10-1987

Basic, Inc. v. Levinson

Lewis F. Powell Jr.

Court..... Voted on....., 19.....

Argued....., 19..... Assigned ....., 19..... No. 86-279

Submitted....., 19..... Announced....., 19.....

October 10, 1986

SG says Grant on Q 1 - This is OK 2/18

BASIC INC.

vs.

LEVINSON

Time for filing extended by J. O'Connor until 8/24/86.

SG's views

	HOLD FOR	CERT.		JURISDICTIONAL STATEMENT				MERITS		MOTION		ABSENT	NOT VOTING
		G	D	N	POST	DIS	AFF	REV	AFF	G	D		
Rehnquist, Ch. J.													
Brennan, J.													
White, J.													
Marshall, J.													
Blackmun, J.													
Powell, J.			✓										
Stevens, J.													
O'Connor, J.													
Scalia, J.													

19019-9-86

Views of SG.
There is an arguable conflict & the issue under 3(10)b is important.
[I'd Deny rather than Grant under SG recommendation]

The SG recommends a GRANT on Q#1. He says the misjoinder issue is an important + recurring problem. He does not completely agree with either the CA3 or the CA6. Given the divergent views, clarification by this Court appears appropriate. I recommend GRANT on Q#1. - Leslie

SG says grant on Q 1 - OK 2/18

PRELIMINARY MEMORANDUM

October 10, 1986 Conference
List 3, Sheet 3

No. 86-279

OK

Basic, Inc., et al. (corp. defndts ~~in 10b-5~~ action)	Cert to CA6 (Martin, Jones, Wellford)	
v.		
Levinson, et al. (ex-shareholders)	Federal/Civil	Timely

1. SUMMARY: Petrs argue: (1) CA6 erred in holding that "no corporate development" statements were materially false and misleading; and (2) CA6 erred in affirming the dc's certification of a plaintiff class based on a presumption of reliance.

2. FACTS AND DECISION BELOW: Petrs are Basic, Inc. and several of its officers and directors. Resps represent a class of shareholders of Basic who sold Basic common stock between Oc-

DENY - Leslie - The misjoinder issue is important. But it appears that the CA3 in Greenfield, not

tober 21, 1977, and December 15, 1978. Beginning in September 1976, James Kelly, an officer in Combustion Engineering, Inc., began negotiations with officers of Basic regarding a possible merger/acquisition. Both company's stock was traded on the New York Stock Exchange (NYSE). Negotiations continued through the end of 1976 and through 1977 and 1978. On October 18, 1977, Basic's management met with its investment bankers to discuss preparation of a valuation of Basic to use in the merger negotiations. On October 19 and 20, 1977, the trading volume of Basic on the NYSE increased from an average of 6,000 to 8,000 shares per day to 29,000 shares per day. On October 21, 1977 Basic issued, through petr Muller, its president, the first of five public announcements that form the basis of resps' action. Petr Muller denied that any negotiations were being conducted with respect to a possible merger.[1]

During the early part of July 1978, Muller and Kelly agreed that Kelly would prepare an informal offer for Basic, and Combustion directed its investment bankers to prepare analyses of acquisition prices. On July 14, the price of Basic's stock rose over 3 points on a trading volume of approximately 18,200 shares.

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[1]The announcement, published in The Cleveland Plain Dealer, stated:

> "President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of $25 a share for control of [Basic]."

A NYSE officer asked a representative of Basic about the unusual activity in Basic stock and Basic again denied that there were any undisclosed merger or acquisition plans or other significant corporate developments.

On September 14, Combustion directed its investment bankers to prepare and deliver to Kelly a draft proposal letter for the acquisition of Basic. On September 25-26, the price of Basic stock increased a total of almost 5 points on a daily volume of over 28,000 shares per day. A NYSE officer again contacted Basic and inquired whether there were any undisclosed merger or acquisition plans, any developments relating to a possible tender offer, or any other corporate developments. Basic stated there were no such developments. Basic's president, Muller, when apprised of the NYSE's inquiries, issued a press release denying the existence of any merger/acquisition negotiations.[2]

The contacts between the two companies continued. During the first week of November, Basic denied, for the fourth time, that there were any developments that would account for the increased activity in its stock.[3] On November 27, Kelly met with

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[2]The release stated:

> "[M]anagement 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."

[3]This denial was contained in Basic's "Nine Month Interim Report to Shareholders." This report stated:

> "With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would

(Footnote continued)

Muller and others from Basic and discussed an all cash price of $35 per share, which Basic rejected. Negotiations continued during the next two weeks, culminating on December 14, 1978 with Combustion's executive committee approving a tender offer for Basic at $46 per share. On December 15, Basic's stock price increased dramatically and, for a fifth time, Basic denied the existence of any corporate developments when queried by the NYSE. Basic requested that the NYSE suspend trading its shares on December 18, and on December 19, Basic accepted Combustion's offer.

Resps filed an action in dc alleging that petrs' various statements denying the existence of merger discussions were false and misleading in violation of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Resps claimed they sustained substantial losses because they relied on petrs' statements and sold their shares of Basic stock at an artificially low price. The dc (ED Ohio, Thomas [sdj]) certified a class consisting of all parties who sold Basic stock during the merger negotiations' time period, applying a presumption that these parties relied upon petrs' statements. Following discovery, the dc granted petrs' motion for summary judgment after finding that the statements, as a matter of law, were not material and that the petrs did not act with scienter.

(Footnote 3 continued from previous page)
account for the high volume of trading and price fluctuations in recent months."

On cross-appeals to CA6, the court reversed the award of SJ, affirmed the class certification, and remanded to the dc for further proceedings. CA6 noted that it need not address whether petrs had an initial affirmative duty to disclose the contacts and negotiations with Combustion. If a corporation is not under a duty to disclose certain information, but voluntarily makes a statement "'calculated to influence the investing public' the corporation then has a duty to disclose sufficient information so that the statement made is not 'false or misleading or ... so incomplete as to mislead.'" Petn App 10a (quoting SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 862 (CA2 1968), cert. denied, 394 U.S. 976 (1969)). Petrs' duty to clarify and disclose the merger discussions arose only because of petrs' statements denying knowledge of "present or pending corporate developments." The petrs had a duty to be truthful and the record clearly shows that the denials were misleading, if not completely false. CA6 relied on First Virginia Bankshares v. Benson, 559 F.2d 1307, 1317 (CA5 1977), cert. denied, 435 U.S. 952 (1978): Under Rule 10b-5, "[a] duty to speak the full truth arises when a defendant undertakes to say anything."

CA6 determined that the facts petrs neglected to disclose were material. Applying the test of materiality articulated in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), CA6 concluded that the reasonable investor, having been informed that petrs were aware of no corporate developments that would cause the increased activity in Basic stock on the NYSE, would have thought that the disclosure of the merger negotiations "signifi-

cantly altered the 'total mix' of information made available." "When a company whose stock is publicly traded makes a statement, as Basic did, that "no negotiations' are underway, and that the corporation knows of 'no reason for the stock's activity' ... information concerning ongoing acquisition discussions becomes material by virtue of the statement denying their existence." Petn App 13a (emphasis in original).

CA6 acknowledged its disposition of the materiality issue conflicted with CA3's decision in Greenfield v. Heublein, Inc., 742 F.2d 751 (CA3 1984), cert. denied, 105 S.Ct. 1189 (1985). On similar facts, CA3 held that a company, which was involved in merger negotiations, did not make a false or misleading statement when it disclosed that it was unaware of any reason for the unusual activity in its stock. CA3 reasoned that the company's mangagement "clearly knew of information that might have accounted for the increase in trading," id., at 759, but held that the statement was not misleading because the merger discussions were not material, and failure to disclose them could not, therefore, be an omission of material fact.

As to the class certification issue, the court, noting that reliance is an essential element of a 10b-5 action that establishes the causal nexus between the defendant's misconduct and the plaintiff's injury, endorsed the dc's application of a presumption of reliance. Without such a presumption, it would be difficult, if not impossible, to satisfy Fed. R. Civ. Proc. 23(b)(3)'s requirement that members of a putative class share questions of law or fact in common that predominate over ques-

tions affecting only individual members. CA6 noted that courts have applied a presumption of reliance in cases that involve material misrepresentations that distort the price of stock on the impersonal market--the so-called "fraud on the market theory." The theory has been consistently applied in this context. See, e.g., Lipton v. Documation, Inc., 734 F.2d 740 (CA11 1984), cert. denied, 105 S.Ct. 814 (1985); T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority, 717 F.2d 1330 (CA10 1983), cert. denied, 465 U.S. 1026 (1984). The presumption is triggered by proving five elements: (1) the defendants made public misrepresentations; (2) the misrepresentations were material; (3) the stock was traded on an efficient market; (4) the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock; and (5) the plaintiff traded in the stock between the time the misrepresentations were made and the time the truth was revealed. CA6 determined resps established the threshold facts for proving their losses.

3. CONTENTIONS: Petrs argue that cert should be granted to resolve the conflict with Greenfield. The financial community needs a clear rule governing a company's obligation to disclose preliminary contacts regarding a possible merger when unusual trading activity occurs. CA6's decision that a "no corporate developments" statement is a material omission when merger discussions are occurring, even if the discussions might not have been material in the absence of the denial, improperly collapses the "materiality" requirement into the "false and misleading" requirement. The proper approach is to analyze whether the merg-

er negotiations, at the time of the statement, had progressed to the point that it was likely that the merger would occur. CA6 failed to apply properly the materiality test of TSC Industries. Under this test, both CA2 and CA3 have held that failure to disclose preliminary merger contacts is not a material omission. Here, by creating a standard that deems material any information relating to preliminary merger contacts, CA6 ignores the plain language of TSC Industries: information is material only if there is "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." 426 U.S., at 449.

Petrs contend that the use of a presumption of reliance in class certifications presents an important issue that this Court should address. Courts that permit such use of presumed reliance generally cite as authority Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). But that case didn't involve class certifications, and, in any event, it merely stands for the proposition that in cases of material nondisclosures reliance may be presumed. That proposition is inapplicable to the situation here that involves an allegation of misleading disclosures. Furthermore, a presumption of reliance should not be applied to resps who were sellers, not buyers, of securities. Decisions to sell are likely to be highly individualized and may not necessarily depend heavily on the market price of the stock. It is unreasonable to assume here that class members sold their stock in reliance upon petrs' "no corporate development" statements.

Resps contend that the materiality inquiry involves a fact-specific analysis that does not merit plenary review by this Court. Contrary to petrs' assertions, CA6 did not establish a per se rule that all preliminary merger contacts are material. CA6 merely decided, in explicit reliance on TSC Industries, that on the facts of this case, petrs' false and misleading statements were material as a matter of law.

CA6's decision does not directly conflict with Greenfield. It is true, resps argue, that the Greenfield majority employed an unreasonably narrow reading of the company's "no corporate development" statement that disregarded the meaning a reasonable investor would attach to the statement. The critical point, however, is that Greenfield held only that the statement was not false or misleading, not that it was immaterial. Hence, there is no direct conflict.

Resps note that the SEC, appearing as amicus curiae below, opposed the dc's holding that false and misleading statements about merger discussions do not become material until an agreement in principle between the parties is reasonably certain. See also In re Carnation Co., Sec. Exch. Act Rel. No. 22214, Fed. Sec. L. Rep. (CCH) ¶83,801 (July 8, 1985) ("[A]n 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.").

As to the presumption of reliance, resps point out that 6 circuits have now approved its use in securities fraud actions.

Resp Opp. 26 (citing cases). There is no legal authority for petrs' argument that the fraud on the market theory is inapplicable to sellers of securities. It is clear that material public misrepresentations can cause a deflation of stock prices in an efficient market, thereby harming those that sell.

4. DISCUSSION: 1. This decision conflicts with Greenfield. It is true that in a technical sense the holding in Greenfield can be construed narrowly to be only that the statement involved there was not false, inaccurate, or misleading. Viewed as such, one can argue, as resps do, that the issue of materiality was never reached by the Greenfield court. I find this argument unpersuasive as it overlooks the underlying premise of Greenfield's holding: because the merger agreement had not been sufficiently finalized, the discussions relating to a possible merger were not material and the company therefore had no duty to disclose them. CA3 thus implicitly rejected the rationale of CA6 here: the duty to disclose information about the merger discussions arose not because the information itself was material, but because the company voluntarily chose to disclose some information related to the negotiations.

2. Resps are correct in arguing that CA6 did not adopt a per se rule that all pre-merger contacts are material. CA6 analyzed the petrs' statements with specific reference to the materiality standards set forth in TSC Industries.

3. There are no inter-circuit conflicts with respect to the presumption of reliance issue. Petrs' argument that for purposes of class certification, reliance shouldn't be presumed in cases

involving allegations of false or misleading statements doesn't seem particularly persuasive. In any event, this case can easily be viewed as a failure to disclose case, in which the rationale of Affiliated Ute applies with full force.

4. The materiality issue is an important one that will undoubtedly recur. Resps assert that the SEC has taken the position that Greenfield was wrongly decided, and language from In re Carnation, supra, suggests resps are correct. For these reasons, in addition to the conflict with CA3, I recommend that the Court CVSG.

5. RECOMMENDATION: CVSG

There is a response.

September 29, 1986 Burcham Opin in petn.

The CA6 in this case, was wrong. Since the CA3's decision in Greenfield, the SEC has taken a position on the issue. Thus, companies are on notice that the decision in Greenfield may not insulate them from liability. I suggest that the Court allow the lower courts to develop the law. If another circuit adopts the Greenfield rationale, cert might then be appropriate.

February 20, 1987

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BASIC INC.

vs.

LEVINSON

SOC put on list. 5/6 rep grant on Q1

Grant across board

HOLD FOR	DEFER		CERT.			JURISDICTIONAL STATEMENT				MERITS		MOTION	
	RELIST	CVSG	G	D	G&R	N	POST	DIS	AFF	REV	AFF	G	D
Rehnquist, Ch. J.			Out										
Brennan, J.			✓										
White, J.			✓		only on Q 1								
Marshall, J.			✓										
Blackmun, J.				Join 3									
Powell, J.			✓	on Q 1									
Stevens, J.			✓										
O'Connor, J.			✓										
Scalia, J.			✓										

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