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Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws

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ILLEGAL CORPORATE PRACTICES AND THE DISCLOSURE REQUIREMENTS OF THE FEDERAL SECURITIES LAWS

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INTRODUCTION

THE mandatory disclosure and antifraud provisions of the federal securities laws[1] are a unique approach to federal regulation. In contrast to most other laws, the securities laws apply not solely to firms in a particular industrial or commercial sector but to virtually every enterprise that draws capital from public investors.[2] Because a disclosure scheme, by its nature, lacks its own set of substantive norms, publicly-held corporations are essentially free under the secur-

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1. The mandatory disclosure and antifraud provisions of the securities laws pertinent to this Article are found in the Securities Act of 1933 (1933 Act or Securities Act), 15 U.S.C. §§ 77a-bbbb (1976), and the Securities Exchange Act of 1934 (1934 Act, Securities Exchange Act or Exchange Act), 15 U.S.C. §§ 78a-kk (1976). Under the Securities Act, the core provisions are § 5, 15 U.S.C. § 77e (1976) (registration and prospectus requirements for an issuer's public offering of securities), and § 17(a), 15 U.S.C. § 77q (1976) (fraud prohibitions in the offer or sale of securities). Under the Securities Exchange Act, the pertinent provisions are § 13(a), 15 U.S.C. § 78m(a) (1976) (annual and periodic reporting requirements for publicly-held issuers), § 14(a), 15 U.S.C. § 78n(a) (1976) (proxy solicitation requirements), §§ 13(e) and 14(d), 15 U.S.C. §§ 78m(e), 78n(d) (1976) (issuer and third-party tender offer requirements), § 14(e), 15 U.S.C. § 78n(e) (1976) (prohibition of fraud in tender offers), and § 10(b), 15 U.S.C. § 78j(b) (1976) (fraud prohibitions in the purchase or sale of securities).

2. At the same time, Congress has provided in the securities laws for substantive regulation of market professionals—broker-dealers and investment advisers—investment companies and industry self-regulatory bodies, such as the exchanges and the National Association of Securities Dealers, Inc. (NASD). In contrast to the general trend of deregulation, Congress has in recent years expanded regulation under the securities laws to embrace others in, or at the periphery of, the securities markets. As amended by the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, the Securities Exchange Act now requires registration and regulation of "securities information processors," municipal securities dealers (including bank dealers), clearing agencies, registrars and transfer agents. Securities Exchange Act, §§ 11A(b), 15B, 17A(b), (c), 15 U.S.C. §§ 78k-1(b), 78o-4(a), 78q-1(b), (c) (1976). Moreover, in the 1975 Amendments, Congress established the Municipal Securities Rulemaking Board as a new self-regulatory body. Securities Exchange Act § 15B(b), 15 U.S.C. § 78o-4(b) (1976).

ities laws to order their own affairs. Corporations are restrained, however, by a myriad of other federal and state laws. The task of enforcing these laws is often entrusted to specialized agencies, which are expected to develop an expertise in their respective areas and to exercise discretion in deciding whether, and under what circumstances, to initiate enforcement actions.

Inevitably, occasions arise in which unlawful conduct by a corporation has import under both a substantive statute and the securities laws. When conduct is clearly illegal and likely to result in significant financial loss, the two statutory schemes may readily coexist and, indeed, complement one another. In other situations, the substantive violation may be unclear, the likelihood of detection or prosecution less than certain, and the damage to profitability, if any, difficult to determine. In these circumstances, the role of a disclosure system is more difficult to assess. Disclosure of illegal conduct falling within the bounds of an expansive materiality standard may be of marginal utility to investors, may burden corporations with unnecessary costs, and may diminish the clarity and focus of corporate filings. Moreover, practical and jurisprudential problems arise when the Securities and Exchange Commission (SEC) or a private plaintiff, in order to prove a disclosure violation, must first prove the illegality of underlying conduct. This is particularly the case when the alleged underlying violation falls within the primary jurisdiction of another expert agency or when the court before which the securities claim is pending would otherwise lack jurisdiction to pass upon the substantive violation.

This Article addresses the legal and policy issues arising from the disclosure obligations of the securities laws when corporate conduct is illegal or "questionable" under other laws, and suggests an approach to sharpen the contours of a duty to disclose corporate misconduct. No attempt is made to present a perfectly ordered model. The decisions in this area do not lend themselves to such an undertaking; a number have been settled by consent, and others have been decided with little attempt by the courts to enunciate principled standards.

From an examination of the case law and purposes underlying the securities laws, however, several factors that bear on the duty to disclose emerge. As addressed in this Article, these entail: (1) whether a type of illegal conduct is material per se; (2) whether discovery or cessation of illegal, or assertedly illegal, conduct may adversely affect future profitability, even if current earnings would not be substantially affected; (3) whether misleading or incomplete disclosure reflects adversely on the integrity of management; and (4) whether specific line item reporting requirements apply to the practices in question. Finally, cutting across these factors are problems of proof and considerations of comity that arise when enforcement of the securities laws depends upon an adjudication of conduct under separate legal standards.

To lay the groundwork, this Article begins with a brief overview of the securities law disclosure scheme.

I. Purposes of Disclosure

The disclosure requirements applicable to businesses whose shares are publicly traded form the heart of the federal securities laws.[3] Through enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress sought to ensure that important information bearing upon an issuer's business would be regularly disclosed to the market place, providing all participants the opportunity to make informed investment judgments.[4] Congress's imposition of affirmative disclosure obligations reflects the unique characteristics of securities. In contrast to products that lend themselves to physical inspection, securities are intangible interests and their trading takes place in an impersonal market. In light of these factors, and taking into account the central role of the securities markets, President Roosevelt in 1933 called for rules to govern those markets which differed from those regulating other forms of commerce.[5]

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3. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-78 (1977); Berman v. Gerber Prod. Co., 454 F. Supp. 1310, 1321 (W.D. Mich. 1978); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 563 (E.D.N.Y. 1971).

4. Addressing the disclosure provisions of the Securities Exchange Act, the House Committee on Interstate and Foreign Commerce explained that the excessive speculation characterizing the securities markets in the 1920's was attributable, in part, to "inadequate corporate reporting which keeps [investors] in ignorance of necessary factors for intelligent judgment of the values of securities." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934). To provide the investor with "an intelligent basis for forming his judgment as to the value of the securities he buys or sells," *id.* at 11, Congress supplemented the public offering disclosure requirements of the 1933 Act with the periodic reporting requirements of the 1934 Act. Through this approach, business facts that had been "the exclusive perquisite of powerful banking and industrial groups" would be available to all. *Id.* at 13; *accord* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc) ("The only regulatory objective [of § 10(b) and rule 10b-5] is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders."), *cert. denied*, 394 U.S. 976 (1969); *see* SEC v. Monarch Fund, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,148, at 96,337 (2d Cir. Oct. 23, 1979). The securities laws, however, stop short of requiring that all investors receive equal access to all pertinent information regardless of its nature or its source. Thus, the Supreme Court has rejected the notion that the securities laws require a "parity-of-information" where neither party to a trade has inside corporate information or owes the other an affirmative duty to disclose. Chiarella v. United States, 445 U.S. 222, 232-33 (1980).

5. The President, in his message to Congress, explained that proposed legislation, ultimately enacted as the Securities Act of 1933, "adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' " S. Rep. No. 47, 73d Cong., 1st Sess. 6 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). The strategy of mandatory disclosure, adopted in the wake of a decade of excessive speculation, was thus intended "to bring into the full glare of publicity those ele-

The choice of a disclosure model in the 1933 Act, however, reflects Congress's rejection of a more intrusive model, the "merit" regulation of securities issuances[6] that many states employ.[7] This federal strategy carried over to the Securities Exchange Act of 1934; the Senate version of the legislation leading to the 1934 Act had, in fact, expressly provided that "[n]othing in this Act shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer."[8] The Securities Exchange Act, as adopted, does not contain express language to that effect because Congress thought it unnecessary.[9]

While fostering informed investment decision-making is the fundamental purpose of the securities laws, Congress also intended to serve at least three subsidiary purposes. First, Congress perceived that the efficiency of the securities markets as a pricing mechanism would improve as trading came to reflect the assessments of an informed investing public.[10] The second by-product was the enhancement of investor confidence, which would lead in turn to increased stability in

ments of real and unreal values which may lie behind a security." *Id.* at 4; *cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("[T]he doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as [investment] advice and securities . . . .").

6. Indeed, both the 1933 Act and the 1934 Act expressly prohibit persons from representing that the SEC has passed upon the investment merits of any issuer's securities. Securities Act of 1933, § 23, 15 U.S.C. § 77w (1976); Securities Exchange Act of 1934, § 26, 15 U.S.C. § 78z (1976).

7. "The approach [of the blue sky laws] is a . . . paternalistic one: a state agency decides whether each security satisfies specified statutory standards . . . and, if not, the security is not considered sound enough to be offered in the state." L. Loss, Securities Regulation 36-37 (1951).

8. S. 3420, 73d Cong., 2d Sess. § 13(d) (1934); *see* S. Rep. No. 792, 73d Cong., 2d Sess. 20 (1934).

9. The Conference Report explained that "this provision is omitted from the substitute [bill] as unnecessary, since it is not believed that the bill is open to misconstruction in this respect." H.R. Rep. No. 1838, 73d Cong., 2d Sess. 35 (1934).

10. As the House Report accompanying the 1934 Act explained, "[t]he 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. . . . The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of securities values truth does find relatively quick acceptance on the market." H. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934); *see* Mundheim, *Selected Trends in Disclosure Requirements for Public Corporations*, 3 Sec. Reg. L.J. 3, 4 (1975). The efficient pricing of the "true" value of securities, coupled with federal authority to restrain the grant of credit for the purchase of securities, would, in Congress's view, greatly lessen the likelihood for excessive speculation. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8, 11 (1934).

the securities markets and greater infusions of capital for industry and commerce.[11]

Third, and most importantly, Congress understood that disclosure would effectively deter corporate misconduct which could not withstand public scrutiny.[12] As the SEC's Disclosure Policy Study explained in 1969:

> Although basically intended to inform, the disclosure provisions of the early Acts were expected to accomplish more. Their principal architects were disciples of Justice Brandeis who, in 1913, made the famous observation in *Other People's Money* that: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants . . ."
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> The fact that there is a significant degree of truth in such observations is attested by all who have worked with disclosure provisions of the '33 and '34 Acts. The registration process has sometimes been referred to as a housecleaning: one of its most valuable consequences is the elimination of conflicts of interest and questionable business practices which, exposed to public view, have what Justice Frankfurter once termed "a shrinking quality."[13]

The theory of deterrence as a secondary purpose of disclosure has found general support in the courts and among commentators.[14] The

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11. Without such confidence, Congress explained, "easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of [the economic] system. When everything everyone owns can be sold at once, there must be confidence not to sell." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

12. *See* Staff of House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess., Report of the Advisory Committee on Corporate Disclosure to the SEC 565 (Comm. Print 1977) [hereinafter cited as Advisory Committee Report]. "Disclosure was . . . thought to be a particularly versatile regulatory concept that, with a minimum of governmental interference to honest business, could be used to improve the fiduciary relationship between those in control of publicly held business enterprises and the investing public by indirectly deterring fraud and other more subtle forms of unethical behavior." *Id.*

13. SEC Staff, Disclosure to Investors (The Wheat Report) 50-51 (CCH Publ. No. 5213, 1969) (footnotes omitted).

14. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 Hastings L.J. 311, 312-13 (1974); Hewitt, *Developing Concepts of Materiality and Disclosure*, 32 Bus. Law. 887, 891 (1977); Mundheim, *supra* note 10, at 4, 27; Nelson, *Bribes, Kickbacks, and Political Contributions in Foreign Countries*, 1976 Wis. L. Rev. 1231, 1239; Sommer, *Therapeutic Disclosure*, 4 Sec. Reg. L.J. 263, 265 (1976); Sonde & Pitt, *Utilizing the Federal Securities Laws to "Clear the Air! Clean the Sky! Wash the Wind!,"* 16 How. L.J. 831, 842-43 (1971); Stevenson, *The SEC and the New Disclosure*, 62 Cornell L. Rev. 50, 60-62 (1976); Weiss, *Disclosure and Corporate Accountability*, 34 Bus. Law. 575, 589-90 (1979). A prime example of disclosure as deterrent is the SEC's "going private" rule. Rule 13e-3, 17 C.F.R. § 240.13e-3 (1981). Among other items of disclosure required, a corporation seeking to shed its publicly-held status must disclose to shareholders its belief in the fairness of the

SEC's Advisory Committee on Corporate Disclosure, comprised in part of members of the securities industry and securities bar, tacitly endorsed the proposition that disclosure may properly have a deterrent effect on conduct as a subsidiary purpose.[15]

The precise range of deterrence, however, remains a matter for debate. One school of thought advances disclosure to deter management self-dealing and conflicts of interest.[16] Others call for disclosure duties to sweep more broadly, in order to deter illegal or unethical corporate conduct that does not necessarily impair, and perhaps in some cases may even advance, corporate profitability.[17] This philosophical difference, in great measure, accounts for the uncertainty over the duty of issuers to disclose illegal conduct. Although courts have reached varying results, the contours of disclosure obligations are discernable.

II. Guideposts to Disclosure of Illegal Conduct Engaged in by Issuers or Their Agents

A. *Per Se Materiality*

If the need for certainty and a desire to promote deterrence were paramount objectives, they could be achieved through the application

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"going private" transaction and explain whether the corporation obtained an independent appraisal of the fairness of the transaction's terms. *See* schedule 13E-3, items 8, 9, 17 C.F.R. § 240.13e-100 (1981).

15. The Advisory Committee recommended that the SEC adopt the following standard to guide the agency's administration of the securities laws: "The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements *which have as their principal objective* the regulation of corporate conduct." Advisory Committee Report, *supra* note 12, at 305 (emphasis added). The SEC declined to endorse this recommendation out of concern that the standard would invite fruitless debate and litigation over whether regulation of corporate conduct in a particular instance was the Commission's primary, rather than secondary, objective. Securities Act Release No. 5906 (Feb. 15, 1978), [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,505, at 80,048. The Commission has, however, recognized that deterrence alone is an inadequate basis upon which to require disclosure. Securities Act Release No. 5627 (Oct. 14, 1975), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,713; *see* Sommer, *supra* note 14, at 265.

16. *See* Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 Va. L. Rev. 1099, 1247 n.527 (1977) (deterrence should extend only to "unethical behavior by controlling stockholders [and] . . . not [to] misconduct standing alone"). Legislative history speaks specifically to deterring conflicts of interest and breaches of fiduciary duty in connection with insider trading, *see* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934), and in the solicitation of shareholder proxies. *Id.* at 14. Manipulation was a second target of deterrence specifically identified by Congress. *Id.* at 11.

17. *See* Stevenson, *supra* note 14, at 53-66; Weiss, *supra* note 14, at 596-603.

of a "bright line" standard treating as per se material any form of corporate conduct known to be illegal, though yet to be adjudicated.[18] Such an approach, however, clashes with well-settled notions of materiality. The touchstone for materiality, as articulated by the Supreme Court in the context of proxy solicitation, turns upon

> [whether] there is a substantial likelihood that a reasonable shareholder would consider [an omitted fact] important in deciding how to vote. . . . 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.[19]

As the Supreme Court and lower courts have explained, the concept of materiality entails selectivity. Unless the disclosure system permits the filtering of facts of actual significance from a larger mass of facts, the

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18. The presence of materially misleading statements or omissions is generally a prerequisite to liability. For example, liability under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976), hinges on a false statement of a "material" fact in a registration statement or the omission of a "material" fact necessary to make other statements not misleading. *See also* Securities Act of 1933, § 8(d), 15 U.S.C. § 77h(d) (1976) (Commission "stop order" proceeding); *id.* § 12(2), 15 U.S.C. 77*l*(2) (1976) (liability in private action arising from offer or sale of a security); *id.* § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1976) (general antifraud prohibition); Securities Exchange Act of 1934, § 9(a)(4), 15 U.S.C. § 78i(a)(4) (1976) (false statements of material facts by broker-dealers to induce trading in exchange-listed securities); *id.* § 14(e), 15 U.S.C. § 78n(e) (1976) (material misstatements or omissions in connection with tender offers); rule 10b-5, 17 C.F.R. § 240.10b-5 (1981) (general antifraud prohibitions governing purchase or sale of securities under the Exchange Act); rule 14a-9, 17 C.F.R. § 240.14a-9 (1981) (antifraud prohibition governing proxy solicitations under the Exchange Act). There are instances, however, when liability may attach even if misleading statements or omissions are not material. *See infra* notes 108-11 and accompanying text.

19. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). The Supreme Court in *TSC* confined its materiality formulation to the proxy rules. Nonetheless, the *TSC* standard has been carried over to other provisions of the federal securities laws, notably rule 10b-5. *See, e.g.*, Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273, 1293 n.9 (9th Cir. 1979); Zweig v. Hearst Corp., 594 F.2d 1261, 1266 (9th Cir. 1979); SEC v. Blatt, 583 F.2d 1325, 1330 (5th Cir. 1978); Holmes v. Bateson, 583 F.2d 542, 558 n.20 (1st Cir. 1978); Harkavy v. Apparel Indus., Inc., 571 F.2d 737, 741 n.5 (2d Cir. 1978); Goldberg v. Meridor, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Hassig v. Pearson, 565 F.2d 644, 649-50 (10th Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236, 247-48 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 705 n.55 (D.D.C. 1978); SEC v. American Beef Packers, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,079, at 91,869-70 (D. Neb. May 4, 1977). Indeed, the *TSC* court cited with approval cases involving § 10(b) of the 1934 Act. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445 n.8 (1976). One year after *TSC*, the Supreme Court again suggested that the same materiality standard governed § 10(b) cases as well. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 n.14 (1977).

utility of disclosure to investors would be diminished.[20] Indeed, under the "buried facts" doctrine, a reporting company may incur liability when material facts, although disclosed, are obscured by their placement or by the inclusion of a mass of trivial information.[21]

Because the pertinence to investors of various forms of unlawful corporate conduct may differ, no court has held that unlawful conduct, standing alone, is material per se. The SEC itself eschewed a per se standard in the "sensitive payments" cases of the mid-1970's. In its Questionable Payments Report to Congress in 1976,[22] the SEC summarized the enforcement actions that it had taken against fourteen corporations and described its voluntary disclosure program, pursuant to which scores of other corporations eventually provided generic disclosure of "sensitive" payments. The SEC explained that the illegality of sensitive payments was not dispositive in determining a corporation's disclosure obligations, but was simply one factor, albeit "a particularly important factor," in assessing materiality.[23]

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20. *See* Tannenbaum v. Zeller, 552 F.2d 402, 433 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977); Umbriac v. Kaiser, 467 F. Supp. 548, 553 (D. Nev..1979). The *TSC* Court stated: "[I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976). Because an over-inclusive materiality standard is self-defeating, the Supreme Court in *TSC* rejected the Seventh Circuit's lower materiality threshold, which encompassed facts a reasonable investor "might" have considered important in determining how to vote. *Id.* at 449. The Supreme Court endorsed the more discriminating standard articulated by the Second and Fifth Circuits. *Id.* at 445, 449; *see* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-05 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301-02 (2d Cir. 1973).

21. *See, e.g.*, Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 774 (3d Cir. 1976); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971).

22. SEC, *Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices* (May 12, 1976) [hereinafter cited as *Questionable Payments Report*], *reprinted in* Sec. Reg. & L. Rep. (BNA) No. 353 (May 19, 1976).

23. *Id.* at 7. The SEC stated obliquely that "[w]here . . . payment violates United States laws, the Commission has adhered to policies governing the need for disclosure of violations of United States laws in other contexts." *Id.* As to foreign payments, the SEC stated: "If the payment is illegal under the local law of a foreign state—a fact which may not always be readily ascertainable—disclosure *may* be required." *Id.* (emphasis added); *see also* Statement of Hon. Roderick M. Hills, Chairman, SEC, Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm. (Jan. 14, 1976), *reprinted in* [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,364, at 85,966-67 (explaining a Commission determination that a corporation was not required to disclose past sensitive payments in view of (1) the company's privately held status at the time of the payments, (2) the small amounts involved, (3) the lowly official status of recipients, (4) non-involvement of

To this general policy, the SEC has fashioned exceptions in two areas. First, while the making of illegal political campaign payments is not, standing alone, material, the SEC's Division of Corporation Finance, in 1974, posited that any formal criminal charge of illegal domestic campaign contributions, without regard to amount, must be disclosed in 1933 Act registration statements and reports filed under the Securities Exchange Act.[24] In a second area, the SEC, until quite recently, required disclosure of all judicial or administrative proceedings by a governmental body arising under environmental protection laws or regulations, regardless of the amount of earnings or business at stake.[25]

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top management, and (5) accurate accounting for such payments by the company). The SEC's disavowal of a per se materiality standard drew criticism from the House Subcommittee on Oversight and Investigation, chaired by Representative John Moss, which called upon the agency to require detailed disclosure of any payment illegal under domestic or foreign law. Staff of Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 2d Sess., SEC Voluntary Compliance Program on Corp. Disclosure 12 (Comm. Print 1976).

24. Securities Act Release No. 5466 (Mar. 8, 1974), [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,699. Although the SEC's Division of Corporate Finance stated that criminal adjudication of unlawful contributions must be disclosed, *id.*, this broke little new ground, since line item disclosure of any criminal conviction of a director or an officer within a preceding five year period was already required in annual 10-K reports, item 12, 4 Fed. Sec. L. Rep. (CCH) ¶ 31,101, and in S-1 registration statements. Item 16, 2 Fed. Sec. L. Rep. (CCH) ¶ 7123. The Division suggested that disclosure may also be required of campaign contributions that "may be illegal" although not formally charged, but recognized that no per se rule could apply. Securities Act Release No. 5466 (Mar. 8, 1974), [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,699.

25. The Commission adopted the environmental disclosure requirement in Securities Act Release No. 5386 (Apr. 20, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,342. In later proceedings involving the Natural Resources Defense Council and other public interest groups, the Commission declined to approve a rule-making petition to extend the disclosure requirement to private environmental litigation. National Resources Defense Council v. SEC, 606 F.2d 1031, 1036-37 (D.C. Cir. 1979); *see* Securities Act Release No. 5627 (Oct. 14, 1975), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,718-19. The Commission based its decision upon difficulties inherent in distinguishing private suits which may be economically material from those seeking "substantially inflated" damages. *Id.* at 85,719. It should be noted that environmental disclosure is in some respect *sui generis*, because the SEC has relied not only upon its authority under the securities laws, but under the National Environmental Policy Act of 1969 (NEPA), 42 U.S.C. §§ 4321-4361 (1976 & Supp. III 1979), as well. *See* Securities Act Release No. 5386 (Apr. 20, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,342. But more recently, the agency has taken the position that NEPA, while permitting added disclosure, does not require unique disclosure rules for environmental matters. Opening Brief of the Securities and Exchange Commission at 61, Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031 (D.C. Cir. 1979) (agencies need only "*consider* environmental issues just as they consider other matters within their mandates" (emphasis in original) (quoting Calvert Cliffs' Coordinating Comm., Inc. v. United States Atomic Energy Comm'n, 449 F.2d 1109, 1112 (D.C. Cir. 1971)). On

B. *Financial Materiality*

The limited instances in which disclosure of illegal, although unadjudicated, conduct has triggered disclosure reinforce the premise that illegality alone is generally not dispositive. Instead, the standard of financial materiality, based on the premise that monetary gain is the paramount, if not sole, concern of stockholders,[26] must generally be met. Apart from current earnings and losses, the standard of financial materiality may require disclosure of matters that reflect upon the stability or "quality" of earnings. Because investors seek to minimize risks associated with any particular rate of return,[27] the SEC's disclosure rules demand adequate explanation of risks attendant to future profitability. A company's prospectus must therefore prominently display special risks,[28] and in disclosure documents generally, companies

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March 3, 1982, the Commission substantially relaxed disclosure requirements in this area. An issuer need disclose an environmental proceeding in which a governmental authority is a party only when the potential monetary sanction is $100,000 or greater. Securities Act Release No. 6383 (Mar. 3, 1982).

26. In explaining prospectus disclosure, the House Report in 1933 stated that the "type of information required to be disclosed is of a character comparable to that demanded by competent bankers from their borrowers." H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933). In the same vein, the SEC has stated: "The Commission's experience over the years in proposing and framing disclosure requirements has not led it to question the basic decision of the Congress that, insofar as investing is concerned, the primary interest of investors is economic. After all, the principal, if not the only reason why people invest their money in securities is to obtain a return. A variety of other motives are probably present in the investment decisions of numerous investors but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed." Securities Act Release No. 5627 (Oct. 14, 1975), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,721; *accord* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975) ("Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction . . . ."); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971) ("a fact is 'material' in a registration statement whenever a rational connection exists between its disclosure and a viable alternative course of action by any appreciable number of investors"). *But see* National Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689, 700 (D.D.C. 1974) ("There are many so-called 'ethical investors' . . . who want to invest their assets in firms which are concerned about and acting on environmental problems of the nation. This attitude may be based purely upon a concern for the environment . . . . Whatever their motive, this Court is not prepared to say that they are not rational investors and that the information they seek is not material information within the meaning of the securities laws.").

27. *See* Lewellen, *The Cost of Capital*, in V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 59-66 (2d ed. 1979). Stated otherwise, investors demand higher rates of return for their assumption of higher risks. *See* H. Markowitz, Portfolio Selection: Efficient Diversification of Investments 5-7 (1959).

28. Securities Act Release No. 4936 (Dec. 9, 1968), 1 Fed. Sec. L. Rep. (CCH) ¶ 3766.

must disclose, for example, the dependency of the company upon one or a few customers for any line of business,[29] any material portion of government business subject to renegotiation of profits or termination at the election of the government,[30] and any dependency upon foreign operations for any line of business.[31] SEC rules also require inclusion of any additional material information necessary to render representations made in disclosure documents, including financial statements, not misleading.[32] These "catchall" requirements may be triggered by any event that poses a significant new risk to the company's business.[33] Because information pertaining to lawful corporate activities or plans must be disclosed if financially material, it would be paradoxical if a corporation incurring, or about to incur, substantial economic loss could avoid disclosure solely because its losses arise from illegal practices.[34]

Stability of earnings may be seriously undermined if a company must resort to illegal measures in its efforts to compete. It is upon this basis that the SEC has predicated the obligation of an issuer to disclose

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29. Regulation S-K, item 101(c)(1)(vii), 47 Fed. Reg. 11,404 (1982) (to be codified at 17 C.F.R. § 229.101).

30. *Id.* item 101(c)(1)(ix), 47 Fed. Reg. 11,405 (1982) (to be codified at 17 C.F.R. § 229.101).

31. *Id.* item 101(d)(2), 47 Fed. Reg. 11,405 (1982) (to be codified at 17 C.F.R. § 229.101).

32. Securities Act rule 408, 17 C.F.R. § 230.408 (1981) (1933 Act registration statements); Securities Exchange Act rule 12b-20, 17 C.F.R. § 240.12b-20 (1981) (1934 Act registration statements, annual and periodic reports); Securities Exchange Act rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (1981) (proxy statements); schedule 14D-1, item 10(b), 17 C.F.R. § 240.14d-100 (1981) (tender offers).

33. *See* Securities Act Release No. 5447 (Dec. 20, 1973), [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,607 (disclosure of impact of possible fuel shortages).

34. So long as disclosure is required of the corporation and not an individual, no serious fifth amendment problems are posed, because it is well-settled that the privilege against self-incrimination is a "*personal* privilege," Couch v. United States, 409 U.S. 322, 328 (1973); Johnson v. United States, 228 U.S. 457, 458 (1913), and accordingly is unavailable to organizations that have a separate legal existence. Bellis v. United States, 417 U.S. 85, 101 (1974) (partnership); United States v. White, 322 U.S. 694, 698 (1944) (labor union); Wilson v. United States, 221 U.S. 361, 383-85 (1911) (corporation). As a corollary, corporate agents cannot assert a personal privilege against self-incrimination to resist demands for information made upon the organization. Bellis v. United States, 417 U.S. 85, 87-88 (1974); Wilson v. United States, 221 U.S. 361, 376 (1911). A separate line of cases requires disclosure—even by individuals—of information under an "essentially regulatory, not criminal" reporting scheme. California v. Byers, 402 U.S. 424, 430 (1971) (upholding requirement that automobile drivers report accidents). Applying the *Byers* standard, the Second Circuit has held that the disclosure requirements of the securities laws are essentially noncriminal and regulatory in nature, thus obviating the applicability of the fifth amendment. United States v. Stirling, 571 F.2d 708, 727-28 (2d Cir.), *cert. denied*, 439 U.S. 824 (1978); SEC v. Radio Hill Mines Co., 479 F.2d 4, 7 (2d Cir. 1973).

illegal or "sensitive" payments to domestic or foreign officials.[35] A theory of materiality based upon risks to earnings stability, however, can be applied to a wider range of illegal corporate conduct. First, unlawful practices may subject a company to substantial fines or require substantial expenditures in order to continue operations. For example, in *In re United States Steel Corp.*,[36] the SEC found that the respondent omitted estimated future capital expenditures for pollution control facilities required to satisfy clean water and air standards. The internal estimates far exceeded sums that the company had spent in earlier years.[37] In 1980, the SEC reached similar conclusions in *In re*

35. *Questionable Payments Report*, *supra* note 22, at 8. Inaccuracy in corporate books and records in accounting for the disposition of corporate assets will heighten "quality of earnings" materiality. The SEC found in the mid-1970's that financial statements of companies making sensitive payments invariably were distorted to conceal or obscure those payments. This falsification "cast[s] doubt upon [a company's] whole system of accounting" which is an "essential component of the disclosure system." *Id.* at 6-7. In Securities Exchange Act Release No. 13,185 (Jan. 19, 1977), [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,896, the SEC proposed rules that (1) required the maintenance of accurate books and records and an adequate system of internal accounting controls, and (2) prohibited the falsification of an issuer's accounting records and the making of false statements to the company's auditors. *Id.* at 87,377-82. The Foreign Corrupt Practices Act of 1977 (FCPA), Pub. L. No. 95-213, 91 Stat. 1494 (codified in scattered sections of 15 U.S.C.), codified the recordkeeping and internal accountability provisions contained in these proposed rules. *See* Securities Exchange Act §§ 13(b)(2)(A)-(B), 15 U.S.C. § 78m(b)(2)(A)-(B) (Supp. IV 1980). In 1979, the SEC adopted rules 13b-1 and 13b-2, 17 C.F.R. §§ 240.13b2-1 to -2 (1981), to supplement the statutory requirements. The FCPA also added a new § 30A to the Securities Exchange Act, 15 U.S.C. § 78dd-1 (Supp. IV 1980), to prohibit publicly held United States companies from making any payment to a foreign governmental or political official, or to an intermediary, to influence governmental or political party action. The SEC has stated that the various provisions of the FCPA "d[o] not alter the existing obligation of [reporting] companies adequately to disclose material questionable and illegal corporate payments and practices." Securities Exchange Act Release No. 14478 (Feb. 15, 1978), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,264 (announcing enactment of FCPA). At this writing, committees in the 97th Congress are revising the accounting and antibribery features of the FCPA, and some amendments are likely. The Senate has passed a bill, S. 708, 97th Cong., 1st Sess., 127 Cong. Rec. S13,969-71 (1981), which, among other things, transfers civil enforcement of § 30A from the SEC to the Justice Department and narrows the liability of United States corporations and officers for foreign bribes by intermediaries.

36. Securities Exchange Act Release No. 16,223 (Sept. 27, 1979), [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,319.

37. From 1974 through 1978, U.S. Steel spent $500 million on pollution control facilities. The company's internal cost estimates for the years 1979-1983, not disclosed in registration statements or periodic reports, ranged as high as $1.8 billion. *Id.* at 82,380 n.15. Although the SEC's line items required disclosure only of material environmental control expenditures for the next two fiscal years, Securities Act Release No. 5704 (Apr. 15, 1976), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,495, at 86,291-92, the SEC held that U.S. Steel, having derived estimates for several years beyond, was required to disclose them. [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 82,383-84. The SEC also found that U.S. Steel

Occidental Petroleum Corp.,[38] another administrative proceeding settled by consent. In that case, disclosure deficiencies were attributable to a wholly owned subsidiary, Hooker Chemical Company, which filed reports that failed to reveal both the total costs required to achieve compliance with environmental standards, and the potential fines attributable to past non-compliance.[39]

Disgorgement of funds or renegotiation of profits comprise another type of risk. For example, in *Heit v. Weitzen*,[40] a government contractor's failure to disclose a contingent liability stemming from overcharges to the federal government in "cost-plus" contracts rendered financial statements materially misleading.[41] Similarly, in *Gladwin v. Medfield Corp.*,[42] a health services company that had received substantial Medicaid overpayments violated the proxy rules by failing to tell shareholders of its contingent liability to return overpaid sums, even though the exact amount of overpayments had yet to be determined.[43]

A third risk is the potential loss of license or other disability that forecloses a line of business. In *Gladwin*, for example, Medicare's fiscal agent suspended payments to the company until past overpayments had been recovered.[44] This risk is also illustrated in a trilogy of cases—*Cooke v. Teleprompter Corp.*,[45] *SEC v. Jos. Schlitz Brewing Co.*,[46] and *SEC v. American Beef Packers, Inc.*[47] In *Cooke*, the district court found that proxy materials failed to advise shareholders that the former chief executive officer, convicted of bribery to secure cable television franchises, continued to play an active role in the company's affairs. Because his association could cost the company its federal licenses, the court held that the proxy statements were materi-

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failed to disclose a number of governmental proceedings involving environmental regulation. In this regard, the SEC interpreted its line item requirement pertaining to any environmental "proceedings . . . by governmental authorities" to include administrative proceedings initiated by a company, explaining that "[t]he obligation to disclose is triggered whenever governmental authority is a party to any administrative proceeding." *Id.* at 82,383.

38. Securities Exchange Act Release No. 16,950 (July 2, 1980), [1980 Transfer Binder] Fed. Sec. L. Rep. ¶ 82,622.

39. *Id.* at 83,348-53. Most costs for past noncompliance were attributable to Hooker Chemical, acquired by Occidental Petroleum in 1968. *Id.* at 83,347-48.

40. 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

41. *Id.* at 914.

42. 540 F.2d 1266 (5th Cir. 1976).

43. *Id.* at 1269.

44. *Id.* at 1268.

45. 334 F. Supp. 467 (S.D.N.Y. 1971).

46. 452 F. Supp. 824 (E.D. Wis. 1978).

47. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,079 (D. Neb. May 4, 1977).

ally deficient.[48] Similarly, in *American Beef Packers* proxy statements were found misleading for failing to disclose the existence of a cash fund used to bribe federal meat inspectors.[49] In contrast to *Cooke, American Beef Packers* involved unadjudicated, indeed uncharged, bribery, and although small in amount,[50] the payoffs were an integral part of the company's operations.[51]

In *Schlitz,* which involved kickbacks to retailers, the court found that violations of the antifraud, reporting and proxy provisions of the 1934 Act were properly alleged, notwithstanding the small sums paid.[52] The court reasoned that the success of the company's overall operations could be shown to derive from these payments, and that the company stood to lose its brewing license.[53]

In any case when materiality turns upon the prospect of a future event, the line between "fact" and mere speculation is a matter of degree, because each involves an element of prediction.[54] The Second Circuit's seminal decision in *SEC v. Texas Gulf Sulphur Co.*[55] calls for a two-part prediction, assessing (1) the likelihood that the future event will eventually occur, and (2) the impact which the event would have on the company's profitability.[56] Under this approach, the likelihood of a future event need not fall within any precise range of probability; even when the event is unlikely to occur, disclosure may be called for if the event's impact would be profound.[57] At least in the absence of insider profiteering, however, courts are reluctant,

48. 334 F. Supp. at 473-74. The court also reasoned that the company would be disadvantaged in seeking franchises from honest municipal officials because of its officer's record. *Id.* at 470-71.

49. SEC v. American Beef Packers, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,079, at 91,872-73 (D. Neb. May 4, 1977).

50. The *American Beef Packers* court established that bribes totalling approximately $31,000 were paid in each of two fiscal years. *Id.* at 91,872. During that period, the company ranked somewhere in the middle of the Fortune 500. *Id.* at 91,866.

51. *Id.* at 91,872. To generate the cash fund, the company sold an estimated $500,000 worth of meat for cash and failed to record those sales in the company's books. *Id.*

52. 452 F. Supp. 824, 830 (E.D. Wis. 1978). The alleged kickbacks of $3 million represented only 3% of net sales in 1976. *Id.*

53. *Id.*

54. To encourage companies' projections for future earnings and other forecasts, the SEC has adopted "safe harbor" rules to exempt from liability companies whose profit projections, made in good faith and based upon reasonable assumptions, turn out to be wrong. *See* Securities Act Release No. 6084 (June 25, 1979), [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (adopting Securities Act rule 175, 17 C.F.R. § 230.175 (1981); Securities Exchange Act rule 3b-6, 17 C.F.R. § 240.3b-6 (1981)). For a discussion of the usefulness and potential pitfalls of financial forecasts and other "soft" information, see Note, *Disclosure of Future-Oriented Information Under the Securities Laws,* 88 Yale L.J. 338 (1978).

55. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969).

56. *Id.* at 849.

57. *Id.* at 849-50.

given the advantage of hindsight, to impose antifraud liability when "predictive" disclosure has been delayed or later shown to have been inaccurate.[58]

Predicting the consequences of unadjudicated, illegal conduct may be especially problematic. The probability of detection and successful prosecution may vary greatly depending upon the nature of the misconduct and the enforcement priorities and resources of governmental authorities.[59] Requiring the public disclosure of these probabilities may turn into a self-fulfilling prophecy, raising the prospect of detection and prosecution from mere possibility to likelihood.[60]

As *Schlitz* and *American Beef Packers* demonstrate, a duty to disclose past or planned illegal activities, if financially material, may

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58. For example, in Harkavy v. Apparel Indus., Inc., 571 F.2d 737 (2d Cir. 1978), the Second Circuit, applying the *Texas Gulf Sulphur* balancing test, found that the company and its officer had no rule 10b-5 liability for failure to disclose the company's plans to expand into a promising new product line. The plaintiff had sold his stock in 1969. The court of appeals held that discussions among management in 1969 were simply tentative. *Id.* at 741-42; *see also* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.) (per curiam) (timing of earnings report is matter of business judgment), *cert. denied*, 414 U.S. 874 (1973); Mesh v. Bennett, 481 F. Supp. 904, 905 (S.D.N.Y. 1979) (no rule 14a-9 violation for failure to provide estimate of the total cost of changes to company's executive incentive stock purchase plan, because such a statement "would have been only speculation"); Marks v. Lainoff, 466 F. Supp. 301, 302 n.1 (S.D.N.Y. 1979) (although merger between defendant company and another may have been discussed, no violation of rule 14a-9 because "merger plans appear to be vague and indefinite at best"). *But see* Marx v. Computer Sciences Corp., 507 F.2d 485, 490 (9th Cir. 1974) (earnings forecast must have reasonable basis when made); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302-03 (2d Cir. 1973) (proxy statement for merger inadequately advised shareholders of plan to sell plants of acquired company). The SEC itself recognizes that companies that make earnings projections or other forecasts do not automatically incur liability if their predictions are later proven wrong. *See supra* note 54.

59. Although predictive disclosure which must take into account the actions of a foreign country is particularly speculative, the SEC has suggested that a company making sensitive payments abroad may have to disclose the risk that a foreign nation could expropriate the company's assets located within its borders. *Questionable Payments Report*, *supra* note 22, at 5. Because of the enormous impact of expropriation, even its mere possibility may suffice to require disclosure under the *Texas Gulf Sulphur* approach.

60. A company may contend that even if its unlawful conduct were known to the government, the chances of prosecution and sanction would be slight. In SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978), for example, the company contended in a motion to dismiss that a suspension of its license was unlikely, given the approach historically taken by the Department of Treasury of not bringing criminal prosecutions under the Federal Alcohol Administration Act, 27 U.S.C. §§ 201-212 (1976). *Id.* at 830. The court, in denying the motion to dismiss, drew some support from the allegation that the government had previously warned the company in 1973 to stop its practice of paying kickbacks. *Id.* The pendency of a criminal indictment against the company, *id.* at 832-33, may also have been persuasive. The court, however, did not expressly rely on this *post hoc* event in reaching its decision.

require, in effect, self-accusation by the company. In *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*,[61] the district court departed from the reasoning found in those cases and posited that the proxy rules simply could not be read to require disclosure of management's plans to violate the labor laws. The court rejected "a parsing of the words of the [proxy] rule," instead relying upon its "overall understanding" of rule 14a-9, and stated:

> No matter how the proxy rule is construed, indeed even if it explicitly stated such a duty, corporate management would not announce in proxy literature an intention to violate laws. It is simply contrary to human nature. The rule, if it were construed to require this, would never succeed in its purpose of bringing such disclosure to the shareholders.[62]

The *J.P. Stevens* court, however, failed to appreciate that a company which plans to pursue illegal activities does have an alternative to self-accusation—to conduct the company's affairs in compliance with the law. Moreover, the court overlooked the more basic proposition that disclosure of any adverse fact, whether relating to illegal conduct or not, may be contrary to human nature and that a company, if given a choice, would often avoid the timely disclosure of unfavorable, although material, information. It is for this very reason that the securities laws impose mandatory disclosure obligations embracing both adverse and favorable financially material information.[63] As additional cases in this area are decided upon financial materiality grounds, it seems unlikely that many courts will accept the *J.P. Stevens* rationale that the self-accusatory nature of disclosure somehow detracts from materiality.

61. 475 F. Supp. 328 (S.D.N.Y. 1979), *vacated as moot per curiam*, 638 F.2d 7 (2d Cir. 1980).

62. *Id.* at 332; *cf.* Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981) (unadjudicated corporate bribes, absent kickbacks or other self-dealing, not material under proxy rules); SEC v. Chicago Helicopter Indus., Inc., No. 79-C-0469, slip op. at 4 (N.D. Ill. Jan. 18, 1980) (unadjudicated violation of banking laws by corporate directors not material, since "[i]t is unlikely that the materiality requirement of Section 10(b) was ever intended to require management to accuse itself of antisocial behavior").

63. Thus, the SEC in its *amicus curiae* brief filed with the Second Circuit in *J.P. Stevens* stated: "[I]t is clear that future plans of a corporation must be disclosed where they are material and *legal*, and there is no basis for concluding that disclosure obligations may be avoided by making future *illegal* plans. The very concept of disclosure may be contrary to human nature, in that management might prefer to conceal all unfavorable information about a company, including such matters as financial losses. Nevertheless, the essence of the federal securities laws, as stated in the preamble to the Securities Act of 1933, is 'to provide full and fair disclosure.' " Memorandum of the Securities and Exchange Commission, *amicus curiae*, at 17-18, Amalgamated Clothing and Textile Workers Union v. J.P. Stevens & Co., 638 F.2d 7 (2d Cir. 1980) (emphasis in original) (per curiam).

C. *Illegal Practices and Integrity of Management*

The primacy with which investors view financially important information may suggest that there is little room left for any other measure of materiality under the securities laws. Indeed, the SEC in the late 1970's, in considering rulemaking petitions that called for the adoption of disclosure rules covering a host of social policy issues, based its rejection of such proposals upon a financial materiality standard.[64] The SEC concluded that if economic concerns were not preeminent, the bounds of materiality would be difficult, if not impossible, to fix.[65] Furthermore, the SEC explained that requiring disclosure of information bearing upon matters of social policy, which may be sought only by "limited segments of the investing public" without regard to the economic importance of that information, would, in effect, compel a subsidy of the costs of such additional disclosure by corporations and shareholders.[66] In light of these considerations, after elaborate ad-

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64. In its release seeking comment on disclosure rules sought by environmental interest groups, the SEC stated: "The [Securities] Acts and the relevant legislative history suggest that a prime expectation of the Congress was that the Commission's disclosure authority be used to require the dissemination of information which is or may be economically significant." Securities Act Release No. 5627 (Oct. 14, 1975), [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,710.

65. The Commission stated: "As a practical matter, it is impossible to provide every item of information that might be of interest to some investor in making investment and voting decisions . . . . [P]articipants in the proceeding suggested more than 100 topics concerning which they desired disclosure. A disclosure document which incorporated each of the suggestions would consist of excessive and possibly confusing detail . . . ." *Id.* at 85,712.

66. *Id.* at 85,712-13. By implication, the SEC, in referring to "limited segments of the investing public," suggested that determinations of materiality could perhaps turn on empirical measurements of the number of investors who deemed particular items of information significant in making investment or voting decisions. Presumably, information bearing on a company's trading with South Africa, even if insignificant from an earnings standpoint, might be material for particular companies if a clear majority of their investors place importance on such disclosure. Elsewhere in its release, the SEC retreated from the implication that materiality may be shaped by periodic sampling of investor interest. Such an approach "would at best produce results that might rapidly become outdated in light of the shifting and fluctuating nature of public opinion and the focus on popular opinion from time to time." *Id.* at 85,712. In its brief on appeal in Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031 (D.C. Cir. 1979), however, the Commission, by use of a double negative, reserved the possibility that materiality standards, in the exercise of the Commission's discretion, could be derived through empirical measurement of investor concerns. *See* Opening Brief of the Securities and Exchange Commission at 55 n.68, Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031 (D.C. Cir. 1979) (although disclosure of financial information "is the raison d'etre of the disclosure provisions of the securities laws . . . it does not follow that the Commission may not consider, in

ministrative proceedings and extensive litigation, the SEC declined to adopt proposals to require certain "social" disclosures bearing upon a company's impact on the environment and upon the company's equal employment opportunity practices.[67]

While economic concerns may be the touchstone of materiality for investors who are deciding whether to buy or sell securities, the concept of materiality has traditionally been thought to have a broader scope in the corporate suffrage setting. In providing the SEC with authority to prescribe disclosure rules governing the proxy solicitation process,[68] Congress understood that information concerning the integrity and fidelity of corporate management was of great importance to investors when called upon to elect directors or approve proposals advanced by management.[69] Thus, even when illegal corporate con-

deciding what disclosure rules to adopt, the nature of investor interest in various types of information" (emphasis omitted)). The Commission has, in fact, placed weight on investor surveys in fashioning certain disclosure rules. *See* Securities Act Release No. 5949 (July 28, 1978), [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,649, at 80,618 n.7 (adopting disclosure rules for legal proceedings involving management as parties). There is, moreover, some judicial support for empirically derived materiality. *See* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971).

67. The SEC thus specifically declined to adopt disclosure rules requiring: (1) a listing of all pending environmental or equal employment opportunity litigation; (2) a statement of the company's "environmental policy"; (3) a summary of all expenditures made to satisfy environmental standards; (4) a comprehensive explanation of the effects which corporate operations have on the environment; and (5) statistics bearing upon equal employment opportunity within the company. Securities Act Release No. 5627 (Oct. 14, 1975), [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,717-19, 85,723-25. The SEC did propose to require in registration statements and in periodic reports and proxy solicitation materials disclosure of a list of environmental compliance reports filed by a company within a twelve-month period that indicated failure to meet environmental standards. Secondly, the SEC proposed to require in certain registration and reporting forms disclosure of estimated material capital expenditures for environmental control facilities for at least the current and succeeding fiscal years. In subsequent action, the SEC adopted the "capital expenditures" proposal but declined to adopt the "compliance report" proposal. Securities Act Release No. 5704 (May 6, 1976), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,495. The Commission's disposition of the rule-making petitions was sustained by the D.C. Circuit in Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031, 1062 (D.C. Cir. 1979).

68. Section 14(a) of the Securities Exchange Act requires proxies to comply with "such rules and regulations as the Commission may prescribe . . . ." 15 U.S.C. § 78n(a) (1976). The SEC has implemented this authority through rules 14a-1 to 14a-12, 17 C.F.R. §§ 240.14a-1 to -12 (1981). *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 444 (1976) (§ 14(a) enacted to promote the free exercise of stockholders' voting rights); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381 (1970) (same); J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964) (speaking of the "broad remedial purposes" of § 14(a), and explaining that Congress perceived "[f]air corporate suffrage [as] an important right that should attach to every equity security bought on a public exchange" (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934))).

69. A Senate Report in 1934 explained that: "Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which

duct may have little immediate impact on corporate profitability, materiality may yet be present if this information is pertinent to investors in assessing the integrity of management.

Although viewed as a separate standard of materiality, "management integrity" is, in a sense, closely tied to financial materiality.[70] Shareholders are no more altruistic than others: They do have an interest, however, in ensuring that corporate fiduciaries subordinate any self-interest that conflicts with the duty to maximize corporate profitability. Consistent with their general aversion to risks, prudent shareholders seek to avoid the risk of loss which may arise from management self-dealing. While an isolated instance of self-dealing may be inconsequential, the opportunity for repetition may be important from a strictly financial standpoint.[71]

Because of this congruence with financial materiality, "integrity of management" materiality most clearly applies when management obscures facts regarding self-dealing or conflicts of interest.[72] In

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authority to cast his vote is sought. For example, in one case . . . proxies were solicited . . . by means of a letter which purported to describe certain transactions . . . [but] which omitted all mention of other important details such as previously granted secret options in the corporation's stock, and the president's individual interest in an underwriting agreement made by the corporation, which furnished the real motive behind the request for ratification." S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934); *see also* 78 Cong. Rec. 7861-62 (statement of Congressman Lea recounting instances of management voting itself "vast bonuses out of all proportion to what legitimate management would justify" and other abuses which raise questions over both the "integrity of . . . management" and the "prudence of . . . investment" in such corporations).

70. Indeed, an early case in which the SEC articulated the "integrity of management" theory involved a public offering of securities, not a solicitation of proxies. *In re* Franchard Corp., 42 S.E.C. 163 (1964). The SEC in *Franchard* reasoned: "Of cardinal importance in any business is the quality of its management. . . . In many respects, the development of disclosure standards adequate for informed appraisal of management's ability and integrity is a difficult task. . . . Managerial talent consists of personal attributes, essentially subjective in nature, that frequently defy meaningful analysis through the impersonal medium of a prospectus. Direct statements of opinion as to management's ability, which are not susceptible to objective verification, may well create an unwarranted appearance of reliability if placed in a prospectus. The integrity of management—its willingness to place its duty to public shareholders over personal interest—is an equally elusive factor for the application of disclosure standards. Evaluation of the quality of management—to whatever extent it is possible—is an essential ingredient of informed investment decision. A need so important cannot be ignored, and in a variety of ways the disclosure requirements of the Securities Act furnish factual information to fill this need." *Id.* at 169-70 (footnotes omitted).

71. *Id.* at 170. In *Franchard*, the promoter's diversion of corporate assets for personal use amounted to no more than 1.5% of the company's assets. *Id.* at 171.

72. Maldonado v. Flynn, 597 F.2d 789, 796-97 (2d Cir. 1979); Bertoglio v. Texas Int'l Co., 488 F. Supp. 630, 658 (D. Del. 1980); SEC v. Kalvex Inc., 425 F. Supp. 310, 315 (S.D.N.Y. 1975); Rafal v. Geneen, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,505, at 92,441 (E.D. Pa. May 8, 1972); Robinson v. Penn Cent.

Maldonado v. Flynn,[73] shareholders in a derivative suit alleged that proxy solicitation for the election of directors was materially misleading for failing to disclose actions taken by directors in connection with the company's stock option plan for key employees. Allegedly in anticipation of the company's tender for its own stock at a premium, a quorum of directors voted to amend the company's stock option plan to permit six senior officers, four of whom were also directors, to accelerate their purchase of company stock. The directors also voted to grant interest-free loans to finance the purchases. The Second Circuit held that failure to disclose the self-interest of four directors in these amendments to the stock option plan was actionable under the proxy rules,[74] because self-dealing by directors is a key indicium of their qualifications to serve as corporate fiduciaries.[75] Similarly, the court in *Bertoglio v. Texas International Co.*[76] held that management breached the proxy rules by omitting mention of changes in the company's stock option plan which were advantageous to directors and officers by increasing the likelihood of early vesting. Although finding the facts "less compelling" than those in *Maldonado* because management ultimately did not reap any benefit,[77] the court explained that shareholders were entitled to know not only about actual abuse, but "opportunities for abuse" as well.[78] The court thus ordered the election of directors set aside and required a resolicitation of proxies from shareholders.[79]

In both *Maldonado* and *Bertoglio*, omissions bearing on self-dealing rendered express statements in the proxy statement misleading,

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Co., 336 F. Supp. 655, 658 (E.D. Pa. 1971); Beatty v. Bright, 318 F. Supp. 169, 174 (S.D. Iowa 1970).

73. 597 F.2d 789 (2d Cir. 1979).

74. The Second Circuit stated: "This claim does not present merely another attempt to use § 14(a) and Rule 14a-9 as an avenue for access to the federal courts in order to redress alleged mismanagement or breach of fiduciary duty on the part of corporate executives . . . . [T]he alleged misleading statements and non-disclosures involve matters of direct and deep concern to shareholders in the exercise of their right to vote, which the Exchange Act expects to be fully disclosed in proxy solicitations for election of officers and directors." *Id.* at 796.

75. The court observed: "Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly relevant to a determination of whether they are qualified to exercise stewardship of the company." *Id.* The Second Circuit drew additional support from the applicability of specific line item disclosure requirements under the proxy rules dealing with management remuneration. *Id.*

76. 488 F. Supp. 630 (D. Del. 1980).

77. *Id.* at 647.

78. *Id.* (citing Maldonado v. Flynn, 597 F.2d 789, 796 (2d Cir. 1979)).

79. 488 F. Supp. at 662-63. The court ordered this relief, notwithstanding the "unclean hands" of proxy opponents who themselves were found to have violated the proxy rules. *Id.* at 662. *But see* Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973) (proxy violations by both sides; no relief awarded).

thereby creating liability under rule 14a-9 for "half-truths."[80] Going one step further, in *Rafal v. Geneen*,[81] the district court found that a proxy statement omitting mention of pending litigation made an implicit representation of management integrity misleading.[82] The court stated that

> in their proxy statement they have elegant pictures of the directors and precise notations of their academic background and corporate experience. In short, these qualifications suggest an imprimatur of extraordinary excellence, responsibility and good judgment—on the basis of their past positions in the corporate world and in the nation.[83]

One hurdle faced by plaintiffs in self-dealing cases, however, is the distinction between fact and motive. As long as objective data are accurately disclosed to shareholders, no liability attaches if a company chooses not to characterize the motive or "true purpose" underlying a particular transaction.[84] As the Second Circuit recognized in *Goldberg v. Meridor*,[85] insiders need only disclose the facts bearing on the conflict of interest, and are not compelled to employ "pejorative nouns or adjectives."[86] Even if material, according to some courts,

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80. Maldonado v. Flynn, 597 F.2d 789, 797-98 (2d Cir. 1979); Bertoglio v. Texas Int'l Co., 488 F. Supp. 630, 659-61 (D. Del. 1980). Failure to disclose material facts does not, ipso facto, create antifraud liability. Chiarella v. United States, 445 U.S. 222, 232-33 (1980) (no liability under rule 10b-5 for silence in the purchase or sale of securities, absent an affirmative duty to disclose).

81. [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,505 (E.D. Pa. May 8, 1972).

82. *Id.* at 92,441. The court found the proxy statements misleading for ignoring that three director nominees were defendants in a derivative action charging a "violation" under § 16(b) of the Securities Exchange Act. *Id.* Notwithstanding the court's characterization, § 16(b) is incapable of "violation." It does not, by its terms, prohibit insiders from engaging in short-swing trading, *see* D. Cook & M. Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 407 (1953) (§ 16(b) "merely provide[s] for civil liability to the corporation for any profits which may have been realized from the short-swing trading"), and those who do are not subject to SEC prosecution for that reason alone. 3B H. Bloomenthal, Securities and Federal Corporate Law § 10.02 (rev. ed. 1981).

83. [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 92,442. The court in *Rafal* appeared to apply the "might" standard rejected by the Supreme Court in *TSC* four years later. The *Rafal* court stated: "No substantial reason has been given as to why IT&T shareholders were not informed of these suits, and no one could argue that the information would have been 'trivial' or irrelevant to some stockholders. . . . I am not unaware of the facts of corporate proxy life. Maybe it won't make any difference to a majority, maybe it will make a difference to only a few, but those few cannot be precluded from knowing the salient facts." *Id.*

84. *See infra* notes 85-87 and accompanying text.

85. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

86. *Id.* at 218 n.8; *see* Rodman v. The Grant Found., 608 F.2d 64, 71 (2d Cir. 1979); Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 610 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Selk v. St. Paul

the motive of management to maintain control is so obvious that omitting to disclose that point is not misleading.[87]

When misconduct not involving self-dealing is concerned, courts generally have declined to predicate materiality on an "integrity" standard.[88] In *Lyman v. Standard Brands Inc.*,[89] for example, shareholders contended that a proxy statement seeking ratification of an auditor's appointment was misleading for omitting that three former employees in a branch office of the auditor had been indicted for securities fraud and that the firm itself had been named as an unindicted co-conspirator. Although recognizing the viability of "management integrity" materiality,[90] the court found no material omission since "[t]he indictment of three employees in [the auditing firm's] office which has had no connection with Standard Brands audit has only the most tenuous relationship to the shareholders' selection of the corporation's independent auditors."[91] Similarly, the Second Circuit, in *Seibert v. Sperry Rand Corp.*,[92] found no deficiency in a company's proxy statement which did not mention that a director nominee was also a director of another company plagued by labor disputes. The court of appeals concluded that vagaries of injury to "corporate image" do not suffice to establish materiality.[93]

Ammonia Prods. Inc., 597 F.2d 635, 639 (8th Cir. 1979); Biesenbach v. Guenther, 588 F.2d 400, 402 (3d Cir. 1978); Golub v. PPD Corp., 576 F.2d 759, 765 (8th Cir. 1978); Bertoglio v. Texas Int'l Co., 488 F. Supp. 630, 650 (D. Del. 1980); Lewis v. Oppenheimer & Co., 481 F. Supp. 1199, 1204 (S.D.N.Y. 1979); Lavin v. Data Systems Analysts Inc., 443 F. Supp. 104, 107 (E.D. Pa. 1977), *aff'd*, 578 F.2d 1374 (3d Cir. 1978); Falkenberg v. Baldwin, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,086, at 91,911 (S.D.N.Y. June 13, 1977). *But see* SEC v. Parklane Hosiery Co., 558 F.2d 1083, 1086 (2d Cir. 1977) (proxy statement misleading in failing to disclose that repayment of personal debts of majority stockholder was purpose behind going-private merger).

87. *See, e.g.*, Rodman v. The Grant Found., 608 F.2d 64, 71 (2d Cir. 1979); O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964); Bertoglio v. Texas Int'l Co., 488 F. Supp. 630, 650 (D. Del. 1980); Falkenberg v. Baldwin, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,086, at 91,911 (S.D.N.Y. June 13, 1977).

88. *See, e.g.*, Hoffman v. Estabrook & Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,587 (1st Cir. Oct. 26, 1978); Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328, 332 (S.D.N.Y. 1979), *vacated as moot per curiam*, 638 F.2d 7 (2d Cir. 1980); Babcock & Wilcox Co. v. United Technologies Corp., 435 F. Supp. 1249, 1289 (N.D. Ohio 1977); Lyman v. Standard Brands, Inc., 364 F. Supp. 794, 798 (E.D. Pa. 1973).

89. 364 F. Supp. 794 (E.D. Pa. 1973).

90. *Id.* at 797 ("full disclosure of pending litigation is especially important if it has any bearing on the competence or motives or integrity of the soliciting directors").

91. *Id.* at 798.

92. 586 F.2d 949 (2d Cir. 1978).

93. *Id.* at 952. The court of appeals also noted that J.P. Stevens' labor record had been widely reported in the media and was a matter of public knowledge. Thus, Sperry Rand's proxy statement was not misleading for not repeating information already in the public domain. *Id.*

In cases when management's actions, although perhaps ill conceived, were undertaken solely to advance corporate interests, courts have been even more reluctant to find disclosure violations. In *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*,[94] the district court observed that such conduct, whether legal or not, is entitled under state law to the protection afforded by the business judgment rule. In the court's view, a policy to violate the labor laws was a matter of business judgment which need not be disclosed in proxy solicitations.[95] The Ninth Circuit articulated similar reasoning in *Gaines v. Haughton*,[96] a proxy case arising from illegal foreign payments paid by Lockheed in the 1970's. Although self-dealing by directors may be "presumptively material," the court held that mismanagement is "never material" under proxy rules,[97] and accordingly dismissed the shareholders' complaint.[98] Invoking the policy reasons of *Santa Fe Industries v. Green*,[99] the Ninth Circuit emphasized that claims of mismanagement belong in state court and that "if all else fails," shareholders can sell their stock.[100]

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94. 475 F. Supp. 328 (S.D.N.Y. 1979), *vacated as moot per curiam*, 638 F.2d 7 (2d Cir. 1980).

95. *Id.* at 331. While rejecting "integrity" materiality, the *J.P. Stevens* court failed to evaluate the financial materiality of the company's labor policy. The proxy rules do not exclude information regarding wasting of corporate assets simply because management could invoke the business judgment rule if sued in state court. Rule 14a-9, 17 C.F.R. § 240.14a-9 (1981), requires the disclosure of *any* material fact necessary to avoid the misleading presentation of other facts set forth in the proxy statement. The *J.P. Stevens* court, failing to address economic materiality, instead knocked down a straw man, stating that: "As to plaintiffs' allegation that Stevens' labor policy has resulted in significant expenses, management is clearly not required to submit in proxy statements . . . all business judgments whenever it would be possible for shareholders to disagree with their efficacy or wisdom." 475 F. Supp. at 331.

96. 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 50 U.S.L.W. 3547 (U.S. Jan. 11, 1982).

97. *Id.* at 776-77.

98. *Id.* at 780. Prior to passage of the Foreign Corrupt Practices Act in 1977, *see supra* note 35, foreign bribes were not explicitly prohibited under United States law. The Ninth Circuit limited its holding to "non-criminal [directors'] conduct in proxy solicitations for their re-election," 645 F.2d at 777 n.24, and, thus, left unresolved whether criminal conduct not involving self-dealing is material under the proxy rules.

99. 430 U.S. 462 (1977).

100. 645 F.2d at 779. In support of a self-dealing/mismanagement dichotomy, the Ninth Circuit cited *Santa Fe* for the proposition that no antifraud cause of action is available when the "essence" of a complaint involves allegations of breach of fiduciary duty. *Id.* at 779 n.33. In contrast to *Gaines*, however, *Santa Fe* presented no allegation of deception, and the Supreme Court held only that breach of fiduciary duty alone—without deception—did not fall within rule 10b-5. 430 U.S. at 474-76. Indeed, the *Santa Fe* Court distinguished cases in which "breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception." *Id.* at 474-75; *see* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)

In a related line of cases, private litigants have met with a singular lack of success in proxy suits brought to recover money damages or restitution from corporate managers who have paid bribes or made questionable payments to improve corporate earnings. Even if proxy materials were misleading in regard to the qualifications of directors, courts have held that solicitation of proxies to elect directors lacks a sufficient causal nexus to later payment of bribes or other illegal conduct to permit monetary relief.[101] As one district court reasoned, a "but for" standard of causation is simply too broad and would

("Congress . . . did not seek to regulate transactions which constitute *no more than* internal corporate mismanagement." (emphasis added)). The Ninth Circuit itself has acknowledged that a single set of facts may give rise to both fiduciary duties and securities antifraud violations. Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273, 1291 (9th Cir. 1979) ("every breach of fiduciary duties is [not] necessarily immune from invocation of [rule 10b-5]"). Indeed, concealing facts that may hamper the ability of shareholders to obtain relief in a state court for breach of fiduciary duty may constitute a deception under the securities laws. *Id.* at 1292; *see infra* notes 122-26 and accompanying text; *see, e.g.*, Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 645-47 (3d Cir. 1980); Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 614 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Goldberg v. Meridor, 567 F.2d 209, 220-21 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Wright v. Heizer Corp., 560 F.2d 236, 250 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

101. Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); Lewis v. Valley, 476 F. Supp. 62 (S.D.N.Y. 1979); Herman v. Beretta, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,574 (S.D.N.Y. Oct. 10, 1978); *In re* Tenneco, Inc. Sec. Litig., 426 F. Supp. 1187 (J.P.M.D.L. 1977); Limmer v. General Tel. & Elec. Corp., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,111 (S.D.N.Y. Mar. 21, 1977); Lewis v. Elam, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,013 (S.D.N.Y. Apr. 5, 1977); Levy v. Johnson, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,899 (S.D.N.Y. Feb. 15, 1977); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); *cf.* Ketchum v. Green, 557 F.2d 1022, 1025 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) (no causal nexus between election of directors and later redemption of stock); Umbriac v. Kaiser, 467 F. Supp. 548, 555 (D. Nev. 1979) ("more in the way of causation must be shown in [proxy] suits where damages are sought"); Halle & Stieglitz, Filor, Bullard Inc. v. Empress Int'l, Ltd., 442 F. Supp. 217, 223-24 (D. Del. 1977) (no causation between election of directors and subsequent director approval of going private transaction). *But see* Weisberg v. Coastal States Gas Corp., 609 F.2d 650, 652-54 (2d Cir. 1979) (causation may be shown to set aside election of directors for failing to disclose bribe payment in proxy materials), *cert. denied*, 445 U.S. 951 (1980). The district court in *Weisberg* distinguished *Herman*, *Limmer* and *Levy* by explaining that "[i]n [those] cases . . . the plaintiff sought damages because of allegedly improper payments, which did not require shareholder approval. The causal link between the proxy solicitation for the election of the directors and the injury complained of—the improper payments—was attenuated at best. In the instant case, however, the challenged 'transaction' is the election of the directors, and we have no doubt that the 'proxy solicitation itself . . . was an essential link in the accomplishment' of that transaction." *Id.* at 654 (citations omitted).

largely federalize state fiduciary law.[102] A number of these cases, as a separate ground for their holdings, have found that materiality is lacking, given the absence of self-dealing.[103]

A minority of courts have, however, applied management integrity materiality to misconduct other than self-dealing. In *Berkman v. Rust Craft Greeting Cards, Inc.*,[104] an investment banking firm, retained to appraise the shares of a takeover target in a friendly cash tender offer, failed to disclose its purchase of a large block of the target's convertible debentures. The investment banker later did so inform four directors of the company, who, in turn, failed to apprise others prior to a board meeting called to consider the appraisal. In granting a motion to enjoin the annual meeting, the court held that the directors' misfeasance was material and rejected the contention that the proxy rules required disclosure only of self-dealing.[105] Other decisions that apply management integrity materiality have been bolstered by prior adjudication of underlying illegality or the pendency of litigation[106] and by the convergence of financial materiality with management integrity.[107]

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102. Levy v. Johnson, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,899, at 91,324 (S.D.N.Y. Feb. 15, 1977).

103. *See, e.g.*, Abbey v. Control Data Corp., 603 F.2d 724, 731-32 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Lewis v. Valley, 476 F. Supp. 62, 66 (S.D.N.Y. 1979).

104. 454 F. Supp. 787 (S.D.N.Y. 1978).

105. *Id.* at 792.

106. Bertoglio v. Texas Int'l Co., 488 F. Supp. 630 (D. Del. 1980) (failure to disclose pending securities fraud litigation, a violation of § 14(a)); SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978) (failure to disclose kickbacks to suppliers; motion to dismiss complaint alleging violations of §§ 13(a), 14(a) and rule 10b-5 denied); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973) (failure to disclose in proxy contest the prior convictions of director nominee of dissident shareholders held to violate § 14(a)); Cooke v. Teleprompter Corp., 334 F. Supp. 467 (S.D.N.Y. 1971) (failure to disclose bribery conviction of person acting as de facto officer of the company held to render proxy statement materially misleading). As the district court in *Bertoglio* explained, the mere pendency of litigation may be important to shareholders: "The allegations in these complaints [alleging securities antifraud violations] relate directly to [the proxy contestant's] discharge of his fiduciary obligations and his forthrightness in certain securities transactions . . . . Even should [the proxy contestant] ultimately be successful in defending against these claims, [the company's] shareholders were entitled to know that serious allegations, arguably bearing on his fitness for the office he sought, had been lodged against him." 488 F. Supp. at 661 (citation omitted).

107. In Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973), for example, the court explained: "There would be a real possibility that the FCC would revoke [the company's] television license if one of the new Board members had . . . a [criminal] record. This information directly affecting a profitable asset would have a significant propensity to affect a shareholder's vote. Thus, the failure to so inform the shareholders was a material omission violative of Rule 14a-9." *Id.* at 914; *see* Cooke v. Teleprompter Corp., 334 F. Supp. 467 (S.D.N.Y. 1971).

D. *Line Item Disclosure Requirements*

Finally, it should be noted that whether or not material from a financial or management integrity standpoint, illegal practices must be disclosed if called for by specific line item disclosure requirements in various SEC reporting forms and schedules.[108] Absence of materiality under these circumstances is not necessarily a defense for disclosure deficiencies. Courts have so found for proxy statements[109] and shareholder reports under section 13(d),[110] and the SEC has taken this position for tender offer filings.[111]

In a few instances, courts have broadly construed line items dealing with management remuneration to reach illegal practices. In *SEC v. Kalvex Inc.*,[112] kickbacks received by a director/officer were found to be a form of remuneration reportable in proxy solicitations.[113]

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108. Of course, some line items are expressly preconditioned upon materiality. See, for example, line items for disclosure of convictions and indictments, *infra* note 116.

109. *See, e.g.*, United States v. Fields, 592 F.2d 638 (2d Cir. 1978) (without discussion of materiality, court held that failure to disclose kickbacks would violate remuneration line item), *cert. denied*, 442 U.S. 917 (1979); Trans World Airlines, Inc. v. Catalano, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,159 (S.D.N.Y. Oct. 31, 1979) (failure to disclose criminal conviction violated schedule 14B); *cf.* 2 L. Loss, Securities Regulation 884-89 (2d ed. 1961); 5 L. Loss, Securities Regulation 2848-51 (1969 Supp.).

110. *See, e.g.*, GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971) (no finding of materiality), *cert. denied*, 406 U.S. 910 (1972); SEC v. General Refractories Co., 400 F. Supp. 1248 (D.D.C. 1975) (same); *cf.* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 462-63 (1976) (indicating that SEC could adopt a proxy rule calling for specific information, regardless of materiality).

111. Statement of the Securities and Exchange Commission, *amicus curiae*, at 1-7, Raybestos-Manhattan, Inc. v. Hi-Shear Indus., Inc., No. 80-9117 (2d Cir. 1981). Failure to report information in response to specific line item requirements subjects a company to an SEC administrative proceeding. Under § 15(c)(4) of the Securities Exchange Act, 15 U.S.C. § 78o(c)(4) (1976), for example, the SEC may bring an administrative proceeding against a reporting company for failure in its annual or periodic reports "to comply with any [reporting] provision, rule, or regulation in any material respect." The inquiry in a § 15(c)(4) proceeding, under this formulation, does not turn on the materiality of information which has been omitted or misstated, but instead turns upon material compliance with a line item requirement. Thus, total failure to respond to a line item, even if the information called for were insignificant, would amount to material noncompliance. It should be noted that administrative proceedings under § 15(c)(4) do not reach violations of the proxy rules. In private litigation, moreover, courts may take into account the absence of materiality in fashioning relief. *Cf.* Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 63-65 (1975) (a technical violation of the Williams Act does not, in and of itself, require the granting of injunctive relief).

112. 425 F. Supp. 310 (S.D.N.Y. 1975).

113. On these facts the *Kalvex* court held that defendant did not comply with item 7 of schedule 14A, 17 C.F.R. § 240.14a-101 (1981), which requires disclosure of direct annual remuneration paid by an issuer to each director or officer whose aggregate direct remuneration exceeds $40,000, and all interested transactions between an issuer and any of its officers or directors. 425 F. Supp. at 314.

Moreover, in a criminal securities fraud case, *United States v. Fields*,[114] the Second Circuit restored counts charging an officer with concealment of kickbacks and short-swing profits from the sale of the company's securities based upon the applicability of "interested transactions" and "management debt" line items.[115]

More specific line items require disclosure of criminal convictions, pending indictments and securities law civil judgments against any officer or director within the preceding five years.[116] Additionally, corporate activity that puts a company's foreign operations at risk may fall within the compass of prescriptive line item disclosure,[117] as will conduct by a government contractor that may trigger a termination of contracts or a renegotiation of profits.[118]

III. Problems of Proof in Illegal Conduct Cases: Proposals

Inseparable from the conceptual underpinnings of a duty to disclose are practical problems that arise when illegality of corporate conduct is an element of proof in a securities law case. Decisions reached after *Santa Fe Industries v. Green*[119] involving management fraud illustrate the dilemma when securities law liability turns on the violation of other law.[120] In these cases, securities antifraud liability is in part

114. [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,552 (2d Cir. 1978).

115. *Id.* at 94,279. At the time, item 7(f) of schedule 14A required disclosure of "any transaction since the beginning of the issuer's last fiscal year . . . to which the issuer or any of its subsidiaries was or is to be a party, in which any of the following persons had or is to have a direct or indirect material interest . . . (1) [a]ny director or officer of the issuer . . . ." 17 C.F.R. § 240.14a-101 (1978). Item 7(e) of schedule 14A at the time required disclosure of: "indebted[ness] to the issuer . . . [of] [e]ach director or officer of the issuer . . . [including] any indebtedness . . . [arising] under Section 16(b) of the [Securities Exchange] Act." *Id.* Under the SEC's current rules, items 402(e) and 402(f) of regulation S-K, 47 Fed. Reg. 11,418 (1982) (to be codified at 17 C.F.R. § 229.402), set forth disclosure requirements for indebtedness of management and interested transactions. Failure to disclose in proxy materials the potential liability of director nominees for short swing profits may also violate the broad antifraud rule, rule 14a-9, 17 C.F.R. § 240.14a-9 (1981), governing proxy solicitations. *See* Rafal v. Geneen, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,505, at 92,441 (E.D. Pa. May 8, 1972).

116. The disclosure obligation, however, is expressly predicated on the condition that a conviction, indictment or civil judgment be "material to an evaluation of the ability or integrity of any director, person nominated to become a director, or executive officer of the registrant." Regulation S-K, item 401(f), 47 Fed. Reg. 11,413 (1982) (to be codified at 17 C.F.R. § 229.401) (incorporated in form S-1, item 11; form 10-K, item 10; and schedule 14A, item 6).

117. Regulation S-K, item 101(d)(2), 47 Fed. Reg. 11,405 (1982) (to be codified at 17 C.F.R. § 229.101).

118. *Id.*, item 101(c)(1)(ix), 47 Fed. Reg. 11,405 (1982) (to be codified at 17 C.F.R. § 229.101).

119. 430 U.S. 462 (1977).

120. *See, e.g.*, cases cited *supra* note 101.

intertwined with liability under state law for breach of fiduciary duty.

The Supreme Court in *Santa Fe* held that unfairness or constructive fraud in a "going private" merger, absent an allegation of deception or manipulation, cannot support rule 10b-5 liability. The Court rejected the contention that failure to provide advance notice of the merger to minority shareholders constituted a material omission, noting the minority's concession that under state law they were powerless to prevent the merger.[121]

Drawing a negative implication from *Santa Fe*, several courts have predicated antifraud liability upon the availability of injunctive relief under state law when management has made misleading statements or omissions regarding self-dealing transactions.[122] The courts are

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121. Santa Fe Indus. Inc., v. Green, 430 U.S. 462, 474 n.14 (1977); 3 L. Loss, Securities Regulation 1431 (2d ed. 1961); Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U. L. Rev. 541, 554-56 (1968). "[R]espondents do not indicate how they might have acted differently had they had prior notice of the merger. Indeed, they accept the conclusion . . . that under Delaware law they could not have enjoined the merger because an appraisal proceeding is their sole remedy in the Delaware courts for any alleged unfairness in the terms of the merger. Thus, the failure to give advance notice was not a material nondisclosure within the meaning of the statute or . . . Rule [10b-5]." 430 U.S. at 474 n.14. In the absence of any remedy other than appraisal, failure to provide *advance* notice of unfair terms could not have caused injury to minority shareholders. *See* Jacobs, *How Sante Fe Affects 10b-5's Proscriptions Against Corporate Mismanagement*, 6 Sec. Reg. L.J. 3, 27 (1978). Although framed in terms of materiality, the answer to the "advance disclosure" argument might have been better cast in terms of causation, an essential element of a private action under rule 10b-5. *See, e.g.*, Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Titan Group, Inc. v. Faggen, 513 F.2d 234 (2nd Cir.), *cert. denied*, 423 U.S. 840 (1975); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970).

122. Deception in management fraud cases arises in essentially two situations. First, state law may require that officers or directors with a self-interest in a corporate transaction disclose that fact to disinterested directors or, in their absence, to the shareholders. Failure to do so, or affirmatively misstating the existence of self-interest, may give rise to securities antifraud liability under rule 10b-5. *See, e.g.*, Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 645-47 (3d Cir. 1980); Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 613-14 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273, 1292 (9th Cir. 1979); Goldberg v. Meridor, 567 F.2d 209, 220-21 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). Under rule 10b-5, of course, the self-dealing transaction must involve the purchase or sale of securities. *Cf.* Goldberg v. Meridor, 567 F.2d 209, 221 n.10 (2d Cir. 1977) (reserving the question whether rule 10b-5 liability might apply even in the absence of any securities transaction by the corporation if the self-dealing were to operate as a fraud on the market as a whole), *cert. denied*, 434 U.S. 1069 (1978). Second, state law may require that shareholder consent be acquired before a particular corporate transaction may be carried out. As discussed, misleading shareholders about officer or director self-interest may create liability under rule 14a-9. *See supra* notes 72-83 and accompanying text. In this situation, liability attaches whether or not self-dealing involves a securities transaction.

divided, however, on precisely what a plaintiff must prove to sustain a securities law claim. Some have held that the plaintiff need show only the availability of injunctive relief under state law;[123] others require a showing of "reasonable basis" or "reasonable probability" of success on the state law claim;[124] still others require proof that plaintiff would in fact prevail in state court.[125] The upshot of these cases is to require, in effect, a "mini-trial" of the state law action for breach of fiduciary duty—truly an ironic twist, given the policy reasoning of *Santa Fe*.[126]

Difficulties of proof also obtain when securities law liability turns on legality of corporate conduct under detailed federal regulatory schemes.[127] This concern, although unarticulated, apparently influ-

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123. *See, e.g.*, IIT v. Cornfeld, 619 F.2d 909, 922-23 (2d Cir. 1980); Goldberg v. Meridor, 567 F.2d 209, 219 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. Pa. L. Rev. 263, 291-94 (1980).

124. *See, e.g.*, Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 647 (3d Cir. 1980) ("reasonable probability"); Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 614 (5th Cir. 1979) ("reasonable basis"), *cert. denied*, 449 U.S. 820 (1980). The Third Circuit in *Healey* stated: "[W]e frame the test in terms of a reasonable probability for two reasons. First, we believe absolute certainty to be both an impossible goal as well as an impracticable standard for a jury to implement. Second, in most cases the state remedy will be a preliminary injunction, which looks to the likelihood of ultimate success." 616 F.2d at 647.

125. Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273, 1294 (9th Cir. 1979).

126. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). In Part IV of its opinion, the *Santa Fe* Court identified several policy considerations, apart from the language of the statute, which weighed against recognition of a rule 10b-5 action. Chief among these was the Court's concern that "extension of the federal securities laws would overlap and quite possibly interfere with state corporate law," particularly with respect to the development of state law fiduciary principles. *Id.* at 479. At the same time, the Court recognized that "the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy." *Id.* at 478. A further paradox in post-*Santa Fe* cases is that the unavailability of a state law remedy *is* dispositive of a federal securities law claim.

127. This is not to suggest that thorny issues under state fiduciary law are not presented in securities antifraud cases. Thus, notwithstanding the Supreme Court's assumption in *Santa Fe*, Delaware decisions reached after *Santa Fe* have established that minority shareholders enjoy not only appraisal rights but may enjoin a merger on grounds of unfairness and lack of valid business purpose. *See* Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1036-37 (Del. 1979); Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977); Tanzer v. Int'l Gen. Indus., Inc., 379 A.2d 1121, 1122 (Del. 1977); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 Yale L.J. 1354, 1354-56 (1978); Ferrara & Steinberg, *supra* note 123, at 278-80; *see also* Goldberg v. Meridor, 567 F.2d 209, 224 n.9 (2d Cir. 1977) (Meskill, J., dissenting) (New York choice-of-law rule applicable to Panamanian corporation with offices in New York and Bermuda is unsettled), *cert. denied*, 439 U.S. 1069 (1978); Maher v. Zapata Corp., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,549 (S.D. Tex. May 27, 1980) (assuming, in the absence of controlling precedent, that Delaware Supreme Court would reject use of business judgment rule to dismiss shareholder's derivative suit under rule 14a-9).

enced the decision in *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*[128] and was clearly identified as a basis for the decision in *SEC v. Chicago Helicopter Industries, Inc.*[129] More problematic still are antifraud cases that turn on legality under foreign law of activities pursued abroad by United States corporations.[130] Piggybacking securities law duties onto other legal standards also implicates considerations of comity. Agencies that enforce federal labor or banking laws, for example, are expected to develop an expertise in their respective areas of jurisdiction and to apply their expertise in shaping the development of the law by exercising prosecutorial discretion in individual cases. Courts confronted by securities antifraud claims based on unadjudicated violations of other statutes should quite understandably have reservations about judging collaterally the legality of conduct under these statutes.

Reconciling the securities laws with the operation of other laws and easing problems of proof, however, can be advanced in at least four ways. First, the *Texas Gulf Sulphur* materiality standard for predictive disclosure can be refined. Under that standard, disclosure of unlawful but unadjudicated conduct may be required even if it is not likely that the conduct will be detected and prosecuted. Financial accounting standards, however, are more circumscribed. To provide benchmarks for predictive disclosure in this area, the accounting profession adopted in 1975 a financial accounting standard, FASB 5,[131] which mandates disclosure of an unasserted litigation claim only when both parts of a two-prong test are met. Disclosure is required when there is (1) a reasonable *probability* that the claim will be asserted, and (2) a reasonable *possibility* that the claim, if asserted, will lead to an adverse result for the company.[132] Under FASB 5, no

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128. 475 F. Supp. 328 (S.D.N.Y. 1979), *vacated as moot per curiam*, 638 F.2d 7 (2d Cir. 1980).

129. No. 79-C-0469 (N.D. Ill. Jan. 18, 1980), *discussed in* Sec. Reg. & L. Rep. (BNA) No. 595, at A-4 (Mar. 18, 1981). In *Chicago Helicopter*, the court stated: "Subject matter jurisdiction of this action is premised on a violation of the securities law, not the banking laws . . . . [I]n the absence of an adjudicated finding of illegality of [the challenged banking] transaction, the Court is not at liberty to assume or make its own finding of such illegality." Slip op. at 5.

130. *See* Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976) (legality of political payments under Italian law); Note, *Disclosure of Corporate Payments Abroad and the Concept of Materiality*, 4 Hofstra L. Rev. 729, 741-44 (1976) (materiality of foreign bribes).

131. Financial Accounting Standards Board, *Accounting for Contingencies*, Statement of Financial Accounting Standards No. 5 (FASB 5) (Mar. 1975).

132. *Id.* Where both prongs are met, and if the amount of loss can be reasonably estimated, FASB 5 requires a loss accrual to be charged to income in the company's financial statements. If no reasonable estimate can be made, FASB 5 requires disclosure of the loss contingency in a footnote to the financial statement. In its *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31

disclosure in financial statements is required of a litigation claim the assertion of which is no more than "reasonably possible."[133] To be sure, FASB 5 provides guidance in the preparation of financial statements, but its mathematical exactitude probably renders it an unduly arbitrary measure of a company's more general disclosure obligations.[134] A more workable standard would steer a middle course between *Texas Gulf Sulphur* and FASB 5, by requiring disclosure of unlawful activities when (1) there is a substantial possibility that the conduct will be detected or will give rise to litigation, and (2) material economic loss would likely result upon such occurrence. Under this standard, companies would assess their disclosure duties within a limited range of probabilities, much as they do in reaching a variety of other decisions.

A second step is to fuse the management integrity and financial materiality standards. In cases of self-dealing, the groundwork has already been laid.[135] More careful inquiry into the financial importance of management integrity must be undertaken in non-self-dealing cases. Plaintiffs should be called upon to demonstrate how assertedly unlawful conduct, arguably undertaken to enhance corporate profitability, in fact has impaired, or threatens to impair, profitability in a material way. Plaintiffs may perhaps meet this burden of proof by showing that a company could not successfully compete without resort to unlawful means, or that discovery and successful prosecution of the unlawful conduct is likely to result in the loss of major contracts or valuable licenses or franchises. If a plaintiff is not held to such a requirement, courts may rightly perceive that a plaintiff, by resort to the securities laws, seeks simply to circumvent state law limitations which preclude shareholder claims based solely upon corporate mismanagement. Focusing on the financially important aspects of man-

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Bus. Law. 1709 (1976), issued in response to FASB 5, the American Bar Association cautioned its members that "[the] judgment [of whether an unasserted claim will be asserted] will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations, and previous public disclosure. . . . In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as 'probable' of assertion should be based only upon compelling judgment." *Id.* at 1723.

133. FASB 5, *supra* note 131.

134. The SEC employed FASB 5 as a yardstick in one recent administrative proceeding but at the same time did not disavow the applicability of the broader *TGS* standard. *See In re* United States Steel Corp., [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,319; *see also* Securities Act Release No. 6130 (Sept. 27, 1979), 2 Fed. Sec. L. Rep. (CCH) ¶ 23,507B (interpretive release on environmental disclosure).

135. *See supra* notes 72-83 and accompanying text.

agement integrity would lessen the likelihood that other courts would follow the reasoning of decisions like *J.P. Stevens.*

Third, where facts bearing upon management integrity but not tied to financial materiality do not fall within specific line item reporting requirements, a presumption should be available to corporations that disclosure is generally not required in periodic reports or other documents filed with the SEC. For example, the Commission's line item reporting requirement for criminal convictions within the past five years suggests, by negative implication, that convictions of less recent vintage ordinarily need not be disclosed in filings with the SEC. Careful deliberation that precedes adoption of specific reporting requirements by the SEC, and the process of soliciting and weighing the views of public commentators, would be undermined if issuers thereafter were not entitled to place at least some weight on lines that the SEC has specifically drawn.

Finally, the SEC, in enforcement actions that turn on violation of other federal law, should attempt to coordinate in some way with those other agencies entrusted with primary jurisdiction over particular areas. The interests of comity and judicial economy could be served, for example, if the SEC and another federal agency were to file a joint complaint charging securities law and substantive violations. When another agency decides for its own reasons not to file a contemporaneous enforcement action, the agency may nonetheless participate as *amicus curiae* in the SEC's case to advise the court on interpretive matters. At the very least, the SEC should advise the court before which the securities case is pending whether any agency with primary jurisdiction over the substantive law that has allegedly been violated objects to prosecution of the SEC's complaint.[136]

There may, of course, be additional ways in which problems of proof and interests of comity can be met in a constructive, practical fashion. When securities law claims are based upon unadjudicated violations of other federal law, the SEC, as a governmental body, must demonstrate its sensitivity to the prerogatives of sister federal agencies and recognize the reluctance of the courts to judge collaterally the illegality of corporate conduct under separate substantive statutes. By taking these steps, the SEC, in particular, and all other plaintiffs can avoid distortion in the application by the courts of the standard of materiality in the securities law disclosure context.

136. An analogy may be drawn to procedures employed in litigation in which applicability of the Act of State doctrine under international law is at issue. In these cases, the State Department advises the court whether or not the private claim should be heard. *See, e.g.*, Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682 (1976); First Nat'l City Bank v. Banco Nacional de Cuba, 406 U.S. 759 (1972); Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964).

Conclusion

The analytical model for assessing materiality under the securities laws of conduct that may be illegal under other governing law is continuing to evolve. But on the basis of decided cases, administrative rulings and the legislative purposes underlying the securities laws, the contours of such a model have begun to emerge. As a threshold proposition, engagement by a company or its officers in illegal or "questionable" practices is not per se material. Accordingly, absent a specific line item directive, a disclosure requirement does not automatically arise. A duty to disclose does attach, however, if the omission of information pertaining to illegal, or assertedly illegal, practices would render financial information that has been set forth in an SEC filing materially misleading. Financial materiality is implicated when the unlawful conduct would subject the company to substantial costs, fines or penalties, or if the stability of company earnings would otherwise be jeopardized.

Although illegal practices may pose no immediate financial risk, materiality may be found, particularly in the proxy context, when such practices adversely reflect upon the integrity of management. Instances of self-dealing by management clearly fall within the compass of "integrity of management" materiality. Whether this standard embraces other kinds of unlawful practices, particularly conduct undertaken to further the interests of the corporation, is a question that has thus far left the courts divided. In this regard, one may expect the courts in the future to be reluctant to extend the boundaries of the "integrity" theory, because to do so—absent some showing that information is pertinent from an economic standpoint—will likely be viewed as needlessly impinging upon the operation of other legal schemes.