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Disclosure of Preliminary Merger Negotiations

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DISCLOSURE OF PRELIMINARY MERGER NEGOTIATIONS

A recurring problem facing corporate management and counsel during preliminary merger negotiations is deciding how to respond when the stock exchange requests an explanation for increased market activity in the corporation's stock.[1] Because of conflicting court opinions,[2] and recent Securities and Exchange Commission ("SEC") rulings,[3] the corporation's obligations are not always clear.

The problem typically arises when rumors of a possible takeover or merger circulate or are leaked by the corporation itself.[4] The investing public responds by buying the corporation's stock, anticipating a high return if a merger materializes.[5] This increased activity causes the price of the stock to rise and triggers a New York Stock Exchange ("N.Y.S.E.") inquiry.[6]

The N.Y.S.E. maintains a surveillance system[7] to monitor large

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1 See, e.g., Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128 (S.D.N.Y. 1984), for a fact pattern paradigmatic of this situation. In *Schlanger*, shareholders of Four-Phase sold their shares after a public announcement that Four-Phase was not aware of any developments which would affect the market for its stock. This statement was issued in response to a New York Stock Exchange ("N.Y.S.E.") inquiry prompted by a sudden rise in price and volume of trading of Four-Phase's stock. At the time of making the statement, Four-Phase was involved in merger negotiations with Motorola, although no offer to merge had been made. Eight days later, Four-Phase announced that it had reached an agreement to merge.

2 Compare *Schlanger*, 582 F. Supp. at 134 (preliminary merger negotiations may be material facts that must be disclosed) with Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984) (preliminary merger negotiations are not material corporate developments and thus need not be disclosed), cert. denied, 105 S. Ct. 1189 (1985).

3 See, e.g., *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985) (preliminary merger negotiations are material). See infra notes 65-67 and accompanying text.

4 See infra note 40.

5 "[A]n investor could quickly profit by buying stock in the target company before the offer is made public, as the offer will be made at a premium above the prevailing market price." W. Cary & M. Eisenberg, Corporations 767 (5th ed. 1980).

6 The new-found interest in the corporate stock increases the demand for the existing shares, which leads to an increase in the cost of acquiring the stock. This surge in stock activity and price draws the attention of the N.Y.S.E. See infra notes 7-10 and accompanying text.

7 The mechanics of the New York and American Stock Exchanges' surveillance systems are described in New York Stock Exchange Listed Company Manual § 202.04, reprinted in 3 Fed. Sec. L. Rep. (CCH) ¶ 23,518 (1985) [hereinafter N.Y.S.E. Manual]; American Stock Exchange, Inc., Listing Standards, Policies and Requirements, 2 Am. Stock Exch. Guide (CCH) § 404, ¶ 10,124 (1984) [hereinafter A.S.E. Guide].

"A company which lists on the Exchange is expected to be guided by Exchange practices and procedures . . . ." N.Y.S.E. Manual, § 201.00. Consequently, the Exchange has the authority to make an inquiry pursuant to the corporation's listing agreement. See generally Comment, Implication of Civil Liability Under the New York Stock Exchange Rules and changes in stock activity in order to uncover unexplained trading trends.[8] When such trends are discovered, the Stock Exchange calls the management of the corporation involved, requesting an explanation for the market activity and the issuance of a press release[9] disclosing this information to the public.[10]

When the Stock Exchange makes this inquiry, the corporation is often involved in the early stages of merger negotiations, where no definite commitments have been made concerning price or merger structure.[11] The N.Y.S.E. request for disclosure of any corporate developments that would explain the increased stock activity puts the corporation on the horns of a dilemma. Disclosure of the preliminary negotiations may jeopardize the merger,[12] but claiming to have no explanation is, under one interpretation,[13] a violation of section 10(b)[14] of the Securities Exchange Act of 1934 (the "Act"),[15] SEC rule 10b-5,[16] and New York[17] and American Stock Exchange rules.[18]

Listing Agreement, 22 Vill. L. Rev. 130 (1976)(discussing the implications of noncompliance with listing agreements).

8 See supra note 7.

9 "It is standard procedure for the N.Y.S.E. to request a [no corporate development] statement when the activity of a listed stock changes significantly indicating that some investors may be buying or selling large numbers of shares based on information not generally known to the public at large." Greenfield v. Heublein, Inc., 742 F.2d 751, 754 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

10 See N.Y.S.E. Manual, supra note 7, §§ 202.04, 202.06; A.S.E. Guide, supra note 7, § 401.

11 See Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (3d Cir. 1984)(N.Y.S.E. inquired into trading increase when corporation was involved in negotiations prior to agreement on merger price or structure), cert. denied, 105 S. Ct. 1189 (1985).

12 See infra notes 74-78 and accompanying text.

13 See infra notes 65-67 and accompanying text. According to the SEC and at least one court, failure to disclose preliminary merger negotiations in response to a N.Y.S.E. inquiry is a violation of section 10b-5. See Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128 (S.D.N.Y. 1984); *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

14 Section 10(b) provides in part:

> It shall be unlawful for any person . . . .
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1982).

15 15 U.S.C. § 78a to hh-1 (1982).

16 The SEC promulgated rule 10b-5 under authority granted to it in § 10(b). The rule provides detailed requirements under § 10(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means

Three possible responses to a N.Y.S.E. inquiry have emerged:[19] (1) making "no comment,"[20] (2) making full disclosure,[21] or (3) claiming "no corporate development."[22] The difficulty arises in determining when the use of a no corporate development response is appropriate and not a violation of rule 10b-5. If a corporation is not engaged in any negotiations at the time of the inquiry, the no corporate development response is clearly appropriate.[23] Conversely, if a corporation has reached an agreement to merge, such a response would be inappropriate as there has been a corporate event which

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or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of 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 . . . .

. . . .

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

[17] The N.Y.S.E. requires that corporations whose securities are listed on the exchange "release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." N.Y.S.E. Manual, supra note 7, § 202.05. The American Stock Exchange, similarly, requires listed corporations to "make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances." A.S.E. Guide, supra note 7, § 401(a). The National Association of Securities Dealers' (NASD) disclosure rules also require a corporation to promptly disclose to the public all material information "which may affect the value of its securities or influence investors' decisions." NASD Manual, Schedule D, Part II, (B)(3)(b) ¶ 1754, at 589.

It is unclear whether a cause of action exists for a breach of N.Y.S.E. requirements. For a more complete discussion see Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 140-43 (7th Cir.) (allowing a suit), cert. denied, 396 U.S. 838 (1969); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181-82 (2d Cir. 1966) (not allowing suit but suggesting the type of situations in which a court *would* imply civil liability); Note, Securities Exchanges—Second Circuit Halts Expansion of Implied Private Rights of Action for Violation of Stock Exchange Rules, 46 Fordham L. Rev. 367 (1977); Comment, supra note 7.

[18] See supra note 17.

[19] A fourth available response to a N.Y.S.E. inquiry is to request a suspension in trading. The N.Y.S.E. can officially suspend or halt trading in an individual security pending a news announcement likely to affect the market for the security. Hopewell & Schwartz, Temporary Trading Suspensions in Individual NYSE Securities, 33 J. Fin. 1355, 1355 (1978).

[20] See, e.g., *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 n.6 (July 8, 1985)("an issuer that wants to prevent premature disclosure of nonpublic preliminary merger negotiations can . . . give a 'no comment' response to . . . inquiries").

[21] See, e.g., Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 134 (S.D.N.Y. 1984) (finding that failure to disclose preliminary merger negotiations may be a violation of 10b-5, thus indicating that such negotiations must be fully disclosed).

[22] See, e.g., Greenfield v. Heublein, Inc., 742 F.2d 751, 754 (3d Cir. 1984) (release stated that "the Company was aware of no reason that would explain the activity in its stock in trading on the NYSE today"), cert. denied, 105 S. Ct. 1189 (1985).

[23] In this situation there is no corporate activity, thus issuing a no corporate development response is disclosing the facts in accordance with rule 10b-5. See supra note 15.

probably explains the increased market activity in the corporation's stock. Where a corporation is involved in the early stages of merger negotiations, however, where no agreements have been reached, courts disagree as to whether the no corporate development response is acceptable. Those courts that would allow this response consider preliminary merger negotiations immaterial. Other courts and the SEC require disclosure of the negotiations, viewing them as material and thus necessary to an informed marketplace.[24]

This Note focuses on whether the no corporate development response should be available to corporations involved in preliminary merger negotiations. Part I explicates the current state of the law under section 10(b) and rule 10b-5. Part IIA discusses the materiality of preliminary merger negotiations. Part IIB discusses the practicality and desirability of each of the options open to a corporation facing a N.Y.S.E. inquiry and concludes that the no corporate development option is desirable.

I. Current State of the Law: The Securities Exchange Act, Section 10(b), and Rule 10b-5

The Act[25] was passed to provide for the regulation of securities exchanges and over-the-counter markets.[26] Its enactment was intended to "insure the maintenance of fair and honest markets"[27] by "substitut[ing] a philosophy of full disclosure [of information] for the philosophy of *caveat emptor*."[28]

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24 The SEC has had a longstanding policy against the disclosure of information, such as predictions and forecasts, that has been classified as "soft" and unreliable. Schneider, Soft Information Disclosures: A Semi-Revolution, 15 Inst. on Sec. Reg. 19, 19-20, 27 (1984). Soft information, unlike hard data, is not objectively verifiable historical information. The SEC position has been that such information is often inaccurate and misleading rather than informative and that it is easier to police the completeness of disclosure if it is limited to hard facts. Id. This policy is currently being revised in favor of increased disclosure. Id. at 19. The SEC has recognized that certain soft information may be helpful to both shareholders and investors. Id. at 30. With this change in policy has come increased scrutiny in rule 10b-5 disclosure litigation. Id. at 19. It is against the backdrop of this hard-soft information dichotomy that the issue of disclosing preliminary merger negotiations arises. See Flynn v. Bass Bros. Enters., 744 F.2d 978 (3d Cir. 1984) (discussing the new approach to disclosure of soft information and how it applies to the disclosure of asset appraisals).

25 15 U.S.C. § 78a to hh-1 (1982). The Act was passed in response to the stock market crash of 1929 and attendant abuses in securities transactions. See Note, Securities Regulation—Rule 10b-5—Misuse of Material Nonpublic Information Obtained Through Regular Access to Market Creates Criminal Liability Under Rule 10b-5, 50 Miss. L.J. 223, 224 (1979).

26 15 U.S.C. § 78b (1982).

27 Id.

28 Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977). One commentator detailed eight policies underlying rule 10b-5: (1) maintenance of the securities markets, (2) equalization of access to information, (3) preservation of equal bargaining strength, (4) disclosure, (5) pro-

This policy of fairness in securities transactions played its largest role in the creation and application of section 10(b) and rule 10b-5.[29] The duty imposed by these laws is best articulated by rule 10b-5(b), which provides that

> it shall be unlawful for any person . . . 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 . . . in connection with the purchase or sale of any security.[30]

While this broad language allows for differing interpretations, many aspects of 10b-5 have become sufficiently well-settled to create a framework for its use.

Courts have interpreted the "in connection with the purchase or sale of any security" clause particularly broadly.[31] Rule 10b-5 applies when a corporation makes a misleading statement even when it is not

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tection of investors, (6) fairness, (7) encouragement of investor confidence, and (8) deterrence of violations and compensation of victims. 5 A. Jacobs, The Impact of Rule 10b-5 § 6.01 (1980).

Commenting on the role of full disclosure in the House bill which eventually became part of the Act, the House Committee stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. 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 speculates on inside information.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934).

[29] "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), rev'd on other grounds, 445 U.S. 222, 234-35 (1980); see Staffin v. Greenberg, 672 F.2d 1196, 1208 (3d Cir. 1982).

[30] 17 C.F.R. § 240.10b-5(b) (1985).

[31] In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), the Second Circuit explained that the phrase "in connection with the purchase or sale of any security" found in § 10(b) was not intended to apply only to corporations and individuals who actually engaged in securities transactions. Id. at 860. See infra note 32.

The Third Circuit, in Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982), "indicated that the requirements of . . . 10b-5's in connection with clause are satisfied . . . when a corporation issues a misleading statement . . . or omits to state a material fact in an issued statement in connection with an investor's purchase or sale of securities." Comment, Corporate Disclosure of Merger Negotiations—When Does the Investor Have a Right to Know? *Greenfield v. Heublein, Inc.*, 36 Syracuse L. Rev. 1155, 1158 n.23 (1985). See *Staffin*, 672 F.2d at 1204 n.8. Therefore, it appears that the requirements of the "in connection with" clauses in Section actually engaged in the purchase or sale of its own securities.[32] Any statement made by a corporation that is likely to have an effect on investors' actions regarding the corporation's stock will meet the rule's "in connection with the purchase or sale" requirement and must therefore comply with all other aspects of the rule.[33]

10(b) and rule 10b-5 are satisfied once a corporation issues a misleading statement, regardless of whether it is trading in its own stock. Comment, supra at 1158 n.23.

32 Rule 10b-5 is limited to situations that are defined as "[i]n connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1985).

The rule is applied in two general types of disclosure situations: where one who owes a duty to others is trading on inside information not known to the other party to the transaction, see, e.g., *Texas Gulf Sulphur*, 401 F.2d at 848, and where a corporation, though not trading in its own stock, issues a statement. See, e.g., Greenfield v. Heublein, Inc., 742 F.2d 751, 756-57 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

> [I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.

Texas Gulf Sulphur, 401 F.2d at 860. Hence, anyone who is trading in securities is clearly covered by the rule.

However, not every person who trades based on information that the other party does not possess violates 10b-5. See United States v. Chiarella, 588 F.2d 1358, 1365-66 (2d Cir. 1978) (discussing outsiders who have inside information, yet who may trade without disclosure or liability), rev'd on other grounds, 445 U.S. 222 (1980). There can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers had placed their trust and confidence." *Chiarella*, 445 U.S. at 232.

Insiders and other fiduciaries are thus two classes of persons who must disclose or refrain from trading because their special positions make it unfair for them to act without disclosing. See *Chiarella*, 588 F.2d at 1365. An insider is a fiduciary. A market insider is anyone who has regular access to material nonpublic information and who serves the issuer—and thus derivatively the shareholder—in a capacity creating a relationship of trust and confidence. Id. at 1366. See Langevoort, Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement, 70 Calif. L. Rev. 1, 20 (1982). One who receives confidential corporate information from an insider is treated as an insider under 10b-5. Id. at 24. E.g., Dirks v. SEC, 463 U.S. 646, 660-64 (1983) (holding one who receives information from an insider—a tippee—to the same duties as an insider).

"The fiduciary principle is often described in terms of an . . . expectation of fair dealing arising from a relationship of trust and confidence . . . ." Langevoort, supra, at 5. Thus, anyone in a relationship of trust and confidence is a fiduciary and has an affirmative duty to disclose or refrain from trading. Id. at 34. "Persons in a position to have special access to confidential information bearing on the value of a security are perceived as being unjustly enriched when they trade with others who are unable to discover that information." Id. at 2. Therefore, "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders . . . will not benefit personally through fraudulent use of material nonpublic information." *Chiarella*, 445 U.S. at 230.

33 See Greenfield v. Heublein, Inc., 742 F.2d 751, 756, 758 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985); *Texas Gulf Sulphur*, 401 F.2d at 860-62; Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 133 (S.D.N.Y. 1984); *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

This reasoning implies that a corporation that is not trading in its own stock or issuing a statement does not fall within the scope of 10b-5 even though it might possess information that investors would consider important. In fact, a literal reading of 10b-5 favors the interpretation that there is no general duty for such corporations to disclose the information.[34] The language of the rule requires that statements of fact be truthful and that statements not omit material facts that would make the corporate statement misleading.[35] This requirement presupposes the existence of a statement. Therefore, the majority of courts find that federal securities laws do not impose a general duty to disclose information if a corporation is not trading in its own stock or issuing a statement.[36]

This Note assumes that a corporation in possession of material information[37] has no affirmative duty to disclose the information it possesses.[38] However, once a corporation makes a statement that is likely to affect investor trading, the corporation must make sure that all material facts are accurately disclosed. A fact is material if a reasonable shareholder would consider the information important in deciding whether or not to buy or sell the security.[39] Rule 10b-5

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[34] Talesnick, Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?, 49 Den. L.J. 369, 388 (1973).

[35] See supra note 16.

[36] See, e.g., Greenfield v. Heublein, Inc., 742 F.2d 751, 756, 758 (3d Cir. 1984) ("a corporation [is] under no duty to disclose . . . inside information" if it is not trading in its own stock or issuing a statement), cert. denied, 105 S. Ct. 1189 (1985); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 133 (S.D.N.Y. 1984) ("federal securities laws do not impose a general duty upon an issuer to disclose material facts or new developments when it is not trading in its own securities"); *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 (July 8, 1985) (rule 10b-5 "prohibition is triggered whenever the issuer speaks, regardless of whether the issuer is trading in its own securities"). However, some commentators disagree. For an argument in favor of an affirmative duty to disclose, see Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose, 67 Geo. L.J. 935, 937 (1979). Additionally, there may be a conflict between the disclosure requirements of the securities laws and the N.Y.S.E. rules. See supra note 17.

[37] See infra note 39 and accompanying text.

[38] See supra note 36.

[39] See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

At least two other standards of materiality have emerged in the case law. The first states that a fact is material if it significantly alters the mix of information available. See, e.g., Goldberg v. Meridor, 567 F.2d 209, 218-19 (2d Cir. 1977); SEC v. Paro, 468 F. Supp. 635, 646 (N.D.N.Y. 1979). The second deems a fact material if it is one that affects the value of the stock. See Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

All standards of materiality aim at giving the investor as much information as is necessary to make an informed decision. "A statement may be immaterial in two ways. First, though relevant to the question to be voted on, it can be insignificant or trivial. . . . [and] [s]econd, though the information may be significant, it may be only tangentially related to the question before the shareholders, and therefore unnecessary." Cohen v. Ayers, 449 F. Supp. 298, 315 (N.D. Ill. 1978). Although these definitions of material fact give guidance to corporations, in requires disclosure of material facts in a manner that does not mislead the public.[40] Thus, the rule is violated only by a misleading statement or omission of a material fact.[41]

The materiality requirement benefits both the corporation and the investor. It relieves the corporation from having to disclose every item within its knowledge, no matter how insignificant,[42] and avoids the need for investors to sift through extraneous information to get to the relevant facts. Furthermore, requiring a corporation to divulge information furthers the policies underlying rule 10b-5: promoting

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individual cases corporations will still have to determine whether specific information is material.

40 An example of a potential 10b-5 violation of this type may be found in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). There the corporation issued a press release in response to rumors about a recent phenomenal drilling discovery. The statement explained that the "rumors were exaggerated and available results were inconclusive." SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 292-93 (S.D.N.Y. 1966). In fact, the drilling had uncovered excellent ore deposits. The circuit court, though not reaching a final decision on the issue, found that the press release did not describe the actual state of the facts and was not candid or complete. Thus, investors were denied the opportunity to draw accurate conclusions and to make investment plans.

41 Jacobs, What Is a Misleading Statement or Omission Under Rule 10b-5?, 42 Fordham L. Rev. 243, 256 (1973). "[I]f the undisclosed [or misrepresented] facts are not material, there is no liability under rule 10b-5." Staffin v. Greenberg, 672 F.2d 1196, 1202 (3d Cir. 1982).

This interpretation of 10b-5 is the subject of some disagreement. In Comment, supra note 31, at 1173-74, the author argues that the duty to disclose material information and the duty not to mislead are two separate requirements of 10b-5. However, the language of 10b-5 and court interpretations of the rule make clear that there is only one duty—the duty not to materially mislead.

Rule 10b-5 forbids making "an untrue statement of a material fact" or omitting "a material fact necessary . . . to make the statements made . . . not misleading." 17 C.F.R. § 240.10b-5 (1985). The focus of the rule is on the inclusion of material facts so as not to mislead. Furthermore, any interpretation of 10b-5 that does not require misrepresentations or omissions to be materially misleading undercuts the function of a materiality standard. Under such an interpretation, any trivial omission would be actionable because any statement that does not include all related information is arguably misleading. This is not the purpose of the rule. Courts applying the rule concur in this conclusion requiring that statements must be materially misleading to be actionable. Jacobs, supra, at 251, 256. The SEC in *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 (July 8, 1985), ruled that a corporation has an "obligation to disclose sufficient information concerning the [merger] discussions to prevent the statements made from being *materially* misleading." Id. (emphasis added) (footnote omitted). See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 383 (1970) (materiality standard for 14(a) action); Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1200 (2d Cir. 1978) (the point is not to nit-pick); Ash v. LFE Corp., 525 F.2d 215, 219 (3d Cir. 1975) ("nit-picking is not the . . . name of the game."); Ronson Corp. v. Liquifin Aktiengesellschaft, 483 F.2d 846, 851 (3d Cir. 1973) (materiality standard for 14(e) action).

42 In TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976), the Court was concerned that too low a threshold of materiality would lead corporate management, concerned about liability, "to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." Id. at 448-49. See Staffin v. Greenberg, 672 F.2d 1196, 1205 (3d Cir. 1982). Thus, a corporation may violate 10b-5 by disclosing too much information since nonmaterial facts may actually be misleading. See infra note 57.

"free and honest markets, disclosure, protection of investors and fostering investor trust."[43]

Rule 10b-5 also protects investors by allowing a private right of action.[44] An investor may sue a corporation that issues a misleading statement if that statement is detrimentally relied upon.[45] Section 10(b) and rule 10b-5, therefore, not only provide a standard for the treatment of material information, but also provide a means for individuals to enforce their rights. Corporations must weigh the risk of liability against the advantages of nondisclosure when they choose to follow or ignore these duties.

II. Corporate Options in Response to New York Stock Exchange Inquiries

Courts disagree about the duty 10b-5 imposes upon a corporation involved in preliminary merger negotiations when responding to an N.Y.S.E. inquiry.[46] It is well-settled that corporations may make no comment.[47] The no comment option does not involve questions of materiality or conflicts between the courts and the SEC. Since the corporation does not have an affirmative duty to disclose information, this option poses no rule 10b-5 problems.[48] Similarly, a corporation

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[43] 5A A. Jacobs, supra note 28, at § 88.04[a].

[44] Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). The Pennsylvania District Court was the first to find a private cause of action implicit in rule 10b-5. This right was first recognized by the Supreme Court in J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964), and further acknowledged in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

[45] An investor who relies on a misleading corporate statement may sell stock whose value later increases due to real, undisclosed factors. When he brings a cause of action, he will argue that he was misled by the corporate statement and that he would not have sold had he known the truth. Similarly, an investor may hold stock in reliance on a corporate statement which presents an unrealistically favorable view of the corporation and thus be injured when the stock price falls.

[46] Compare Greenfield v. Heublein, Inc., 742 F.2d 751, 759 (3d Cir. 1984) (holding that a corporation engaged in preliminary merger negotiations may issue a no corporate development statement in response to a N.Y.S.E. inquiry), cert. denied, 105 S. Ct. 1189 (1985), with Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 132-34 (S.D.N.Y. 1984) (finding that a no corporate development statement in this situation may be misleading).

[47] See *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985). Courts and commentators have recognized this option either explicitly, see Greenfield v. Heublein, Inc., 742 F.2d 751, 759 n.7 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985) (majority opinion), 760 n.1, 761 n.3, 763 (Higginbotham, J., dissenting); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 132 (S.D.N.Y. 1984); *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 87,596 n.6; Brodsky, Disclosure of Merger Negotiations, N.Y.L.J., Nov. 6, 1985, at 1, col. 1, at 28, col. 2, or by noting that before making a voluntary statement there is no duty to disclose, see *Greenfield*, 742 F.2d at 756; Kaufman & Hoyns, Disclosure Dilemma: What to Say When the Stock Exchange Calls?, N.Y.L.J., January 18, 1985, at l, col. 3, at 6, col. 6; *Schlanger*, 582 F. Supp. at 133.

[48] See supra notes 34-38 and accompanying text; infra notes 81-82 and accompanying text.

may fully disclose the substance of negotiations.[49] The conflict centers around whether a corporation in such circumstances has the option of issuing a no corporate development statement.[50] This section will examine the no corporate development option from both a legal and practical perspective and will consider the propriety of its use.

A. *Applying Rule 10b-5 to the Facts: The Materiality of Preliminary Merger Negotiations*

A corporation engaged in preliminary merger negotiations may want to respond to a N.Y.S.E. inquiry in order to dispel merger-related rumors[51] or to protect the secrecy of its negotiations. To further this objective, the corporation will issue a press release stating that "the company is not aware of any corporate developments which should affect the market of its stock" (statement I).[52] A shareholder may rely on this statement and sell his shares. Later, when the terms of the merger are clearer—for example, as early as the next day—the

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49 See Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 134 (S.D.N.Y. 1984). But see infra notes 73-80 for the problems of full disclosure.

50 See Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

51 The existence of rumors about a corporation or its activities may itself create an obligation for a corporation to disclose information. If the fact which is the subject of a rumor is not material, the corporation does not have a duty to comment and failure to do so will not violate 10b-5. Sheffey, Securities Law Responsibilities of Issuers to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem, 57 Notre Dame L. Rev. 755, 757 (1982).

In general, there is no duty for a corporation to respond to or correct rumors or publicity which cannot be attributed to it. See State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981), and Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980), where issuers learned of publicity reports that they knew might influence the investing public yet were found not to have violated 10b-5 for failure to make corrective disclosure. See also Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 949 (2d Cir. 1969) (establishing the rule that issuers are not obligated to make corrective disclosure in response to rumors not "attributable" to them).

If, however, the issuer is at least partially responsible for dissemination of the publicity or rumor, it has a duty to insure that the information is not false or misleading. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 857-64 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); Sheffey, supra, at 779-85, 790-95. Responsibility may arise either directly, by actually giving or leaking the information, or indirectly, if a third party is the source of the statement or rumor but stands in a special relationship with the corporation. See Green v. Jonhop, Inc., 358 F. Supp. 413, 420 (D. Or. 1973); Sheffey, supra, at 779-85. Thus, "[w]hether the issuer is legally obligated to disclose will turn on whether the rumor . . . is 'attributable' to it." Id. at 795.

Consequently, in the context of increased trading activity, a corporation may have a duty to respond to a N.Y.S.E. inquiry not due to the existence of preliminary merger negotiations but because of material market rumors attributable to it. Additionally, a corporation that does not have this duty may choose to comment so as to dispel false rumors which may be having an adverse effect on the market for its stock or on its business dealings.

52 See, for example, Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 129 (S.D.N.Y 1984).

corporation will disclose that it has reached an agreement with company *X* (statement II).[53] The shareholder who sold after statement I feels misled and cheated. Had he waited to sell his shares until after statement II, he would have received a higher price. The former shareholder casts the blame for his loss on statement I and brings a suit under rule 10b-5 for damages equal to the difference between the price he received for his stock and the price provided for under the merger agreement.

Some courts are amenable to this type of shareholder action;[54] others are not.[55] All courts agree that if a corporation issues a statement in response to a N.Y.S.E. inquiry, rule 10b-5 requires that the statement disclose all material information.[56] However, they disagree as to whether preliminary merger negotiations are material facts under rule 10b-5 which must be included in the corporation's initial press release.

The Third Circuit holds that the no corporate development response satisfies rule 10b-5's requirements. In their view, "[a]s a matter of law, preliminary merger discussions are not material corporate developments, and thus need not be disclosed."[57] Accordingly, if the

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53 See Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

54 See Levinson v. Basic, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,529 (6th Cir. 1986); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128 (S.D.N.Y 1984).

55 See Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

56 Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-62 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 133 (S.D.N.Y. 1984).

57 Greenfield v. Heublein, Inc., 575 F. Supp. 1325, 1336 (E.D. Pa. 1983).

Although the American Stock Exchange has a strict disclosure policy, see supra note 39, it agrees that preliminary negotiations may not have to be disclosed.

> In the course of a successful negotiation . . . the only information known to each party at the outset may be the willingness of the other to hold discussions. Shortly thereafter, it may become apparent to the parties that it is likely an agreement can be reached. Finally, agreement in principle may be reached on specific terms. In such circumstances . . . a company need not issue a public announcement at each stage of the negotiations, describing the current state of constantly changing facts, but may await agreement in principle on specific terms.

A.S.E. Guide, supra note 7, § 402.

The reason preliminary merger negotiations have been considered immaterial as "a matter of law" is that their disclosure may itself be misleading. See Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985); Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982); Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1084-85 (5th Cir. 1970). If preliminary merger negotiations are disclosed and a merger does not materialize, there may be a 10b-5 action. The Second Circuit, in Reiss v. Pan Am. World Airways, Inc., 711 F.2d 11 (2d Cir. 1983), concluded that merger negotiations need not be disclosed, stating that they "have no doubt that had Pan Am disclosed the existence of negotiaonly explanation for increased market activity involves the negotiations or other nonmaterial corporate developments, then the corporation cannot be held liable under 10b-5.

In *Greenfield v. Heublein, Inc.*,[58] Heublein issued a press release stating that it was "aware of no reason that would explain the activity in its stock"[59] while it was engaged in preliminary discussions with R. J. Reynolds. At the time of the statement, Heublein and Reynolds had discussed the possibility of a friendly merger as a defensive tactic to a threatened hostile takeover of Heublein. However, a merger with Reynolds was not being seriously considered at the time. Greenfield and other shareholders sold their shares in reliance upon Heublein's statement. When Heublein and Reynolds later merged, the shareholders sued and the Third Circuit issued the leading opinion in support of the no corporate development response. The court held that in order for merger negotiations to be material an "agreement in principle" as to the price and structure of the merger must have been reached.[60] The court reasoned that when price and structure have been agreed to, "[t]hey constitute a usable and definite measure for determining when disclosures need be made."[61] Before that point, the negotiations "are inherently fluid and the eventual outcome is shrouded in uncertainty."[62] To disclose at that time could easily mislead shareholders since the bargaining "may fail as well as succeed and . . . may succeed on terms which vary greatly from those . . .

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tions . . . and had those negotiations failed, we would have been asked to decide a section 10b-5 action challenging that disclosure." Id. at 14.

58 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

59 Id. at 754.

60 Id. at 756. See Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982).

> 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. If the announcement is withheld until an agreement in principle on a merger is reached, the greatest good for the greatest number results. If the merger occurs, all of the company's shareholders usually benefit; if no merger agreement is reached, the stock performs as it would have in any event.

Id. at 1207.

61 *Greenfield*, 742 F.2d at 757.

62 *Reiss*, 711 F.2d at 14.

> Any disclosure up to [the point of an agreement in principle] would have been based on facts that were subject to change at any time. As the situation evolved, successive, possibly cancelling, announcements might have been required. This would have tended to confuse and mislead, rather than enlighten, the investing public.

Greenfield, 742 F.2d at 757. See also Staffin v. Greenberg, 672 F.2d 1196, 1206-07 (3d Cir. 1982) ("A company need not issue a public announcement at each stage of the negotiations, describing the current state of constantly changing facts, but may await agreement in principle on specific terms.").

anticipated."[63] Thus, under *Greenfield*, rule 10b-5 requires the corporation to fully disclose any merger plans only after the parties have agreed upon price and structure.[64]

Those refuting this reasoning support full disclosure of preliminary merger negotiations in the corporate statement. The SEC has recently commented on this matter in *In re Carnation Co.*,[65] in which Carnation issued no corporate development statements in response to two N.Y.S.E. inquiries while engaged in negotiations with Nestles. No agreements as to price and structure of a merger had been reached before the statements were issued, but both had been discussed. The SEC found that preliminary merger negotiations were material "because, if disclosed fully and accurately, they would . . . 'assume[] actual significance in the deliberations of,' and would . . . 'significantly alter[] the total mix of information made available [to]' the reasonable . . . shareholder."[66] Thus, the SEC's position is that preliminary merger negotiations must be fully disclosed in any corporate response to a N.Y.S.E. inquiry.[67]

The SEC and the *Greenfield* court disagree with respect to the level of definiteness necessary to make information material. Under the SEC's reasoning, indefiniteness does not necessarily preclude materiality since preliminary negotiations are material because they affect shareholder decisions.[68] Under the Third Circuit's view,

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63 Starkman v. Marathon Oil Co., 772 F.2d 231, 243 (6th Cir. 1985).

64 "Finally, with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity." *Greenfield*, 742 F.2d at 757.

65 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

66 Id. at 87,597 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

67 Recently, in Levinson v. Basic, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,529 (6th Cir. 1986), the Sixth Circuit has sided with the SEC in finding that preliminary merger negotiations are material. The facts in *Levinson* are almost identical to those in *In re Carnation*. While engaged in merger negotiations with Combustion Engineering, Basic issued five separate statements that it was unaware of any reason for increased trading activity in its stock. When Basic issued the first statement, price had not been discussed. By the third statement, Basic had received a draft proposal. Shareholders relied on these statements and sold their shares. The shareholders brought a 10b-5 suit when a merger between Basic and Combustion Engineering was announced. The court found that the existence of preliminary negotiations was a material fact. It reasoned that the negotiations were material "by virtue of the statement denying their existence." Id. at 93,172 (emphasis omitted). Even if the negotiations were not material, the court noted, they became so once a statement denying their existence was issued. Id. at 93,173.

On the facts of *Levinson*, the *Greenfield* court would probably have found that an "agreement in principle" existed at the time the third statement was issued.

68 The SEC's full disclosure requirement revives a concept that the Act was intended to extinguish: caveat emptor. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977). By forcing corporations to disclose preliminary merger negotiations, the SEC forces the buyer to sift through the corporation's statements to determine if a merger is likely to occur. This

materiality and indefiniteness are mutually exclusive as preliminary negotiations are too unstable to rely upon. The *Greenfield* view of materiality is preferable because it better reflects the purposes of 10b-5.[69] While both the SEC and the Third Circuit consider the impact of information on the investor, the Third Circuit also takes into account whether the information is definite enough to be reasonably relied upon. This is more consistent with the language in 10b-5 requiring disclosed statements not to be misleading.

B. *The Corporation's Dilemma*

The present conflict over the materiality of preliminary merger negotiations puts corporations in most states[70] in a tenuous position when responding to a stock exchange inquiry. In order to afford corporations some security in framing a response to these inquiries, the courts must decide which of the two standards furthers the purposes and policies of the Act. In an effort to discover the more desirable precedent, this section will examine the effects of implementing either the Third Circuit or the SEC decision as the legal standard.

Assume that corporation *A* has decided that it would be beneficial to merge with corporation *Z*. Representatives of *A* and *Z* meet to discuss each other's needs and demands and to exchange financial statements. Rumors of these discussions circulate and generate increased market activity in corporation *A*'s stock. The N.Y.S.E. calls *A*, requesting an explanation for this activity. What are *A*'s options?

1. The SEC Approach

If the SEC release[71] establishes the accepted standard of conduct,

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defeats the usefulness of a materiality standard. See supra notes 42-43 and accompanying text. Under *Greenfield*, the corporation only discloses the merger negotiations after price and structure have been agreed upon. See supra notes 58-64 and accompanying text. The *Greenfield* holding protects the buyer from his own poor judgment. This is consistent with the Act's policy of protecting investors. See supra note 28.

69 At first glance it might seem that the SEC view offers more information to the investor as it mandates the disclosure of even "soft" information. However, this view is deceptive. In fact, less information is given out because the threat of liability for underdisclosure will narrow the options available to corporate management. They will never choose full disclosure. See infra notes 73-80 and accompanying text.

70 As of July 20, 1986, only the Third Circuit, Sixth Circuit, the Northern District of Illinois and the Southern District of New York have addressed this issue. See *Greenfield*, 742 F.2d 751; *Levinson*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,529; Jordan v. Duff & Phelps, Inc. (N.D. Ill. 1986); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128 (S.D.N.Y. 1984).

71 *In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985). SEC releases are advisory in nature. They "do not have the effect of rules and regulations of the SEC adopted pursuant to the power conferred by, or under the procedure

then *A* must disclose the preliminary merger negotiations with *Z* if it issues a statement.[72] *A*, therefore, must choose between fully disclosing or issuing a no comment response.

While *A* may avoid shareholder suits for violation of 10b-5 by fully disclosing the negotiations with *Z*,[73] full disclosure presents potential disadvantages as "an issuer who discloses too early may harm its business position or unintentionally issue a misleading release because of incomplete information."[74] Consequently, it may not be to *A*'s advantage to disclose.[75] Furthermore, "investors may interpret 'we're talking' as evidence [that] there's a deal."[76] As a result, they may purchase stock in larger than usual numbers anticipating that the tender price will be higher than their purchase price, thus causing the price of the stock to rise. This speculative increase "could cause the market price of [corporation *A*'s] stock to rise . . . beyond the expected tender price and lead to the collapse of the merger negotiations."[77]

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established by, section 19(a) of the 1933 [Securities] Act, 15 U.S.C.A. 77s(a)." DiJulio v. Digicon, Inc., 339 F. Supp. 1284, 1290 (D. Md. 1972). However, as the administrator of both the 1933 and 1934 Acts, the SEC plays an important role in interpreting the Acts and its opinion is well-respected.

72 See *In re* Carnation, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985); see also Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128, 134 (S.D.N.Y. 1984) (agreeing with the SEC position that preliminary merger negotiations must be disclosed).

73 If *A* issued a no corporate development statement, *A* would run the risk of being held liable for violating 10b-5 since courts faced with this issue will, under this scenario, follow the SEC position. See supra notes 65-66 and accompanying text.

74 Wander & Schwartzman, Timely Disclosure, 17 Rev. Sec. Regs. 861, 861 (1984) (footnote omitted). Corporate statements announcing the details of merger talks would "[n]ot only . . . have a disruptive effect on the stock markets, but, considering the delicate nature of most merger discussions, might seriously inhibit such acquisitive ventures." Greenfield v. Heublein, Inc. 742 F.2d 751, 757 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985).

David Kay, head of mergers and acquisitions at Drexel Burnham Lambert Inc. recently argued against the SEC release based on the belief that its requirements are dangerous to the naive investor. He stated: " 'By giving credibility' to deals early in discussions, 'you are going to be expanding the universe of investors who want to play' the takeover game to include investors who are 'less sophisticated and less able to stand the risks of speculation.' " Hertzberg & Leefeldt, SEC's Merger-Disclosure Ruling May Add to Stock-Price Volatility, Wall St. J., July 10, 1985, at 31, col. 4 (quoting David Kay).

75 Porter Bibb, head of corporate finance at Ladenburg, Thalmann & Co., stated: " 'Dealmaking is chemistry . . . [a]nd the most important catalyst is confidentiality. The more people who know, the less chance there is of getting it done.' " Hertzberg & Leefeldt, supra note 74, at 31, col. 5.

76 Id. (quoting Malcolm Lowenthal, a vice president at Shearson Lehman Brothers, Inc.).

77 Wander & Schwartzman, supra note 74, at 861 n.1.

> Obviously, a company intending to make a tender offer strives to keep its plan secret. If word of the impending offer becomes public, the price of the stock will rise toward the expected tender price. Thus, the primary inducement to stockholders—an offer to purchase their shares at an attractive price above the mar-

These possibilities are undesirable to *A*.[78]

Additionally, the collapse of merger negotiations with *Z* may subject *A* to shareholder suits for violating 10b-5[79]—the very fate it sought to avoid by disclosing. Investors could argue that *A*'s statement was misleading and caused them to purchase stock under the false but justifiable belief that the merger was definite.[80] Thus, the risk *A* sought to avoid by disclosing still exists.

Neither jeopardizing the merger nor defending a suit is tolerable to corporation *A*. Consequently, after considering the disadvantages, *A* will decide that full disclosure of the preliminary merger negotiations is unacceptable.

A's remaining option is to respond to the N.Y.S.E. inquiry with no comment, which "is the legal equivalent of not making a statement

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> ket—is lost, and the offeror may be forced to abandon its plans or to raise the offer to a still higher price. The cost . . . might prove prohibitive.

Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., 72 (1967) (statement of Donald L. Calvin, vice president, New York Stock Exchange, on behalf of the N.Y.S.E.). This reasoning is applicable to mergers and suggests the possible parade of horrors which might flow from the disclosure of merger negotiations. See Klein, Disclosure of Merger Negotiations, 19 Rev. Sec. & Commodities Reg. 8, 10 (January 8, 1986) (stating that early disclosure of merger negotiations pursuant to the SEC position may cause the stock prices of the company to rise and therefore increase the price of the transaction beyond an acceptable level).

78 In addition, society suffers when mergers are stifled because of speculative purchases. Mergers are becoming extremely common in the 1980's and economic efficiency argues strongly in their favor. See R. Posner, Economic Analysis of Law 181-83 (1977). When two companies merge, production facilities and distribution networks are integrated, enhancing profitability. See Scott, On the Theory of Conglomerate Mergers, 32 J. Fin. 1235 (1977). Moreover, "by a process of voluntary exchange, resources are shifted to those uses in which the value to the consumer, as measured by the consumer's willingness to pay, is highest. When resources are being used where their value is greatest, . . . they are being employed efficiently." Posner, supra, at 4. An artificial stock price increase that thwarts the potential merger leaves everyone dissatisfied. The purchasing company is worse off because its wish to purchase the target company—at a price that was probably higher than the pre-disclosure price—remains unfulfilled because the speculative price is too high. The shareholders are also worse off because they are holding stock worth far less than they paid for it. Thus, from an economic efficiency viewpoint, a requirement of full disclosure is inefficient because it can result in overvaluation of the target corporation's stock and deprive those who most value property possession of the property—be it money or the management of the company.

79 *A*'s negotiations may collapse either due to premature disclosure or independent reasons. In either case, the potential for suit is the same. See Greenfield v. Heublein, Inc., 575 F. Supp. 1325 (E.D. Pa. 1983). Shareholders who purchased shares at a rate inflated by the disclosure of merger discussions suffer an economic loss when the price of the stock collapses due to the downfall of the merger negotiations. "It is not difficult . . . to imagine such shareholders pursuing an action under Rule 10b-5 on the grounds that the disclosure of the preliminary merger discussions was materially misleading." Id. at 1336. See supra note 57. See also Klein, supra note 77, at 10 (disclosure of preliminary or tentative discussions may be misleading and subject the corporation to liability).

80 See supra note 56.

at all."[81] There are several advantages to this option. Since corporation *A* has no duty to disclose absent a statement, responding no comment in lieu of a statement will not give rise to liability under 10b-5.[82] Furthermore, by not disclosing the merger negotiations, *A* maintains the secrecy necessary to promote the negotiations.

In light of the balance between the two options under the SEC decision, "[n]o comment may become the new rule of the road."[83]

2. The Third Circuit Approach

If the Third Circuit decision in *Greenfield* becomes the majority rule, *A* would have the further option of issuing a no corporate development statement in response to the N.Y.S.E. inquiry. Since under this reasoning preliminary merger negotiations that have not reached agreement as to price and structure are not material facts,[84] *A* may issue this statement without fear of liability.

The issuance of a no corporate development statement does not impede the merger discussions with *Z*.[85] By denying the rumors of corporate activity, *A* does not contribute to the surge in investment and may actually relieve the increase in stock prices. In either case, *A*'s statement does not jeopardize the merger negotiations. Additionally, by not having specifically disclosed the existence of any negotiations, *A* will not incur liability if the negotiations fail.[86]

The no corporate development statement poses no disadvantages

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81 Greenfield v. Heublein, Inc., 742 F.2d 751, 760 & n.1 (3d Cir. 1984) (Higginbotham, J., dissenting), cert. denied, 105 S. Ct. 1189 (1985).

82 See supra notes 47-48 and accompanying text. There is no liability provided the corporation has not issued a previous statement on the topic. If it has, no comment may not be a permissible response. The no comment response itself, however, does not create a duty to update information previously disclosed. *Greenfield*, 742 F.2d at 763 (Higginbotham, J., dissenting). A corporation may have a duty to update a statement it has made if it becomes materially misleading in light of events subsequent to its issuance. Id. at 758. See Sharp v. Coopers & Lybrand, 83 F.R.D. 343, 346-47 (E.D. Pa. 1979). Consequently, *A* may have a duty to issue a comment if the N.Y.S.E. inquiry bears on a previous statement.

83 Hertzberg & Leefeldt, supra note 74, at 31, col. 6 (quoting Morris Kramer of Skadden, Arps, Slate, Meagher & Flom). See Klein, supra note 77, at 11.

84 See supra notes 60-64 and accompanying text.

85 Initially, rumors of a proposed merger cause the fluctuation of stock prices as speculation leads to a surge in demand for the stock. See Sterngold, A Bonanza in Pennzoil: Stock and Options Soar, N.Y. Times, Jan. 8, 1986, at D1, col. 4. This alone may threaten negotiations since the market price may approach the price the offering company, *Z*, may want to pay. However, by making a statement denying the rumors, a corporation may stabilize the market to some extent.

86 Under the SEC reasoning, see supra note 79 and accompanying text, *A* risked being sued for making a misleading statement if the negotiations failed. Under the *Greenfield* precedent, *A* avoids this risk. Since preliminary merger negotiations are not material under this approach, failure to disclose is not a violation of 10b-5 and poses no risk of countersuit if the negotiations fall through.

to *A*.[87] *A* is shielded from liability, and its negotiations with *Z* are not hampered. *A* still has the option, however, of making a no comment response.[88] There is less reason for *A* to make that choice than under the SEC approach because it is equally well-protected by responding with a no corporate development statement.[89]

3. Comparative Analysis

Neither the *Greenfield* view nor the SEC view in the above illustrations resulted in actual disclosure of preliminary merger negotiations.[90] Under the SEC's standard, corporation *A* would choose to make no comment because full disclosure destroys the secrecy necessary for successful negotiations. Additionally, since it is quite possible that negotiations in the early stages will be unsuccessful, it would be unwise for *A* to disclose information that actually might precipitate the downfall of the negotiations and form the basis of a suit.[91] Under the Third Circuit's standard, corporation *A* would choose to make a no corporate development statement because no comment is often misinterpreted and may jeopardize the negotiations. Thus, since a corporation will probably issue either a no comment response[92] or a no corporate development statement,[93] we need only compare the desirability of these two options.

Despite the appeal of making no comment,[94] "companies may be reluctant to issue a 'no comment' response . . . because that may be viewed as confirmation of the accuracy of the rumors"[95] that the corporation intends to merge. This interpretation is analogous to jury perception of the use of the fifth amendment privilege not to testify in a criminal trial as an admission of guilt.[96] If the public views the no

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87 This is true if no corporate development and the *Greenfield* decision become the accepted approach. Otherwise, a corporation risks the possibility of a court reaching a different materiality determination and finding a violation of 10b-5.

88 However, *A* may be better protected by issuing a no corporate development statement than a no comment response. See infra note 95 and accompanying text.

89 At later stages in negotiations, when a no corporate development statement is no longer available, the no comment option may become an important alternative to full disclosure.

90 This is a reflection on the practicality of the SEC's requirement.

91 See supra notes 73-80 and accompanying text. Disclosing the preliminary merger negotiations may jeopardize the negotiations due to rising stock prices and lack of secrecy. If the negotiations fall through due to disclosure, a threat of suit arises for issuing misleading information. *A* is better off not disclosing. See supra note 57.

92 See supra notes 81-83 and accompanying text.

93 See supra notes 84-89 and accompanying text.

94 See supra notes 81-82 and accompanying text.

95 Brodsky, supra note 47, at 28, col. 2. ("[T]he trading market may perceive [a no comment response] as an acknowledgment by the company that there are significant developments."); see Klein, supra note 77, at 11.

96 Courts have held that defendants may compel judges to instruct the jury that the failure

comment statement as an indication that something is brewing,[97] investors will buy the stock, prices will rise, and the merger negotiations may fall through as the higher market price serves to push the offering price beyond the level desired to be paid by the offering company. The net result may be the same as that under full disclosure—no merger. This fate is undesirable to the corporation.[98]

Courts choosing to follow either the SEC or the Third Circuit must consider which view furthers the purposes of rule 10b-5 and the Act—preserving free and honest markets, fostering investor trust, and protecting the investor.[99] A no comment statement does not further these goals. No accurate information is disclosed to the public and investors are encouraged to speculate at their own risk. This is tantamount to the revival of the concept of caveat emptor.[100] Additionally, the investor has no means of protecting himself under the Act. The no comment response is outside the scope of rule 10b-5 because a corporation that responds in this way is neither trading in its own stock nor issuing a statement.[101] Hence, there can be no violation of 10b-5 even if the corporation has reached an agreement in principle.

Alternatively, a no corporate development statement protects the corporation from liability and decreases the threat to negotiations.[102]

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of the defendant to take the stand, as allowed by the fifth amendment, does not give rise to a presumption of guilt. See United States *ex rel.* Mitchell v. Pinto, 438 F.2d 814, 817-18 (3d Cir.), cert. denied, 402 U.S. 961 (1971); State v. Smith, 100 N.J. Super. 420, 242 A.2d 49 (1968). The reason is that absent such an instruction "the jury is not likely to overlook defendant's failure to testify . . . and may very well draw adverse inferences." *Smith*, 100 N.J. Super. at 424, 242 A.2d at 51. "The layman's natural first suggestion would probably be that the resort to [the] privilege [not to testify] . . . is a clear confession of crime." 8 J. Wigmore, Evidence § 2272, at 426 (McNaughton rev. ed. 1961).

97 See supra note 95.

98 The type of corporation referred to throughout this analysis is one that must consummate the merger in order to fulfill its goal.

However, not all corporations will view the collapse of merger negotiations as undesirable. Rumors in the marketplace concerning the possible merger raise the price of the corporation's stock. Thus, when the negotiations fall through, the corporation is still a more valuable entity than before the negotiations began because shareholders may hold their stock in anticipation of an impending merger which keeps the stock price elevated.

99 See supra notes 25-28 and accompanying text.

100 See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977).

101 See supra text accompanying notes 32-33.

102 See supra notes 85-86 and accompanying text. There is, however, the possibility of an administrative problem for courts if they choose to follow the Third Circuit approach. Because that view differentiates between preliminary merger negotiations and agreements in principle, requiring that the latter and not the former be disclosed, courts will often be burdened with the task of scrutinizing the negotiations to determine their level of development. This burden does not exist under the SEC release as it found that any preliminary negotiations were material. See supra notes 65-67 and accompanying text. Further, when no comment is used under the full disclosure requirement, the issue of materiality is not reached at all. The possibility of an increased burden on the courts would be unlikely to prevent the use of the Third

Unlike the no comment response, it serves to promote the policies underlying the Act by protecting investors from information that is inherently unstable and therefore potentially misleading. A response of no corporate development at least tells the public that no agreement in principle to merge has been reached. Not even this much information is revealed when the corporation simply states no comment.[103]

If an investor learns that a corporation that issued a no corporate development statement had already reached an agreement in principle[104] at the time of making the statement, he has a cause of action against the corporation and is protected against his loss. This protection is not available to an investor who suffered from speculating in reliance upon a no comment response. Furthermore, this kind of protection was anticipated by the framers of the Act, whose goal was to protect investors,[105] and by subsequent courts interpreting the Act as implying a private right of action under rule 10b-5.[106]

While neither the rule of the Third Circuit nor that of the SEC results in actual disclosure of preliminary merger negotiations,[107] the Third Circuit's approach does more to serve the goal of disclosure. The no corporate development response informs the public that there is no "agreement in principle" to merge[108] while a no comment re-

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Circuit approach in the future. In weighing the goals of the Act against the burden to courts in enforcing a standard which promotes those goals, one certainly must conclude that the administrative task is necessary.

103 A no comment statement does not give the public any information concerning the corporation's activities. Upon its issuance, a corporation may be involved in preliminary merger negotiations, may have signed an agreement, or may not even be considering a merger. Alternatively, when a corporation issues a no corporate development statement, it is disclosing to the public that no agreement in principle to merge has been reached. Therefore, investors know that the corporation may at most be involved in preliminary discussions and may weigh that fact in determining how to act.

Under the efficient capital market model, the price of a security reflects all publicly available information about its issuer. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 383-84 (1970). This is "economically desirable because investment will be channeled into the most profitable areas and capital will be allocated efficiently." Dennis, Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix, 25 Wm. & Mary L. Rev. 373, 375 (1984) (citation omitted). Since "[a]ccurate information is necessary to ensure that money moves to those who can use it most effectively," a response to the N.Y.S.E. which gives the most information is desirable. Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 673 (1984). Consequently, a no corporate development statement, indicating to the investing public that no agreement in principle has been reached, enables the market to operate more efficiently than a no comment response, which leaves the public uninformed.

104 See supra notes 60-64 and accompanying text.

105 See supra note 28 and accompanying text.

106 See supra note 44 and accompanying text.

107 See supra text accompanying note 90.

108 See *Greenfield*, 742 F.2d at 756-57.

sponse increases investor speculation.[109] On balance, the Third Circuit's approach seems to be a logical precedent for future courts to follow. It allows corporations to protect their interests while furthering the goals of the Act and rule 10b-5 and promotes less speculation than does full disclosure or the no comment response which is often used in its place. These practical and policy advantages support the preference for classifying preliminary merger negotiations as not material.[110]

CONCLUSION

Courts have a choice between following the SEC's full disclosure or the Third Circuit's no corporate development reasoning. The issues examined in this Note illustrate the ramifications of the differing court interpretations and suggest that the no corporate development response strikes the best balance between the goals of the Act and the interests of corporations.

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109 See supra note 103.

110 See supra note 57 and accompanying text.