Washington and Lee Law Review

Volume 44 | Issue 3 Article 4

Summer 6-1-1987

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IS SILENCE GOLDEN? A DIRECTOR'S DUTY TO DISCLOSE PRELIMINARY MERGER AND ACQUISITION NEGOTIATIONS

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I. INTRODUCTION

As leaders and spokespersons of the corporation, directors have a fiduciary duty to act and to make decisions, in the best interests of the corporation.[1] The recent wave of corporate mergers and acquisitions,[2]

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1. *See* Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) ("the officers and directors are the agents and fiduciaries of the shareholders and owe a duty of complete loyalty."); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) ("A board member's obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and the duty of loyalty. The duty of care refers to the responsibility of a corporate fiduciary to exercise, in the performance of his tasks, the care that a reasonably prudent person in a similar position would use under similar circumstances."); *see also* Unocal v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); BRODSKY & ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS § 2:06 (1984); KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 1.06 (1978); Kaplan, *Fiduciary Responsibility in the Management of the Corporation,* 31 BUS. LAW. 883 (1976).

2. Since the late 1890's, there have been four cycles of concentrated corporate merger and acquisition activity. Presently, we are in the midst of the fourth and largest cycle which began in 1974. Sloan, *Why Is No One Safe?,* FORBES MAG., 1978 at 134-40 (Mar. 11, 1978). A significant factor contributing to this latest period of concentrated merger and acquisition activity was the double-digit inflation rates of the late 1970's and early 1980's. During this period, rising inflation caused the value of a corporation's hard assets (real estate, machinery, and business inventory) to increase at a rate substantially higher and faster than the market value of the corporation's stock. Therefore, the corporation's stock market value did not reflect accurately the dollar value of the corporation's assets (break up value). By purchasing a controlling stock interest in the corporation and then breaking up the corporation by selling off its assets and subsidiaries piecemeal, corporate raiders were able to realize tremendous profits.

Another contributing factor was the rise of the new breed of aggressive investment and merchant bankers. These bankers helped raiders by raising large sums of money to fund corporate takeovers through the public offering and private placement of high interest yielding bonds rated BB+ or below by Standard & Poor's, or Bal or less by Moody's Investors Service ("Junk Bonds"). These bankers also helped raiders by lending them large sums of capital secured only by stock and/or assets in the target corporation, to be repaid either by selling the target's assets and subsidiaries piecemeal, and paying off the debt with the sale proceeds, or by continuing to operate the company and servicing the financing debt with the company's cash flow. Finally, the bankers assisted raiders by becoming partners with the raiders in the takeovers by taking equity positions in deals. See Troubh, *Characteristics of Target Companies,* however, has altered the type of decisions directors must make. Now rather than being strictly concerned with corporate growth, directors also must address such issues as defensive tactics, greenmailing, and hostile takeovers.[3]

These new issues confronting directors have changed their role from high priced figureheads to accountable decision makers. Moreover, because many of their decisions directly affect the market value of the corporation's

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32 Bus. Law. 1301 (1977) (an extensive analysis of what factors makes a corporation ripe for a takeover).

3. Prior to this merger and acquisition wave, directors could concentrate strictly on corporate business. Once this wave started, however, directors were forced to shift much of their attention to potential hostile takeover attempts. This not only meant planning against hostile takeovers by adopting such defensive tactics as poison pills and golden parachutes, but also once a raider commenced a takeover bid, directors had to make critical decisions that many times permanently altered the corporation such as selling off corporate assets, or subsidiaries, burdening the corporation with extensive, high yield, long term debt or dissolving the corporation by merging it into another corporation that offered a better per share price to the shareholders than that offered by the raider. Some commentators, and courts, however, have noted that takeovers may be beneficial to shareholders. *See* Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 253-54 (7th Cir. 1986) ("To allow management to use its control of the board of directors to frustrate all hostile takeovers would nullify an important protection for shareholders. The threat of a hostile takeover plays a vital role in keeping management on its toes. If CTS's management is allowed to insulate itself from any change of control . . . , the shareholders may be unable to realize the potential value of their investment."). *See also* Easterbrook and Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer,* 94 Harv. L. Rev. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 Stan. L. Rev. 819 (1981).

The theory that advocates takeovers as beneficial to shareholders views hostile takeovers as a curb, or check, against complacent and inefficient management. Indeed, prior to the current merger and acquisition period, a board had little incentive to take steps to increase the market value of the corporation's stock, since the board and management had little, if any, fear of being ousted and replaced through a hostile takeover. Now, however, as a result of the omnipresent threat of a hostile takeover, directors are more accountable to the shareholders. To prevent raiders from launching a successful hostile takeover and replacing the board and management, directors have taken action to raise the stock's market value. By raising the stock's market value, directors keep shareholders satisfied which makes it more difficult for raiders to coerce shareholders to tender their shares in a hostile tender offer. Additionally, by raising the stock's market price to reflect more accurately the corporation's break-up value, the monetary incentive for raiders to commence a hostile takeover and liquidate the company is decreased.

This tactic recently was illustrated in the takeover battle between Carl Icahn ("Icahn") and USX Inc. ("USX"). Icahn, believing USX's stock was undervalued, began purchasing large blocks of USX stock at an average of $22.20 per share. Thereafter, he informed the USX Board that he would commence a tender offer at $31 per share. Anticipating a hostile tender-offer from Icahn and desiring to prevent its shareholders from tendering their shares to Icahn, the USX Board, in addition to other defensive steps, made numerous public announcements that it was meeting with its investment bankers to restructure USX to raise the market value of USX stock. By raising the market value of USX stock, the Board hoped it would provide shareholders with an incentive not to tender their shares if Icahn commenced his threatened hostile tender offer. Business Week, *It's USX Vs. Everybody,* Oct. 6, 1986, at 26-27.

stock,[4] there has been a tremendous surge of both class action suits against directors, and shareholder derivative suits.[5] This not only has made it difficult for corporations to obtain director and officer liability insurance,[6]

4. The stakes in fighting off a hostile takeover can be exceedingly high to the corporation. This is reflected in the market value of the corporation's stock. To thwart raiders, directors often take steps that changes the corporate structure and cripple its ability to grow, such as selling corporate assets or subsidiaries, creating new classes of stock with various rights, and saddling the corporation with long term, high interest debt. A recent example of the massive restructuring corporations have undertaken to fend off hostile takeovers was illustrated in the takeover battle between T. Boone Pickens ("Pickens") and the Diamond Shamrock Corporation ("Diamond Shamrock"). To prevent Pickens from succeeding in his takeover bid, Diamond Shamrock's management adopted a major restructuring plan. As part of this plan, the company took such drastic steps as firing the Chairman of the Board, spinning off two of its subsidiaries, creating and issuing a new class of common stock which split the company in half, repurchasing a large block of its own stock, and issuing to Prudential Insurance Co. of America a series of preferred voting stock. *See* Wall St. J., *Restructuring Set by Diamond Shamrock Corp.,* Feb. 3, 1987, at col. 1.

One of the many problems resulting from fighting off raiders with such kamikaze defensive tactics as those adopted by Diamond Shamrock is that the corporation's stock market value fluctuates—many times downward. For example, by adopting a poison pill, directors and management effectively entrench themselves in office, leaving investors with little hope of new management. The entrenchment of an unproductive board and management team often is looked upon unfavorably by equity analysts and institutional investors who own large blocks of the corporation's stock. As a result, the analysis may issue negative recommendations to investors and the institutional investors may sell their equity holdings causing a significant drop in the stock's market value. Additionally, simply by adopting a defensive tactic, the market value of a corporation's stock may drop. Indeed, a recent SEC study released on March 10, 1986, by the Securities and Exchange Commission's Office of the Chief Economist found that defensive tactics can decrease the value of a company's stock. The study was based on 37 companies that had adopted poison pills. Depending upon the type of poison pill adopted and whether the corporation was viewed as a takeover target, the study showed that the market value of corporation's stock decreased in a range of .93-2.39% *See generally The Economics of Poison Pills,* Office of the Chief Economist, Securities and Exchange Commission, (Mar. 5, 1986).

5. *See* Ichel, *Officers' and Directors' Liability, A Review of the Business Judgment Rule,* Practicing Law Institute, (May-June 1985). While both shareholder derivative suits and class action suits can be brought against corporations, there are substantial differences between the two types of suits. In a shareholder derivative suit, the shareholder brings the action on behalf of the corporation. Additionally, the shareholder must be a shareholder when he brings the action, and the shareholder must have requested the corporation's directors to bring an action, and the directors unjustifiably refused, or the shareholder demonstrated that such a request would have been futile. *See* BRODSKY & ADAMSKI, *supra* note 1 and §§ 9.01-.13. Class action suits, however, are brought by one or more shareholders individually and on behalf of a group of shareholders who all suffered damages from the same corporate action. Additionally, the shareholder[s] bringing the action does not have to make a demand upon the board of directors. *See* KNEPPER *supra* note 1 at §§ 16.01-.14.

6. In a speech given at the Practicing Law Institute's 18th Annual Institute on Securities Regulation on November 6-8, 1986, Joseph Hinsey IV, a member of White & Case, presented a status report on directors' and officers' ("D & O") liability insurance. The report compared the D & O insurance market in September 1984 with the market in 1986. The comparison showed that in 1984 it was a "buyers' market," whereas in 1986, underwriters wrote little, if

but also has decreased severely a corporation's ability to attract qualified individuals willing to serve as directors.[7]

Many of these problems can be attributed to the fact that because the present merger and acquisition era is relatively new, and because a hostile takeover attempt often is brought on with lightning speed, directors are forced to decide important corporate issues quickly, and without legal precedent to guide them. Two such issues of growing concern to directors are their legal duty to disclose publicly ongoing merger or acquisition negotiations, and their duty to respond to public inquiries regarding such negotiations. These issues present practical difficulties to directors because disclosing such information too early in the negotiation process can "chill" a possible merger or acquisition, or can interfere with a corporation's ability to transact business effectively,[8] while disclosing such information too late

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any, new business. Moreover, the report also showed that there has been a significant increase in the premiums for D & O policies for existing policyholders. 18 SEC. REG. & L. REP. (B.N.A.) 1638-39 (Nov. 14, 1986); *see also Directors' and Officers' Liability Insurance and Self Insurance,* PRACTICING LAW INSTITUTE 13, 15-16 (March 12, 1986) ("at present there are only six insurance companies offering coverage on a general basis in the United States. . . . Those companies are offering their policies at greatly increased premiums and with higher deductible amount than the policies with the same limits of prior years."); BLOCK, BARTON, & RADIN (discussing D & O insurance crisis).

7. On a cost/benefit analysis, the rewards of a directorship can be overshadowed by the potential personal liability of directors resulting from the D & O insurance crisis. Without D & O insurance directors face the possibility of substantial personal liability. Therefore, qualified individuals are reluctant to serve as corporate directors. To offset this problem, state legislators have begun to pass legislation that permits corporations to limit director's liability and indemnify directors for legal expenditures and damages resulting from certain actions taken in their capacity as directors, through provisions in the corporations by-laws and certificate of incorporation. *See, e.g.,* DEL. CODE ANN. Tit. 8, Section 145 (1986). For an indepth discussion of Delaware's recent amendments to its D & O indemnification and insurance statute see Block, Barton, & Radin, *Indemnification and Insurance of Corporate Officials,* 13 SEC. REG. L. J. 239 (1985-86); BLOCK, BARTON & RADIN, *supra* note 6 and 332-44. *See also* BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS—INDEMNIFICATION AND INSURANCE (1981) (discussing D & O indemnification and insurance).

8. In many instances, secrecy is the key to the successful completion of corporate transactions. If a target corporation discloses its plans to be acquired or merge with another corporation, the market value of the target corporation's stock may increase in response to speculation by arbitrageurs and speculators that the acquiror will offer a premium for the target's shares in a hostile tender offer. This increase in the stock's market value forces the acquiror to pay a higher price per share to provide the target's shareholders with a sufficient premium to induce them to tender their shares. This increased cost may make the takeover either unprofitable or prohibitively expensive for the acquiror. For example, if corporation X's publicly traded stock is quoted at $10 per share, to induce X's shareholders to tender their stock, corporation Y may offer $12 per share—a $2 premium. If, however, the public learns of the deal, investors and arbitrageurs expecting a $12 tender offer will purchase the stock, increasing the stock's demand, decreasing its supply, and thus driving its market value up to $11 or $12. Now, if corporation Y makes a tender offer for X's stock at $12 per share, X shareholders only would receive, at most, a $1 premium—probably not enough to make them tender. Therefore, corporation Y is forced to increase its tender offer to $13 per share. At $13 per share, corporation Y may abandon its efforts either because profits that it could

often results in disgruntled former shareholders alleging fraud in their 10b-5 complaints.[9]

Presently, there is some conflict within the circuits as well as between some circuit courts and the Securities and Exchange Commission (the "SEC") regarding when preliminary merger or acquisition negotiations become material and subject to the disclosure provisions of the federal securities laws.[10] Moreover, there is a sharp difference of opinion between the circuits regarding whether a director can deny the existence of such preliminary negotiations by issuing a "no corporate development statement" if in fact negotiations are being conducted. While the SEC and some circuit courts have taken the position that such a denial is a materialk mistatement,

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have reaped by acquiring corporation X at $11 per share are not attainable at $13 per share, or because it cannot obtain the additional financing to tender for X's stock at $13 per share.

Additionally, disclosure of negotiations may cause negotiations to break off if the acquiring corporation has conditioned the deal on negotiations remaining private. For example, in the acquisition of Carnation Co. ("Carnation") by Nestle, S. A. ("Nestle") Nestle conditioned its acquisition of Carnation on the acquisition negotiations remaining private. *See* In re Carnation Co., Sec. Release No. 22214 [1984-1985 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801, 87,592 AT 87,593 (JULY 8, 1985).

9. By denying that negotiations are occurring or failing to disclose negotiations timely, directors face the possibility of class action suits by former shareholders alleging that the directors omitted or failed to disclose material information (the ongoing negotiations) which caused them to suffer trading losses. *See, e.g.,* Levinson v. Basic Inc., 786 F.2d 741, 746-47 (6th Cir. 1986), *cert. granted,* U. S. (Feb. 23, 1987) (No. 86-279, 1987 Term); Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982).

10. *Compare* SEC v. Geon Indus., 531 F.2d 39, 47 (2d Cir. 1976) ("inside information [regarding a merger] can become material at an earlier stage than would be the case as regards lesser transactions"); SEC v. Shapiro, 494 F.2d 1301, 1305-07 (2d Cir. 1974) ("although the negotiations had not jelled to the point where a merger was probable," prospect of tremendous earnings for merging company supported finding of materiality); Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128, 134 (S.D.N.Y. 1984) (inchoate merger negotiations were probably material and should have been disclosed when defendant chose to issue voluntary statement in response to exchange inquiry); and In re Carnation Co., Sec. Release No. 22214 [1984-85 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801 at 87,596 (public denial of take-over rumors was materially misleading even though parties had only one meeting and several telephone conversations) *with* Flamm. v. Eberstadt, 814 F.2d 1169, 1178 (7th Cir. 1987) ("public corporations need not disclose ongoing negotiations until they have produced agreement on the price and structure of the deal"); Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984) ("no duty to disclose antitakeover negotiations that arose prior to time target corporation and its white knight agreed on merger price and structure"); Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983) (merger negotiations "are inherently fluid" and premature disclosure "may in fact be more misleading than secrecy so far as investment decisions are concerned"); Staffin v. Greenberg, 672 F.2d 1196, 1206-07 (3d Cir. 1982) ("reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may itself be misleading") ("Where an agreement in principle [to merge] has been reached a duty to disclose *does* exist.") (original emphasis); Radiation Dynamics, Inc. v. Goldmunts, 464 F.2d 876, 891 (2d Cir. 1972) (commitment to sell occurred when "parties obligated themselves to perform . . . even if the formal performance . . . is to be after a lapse of time"); Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1084-85 (5th Cir. 1970) (preliminary merger discussions are immaterial as a matter of law since disclosure of them

thereby, subjecting the corporation to liability,[11] a number of federal courts have held that prior to such negotiations ripening into an agreement in principle, directors legally can deny the existence of such negotiations.[12]

In an effort to provide corporate directors with legal advice which protects them from liability while still offering them the flexibility to conduct corporate transactions, this article will provide a comprehensive analysis of the federal securities law's disclosure rules regarding preliminary merger and acquisition negotiations. This article also will examine both the federal courts' and the SEC's application and interpretation of these rules.

To determine if merger and acquisition negotiations must be disclosed, the courts have employed a two-prong test: (1) is the corporation under a disclosure duty, and (2) have the negotiations reached the material threshold. Accordingly, Part II of this Article examines the instances when corporations are under a legal duty to disclose merger or acquisition negotiations (the first prong), and Part III provides a detailed review of the positions taken by the courts regarding when preliminary negotiations cross the material threshold (the second prong). Finally, Part IV analyzes and critiques the different legal standards adopted by the courts in deciding merger and acquisition negotiation disclosure cases. Additionally, drawing upon these standards and the federal securities laws, Part IV also provides directors with legal guidance in determining how legally to respond to inquiries regarding whether negotiations are being conducted.

II. DUTY TO DISCLOSE

Congress enacted the federal securities laws to protect investors from fraud by providing them with information necessary to make informed investment decisions in the purchase or sale of securities.[13] To effectuate

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may itself be misleading); Zuckerman v. Harnischfeger Corp., 591 F. Supp. 112, 120 (S.D.N.Y. 1984) (when faced with exchange inquiry, defendants not required to volunteer information about merger negotiations that they presumed to be nonpublic). Note, *Stock Exchange Inquiry: Problems with Disclosure of Preliminary Merger or Acquisition Negotiations,* 11 J. Corp. Law 715, 718-19 (1986).

11. *See, e.g.,* Levinson v. Basic Inc., 786 F.2d 741, 746 (6th Cir. 1986), *cert. granted,* U.S. (February 3, 1987) (No. 86-278, 1987 Term); In re Carnation Co., S.E.C. Release No. 22214 [1984-85 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801, 87,592, 87,595; Schlanger v. Four Phase Systems, Inc., 582 F. Supp. 128, 133-34 (S.D.N.Y. 1984).

12. *See, e.g.,* Greenfield v. Heublein, Inc., 742 F.2d 751, 756-57 (3d Cir. 1984); *see also* Flamm v. Eberstadt, 814 F.2d 1169, 1178-79 (7th Cir. 1987) (inferring agreement with *Greenfield).*

13. *See* SEC v. Texas Gulf Sulpher Co., 401 F.2d 833, 858-59 (2d Cir. 1968) (quoting House Report 1383). By providing investors with material information concerning the stock they were purchasing, Congress felt that it could protect investors by curbing the fraudulent practices used on investors prior to the enactment of the securities laws. Significantly, in a 1934 House Committee debate discussing House Bill 9323—the Bill later integrated with Senate Bill (S. 3420) to form the Bill that subsequently passed in both the House and Senate to become the Securities Exchange Act of 1934—the House stated:

this goal, Congress created the SEC[14] and provided it with broad powers to enact rules and regulations designed to guarantee that its policies were met.[15] Since the vast amount of information needed by investors to make informed investment decisions is held exclusively by the seller or issuer of the instrument, the SEC enacted detailed disclosure rules and regulations requiring issuers to disclose continuously all information potentially affecting the value of their securities.[16]

> *No investor, no speculator, can safely buy and sell securities upon the exchanges 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 [sic] 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. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market.* That is why in many cases it is so carefully guarded. *Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information.* Despite the tug of conflicting interests and the influence of powerful groups, *responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges.* Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet.

H.R. REP. No. 1383, 73 Cong., 2d Sess. 5, 11-12 (1934) (emphasis added).

14. For an in-depth discussion of the history and role of the SEC. see 11A, GADSBY, BUSINESS ORGANIZATIONS § 102 (1981).

15. Included in both the Securities Act of 1933 (the "Securities Act"), and the Securities Exchange Act of 1934 (the "Exchange Act"), are general rulemaking provisions providing the SEC with the power to enact rules and regulations to carry out the provisions of the securities acts. Specifically, Section 19(a) of the Securities Act, 15 U.S.C. § 77s(a), provides, in pertinent part:

> The Commission shall have the authority . . . to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter. . . .

Additionally, Section 23(a) of the Exchange Act, 15 U.S.C. § 78w(a)(1), provides, in pertinent part:

> The Commission . . . shall . . . have power to make rules and regulations as may be necessary or appropriate to implement the provisions of this chapter.

16. Under the Securities Act, Sections 5, 7 and 10, 15 U.S.C. §§ 77e, 77g, and 77j, require extensive disclosure of information in connection with registration statements and offering prospect uses. Under the Exchange Act, disclosure is required under Sections 12(b)

In theory, full disclosure is the ideal method of protecting investors by keeping them abreast of information capable of affecting the value of their stock. When examining the realities of the marketplace, however, full disclosure in certain instances may prove to be more harmful and confusing to investors than helpful. Indeed, such factors as the lack of sophistication of the ordinary investor to analyze properly the vast amounts of disseminated corporate information and the general unpredictable reaction of the public stock exchanges to corporate releases often results in empty-pocket investors perplexed as to how they suffered trading losses relying upon corporate disclosures.

To protect investors from these dangers while still providing them with sufficient information to make informed investment decisions, the SEC has limited a corporation's duty to disclose non-public information.[17] One limitation is only requiring corporations to disclose "material" information.[18] This limitation provides the SEC and the courts with substantial flexibility and discretion in defining what information a corporation must disclose.

Essentially, the SEC and the courts have defined material information as any information that a reasonable investor would find necessary in making an informed investment decision.[19] Because the words "merger"

(information required to be disclosed by issuers with securities registered on a national exchange), 13(a) (information required to be disclosed in annual, and various periodic reports), 13(d) (information required to be disclosed by person acquiring 5% of corporation's stock), 13(e) (information required to be disclosed when issuer repurchases or exchanges for its own stock), and 14(a), (d), (e), and (f) (information required to be disclosed when issuer repurchases its own stock), and 14(a), (d), (e), and (f) (information required to be disclosed in connection with tender offers and proxy solicitations). 15 U.S.C. §§ 78, 78m(d), 78(e), 78(n) (a), 78n(d), (e), and (f).

17. Nothwithstanding the broad statutory language of the Securities Act, and the Exchange Act, the SEC has placed significant limitations on a corporation's disclosure obligations. These limitations include requiring the dissemination of only certain kinds of information such as information regarding a corporation's capital structure and management. For an in-depth discussion of the SEC's interpretation of its disclosure rule-making powers under the securities acts, and its limitations on corporate disclosure see M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES, at § 1.02 (1986).

18. The disclosure statutes expressly provide that whether in proxy statements, tender-offers, or other disclosure requirements, corporations only are required to disclose material information. For example, Rule 14a-9(a) regulation proxy statements provided, in pertinent part:

> No solicitation . . . shall be made by means of any proxy statement . . . containing any statement which, at the time and in light of the circumstances under which it is made, is false of misleading with respect to any *material* fact, or which omits to state any *material* fact.

17 C.F.R. § 240.14a-9 (1987) (emphasis added).

19. *See* TSC Industries v. Northway Inc., 426 U. S. 438, 449 (1976) (the Court defined a fact as material if the fact "would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be 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."); *see also* In re Carnation Co. [1984-1985 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801, 87,592 at 87,596 ("When

and "acquisition" have become synonymous with stock value fluctuations, negotiations concerning such transactions clearly affect the market value of a corporation's stock. At first glance, it appears that the reasonable investor would find such negotiations important in making an investment decision, and, therefore, these negotiations would constitute material information requiring disclosure. Nevertheless, because such negotiations may never ripen into a deal, some courts attempt to protect eager but unsophisticated investors by holding that, prior to merger or acquisition negotiations reaching the "agreement in principle"[20] stage, such negotiations are immaterial as a matter of law and are not subject to the disclosure provisions of the federal securities laws.[21]

Because the first prong in determining whether preliminary merger and acquisition negotiations must be disclosed is determining whether the corporation is under a disclosure duty, Part A examines the instances when the law places either an express or implied duty upon issuers to disclose such negotiations.

A. DISCLOSURE DUTIES UNDER THE FEDERAL SECURITIES LAWS

1. *Express Disclosure*

Under the federal securities laws, corporations have both an express and implied duty to disclose material corporate information.[22] The express

an issuer makes a public statement, information concerning preliminary acquisition negotiation discussions is material and must be disclosed if the information assumes 'actual significance in the deliberation of' and significantly alters 'the total mix of information available [to]' the reasonable shareholder."); *see also* A. Bromberg & L. Lowenfels, Securities Fraud and Commodities Fraud § 7.04(312) at 7:158.5-8 (1986).

20. An agreement in principal is reached when the two parties agree on the price the acquiror will pay for the target's assets or shares, and upon the structure of the deal—stock for stock, cash for stock, etc. *See e.g.*, Flamm v. Eberstadt, 814 F.2d 1169, 1178 (7th Cir. 1987); Greenfield v. Heublein, Inc., 742 F.2d 751, 756-57; Staffin v. Greenberg, 672 F.2d 1196, 1206; *Guy v. Duff & Phelps Inc.*, 628 F. Supp. 252, 255 (N.D. Ill. 1985); *see also* A. Bromberg & L. Lowenfels, *supra* note 19, § 7.4(3)(1) at 7:158.64-66 (discussing agreement in principle).

21. *See, e.g., Flamm*, 814 F.2d 1169, 1178 (7th Cir. 1987) ("corporations need not disclose ongoing negotiations until they have produced agreement on the price and structure"); *Greenfield*, 742 F.2d 751, 756 ("With specific reference to merger discussions, we have held that, so long as they are preliminary, no duty to disclose arises. We reasoned that because disclosure of such tentative discussions may itself be misleading to shareholders, preliminary merger discussions are immaterial as a matter of law."); *Staffin*, 672 F.2d 1196, 1206 ("The reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may itself be misleading. A substantial body of opinion suggests that disclosure of preliminary merger discussions would, by and large, do more harm than good to shareholders. . . ."); *Guy*, 628 F. Supp. 252, 255 ("no 'agreement in principle' is reached until the parties have at least agreed on both price and structure.") (emphasis in original); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 776, 230 Cal. Rptr. 815, 820 (Cal. App. 6 Dist. 1986) ("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.").

22. The express disclosure provisions of the securities acts are the "reporting sections."

disclosure rules require disclosure of certain specified information in annual reports,[23] quarterly reports,[24] current reports,[25] tender offers and proxy statements.[26] The information required in these reports generally concerns the corporation's finances, capital structure, and personnel. The SEC expressly has mandated disclosure of this information because regardless of the transaction this information is considered essential for investors to make informed investment decisions.

The express disclosure provisions of the federal securities laws, however, apply only to the disclosure of preliminary merger negotiations in the context of tender-offers.[27] Briefly, when an acquiring company seeks to merge or to takeover a target corporation it must, at a minimum, acquire 51% of

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These sections require issuers to file with the SEC, and to send to shareholders, specified information. Issuers are required to file and send this information at various periods throughout the fiscal year (quarterly, yearly), and upon the happening of certain events (proxy solicitations, issuer repurchases, etc.). *See generally supra* notes 15-16 and accompanying text. The implied disclosure provisions of the securities acts effectively force issuers to disclose material information by imposing fraud sanctions on the corporation and its officers and directors for failing to disclose material information, or for issuing false or misleading material facts. For example, Rule 10b-5 of the Exchange Act provides, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, 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.

17 C.F.R. § 240.10b-5 (b) (1987).

23. *See* 17 C.F.R. § 240.13a-1 (1987) (requirement to file annual reports on Form 10-K).

24. *See* 17 C.F.R. § 240.13a-13 (1987) (requirement to file quarterly reports on Form 10-Q).

25. *See* 17 C.F.R. § 240.13a-11 (1987) (requirement to file current reports on Form 8-K); *see generally* Block, Barton & Garfield, Affirmative *Duty to Disclose Material Information Concerning Issuer's Financial Condition and Business Plans,* 40 BUS. LAW. 1243 (1985) (discussion of legal issues arising out of a duty to disclose information in Forms 10-K, 10-Q, and 8-K).

26. *See* 17 C.F.R. § 240.14a-101 (schedule 14A, information required in proxy statement); 17 C.F.R. § 240.14a-102 (schedule 14B, information required in tender offer statement).

27. Section 14(d)(4) of the Exchange Act entitled "Recommendations Regarding Acceptance of Rejection of Tender Offer," provides:

> Any solicitation or recommendation to the holders of such a security to accept or reject a tender offer or request a invitation for tenders shall be made in accordance with such rules and regulations as the Commission may prescribe.

15 U.S.C. § 78(d) (1968).

Pursuant to this Section, the SEC adopted Rule 14d-9. Rule 14d-9 provides, in pertinent part:

> No solicitation or recommendation to security holders shall be with respect to a tender offer . . . unless as soon as practicable. . . . Such person shall file with the Commission . . . a Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9.

17 C.F.R. § 240.14D-9 (1987).

Item 7 to Schedule 14D-9, entitled "Certain Negotiations And Transactions By The Subject Company," provides:

> (a) If the person filing this statement is the subject company, state whether or not

the target's outstanding stock.[28] To acquire this percentage, the acquiror publicly announces its intention to purchase a set percentage of stock from

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any negotiation is being undertaken or is underway by the subject company in response to the tender offer which relates to or would result in:

(1)An extraordinary transaction such as a merger or reorganization, involving the subject company or any subsidiary of the subject company;

(2)A purchase, sale or transfer of a material amount of assets by the subject company or any subsidiary of the subject company;

(3)A tender offer for or other acquisition of securities by or of the subject company; or

(4)Any material change in the present capitalization or dividend policy of the subject company.

Instruction: If no agreement in principle has yet 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.

(b)Describe any transaction, board resolution, agreement in principle, or a signed contract in response to the tender offer, other than one described pursuant to Item 3(b) of this statement, which relates to or would result in one or more of the matters referred to in Item 7(a)(1), (2), (3) or (4).

Because the SEC has emphasized the importance of merger negotiations to a shareholder considering selling his stock, it strictly enforces such disclosure. A recent ruling by the SEC helps demonstrate the exacting duty of issuers under Rule 14d-9 to disclose ongoing merger negotiations during a tender offer. In *In the Matter of Revlon, Inc.*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,006 (June 16, 1986), in response to a hostile tender-offer by Pantry Pride, Inc., ("Pantry Pride"), Revlon, Inc. ("Revlon") filed a Tender-Offer Recommendation/ Solicitation Statement advising its shareholders that Pantry Pride's offer was inadequate. *Id.* at 88,142. Additionally, in this statement Revlon disclosed that it might undertake merger negotiations with a third party. *Id.* at 88,143. Two days after Revlon Filed its Rule 14d-9 statement, it entered into merger negotiations with a white knight, Forstmann Little & Co. ("Forstmann Little"). Approximately six days after these negotiations began, Revlon amended its Schedule 14D-9 statement disclosing that it had initiated merger negotiations with Forstmann Little. *Id.* at 88,145.

Because of the six day delay between the time Revlon entered into negotiations with Forstmann Little and the time Revlon filed the amendment to its Tender-Offer Statement that disclosed such negotiations, the SEC instituted proceedings against Revlon. *Id.* at 88,142. In finding that Revlon's six day delay in amending its Schedule 14D-9 Statement failed to comply with the timely disclosure requirements of Rule 14d-9, the SEC emphasized the duty of target corporations to amend its Tender-Offer Statement accurately, completely, and timely. *Id.* at 88,146. Significantly, the SEC found that Revlon should have filed its amendment disclosing that negotiations were underway "as soon as practicle after negotiations were commenced." *Id.* at 88,147.

Based upon the Revlon discussion, issuers involved in a tender offer, who subsequently become involved in merger negotiations with another party to avoid liability and litigation, must promptly amend their Schedule 14d-9 Statement to inform shareholders of such negotiations.

28. Every State permits two or more corporations to merge together even when shareholders of the merging corporation dissent to the merger. Each state statute condition this right, however, upon the surviving corporation acquiring a statutorily prescribed amount of the target's stock. This amount can be as low as 51%. *See e.g.*, CAL CORP CODE § 903(a)(4)-(6) (West 1977); DEL. CODE ANN. tit. 8, § 242(b)(2) (Replacement volume 1983); N.Y. BUS. CORP.

each target stockholder at a specified price. These announcements are commonly referred to as "tender-offers."[29] In response to a tender offer, the target company issues to its shareholders a "Tender-Offer Recommendation/Solicitation Statement"[30] which will either recommend shareholders to tender or not tender their shares. To prevent losing control of the corporation, the board also may solicit the stock for itself by including in the statement an offer to repurchase the corporation's stock at a price above the raider's offer. If the raider's tender-offer is in response to a friendly deal (one negotiated and agreed to at arms length), the target's board recommends that shareholders accept the offer. If, however, the tender-offer is hostile (one not approved by the target's management), the board recommends shareholders not to tender, usually citing the inadequacy of the offer.

Rule 14D-9 and Schedule 14D-9 specify the information required in the target's Tender-Offer Statement.[31] This information is expressly required because the SEC has determined that shareholders must have it to make an informed decision as to whether or not to tender their shares to the raider. Significantly, Item 7(a)(1) of Schedule 14D-9 expressly requires that target corporations include in the Tender Offer Statement any merger negotiations that "are being undertaken or are underway."[32] The "Instruction" to Item 7(a), however, recognizes that negotiations occur prior to reaching an "agreement in principle."[33] Therefore, if negotiations have not reached this critical stage, and the target's board determines that disclosure of the parties or terms would jeopardize the deal, Item 7 permits the board simply to

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LAW § 804(a)(3) (McKinney 1986). These statutory mergers are commonly referred to as "squeeze-out" mergers, because they allow the surviving corporation to force the minority shareholders of the merged corporation to sell their shares at a price the surviving corporation deems fair. A dissenting shareholder's sole remedy if he determines the price offered is unfair is to have his shares appraised by an independent appraiser. For a detailed discussion of squeeze-out mergers see 1 F. H. O'NEAL & R. THOMPSON, O'NEALS OPPRESSION OF MINORITY SHAREHOLDERS §§ 5.04-08 (2d ed. 1985); *see also* Thompson, *Squeeze-Out Mergers the New Appraisal Remedy,* 62 WASH. U. L. Q. 415 (1984-85) (discussing minority shareholders' right of appraisal).

29. Tender-offer is not defined in the Exchange Act. Blacks Law Dictionary, however, defines a tender-offer as:

> An offer to purchase shares made by one company direct to the stockholders of another company, sometimes subject to a minimum and/or a maximum that the offeror will accept, communicated to the shareholders by means of newspaper advertisements and (if the offeror can obtain the shareholders list, which is not often unless it is a friendly tender) by a general mailing to the entire list of shareholders, with a view to acquiring control of the second company. Used in an effort to go around the management of the second company, which is resisting acquisition.

BLACKS LAW DICTIONARY 1316 (5th ed. 1979).

30. *See supra* note 27 and accompanying text.

31. *Id.*

32. *Id.*

33. *See supra* note 20, and accompanying text.

state that negotiations are underway. This avoids disclosing sensitive information and jeopardizing the deal.[34]

Moreover, although the express reporting requirements only require disclosure of preliminary merger negotiations in Tender-Offer Recommendation/Solicitation Statements, corporate officers, directors, and lawyers must use care in completing other SEC disclosure reports if such negotiations have been conducted or are being conducted. In these reports, directors must not deny that merger or acquisition negotiations are occurring. For example, if such negotiations are denied in a proxy solicitation and such negotiations are occurring, the denial would be actionable under the Williams Act which prohibits false or misleading statements in connection with proxy solicitation.[35] Furthermore, if negotiations have not been conducted, corporations should not disclose this fact because the corporation will come under a continuing duty of ensuring the continuing accuracy of such disclosure, which would require the corporation to disclose any subsequent merger or acquisition negotiations.[36]

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34. *See supra* note 27, and accompanying text.

35. Section 14(e) of the Exchange Act (the Williams Act) provides:

> Sec. 14(e) It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statement made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e). To curb the abuses involved in tender offers and to further regulate corporate takeovers and proxy fights, Congress enacted the Williams Act. Essentially, the Williams Act requires corporations that make tender offers to provide the target corporation's shareholders with information about itself and its offer. Moreover, the Williams Act requires the acquiring corporation to provide shareholders with sufficient time to evaluate the offer and decide whether to tender their shares. *See generally* Greene and Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions,* 132 U. PA. L. REV. 647 (1984); Junewicz, *The Appropriate Limits Of Section 14(e) Of The Securities Exchange Act of 1934,* 62 TEX. L. REV. 1171 (1984) (discussing tender offers and the Williams Act).

Because the Williams Act prohibits untrue statements in connection with a tender offer, if a corporation denies the existence of ongoing merger or acquisition negotiations when advising its shareholders whether to tender their shares in response to a tender offer, the corporation will violate the Williams Act and become subject to liability and sanctions under the Exchange Act.

36. This duty is referred to as the "Duty To Update Prior Statements." *See* BARTON, BARTON, & GARFIELD, *supra* note 25 at 1251. Courts have failed to establish parameters that clearly define the period during which a corporation must update prior statements. In *Ross v. A. H. Robins Co.,* 465 F. Supp. 904 (S.D.N.Y.), *rev'd on other grounds,* 607 F.2d 545 (2d Cir. 1979), *cert. denied,* 446 U. S. 946 (1980) *reh'g denied,* 448 U.S. 911 (1980), however, the Federal District Court for the Southern District of New York indicated that the duty to update remained upon the issuer "so long as the prior statements remains 'alive.' " 465 F. Supp. at

Accordingly, absent issuing a Tender-Offer Recommendation/Solicitation Statement, corporations are not expressly required to disclose merger and acquisition negotiations. Moreover, as a rule, directors should avoid any mention of such negotiations in other SEC filings or reports. If, however, such negotiations are disclosed, corporate officials and lawyers must ensure that the disclosure is complete, accurate, and timely; which may require amending a prior statement to ensure its continued accuracy.

2. *Implied Disclosure*

Even absent an express duty to disclose merger or acquisition negotiations, a corporation may be required to disclose such negotiations under the securities law's anti-fraud provisions. The anti-fraud provisions are the catchall disclosure provisions of the federal securities laws and require that all information investors need to make informed investment decisions that is not disclosed under the securities law's express reporting requirements is disseminated to investors.[37] Indeed, similar to the express disclosure provisions[38] these provisions also are designed to force issuers to disclose all material information by imposing fraud penalty provisions for incidents of improper disclosure.[39]

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908. In examining the factors that determine the lifespan of a prior statement the court stated that:

> [L]ogic compels the conclusion that time may render statements immaterial and end any duty to correct or revise them. In measuring the effect of time in a particular instance, the type of later information and the importance of earlier information contained in a prior statement must be considered.

Id.

The court then held that a prior statement remained alive as long as "traders in the market could reasonably rely on the statement." *Id.; see also* STEINBERG, supra note 17, at 2.02; 2 A. BROMBERG SECURITIES LAW, FRAUD § 6.11 (543) (1977). Recently, there have been indications that the SEC may consider a safe harbor rule which would define the lifespan of a statement in the market. *See* 18 SEC. REG. & L. REP. (BNA) 521 (April 11, 1986) (address by SEC Commissioner Joseph Crundfest at American Bar Association luncheon on April 5, 1986).

Thus, in the context of merger and acquisition negotiations, it appears that an issuer would have a continuing duty to update its statement—that no negotiations have, or are, occurring—until any existing speculation regarding such a transaction subsides, and sufficient time has passed. To ensure that speculation has died and that sufficient time has passed, issuers can check the trading volume in its stock to determine if the trading volume is the same, for a period of time evidencing a pattern, as it was prior to any merger or acquisition speculation.

37. Because the express disclosure provisions of the securities acts cannot ensure that all information an investor needs to make an information investment decision involving the purchase or sale of a security necessarily will be disseminated, the antifraud provisions provide securities investors with additional information. By imposing sanctions for failing to disclose, provisions attempt to ensure that securities investors will be adequately and accurately informed about a security prior to making an investment decision.
security prior to making an investment decision.

38. *See supra* notes 22-36 and accompanying text.

39. *See supra* note 22 and accompanying text. In addition to Section 10b of the Exchange

Thus, describing these provisions as "anti-fraud" is somewhat misleading because essentially they are disclosure provisions. The anti-fraud sections are extremely important in the SEC's grand scheme of providing investors with the "total mix" of information necessary to make informed investment decisions[40] because they require the issuer to disclose material information that the express disclosure provisions fail to require.[41]

Generally, there are three situations that create an implied duty for issuers to disclose preliminary merger or acquisition negotiations under the federal securities law's anti-fraud provisions: (1) to prevent insider trading,[42] (2) to quell merger or acquisition rumors,[43] and (3) to prevent dissemination of false and misleading corporate statements.[44]

(a) The Alternative Duty: Disclose Or Abstain

Corporations, or corporate insiders, may find themselves under an implied duty to disclose merger or acquisition negotiations to avoid violating insider-trading laws.[45] A fundamental tenet of the anti-fraud provisions

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Act and Rule 10b-5 promulgated thereunder, which prohibits fraud in connection with the purchase or sale of a security, Section 17(a) of the Securities Act makes it illegal to engage in fraud in connection with the offer or sale of a security.

Thus, because Section 17(a) specifically makes it illegal for issuers to offer or sell securities by omitting or issuing false or misleading material statements, this section forces issuers to disseminate all material information concerning a security to both prospective and actual purchasers. *See also infra* note 45.

40. *See supra* note 13 and accompanying text.

41. *See supra* notes 37 and accompanying text.

42. *See infra* notes 45-61 and accompanying text.

43. *See infra* notes 62-74 and accompanying text.

44. *See infra* notes 76-91 and accompanying text.

45. Various sections of the securities acts make insider trading unlawful. The most prominent section, however, are Section 10b of the Exchange Act and Rule 10b-5 enacted thereunder. Section 16 of the Exchange Act also is aimed at insider trading. 16(a) requires insiders to report certain securities transactions involving their dealings in the corporation's stock. 16(b) permits the corporation to recover any short swing profits that insiders might reap from stock transactions involving their corporation stock. *See* BLOOMENTHAL, SECURITIES LAW 365 (1966). The full text of Section 16(b) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was

provides that insiders, and in certain circumstances, their tippees must either disclose material nonpublic information in their possession prior to trading or refrain from such trading.[46] Therefore, courts applying Rule 10(b)-5 have held that persons who trade in securities on the basis of non-public material information, or disseminate that non-public information to a limited number of persons knowing those persons intend to trade in the stock, engage in fraudulent conduct[47] commonly referred to as "insider trading."[48] The mere

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> realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78 p(6) (1982). *See* STEINBERG, *supra* note 17 at 24.01 (detailed discussion of Section 16); *see also* Block & Barton, *Section 16(b) of the Exchange Act: An Archaic Insider Trading Statute in Need of Reform,* 12 SEC. REG. L. J. 203 (1984-85); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales Merging the Objective and Pragmatic Analyses,* 1981 DUKE L. J. 914; Wu, *An Economist Looks at § 16 Of The Securities Exchange Act of 1934,* 68 COLUM. L. REV. 260 (1968).

Section 17(a) of the Securities Act also is designed to prevent insider trading. Section 17(a) provides:

> It shall be unlawful for any person in the offer sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
> (1)to employ any device, scheme or artifice to defraud, or
> (2)to obtain money or property by means of any untrue statement of a material fact or any omission 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
> (3)to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Because this Section almost is a mirror image of Rule 10b-5 and because the courts are divided on whether Section 17 provides a private cause of action, this section has not been relied upon the insider trader cases as heavily as Section 10b and Rule 10b-5. *See* T. HAZEN, THE LAW OF SECURITIES REGULATION 508 (1985); 2 L. LOSS, SECURITIES REGULATION 1224 (1961); Scholl & Perkowski, *An Implied Right of Action Under 17(a); The Supreme Court Has Said "No," But Is Anybody Listening?,* 36 U. MIAMI L. REV. 41 (1981); Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington,* 68 GEO. L. J. 163 (1979).

46. STEINBERG, *supra* note 17 at § 3.01. *See e.g.,* Dirks v. SEC 463 U. S. 646, 653-54, 659-60 (1983); Chiarella v. United States, 445 U. S. 222, 230 (1980); Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

47. *See e.g., Dirks,* 463 U. S. at 659 ("Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.").

48. Congress has yet to provide a definition for insider trading. The recent exposure of the abuses on Wall Street involving Ivan Boesky and other well known securities professionals, however, has resulted in an increasing demand on Congress to provide a clear cut definition of insider trading. Indeed, at a February 24, 1987, congressional hearing, Senator Donald Riegle, Chairman of the Securities panel of the Senate Banking Committee, asked former SEC general counsel, Harvey Pitt to organize a panel of securities lawyers and SEC officials to draft a statutory definition of insider trading. *See* The Wall Street Journal, *Bigger SEC Budget, Clearer Definition of Insider Trader,* Feb. 24, 1987, at 5 Col. 1.

knowledge of non-public material information, however, is not unlawful.[49] Rather, only when that information is material, and when the person possessing it has a fiduciary duty to the corporation and shareholders, and trades in the stock or passes it on knowing the recipients will trade, has he violated the securities laws.[50]

Therefore, assuming preliminary merger or acquisition negotiations are material, an implied duty to disclose such negotiations arises if corporate insiders who have knowledge of such negotiations, or the corporation, trade in the corporation's stock prior to disclosure of such negotiations. To protect themselves and the corporation from violating this duty, directors have two alternatives: (1) publicly disclose negotiations prior to trading, or (2) abstain from trading until negotiations conclude.[51]

In deciding which avenue to take, a director's decision usually is guided by a number of factors. The most prominent factors are the nature of the deal, and their fiduciary responsibility to act in the corporation's best interests. Thus, in determining whether or not to disclose negotiations to allow the corporation to trade, directors should consider carefully the benefits of the proposed deal to the corporation and how disclosure may affect the deal.

When negotiating a "friendly" deal,[52] a director's course of action is clear—remain silent and refrain from trading. From a tactical approach this

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49. In *Chiarella,* the Court stated that:

> *We hold that a duty to disclose under* § 10(b) *does not arise from the mere possession of nonpublic market information.* The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

445 U. S. at 235 (emphasis added). *See also Dirks,* 463 U. S. at 654 ("'a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information'").

50. The various sections of the securities acts, and the rules and regulations enacted thereunder do not provide expressly all the elements necessary for the courts to find a violation of the securities acts', insider trading laws. Rather, the courts construing these laws, rules, and regulations, have implied some of these requirements. *See* Milich, 11 J. CORP. L. 179 (1986) (extensive analysis of the elements of a Rule 10b-5 insider trading violation); Farley, *A Current Look at the Law of Insider Trading,* 39 BUS. LAW. 1771 (1984); Carlton and Fischel, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857 (1983).

51. This duty is commonly referred to as the "Duty to disclose or Abstain from Trading." *See e.g.,* Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) ("The duty imposed on a company and its officers is an alternative one: they must disclose material information either to no outsiders or to all outsiders equally."); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 495 F.2d 228, 236 (2d Cir. 1974) ("'anyone in possession of material inside information must either disclose it . . . or . . . must abstain from trading or recommending the securities.'"); SEC v. Texas Gulf Sulpher Co., 401 F.2d 833, 848 (2d Cir. 1968) (en *banc), cert. denied,* 394 U. S. 976 (1969) ("anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed."). *See also* BROMBERG & LOWENFELS, *supra* note 19 at § 7.4 (181) (discussing "disclose or abstain duty").

52. To acquire a public corporation, a corporation essentially has two methods: (1) negotiate a deal with the target's board of directors, who then recommend to the shareholders

course of conduct is imperative because disclosing negotiations prematurely may prevent completion of the deal. Indeed, since a statutory merger requires the acquiring corporation to purchase, at a minimum, 51% of the target's stock,[53] acquirors are forced to make tender-offers to acquire this stock percentage.[54] Since shareholders will not tender their shares at market price, acquirors must offer a premium for the shares.[55] The premium proposed, however, may decrease if negotiations of a possible tender offer are disclosed because the stock's market price may increase. This increase results from arbitrageurs[56] and speculators, who, depending of course on the viability of such a tender-offer, purchase large blocks of the corporation's stock. This decreases the stock's market supply and causes the stock's market value to rise.[57] Accordingly, the inflated price may make the deal prohibitively expensive for the acquiror, thus quashing the deal.[58]

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to accept the acquiror's terms—a friendly deal—or (2) bypass negotiations with the target's board, and commence a hostile takeover by commencing a hostile tender offer for the corporation's stock.

53. *See supra* note 28 and accompanying text.

54. In many large public corporations, the majority of common stock is held by a wide array of shareholders in amounts usually not exceeding 2-4%. To acquire a 51% block of stock, an acquiror must make an impersonal public offer to the target corporation's shareholders. An acquiror usually informs the shareholders of its tender offer by advertising its offer to buy the target shareholders' stock in the financial pages of newspapers and if a shareholder list is obtainable, through direct mailings to the shareholders.

55. Because a shareholder can sell his stock through his stockbroker in a nonpersonal market sale for the price the stock is quoted on the market, the shareholder has no reason to sell his stock to an acquiror at the same price as the stock is quoted on the market. Therefore, an acquiror must provide the shareholder with an incentive to tender his shares—a premium. This premium is usually cash and/or stock in the acquiror's corporation. For example, if target corporation X's stock is quoted on the N.Y.S.E. at $10 per share, X shareholders will not sell their shares to acquiring corporation Y for $10 a share. Therefore, to induce X shareholders to sell their stock, corporation Y may offer corporation X shareholders $15 per share—a $5 premium.

56. An arbitrageur is a person, or group, who:

> Simultaneous[ly] purchase in one market and [sell] in another . . . a security or commodity in the hope of making a profit on price differences in the different markets.

BLACKS LAW DICTIONARY 95 (5th ed. 1979). *See* M. LIPTON AND E. STEINBERGER, TAKEOVERS AND FREEZEOUTS, §§ 1.07[2] at 1-50-51 (detailed look at arbitrageurs and their role in takeovers); *see also* Rubin, *Arbitrage*, 32 BUS. LAW. 1315 (1977).

57. Upon learning of a possible tender offer, arbitrageurs purchase large percentage blocks of target corporation's stock hoping to sell the stock at a premium to the acquiring corporation or to sell it back to the target corporation. By purchasing large blocks of stock, the arbitrageurs decrease the amount of stock available for purchase. Specialists, or "market makers," recognizing this decrease in the market supply of the stock, as the market demand for the stock increases in response both to the fight between the target and acquiring corporation, and to the demand by investors to purchase an "in-play" stock, raise the selling price of the target's stock. Accordingly, as the supply of the stock decreases and the demand increases, the stock's market price increases.

58. *See supra* note 8.

Since not all deals proposed by an acquiror are in shareholders' best interests, directors may consider disclosing negotiations to permit the corporation to trade in its own stock as a defensive tactic. If the corporation is engaged in merger or acquisition negotiations, and the board determines that the negotiations will not produce a deal beneficial to the corporation, it may break off negotiations. The raider may then resort to a hostile takeover bid, thus placing shareholders in danger of a two-tier squeeze out merger.[59]

To protect shareholders from this danger, the board can publicly disclose such negotiations to allow the corporation to repurchase its stock or sell it in a private transaction to a "White Knight."[60] By disclosing and then trading in its stock, corporations can thwart raiders by either purchasing enough of its own stock to prevent a raider from acquiring a percentage high enough to take control of the corporation, or by selling enough shares to a White Knight to ensure a friendly takeover. Moreover, by disclosing such negotiations the market price of the corporation's stock may increase to the level of forcing the raider to abandon its bid.[61]

Thus, although a director's duty is clear—either refrain from disclosing negotiations and prevent the corporation from trading in its stock, or disclose negotiations and then trade—in deciding which alternative to take, directors must carefully consider the merits of the deal being negotiated and how disclosure will affect the deal.

(b) The Duty To Quell Merger Rumors

The potential to reap tremendous profits from the receipt of non-public information creates an inherent difficulty for management to prevent leaks of ongoing merger or acquisition negotiations. As a result, directors often find themselves conducting "non-public" negotiations while the price of the corporation's stock soars as rumors of an impending deal circulate.[62]

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59. *See supra* note 28 and accompanying text (discussing squeeze-out mergers).

60. A white knight is an alternative buyer. If the target corporation determines that the offer by the corporation seeking to acquire it is inadequate, it may contract to sell a controlling stock interest in itself to a friendly third party, a white knight. By selling its authorized but unissued shares to the white knight and having the white knight purchase additional shares on the market, the target corporation can both prevent a corporation from purchasing a controlling stock interest and, presumably, provide its shareholders with a better price for their shares. *See* A. FLEISHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING at 323; M. LIPTON & E. STEINBERGER, *supra* note 56 at § 26.05[5][c].

61. *See supra* note 8 and accompanying text.

62. A recent SEC Study examined the market price of the stock of 172 corporations prior to the announcement of a takeover bid. The study showed that, in each case, the trading volume and the market price of the target's stock rose substantially prior to the announcement of a takeover. The study showed that the target's stock price rose as high as 40% of the premium paid in a successful takeover. *See* The Wall Street Journal, *Factors Other Than Insider Trading Can Boost Stock Before a Bid, SEC Says,* March 11, 1987, at 4, Col. 5-6.

In deciding how or whether to respond to these rumors, either in response to inquiry, or voluntarily to keep the stock's market price down, directors must pay careful attention to the federal securities laws, and the rules of the exchange on which the corporation's shares are traded.

Under the federal securities laws, a director's duty to respond to rumors is determined solely by the source of the rumors. If rumors of negotiations are attributable to the issuer, directors must verify and/or correct such rumors. The failure to do so is actionable under Rule 10b-5 as a false or misleading statement. If, however, rumors cannot be linked to the issuer, the directors are relieved not only of a duty to verify such rumors, but also are not required to correct false or misleading merger and acquisition rumors.[63]

Additionally, a recent Wall Street Journal article examined the market activity of the stock of seven corporations engaged in merger or acquisition negotiations prior to a public announcement of a deal. The study showed that in each case while the parties were conducting negotiations and prior to the corporations publicly announcing a deal, the market price and the trading volume of the corporations' stock had increased significantly. *See* The Wall Street Journal, *Unusual Stock Moves Continue To Raise Questions About Leaks,* Feb. 6, 1987, at 23, col.5.

63. The seminal case addressing an issuer's duty to respond to rumors is *SEC v. Texas Gulf Sulphur Co.,* 258 F. Supp. 262 (S.D.N.Y. 1966), *rev'd,* 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). In *Texas Gulf Sulphur,* rumors spread publicly that Texas Gulf Sulphur Co. ("TGS"), had discovered an ore vein of tremendous magnitude. In response to the rumors, TGS issued a press release denying the discovery. Despite finding that TGS had in fact discovered ore and that TGS's public statement that denied such a discovery violated Rule 10b-5, the court indicated that TGS had not been under a duty to clarify the rumors concerning the discovery. The court stated:

> At the very least, *if TGS* [the corporation] *felt compelled to respond to the spreading rumors* of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and the release was prepared as of April 10 information rather than purporting to report the progress to date.

Texas Gulf Sulphur, 401 F.2d at 863-64 (emphasis added). *See also* SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 85 (S.D.N.Y. 1970), *modified,* 446 F.2d 1301 (2d Cir. 1971), *cert. denied,* 404 U. S. 1005 (1971) ("When a company chooses to issue a press release to respond to speading rumors regarding its activities.").

In *Electronic Specialty Co. v. International Controls Corp.,* 409 F.2d 937 (2d Cir. 1969), the Second Circuit expanded its holding in *Texas Gulf Sulphur* by holding that issuers are not required to respond to rumors not attributable to it. In *Electronic Specialty,* a newspaper article reported that an acquiring corporation had purchased a block of the target corporation's stock, and planned to commence a tender offer for additional stock. Because there was no evidence linking the rumors to the acquiring corporation, the court rejected the target corporation's claim that the acquiror had a duty to correct the rumors, and held:

> While a company may choose to correct a misstatement in the press not attributable to it . . . we find nothing in the securities legislation requiring it do so.

Id. at 949; *see also* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981) ("A company has no duty to correct or verify rumors in the marketplace unless those rumors can be attributed to the company."); Elkind v. Liggett & Myers, Inc. 635 F.2d 156, 162 (2d Cir. 1980) ("[w]hile a company may choose to correct a misstatement in the press not attributable to it, . . . we find nothing in the securities legislation requiring it to do so.") (citations omitted); Zuckerman v. Harnischfeger Corp., 591 F. Supp. 112, 122 (S.D.N.Y. 1984) ("plaintiff has not alleged that the [merger] rumors emanated from the Company . . .

Corporations whose securities are listed on either the New York or American Stock Exchange, or on the National Association of Securities Dealers Automated Quotation System (NASDAQ) have more exacting duties to respond to merger and acquisition rumors than non-listed corporations. These regulatory bodies have adopted full affirmative disclosure requirements.[64] These requirements are premised on the assumption that an orderly and efficient securities market can be achieved only if all participants share equal access to material information.[65]

Essentially, the rules of these bodies are the same. Each require issuers to release promptly and fully any information reasonably expected to affect materially the market for its securities with a prompt, frank, and explicit response to merger and acquisition rumors.[66] If rumors are correct, an

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[a]accordingly defendants were under no obligation to disclose their discussions."); Weintraub v. Texasgulf Inc., 564 F. Supp. 1466, 1470 (S.D.N.Y. 1983) ("no duty to conduct . . . an investigation [concerning unusual market activities in corporation stock] absent a showing that the subject of the rumors is also their source."); Hutto v. Texas Income Properties Corp. 416 F. Supp. 478, 482 (S.D. Tex. 1976) ("this court will not impose a duty on directors . . . to retract an unsigned newspaper article which in no way attributes any representation to them. . . ."). For a discussion of why issuers should be required to respond to rumors in the marketplace see 5A. JACOBS, *The Impact of Rule 10B-5,* 2288.04[b] at 17-27 [1987]. For a discussion of an issuer's duty to respond to rumors see Sheffey, *Securities Law Responsibilities of Issuers to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem,* 57 NOTRE DAME L. REV. 755, 770-95 (1982); *see also* STEINBERG, *supra* note 17 at § 912 (1980); Jacobs, *What is a Misleading Statement or Omission Under Rule 10b-5?,* 42 FORDHAM L. REV. 243, 258-59 (1973).

64. Sheffey, *supra* note 63 at 757-58. The full affirmative disclosure requirements are commonly referred to as "timely disclosure policies." *Id. See generally* NEW YORK STOCK EXCHANGE COMPANY MANUAL (Aug. 1, 1977), A23-A25 (Jan. 25, 1978), *reprinted in NYSE Requirements,* 3 FED. SEC. L. REP. (CCH) 23,515-520 (Aug. 23, 1985) [NYSE MANUAL]; 2 AM. STOCK EX. GUIDE (CCH) 9012 (REVISED TO SEPT. 30, 1976), *reprinted from* Am. Stock Ex. Guide (CCH) (1976) [HEREINAFTER AMEX Constitution]; Am. Stock Ex. Guide §§ 401-05, *reprinted in AMEX Disclosure Policies,* 3 Fed. Sec. L. Rep. (CCH) 23,124A-124E (JUNE 29, 1983); National Association of Securities Dealers Manual (1985) *reprinted in* NASD Manual (CCH) 1653A ("NASD Manual").

65. Sheffey, *supra* note 63, at 758. *See also* NYSE MANUAL at A23 *supra* note 64, 23,517 at 17,211 ("A sound corporate disclosure policy is essential to the maintenance of a fair and orderly securities market."); AMEX GUIDE § 401 *supra* note 64, at 23,124A at 17,097 ("The Exchange considers that the conduct of a fair and orderly market requires every listed company to make information necessary for informed investing available to the public; and to take reasonable steps to ensure that all who invest in its securities enjoy equal access to such information").

66. The NYSE MANUAL provides:

> The market activity of a company's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has 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. It is obvious that if such a public statement is contemplated, management should be checked prior to any public

explanatory confirmation is necessary;[67] if rumors are false or inaccurate, a denial or clarification is required;[68] and if the issuer knows of no corporate development to account for the unusual market activity, a statement to that effect must be issued.[69] Significantly, these rules differ from those under the federal securities laws because a response is required regardless of the source of the rumor.[70]

Thus, compliance with the federal securities laws regarding merger and acquisition rumors and the rules of the exchange on which the issuer is listed can create conflicts for directors. If rumors are attributable to the issuer, a director's disclosure duty is the same under both the securities laws and the exchange rules—verify and/or correct.[71] If such rumors cannot be linked to the issuer, however, a director's disclosure duties under the federal securities laws conflict with those imposed by the exchanges.[72]

Confronted with this dilemma, a director may elect to follow the federal

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> comment so as to avoid any embarrassment or potential criticism. 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. Such statements are essential despite the business inconvenience which may be caused and even though the matters may not as yet have been presented to the company's Board of Directors for consideration.

NYSE MANUAL at A23, *supra* note 64, 23,517 at 17,212. The AMEX Guide provides:

> (c) Clarification of Confirmation of Rumors and Reports—Whenever a listed company becomes aware of a rumor or report, true or false, that contains information that is likely to have, or has had, an effect on the trading in its securities, or would be likely to have a bearing on investment decisions, the company is required to publicly clarify the rumor or report as promptly as possible.
>
> (d) Response to Unusual Market Action—Whenever unusual market action takes place in a listed company's securities, the company is expected to make inquiry to determine whether rumors or other conditions requiring corrective action exist, and, if so, to take whatever action is appropriate. If, after this review, the unusual market action remains unexplained, it may be appropriate for the company to issue a "no news" release—i.e. announce that there has been no material development in its business and affairs not previously disclosed or, to its knowledge, any other reason to account for the unusual market action.

AMEX Guide, § 401, *supra* note 64, 23,124A at 17,097. The NASD Manual provides that an issuer shall:

> promptly . . . disclose to the public through the press any material information which may affect the value of its securities or influence investors decisions.

NASD MANUAL *supra* note 64 at Schedule D, Part II, § (B)(3)(b). *See* Sheffey, *supra* note 63 at 757-60 (review of corporation's duty under stock exchange and NASD rules concerning merger and acquisition activity); *see also* Note, *supra* note 10 at 724-25.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Compare supra* note 63 and accompanying text (discussing issuer's limited duty to respond to rumors concerning merger and acquisition activity under federal securities laws) *with supra* notes 64-69 and accompanying text (discussing issuer's obligation to respond to rumors concerning merger and acquisition activity under stock exchange and NASD rules).

71. *See supra* notes 66-69 and accompanying text.

72. *See supra* note 70.

securities laws and not disclose negotiations. Failing to disclose such negotiations, however, may violate stock exchange rules, resulting in sanctions.[73] On a cost/benefit analysis, however, since disclosure of negotiations may increase the market price of the corporation's stock and jeopardize the deal,[74] directors may consider choosing not to disclose to help ensure the successful completion of the proposed transaction.[75]

Thus, provided merger or acquisition rumors are not attributable to the corporation, directors are relieved of any duty to disclose such negotiations under the federal securities laws. Under the rules of the exchanges, however, directors must respond to merger or acquisition rumors regardless of whether or not the issuer is the rumor source. When merger or acquisition rumors are not attributable to the corporation, directors, in deciding whether to risk jeopardizing the deal by disclosing negotiations under stock exchange rules, should carefully consider the benefits of the deal, and the possible affect disclosure will have on the deal.

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73. Failure to disclose in a timely manner as prescribed by the stock exchanges and NASD can result in the corporation's securities being immediately suspended from trading. *See* 17 C.F.R. § 240.12d2-1 (a) (1985) ("A national securities exchange may suspend from trading a security listed and registered thereon in accordance with its rules."); NEW YORK STOCK EXCHANGE GUIDE, Rule 499 (March 1985), *reprinted in* 2 NEW YORK STOCK EXCHANGE GUIDE, (CCH) 2596 at 4243 [hereinafter NYSE GUIDE] ("Securities admitted to the list may be suspended from dealings or removed from the list any time."); AMEX Constitution at art. II, § 2, *supra* note 64, 9012 at 2118 (AMEX Board of Governors may "suspend dealings in [listed] securities at any time without notice when it deems that such action is appropriate and then can remove the same from listing."). Furthermore, NASD may suspend trading of an issuer's securities for violation of its disclosure obligations. *See* NASD MANUAL at By Laws, art. XVI, Schedule D, Part II, § (B)(3)(b). Note, *supra* note at 725 n.57. Additionally, the exchanges may delist a corporation's securities. *See* 17 C.F.R. § 240.12d2-2(b)(1) (1984) ("national securities exchange may strike a security from listing and registration"); NYSE GUIDE at Rule 499, *supra* note 64, 2596 at 4243; AMEX Constitution at art. II, § 2, *supra* note 64, 9012 at 2118.

74. *See supra* note 8 and accompanying text.

75. When negotiating a merger or acquisition, the most important goal of the issuer is the successful completion of the deal. Because technical compliance with stock exchange or NASD rules may prevent a deal from being completed, directors must look at the harm of failing to disclose its negotiations. Although the exchanges can halt trading in the corporation's securities or even impose the more draconian remedy of delisting the corporation's stock, as a practical matter, the exchanges rarely, if ever, impose such penalties for failing to disclose negotiations. Indeed, it is questionable whether the exchanges really intend for corporations engaged in merger or acquisition negotiations to disclose publicly such negotiations and jeopardize the successful completion of the proposed deal, especially when the corporation did nothing more than fail affirmatively to disclose negotiations—clearly not the same type of culpable behavior as issuing false or misleading statements. This position has some support. New York Stock Exchange Chairman John J. Phelan has indicated that notwithstanding the N.Y.S.E. rule demanding affirmative disclosure of merger or acquisition negotiations if rumors are circulating, corporations should be allowed to issue a "no-comment" statement in response to inquiries regarding such negotiations. He noted that although a no-comment statement is less than a full response, it still indicates to the market that some significant event is occurring. *See* SEC ROUNDTABLE (2-19-86), 18 SEC. REG. & L. REP. (BNA) 251, 253 (2-21-86).

(c) The Duty Not to Issue False Or Misleading Statements

The duty not to issue false or misleading statements is the focal point of the present controversy concerning the disclosure of preliminary merger and acquisition negotiations.[76] Under Rule 10b-5 of the anti-fraud provisions,[77] issuers can be held liable for issuing false or misleading statements to the public, if the statement "is reasonably calculated to influence the investing public."[78] Although only in limited circumstances is a corporation under an affirmative duty to disclose publicly such negotiations,[79] once it chooses to issue a statement concerning the existence or non-existence of negotiations it comes under the exacting duty of ensuring disclosure is accurate.[80] This duty not only demands accuracy, but also requires complete disclosure.[81] Additionally, if disclosure is accurate when made but subsequent events make it misleading, issuers must amend the statement to ensure its continued accuracy.[82]

An affirmative duty to disclose usually arises in the context of merger and acquisition negotiations when a corporation is engaged in non-public negotiations, and these negotiations are leaked to the public causing the stock's market price to rise.[83] Either in response to public inquiries seeking

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76. Many cases that involve a corporation's duty to disclose merger or acquisition negotiations are centered around whether a corporation's public denial of ongoing negotiations qualified as false and misleading. *See, e.g.,* Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986), *cert. granted,* ___ U.S. ___, 107 S. Ct. 1284 (February 23, 1987) (No. 86-279, 1987 Term); Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), *cert. denied,* 469 U.S. 1215 (1985); Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128 (S.D.N.Y. 1984).

77. *See supra* note 22 for the text of Rule 10b-5.

78. Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) ("Accordingly we hold that Rule 10b-5 is violated whenever assertions are made. . .in a manner reasonably calculated to influence the investing public. . . .").

79. *See supra* note 63 and accompanying text. (Discussing corporation's limited duty to affirmatively disclose merger or acquisition negotiations.).

80. Securities and Exchange Commission v. Texas Gulf Sulpher Co., 401 F.2d at 862 (issuer must ensure that a statement to public that is "reasonably calculated to influence the investing public" is not "false or misleading"); *see also* SEC Securities Act Release No. 33-6504, 3 *Fed. Sec. L. Rep.* (CCH) 23,120B at 17,095-3 (1984) (discussing duty of issuers to make accurate, nonmisleading statements that may reach "investors and the securities markets").

81. *Texas Gulf Sulphur,* 401 F.2d at 862 ("10b-5 is violated whenever assertions [statements by issuer calculated to influence investing public]. . .are so incomplete as to mislead"); *see also Greenfield,* 742 F.2d at 758.

82. *Greenfield,* 742 F.2d at 758 ("Further, if a corporation voluntarily makes a public statement that is correct when issued, it has a duty to update that statement if it becomes materially misleading in light of subsequent events"); Ross v. A. H. Robins Co., Inc., 465 F. Supp. 904, 908 (S.D.N.Y. 1979) *rev'd on other grounds,* 607 F.2d 545 (2d Cir. 1979), *cert. denied,* 446 U. S. 946 (1980) ("It is now clear that there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events"); Sharp v. Coopers & Lybrand, 83 F.R.D. 343, 346 (E.D. Pa. 1979) ("duty to correct a previously truthful but not fraudulent opinion [accountant opinion letter] arises from 10(b) of the Securities Exchange Act of 1934").

83. *See supra* notes 62 and accompanying text.

to confirm rumors,[84] or voluntarily,[85] directors often issue public statements[86] indicating that they are unaware of any reason why the stock's market price rose (a "no corporate development statement"), when, in fact, the leaked negotiations were the cause.

On the basis of these statements, investors, who purchased the target company's stock anticipating a takeover, may sell their shares, having in effect been told that a takeover will not occur. After these investors sell, the negotiations between the corporations solidify and the corporations agree to a deal calling for the acquiror to tender for the target's stock at a price above what the former shareholders, who relied on the corporate announcement, received for their shares.[87] Having lost the chance to tender at the higher price, these former shareholders bring 10b-5 actions against the corporation and directors. These actions allege that the "no corporate development statement" was false, and caused them to sell at a lower price.[88]

Deciding how to respond to inquiries regarding a merger or acquisition places directors in a difficult position. Disclosing such negotiations prior to closing the deal may cause it to fall through;[89] however, denying the existence of such negotiations may instigate protracted and costly securities litigation.

While some circuits permit directors to deny ongoing merger or acquisition negotiations in response to public or stock exchange inquiries,[90] other circuits and the SEC hold that such a denial is a false and misleading

84. Inquiries concerning such rumors may come from the exchanges on which the corporation's stock is listed (N.Y.S.E., AMEX, NASD), institutional investors, magazines (Forbes, Fortune), or newspapers (Wall Street Journal).

85. Because rumors of a pending merger or acquisition increase the market price of a corporation's stock, which increase the amount an offeror must pay for each share of stock, corporation's may deny such rumors to keep the acquiror's cost from becoming prohibitively expensive. *See supra* note 8.

86. *See, e.g., Levinson,* 786 F.2d at 741, 744-45 (6th Cir. 1986), *cert. granted,* ___ U.S. ___, (Feb. 23, 1987) No. 86-279 (1987 Term) (press releases and response to N.Y.S.E. inquiry); *Greenfield,* 742 F.2d at 754 (response to N.Y.S.E. inquiry); Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128, 129 (S.D.N.Y. 1984) (announcement over Dow-Jones wire); In re Carnation Co., FED. SEC. L. REP. (CCH) 83,801 (press release).

87. For example, if A hears rumors of a takeover of corporation X by corporation Y, A may purchase corporation X's stock at $10 per share. Thereafter, corporation X may announce publicly that no merger is being contemplated. On the basis of this announcement A may sell his shares for $10 per share or possibly less because the $10 per share price A paid for his X stock could have been inflated due to the merger rumors. After A sells, however, X and Y may reach an agreement calling for Y to offer $15 per share for X's shares. Thus, by relying on X's no corporate development announcement, A lost out on the right to sell his X stock to Y at a $5 per share premium.

88. *See, e.g., Levinson,* 786 F.2d at 742-43; *Greenfield,* 742 F.2d at 754-55; *Schlanger,* 582 F. Supp. at 130.

89. *See supra* note 8 and accompanying text.

90. *See supra* note 12 and accompanying text.

statement that subjects the corporation and its directors to liability.[91] To provide guidance for corporate officers and directors, Part III and IV address the issues of materiality, and how directors should respond to such inquiries. Part III discusses when negotiations reach the material threshold. Part IV then provides a practical, in-depth analysis of how lawyers should advise corporate officials to respond to inquiries regarding the existence of ongoing merger or acquisition negotiations.

III. MATERIALITY OF MERGER NEGOTIATIONS

Not all merger or acquisition negotiations are material.[92] In deciding whether information is material under the federal securities laws, courts implicitly have substantial discretion.[93] Because courts are vested with such discretion, they have established slightly different standards for determining the point in the negotiation process when such negotiations become material.[94] In determining when the materiality threshold is crossed in merger and acquisition negotiations, courts generally consider two factors: (1) the need of the corporation to transact business effectively,[95] and (2) the need to protect investors.[96]

At best, preliminary merger or acquisition negotiations are tenuous,[97] and for every deal consumated, a greater percentage fail. To finalize a deal

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91. *See supra* note 11 and accompanying text.

92. The courts generally hold that merger and acquisition negotiations are material only when an agreement in principle has been reached. *See supra* note 20 and accompanying text (discussing agreement in principle standard).

93. Because information is material only if a reasonable investor would find the information significant in making an informed investment decision, courts have substantial latitude in deciding whether certain information would be significant to the reasonable investor. *See supra* notes 17-19 and accompanying text (discussing materiality of corporation information).

94. *See supra* note 10 and accompanying text.

95. *See, e.g.*, Flamm v. Eberstadt, 814 F.2d 1169, 1178 (7th Cir. 1987) ("premature disclosure may frustrate the achievement of the firm's objectives"); Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (3d Cir. 1984) ("Not only would [disclosure of preliminary negotiations] have a disruptive effect on the stock markets, but, considering the delicate nature of most merger discussions, might seriously inhibit such acquisitive ventures."); Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982) ("'If word of the impending offer becomes public . . . the primary inducement to stockholders . . . is lost, . . . and the offeror may be forced to abandon its plans. . . .") (quoting Transcript, hearing before the Senate Subcommittee on Securities of the Committee on Banking and Currency, United States Senate, 90th Cong. 1st Sess., S. 510, p. 72, March 22, 1967).

96. Levinson v. Basic Inc., 786 F.2d 741, 746 (6th Cir. 1986), *cert. denied*, ___ U.S. ___ (Feb. 23, 1987) ("These requirements insure that all investors have all the relevant information for their investment decisions."); *Greenfield*, 742 F.2d at 756 ("need to protect shareholders from the potentially misleading disclosure. . ."); Starkman v. Marathon Oil Co., 772 F.2d 231, 238 (6th Cir. 1985), *cert. denied*, ___ U.S. ___ (Feb. 24, 1986) ("Our adherence to this basic proposition [disclosure required only of material facts] ensures that target management's disclosure obligations will strike the correct balance between the competing costs and benefits of disclosure [to the target's shareholder].").

97. *See generally* 742 F.2d at 756-57 (merger negotiations characterized as "tentative discussions," and "delicate in nature"); Reiss v. Pan American World Airways, Inc., 711

of such magnitude as a merger or acquisition involving companies whose stock is publicly traded, not only must an acquisition price be agreed upon, but also other sensitive factors such as the structure of the deal and management considerations must be considered and resolved.

Because such negotiations are so tenuous, courts recognize that forcing negotiation disclosure could have disastrous effects on corporations as well as investors. From the corporation's viewpoint, disclosing preliminary negotiations can quash a deal by effectively forcing the offeror to abandon its offer.[98] Moreover, from the investor's viewpoint, early disclosure also is dangerous since upon learning of merger or acquisition negotiations, investors, unaware of the tenuous nature of such negotiations, often purchase stock at an inflated price driven up by the stock's increased market demand that results from the disclosure of negotiations. Thereafter, negotiations break off causing the public's demand for the stock to lessen, the stock's market value to decrease, and consequently causing those investors to either sell the stock at the deflated price, or hold the stock until, if ever, its value rises.[99]

One method courts can use to protect both investors and corporations from the dangers of preliminary disclosure is to raise the threshold point in the process for holding such negotiations material. The later the point when negotiations become material and subject to disclosure, the less chance investors have of being misled and the better chance corporations have of completing transactions.

F.2d 11, 14 (2d Cir. 1983) ("Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty."); SEC v. Geon Industries, Inc., 531 F.2d 39, 48 (2d Cir. 1976) ("the mortality rate of mergers in . . . formative stages is doubtless high."); Missouri Portland Cement Co. v. H. K. Porter Co., 535 F.2d 388, 398 (8th Cir. 1976) (merger negotiations described as "contingent" and "indefinite"); Guy v. Duff & Phelps, Inc., 628 F. Supp. 252, 256 (N.D. Ill. 1985) (quoting *Reiss* for proposition that merger "negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty.").

98. *See supra* note 8 and accompanying text.

99. *See, e.g.*, Michaels v. Michaels, 767 F.2d 1185, 1195-96 (7th Cir. 1985), *cert. denied*, ___ U.S. ___ (Jan. 13, 1986) (No. 85-252) ("disclosing preliminary merger negotiations would cause speculative investment in the target company's stock, thus raising the price. If the merger negotiations subsequently fail, as they frequently do, the price of the target company's stock falls. Investors, who bought shares at the inflated, post-disclosure prices, suffer a loss and shareholders, who would have otherwise sold may find that they can no longer obtain even the pre-disclosure price."); Staffin v. Greenberg, 672 F.2d at 1207 ("Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left 'holding the bag' on a stock whose value was inflated purely by an inchoate hope."); Greenfield v. Heublein, Inc., 575 F. Supp. 1325, 1336 (E. D. Pa. 1983), *aff'd*, 742 F.2d 751 (3d Cir. 1985), *cert. denied*, ___ U.S. ___, 105 S. Ct. 1189 (1985) ("A premature disclosure of preliminary discussions is likely to cause the market price of the target company's stock to rise towards the expected tender offer price. Because a tender offer must usually be made at a premium above the market price, this rise in market price will push up the price that the acquiring party must offer in order to make the tender offer attractive to the shareholders. This may, in turn, cause the acquiring party to lose interest in the acquisition which results in those shareholders, who had purchased shares at a rate inflated by the disclosure of merger discussions, to suffer an economic loss when the price of the stock collapses to its pre-disclosure price.").

In determining when the material threshold is crossed, courts have not agreed on a "bright line"[100] standard; below the line being non-material, and above the line being material. Courts generally have taken the position that once an "agreement in principle" is reached the negotiations pass the preliminary stage and become material.[101]

Essentially, an agreement in principle is reached when the parties have agreed on two factors: (1) the price the acquiror will pay for each target share (price), and (2) the structure of the deal (structure).[102] Price and structure is a logical standard because at this stage in the negotiation process the agreement resembles a binding contract.[103] Also at this point, disclosure of such information will, in all likelihood, neither quash the deal nor mislead investors because the two corporations have indicated a definite intent and commitment to consummate the deal.[104]

Although the standard may vary slightly within the circuits,[105] generally once an agreement in principle is reached and the corporation is under an express or implied disclosure duty, directors must affirmatively disclose merger or acquisition negotiations.[106]

IV. RESPONDING TO MERGER INQUIRIES

Sections II and III have detailed when directors have a legal duty to affirmatively disclose preliminary negotiations. Because leaks of merger or acquisition negotiations cause an increase in the trading volume and market price of a corporation's stock, which may result in a public or stock exchange inquiry regarding such negotiations, directors must be cognizant of how to respond voluntarily to such inquiries, even though they are not under a disclosure duty.

Directors confronted with inquiries regarding merger and acquisition negotiations have three ways of responding: (1) deny the existence of such negotiations by issuing a "no corporate development" statement[107] (2) issue

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100. *Greenfield,* 742 F.2d at 757 ("difficult to draw a bright line definition . . .").

101. *See supra* note 21 and accompanying text.

102. *Id.*

103. By agreeing on the price and structure of a deal, the parties have agreed on two of the essential elements that constitute a binding contract, price and quantity (the price and number of shares the acquiror will purchase). *See* Greenfield v. Heublein, 742 F.2d at 757 ("Agreement as to price and structure provides concrete evidence of mature understanding. . . .").

104. *See Greenfield,* 742 F.2d at 757 ("with both price and structure agreed to, there is only minimal chance that a public announcement would quash the deal or that the investing public would be misled . . ."). Once these factors are agreed upon, the corporations probably have taken into account the fact that the price of the target's stock will rise, and have designed the price and structure of the deal accordingly.

105. *See supra* note 10 and accompanying text.

106. *See supra* notes 21 and accompanying text.

107. A "no corporate development statement" is a responsive reply by an issuer confronted with inquiries by one of the stock exchanges, or the public. By issuing such a statement, the

a "no-comment" statement or[108] (3) respond with "complete candor" by fully disclosing negotiations. In choosing the proper alternative, directors must pay careful attention to the effect that each response has on the transaction being negotiated, and the legal consequences resulting from their response.

A cardinal rule of thumb under the federal securities laws is that the less information an issuer discloses, the less chance it can be found liable for issuing false or misleading statements.[109] Because an issuer is required to disclose only material information,[110] provided merger and acquisition negotiations never reach the material threshold, a corporation can, and should, avoid disclosing such negotiations voluntarily.

Notwithstanding this rule, there are times when directors may believe disclosure is needed. During merger or acquisition negotiations dramatic fluctuations in a stock's market value or trading volume may result from leaks of merger negotiations. This increased activity usually invokes inquiries from the stock exchange on which the corporation's shares are listed or from the investing public. Therefore, from a practical point of view, it is imperative that directors know how to respond to such inquiries. While all courts and the SEC agree directors legally can remain silent or issue a "no comment" statement to such inquiries,[111] the courts disagree as to whether a director can deny the existence of non-material merger negotiations by issuing a no corporate development statement if negotiations are being conducted.[112]

This difference results from the courts' different interpretation of the federal securities laws and from their view of how much protection investors need. Some courts and the SEC interpret these laws to the letter and hold that any false or misleading statements regarding preliminary merger or

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issuer affirmatively is telling the exchange or public that merger or acquisition negotiations are not being conducted.

108. A "no comment statement" is a noncommital reply by an issuer. An issuer who responds with such a statement tells the exchange and/or the public that it is neither confirming nor denying the existence of negotiations. Such a statement is significantly different from a no corporate development statement which affirmatively tells the exchange or public that the issuer is not involved in any negotiations.

109. When preparing SEC filings or other corporate documents, the ideal pattern to be followed is include only information required by the SEC, the Securities Act or Exchange Act. The more information included in such filings, the greater the opportunity for shareholders or the SEC to use that information in legal proceedings against the issuer. This also is true for issuers making public announcements.

110. *See supra* notes 17-19 and accompanying text.

111. *See, e.g.,* Greenfield v. Heublein, Inc. 742 F.2d at 759 n.7; SEC v. Geon, 531 F.2d at 50; Zuckerman v. Harnischfeger Corp., 591 F. Supp. at 118-19; Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. at 132; In re Carnation Co., *Fed. Sec. L. Rep.* (CCH) 83,801 at 87,595-96 n.6.

112. *Compare supra* note 12 and accompanying text (cases permitting denial of ongoing negotiations) *with supra* note 11 and accompanying text (cases holding denial of ongoing negotiations is unlawful).

acquisition negotiations is material, violating Rule 10b-5.[113] Other courts, however, recognize that the average investor is not sufficiently sophisticated to analyze properly a corporate announcement disseminating the existence of preliminary negotiations, and may be misled in making investment decisions.[114] Therefore, to protect investors, these courts hold that as a matter of law such negotiations are immaterial, and a director legally can issue a statement denying that the corporation is conducting negotiations.[115]

To provide directors with guidance in how to respond to such inquiries, Section A discusses the Sixth Circuit and SEC position, and Section B examines the Third Circuit's position. Section C analyzes these two positions, and argues that the Third Circuit approach not only offers more protection for investors of securities but also furthers the objectives of the securities acts. Finally, Section D, drawing on case law, the SEC's position, and the federal securities laws, details exactly how directors should respond to inquiries regarding merger or acquisition negotiations.

A. THE SIXTH CIRCUIT AND SEC APPROACH

The SEC and a number of courts, including the Sixth Circuit, have taken the position that an issuer cannot issue a no-corporate development statement or deny negotiations if preliminary merger or acquisition negotiations are being conducted.[116] These courts hold that although an issuer is not required to disclose such negotiations if negotiations are not material, or the issuer is not under a disclosure duty, once an issuer decides to speak, rule 10b-5 places a duty upon it to speak fully and truthfully.[117] Therefore, when an issuer issues a statement indicating that it is unaware of any reason why the market value or trading volume of its stock rose (a no corporate development statement), when in fact the issuer was conducting preliminary merger or acquisition negotiations, the issuer violates Rule 10b-5.[118]

The primary cases advocating the position held by the Sixth Circuit and the SEC are *Levinson v. Basic Inc.*[119] and *In re Carnation Co.*[120] A review

113. *See supra* notes 22 and accompanying text.

114. *See, e.g.,* Starkman v. Marathon Oil Co., 772 F.2d at 239 ("deluge of information and hourly reports on [merger] negotiations . . . more likely to confuse . . . reasonable lay shareholder"); Michaels v. Michaels, 767 F.2d at 1196 ("need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations"); Greenfield v. Heublein, Inc., 742 F.2d at 756 ("disclosure of such tentative discussions may itself be misleading to shareholders"); Reiss v. Pan American World Airways, Inc., 711 F.2d at 14 ("Disclosure [of merger negotiations] may be more misleading than secrecy so far as investment decisions are concerned"); Kronfeld v. Transworld Airlines, Inc., 631 F. Supp. at 1265 ("'[d]isclosure may in fact be more misleading than secrecy'") (quoting *Reiss*).

115. *See supra* note 12 and accompanying text.

116. *See, e.g.,* Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986); Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128 (S.D.N.Y. 1984); In re Carnation Co., Sec. Release No. 22214 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) 83,801, 87,592.

117. *Id.*

118. *Id.*

119. 786 F.2d 741.

120. Sec. Release No. 22214 [1984-1985 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801, 87,592.

of these cases is useful to demonstrate how some courts and the SEC analyze merger and acquisition negotiation disclosure cases, and how issuers can avoid the mistakes made by the issuers in these cases.

In *Levinson,* the Sixth Circuit Court of Appeals held that Basic Incorporated's voluntary denial of merger negotiations violated Rule 10b-5 because negotiations were being conducted.

In *Levinson,* Combustion Engineering ("Combustion") became interested in acquiring Basic Incorporated ("Basic"). From September 1976 until April 1977, the two corporations took various steps in preparation of such a deal including analyzing potential antitrust problems, exchanging non-public financial information, preparing a financial analysis of the deal, and conducting negotiations.[121]

Negotiations and preparations continued for over a year. During this time, the market price and trading volume of Basic's stock fluctuated dramatically.[122] On five separate occasions during this period, either voluntarily,[123] or in response to inquiries from New York Stock Exchange officials,[124] Basic's management issued releases stating that it was "unaware of any present or pending developments [to] account for the high volume of trading and price fluctuations [of Basic's stock] in recent months."[125]

Finally, on December 18, 1978, Basic requested the Exchange to suspend trading in its stock because of a possible merger,[126] and on December 19, it announced its approval of Combustion's tender offer to purchase all of Basic's common stock.[127] Following this announcement three former Basic shareholders, representing a class of plaintiffs who sold their Basic Stock between October 21, 1977 (the date of Basic's first announcement deny merger negotiations) and December 19, 1978 (the date Basic announced approval of the merger), brought suit against Basic under Section 10(b) and Rule 10b-5.[128]

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121. 786 F.2d at 743-45.

122. *Id.* at 744-45. On October 19 and 20, the trading volume of Basic's stock increased from an average of 6,000-8,000 shares per day to 29,000. On July 14, 1977 the market price of Basic's stock increased 12%, and on September 24 and 25 the market price of Basic's stock increased 2-1/8 and 2-1/2 points, respectively.

123. *Id.* at 744, 745. Basic made two voluntary denials of merger negotiations. The first denial was in response to an increase in the trading volume of Basic's stock. The second denial was made directly to Basic's shareholders in its "Nine Month Interim Report to Shareholders."

124. *Id.* at 745. On three separate occasions, in response to sharp increases in the trading volume and market price of Basic's stock a N.Y.S.E. official asked a senior vice president of Basic "whether there were any undisclosed 'merger or acquisition' plans, any development relating to a possible 'tender offer' any developments relating to a prior announcements, any rumors, or any other significant corporate developments." *Id.* In response to those inquiries, Basic's officer issued no corporate development statements, and indicated the corporation was unaware of any events causing the increased activity in Basic's stock. *Id.*

125. *Id.*

126. *Id.* On December 18, 1977, only three days after Basic issued its fifth and final no-corporate development statement, it requested the N.Y.S.E. to halt trading in its stock.

127. *Id.*

128. *Id.* at 742-43.

In their complaint the plaintiffs alleged that Basic's four public statements denying merger negotiations were false and misleading because merger negotiations were in fact occuring.[129] The plaintiffs further alleged that by relying on Basic's no corporate development statements they sustained trading losses by selling their Basic stock at a price below what they would have received had they held their shares and sold to Combustion at its tender offer price.[130]

In analyzing the plaintiffs' claims, the Sixth Circuit first indicated that the test of liability under Rule 10b-5 disclosure cases was two prong: (1) whether a general duty to disclose existed, and (2) if such a duty did exist was the disclosure, or lack thereof, material.[131] Applying the law to the facts, the court found that Basic had a duty to disclose the merger negotiations. The court stated that although Basic had no duty to speak while merger negotiations were in the preliminary stage,[132] once it decided to disclose it had a duty to speak truthfully and to ensure disclosure was not misleading.[133] By publicly denying knowledge of any corporate developments that would account for the increased activity in its stock, when in fact it was involved in merger negotiations, the court held that Basic's announcements were false and misleading.[134]

After finding that Basic was under a duty to speak, and that Basic had violated that duty by failing to disclose the existence of negotiations (the first prong),[135] the court then addressed whether the omitted merger negotiations were material (the second prong). The court stated that in *TSC Industries, Inc. v. Northway, Inc.*[136] the United States Supreme Court held that an omitted fact is material if there is a substantial likelihood that a reasonable investor would view the fact as altering the total mix of information made available to him.[137] In holding that Basic's omission was material under the *TSC Industries* standard, the court stated that "without doubt" a reasonable investor would find that knowledge of the merger negotiations would "significantly alter the total mix of information made available."[138]

Faced with a similar set of facts the SEC adopted a position identical

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129. *Id.* at 743.

130. *Id.*

131. *Id.* at 746 ("10b-5 cases begin with an analysis of whether a general duty to disclose exists. Then it must be determined whether the facts that the plaintiffs claim should have been disclosed were material").

132. *Id.* at 747 ("In these early stages of the discussions between Combustion and Basic, Basic had no duty to speak").

133. *Id.* ("[B]ut once [Basic] spoke, it assumed the legal duty to be truthful").

134. *Id.* ("Basic's denials of any knowledge of corporate developments that would cause high trading volume in Basic stock [was] misleading, if not totally false").

135. *Id.* at 747-49 ("Having established a duty to disclose certain omitted facts, we must now determine whether those facts were material").

136. 426 U.S. 438 (1976).

137. 786 F.2d at 747-48.

138. *Id.* at 748 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

to that of the Sixth Circuit. In *In the Matter of Carnation Company,*[139] the SEC ruled that a corporation's announcements that it was unaware of any corporate developments to account for the unusually high trading volume and price increase in its stock, when in fact that corporation was engaged in merger negotiations, was a false and misleading statement in violation of Rule 10b-5.[140]

In *Carnation,* Carnation Company ("Carnation") was a public corporation whose common stock was traded on the N.Y.S.E.[141] In June, 1984, Carnation's majority shareholder and former president Dwight Stuart ("Stuart") informed Carnation's Board of his desire to sell his Carnation stock, his meetings with his investment bankers to pursue such a sale, and the interest expressed by Nestle, S.A., ("Nestle") as a possible purchaser.[142] Throughout July merger negotiations ensued between Carnation and Nestle.[143] During this time various newspaper and magazine articles reported rumors that Stuart was considering selling his Carnation stock, and that Nestle, among others, was a possible buyer.[144] Moreover, from August until early September, articles noted the increase in trading volume of Carnation's stock.[145] On August 7, 1984, in response to a $4-5/8 price jump in the market value of Carnation's stock, Carnation's treasurer issued a public statement that there was "no news from the company and no corporate developments that would account for the stock action."[146] Significantly, the treasurer had no knowledge of the ongoing merger negotiations between Nestle and Carnation, and had not discussed the statement with anyone at Carnation prior to its release.[147]

Following the release, negotiations between Nestle and Carnation intensified as the two parties attempted to agree on a per-share stock purchase price. On August 21, after Carnation's stock reached a new high, Carnation's treasurer again issued statements indicating that Carnation knew "of no corporate reason for the recent surge in its stock price,"[148] and that

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139. Sec. Release No. 22214 [1984-1985 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 83,801, 87,592.

140. *Id.* at 87,597.

141. *Id.* at 87,593.

142. *Id.*

143. *Id.*

144. *Id.* at 87,593-94.

145. *Id.* at 87,594.

146. *Id.*

147. *Id.* at n.5. Although the Carnation officer who issued the statement had no knowledge that negotiations between the corporations were occurring, the SEC still found the statement false and misleading. *Id.* In fact, the SEC included a separate footnote in its enforcement report indicating that the officer lacked knowledge of the negotiations. *Id.* This seems to indicate that the SEC will impute the knowledge of a corporation's "inner-circle" to other corporate officials. This position would seem to encourage corporations to widen the circle of corporate officials privy to such sensitive information and risk leaks and possible insider trading.

148. *Id.*

Carnation was "not negotiating with anyone."[149] Following those statements the market value of Carnation's stock dropped $1-7/8.[150]

Finally on September 2, 1984, the parties reached an agreement[151] and presented the agreement to the Carnation and Nestle Boards on September 3.[152] On September 4, a joint announcement was made by Carnation and Nestle indicating that Carnation approved Nestle's buyout offer at $83 per share.

Since the SEC encourages companies to respond promptly to market rumors concerning material corporate developments,[153] the SEC took the opportunity presented by the *Carnation* case to express its views on the disclosure duties of corporations engaged in preliminary merger negotiations, by bringing an enforcement action against Carnation. In its analysis, the SEC first stressed the need for accuracy of information in the securities market.[154] The SEC then indicated that to ensure such accuracy when an issuer makes a public statement it has duty to ensure that the statement is accurate and complete.[155] Significantly, the SEC stated that if the issuer is aware of non-public information concerning acquisition negotiations when the statement is made, it has a duty to disclose "sufficient information concerning the discussions to prevent the statements made from being materially misleading."[156] Moreover, the SEC indicated that preliminary merger negotiations are material,[157] and, therefore, although an issuer may issue a no-comment state-

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149. *Id.*

150. *Id.*

151. *Id.* at 87,595.

152. *Id.* Thus, from the time negotiations began in July of 1984, until the parties publicly announced the merger in September, the market price of Carnation's stock increased approximately 23 points, or 35%. This increase demonstrates the difficulty of preventing leaks and insider trading, since the increase occurred prior to a public statement announcing the deal. Moreover, three former Carnation shareholders have brought a class action suit against a Carnation investment banker, Martin Siegal, of Kidder, Peabody, Inc., who acted as an advisor to Carnation in the deal. In their complaint they allege that Seigal passed information of the deal to tippees, including Ivan Boesky, who with that information drove the price of Carnation stock up, profited by over $28,000,000, and caused the selling shareholders to lose the opportunity to receive a higher premium for their shares. *See* Newsweek, *Insider Trading's Victims,* April 6, 1987, at 40-41.

153. *See* Exchange Act Release No. 8995, 3 *Fed. Sec. L. Rep.* (CCH) 23,120A AT 17,095-92 (encouraging corporations to"set up procedures which will insure that prompt disclosure be made of material corporate developments, both favorable and unfavorable"); *see also Carnation* 83,801 at n.6 ("The Commission encourages public companies to respond promptly to market rumors concerning material corporate developments").

154. In re Carnation Co., *Fed. Sec. L. Rep* (CCH) 83,801 at 87,595 ("the importance of accurate and complete issurer 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").

155. *Id.*

156. *Id.*

157. *Id.* at 87,596.

ment,[158] if the issuer issues a no-corporate development statement, the statement is false and misleading if the issuer is engaged in negotiations.[159]

Applying these principals to the *Carnation* facts the SEC had little difficulty in concluding that Carnation's no corporate development announcements were false and misleading, and violated Rule 10b-5.[160] Moreover, the SEC expressly stated that decisions by courts—holding an issuer's announcement that it was unaware of any reason to explain the unusual trading activity in its stock not false and misleading even though merger negotiations were being conducted—were decided incorrectly.[161]

As these cases illustrate both the SEC and the Sixth Circuit hold that, prior to merger or acquisition negotiations reaching the material threshold, issuers can issue a no comment statement or remain silent in response to inquiries regarding such negotiations. If, however, the issuer chooses to voluntarily issue a statement concerning negotiations, the statement cannot be false and misleading. Thus, if merger or acquisition negotiations are being conducted, corporate officials must be advised not to issue a no corporate development statement or deny such negotiations to avoid violating Rule 10b-5.

Notwithstanding this approach, in an effort to provide shareholders with greater protection from misleading statements, other courts hold that, provided merger or acquisition negotiations remain preliminary, issuers publicly can deny such negotiations.

B. THE 3RD CIRCUIT'S APPROACH

In *Greenfield v. Heublein Inc.*,[162] the Third Circuit Court of Appeals held that because merger negotiations between two corporations had not reached the agreement in principle stage, such negotiations were nonmaterial,[163] and the target corporation's no corporate development statement, issued in response to inquiries regarding the existence of merger talks, was legal.[164]

In *Greenfield,* in mid-1981, Heublein, Inc. ("Heublein") became regarded as an attractive takeover target,[165] and General Cinema Corporation ("General Cinema") launched a takeover campaign by purchasing 18.9%

158. *Id.* at 87,595 n.6 ("However, 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").

159. *Id.* at 87,596 ("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").

160. *Id.* at 87, 596-97.

161. *Id.* at 87,596 n.8 ("The Commission believes that *Heublein* was wrongly decided").

162. 742 F.2d 751 (6th Cir. 1984).

163. *Id.* at 756.

164. *Id.* at 759.

165. *Id.* at 753.

of Heublein's common stock.[166] Additionally, in early 1982, R. J. Reynolds Industries Inc. and its subsidiary R. J. Reynolds Tobacco Company (collectively "Reynolds") also became interested in acquiring Heublein.[167] Reynolds wanting to avoid a bidding war with General Cinema, informed the Heublein Board that it would be interested in a friendly takeover and took a sideline position as an available white knight.[168]

On July 8, 1982, General Cinema issued to the Heublein Board a series of "non-negotiable" demands requiring the Board to accept its demands or face the perils of a hostile takeover.[169] Finding Cinema's demands unacceptable, and desiring to remain independent, on July 9, the Heublein Board met with Reynolds to discuss a friendly merger.[170] No formal understanding or agreement, however, was reached.

On July 14, General Cinema informed Heublein of its intention to sell one of its assets valued at $150,000,000.[171] Recognizing that the substantial capital influx would provide General Cinema with capital necessary to pursue its takeover bid, Heublein arranged another meeting with Reynolds.[172] Significantly, that same day, the trading volume and market price of Heublein's stock increased,[173] and the N.Y.S.E. requested Heublein to issue a public statement explaining the unusual activity.[174] In response, a Heublein spokesman issued a statement that the company "was aware of no reason that would explain the activity in its stock."[175]

Thereafter, Heublein continued negotiating with General Cinema in the hopes of avoiding a hostile takeover. On July 23, however, General Cinema reiterated its non-negotiable demands and threatened to resume its hostile bid.[176] Heublein then turned to Reynolds and intensified negotiations. On July 27, Heublein and Reynolds tentatively agreed on a per-share price,[177] and on July 28, Heublein requested the N.Y.S.E. to halt trading in its stock.[178] The next day, the Boards approved the merger and publicly announced the deal.[179]

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166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.* at 754.
172. *Id.*
173. *Id.* at n.l. On July 13, approximately 32,500 shares of Heublein stock were traded. On July 14th, however, the trading volume of Heublein stock increased approximately 800% to 242,500 shares.
174. *Id.* at 754.
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.* Only hours prior to requesting the N.Y.S.E. to halt trading in its stock, Heublein responded to a N.Y.S.E. inquiry that concerned merger negotiations with a no corporate development statement.
179. *Id.* During the three week period from the start of negotiations to the announcement of the deal, the market price of Heublein's stock increased approximately 33%.

Following the merger announcement, a former Heublein shareholder brought suit against Heublein under sections 10(b), 14(e), and Rule 10(b)-5.[180] In his complaint, the plaintiff alleged that based upon Heublein's July 14 no corporate development statement, he sold his Heublein stock $15 below what he would have received had he sold his shares to Reynolds pursuant to the merger agreement.[181]

In granting Heublein's motion for summary judgment the District Court for the Eastern District of Pennsylvania found that the merger negotiations between Heublein and General Cinema were preliminary.[182] Therefore, the court held that Heublein was not under a disclosure duty, did not violate the securities laws as a matter law, and granted its motion for summary judgment.[183]

On appeal, the Third Circuit first addressed the issue of under what circumstances a corporation is under a duty to disclose merger negotiations.[184] The court found that, because of the tentative nature of merger negotiations, disclosure of such negotiations would be misleading to shareholders.[185] Therefore, the court concluded that, prior to reaching an agreement in principle, merger negotiations are immaterial as a matter of law and are not required to be disclosed.[186]

Applying the law to the facts, the court held that because Heublein and Reynolds never reached an agreement on price and structure prior to Heublein's no corporate development statement, there was no agreement in principle.[187] Accordingly, Heublein did not violate the securities laws for failing to disclose the merger negotiations prior to July 27 (the date when the parties agreed on price and structure).[188]

The court then addressed whether Heublein's no corporate development statement was false and misleading.[189] After reiterating its earlier finding that the merger discussions were preliminary and finding that there was nothing to suggest that Heublein officials leaked rumors or engaged in insider trading,[190] the court held that the Board "understandably [was] unable to explain what had caused the dramatic increase in activity in

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180. *Id.* at 755. Plaintiff also brought suit under the Williams Act, Section 14(e) of the Exchange Act. Since the court held Heublein's statements to be non-material under Rule 10b-5 the court did not address plaintiff's Williams Act claims.

181. *Id.* at 754. Plaintiff sold his stock at $45.25 per share, allegedly based in part on Heublein's no corporate development statement. Heublein subsequently agreed to a buy out Reynolds at $60 per share.

182. 575 F. Supp. 1325, 1336 (E.D. Pa. 1983).

183. *Id.* at 1336-37.

184. *Greenfield,* 742 F.2d at 756.

185. *Id.*

186. *Id.*

187. *Id.* at 757.

188. *Id.* at 758.

189. *Id.*

190. *Id.* at 759.

Heublein's stock . . . and, therefore, that as a matter of law Heublein's no corporate development statement was not false, inaccurate, or misleading."[191]

Significantly, Judge Higginbotham ("Higginbotham") filed a dissenting opinion.[192] In his dissent, Higginbotham asserted that the majority's holding was wrong because it failed to distinguish between the duty to disclose and the duty not to mislead.[193] Higginbotham agreed that, because the corporations had not reached an agreement in principle, Heublein was not under a disclosure duty.[194] Once Heublein decided to speak voluntarily, however, it came under the duty not to mislead.[195] Higginbotham concluded that, since Heublein knew of information that could have caused the unusual market activity in its stock (leaked merger negotiations), its no corporate development statement was false and misleading.[196]

C. A CRITIQUE OF THE THIRD AND SIXTH CIRCUIT APPROACH

The holdings of both circuits, while reaching different results, are designed to protect investors. From a practical point of view, however, the Third Circuit's approach is significantly more appealing and effective, in light of the public policy of investor protection behind the securities laws. Because Congress enacted the federal securities laws to protect investors of securities,[197] the courts, SEC, and legislators should design their decisions, rules, and regulations to further this objective. Therefore, in deciding merger or acquisition disclosure cases, courts should frame their decisions so as to best protect securities investors.

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191. *Id.*

192. *Id.* at 760. Judge Higginbotham wrote the majority opinion in Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982). In *Staffin,* the Third Circuit held that prior to merger or acquisition negotiations reaching the agreement in principle stage, such negotiations are immaterial, and need not be disclosed.

193. *Greenfield,* 742 F.2d at 761.

194. *Id.* at 760 n.1.

195. *Id.* at 761.

196. *Id.* at 763-65. Judge Higginbotham stated that Heublein's no corporate development statement was false because Heublein knew of developments that *could have* caused the rise in the volume and market price of its stock—the merger negotiations. Judge Higginbotham argued that it was incorrect to allow corporations to assume that the unusual market activity of its stock did not result from leaks that were directly attributable to the corporation, when the White House could not prevent the leak of secret government documents, the "Pentagon Papers." *Id.* at 763-64. Therefore, he argued that the key inquiry should be "whether *any* information existed *to be leaked.*" *Id.* at 764 (emphasis in original). Thus, under Judge Higginbotham's approach, any time a corporation is engaged in merger or acquisition negotiations and the trading volume or market price of its stock increases, a corporation cannot lawfully issue a no corporate development statement to inquiries because the corporation has knowledge of information that *could* cause the unusual market activity in its stock.

197. *See supra* note 13 and accompanying text.

To achieve this result, courts must look not only to the language of the securities acts, but must carefully consider the day to day workings of the financial markets and the lack of financial sophistication of the ordinary investor. Specifically, courts must recognize that the recent surge of mergers and acquisitions has created a distorted and unrealistic picture of the stock market to investors. Investors, through the media and brokerage houses, have been coerced into believing that, by purchasing a stock "in-play," they necessarily will receive a huge return on their investment resutling from a hostile takeover. This scenario, however, simply is not an accurate protrayal of the market place.

Moreover, courts also must consider that the average securities investor receives news of corporate announcements well after people in the securities markets and is investing in a stock whose market value already reflects the corporate development announced in the disclosure. For example, when a corporation announces ongoing merger or acquisition negotiations, almost immediately, arbitrageurs and other members of the securities industry receive such information electronicaly over the "wire." They then decrease the market supply of the target's stock by purchasing large blocks of the stock, which results in the stock's market price rising to the point near the anticipated level that the acquirer will offer for each target share in a tender offer.

Therefore, by the time investors "hear," or read, of a potential merger or acquisition and then purchase the stock through their brokers, the stock's market value already has been inflated close to its "peak." Thus, far from purchasing an in-play stock, these investors, unwittingly, have in reality purchased a stock whose potential gain may be limited, but whose potential loss not only is great but also is likely to occur.

Finally, and perhaps of most importance, courts also must consider that the true purpose and goal of the securities laws is to protect investors of securities,[198] and that disclosure only is the means to achieve this end.[199]

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198. Ernst & Ernst v. Hochfelder, 425 U. S. 194, 195 (1976) ("The Securities Act of 1933 was designed to provide investors with full disclosure of material information . . . to protect investors"); Securities and Exchange Commission v. Ralston Purina Co., 346 U. S. 119, 124 (1953) ("The design of the Statute [Securities Act] is to protect investors"); Adiota v. Kagon, 599 F.2d 1111, 1115-16 (2d Cir. 1979) ("[T]he securities acts are designed to protect investors by promoting full disclosure"); United States v. Naftalin, 579 F.2d 444, 447 (8th Cir. 1978) ("The legislative purpose in enacting [10(b)-5] was to protect investors"); United States v. Carman, 577 F.2d 556, 586 (9th Cir. 1978) ("purpose of the Securities Act is to compel . . . disclosure in the issuance of securities so that investors will be adequately protected"); Desser v. Ashton, 408 F. Supp. 1174, 1176 (S.D.N.Y. 1976) ("the anti-fraud provisions . . . are to be liberally and flexibly construed so as to further the aim of Congress to protect investors"). *See also supra* note 13. The legislative history, cited in footnote 13, addresses the issue of the benefits of a disclosure for the protection of investors. The crux of this passage, however, reveals that the sole purpose of disclosure is to protect securities investors. Indeed, the opening sentence of this passage states that "No investor . . . can safely buy and sell securities upon the exchanges. . . ." *Id.* The aim of the Securities Act clearly was not disclosure for the sake of disclosure, but rather disclosure for the protection of investors. In a March 29, 1933 speech

Therefore, when disclosure ceases to work as an effective tool to protect investors, such as in the context of preliminary merger or acquisition negotiations, courts should not dogmatically continue to frame their decision around forcing corporations to disclose information, when such disclosure is detrimental to them.[200]

The position adopted by the SEC and the Sixth Circuit regarding disclosure of preliminary negotiations fails to take into account these considerations and relies solely on a strict interpretation of the securities acts. By prohibiting issuers from denying ongoing merger and acquisition negotiations, this approach clearly fails as an optimum, or even sufficient, method of investor protection.

By prohibiting a corporation from denying ongoing merger or acquisition negotiations, courts following the Sixth Circuit's approach effectively force corporations to disclose such negotiations.[201] By disclosing preliminary merger or acquisition negotiations, the target corporation's stock price rises,

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by President Roosevelt to congress that urged the adoption of federal securities legislation, Roosevelt stated that "[t]he purpose of this legislation I suggest is to protect the public. . . . This is but one step in our broad purpose of protecting investors. . . ." S. Rep. No. 47, at 6-7, and H. R. Rep. No. 85, at 1-2, 73d Congress, 1st Session (1933). *See also* SEC, The Work Of The Securities And Exchange Commission at vii (1974) ("The Commission [SEC] administers several statutes in the general field of securities and finance, all enacted by Congress for the protection of the interests of investors. . ."); Gadsby, *Historical Development of the S.E.C.—The Government View,* 28 Geo. Wash. L. Rev. 6, 9 (1959-60) (In his article Gadsby, who then was chairman of the SEC, stated that one of the "principal objectives of the 1933 act [was] . . . to protect investors").

199. *Id.*

200. Courts, in framing their decisions, have noted that their emphasis should be on the goals of the securities acts, not on disclosure if disclosure fails to further these goals. *See, e.g.,* Reiss v. Pan American World Airways, 711 F.2d 11, 14 (2d Cir. 1983) ("It does not serve the underlying purpose, of the securities acts to compel disclosure of merger negotiations in the not unusual circumstances before us"); Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982) ("A substantial body of opinion suggests that disclosure of preliminary merger discussions would, by and large, do more harm than good to . . . the values embodied in the anti-fraud provisions of the Act"). Unfortunately, as many commentators have noted, the SEC has lost track of the goals of the securities act and has pursued disclosure as an end rather than a means. *See, e.g.,* Note, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements,* 96 Yale L. J. 547, 562 n.78 ("The SEC's misguided pursuit of disclosure as an end in itself has been widely observed"); S. Philips & J. Zecher, The SEC And The Public Interest 111-14 (1979); *supra* note 45 at 260 ("The Commission, dominated by lawyers in zealous pursuit of [fairness] and [protection of investors] too often fail to recognize the economic ramifications of such [disclosure] regulations"); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry,* 29 Stan L. Rev. 1031, 1069 (1977) ("Belief in the virtues of disclosure and in the evils of insider trading has become so strong that the SEC has not considered seriously the true effects of its regulations on the investors who it is charged with protecting").

201. Although the SEC and the Sixth Circuit permit issuers to remain silent, or issue a no comment statement, such a response tells the public that negotiations are in fact occurring. *See* Flamm v. Eberstadt, 814 F.2d 1169, 1178 (7th Cir. 1987) ("if the firm [issuer] says 'no comment' that is the same thing as saying 'yes' [that negotiations are occurring] because investors will deduce the truth. No corporation follows the CIA's policy of saying 'no comment' to every inquiry").

and investors, unaware of the tenuous nature of such preliminary negotiations, purchase the stock at the inflated price. Thereafter, the negotiations may break off, the stock's market price drops to its pre-announcement level, and the shareholders are stuck with their losses.

In contrast to the Sixth Circuit's approach, the Third Circuit's approach is a significantly better method of protecting investors. Taking into account the tenuous nature of preliminary merger or acquisition negotiations, the lack of sophistication of the ordinary investor, and the realities of the securities' markets, the Third Circuit's approach allows corporations to deny that merger or acquisition negotiations are ongoing, prior to an agreement in principle being reached. This position, therefore, protects investors from unwittingly speculating on a proposed corporate merger or acquisition that, in reality, may never occur.

Moreover, by taking these factors into account, the Third Circuit's approach better protects investors and is significantly more in line with the goals of the federal securities laws.

D. THE PROPER LEGAL RESPONSE TO MERGER OR ACQUISITION NEGOTIATION INQUIRIES

As demonstrated above, the courts differ on an appropriate response to inquiries regarding merger or acquisition negotiations. Therefore, regardless of which approach is better designed to protect investors, it is imperative that, prior to responding either to a stock exchange or public inquiry regarding such negotiations, directors be aware of the position courts in their jurisdiction follow.

Directors confronted with merger negotiation inquiries can always issue a no comment statement or remain silent to such inquiries. As a practical matter, however, these responses are essentially a signal to the public that a deal is being negotiated, and, therefore, cause the stock's market price to rise.[202]

Alternatively, directors can reply to such inquiries with full candor by fully disclosing such negotiations. This approach, however, is filled with pitfalls. By disclosing information, directors open themselves up to potential liability. Since the SEC demands that disclosure be complete and accurate, any disclosure will be scrutinized closely by both the SEC and the courts in response to actions brought by former shareholders. Thus, if directors choose to disclose, they must carefully review their present and past disclosures to ensure that the disclosure is complete, accurate, and in no way misleading.

Additionally, from a practical view, full disclosure may jeopardize the merger or acquisition being negotiated, because disclosure may cause the market price of the target's stock to rise. This rise may then make the deal prohibitively expensive to the acquirer and force him to abandon his bid.

Finally, directors can issue a no corporate development statement in

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202. *Id.*

response to merger or acquisition negotiation inquiries. Prior to issuing such a statement directors must determine whether such a response is legal in their jurisdiction.

In jurisdictions following the Sixth Circuit's approach, directors cannot legally issue a no corporate development statement if they are negotiating a deal, even if negotiations are in the preliminary stage. In jurisdictions following the Third Circuit's approach, however, directors legally can issue a no corporate statement, provided an agreement in principal has not been reached (price and structure).

Directors in jurisdictions that have yet to address the issue, based on the *Carnation* case, can expect to engage in protracted litigation with the SEC, as well as private investors, if they issue a no corporate development statement while negotiations are being conducted. If, however, directors in those jurisdictions, or in jurisdictions that adopt the Sixth Circuit's approach, conclude that a potentially favorable deal may be caused by issuing a no-comment statement or disclosing negotiations, they may decide that litigation is the better alternative.