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Rule 10b-5 and the Duty To Disclose
Merger Negotiations in Corporate Statements

C. Daniel Ewell

A corporation whose stock is traded on any national stock exchange is subject to the disclosure requirements of both the federal securities laws and stock exchange rules. The purpose of disclosure is to provide investors with adequate information on which to base investment decisions and to maintain fair and orderly securities markets.

Premature disclosure of corporate merger negotiations, however, poses a substantial threat to investors because of the likelihood that disclosure will cause the negotiations to terminate, causing shareholders to lose valuable merger premiums. In recognition of this potential loss, both Securities and Exchange Commission Rule 10b-5 and the rules of the major stock exchanges generally permit corporations to delay disclosure of merger negotiations until the parties reach an agreement in principle to merge.

When rumors develop or there is unusual trading activity in a stock, however, stock exchange rules do require that a corporation either disclose the reason for the unusual activity or make a public statement to the effect

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3. Assertions of the policies underlying the disclosure requirements of the Securities Acts are included in H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933) (statement of President Roosevelt that 1933 Act is "but one step in our broad purpose of protecting investors"); H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934); SEC, The Work of the Securities and Exchange Commission v (1974) [hereinafter Work of the SEC] ("securities laws were designed to facilitate informed investment analyses and prudent and discriminating investment decisions"); Hewitt, Developing Concepts of Materiality and Disclosure, 32 Bus. Law. 887, 891 (1977) (investors protected by disclosure "in that members of the securities industry would be deterred from engaging in questionable practices"); NYSE Manual, supra note 2, ¶ 23,515 ("[a] sound corporate disclosure policy is essential to the maintenance of a fair and orderly securities market"); ASE Guide, supra note 2, ¶ 23,124A ("the conduct of a fair and orderly market requires every listed company to make available to the public information necessary for informed investing"); see also infra notes 11-12.
5. The two major American stock exchanges are the New York Stock Exchange (NYSE) and the American Stock Exchange (ASE). The NYSE is the more important in terms of the value of stock traded. Approximately 94% of trading (based on the dollar value of traded stocks) takes place on either the NYSE or the ASE. Securities, Exchanges and the SEC 65 (P. Tyler ed. 1965).
6. See infra notes 27-30 and accompanying text.
that it knows of "no corporate development" that would account for the unusual activity.\footnote{NYSE Manual, supra note 2, § 202.03, at ¶ 23,517; ASE Guide, supra note 2, § 401(d), at ¶ 23,124A. Some commentators have characterized the exchanges as "paper tigers" because the exchanges have allegedly failed to enforce their rules stringently. See Kaufmann & Hoyns, Disclosure Dilemma: What To Say When the Exchange Calls?, N.Y.L.J., Jan. 18, 1985, at 1, col. 3. Any disinclination of the exchanges to enforce their rules through extended trading halts or delisting may be the result of competition from so-called "third-market" securities firms that continue to trade exchange-listed stocks after trading is halted on a major exchange. Recent proposals to extend trading halt requirements to third-market firms would eliminate the competitive threat posed by those firms when a major exchange halts trading. Hertzberg, SEC Is Urged To Extend Rules on Halts in Trading To Cover Third-Market Firms, Wall St. J., Feb 20, 1986, at 4, col. 3.}

Some courts, as well as the SEC, have recently taken the position that "no corporate development" statements issued during preliminary merger negotiations may be materially false or misleading and thus may violate Rule 10b-5.\footnote{Levinson v. Basic Inc., 786 F.2d 741, 747 (6th Cir. 1986); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 134 (S.D.N.Y. 1984); In re Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,592 (July 8, 1985).}

The conflict between these recent holdings and the stock exchange rules leaves corporate management in a quandary over appropriate disclosure when unusual trading activity develops in the corporation's stock during preliminary merger negotiations. Disclosure of the negotiations may result in loss to the corporation's shareholders, whereas nondisclosure may result in a suit by a disappointed shareholder under Rule 10b-5. This Note argues that the policies underlying the federal securities laws,\footnote{See supra note 3.} namely protecting investors' economic interests and encouraging efficient capital resource allocation, are best served by holding that a corporation does not violate Rule 10b-5 when it issues a "no corporate development" statement while engaged in preliminary merger negotiations. This Note argues that the policies underlying the federal securities laws,\footnote{See, e.g., WORK OF THE SEC, supra note 3, at vii (primary purpose of 1934 Act is protection of investors' interests); Wolfson & Russo, The Stock Exchange Member: Liability for Violation of Stock Exchange Rules, 58 CALIF. L. REV. 1120, 1147 (1970) (1934 Act contains over 50 separate references to goal of investor protection).} namely protecting investors' economic interests and encouraging efficient capital resource allocation, are best served by holding that a corporation does not violate Rule 10b-5 when it issues a "no corporate development" statement while engaged in preliminary merger negotiations. This Note proposes a standard of constructive immateriality for use in analyzing "no corporate development" statements for the purposes of 10b-5 liability.

\section{I. CORPORATE DISCLOSURE OBLIGATIONS}

The Securities Exchange Act of 1934 created a scheme of mandatory disclosure of important corporate information and prohibited fraudulent practices.\footnote{15 U.S.C. § 78m (1982) (periodic disclosures to SEC); 15 U.S.C. § 78j (1982) (antifraud provisions).} The 1934 Act's disclosure requirements were adopted to protect investors\footnote{See, e.g., H.R. REP. No. 85, 73d Cong., 1st Sess. 2-3 (1933); R. KARMEL, REGULATION BY PROSECUTION 259 (1977) (securities markets are "nation's primary mechanism for allocating eco-}
ments,\textsuperscript{13} the Act’s antifraud provisions impose additional requirements concerning corporate disclosure.\textsuperscript{14} In particular, SEC Rule 10b-5,\textsuperscript{15} promulgated under section 10(b) of the 1934 Act, prohibits false or misleading statements or omissions of material fact in connection with the purchase or sale of a security.

Pursuing the goal of protecting investors through full and complete disclosure, both the courts and the SEC have interpreted Rule 10b-5

nomic resources among competing companies”); Friend, \textit{The SEC and the Economic Performance of Securities Markets}, in \textit{Economic Policy and the Regulation of Corporate Securities} 190 (H. Manne ed. 1969) (allocative efficiency has been traditionally regarded as “most important economic function” of securities markets); Schoenbaum, \textit{The Relationship Between Corporate Disclosure and Corporate Responsibility}, 40 \textit{Fordham L. Rev.} 565, 576-77 (1972) (“The concept of assuring a free and open securities market also has the aim of improving the allocative efficiency of the capital markets.”); see also Note, \textit{The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry}, 29 \textit{Stan. L. Rev.} 1031, 1032 (1977) (one purpose of Securities Acts was to improve economic functioning of markets and thus to improve resource allocation).

Goals of the securities laws are often framed in terms of disclosure. \textit{See, e.g.}, Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir. 1970) (1934 Act “designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete and misleading information”); Block, Barton & Garfield, \textit{Affirmative Duty To Disclose Material Information Concerning Issuer’s Financial Condition and Business Plans}, 40 \textit{Bus. Law.} 1243 (1985) [hereinafter \textit{Affirmative Duty}] (central goal of Securities Acts is ensuring that investors “will be adequately informed of material information” affecting value of securities). Disclosure, however, is properly viewed not as an end in itself, but rather as means by which to effect the primary goals of protecting investors and improving resource allocation. \textit{See, e.g.}, Easterbrook & Fischel, \textit{Mandatory Disclosure and the Protection of Investors}, 70 \textit{Va. L. Rev.} 669, 709 (1984) (“The principal benefit usually asserted for mandatory disclosure is that investors will make more money.”).

In fairness to the SEC, it should be noted that this fundamentally economic conception of the purposes of the Securities Acts has not been universally recognized. \textit{See, e.g.}, SEC, \textit{Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (The Wheat Report)} 50-54 (1969) (policies underlying SEC Rule 10b-5 include disclosure, promoting free and honest markets, protection of investors, and fostering investor trust); Comment, \textit{Corporate Disclosure of Merger Negotiations—When Does the Investor Have a Right To Know?}, 36 \textit{Syracuse L. Rev.} 1155, 1170-78 (1985) (non-economic analysis of disclosure obligations imposed by Rule 10b-5 in merger context).


15. 17 C.F.R. § 240.10b-5 (1986). Rule 10b-5 provides that

\begin{itemize}
\item[(a)] It shall be unlawful for any person, directly or indirectly, by the use of any instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
\item[(b)] To employ any device, scheme, or artifice to defraud,
\item[(c)] To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
\item[(d)] To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person,
\end{itemize}

in connection with the purchase or sale of any security.

broadly. For example, courts have construed Rule 10b-5 to require insiders to disclose material information prior to trading in a corporation's securities. The Rule also requires disclosure when necessary to ensure that corporate statements are not materially false or misleading (as these terms have been interpreted by courts). But despite the 1934 Act's general policy—expanded by courts and the SEC—of encouraging disclosure of material corporate information, Rule 10b-5 has not been held to impose a general obligation of continuous and complete disclosure of material information.

The rules of the major stock exchanges, however, do impose significant disclosure obligations on listed corporations beyond those imposed by the federal securities laws. Unlike Rule 10b-5, stock exchange rules mandate full and immediate disclosure by corporations of all material information. The exchanges may enforce these rules by making violations public, temporarily suspending trading in a corporation's stock, or instituting a proceeding to delist a corporation's stock. The rules of the New York Stock Exchange (NYSE) provide, for example, that a listed corporation

16. Justice Rehnquist has characterized Rule 10b-5 as a "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975); see also L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 820 (1983) ("it is difficult to think of another instance in the entire corpus juris in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little"); Kripke, Rule 10b-5 Liability and "Material" Facts, 46 N.Y.U. L. Rev. 1061, 1062 (1971) ("[i]t is an anomaly that so important an element of the federal law of corporations as 10b-5 should stand on so flimsy a base").


18. Texas Gulf, 401 F.2d at 833.


21. See supra note 5.

22. See NYSE MANUAL, supra note 2, §§ 801-809, at ¶¶ 23,171-23,184; ASE GUIDE, supra note 2, §§ 1001-1005 (1973). Recent cases indicate, however, that violation of exchange rules alone will not support a private cause of action for damages. See, e.g., Carrott v. Shearson Hayden Stone, Inc., 724 F.2d 821, 823 (9th Cir. 1984) (no private right of action for violation of NYSE "know your customer" rule); State Teachers Retirement Board v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981) (violation by corporation of NYSE rule mandating disclosure in the event of unusual activity does not give rise to implied federal right of action).
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"is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities." Like Rule 10b-5, however, the rules of the NYSE and American Stock Exchange (ASE) permit a corporation to delay disclosure of material information if immediate disclosure would impede the company's pursuit of valid corporate objectives, at least where the information can be confined to a small group of individuals.

II. Disclosure of Merger Negotiations

A. Stock Exchange Disclosure Requirements: The "No Corporate Development" Statement

The rules of the major stock exchanges require that a corporation publicly explain any rumors concerning the corporation and explain unusual market activity in its stock. Alternatively, a corporation may issue a statement that it knows of "no corporate development" that would account for the unusual activity. "No corporate development" statements are considered an effective check on unwarranted speculation in a corporation's stock; the statement is intended to inform the market whether rumored developments have in fact occurred. Absent corporate awareness of leaks of confidential information, the stock exchanges do not require a corporation to disclose preliminary merger negotiations in response to a request for a "no corporate development" statement. Because the stock exchanges have not taken disciplinary action against corporations that issue

23. NYSE Manual, supra note 2, § 202.05, at ¶ 23,519; see also ASE Guide, supra note 2, § 401(a), at ¶ 23,124A ("a listed company is required to make immediate public disclosure of all material information concerning its affairs").

24. NYSE Manual, supra note 2, § 202.01, at ¶ 23,515 (premature public announcement may properly be delayed for valid business purpose "where adequate security can be maintained"); ASE Guide, supra note 2, § 402(a), at ¶ 23,124B (similar provisions).

25. The New York Stock Exchange Listed Company Manual provides that if rumors or unusual market activity indicate that information on impending developments has been leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect. . . . If rumors are correct or there are developments, an immediate candid statement to the public as to the state of negotiations or of development of corporate plans in the rumored area must be made directly and openly.

NYSE Manual, supra note 2, § 202.03, at ¶ 23,517. When rumors develop or unusual price changes occur, or when there is an unexplained influx of buy or sell orders, an exchange official routinely will contact the company to request that a statement be made pursuant to the exchange's rules. NYSE Manual, supra note 2, § 202.04, at ¶ 23,518; ASE Guide, supra note 2, at ¶ 23,124B.


27. This reflects the exchanges' view that the decision as to whether a "no corporate development" statement is appropriate in response to a stock exchange inquiry during preliminary merger negotiations is generally best left to the corporation and its counsel. Telephone interview with William Bors, Managing Director, Corporate Liaison Division, and Bruno Lederer, Assistant General Counsel, New York Stock Exchange (Oct. 20, 1986) [hereinafter NYSE Interview].
“no corporate development” statements during preliminary merger negotiations, management may at least temporarily avoid disclosing such negotiations. The exchanges’ acceptance of delayed disclosure may demonstrate their awareness that the damage to shareholders resulting from premature disclosure would probably outweigh the benefits of disclosure.

B. “No Corporate Development” Statements Under Rule 10b-5

“No corporate development” statements made during preliminary merger negotiations are subject to Rule 10b-5. Whereas Rule 10b-5 does not impose an affirmative obligation on a corporation to disclose the fact that it is engaged in preliminary merger negotiations, the courts that have specifically considered whether “no corporate development” statements issued during preliminary merger negotiations violate Rule 10b-5 have reached inconsistent results.

In Greenfield v. Heublein, Inc., plaintiffs claimed that Heublein violated Rule 10b-5 by failing, in its response to a NYSE request, to disclose that it was engaged in preliminary negotiations regarding the possible acquisition of the corporation by R.J. Reynolds Industries, Inc. Heublein instead issued a “no corporate development” statement. The Third Circuit held that, as a matter of law, Heublein’s “no corporate development” statement was not “false, inaccurate, or misleading.” Holding that Heublein had no duty to disclose that it was engaged in preliminary merger negotiations, the court further reasoned that because Heublein had no in-

28. Id.
29. Even when the letter of the stock exchange rules might appear to require disclosure in a given instance, exchange officials may be willing to forego disciplinary action against a corporation if its reason for noncompliance is sufficiently compelling. The NYSE listing agreement provides that where strict compliance with the conditions of the listing agreement is difficult “the Exchange is inclined to place the emphasis upon the spirit, rather than upon the letter, of the agreement . . . .” New York Stock Exchange Company Manual § A-34 (1985); see Feuerstein, supra note 20, at 391 (“timely disclosure should ordinarily be enforced informally by the self-regulatory bodies rather than formally by the Commission.”).
32. In mid-1981, the General Signal Corporation began to accumulate Heublein shares on the open market. Regarding this activity as hostile, Heublein in July 1982 began negotiations with Reynolds, a potential friendly merger partner. On July 14, unusual trading volume in Heublein stock prompted the NYSE to request a “no corporate development” statement from Heublein. On the same day, Heublein stated that “the Company was aware of no reason that would explain the activity in its stock in trading on the NYSE today.” 742 F.2d at 754. Negotiations between Heublein and Reynolds proceeded, and on July 27 an agreement in principle for the acquisition of Heublein by Reynolds was reached. On July 28 Heublein publicly disclosed the existence of the agreement in principle to merge.
33. 742 F.2d at 759.
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dication that information regarding the merger negotiations had been released or that insider trading was occurring, Heublein's "no corporate development" statement did not violate Rule 10b-5.34

Explicitly declining to follow Greenfield, the Sixth Circuit held in Levinson v. Basic Inc.,35 on facts similar to those before the court in Greenfield, that statements made by Basic denying the existence of merger negotiations and asserting that Basic knew of no corporate development to account for unusually heavy trading in its stock could not be held as a matter of law to be neither false nor misleading under Rule 10b-5. Likewise, in Schlanger v. Four-Phase Systems, Inc.,37 the court rejected the reasoning of Greenfield and held that the question of whether a "no corporate development" statement made during preliminary merger negotiations was false or misleading under Rule 10b-5 could not be resolved as a matter of law in defendant's favor on a motion for summary judgment.38

The SEC has also rejected the reasoning of Greenfield. In In re Carnation Co.,39 the SEC announced that Greenfield "was wrongly de-

34. This holding was reached despite the court's recognition that Heublein "clearly knew of information that might have accounted for the increase in trading . . . ." 742 F.2d at 759. With respect to the possibility that information regarding the negotiations had leaked to the public, the court reasoned that despite the unusual market activity, "because of the confidential nature of these discussions, there was no basis for [Heublein] to believe . . . that any of the details of these discussions, not previously known to the public, had been recently leaked." Id. (footnote omitted).

35. 786 F.2d 741 (6th Cir. 1986).
36. 786 F.2d at 747-49. Levinson arose out of plaintiffs' sale of Basic stock during preliminary negotiations between Basic and Combustion Engineering, Inc. that eventually led to the acquisition of Basic by Combustion Engineering. As in Greenfield, plaintiffs claimed that three of Basic's public statements made during the merger negotiations were false or misleading because they failed to disclose the negotiations. In the first contested statement, a Basic official stated to a newspaper reporter that "the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger." Id. at 744. In the second and third statements at issue, Basic stated in response to NYSE inquiries that "management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days." Id. at 745. Although the Levinson court criticized the Third Circuit's holding in Greenfield, the two cases are not necessarily inconsistent. Unlike Heublein, Basic, in a voluntary public statement to a newspaper reporter, affirmatively denied that merger negotiations were being conducted. Moreover, Basic's "no corporate development" statements, unlike Heublein's, stated that the company knew of no present or pending corporate development that would account for the unusual activity in its stock. Specifically denying the existence of pending developments, Basic's "no corporate development" statement was affirmatively misleading in a way that Heublein's was not.

37. 582 F. Supp. 128 (S.D.N.Y. 1984). Schlanger arose out of negotiations which eventually led to the acquisition by Motorola of Four-Phase Systems, Inc. During the period in which preliminary negotiations were underway, Four-Phase was contacted by a NYSE official and asked to comment on a sudden rise in the market price and trading volume in the company's stock. Four-Phase responded by stating that "the Company is not aware of any corporate developments which would affect the market of its stock." Id. at 129.

38. Id. at 133.
39. In re Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,592 (July 8, 1985). This release arose out of the SEC's investigation into unusual trading activity which occurred during preliminary acquisition negotiations between Nestle, S.A. and Carnation Company. After rumors began to circulate about a possible acquisition and the exchange observed unusual activity in Carnation stock, Carnation issued a public statement that "[t]here is no news from
ceded,” and argued instead that a “no corporate development” statement issued while the corporation is conducting preliminary merger negotiations is materially false or misleading and violates Rule 10b-5.40 According to the SEC, “[i]f 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.”41

C. The Disclosure Quandary

The interaction between management’s goal of shareholder wealth maximization, stock exchange rules requiring public statements in response to unusual market activity, and the current uncertainty as to the sufficiency under 10b-5 of “no corporate development” statements leaves corporate management facing a difficult dilemma. Although the success of merger negotiations may depend on maintaining confidentiality, the demands of stock exchange disclosure requirements and recent interpretations of Rule 10b-5 by some courts and the SEC may force management to disclose the negotiations.

Disclosure of the status of merger negotiations may lead to their breakdown and the consequent loss to shareholders of valuable merger premiums. Corporate mergers typically result in gains to target shareholders. Shareholders generally receive—either in cash or in the securities of the acquiring firm—an amount significantly in excess of the market price of their stock at the time of the merger. Acquiring corporations are able to pay these substantial merger premiums because of anticipated gains from increased operating efficiency or economies of scale.44

the company and no corporate developments that would account for the stock action.” Id. at 87,594.

40. Id. at 87,596–97 & n.8.
41. Id. at 87,595.
42. The term “merger” is used throughout this Note to refer both to statutory mergers and to friendly cash tender offers undertaken as the first step of a plan by the acquiror to later merge the two corporations.
44. The extent to which these anticipated post-merger gains are actually realized by acquiring firms is unclear. Compare Jensen & Ruback, supra note 43, at 11, 16 (acquirors gain 3.8%) and Langeteig, An Application of a Three-Factor Performance Index To Measure Stockholder Gains from Merger, 6 J. Fin. Econ. 365, 381 (1978) (mergers result in “normal or slightly superior return for the acquiring firm’s stockholders”) with Malatesta, The Wealth Effects of Merger Activity and the Objective Functions of Merging Firms, 11 J. Fin. Econ. 155 (1983) (acquiring firms lose over long term) and Hogarty, The Profitability of Corporate Mergers, 43 J. Bus. 317, 325–26 (1970) (few
Public disclosure of preliminary merger negotiations often leads to the breakdown of negotiations and the consequent loss of valuable merger premiums. This occurs for two reasons. First, acquiring corporations as a matter of course demand confidentiality in negotiating mergers and will react negatively to disclosure. Second, disclosure may drive the price of the target corporation’s stock so high that the premium which must be offered in order to consummate the merger is prohibitive and the negotiations are abandoned. As a result, shareholders benefit from the maintenance of corporate silence concerning preliminary merger negotiations.

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mergers result in gains (for acquiror). See also Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1173 (1984) (corporate control contests sometimes create wealth and sometimes only redistribute it); Mason & Goudzwaard, Performance of Conglomerate Firms: A Portfolio Approach, 31 J. Fin. 39, 45 (1976) (randomly selected portfolios outperform conglomerate firm portfolios).

45. For example, during the recent merger negotiations between Nestle and Carnation, Nestle told Carnation that if Carnation made any public disclosure of the fact that the two corporations were engaged in negotiations toward Nestle’s acquisition of Carnation, Nestle would terminate the discussions. In re Carnation Co., [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,593 (July 8, 1985). Similarly, the chairman of the American Bar Association’s Committee on the Federal Regulation of Securities has stated that premature disclosure “may well interfere with the consummation of a corporate transaction.” Lanzner, “No comment”, FORBES, Sept. 16, 1985, at 41 [hereinafter No Comment].

An important reason for corporate management’s concern for confidentiality is management’s fear that disclosure may trigger a bidding contest for the target corporation. In general, target management will prefer negotiated mergers to bidding contests, because in a negotiated merger management is better able to select a “compatible” merger partner and/or negotiate an attractive severance package. Management’s decision to enter into merger negotiations is discretionary, and an increased likelihood of public disclosure of preliminary merger negotiations will reduce management’s incentive to enter into negotiations in the first place, thereby resulting in lost merger opportunities for shareholders.

46. See Affirmative Duty, supra note 12, at 1244; Willensky, Making It Happen: How To Execute an Acquisition, BUS. HORIZONS, Mar.–Apr. 1985, at 38, 44. The SEC itself is aware of this effect. Langley, SEC To Require Some Disclosure of Merger Talks, Wall St. J., July 9, 1985, at 3, col. 1 (statement of SEC senior enforcement counsel that when disclosure occurs, target company’s stock price may rise to premium level offered by potential acquiror). Of course, when the merger negotiations terminate as a result of this disclosure, the stock price drops, often to a level below the pre-negotiation price. Bleakley, The Perils of the Takeover Game, N.Y. Times, Jan. 15, 1984, § 3, at 10, col. 2.

47. This refers to shareholders in the aggregate. Those shareholders who sell their shares during the pendency of preliminary merger negotiations would arguably be better off with early disclosure, and shareholders of acquiring firms might also desire early disclosure so as to discourage mergers which do not maximize their individual wealth. The potential losses which these groups might suffer, however, are small in comparison with the gains realizable by target shareholders who do not sell their shares prior to the announcement of a merger. See infra note 79; see also sources cited supra note 43 (loss to acquiring firms’ shareholders, if any, is small in comparison with gain to acquired firms’ shareholders). Moreover, investors can completely eliminate their risk by holding a diversified portfolio of stocks. Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 STAN. L. REV. 1, 8–9 (1982).

48. Where disclosure does not cause the merger negotiations to terminate and a successful merger eventually occurs, either with the initial bidder or with a subsequent offeror, the target corporation’s shareholders are likely to be better off than if there had been no disclosure. This result comes about because disclosure drives up the stock price, and consequently also the price paid in a merger or acquisition. However, the shareholders’ ex ante expected return is lower with disclosure because of the increased likelihood that the merger negotiations will terminate and the premium will be lost. Furthermore, although competitive bidding will result in higher merger premiums in successful mergers, it will impair shareholder welfare by reducing the frequency of mergers. This will occur for two
It is only when an agreement in principle to merge has been reached and the possibility of upsetting the negotiations by disclosure is minimal that shareholders are likely to be well served by disclosure. Maintaining the secrecy of preliminary merger negotiations, then, is at a minimum consistent with, and may even be required by, corporate management's fiduciary duty to maximize shareholder wealth.

Silence or a simple “no comment,” on the other hand, may lead to extreme exchange sanctions, such as delisting or suspension of trading in the corporation's stock. In addition, the “no corporate development” statement, accepted by the exchanges as an alternative to full disclosure where there is unusual trading activity, may give rise to potentially huge damage claims under 10b-5 by shareholders who sell during the preliminary merger negotiations.

As merger activity has accelerated, so has the number of “no corporate development” statements. The NYSE has requested the issuance of approximately twenty “no corporate development” statements in the past twenty months alone. Since the 1984 Schlanger decision, the SEC's 1985 finding in Carnation, and the Levinson decision, however, corporations—and their shareholders—have been faced with the prospect of crippling liability for making these statements.

reasons: First, if the result of an attempted friendly merger is a takeover by a potentially unfriendly third party, target management will not be inclined to undertake merger negotiations. See supra note 45. Second, acquirors will invest less in searching for potential merger partners if this search merely triggers a bidding contest ending with the target corporation merging with a third party. Easterbrook and Fischel have made a similar argument in the context of hostile takeovers. See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981); Easterbrook & Fischel, supra note 47 (arguing that shareholder wealth is maximized ex ante when target management does not undertake defensive tactics which would impede successful acquisitions). But see Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028 (1982) (arguing that shareholder wealth is maximized by facilitating competing bids); Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982) (same).

49. An agreement in principle has been held to exist when the negotiating corporations reach fundamental agreement on both the price and the structure of a merger. Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (3d Cir. 1984) ("with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal . . . "), cert. denied, 105 S. Ct. 1189 (1985).

50. NYSE Interview, supra note 27.

51. In Schlanger, for example, plaintiff represented the class of Four-Phase shareholders who sold their stock between the time of the “no corporate development” statement and the announcement of the merger. The claimed damages in that case, based on the changes in stock price over an eight-day period, were approximately $10 million. The potential liability of other corporations issuing “no corporate development” statements is equally huge. See No Comment, supra note 45, at 41 (quoting statement by financial public relations executive that "our clients are scared to death" about potential liability after Carnation); Kaufmann & Hoyns, supra note 7, at 7, col. 1 ("The options . . . available to a company on receiving an exchange inquiry when it does not wish to disclose confidential information present a choice among negatives . . . ").

It has been suggested that a corporation asked to issue a “no corporate development” statement may simply refuse, or issue a “no comment.” Greenfield v. Heublein, Inc., 742 F.2d 751, 763 (3d Cir. 1984) (Higginbotham, J., dissenting), cert. denied, 105 S. Ct. 1189 (1985); Kaufmann & Hoyns,
III. A Proposed Standard of Materiality for the Disclosure of Merger Negotiations

The goal of maximizing shareholder wealth requires that corporations delay disclosure of preliminary merger negotiations until discussions have reached a stage where disclosure is unlikely to result in their termination. Delay can be facilitated in either of two ways: by changing current stock exchange disclosure requirements or by holding that the failure to disclose merger negotiations in a “no corporate development” statement does not violate Rule 10b-5.

A. Changing the Stock Exchange Rules

Avoiding premature disclosure of merger negotiations could be achieved through a change in existing stock exchange rules. Such a change would involve either eliminating “no corporate development” statements altogether or permitting a corporation to issue a “no comment” statement while engaged in preliminary merger negotiations.52 There are serious problems, however, with both of these possible solutions.

“No corporate development” statements provide valuable information to the market when, as is often the case, unusual market activity is the result of unfounded rumors. “No corporate development” statements may be required not only in the case of rumors about potential mergers, but also, for example, where unusual trading is occurring based on false rumors of the death or defection of a key executive or of developments concerning a critical contract or project. Because “no corporate development”

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52. The SEC allows the “no comment” statement in some circumstances. The Commission observed in a footnote to Carnation that “an issuer that wants to prevent premature disclosure of nonpublic preliminary merger negotiations can, in appropriate circumstances, give a “no comment” response to press inquiries concerning rumors or unusual market activity.” In re Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 n.6 (July 8, 1985). By contrast, the “no comment” statement made in response to a stock exchange inquiry is in direct violation of exchange rules, see supra note 51. In the event that a listed company either fails to respond to a NYSE inquiry or simply issues a “no comment” statement, the NYSE’s current policy is to issue its own statement to the press explaining that unusual activity was observed in the company’s stock, that the company was contacted and a statement was requested, and that the company either failed to explain the unusual activity or simply responded with a “no comment.” NYSE Interview, supra note 27.
statements are useful in curbing unwarranted speculation, their blanket elimination would be inadvisable.\textsuperscript{53}

Permitting a corporation to respond with a simple "no comment" rather than a "no corporate development" statement when merger negotiations are under way is equally problematic. Because a "no comment" will presumably be issued only when the corporation is engaged in preliminary merger negotiations, the issuance of such a statement will give a clear signal to the market that merger negotiations are being conducted and thus may give rise to the same problems that result from explicit disclosure.\textsuperscript{54} In any event, the SEC controls the mechanism for changing exchange rules\textsuperscript{55} and would likely discourage any attempt to relax the exchanges' disclosure requirements.\textsuperscript{56}

B. \textit{The "False or Misleading" Approach}

To support liability under Rule 10b-5, a corporate statement or omission must be (1) \textit{false or misleading} as to (2) a \textit{material fact}.\textsuperscript{57} Courts may avoid the imposition of liability under Rule 10b-5 either by holding the failure to disclose neither false nor misleading, or by holding it immaterial.

In judging the legality under Rule 10b-5 of corporate statements made during merger negotiations, courts and the SEC—apparently assuming materiality—have focused on whether a given statement or omission was false or misleading. In \textit{Greenfield v. Heublein, Inc.},\textsuperscript{58} for example, the court refused to hold Heublein liable under 10b-5 for issuing a "no

\textsuperscript{53} As the NYSE Listed Company Manual explains, a "no corporate development" statement "can have a salutary effect" on the stability of the market for a corporation's stock. NYSE Manual, \textit{supra} note 2, § 202.03, at ¶ 23,517.

\textsuperscript{54} This concern is illustrated by the response of a corporate official asked by a reporter whether the corporation was engaged in any merger discussions: "No comment... If [merger talks] were the case, we'd certainly not want to comment on it... and if they aren't the case, we'd probably not want to comment on it, just to be consistent and not to tip our hand if it ever comes up in the future." Most Objects of Merger Rumors Say Very Little When Asked What's Up, \textit{Wall St. J.}, July 9, 1981, at 27, col. 4. As this anecdote demonstrates, the disclosure dilemma facing corporate officials who must respond to stock exchange inquiries is not eliminated by simply permitting the corporation to remain silent or respond with a "no comment." Corporate silence or a "no comment" during a period of unusual market activity—particularly if accompanied by rumors of a merger—will be a red flag to the market that merger negotiations are being conducted and may result in the same problems that result from explicit disclosure.


\textsuperscript{56} This is in keeping with the Commission's general, albeit mistaken, view that investors are uniformly best served by full and immediate disclosure. \textit{See}, e.g., Exchange Act Release No. 8995, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,120A, at 17,095-2 (encouraging corporate managements to "set up procedures which will insure that prompt disclosure be made of material corporate developments, both favorable and unfavorable, so that investor confidence can be maintained in an orderly and effective securities market").

\textsuperscript{57} 17 C.F.R. § 240.10b-5(b) (1986).

\textsuperscript{58} 742 F.2d 751 (3d Cir. 1984), \textit{cert. denied}, 105 S. Ct. 1189 (1985).
corporate development" statement during the course of preliminary merger negotiations. Even though management was aware that unusual trading might have been due to the negotiations, Heublein's management was not aware of any leaks or insider trading, and the court therefore ruled as a matter of law that the statement was not false, misleading, or inaccurate.\footnote{59. 742 F.2d at 759.}

Greenfield's analysis has been vigorously attacked on the ground that given the circumstances surrounding the unusual market activity in Heublein stock, it was in fact false or misleading for Heublein to state that it knew of no reason for the unusual activity. Courts and commentators alike have argued that Greenfield adopts an overly restrictive view of what statements are false or misleading under Rule 10b-5.\footnote{60. For criticisms of Greenfield, see In re Carnation Co., [1984--1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 83,801, at 87,592 (July 8, 1985); Schlienger v. Four-Phase Sys., 582 F. Supp. 128, 132 (S.D.N.Y. 1984) ("[T]he Greenfield decision is wrong, essentially because it fails to distinguish between cases involving false or misleading statements, and situations involving a decision merely to remain silent and not disclose pre-merger negotiations."); Kaufmann & Hoyts, supra note 7, at 6, col. 4 (Greenfield's "false or misleading" analysis unconvincing); Comment, supra note 12, at 1174 (arguing that "[t]he majority erred . . . when it reasoned that Heublein did not breach its duty not to mislead merely because the [no corporate development] statement contained no false information").

The leading treatment of the contours of "misleading" for 10b-5 purposes is Jacobs, What is a Misleading Statement or Omission Under Rule 10b-5, 42 FORDHAM L. REV. 243 (1973). Regarding the determination of whether a corporate press release is misleading, one court held that "[t]he misleading, misrepresented or untruthful character of the release may appear from the nature of the statement considered alone, or . . . from the half truths, omissions or absence of full candor . . . ." Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1971) and 405 U.S. 918 (1972).

The materiality approach was used to resolve the disclosure quandary which confronts corporations during preliminary merger negotiations.

C. The Materiality Approach

Analysis of "no corporate development" statements under Rule 10b-5 has focused exclusively on whether a given statement was false or misleading under the circumstances.\footnote{61. See, e.g., Greenfield v. Heublein, Inc., 742 F.2d at 757; In re Carnation Co., [1984--1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 83,801, at 87,595-97 (July 8, 1985).} Although merger negotiations may be intu...
itively "material," there is substantial support for holding that, for purposes of imposing 10b-5 liability, nondisclosure of such negotiations through a "no corporate development" statement is not a material omission.

1. **The Judicial Definition of Materiality**

The language and legislative history of the Securities Acts provide little guidance as to what facts are "material" for disclosure purposes. Consequently, the definition of materiality under 10b-5 is primarily a judicial creation. The currently accepted standard was enunciated by the Supreme Court in *TSC Industries v. Northway, Inc.* A fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." The test set forth by the Supreme Court in *TSC* does not, of course, solve the question of what statements or omissions are material; it merely sets forth the broad outline of materiality. Because of the ambiguity inherent in such a fact-sensitive inquiry, what is "material" in a given case depends in large part on whether a finding of materiality would promote the policy objectives underlying the Securities Acts. For example, despite their obvious interest to investors, corporate forecasts and projections have also been deemed immaterial for purposes of disclosure under the Securities Acts on the ground that disclosure of such information is inherently misleading and likely to harm investors. On the other hand, courts have

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64. 426 U.S. at 449 (1976).

65. For a comprehensive discussion of the concept of materiality under the Securities Acts, see Hewitt, *supra* note 3. Hewitt observes that "over time, the context in which the concept of materiality is applied changes. . . . While the definition of materiality may remain constant, the determination of whether a particular fact is material may vary." *Id.* at 898. See also Bauman, *supra* note 20, at 937 n.11 (courts apply different standards of materiality in different contexts, and "information may be defined as material for some purposes but not for others").

66. See Starkman v. Marathon Oil Co., 772 F.2d 231 (6th Cir. 1985) (projections and asset appraisals material only if underlying predictions are "substantially certain to hold"); Flynn v. Bass Bros. Enters., 744 F.2d 978, 985 (3d Cir. 1984) ("[a]s a matter of public policy, the SEC and the courts generally have not required the inclusion of appraised asset valuations, projections, and other 'soft' information in proxy materials or tender offers"); James v. Gerber Prod. Co., 587 F.2d 324, 327 (6th Cir. 1978) ("sales figures, projections, forecasts and the like only rise to the level of materiality when they can be calculated with substantial certainty"). The SEC has made small steps toward permitting disclosure of certain types of projections and forecasts by enacting a "safe harbor" rule for projections prepared with a reasonable basis and disclosed in good faith. See Safe Harbor Rule for
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long recognized that a corporate development which is not material for disclosure purposes must be disclosed when insiders trade in the corporation's stock.\footnote{67}

The flexibility of the materiality standard is particularly apparent in the series of recent cases involving allegations that management's failure to disclose preliminary merger negotiations violated the corporation's duty to disclose under Rule 10b-5.\footnote{68} Despite the apparent materiality of these preliminary merger negotiations under the TSC test, the courts have not required corporations to disclose such negotiations, instead ruling that they are "immaterial as a matter of law."\footnote{69} Nondisclosure in this context has been held constructively immaterial for two reasons. First, courts have recognized that disclosure would result in lost or frustrated merger opportunities.\footnote{70} Second, because preliminary merger negotiations are by their nature fluid and their outcomes uncertain, courts have reasoned that disclosure itself may be misleading to investors.\footnote{71}

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\footnote{69} See, e.g., Reiss v. Pan Am. World Airways, 711 F.2d 11 (2d Cir. 1983); Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982); Comment, supra note 12, at 1160 ("[C]oncerns for discouraging undue speculation and for protecting the shareholder's ultimate benefit upon a consummated merger have led courts to hold that, as a matter of law, preliminary merger negotiations are not material developments that need to be disclosed . . . .'').

\footnote{70} See Reiss, 711 F.2d at 14; Staffin, 672 F.2d at 1206; Nutis v. Penn Merchandising Corp., 615 F. Supp. 486 (E.D. Pa. 1985); see also Paul v. Berkman, 620 F. Supp. 638 (W.D. Pa. 1985) (rule of immateriality applies only to mergers, not sales of assets). The SEC has recently argued that preliminary merger negotiations should be considered material prior to the point of agreement on price and structure. Brief of SEC as Amicus Curiae at 1, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985) (Nos. 84-1631, 84-1714) (arguing in case involving closely-held corporation that "merger negotiations may become material at a far earlier stage" than agreement on price and structure).

\footnote{71} For example, the court in Staffin reasoned that "[i]f word of the impending offer becomes public, the price of the stock will rise towards the expected tender price. Thus, the primary inducement to stockholders—an offer to purchase their shares at an attractive price above the market—is lost, and the offeror may be forced to abandon its plans . . . ." 672 F.2d at 1206 (citation omitted).

71. This has been the primary justification put forth by courts for a rule holding preliminary merger negotiations immaterial as a matter of law and thus not subject to disclosure. The Second Circuit in Reiss, for example, based its holding that the negotiations in question were immaterial on the fact that preliminary merger 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. Similarly, the Third Circuit in Staffin held that "[t]he reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may be misleading." 672 F.2d at 1206 (one of two separate justifications).


While accurate disclosure of preliminary merger negotiations is not inherently misleading to inves-
2. Materiality and "No Corporate Development" Statements

As long as a corporation remains silent, it will not be held liable under Rule 10b-5 for failing to disclose preliminary merger negotiations. Some courts and the SEC, however, have distinguished the situation in which the corporation fails to disclose preliminary merger negotiations but, rather than remaining silent, makes some kind of an affirmative statement. The argument made by the Levinson and Schlanger courts, and by the SEC, is that there is a fundamental difference under Rule 10b-5 between the situation in which a corporation remains silent during preliminary merger negotiations and the situation in which it makes a public statement (whether solicited or not). They contend that "information concerning ongoing acquisition discussions becomes material by virtue of the statement denying their existence." Underlying this argument appears to be the conviction, as stated by the SEC, that "[t]he importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized."

In fact, accurate and complete disclosure—although an important goal of the 1934 Act—can be overemphasized. The SEC, like some courts, has failed to recognize that preliminary merger negotiations present the unusual situation in which disclosure does not maximize but rather impairs investor welfare. From the perspective of the target corporation's tors, it may be difficult or impossible to convey accurate information because of the ephemeral nature of the negotiations. Any disclosure is likely later to be contested on grounds that it misstated the nature of the negotiations or failed to include material facts. In fact, some courts have suggested that a corporation might be subject to liability under Rule 10b-5 for disclosing preliminary merger negotiations. Reiss, 711 F.2d at 14; Guy v. Duff & Phelps, Inc., 628 F. Supp. 252, 256 (N.D. Ill. 1985) (if acquisition does not materialize, investors who purchased in reliance on corporation’s premature disclosure “may have a solid securities law cause of action because of the inflated price they have paid”). Moreover, a corporation that discloses preliminary merger negotiations becomes subject to an ongoing duty to correct or update its initial disclosure if it subsequently becomes false or misleading. See Ross v. A.H. Robins Co., 465 F. Supp. 904 (S.D.N.Y.) (general duty to correct or revise prior public statements which were accurate when made but which have subsequently become false or misleading), rev’d on other grounds, 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980). Uncertainty surrounding the necessity of updating prior merger disclosures creates an additional source of potential liability for corporate management.

72. See Reiss, 711 F.2d at 13–14; Staffin, 672 F.2d at 1196.
73. 786 F.2d 741 (6th Cir. 1986).
76. Levinson, 786 F.2d at 748.

78. The SEC’s misguided pursuit of disclosure as an end in itself has been widely observed. See, e.g., S. PHILLIPS & J. ZECHER, THE SEC AND THE PUBLIC INTEREST 111–14 (1979) (SEC concerned with political support maximization rather than cost-effective disclosure policies); Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 Colum. L. Rev. 260 (1968) (economically efficient disclosure policy does not exist because SEC is “dominated by lawyers in zealous pursuit of ‘fairness’ and ‘protection of investors’” who fail to recognize economic ramifica-
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shareholders, the losses likely to be incurred by nontrading shareholders as a result of disclosure will be greater than the gains of shareholders who would have traded had the negotiations not been disclosed.79

Moreover, the total gains realized by the target corporation's shareholders do not come at the expense of other investors. To the extent that mergers lead to more efficient allocation of capital resources due to more effective management, product and market complementarity, operating and financial economies, or other synergies that may be realized between the merging companies, mergers result in net social welfare gains.80 These social gains will be imperiled if corporations are forced to disclose preliminary merger negotiations.

3. A New Standard of Materiality

The disclosure quandary currently facing corporate management can be resolved by extending the existing doctrine of constructive immateriality in cases of corporate silence to cover "no corporate development" statements. As a matter of law, a corporation's issuance of a "no corporate development" statement in response to a stock exchange request while preliminary merger negotiations are being conducted should not be considered a material omission of fact giving rise to 10b-5 liability. Although information concerning merger possibilities is clearly material under the TSC "reasonable investor" standard,81 the same considerations that have justified what is, in effect, a public policy exception to the TSC test in other circumstances of disclosure policies; Note, supra note 12, at 1069 ("Belief in the virtues of disclosure . . . has become so strong that the SEC has not considered seriously the true effects of its regulation on the investors who it is charged with protecting."). As Kaufmann and Hoyns observed, "[t]he need to maintain confidentiality of a proposed transaction until definitive agreements have been executed is as great as the interest of the stock market in rumors of a corporate acquisition." Kaufmann & Hoyns, supra note 7, at 1, col. 3.

A substantial body of literature has questioned whether the SEC's mandatory disclosures are even necessary to protect investors. These commentators have argued that there are substantial private incentives for disclosure of material corporate information. See, e.g., Ross, The Economics of Information and the Disclosure Regulation Debate, in ISSUES IN FINANCIAL REGULATION (F. Edwards ed. 1979). Good general reviews include J. SELIGMAN, THE SEC AND THE FUTURE OF FINANCE (1985) and Easterbrook & Fischel, supra note 12.

79. This is true for two reasons. First, merger negotiations generally develop rapidly, and disclosure is usually only delayed for a matter of days. See Greenfield v. Heublein, Inc., 742 F.2d 751, 754 (3d Cir. 1984) (delay of fifteen days), cert. denied, 105 S. Ct. 1189 (1985); Schlanger v. Four-Phase Sys., 582 F. Supp. 128, 129-30 (S.D.N.Y. 1984) (delay of eight days). Second, the proportion of trading to nontrading shareholders on a given day is very small. For example, on the day that Heublein issued its "no corporate development" statement—a day of unusually heavy trading—only 242,000 shares, or 1.1% of Heublein's outstanding shares, changed hands. See Greenfield, 742 F.2d at 753-54.

80. See supra notes 43-44; see also Easterbrook & Fischel, supra note 48, at 1165-74 (takeovers beneficial to both shareholders and society).

merger nondisclosure cases support a finding of immateriality in this instance.

First, avoiding premature disclosure will result in a greater number of successfully completed mergers than a policy requiring disclosure. Second, because preliminary merger negotiations develop rapidly and are subject to constant change, disclosure may itself be misleading to investors. These similarities give judicial assessments of immateriality for "no corporate development" statements a rational basis in prior cases that have held that preliminary merger negotiations are immaterial as a matter of law and are not subject to a general duty of affirmative disclosure. This approach solves management's disclosure dilemma without artificially stretching the definition of "false or misleading" in a way that could be misapplied in other contexts. The narrowly drawn exception proposed by this Note will apply only to those unusual situations in which full disclosure of otherwise material information will tend to harm rather than benefit investors.

IV. INSIDER TRADING AND DISCLOSURE

The concern exhibited by courts over disclosure during preliminary merger negotiations may stem from a belief that the unusual activity that triggers a "no corporate development" statement is probably the result of trading by investors on the basis of nonpublic information. The Securities Acts are not solely oriented toward maximizing the aggregate wealth of investors. The goal of facilitating mergers—and thereby maximizing

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83. See supra notes 45–48 and accompanying text.
84. See supra note 71 and accompanying text; see also Comment, supra note 12, at 1170–73 (discussing courts' rationales for holding preliminary merger negotiations immaterial as matter of law).
85. See, e.g., Reiss, 711 F.2d at 13–14; Staffin, 672 F.2d at 1203–04.
86. The exception is naturally limited by the unique nature of disclosure problems posed by preliminary merger negotiations. First, merger negotiations—unlike many other types of corporate developments—are likely to terminate and result in a loss to shareholders if held material and subject to disclosure. Second, successful merger negotiations uniquely result in gains not only to target shareholders (distributive gains), but also to society at large (social gains). Both of these factors justify carving out a limited exception to the general standard of materiality.
87. See, e.g., Greenfield, 742 F.2d at 764 (“material nonpublic information is leaked to some ‘favorites’ among the investing public”) (Higgenbotham, J., dissenting); Schlanger, 582 F. Supp. at 132 (“No explanation of the price activity . . . is suggested, other than leaks of the existence of the merger discussions.”).

Although net social welfare is enhanced by offering maximum encouragement to merger negotiations, insider trading has distributional consequences. To the extent that the bulk of the gains from mergers accrue to corporate insiders, non-insider investor welfare and confidence in the securities markets are impaired. Forcing disclosure of negotiations would eliminate the potential gain available to insiders by making knowledge of the negotiations available to all market participants.
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To the extent that investor wealth—must be weighed against the countervailing goals of ensuring fair trading and maintaining investor confidence in the securities markets.88 In recognition of these considerations, courts have held uniformly that Rule 10b-5 prohibits trading in a corporation’s stock by insiders on the basis of nonpublic information.89

It is clear that mergers are often preceded by trading based on information not generally available to the public.90 The federal securities laws, however, prohibit only insider trading based on a breach of fiduciary duty or a relationship of confidentiality.91 It is not clear by any means that most—or even a great deal—of the “insider” trading occurring prior to mergers violates federal insider trading laws.92 Moreover, rather than being the result of either legal or illegal insider trading, unusual market

88. See supra note 12.
90. As one market professional put it, “Wall Street has more leaks than a cheap apartment’s plumbing.” Illegal Insider Trading Seems To Be on Rise; Ethics Issues Muddled, Wall St. J., Mar. 2, 1984, at 1, col. 6. Studies of stock price movements indicate that mergers almost invariably are preceded by stock price rises, indicating trading on nonpublic information. Keown & Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, 36 J. Fin. 855 (1981). But see Stewart & Hertzberg, Wall Street Arbitragers Are Deafened by Silence on May Stores Takeover Bid, Wall St. J., June 22, 1986, at 5, col. 1 [hereinafter Arbitragers] (pre-announcement stock price drop followed by sharp price increase on announcement). Recent departures from the typical pattern of pre-announcement stock price increases may be the result of a number of highly publicized insider trading actions brought by the SEC in the last year. See Stewart & Hertzberg, Fall of Ivan Boesky Leads to Broader Probe of Insider Information, Wall St. J., Nov. 17, 1986, at 1, col. 6; Nash, An Insider Scheme Is Puts in Millions, N.Y. Times, May 13, 1986, at 1, col. 3 (indictment of investment banker Dennis B. Levine); Cole, Five Indicted In Latest Insider Case, N.Y. Times, May 29, 1986, at D1, col. 3 (five additional indictments of Wall Street professionals); see also Arbitragers, supra, at 5, col. 2 (most arbitrageurs attributed stock price drop prior to announcement of May Stores acquisition to SEC’s clamping down on insider trading).
91. The legal definition of an “insider” has been restricted to one who obtains information through a fiduciary relationship with the corporation or “misappropriates” it from an employer. The Supreme Court has rejected the SEC’s position that the Securities Acts require that all investors trade on the basis of equal information. See Dirks v. SEC, 463 U.S. 646, 655 (1983); Chiarella v. United States, 445 U.S. 222, 225-35 (1980); see also Heller, Chiarella, SEC Rule 14e-3 and Dirks: “Fairness” Versus Economic Theory, 37 Bus. Law. 517, 532 (1982). Thus non-fiduciaries—barbers, taxi drivers, waiters—may legitimately trade on the basis of nonpublic information which they obtain. In an economic sense, of course, these investors are “insiders”—that is, they are trading on the basis of information not widely available to the investing public. See Carlton & Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 860-61 (1983) (distinguishing between legal and economic definitions of insider trading).
92. Trading on nonpublic information does not necessarily constitute illegal insider trading. Some market professionals invest substantial resources in collecting information and employ a variety of sophisticated techniques for gathering nonpublic information about impending corporate developments. One Wall Street arbitrageur is said to have a staffer whose job it is to track the movements of corporate jets in order to gain information about possible mergers. 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. Other tactics for obtaining an informational advantage include monitoring trading patterns, watching investment banks’ “restricted lists” of stocks (which indicate possible merger clients), and even checking prep school records to see if chief executive officers are likely to be predisposed to merge their corporations. See Anders, Here’s How Stock-Market Experts Decide Which Rumors To Act On, Wall St. J., Feb. 4, 1986, § 2, at 1, col. 4.

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activity accompanying preliminary merger negotiations may often be due to rumors or speculation entirely unrelated to the negotiations.93

To acknowledge that preliminary merger negotiations may be accompanied by illegal insider trading does not mean that the proposed standard of constructive immateriality should be abandoned. Recent attempts to use Rule 10b-5 to police perceived insider trading abuses in the preliminary merger negotiation context represent an unwarranted extension of Rule 10b-5 for at least three reasons.

First, forcing early disclosure is overbroad as a method of policing illegal insider trading. Disclosure based on a presumption that someone is probably trading on inside information is too extreme a prescription. It would, in effect, impose a duty on corporations to make continuous disclosure of all material corporate developments—a result that courts and the SEC have decisively rejected.94 Suspected insider trading violations by corporate insiders or their tippees should be pursued directly by the SEC through actions against individual inside traders, not by forcing premature corporate disclosure of merger negotiations.95

Second, because of the increased likelihood of successful mergers, shareholders in the aggregate are likely to be better off if disclosure can be delayed until an agreement in principle is reached, even if some insider trading takes place.96 Although complete and immediate disclosure would eliminate informational disparities, it would result in a net loss to shareholders.

Third, the stock exchanges have the authority to require corporations to make full and complete disclosures of corporate developments if rumors or unusual activity in the corporation’s stock indicates that insider trading is occurring.97 The exchanges are most familiar with the trading and price patterns of individual stocks, and they have elaborate “stock watch” pro-

93. See, e.g., Anders, supra note 92 (statement of Wall Street trader that most of approximately twenty takeover rumors he hears each day “are garbage”).
94. See supra note 20 and accompanying text. Moreover, it is extremely difficult to distinguish whether unusual trading is the result of illegal trading based on nonpublic information because “[i]t is often hard to draw a line between a shrewd guess by an investor and inside information.” Louis, The Unwinnable War on Insider Trading, FORTUNE, July 13, 1981, at 72, 76.
95. Recent enforcement actions taken by the SEC against a number of Wall Street professionals alleged to have violated insider trading laws forcefully demonstrate the agency’s ability to police insider trading by market insiders. See Nash, supra note 90, at 1, col. 3 (charges against Dennis B. Levine represent largest SEC insider trading action ever undertaken; see also SEC Using New Means To Track Insider Trading, L.A. Times, June 16, 1986, pt. IV, at 5, col. 1 (computers and international cooperation laws making it easier to uncover insider trading).
96. Because of the relatively small number of shares changing hands in the generally brief period between the onset of unusual market activity and the public announcement of a merger agreement, the economic harm to shareholders prevented by eliminating insider trading through disclosure will often, if not always, be smaller than the harm caused by premature disclosure.
97. See NYSE MANUAL, supra note 2, § 202.01, at ¶ 23,515; ASE GUIDE, supra note 2, § 402(d), at ¶ 23,124B.
grams designed to detect insider trading. Because of their superior monitoring capabilities, the stock exchanges are better suited than the SEC to determine when—if ever—shareholders are best served by immediate disclosure of merger negotiations.

V. CONCLUSION

Judge Friendly once observed that "[p]robably there will no more be a perfect tender offer than a perfect trial." In resolving the conflicting goals underlying the Securities Acts as they relate to corporate disclosures of negotiations leading to mergers and tender offers, courts and the SEC have been reluctant to determine the scope and timing of corporate disclosure required by SEC Rule 10b-5 with explicit reference to the costs and benefits of disclosure. In deciding whether a given statement is materially false or misleading under 10b-5, courts have avoided inquiry into the effects that their determinations will have on the aggregate wealth of investors and have focused instead on whether disclosure would be desirable to the paradigmatic "reasonable investor."

This analysis, like the investors it is designed to protect, is unsophisticated. Maximizing the aggregate wealth of investors is one of the most coherent goals underlying the Securities Acts. The federal securities laws are best viewed as pursuing primarily economic goals; an approach to these laws which recognizes their fundamentally economic basis is therefore most likely to achieve rational results. The controversy over the adequacy of "no corporate development" statements for the purposes of Rule 10b-5 illustrates the tension between the economically-oriented method of analysis recommended by this Note and the prevailing approach to interpretation of the securities laws taken by many courts and the SEC. Only

98. See, e.g., SEC Using New Means To Track Insider Trading, supra note 95, at 5, col. 1 (in past three years NYSE has invested over $15 million on insider trading detection; approximately 10,000 unusual trades are investigated each year); Crudele, Big Board Forms Unit To Spot Illegal Trades, N.Y. Times, June 20, 1985, at D8, col. 5; Noble, Stalking Stock-Trading Abuses: Big Board Unit Investigates Insider Actions, N.Y. Times, Mar. 6, 1981, at D1, col. 3.

99. The primary responsibility for regulating the conduct of stock exchange member firms was granted by the 1934 Act to the stock exchanges. See Silver v. New York Stock Exchange, 373 U.S. 341, 351–52 (1963) (Securities Acts meant to supplement, not replace, self-regulation by exchanges); SEC, DIV. OF TRADING & EXCHANGES, STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE 47 (Jan. 3, 1962) ("The Exchange Act contemplates that the responsibility for regulation of the conduct of members of national exchanges be divided between the exchanges and the Commission, the initial and direct responsibility being placed on the exchanges themselves.") (footnote omitted). Because their success depends on maximizing the volume of trading, the exchanges "have an incentive to adopt rules that require listed firms to disclose the amount and type of information that investors demand." Easterbrook & Fischel, supra note 12, at 690. Exchanges are also flexible in administering existing rules when the harm resulting from enforcing strict compliance would likely outweigh the benefits to investors.

when courts and the SEC begin to consider the economic effects on corporate shareholders of forcing disclosure of preliminary merger negotiations can this dilemma be resolved.