that companies assess the materiality of negotiations under the more longstanding and conservative standard espoused in *Texas Gulf Sulphur*. Thus, a company must weigh the magnitude of the resulting agreement against the probability that an agreement will occur. By following the *Texas Gulf Sulphur* approach, the materiality analysis necessarily will be undertaken on a case-by-case, fact-intensive basis.

Second, notwithstanding dictum to the contrary, the standard for materni-

---

281. See, e.g., Powell v. American Bank & Trust Co., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,916 (N.D. Ind. Aug. 13, 1986). Even in the Third Circuit, some district courts have been troubled by the reasoning in *Heublein* and have endeavored to interpret the case restrictively. In Paul v. Berkman, 620 F. Supp. 638 (W.D. Pa. 1985), plaintiff, a 21% shareholder of Associated Communications Corp. (ACC), sold his shares back to the corporation. Before the stock purchase agreement was signed, ACC began discussing the sale of 11 radio stations to another corporation. Following the announcement of an agreement to sell the stations, ACC's stock price more than doubled. Plaintiff alleged that ACC had a duty to reveal the existence of the negotiations and that failure to do so vitiated the stock purchase agreement. Defendants, relying on *Heublein*, argued that the negotiations were not material. The district court determined that *Heublein* was not dispositive, concluding that the reasoning in *Heublein* applied only to merger discussions. "*Heublein* does not, even arguably, address when the duty to disclose arises in the context of negotiations for the sale of assets." *Id.* at 642. The court also emphasized that unlike in *Heublein*, disclosure of the negotiations would not have "thwart[ed] the transaction." *Id.*
ality remains the same for all cases brought under the antifraud provisions. *Geon* and *Levinson* aside, whether a case involves the duty to abstain or disclose, or involves a misleading statement filing, the standard for materiality does not vary. Consequently, in assessing materiality, prudence again dictates that substantial attention be accorded to those insider trading cases that found negotiations to be material at relatively early stages. In examining the materiality of the negotiations for purposes of a release or filing, a company should attempt to decide whether knowledge of the same negotiations would impose upon insiders the duty to “abstain or disclose.” If the answer is in the affirmative, the negotiations are likely to be material in other contexts.

Beyond these generalities, a few specific conclusions are in order, although given the case-by-case, fact-intensive analysis, little can be ventured with absolute certainty. As is typical, the ends of the spectrum are relatively easy to identify. Certainly, “the law does not require that private dreams, musings, aspirations and other remote hopes of the buyer of stock be disclosed to the seller.”282 Moreover, primal steps toward an agreement typically will not be material. Mere inquiries, isolated contacts, or expressions of interest, without more, generally will not cross the materiality threshold.283 Such information would be of little or no use to shareholders or other investors in making investment decisions. Indeed, disclosure of mere inquiries could flood the market with a morass of extraneous information which might actually obscure more important and material matters.

At the other end of the spectrum, discussions over an important agreement will be material where the parties have negotiated all material terms and only actual consummation of the agreement remains. Essentially, this is what the *Staffin-Heublein* cases hold. The difficulties arise with situations falling somewhere between the two extremes.

Discussions beyond limited or isolated contacts can be material. For certain highly important agreements, e.g., merger agreements or agreements involving substantially all of a company’s assets, negotiations often will be material at a very early stage. Materiality, at least in the context of merger negotiations, would therefore seem triggered whenever the target and bidder have expressed sufficient mutual interest to begin actual bargaining, whether directly or through intermediaries. Although the prospect of a merger may still be highly speculative, at least some possibility exists that it will occur. The knowledge that both companies appear seriously interested in a business

283. See supra note 166.
combination would seem relevant and material to those shareholders deciding whether to retain or to sell their shares.

Given the lack of certainty in this area, companies can institute a number of procedures designed to preserve secrecy by minimizing the likelihood that disclosure of the negotiations will be required. First, to reduce the risk of a misleading disclosure, corporate communications should be centralized. A company should have a spokesperson who acts as the sole authorized individual to respond to inquiries from the press, public, shareholders, analysts, and stock exchanges. Typically, a corporate spokesman frequently is not an attorney and, therefore, will not be familiar with all the nuances of the securities laws. Moreover, he or she frequently will not have the most current information about every corporate development, particularly highly sensitive ones. Therefore, a company should consider a set of written guidelines or instructions for the corporate spokesman. Such instructions might provide that inquiries, particularly from the press, about any major development should not be answered without first consulting relevant personnel inside the company. The corporate spokesman in *Carnation* incorrectly denied that negotiations with Nestle were taking place. While he no doubt thought his denial was accurate, efforts to contact the appropriate officers within Carnation to determine the proper state of affairs probably would have prevented the misleading release. Such a policy effectively would place the responsibility for proper disclosure in the hands of high level corporate officials.

In some circumstances, instructions might provide for a canned response to certain types of inquiries. Instructions regarding questions about market rumors should require that the spokesperson automatically give a “no comment” response. Absent a preexisting, consistently applied policy, however, a “no comment” response to inquiries about rumors sometimes may be tantamount to an admission that negotiations are taking place. Moreover, a “no comment” response in certain circumstances will not always be

---

284. See, e.g., Cole, *Unocal Stock Surges on Takeover Rumors*, N.Y. Times, July 14, 1984, at 37, col. 1 (“Unocal, following its standard procedure, said it never comments on rumors dealing with mergers and acquisitions.”); Hull, *Unocal Stock Rises on Unconfirmed Report that Indiana Standard Will Make a Bid*, Wall St. J., July 16, 1984, at 6, col. 2 (when asked to comment on rumors that Standard Oil Co. (Indiana) intended to make tender offer for Unocal, a “spokesman for Indiana Standard said that, as a matter of policy, it refused to confirm or deny the rumors.”).

285. A policy of responding “no comment” to inquiries about mergers sometimes may be tantamount to an admission that negotiations are taking place, particularly where no such policy existed previously. See Vise, *Richardson-Vicks Stock Soars on Rumor of Sale*, Wash. Post, Oct. 1, 1985, at B1, col. 4 (where Richardson-Vicks had previously denied any plans to be acquired, sudden refusal to respond to questions or return phone calls interpreted by analysts to mean white knight negotiations were taking place).
appropiate and sometimes may contravene the securities laws.\textsuperscript{286}

Perhaps most importantly, a company should adopt a forthright policy that errs on the side of more rather than less disclosure. Whether ongoing negotiations are material and whether they must be disclosed are issues laden with uncertainty and confusion, with little likelihood of any improvement in the near future. Given the uncertain state of the law, companies should, when in doubt, favor disclosure.

In addition to a policy of forthright disclosure, companies seeking to minimize exposure under the securities laws should also strive for far greater precision in drafting disclosures. For example, in cases where preliminary contacts between prospective merger partners have occurred, a company may decide that the contacts do not rise to the level of negotiations and, in response to inquiries, may give a blanket denial of any ongoing negotiations. An enterprising plaintiff, however, may later argue that the contacts did rise to the level of negotiations and that the release was, therefore, misleading. The easiest way to prevent such a suit is to issue an accurate release in the first instance. A frank admission in the release that contacts occurred but that negotiations have not yet commenced will make a subsequent challenge more difficult because it will be harder to prove that such release was misleading and that corporate officials acted with the requisite scienter.

Additionally, companies should endeavor to make public disclosures time specific. Open-ended releases (e.g., "we have no intention of entering into negotiations at this time") arguably may give rise to a duty to correct or update in the event negotiations subsequently commence. To minimize the duty to correct, a release might state that as of 5:00 p.m. on the date of issue, no negotiations have commenced. Such a press release is less likely to be "alive" and subject to a duty to update.

In summary, the materiality of ongoing negotiations represents an area of continued ferment. The elusiveness of the concept coupled with murky legal reasoning has resulted in substantial confusion. Nonetheless, \textit{Texas Gulf Sulphur} provides the essential framework for determining materiality. Notwithstanding the case-by-case, fact-intensive nature of the test, the substantial body of case law analyzing the materiality of ongoing negotiations provides some degree of assurance in determining whether negotiations are material.
