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## Kahn v. Virginia Retirement System: The Impact of Rule 10b-5's Corporate Disclosure Requirements on the Williams Act's Tender Offer and Best Price Rules

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1995]

**KAHN v. VIRGINIA RETIREMENT SYSTEM: THE IMPACT OF RULE  
10b-5'S CORPORATE DISCLOSURE REQUIREMENTS ON THE  
WILLIAMS ACT'S TENDER OFFER AND BEST PRICE RULES.**

I. INTRODUCTION

Today, corporate management must often address questions of when to disclose large corporate transactions.<sup>1</sup> In many situations, the Securities Exchange Act of 1934 provides answers by requiring mandatory disclosure to protect investors<sup>2</sup> and promote the efficiency of the stock market by eliminating fraud.<sup>3</sup> Specifically, Rule 10b-5, promulgated by the Securities Exchange Commission (SEC), prohibits corporations from making misleading statements and omissions of material fact regarding the

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1. Dawn Callaway, *The Duty to Disclose v. The Duty Not to Mislead During Merger Negotiations*, 23 WAKE FOREST L. REV. 143, 144 (1988) (discussing difficulties corporations face when deciding whether or not to disclose merger negotiations). Callaway argues that this dilemma stems from the multiple disclosure requirements imposed on corporations. *Id.* Such requirements include federal securities laws, stock exchange rules and state law fiduciary duties imposed on corporate management. *Id.* When interpreting whether a corporation has complied with these requirements, the courts must acknowledge the adverse consequences that may result from premature disclosure. *Id.* Primarily, the courts' concern with premature disclosure is that rival bidders might cause the price of the security to rise, thus reducing the willingness of many firms to enter into merger negotiations and inducing others to lower their initial offering price. *Id.* However, the market price may still rise, due to speculation that the disclosure will attract rival bidders. *Id.* If the stock price does rise, many acquiring firms may terminate the merger negotiations, resulting in the shareholders' loss of valuable merger premiums. *Id.* (citing *Staffin v. Greenberg*, 672 F.2d 1196, 1206 (3d Cir. 1982)) (arguing that public disclosure of preliminary merger discussions may actually harm more than help stockholders because disclosure often causes stock price to rise toward expected tender price).

2. C. Daniel Ewell, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 YALE L.J. 547, 548 (1987); see, e.g., Nicholas Wolfson & Thomas A. Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CAL. L. REV. 1120, 1147 (1970) (stating that 1934 Act refers to investor protection goal 50 separate times).

3. Ewell, *supra* note 2, at 548; see, e.g., H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933) (noting that securities markets are "nation's primary mechanism for allocating economic resources among competing companies"); Irwin Friend, *The SEC and the Economic Performance of Securities Markets*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 190 (H. Manne ed., 1969) (stating that "allocational efficiency has been regarded as the most important economic function" of securities markets); Thomas J. Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 FORDHAM L. REV. 565, 577 (1972) (stating that free and open securities markets also improve allocative efficiency of capital markets); see also Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1032 (1977) (noting that one purpose of Securities Acts was to improve market's economic functions, thereby improving resource allocation).

purchase or sale of securities.<sup>4</sup> Nevertheless, despite the pro-disclosure philosophy of Rule 10b-5, the Rule does not impose a general obligation for complete disclosure of all information until a specific duty to disclose arises.<sup>5</sup>

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4. Ewell, *supra* note 2, at 549. Rule 10b-5 provides:

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986). See generally ARNOLD JACOBS, *Litigation and Practice Under Rule 10b-5*, in 5 SECURITIES LAW SERIES (2nd ed. 1981) (discussing Rule 10b-5 and its judicial application).

5. Yolanda E. Stefanou, *Basic Inc. v. Levinson: The Disclosure of Preliminary Merger Discussions Within the Context of Rule 10b-5*, 3 ADMIN. L.J. 465, 487 (1989) (discussing argument that silence is not "misleading" absent clear duty to disclose). In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the United States Supreme Court established a materiality standard to determine when a duty to disclose arises based on whether a substantial likelihood exists that disclosure would be significant to a reasonable investor. *TSC Industries* 426 U.S. at 449. However, in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the United States Supreme Court explained that "[t]he application of [the *TSC Industries*] materiality standard to preliminary merger discussions is not self evident" because a merger's possibility is itself "contingent or speculative in nature." *Basic Inc.*, 485 U.S. at 232. Nevertheless, the *Basic Inc.* Court expressly adopted the *TSC Industries* materiality standard for Rule 10b-5 analysis. *Id.*

For a discussion of cases holding that no duty of continuous disclosure exists under Rule 10b-5 absent insider trading or exigent circumstances, see *Staffin v. Greenburg*, 672 F.2d 1196, 1205 (3d Cir. 1982) (holding that stockholder acquiring interest in company had no pre-acquisition duty to disclose information regarding struggle for corporate control); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 299 (7th Cir. 1981) (noting timing of release of corporate information should be based on business judgment of issuer); *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 48 (2d Cir. 1976) (noting difference in materiality standard for inside information as compared to inaccurate information); *Financial Indus. Fund v. McDonnell Douglas Corp.*, 474 F.2d 514, 519 (10th Cir.) (stating duty to disclose does not commence until information is "available and ripe for publication") (citing *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971), *cert. denied*, 414 U.S. 874 (1973); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 949 (2d Cir. 1969) (stating that "[w]hile a company may choose to correct a misstatement in the press not attributable to it . . . we find nothing in the securities legislation requiring it to do so"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968) (noting that "the timing of disclosure is a matter for the business judgement of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC").

Commentators have also addressed the duty to disclose issue. See Donald M. Feuerstein, *The Corporation's Obligations of Disclosure Under the Federal Securities Laws When It Is Not Trading in Its Stock*, 15 N.Y.L.F. 385, 391-92 (1969) (discussing *Texas Gulf Sulphur* and duty to disclose); John M. Sheffey, *Securities Law Responsibilities of*

In establishing a corporation's duty to disclose a transaction, the entity must first determine whether the transaction is material.<sup>6</sup> The United States Supreme Court has articulated a fact-intensive inquiry for determining the materiality of merger negotiations.<sup>7</sup> Based on the speculative nature of preliminary merger negotiations, assessing the significance of the information involves weighing both the indicated probability the event will occur and the anticipated magnitude of the transaction in light of the totality of company activity.<sup>8</sup> When disclosing information to the public concerning significant transactions, a corporation must also consider the

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*Issues to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem*, 57 NOTRE DAME L. REV. 755, 760-70 (1982) (arguing that express duty to disclose does not exist). The SEC encourages prompt announcement of material corporate information, but has never imposed such a disclosure requirement. See SEC Comment on Timely Disclosure of Material Corporate Developments, Exchange Act Release No. 8995, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915, at 80,035 (Oct. 15, 1970) (stating that except when corporate insiders trade in corporate stock, no mandatory immediate disclosure is required).

6. *Basic Inc.*, 485 U.S. at 239 & n.17. Absent three special circumstances, a firm retains no duty to disclose preliminary merger negotiations. Callaway, *supra* note 1, at 147. This commentator suggests that "[a]lthough information concerning merger possibilities is clearly material under the TSC [*Industries*] 'reasonable investor' standard, the same considerations that have justified what is, in effect, a public policy exception to the TSC [*Industries*] test in other merger nondisclosure cases support a finding of immateriality in this instance." *Id.* at 146 n.31 (quoting Note, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 YALE L.J. 547, 563-64 (1987)) (citing *Reiss v. Pan Am World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983)). When the merger negotiations involve trading by issuers or insiders of the corporation, the negotiations must be disclosed. *Id.* at 147 (citing *Greenfield v. Hueblein*, 742 F.2d 751 (3d Cir. 1984)). Similarly, a leak of information by the issuer mandates disclosure. *Id.* Finally, an issuer's earlier statement that has subsequently become misleading since its issuance requires disclosure. *Id.* (citing *Ross v. A.H. Robins Co.*, 465 F. Supp. 904 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980)).

7. *Basic Inc.*, 485 U.S. at 230. The Court refused to endorse a bright line rule, such as the "agreement in principle" test. *Id.* at 236. "Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive." *Id.* The Court noted that materiality depends on the significance a reasonable investor would place on the particular information in deciding how to vote. *Id.* (citing *TSC Indus.*, 426 U.S. at 450).

If the impact of the corporate development is certain, the TSC *Industries* application is straightforward. *Id.* at 232. Conversely, when the event is contingent, like merger negotiations, application of the "reasonable investor" test is more difficult. *Id.* However, the Court did not address other kinds of contingent or speculative information, such as earnings, forecasts or projections. *Id.* at 232 n.9.

8. *Id.* at 238 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc)). The *Basic Inc.* Court stated that "no particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material." *Id.* at 239. However, silence without a duty to disclose is not misleading under Rule 10b-5. *Id.* at 239 n.17. "No comment" statements are generally considered the same as silence. *Id.* (citing *In re Carnation Co.*, Exchange Act Release No. 22,214, 33 S.E.C. Docket 1025 (1985)).

dictates of the Williams Act.<sup>9</sup> Although the Williams Act primarily concerns tender offers made by a bidder,<sup>10</sup> a public pre-tender announcement may also trigger mandatory disclosures under the Act.<sup>11</sup> Section 14(d) outlines the Williams Act disclosure requirements.<sup>12</sup>

In *Kahn v. Virginia Retirement System*,<sup>13</sup> the United States Court of Appeals for the Fourth Circuit examined this materiality requirement for other contingent corporate developments.<sup>14</sup> Specifically, the Fourth Circuit addressed the issue of interpreting a corporate disclosure in light of conflicting SEC regulations.<sup>15</sup> The *Kahn* court found that the negotiations at issue concerned matters significant to a reasonable investor's trading decision.<sup>16</sup> Thus, the *Kahn* court concluded that a Rule 10b-5

9. See 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994). Congress enacted the Williams Act amendments to regulate the increased use of cash tender offers in corporate takeovers. *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 22 (1976). Prior to the Williams Act, cash tender offers were not subject to the disclosure requirements of the federal securities laws. *Id.* Congress believed that shareholders needed more complete disclosure from tender offer bidders to make an informed decision whether to tender their shares. See generally S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967) (stating "[t]he competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to the stockholders"); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2-4 (requiring disclosure of pertinent information to stockholders in "takeover bid" or repurchase of equity securities). For a detailed discussion of the Williams Act requirements, see *infra* note 27 and accompanying text.

10. 15 U.S.C. § 78n(d)(1). "It shall be unlawful for any person . . . to make a tender offer for . . . any class of any equity security . . . if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than [five] per centum of such class . . ." *Id.* However, neither Congress nor the SEC has expressly defined a tender offer. *Telvest, Inc. v. Bradshaw*, 618 F.2d 1029, 1032 (4th Cir. 1980). For a discussion of the various judicial tests, including the "Eight Factor" test, see *infra* notes 33-36 and accompanying text.

11. See Adoption of Amendments to Tender Offer Rules, Exchange Act Release No. 16,384, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,373, at 82,577 (Nov. 29, 1979) [hereinafter Release 16,384]; 17 C.F.R. § 240.14d-2 (1979). Rule 14d-2 states that the issuance of a "public announcement by a bidder . . . with respect to a tender offer . . . shall be deemed to constitute the commencement of a tender offer" thereby triggering the Williams Act. 17 C.F.R. § 240.14d-2(b).

12. 15 U.S.C. § 78m(d)(1). To commence a tender offer, the public announcement must contain "(1) The identity of the bidder; (2) The identity of the subject company; and (3) The amount and class of securities being sought and the price or range of prices being offered therefor." 17 C.F.R. § 240.14d-2(c).

Once the tender offer begins, the bidder has five days to comply with the filing requirements of the Williams Act or to delay the tender offer. 17 C.F.R. 240.14d-2(b)(1)-(2). If the bidder does not act, the tender offer will be deemed commenced on the public announcement date and bidder will have violated filing and disclosure requirements. Release 16,384, *supra* note 11.

13. 13 F.3d 110 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994).

14. See *id.* (analyzing *Basic Inc.* standard as it relates to corporate restructuring).

15. For a discussion of conflict between SEC requirements, see *infra* notes 33-36 and accompanying text.

16. For a detailed discussion of the three way transaction, see *infra* notes 106-08 and accompanying text.

disclosure should not be treated as a tender offer made by or on behalf of the bidder.<sup>17</sup>

This Note examines the difficulties courts face in determining when general business developments must be disclosed under Rule 10b-5 despite the ramifications of the Williams Act.<sup>18</sup> Section II details the Williams Act, its disclosure requirements, and the judicial definition of a tender offer.<sup>19</sup> In addition, Section II investigates the Supreme Court's landmark decision concerning materiality and timing of disclosure in *Basic Inc. v. Levinson*.<sup>20</sup> Finally, this Section examines how federal courts have applied the *Basic Inc.* decision to alleged omissions relating to merger negotiations.<sup>21</sup> Section III presents the facts of *Kahn* and discusses this Fourth Circuit opinion.<sup>22</sup> Section IV suggests that the Fourth Circuit, in expanding the subject corporation's Rule 10b-5 mandatory disclosure requirements under *Basic Inc.*, failed to engage in the appropriate fact-intensive inquiry regarding the materiality of the press release.<sup>23</sup> Section V considers the potential impact that the Fourth Circuit's decision will have on future cases involving the materiality of contingent corporate developments.<sup>24</sup>

## II. BACKGROUND

### A. *The Williams Act*

Prior to the 1960s, the traditional means for corporate takeover attempts was an exchange offer of securities or a proxy solicitation.<sup>25</sup> In

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17. For a discussion of the Fourth Circuit decision, see *infra* notes 117-43 and accompanying text.

18. For a discussion of the fact-intensive nature of the analysis, see *infra* notes 138-43 and accompanying text.

19. For a detailed discussion of the Williams Act and tender offers, see *infra* notes 25-44 and accompanying text.

20. 485 U.S. 224 (1988). For a detailed discussion of the Supreme Court's decision and rationale in *Basic Inc.*, see *infra* notes 63-73 and accompanying text.

21. For a detailed discussion of the application of *Basic Inc.* by the lower federal courts, see *infra* notes 74-94 and accompanying text.

22. For a discussion of the facts of the shareholder derivative suit underlying the *Kahn* opinion, see *infra* notes 96-116 and accompanying text. For a discussion of the Fourth Circuit opinion, see *infra* notes 117-43 and accompanying text.

23. For a critical analysis of the Fourth Circuit's opinion, see *infra* notes 144-65 and accompanying text.

24. For a discussion of the possible impact on various corporate entities from the Fourth Circuit's opinion, see *infra* notes 166-68 and accompanying text.

25. *Piper v. Chris Craft Indus.*, 430 U.S. 1, 22 (1976). The proliferation of cash tender offers as devices for securing corporate control is analyzed in detail in Samuel L. Hayes & Russell A. Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135 (Mar. - Apr. 1967). An exchange offer refers to that part of a bilateral contract that includes the consideration for the ultimate contract when the offer is accepted. BLACK'S LAW DICTIONARY 563 (6th ed. 1990). Solicitations include "any other writings which are part of a continuous plan ending in solicitation and [which] prepare the way for its success." *SEC v. Okin*, 132 F.2d 784, 786 (2d Cir. 1943).

response to the proliferation of cash tender offers to effectuate corporate takeovers, Congress passed the Williams Act in 1968.<sup>26</sup> The Williams Act protects shareholders by ensuring the disclosure of adequate information about the terms and implications of the tender offer before deciding to sell or retain their shares.<sup>27</sup>

Under the Williams Act, the key to investor protection involves interpreting the ambiguous term "tender offer."<sup>28</sup> Interpreting "tender offer" remains particularly problematic when a company makes a public announcement of a tender offer's material terms before the tender offer begins.<sup>29</sup> These announcements may cause shareholders to make investment decisions regarding a tender offer with incomplete informa-

26. *Piper*, 430 U.S. at 22. Such offers were then outside the reach of existing federal securities disclosure requirements. *Id.* Proxy solicitations were regulated under section 14 of the Securities and Exchange Act of 1934, and exchange offers were subject to the registration requirements of section 77e of the 1933 Securities and Exchange Act. *Id.* In response to this perceived gap in existing legislation, Senator Harrison Williams introduced a bill in 1965 to subject cash tender offerors to advance disclosure requirements. *Id.* For a detailed discussion of the disclosure requirements of the Williams Act, see *infra* note 27.

27. *Id.* at 35. The Williams Act requires takeover bidders to file a statement indicating the identity and background of the offeror, the source and amount of consideration used to make the purchase, the offeror's holdings in the target corporation, and offeror's plans regarding the structure of the target corporation. 15 U.S.C. § 78m(d)(1) (1994). Additionally, the Act provides three benefits for those who elect to tender their stock. 15 U.S.C. § 78n(d)(5)-(7). First, stockholders accepting tender offers may withdraw during the first seven days of the tender offer and at any time after 60 days from the commencement of the offer. 15 U.S.C. § 78n(d)(5). Second, when less than all outstanding shares are offered and more than the requested number of shares are tendered, the tendered securities must be accepted pro rata by the offeror during the first six months of the offer. 15 U.S.C. § 78n(d)(6). Finally, if during the tender offer period, the amount paid for the target shares is increased, all tendering shareholders are to receive the additional consideration. 15 U.S.C. § 78n(d)(7). The Williams Act also contains a broad anti-fraud prohibition, which states in pertinent part:

It shall be unlawful for any person to make any untrue statement of a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request for invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

15 U.S.C. 78n(e).

28. *Kahn v. Virginia Retirement Sys.*, 13 F.3d 110, 114 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994). A conventional tender offer is a public invitation to "all shareholders of a corporation to tender their shares for sale at a specified price." Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1251 (1973). The conventional tender offer typically remains open for two weeks at a premium over market price. *Id.* at 1251-52. For a discussion of non-conventional tender offers, see *infra* notes 35-36 and accompanying text.

29. *Kahn*, 13 F.3d at 114. "Such pre-commencement public announcements cause security holders to make investment decisions with respect to a tender offer on the basis of incomplete information and trigger market activity normally attendant to a tender offer, such as arbitrageur activity." *Kahn v. Virginia Retirement*

tion.<sup>30</sup> To reduce such pre-tender offer announcements and to prevent inadvertent tender offers, the SEC promulgated Rules 14d-2(b)<sup>31</sup> and 14d-2(c).<sup>32</sup>

Courts have fashioned several tests in determining whether a party's actions constitute a tender offer for purposes of the Williams Act.<sup>33</sup> A conventional tender offer consists of a public invitation, "to all shareholders of a corporation, to tender their shares for sale at a specific price."<sup>34</sup> If a securities transaction does not meet this traditional definition, some courts use an "Eight Factor" test to determine if the transaction is a tender offer.<sup>35</sup> Another more flexible judicial test involves

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ment Sys., 783 F. Supp. 266, 271 (E.D. Va. 1992) (quoting language in Release 16,384, *supra* note 11, at 82,582-83).

30. See Release 16,384, *supra* note 11, at 82,582 (attempting to clarify when tender offer begins). These "pre-commencement public announcements cause the contest for control of the subject company to occur prior to the application of the Williams Act and therefore deny security holders the protections which that Act was intended by Congress to provide." *Id.* at 82,583.

31. 17 C.F.R. § 240.14d-2(b). Under Rule 14d-2(b), a bidder's public announcement of the material terms of a cash tender offer, through a press release, newspaper advertisement or public statement triggers the tender offer rules under section 14(d) of the Exchange Act. Release 16,384 *supra* note 11, at 82,583.

32. 17 C.F.R. § 240.14d-2(b). To provide certainty to bidders, the information which triggers Rule 14d-2(b) is specified in 14d-2(c). Release 16,384, *supra* note 11, at 82,583. For a detailed discussion of these particular disclosure requirements, see *supra* note 12.

33. *Weeden v. Continental Health Affiliates, Inc.*, 713 F. Supp. 396, 402 (N.D. Ga. 1989). The courts were "apparently concerned that methods of acquisition representing deviations from the conventional tender offer but exerting similar deleterious effect on shareholders could be resorted to in circumvention of the regulatory process . . ." *Id.* For a discussion of the "Eight Factor" test and the totality of circumstances test, see *infra* notes 35-36 and accompanying text.

34. *Weeden*, 713 F. Supp. at 402 (quoting Note, *supra* note 28, at 1251). "[T]he SEC has consistently refused to supply a definition since the dynamic nature of tender offers demands judicial flexibility in determining what kinds of acquisitions should be subject to the Act." *Id.* at 401 (citing *Pin v. Texaco Inc.*, 793 F.2d 1448, 1453 (5th Cir. 1986)).

35. *American Carriers Inc. v. Baytree Investors, Inc.*, 685 F. Supp. 800, 809 (D. Kan. 1988). The court in *Weeden* also noted:

Congress left the SEC with the task of providing concrete meaning to the term tender offer. The SEC has never articulated a precise test but has, on several occasions, provided courts with a list of seven or eight factors that its [sic] considers relevant to the determination of whether a given transaction constitutes a tender offer for Williams Act purposes.

*Weeden*, 713 F. Supp. at 402 n.5. The following eight factors have been considered when determining whether a tender offer has been made:

- (1) [a]ctive and widespread solicitation of public shareholders for the shares of an issuer;
- (2) solicitation made for a substantial percentage of the issuer's stock;
- (3) offer to purchase made at a premium over the prevailing market price;
- (4) terms of the offer are firm rather than negotiable;
- (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
- (6) offer open only for a limited period of time;



considering the transaction in light of the totality of corporate circumstances.<sup>36</sup>

In *Weeden v. Continental Health Affiliates, Inc.*,<sup>37</sup> the United States District Court for the Northern District of Georgia reached the same result by applying both the "Eight Factor" test and the totality of circumstances test to a potential tender offer.<sup>38</sup> In *Weeden*, the bidder sent a letter to the subject company's board of directors seeking to negotiate an acquisition of common stock at \$6.00 per share.<sup>39</sup> Because the letter only met two prongs of the "Eight Factor" test, the district court concluded that the bidder's letter did not constitute a tender offer.<sup>40</sup> The court also held that

(7) offeree subjected to pressure to sell his stock;

(8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of a large amount of target company's securities.

*Id.* at 402 (citing *Zuckerman v. Franz*, 573 F. Supp. 351, 358 (S.D. Fla. 1983). See generally *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) (using "Eight Factor" test to determine if public announcement resulted in tender offer); *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773 (S.D.N.Y. 1979) (same).

36. *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 57 (2d Cir. 1985). The Second Circuit described this more flexible test:

[T]he question of whether a solicitation constitutes a "tender offer" within the meaning of [section] 14(d) turns on whether, viewing the transaction in the light of the totality of circumstances, there appears to be a likelihood that unless the pre-acquisition filing strictures of that statute are followed there will be a substantial risk that solicitees will lack the information needed to make a carefully considered appraisal of the proposal put before them.

*Id.* For examples of the application of this totality of circumstances test, see *FMC Corp. v. Boesky*, 727 F. Supp. 1182, 1198-99 (N.D. Ill. 1989) (using totality of circumstances test in recapitalization and change in corporate structure); *Weeden*, 713 F. Supp. at 403 (applying totality of circumstances test for proposal to purchase all outstanding common stock); *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1130-31 (D. Del. 1988) (applying totality of circumstances test to buyout of one shareholder's securities). *American Carriers, Inc. v. Baytree Investors, Inc.*, 685 F. Supp. 800, 809 (D. Kan. 1988) (applying totality of circumstances test to tender offer of 51% of stock).

37. 713 F. Supp. 396 (N.D. Ga. 1989).

38. *Id.* at 403. The tender offer falls outside the classical definition because the offer was a letter to the board, no fixed time limit was given and no pressure was exerted on the shareholders to sell their stock. See *id.* at 397.

39. *Id.* On September 7, 1988, the Chief Executive Officer (CEO) of Continental issued a press release stating the terms in the letter to the Board of Directors. *Id.* Both the letter and press release stated that financing or further review of the business would not preclude the offer. *Id.* Additionally, on September 7, 1988, Continental filed a Schedule 13D, disclosing its purchase of 6.9% of Healthdyne, the target corporation, common stock and its intention to gain control of the company by acquiring all of its outstanding stock. *Id.*

40. *Id.* at 402. The court found that Continental's proposal satisfied the second and third prong of the test. *Id.* Continental's proposal met the second factor, solicitation made for a substantial percentage of the issuer's stock, because it included all outstanding shares of common stock. *Id.* Additionally, Continental met the third prong, offer to purchase made at a premium over the prevailing market price, because the \$6.00 per share price included a premium over market. *Id.*

applying the totality of circumstances test to the bidder's letter would not change the "no tender offer" result.<sup>41</sup>

Subsequently, in Exchange Act Release 34-16623, the SEC clarified certain confusion surrounding the tender offer rules.<sup>42</sup> The SEC stated that a Rule 14d-2 tender offer will only commence via a public announcement by the bidder or on the bidder's behalf.<sup>43</sup> The SEC also emphasized that when the bidder's intentions become public, any affirmation of Rule 14d-2(c) information, by or on behalf of the bidder, starts the tender offer period.<sup>44</sup>

### B. "Best Price Rule"

The SEC designed the "Best Price Rule" of the Williams Act to prevent a tender offeror from discriminating among tendering shareholders.<sup>45</sup> The SEC further specified that a tender offer must extend to all

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41. *Id.* at 403. The Continental proposal does not indicate that shareholders lacked vital information concerning the proposed acquisition or that they were pressured into making uninformed decisions regarding their stock. *Id.*

42. Kahn v. Virginia Retirement Sys., 13 F.3d 110, 115 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994) (citing Interpretative Release Relating to Tender Offer Rules, Exchange Act Release 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)). The Interpretative Release discusses questions relating to events causing the commencement of a tender offer, the adequacy of the dissemination of the offer and the time period which the offer is open. *Id.* (citing Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)). The release addresses these areas because compliance with these rules has been difficult. *Id.* (citing Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)).

43. *Id.* (citing Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)). The Interpretive Release states, in pertinent part:

In certain situations where the bidder and subject company agree or arrange that the subject company will make the public announcement and such public announcement does not arise solely out of the subject company's disclosure duty, the public announcement will be viewed as being made on behalf of the bidder.

*Id.* (quoting Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)).

44. *Id.* (citing Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,284I (March 5, 1980)). This affirmation may occur when the bidder may not be able to deny its intentions. *Id.* The information in the affirmation relates to the tender offer requirements in Rule 14d-2(c). *Id.* This affirmation does not occur as a result of a joint press release, but usually requires a subsequent publication by or on behalf of the bidder. *Id.*

45. Field v. Trump, 850 F.2d 938, 942 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989). The "Best Price Rule" of the Williams Act states that:

Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to tender offer or request or invitation

holders of the securities subject to the offer and that such holders must receive the highest consideration paid during the tender offer period.<sup>46</sup> The SEC adopted Rule 14d-10 to codify the "Best Price Rule" and the "all holders" requirement.<sup>47</sup> To assert a Rule 14d-10 claim, the plaintiff must allege and prove that a tender offer commenced under Rule 14d-2 prior to the occurrence of the complained purchases.<sup>48</sup> The SEC also promulgated Rule 10b-13, which prohibits "side transactions" and purchases during the tender offer period, to prevent price discrimination.<sup>49</sup>

In *Field v. Trump*,<sup>50</sup> the United States Court of Appeals for the Second Circuit discussed the interplay among Rule 14d-2, Rule 14d-7 and Rule

for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation.

*Id.* (quoting 15 U.S.C. § 78n(d)(7)(1968)).

46. *Id.* (citing Proposed Amendments to Tender Offer Rules, Exchange Act Release No. 22,198 [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,797 (July 1, 1985)). The purpose of the SEC's position is "to prevent a tender offeror from discriminating in price among tendering shareholders." *Id.*; see Proposed Amendments to Tender Offer Rules, Exchange Act Release No. 22,198, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,797 (July 1, 1985) (noting SEC's position favoring "all holders" requirement and "Best Price Rule").

47. *Field*, 850 F.2d at 942-43. The "all holders" requirement provides that:

(a) No bidder shall make a tender offer unless:

(1) The tender offer is open to all security holders of the class of securities subject to the tender offer; and

(2) The consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer.

*Id.* at 943 (citing 17 C.F.R. § 240.14d-10 (1987)).

48. *Kahn v. Virginia Retirement Sys.*, 783 F. Supp. 266, 269 (E.D. Va. 1992), *aff'd*, 13 F.3d 110 (1993), *cert. denied*, 114 S. Ct. 1834 (1994). The court also noted that:

[i]n order to establish a violation of Rule 14d-10, plaintiffs must allege and prove at a minimum, four elements: (1) that the bidder, (2) during the pendency of the bidder's tender offer, (3) purchased a security subject to the tender offer, (4) for more consideration than the bidder paid to other shareholders pursuant to the tender offer.

*Id.*

49. *Field*, 850 F.2d at 943. Rule 10b-13 provides in pertinent part:

(a) No person who makes a cash tender offer or exchange offer for any equity security shall, directly or indirectly, purchase, or make any arrangement to purchase, any such security (or any other security which is immediately convertible into or exchangeable for such security), otherwise than pursuant to such tender offer or exchange offer, from the time such tender offer or exchange offer is publicly announced or otherwise made known by such person to holders of the security to be acquired until the expiration of the period, including any extensions thereof, during which securities tendered pursuant to such tender offer or exchange offer may by the terms of such offer be accepted or rejected.

*Id.* (citing 17 C.F.R. § 240.10(b)-13 (1992)). "Side transactions" refer to purchases of securities subject to a tender offer outside the scope of the tender offer. *Id.*

50. 850 F.2d 938 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989).

14d-10.<sup>51</sup> In *Field*, Pay 'N Save, the target corporation, publicized a merger and tender offer with the Trumps, a group of potential investors, in a September 7, 1984 press release.<sup>52</sup> Five days later, the Trumps withdrew their tender offer with Pay 'N Save and commenced negotiations with the Stroums, owners of 18% of Pay 'N Save's outstanding common stock.<sup>53</sup> The plaintiff shareholders alleged that the Stroums received a premium from these negotiations, not available to the other shareholders, that violated the "Best Price Rule".<sup>54</sup> The district court dismissed the Rule 14d-7 complaint and concluded that, based on the Trumps' withdrawal, no tender offers existed on the settlement agreement date.<sup>55</sup> The Second Circuit reversed holding that, based on the lower court's reasoning, tender offerors would circumvent the "Best Price Rule" by periodically withdrawing their tender offer, during which time they make purchases at premiums and after which time they announce a new tender offer.<sup>56</sup>

51. *Id.* at 943. The district court relied on SEC Rule 14d-2(b), which governs the commencement of a tender offer. *Id.* This rule provides that "such tender offer shall not be deemed to [have commenced under this section] on the date of such public announcement if within five business days of such public announcement, the bidder . . . [m]akes a subsequent public announcement stating that the bidder has determined not to continue with such tender offer . . ." *Id.* (citing 17 C.F.R. § 240.14d-2(b) (1987)). For a detailed discussion of these provisions of the Williams Act, see *supra* notes 25-32 and accompanying text.

52. *Field*, 850 F.2d at 941. The case involves Pay 'N Save Corporation's acquisition of Schuck's Auto Supply, Inc. in January of 1984. *Id.* The transaction resulted in Samuel N. Stroum and Stuart M. Sloan, the defendants (the Stroums), holding 18.4% of Pay 'N Save's outstanding common stock. *Id.* On August 31, Julius and Eddie Trump (the Trumps), through corporations they owned and controlled, proposed a cash tender offer of \$22.00 per share for two-thirds of the company's outstanding common shares. *Id.* This transaction was to be followed by a cash-out merger at the same price. *Id.* One week later, the Trumps raised their offer to \$22.50 per share, but warned that it was a "take it or leave it" offer. *Id.* The majority of the Pay 'N Save Board of Directors approved the \$22.50 offer. *Id.* However, Stroum and Sloan dissented. *Id.* The board publicized the \$22.50 offer in a press release. *Id.*

53. *Id.* at 941. At 5:10 p.m. on September 12, after a meeting between the Trumps and the Stroums, the Trumps told Pay 'N Save's Board of Directors that they were withdrawing the previously announced tender offer in order to facilitate the negotiations with the Stroums. *Id.*

54. *Id.* at 942. The subsequent negotiations with the Stroums produced a \$4.2 million settlement agreement at a price of \$25.00 per share. *Id.* The settlement agreement included \$3.3 million for an option to purchase the Stroum's shares at \$23.50 per share. *Id.* Additionally, the Trumps paid the Stroums \$900,000 for the Stroums' "fees and expenses." *Id.* The next day Pay 'N Save issued a press release announcing that the Trumps would commence a new \$23.50 per share tender offer. *Id.*

55. *Id.* at 943. Although the public announcement of the key terms of a tender offer results in the technical commencement of such offer, the offer will be deemed to have not commenced if a withdrawal is announced in five business days. 17 C.F.R. § 240.14d-2(b) (1987).

56. *Field*, 850 F.2d at 944. The *Field* court explained that the "Best Price Rule" is unenforceable if offerors may periodically announce withdrawals during which purchases are made followed by new tender offers. *Id.* The court stated that whether the \$900,000 of fees and expenses the Trumps paid the Stroums were

C. *Materiality Before Basic Inc.*

Prior to the Supreme Court's decision in *Basic Inc.*, federal circuit courts that had addressed the materiality of possible takeover discussions reached different results.<sup>57</sup> In *Staffin v. Greenberg*,<sup>58</sup> the United States Court of Appeals for the Third Circuit found that information regarding preliminary merger talks remains immaterial as a matter of law until the parties agree in principle on the price and structure of the transaction.<sup>59</sup> The three rationales supporting this "agreement in principle" test include the bright-line nature of the rule, the need to preserve the confidentiality of merger discussions and the concern of overwhelming an investor with trivial information.<sup>60</sup> In another ruling, the United States Court of Appeals for the Sixth Circuit concluded that preliminary negotiations were

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actually incurred remains irrelevant under the "Best Price Rule." *Id.* The Trumps expended some or all of those sums to obtain a premium for the Stroums. *Id.* at 944 n.1. Additionally, the *Field* court noted the "Best Price Rule" would be unworkable if offerors were permitted to discriminate among shareholders according to expenses that were not uniformly incurred. *Id.*

57. For a discussion of the varying results of the federal circuit courts before *Basic Inc.*, see *infra* notes 58-62 and accompanying text. For a discussion of the Supreme Court's decision in *Basic Inc.*, see *infra* notes 63-73 and accompanying text.

58. 672 F.2d 1196 (3d Cir. 1982).

59. *Id.* From 1968 to 1979, Herbert Cook and his family controlled between 16% and 20% of the stock of Bluebird Incorporated, one of the nation's largest producers of ham. *Id.* at 1198. Joel Greenberg, a Chicago commodities trader, requested membership on Bluebird's board of directors in 1977. *Id.* Cook did not "like or trust" Greenberg, and he rejected each of Greenberg's attempts to join the board of directors. *Id.* Ultimately, on March 27, 1979, Greenberg purchased Cook's shares for \$12.50 per share, and Cook left the company. *Id.* at 1199. Bluebird issued a tender offer to its shareholders on June 11, 1979 and extended it to July 6, 1979. *Id.* On July 12, 1979, Cook met with Northern Inc., a potential "white knight," to discuss the possibility of Northern acquiring Greenberg's controlling interest. *Id.* at 1200. Cook contacted Greenberg about this discussion and scheduled a meeting between Northern and Greenberg for mid-August. *Id.* In the first week of August, Bluebird's prior stock jumped dramatically. *Id.* Bluebird issued a press release on August 7, 1979 disclosing exploratory talks with an unidentified purchaser. *Id.* On August 10, 1979, Greenberg brought a suit in the District Court for the Eastern District of Pennsylvania to uncover evidence that defendants had fraudulently concealed a plan to merge Bluebird and Northern. *Id.* On August 23, 1979, Northern, Bluebird, Cook, and Greenberg reached an agreement in principle for Northern to purchase all of Bluebird's stock for \$14.875 per share. *Id.*

60. See *Basic Inc. v. Levinson*, 485 U.S. 224, 233-34 (1988). Other circuits have supported the agreement in principle test. See, e.g., *Flamm v. Eberstadt*, 814 F.2d 1169, 1176 (7th Cir. 1987) (explaining that disclosure may compromise corporate position and may hurt shareholder more than help); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984) (stating that agreement as to price and structure must be reached before finding of materiality is made), *cert. denied*, 469 U.S. 1215 (1985) *Reiss v. Pan Am. World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983) (noting that duty to disclose ongoing merger negotiation is triggered when agreement in principle is released). For support of the Supreme Court's dismissal of the agreement in principle test in *Basic Inc.*, see *infra* notes 69-73 and accompanying text.

material because a corporation denied their existence.<sup>61</sup> Finally, the United States Court of Appeals for the First Circuit determined the materiality of merger negotiations on a case-by-case basis, based on the totality of circumstances.<sup>62</sup>

D. *Basic Inc. v. Levinson: The Supreme Court Defines Materiality in the Corporate Disclosure Context.*

The United States Supreme Court sought to resolve the split among federal circuit courts of appeals regarding the proper standard of materiality applicable to preliminary mergers in *Basic Inc. v. Levinson*.<sup>63</sup> The Supreme Court also addressed the narrow question "whether information concerning the existence and status of preliminary merger discussions is significant to a reasonable investor's trading decision."<sup>64</sup> From September 1976 to December 1978, Basic Inc. and Combustion Engineering discussed a possible merger.<sup>65</sup> During this time, Basic Inc. officials made three public statements denying merger plans.<sup>66</sup> As a result, Max Levin-

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61. *Basic Inc. v. Levinson*, 786 F.2d 741, 748 (6th Cir. 1986). Subsequently, the Sixth Circuit denied a petition for rehearing en banc in this case. *Basic Inc.*, 485 U.S. at 237 n.15. Judge Welford, concurring separately, explained that he did not read the panel's opinion to create a "conclusive presumption of materiality for any undisclosed information claimed to render inaccurate statements denying the existence of alleged preliminary merger discussions." *Id.* Judge Welford believed that the decision simply reversed the district court decision, based on an agreement in principle standard. *Id.*

62. *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978) (upholding materiality finding of lower court regarding omission of information relating to merger negotiations and corporation's financial condition); see also *Huddleston v. Herman & MacLean*, 640 F.2d 534, 546 (5th Cir. 1981) (noting that whether actions violate Rule 10b-5 involves specific factual questions); *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 79-80 (2d Cir. 1980) (limiting scienter requirement for Rule 10b-5 actions to facts of particular case); *Sherman v. Sokoloff*, 570 F. Supp. 1266, 1269 & n.8 (S.D.N.Y. 1983) (focusing on financial sophistication of plaintiffs in determining duty to disclose).

63. *Basic Inc.*, 485 U.S. at 230.

64. *Id.* at 235.

65. *Basic Inc.*, 786 F.2d at 743-45. In September of 1976, Combustion Engineering, Inc. (Combustion) began discussing a possible merger with Basic Inc. *Id.* at 743. In November of 1976, Combustion had its investment bankers prepare acquisition analyses of Basic Inc. at prices of \$18, \$20 and \$22 per share. *Id.* at 743-44. In August of 1977 and on October 18, 1977, Basic Inc., discussed valuation of the company with its investment bankers for use in merger negotiations. *Id.* at 744. On repeated occasions through 1977 and 1978, high trading occurred in Basic Inc. stock. See Callaway, *supra* note 1, at 152. On October 19 and 20, 1977, trading was particularly heavy when volume rose to 29,000 shares per day from an average of 6,000 to 8,000 shares per day. *Id.* On December 14, 1978, Combustion approved Basic Inc.'s acquisition offer at \$46 per share. *Basic Inc.*, 786 F.2d at 745.

66. *Basic Inc.*, 786 F. 2d at 742. On October 21, 1977, Basic Inc. issued a public statement that said "the company knew of no reason for the stock's activity and that no negotiations were underway with any company for a merger." *Id.* at 745. Negotiations between the two companies continued into 1978. *Id.* On July 14, 1978, Basic Inc. continued to flatly deny the existence of any undisclosed merger plans. *Id.* Basic Inc. again flatly denied any merger negotiations on Sep-

son and two other shareholders later brought suit alleging that these false and misleading denials violated SEC Rule 10b-5.<sup>67</sup> On appeal, the United States Supreme Court held that materiality hinges on the significance that a reasonable investor would place on the omitted or misrepresented information.<sup>68</sup>

*Basic Inc.* thus requires a fact-intensive, case-by-case, analysis when determining the materiality of contingent corporate events.<sup>69</sup> According to

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tember 25, 1978 in a "Nine Month" interim report to shareholders on October 12, 1978. *Id.* The October 12 statement read: "[w]ith regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months." *Id.* Basic Inc.'s management also denied any knowledge of a corporate development the day after the December 14, 1978 acquisition offer. *Id.*

67. *Id.* at 742-43. The plaintiffs are a representative class of shareholders who sold stock between October 21, 1977 and December 15, 1978 at artificially depressed prices. *Id.* at 743. Because of the misrepresentations, the shareholders claim that they sold stock at low prices, sustaining considerable loss. *Id.* The District Court for the Northern District of Ohio granted summary judgment to Basic Inc. based on the finding that the statements were not material and thus neither false nor misleading. *Id.* However, the district court applied a presumption of reliance when it certified the derivative suit thereby supporting a fraud-on-the-market theory. *Id.* at 749-50.

On appeal, the United States Court of Appeals for the Sixth Circuit held that a duty to disclose arose when Basic Inc.'s corporate officials made statements regarding the merger rumors. *Id.* at 746. The Sixth Circuit found that Basic Inc. misled the public when it issued statements declaring that it did not know why its stock was trading at a high volume with large fluctuations. *Id.* at 748. The court reasoned that information concerning insignificant developments become material when corporate executives affirmatively deny the existence of such developments. *Id.* The information denied is material whether or not the information would have been material absent denial. *Id.*

68. *Basic Inc.*, 485 U.S. at 240. The Supreme Court extended the materiality test established in *TSC Industries* to situations involving the determination of materiality in the context of preliminary merger discussions. *Id.* *TSC Industries* established a standard that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The Supreme Court found no authority in the text of Rule 10b-5, the legislative history or previous decisions for altering the materiality standard depending on the plaintiff's identity or evidence of insider profit. 17 C.F.R. § 240.10b-5 (1986); *see, e.g.*, *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227, 1231 (1st Cir. 1984) (noting that "[a] fact does not become more material to the shareholder's decision because it is withheld by an insider, or because the insider might profit by withholding it"); *cf. Aaron v. SEC*, 446 U.S. 680, 691 (1980) (noting that "scienter is an element of a violation of [section] 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought"). Insider trading can alone indicate materiality. *See SEC v. Geon Indus., Inc.*, 531 F.2d 39, 48 (2d Cir. 1976) (noting that "[i]n cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in a publicly disseminated press release"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir. 1968) (en banc) (explaining that insider must either disclose significant information or abstain from trading).

69. *Basic Inc.*, 485 U.S. at 239. The SEC has endorsed the highly fact sensitive probability/magnitude balancing approach of *Texas Gulf*. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc). The *Texas Gulf* court explained

the Supreme Court, the proper mode of analysis involves evaluating both the probability of the event and the transaction's anticipated magnitude in light of the totality of corporate activity.<sup>70</sup> The Supreme Court also adopted the theory expressed by Justice Friendly, in *SEC v. Geon Industries Inc.*,<sup>71</sup> that information regarding a merger may potentially be the most important event in a corporation's life.<sup>72</sup> In rejecting the "agreement in principle" test, the Supreme Court attacked each of the three rationales supporting that standard.<sup>73</sup>

#### E. *The Progeny of Basic Inc.*

Certain federal courts have applied the *Basic Inc.* materiality formulation to corporate disclosure cases.<sup>74</sup> In *Taylor v. First Union of South Caro-*

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that the possibility of merger, even if no merger takes place, may still have immediate significance to investors in corporate securities. *Id.* at 850. The Second Circuit does not require immediate disclosure of material facts. *Id.* at 859 n.12. The timing of disclosure is based on the corporate officers' judgment coupled with the requirements of the exchanges and the SEC. *Id.* In some instances, a valid corporate purpose is served by delaying publication of corporate information. *Id.*

70. *Basic Inc.*, 485 U.S. at 238-39 (citing *Texas Gulf*, 401 F.2d at 849). The corporation must examine internal functions, actions and interests of the corporate officials charged with making the alleged merger decision. *Id.* at 239. Then, the corporation must consider the relative sizes of the two corporations and possible market impact of their merger. *Id.* The Court noted that "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of [the corporation's] interest." *Id.* To assess the magnitude of the transaction, the factfinder should consider the size of the entities and the possible premiums over market prices. *Id.*

71. 531 F.2d 39, 47-48 (2d Cir. 1976).

72. *Basic Inc.*, 485 U.S. at 238 (citing *Geon*, 531 F.2d at 47-48). This information can become material at an earlier stage than would be the case with lesser transactions, even though the possibility that the merger might never be completed may be high. See *Geon*, 531 F.2d at 48.

73. See *Basic Inc.*, 485 U.S. at 233. The first justification focuses on the tentative nature of preliminary merger negotiations and the desire to protect the investor from needless and trivial information. *Id.* at 234. The Supreme Court adopted the position that most investors are relatively sophisticated not warranting such paternalistic protections. *Id.* (citing *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1986), cert. denied, 484 U.S. 853 (1987)). The second rationale involved the importance of secrecy at early stages of merger negotiations. *Id.* at 234-35. The Court emphasized the distinction between legitimate secrecy and blatant inaccuracy. *Id.* at 239 n.17. One may be silent and not mislead under Rule 10b-5. *Id.* The Supreme Court reasoned that the secrecy rationale was inapposite to the materiality question. *Id.* The Court did concede that a bright-line rule might be administratively convenient. *Id.* at 236. Nevertheless, ease of application alone is not an excuse to ignore the purposes of the Securities Act. *Id.* The Court cautioned and garnished support from the Advisory Committee on Corporate Disclosure, against confining materiality to a rigid formula. *Id.* The Supreme Court also rejected the Sixth Circuit rationale that the denial of a statement rendered it material. *Basic Inc.*, 786 F.2d at 749. The Court concluded that this approach failed to demonstrate adequately that statements were misleading as to a material fact. *Basic Inc.*, 485 U.S. at 238.

74. For a discussion of these federal cases, see *infra* notes 75-94 and accompanying text.



lina,<sup>75</sup> the Fourth Circuit held that speculative merger discussions were not material under *Basic Inc.*<sup>76</sup> The court noted that the plaintiffs lacked evidence of an agreement in principle, board resolutions, actual negotiations or instructions to investment bankers to facilitate the merger.<sup>77</sup> Additionally, the merger between the parties hinged on a change in the interstate banking laws.<sup>78</sup> The court concluded that these discussions only reflected a vague promise to establish a future relationship and did not warrant disclosure under Rule 10b-5.<sup>79</sup>

75. 857 F.2d 240 (4th Cir. 1988).

76. *Id.* at 242. In February 1984, after a bitter dispute, Southern forced Bennie Taylor to resign his position as a director and agreed to repurchase Taylor's Southern stock. *Id.* After Southern refused to repurchase Bennie Taylor's shares above the market price, Bennie and Patricia Taylor (the Taylors) initiated negotiations with First Union, and agreed to sell their Southern stock to First Union for \$18 per share. *Id.* First Union did not inform the Taylors that it had previously approached Southern to discuss a merger between the two banks if interstate banking became legal in South Carolina. *Id.* Sixteen months later, after the Supreme Court declared interstate banking constitutional, First Union and Southern met several times to solidify the merger proposal. *Id.* at 243. First Union purchased all of Southern's outstanding stock for \$33 per share. *Id.* The Taylors sued both Southern and First Union claiming that the banks conspired to withhold information from them to facilitate the acquisition of their shares at artificially low prices. *Id.*

77. *Id.* at 243. First Union and Southern had established a business relationship at the time First Union and Bennie Taylor negotiated the sale of the Taylors' stock. *Id.* This business relationship remained changeable. *See id.* Business people routinely discuss and exchange information on matters that may or may not result in some future agreement. *Id.* at 244. The court determined that First Union had no general duty to disclose material facts prior to purchasing stock of Southern from a Southern shareholder. *Id.*; *see also* *Holstein v. Armstrong*, 751 F. Supp. 746, 747 (N.D. Ill. 1990) (holding that directors of UAL did not violate Rule 10b-5 by failing to publicly disclose takeover proposal). The defendants in *Holstein* had not traded UAL stock and had not made misleading statements regarding the takeover proposal. *Id.*

78. *Taylor*, 857 F.2d at 243. The United States Supreme Court had yet to rule on the constitutionality of interstate banking. *Id.* Thus, the merger was contingent upon a change in the banking laws beyond the control of the parties. *Id.*

79. *Id.* at 244. Evidence indicated that Taylor attended the Southern Board of Directors' meeting, approving First Union's investment in Southern. *Id.* Taylor knew that Southern presented an attractive acquisition target should interstate banking become legal. *Id.* Taylor had also been warned by his attorney of a possible Southern-First Union merger. *Id.* The court might have been influenced by the plaintiff's position as a savvy business man who should have anticipated the possibility of a merger. *See id.* at 242-44. Therefore, the incremental information that certain meetings had occurred and understandings reached between the two institutions would not materially add to the mix of information available to a reasonable investor. *Id.* at 244.

Had Bennie and Patricia Taylor sold their stock to Southern, as initially intended, Southern may have had a duty to disclose material information because it would have been trading in its own stock. *See* *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc) (stating that insiders must disclose material information or abstain from trading and recommending securities). The Fourth Circuit's materiality analysis would then have been more critical to the outcome of this decision. *See id.* (noting mandatory disclosure of inside trading information).

In *Jackvony v. Rhode Island Hospital Trust Financial Corp.*,<sup>80</sup> the First Circuit affirmed a directed verdict for Hospital Trust, ruling that a company's "general interest" in a merger was not material absent specific pre-merger events.<sup>81</sup> The court found that Hospital Trust considered itself a potential takeover target and that the officers and directors discussed the possibility of seeking a merger with another bank.<sup>82</sup> However, unlike the issuer in *Basic Inc.*, Hospital Trust had not received any concrete offers and had not engaged in any specific discussions with a potential merger partner.<sup>83</sup> Because the public was aware of the deregulation and takeover environment, the undisclosed information would not alter the total mix of information available to investors.<sup>84</sup>

In *Hartford Fire Insurance Co. v. Federated Department Stores, Inc.*,<sup>85</sup> the United States District Court for the Southern District of New York held that merger prospects are not necessarily material for Rule 10b-5 purposes.<sup>86</sup> In determining the probability of a takeover, the *Hartford* court focused on the level of interest demonstrated at the highest corporate

80. 873 F.2d 411 (1st Cir. 1989).

81. *Id.* at 414. This case arose from a stock purchase, resulting in a merger between Columbus National Bank and Hospital Trust. *Id.* Mr. Jackvony, a shareholder of Columbus, claimed that Hospital Trust should have disclosed its "general interest" in facilitating a merger with a larger bank prior to closing the merger with Columbus. *Id.* He alleged that had he known Hospital Trust considered itself a potential takeover target at the time of the merger, he would have elected to take more Hospital Trust shares instead of cash for his Columbus stock. *Id.* Hospital Trust was acquired at a premium by another bank. *Id.*

82. *Id.* Hospital Trust directors and officers had expressed concern internally about being acquired merely in the broader context of considering various options for the future. *Id.*

83. *Id.* at 415. Any reasonably sophisticated investor buying securities in a large corporation would expect other corporations to express occasional interest in buying such shares. *Id.* A reasonable investor would also expect a large corporation's directors to discuss a plan of action in the event of such an offer. *Id.* The court stated that announcements made by large corporations every time directors discuss matters in vague terms such as those presented in this case or receive "tentative feelers" of the general kind here, would more likely confuse, rather than inform, the marketplace. *Id.*

84. *Id.* Additionally, in 1982, the banking community believed that banking laws would soon change, and that previously forbidden interstate bank expansion would soon become permissible. *Id.* The community was also aware that many regional banks were considering expansion and that some New England banks might acquire others. *Id.* Given this general knowledge, the information Jackvony cites would not alter the mix of information available to a reasonable investor. *Id.*

85. 723 F. Supp. 976 (S.D.N.Y. 1989).

86. *Id.* at 976-80. In *Hartford*, bondholders of Federated Department Stores sued, claiming that Federated had failed to disclose in the bond offering the possibility of Federated's acquisition in a highly leveraged takeover. *Id.* Such an acquisition would increase the risk of the bonds. *Id.* For some time, Federated had considered itself a prime takeover candidate prior to the issuance of the bonds. *Id.* Federated was eventually acquired by Campeau U.S. in a highly leveraged hostile transaction. *Id.* Shortly thereafter, the investment grade of the bonds plummeted from low-risk ratings to "junk" status. *Id.*

levels.<sup>87</sup> The district court found that the possibility of a takeover was unlikely because Federated showed no acquisition interest and lacked control over the timing of a hostile takeover.<sup>88</sup> Federated could not gauge the magnitude of the event because it could not anticipate the takeover's structure, the debt to be incurred, or the size of the entities involved.<sup>89</sup> Finally, non-disclosure would not alter the overall mix of available information because Federated was considered an attractive candidate in a takeover environment.<sup>90</sup> Like the First Circuit's decision in *Jackvony, Hartford* involved general concerns regarding possible acquisition, but no specific pre-merger events occurred.<sup>91</sup> The investing public likewise remained aware of the general takeover environment.<sup>92</sup>

The post-*Basic Inc.* cases demonstrate the Supreme Court's flexible and fact-specific approach to materiality has not altered traditional disclo-

87. *In re Columbia Sec. Litig.*, 747 F. Supp. 237 (S.D.N.Y. 1990). Allegations of meetings with top executives of a merger candidate and movements at executive levels to pursue and finalize a merger with such a candidate, indicate an interest at the highest corporate level. *Id.* at 243. This higher level interest precludes a motion to dismiss for failure to plead adequately that press releases denying merger negotiations were materially misleading. *Id.*

88. *Hartford*, 723 F. Supp. at 987. Federated was widely rumored as a possible takeover candidate, but the company had not identified a potential acquirer, nor had a suitor contacted Federated or made an offer to purchase the company. *Id.* In addition, Federated had not indicated any interest in being acquired. *Id.* No board resolutions, instructions to investment bankers, contacts with lawyers, or negotiations with another company existed. *Id.* On the contrary, Federated demonstrated their opposition to a takeover by instituting a shareholder rights plan and repurchasing large blocks of its stock. *Id.*

89. *Id.* When the plaintiffs purchased the notes, the magnitude of the transaction could not be determined with exactitude. *Id.* Absent an indication of interest, a formal offer, or some progress toward the price and structure of the transaction, Federated had no means of appraising the size of the two corporate entities or the potential premiums above market price. *Id.*

90. *Id.* at 987-88. Disclosure that Federated was an attractive "takeover" candidate, that management might receive offers, or that a highly leveraged acquisition could transform the company's structure and long term forecast would not have altered the "total mix" of information available to investors. *Id.* Indeed, years before Federated issued the notes, press reports in the business community identified Federated as an attractive takeover possibility and a frequently discussed acquisition target. *Id.* at 988. Articles also appeared detailing the risks that takeovers posed for those holding investment grade securities like bonds and notes. *Id.*

91. *Id.* at 988. For a discussion of *Jackvony*, see *supra* notes 80-84 and accompanying text.

92. *Id.* at 988-89. Despite the fact-intensive nature of the *Basic Inc.* inquiry, summary judgment is appropriate where the prospective merger is too inchoate to be material. *Basic Inc. v. Levinson*, 485 U.S. 224, 241 (1988); see also *Savage v. Federated Dep't Stores Inc., Retirement Income & Thrift Incentive*, No. 89-5425 (D.N.J.), *aff'd*, 893 F.2d 1331 (3d Cir. 1989) (stating that omitted information cannot be considered misleading, and thus give rise to duty to disclose, if that information is already available in marketplace). For a detailed analysis of this proposition, see *In re Apple Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989) (noting summary judgment may be granted in appropriate securities fraud cases despite fact-specific nature of materiality), *cert. denied*, 110 S. Ct. 3229 (1990).

sure obligations under federal securities laws.<sup>93</sup> The plaintiffs must first prove that the issuer had a duty to disclose, and second show that the omitted information was material.<sup>94</sup> Against this backdrop, the *Kahn* court considered the June 18, 1991 press release disclosing the proposed terms of Richmond Fredricksburg and Potomac Corporation's ("RF&P") restructuring.<sup>95</sup>

### III. *KAHN V. VIRGINIA RETIREMENT SYSTEM*

#### A. *Facts*

Beginning in 1983, CSX Corporation ("CSX") wanted to obtain control over RF&P's 113-mile rail line, strategically located in the middle of CSX's rail network.<sup>96</sup> In 1985, RF&P formed a Special Committee of independent members of RF&P's Board of Directors to consider various transactions with CSX.<sup>97</sup> Between 1986 and early 1991, the Special Com-

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93. See, e.g., *Bolton v. Tesoro Petroleum Corp.*, 871 F.2d 1266 (5th Cir. 1989) (applying fact-intensive analysis to corporate restructuring), *cert. denied*, 110 S. Ct. 83 (1989); *Seagoing Uniform Corp. v. Texaco, Inc.*, 705 F. Supp. 918 (S.D.N.Y. 1989) (applying fact-intensive analysis to greenmail); *SEC v. Clark*, 699 F. Supp. 839, 846 (W.D. Wash. 1988) (emphasizing that materiality is fact-intensive question for enforcing actions against persons trading on non-public information); *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119 (D. Del. 1988) (applying fact-specific analysis to negotiations regarding sale of subsidiary, and employee stock purchase options). For a critical analysis of how these disclosure obligations apply to the *Kahn* case, see *infra* notes 166-73 and accompanying text. For commentary supporting this analysis, see *supra* note 92. See also *Jackvony v. Rhode Island Hosp. Trust Fin. Corp.*, 873 F.2d 411 (1st Cir. 1989) (noting, after fact-intensive analysis, agreement was too speculative to require disclosure); *In re Columbia Sec. Litig.*, 747 F. Supp. 237, 237 (noting that meetings of top shareholders resulting in merger possibility is beyond speculative); *Hartford*, 723 F. Supp. at 976 (noting, based on specific factual context, potential sale or leveraged buyout were not material).

94. *Basic Inc.*, 485 U.S. at 239 n.17. The disclosure duty arises when a corporation trades in its own securities, makes prior inaccurate disclosures, or when a statute mandates disclosure. *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22 (1st Cir. 1987). For the text of Rule 10b-5(b) regarding the duty of disclosure and materiality, see *supra* note 4.

95. *Kahn v. Virginia Retirement Sys.*, 13 F.3d 110, 111 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994). Specifically, the plaintiff shareholders claim this press release constitutes a "tender offer" pursuant to Rule 14d-2 of the Williams Act. *Id.* at 112. For a discussion of this portion of the Williams Act, see *supra* note 48 and accompanying text.

96. *Kahn* 13 F.3d at 112. Without access to the RF&P rail lines, CSX would be forced to seek costly and inefficient methods of connecting its rail traffic. *Kahn v. Virginia Retirement Sys.*, 783 F. Supp. 266, 267 (E.D. Va. 1992), *aff'd*, 13 F.3d 110 (1993), *cert. denied*, 114 S. Ct. 1834 (1994). This access would conveniently link its northern rail lines (the old Chessie system) and its southern rail lines (the former Seaboard system). *Kahn*, 13 F.3d at 112.

97. *Kahn*, 783 F. Supp. at 267.

mittee considered and proposed a variety of transactions that RF&P's Board of Directors rejected.<sup>98</sup>

In February 1991, the Virginia General Assembly included a budget directive that the Virginia Retirement System ("VRS") purchase the Commonwealth's appreciation rights on 3.5 million restricted RF&P shares owned by VRS.<sup>99</sup> These appreciation rights allowed the Commonwealth to purchase the shares from VRS at VRS's determined book value, and subsequently resell the shares to VRS at market price.<sup>100</sup> In May, 1991, the Governor signed this budget directive into law.<sup>101</sup> VRS transferred \$71 million to the Commonwealth to obtain clear title to 3.5 million shares of non-voting stock.<sup>102</sup> Previously, the Special Committee issued a press release, recommending a revised joint transaction among RF&P, CSX and VRS.<sup>103</sup> The RF&P Board of Directors later is-

98. *Kahn*, 13 F.3d at 112. These transactions included a sale of RF&P's railroad assets, an asset stock exchange, a cash-out merger and a tender offer. *Kahn*, 783 F. Supp. at 267.

99. *Kahn*, 13 F.3d at 112. The Commonwealth sold these shares for approximately \$71 million. *Id.*

100. *Id.* at 112. The net effect of the transaction was that the Commonwealth received \$48.21 per share. *Id.* at 112-13 n.3. At the time of the transaction, the Commonwealth had the right to purchase the shares from VRS at the VRS determined book value of \$28.00, and subsequently resell to VRS at market price. *Id.* In this case, the Commonwealth sold its right in the shares to VRS for the net amount of \$20.21 per share in lieu of purchasing and reselling the shares. *Id.* This amount was the equivalent of the Commonwealth buying the shares from VRS at \$28.00 per share and reselling them to VRS at \$48.21 per share. *Id.*

101. *Id.* at 112. Prior to the transaction the Commonwealth had the right to purchase the RF&P stock from VRS. *Kahn*, 783 F. Supp. at 268. The Commonwealth could not sell this right to anyone at the original market price, but could resell it to VRS and realize the appreciation on the stock. *Id.* For a discussion of the mechanics of the appreciation recognition, see *supra* note 100 and accompanying text.

102. *Kahn*, 783 F. Supp. at 268. This transfer occurred on June 28, 1991, 10 days after the RF&P Special Committee issued a public announcement recommending a revised three-way transaction between RF&P, CSX and VRS to the RF&P Board of Directors. *Id.* For the text of the RF&P press release, see *infra* note 103. For a discussion of the three-way transaction, see *supra* notes 100-01 & *infra* notes 103-04 and accompanying text.

103. *Kahn*, 13 F.3d at 112. RF&P issued this press release on June 18, 1991, using RF&P stationary, stated in full:

A Special Committee of RF&P Corporation's Board of Directors announced today that it was prepared to recommend to RF&P's Board of Directors a revised transaction among RF&P, CSX Corporation and the Virginia Retirement System in which RF&P's public shareholders would have the opportunity to receive \$39 per share in cash for any and all of their shares. In the proposed transaction, CSX Corporation effectively will transfer to RF&P and VRS the approximately 6.8 million shares of RF&P it owns or controls for \$35 a share and acquire the RF&P railroad and receive certain other assets and benefits for \$135 million, retaining the balance of \$104 million in cash.

Speaking through its chairman, C. Coleman McGehee, the Special Committee announced that the proposed transaction still is subject to a number of conditions including negotiation of definitive agreements and

sued another press release agreeing in principle to the three-way transaction.<sup>104</sup>

These press releases highlighted the three important transactions constituting the corporate restructuring.<sup>105</sup> First, on August 28, 1991, CSX and RF&P executed an Asset Purchase Agreement whereby RF&P obtained 3.9 million shares of RF&P non-voting stock held by CSX in exchange for RF&P's railroad assets.<sup>106</sup> Second, also on August 28, CSX and VRS entered a Stock Purchase Agreement where CSX would transfer approximately 2.97 million shares of RF&P voting and non-voting stock to VRS for \$105.8 million in cash.<sup>107</sup> Finally, on August 30, 1991, Systems Holding Inc. ("SHI") commenced a public tender offer for all outstanding shares of RF&P stock at \$39.00 per share.<sup>108</sup>

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approval by the RF&P Board. As a part of the proposed offer, the Special Committee will recommend that the RF&P Board not declare the regular second quarter dividend, retaining the right to declare the dividend at a later date if the transaction does not proceed.

Mr. McGehee noted that the revised transaction is a significant improvement for the public shareholders. As originally proposed in August, 1990, the public shareholders would have been able to exchange only about one-sixth of their shares at \$35 a share.

Jacqueline G. Epps, Chair of the Virginia Retirement System's Board of Trustees, stated that "while the negotiations have been long and complicated, it appears that everybody stands to gain from the proposed transaction."

John W. Snow, chairman and chief executive officer of CSX, said, "We are pleased with the agreement and look forward to continuing to operate the RF&P railroad as a key part of the CSX rail system."

*Id.* at 112 n.2.

104. *Id.* at 112. RF&P issued this release on June 21, 1991, three days after it released the press release publicizing the proposed transaction. *Id.*

105. *Id.* The overall impact of this transaction is best described as follows:

In short, RF&P is now a real estate company with no railroad operations; VRS beneficially owns substantially all of the outstanding RF&P stock; CSX owns and operates the railroad assets; and almost all of RF&P's public shareholders have received \$39.00 per share in cash for their stock and are no longer shareholders of RF&P.

*Kahn*, 783 F. Supp. at 268.

106. *Kahn*, 13 F.3d at 112. On October 10, 1991, pursuant to a 1991 Asset Purchase Agreement, executed on August 28, 1991, CSX acquired RF&P's railroad assets in consideration for the transfer by CSX to RF&P of approximately 3.9 million shares of the non-voting RF&P stock. *Kahn*, 783 F. Supp. at 268. As a result of this transaction, CSX exchanged the majority of its non-voting stock in RF&P and now controlled and operated the railroad assets either as the owner or as the beneficiary of permanent easements. *Id.*

107. *Kahn*, 13 F.3d at 113. This figure represents a consideration of \$35.58 per share. *Kahn*, 783 F. Supp. at 268. The net result of the stock sale eliminated CSX as the beneficial owner of 62.7% of the RF&P voting stock and vested in VRS ownership of substantially all of the RF&P voting stock. *Id.*

108. *Kahn*, 13 F.3d at 112. Systems Holdings, Inc., ("SHI") was a wholly-owned subsidiary of RF&P created to effect the tender offer and to hold RF&P shares. *Id.* On October 9, 1991, SHI accepted for payment substantially all the RF&P shares held by the public shareholders. *Kahn*, 783 F. Supp. at 268. The

On September 24, 1991, two RF&P shareholders instituted a derivative suit against VRS, CSX and RF&P alleging violations of section 14d-7 of the Williams Act and SEC Rule 14d-10. In addition, the shareholders alleged the companies violated SEC Rule 10b-13, as well as breaching the fiduciary duties imposed upon them.<sup>109</sup>

The plaintiffs claimed that the tender offer began on June 18, 1991, when RF&P's Special Committee issued its press release.<sup>110</sup> Based on this alleged tender offer, the plaintiffs asserted that the defendants violated the "Best Price Rule."<sup>111</sup> According to the complaint, the violations occurred when the Commonwealth transferred 3.5 million shares to VRS on June 28, 1991 and when CSX received stock in conjunction with the August 28, 1991 railroad and stock sales.<sup>112</sup>

The United States District Court for the Eastern District of Virginia granted the defendant's Rule 12(b)(6) motion to dismiss for failure to state a cause of action.<sup>113</sup> The district court held that the Special Committee's June 18, 1991 press release did not commence a tender offer and that no violation of Rule 14d-7, Rule 14d-10, or Rule 10b-13 occurred.<sup>114</sup> The district court ruled that the tender offer did not begin until SHI's

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RF&P Schedule 14D-9 defines public shareholders as those who own RF&P stock other than VRS, CSX or their corporate affiliates. *Id.*

109. *Id.* at 269. The court dismissed the Williams Act and the 10b-13 claims and refused to exercise jurisdiction over the state breach of fiduciary duty claim. *Id.* The parties stipulated to these terms. *Id.* For a discussion of Rule 10b-13, see *supra* note 49 and accompanying text.

The shareholders filing this lawsuit were Alan R. Kahn and Hunter A. Hogan, Jr. *Kahn*, 13 F.3d at 110. These shareholders brought the action in the United States District Court for the Eastern District of Virginia. *Id.* Because Kahn sought damages instead of injunctive relief, the three-way transaction continued until its completion on October 10, 1991. *Id.* at 113.

The plaintiffs alleged that VRS and SHI violated the Williams Act. *Kahn*, 783 F. Supp. at 268. The plaintiffs also claimed that CSX and RF&P aided and abetted these violations. *Id.*

110. *Id.* For a discussion of this press release, see *supra* note 103 and accompanying text.

111. *Kahn*, 13 F.3d at 113. Rule 14d-10 codifies the "Best Price Rule," requiring that a tender offeror pay every tendering shareholder the highest consideration paid any other shareholder during the term of the tender offer. *Kahn*, 783 F. Supp. at 269. For a detailed discussion of the "Best Price Rule," see *supra* note 45 and accompanying text.

112. *Kahn*, 783 F. Supp. at 268. The Commonwealth received \$48.21 per share, which exceeded the \$39.00 per share in the alleged June 18, 1991 tender offer. *Id.* These transactions were also in excess of the \$39.00 per share paid to the shareholders on June 18, 1991. *Id.* at 269.

113. *Kahn*, 783 F. Supp. at 267. The court, however, denied the defendant's claim of immunity under the Eleventh Amendment of the Constitution. *Id.* at 272-74. In addition, the district court, after dismissing the federal securities claims, did not exercise supplemental jurisdiction over the state law breach of fiduciary duty claim. *Kahn*, 13 F.3d at 113.

114. *Kahn*, 783 F. Supp. at 272. Also, the district court asserted that the June 18, 1991 press release did not comply with the requirements for a tender offer because the release did not identify the bidder. *Id.*

formal announcement on August 30, 1991.<sup>115</sup> The plaintiff shareholders appealed the district court's decision to grant the defendant's motion to dismiss.<sup>116</sup>

### B. Judge Widener's Opinion

#### 1. Tender Offer Analysis

Writing the opinion for the Fourth Circuit, Judge Widener began his determination of whether the district court properly granted the defendant's Rule 12(b)(6) motion by examining the purpose of the Williams Act and the impact of classifying a public announcement as a tender offer.<sup>117</sup> He noted that although Congress designed the Act to protect investors, neither Congress nor the SEC expressly defined what constitutes a tender offer.<sup>118</sup> The court further stated that as a result of this ambiguity, many pre-tender offer announcements could trigger market activity normally linked to valid tender offers and cause investors to make hasty decisions based on incomplete information.<sup>119</sup> Moreover, the court reasoned that the SEC promulgated Rule 14d-2 to prevent unintentional tender offers, by requiring tender offerors to specify the identity of the bidder and the subject company's identity as well as the amount, class and prices of the securities offered.<sup>120</sup> Once a tender offer commences, the court noted that the bidder has five days either to discontinue the offer or to comply

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115. *Kahn*, 13 F.3d at 113. This tender offer did not commence until SHI's formal announcement on August 30, 1991. *Id.*

116. *Id.* The United States District Court for the Eastern District of Virginia granted the defendant's 12(b)(6) motion to dismiss, but denied the defendant's sovereign immunity motion. *Kahn*, 783 F. Supp. at 274.

117. *Kahn*, 13 F.3d at 113-14. Congress passed the Williams Act in 1968 in response to the proliferation of cash tender offers for corporate takeovers. *Id.* Through the Williams Act, Congress sought to protect investors by requiring tender offerors to make full and adequate disclosure, and by imposing certain obligations on tender offerors during the tender offer period. *Id.* For a detailed discussion of the Williams Act and its purpose, see *supra* notes 25-32 and accompanying text.

118. *Kahn*, 13 F.3d at 114. While this ambiguity gave courts flexibility in determining which actions were subject to the Williams Act, the vagueness also has allowed certain abuses that the Williams Act originally sought to remedy. See Release 16,384, *supra* note 11, at 82,582-83 (noting problems such as arbitrage which may occur with pre-tender offer public announcements).

119. *Kahn*, 13 F.3d at 114 (noting that pre-tender offer announcements may result in uninformed decisions). If tender offer activity begins as a result of a public announcement concerning material terms, the contest for control of the subject company will occur prior to the application of the Williams Act requirements, thereby denying the shareholders the protection Congress intended to provide. *Kahn*, 783 F. Supp. at 271.

120. *Kahn*, 13 F.3d at 114. These specific requirements allow courts and investors to distinguish easily between public announcements that start tender offers and those that do not. *Id.* This result prevents the abuse linked to the uncertainty of public announcements, leading to an inadvertent commencement of a tender offer. *Id.* For a detailed discussion of Rule 14d-2 of the Williams Act, see *supra* notes 11, 31-32 and accompanying text.



with the filing and disclosure requirements mandated by the Williams Act.<sup>121</sup>

The Fourth Circuit next examined the RF&P press release in light of Rule 14d-2's purpose.<sup>122</sup> The court pointed to SEC Regulation 34-16623 which states that Rule 14-d requires a public announcement be made by or on behalf of the bidder to trigger a tender offer.<sup>123</sup> The shareholders alleged that the press release satisfied Rule 14d-2(c) because the release was either made on behalf of VRS, was joint, or was affirmed as a tender offer.<sup>124</sup> The Fourth Circuit rejected the shareholders' argument which contended that the Special Committee made a joint release, because this

121. *Kahn*, 13 F.3d at 114. "As a result, it is not anticipated that a bidder making such a public announcement will select the 'do nothing' alternative." *Id.* Usually, if a bidder does nothing, interested investors will try to make the public announcement of a tender offer, and force bidder compliance with the Williams Act disclosure requirements. *Id.* (citing *Weeden v. Continental Health Affiliates Inc.*, 713 F. Supp. 396, 397 (N.D. Ga. 1989) (seeking to force defendant to comply with "Five Day Rule" of Rule 14d-2(b)(2)); *see also American Carriers Inc. v. Baytree Investors Inc.*, 685 F. Supp. 800, 801 (D. Kan. 1988) (seeking to enjoin defendants from making or announcing tender offer unless defendants comply with disclosure requirements of Securities Exchange Act 1934).

122. *Id.* No basis warrants the conclusion that VRS, or a party on behalf of VRS, made the June 18, 1991 announcement. *Kahn*, 783 F. Supp. at 271. The press release was clearly issued by RF&P, and not the bidder, VRS or SHI. *Id.* RF&P issued the press release on their personalized stationary. *Id.* The release also outlined the proposed transaction and included several statements by C. Coleman McGehee, Chairman of the Special Committee at RF&P. *Id.* McGehee explained that the proposed transaction remained subject to a number of conditions, including approval by the RF&P Board of Directors. *Id.*

123. *Kahn*, 13 F. 3d at 115. The SEC interpreted the rules in a question and answer format, and a question directly on point states:

Question: Will a public announcement by the subject company or by another person having no relationship with a bidder of a bidder's intention to make a cash tender offer together with the information referred to in Rule 14d-2(c) commence the five business day period in Rule 14d-2(b)?  
Response: No. Only a public announcement by the bidder or *on the bidder's behalf* will commence a tender offer pursuant to any of the provisions of Rule 14d-2. As a practical matter, however, if a bidder's intention becomes generally known, the bidder may be unable to deny its intentions, and any affirmation of the information referred to in Rule 14d-2(c) by or on behalf of the bidder would cause the tender offer to start under Rule 14d-2(b).

In certain situations where the bidder and the subject company agree or arrange that the subject company will make the public announcement and such public announcement does not arise solely out of the subject company's disclosure duty, the public announcement will be viewed as being made on behalf of the bidder.

*Id.* (quoting Interpretive Release Relating to Tender Offer Rules, Exchange Act Release No. 34-16,623, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,484I (March 5, 1980) (emphasis added)).

124. *Kahn*, 13 F.3d at 115. *Kahn* alleged that the release was either joint, or was affirmed as a VRS tender offer. *Id.* In support of the assertion that a valid tender offer existed, *Kahn* relied on *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988), *cert. denied* 489 U.S. 1012 (1989), in which the Second Circuit concluded that a press release by a target corporation constituted tender offer. *Kahn*, 13 F.3d at

announcement did not use the specific term "tender offer," failed to identify the bidder and did not specify a time limit.<sup>125</sup>

The Fourth Circuit also considered shareholder Kahn's claim that *Field* supported the proposition that RF&P's June 18, 1991 announcement constituted a tender offer.<sup>126</sup> The court concluded that *Field* supported a contrary position because the *Field* press release positively identified the bidders.<sup>127</sup> The court further stated that the Trumps' attempt to withdraw the *Field* tender offer,<sup>128</sup> as contrasted with VRS' and SHI's inaction in response to the June 18, 1991 announcement, supported the district court's holding of "no tender offer."<sup>129</sup> Finally, the absence of any shareholder reliance on the June 18, 1991 announcement weakened Kahn's contention that the press release constituted a valid tender offer.<sup>130</sup>

The Fourth Circuit revisited the purpose of SEC Rule 14d-2 when examining Kahn's argument that the June 18, 1991 press release described the bidder with enough detail for investors to discern the bidder's identity.<sup>131</sup> The court noted that Kahn's assertion would allow vague infer-

115. For a detailed discussion of *Field*, see *supra* notes 50-56 and accompanying text.

125. *Kahn*, 13 F.3d at 115. The press release did not specify the term "tender offer," did not announce any fixed time limits, and did not mention the identity of the bidder. *Kahn*, 783 F. Supp. at 271. The press release identified and quoted Jacqueline Epps, the chair of VRS's Board of Directors, but nothing in her statement could be reasonably inferred to mean that VRS was the bidder. *Id.* Given the preliminary nature of the negotiations at the time, the proposed transaction, which was consistent with the RF&P press release, could take one of many forms including a merger, an exchange offer, or a self-tender offer by RF&P. *Id.* at 271-72.

126. *Kahn*, 13 F.3d at 115. In *Field*, Pay 'N Save, the target corporation, issued a press release stating that a merger agreement had been reached with the Trumps, at the proposed tender offer price of \$22.50 per share. *Field*, 850 F.2d at 941. The *Field* court found that this press release constituted the commencement of a tender offer made on behalf of the bidder. *Id.* at 943. For a detailed discussion of *Field*, see *supra* notes 50-56 and accompanying text.

127. *Kahn*, 13 F.3d at 115. RF&P's announcement did not specify the bidders. *Id.* at 112 n.2. *Field* stated that the announcement constituted a tender offer, where RF&P's publication did not use the word "tender offer." See *id.* at 115 (citing *Field*, 850 F.2d at 941).

128. *Id.* On September 12, after a meeting between the Trumps, the Stroums, and Sloan, the Trumps told the Pay 'N Save Board of Directors that they were withdrawing their previously announced tender offer. *Field*, 850 F.2d at 941. The Trumps also issued a press release announcing both the withdrawal of their tender offer and cessation of further negotiations with the Stroums. *Id.*

129. *Kahn*, 13 F.3d at 115. In addition to the inactivity after the June 18, 1991 press release, SHI expressly made a tender offer on August 30, 1991. *Id.*

130. *Id.* at 115-16. Finally, the court noted that no shareholder sought to declare a tender offer, enjoin a tender offer, or force VRS/SHI to comply with the Williams Act. *Id.* One of these activities typically occurs when a formal tender offer is declared. *Id.*

131. *Id.* at 116. Kahn also asserted that although the June 18, 1991 press release did not specifically identify the bidder or proposed transaction, RF&P described them with sufficient accuracy to allow investors to determine the bidder's identity. *Id.* Kahn argued that including the word exchange in the press release

ences to trigger a tender offer.<sup>132</sup> The Fourth Circuit concluded that such activity defeats the purpose of Rule 14d-2(c) by detracting from the certainty provided to bidders.<sup>133</sup> The court further stated, however, that a tender offer may begin if a bidder affirms generally known intentions.<sup>134</sup> The court concluded that although the June 18, 1991 press release was joint, because the bidder did not subsequently affirm the release's information, the press release did not constitute a valid tender offer.<sup>135</sup>

## 2. Materiality Analysis

Continuing its analysis, the Fourth Circuit next determined that the June 18, 1991 public announcement was mandatory under Rule 10b-5 of the 1934 Securities and Exchange Act.<sup>136</sup> The court further noted that the June 18, 1991 announcement was not an agreement in principle that would fall under the purview of *Staffin*.<sup>137</sup> Nevertheless, the court considered the Supreme Court's test in *Basic Inc.* that required preliminary negotiations to be disclosed when their existence and status becomes

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allowed investors to identify VRS as the bidder. *Id.* Kahn also quoted a June 21, 1991 newspaper article explaining the RF&P transaction. *Id.* The Fourth Circuit noted that although these inferences may meet the requirements of 14d-2(c), Kahn's argument failed when considering the purpose of Rule 14d-2. *Id.*

132. *Id.* In this case, knowledgeable investors like Kahn, presidents of investment management firms and reporters would control the commencement of tender offers. *Id.* This control would thwart the purpose of the Williams Act. *Id.* For a further discussion of the purpose of the Williams Act, see *supra* notes 10-12, 25-32 and accompanying text.

133. *Kahn*, F.3d at 116. A press prediction alone does not constitute a tender offer. *Id.*

134. *Id.* As a practical matter, when a bidder's intentions are generally known, the bidder may not be able to deny the intentions. *Id.*

135. *Kahn*, F.3d at 116. The shareholders failed to allege facts showing that VRS affirmed the information in the June 18, 1991 press release. *Id.* The joint release must be affirmed in a subsequent editorial to constitute a tender offer. *Id.*

136. *Id.* For the pertinent text of Rule 10b-5, see *supra* note 4.

137. *Kahn*, 13 F.3d at 116. The Third Circuit held where an agreement in principle has been reached, a duty to disclose exists. *Staffin v. Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982). The *Staffin* court also upheld a finding of liability when an insider intentionally suspended discussions that created a likelihood of merger. *Id.* The Third Circuit reasoned that disclosure of preliminary merger talks would do more harm than good, and would itself be misleading. *Id.* at 1206. The *Staffin* court noted that the Senate Subcommittee focused on the relationship between the tender offer price and the market price when analyzing this issue. *Id.* (citing *Hearings Before the Subcommittee on Securities of the Committee on Banking and Currency*, 90th Cong., 1st Sess. 72 (1967)). The Subcommittee noted that when word of the offer is publicized, the stock price fluctuates toward the expected tender price. *Id.* Thus, the primary inducement to shareholders, the offer by another to purchase their shares at a premium, is lost. *Id.* The American Stock Exchange noted that corporate developments may produce material information that is subject to rapid change. *Id.* at 1206-07. The Exchange concluded that successive public announcements on the same subject with changing facts would confuse and mislead the public. *Id.* For a detailed discussion of *Staffin*, see *supra* notes 58-60 and accompanying text.

significant to the reasonable investor's trading decisions.<sup>138</sup> The Fourth Circuit found that the holding of *Basic Inc.*, which rejects the bright-line "agreement in principle" test for preliminary merger negotiations, also applied to the RF&P restructuring.<sup>139</sup>

Finally, the Fourth Circuit found that the terms of the RF&P restructuring would be important to a reasonable investor's trading decisions.<sup>140</sup> Nonetheless, the Fourth Circuit limited its holding to the appropriateness of the June 18, 1991 disclosure regarding the restructuring.<sup>141</sup> The court established that the press release was not made on behalf of the bidder because the June 18, 1991 press release related to a public announcement required under RF&P's Rule 10b-5 disclosure duty.<sup>142</sup> For these reasons,

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138. *Kahn*, 13 F.3d at 116. The Supreme Court applied this materiality standard in *TSC Industries v. Northway, Inc.*, 426 U.S. 438 (1976), by stating that an "omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus.*, 426 U.S. at 449. Likewise, the Court applied this standard in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) by stating that "[w]e now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context." *Basic Inc.*, 485 U.S. at 232. The Supreme Court was cautious not to set a materiality standard that was too low, noting that certain information regarding corporate developments might be of dubious significance. *Id.* at 448. A minimal standard may result in an overabundance of information causing management "simply to bury the shareholders in an avalanche of trivial information . . . a result that is hardly conducive to informed decisionmaking." *Id.* at 448-49.

139. *Kahn*, 13 F.3d at 116-17. After an extensive study, the Advisory Committee on Corporate Disclosure cautioned the SEC against restricting materiality to a strict formula. *Basic Inc. v. Levinson*, 485 U.S. 224, 236 & n.14 (1988) (citing *House Committee on Interstate and Foreign Commerce, Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, 95th Cong., 1st Sess. 327 (1977)). Although the Committee believed that absolute certainty in determining materiality would be ideal, such a goal remains unrealistic in practice. *Id.* at 236 n.14. The materiality concept is judgement driven. *Id.* Thus, the Committee advised the SEC to avoid the pursuit of certainty and to continue examining materiality on a case-by-case basis. *Id.*

140. *Kahn*, 13 F.3d at 117. The Supreme Court identified a Second Circuit case, which acknowledged that materiality should be determined on the particular facts of the case, in stating:

[S]ince a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards to a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions . . . and this even though the mortality rate of mergers in such formative stages is doubtless high.

*Basic Inc.*, 485 U.S. at 238 (citing *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)).

141. *Kahn*, 13 F.3d at 117. The court did not decide when the disclosure of such negotiations would be required, because the court determined disclosure on June 18, 1991 was appropriate. *Id.*

142. *Id.* The district court stated:

The SEC has expressly recognized that a company's disclosure obligations may require that statements be made with respect to information concerning the company, and it would create insurmountable conflicts for a tender offer to be deemed commenced by virtue of such disclosure. The SEC could also not impose conflicting regulatory requirements on com-

the Fourth Circuit ultimately concluded that the RF&P press release was not a public announcement commencing a tender offer under Rule 14d-2(b).<sup>143</sup>

#### IV. CONSISTENCY OF RESULT, BUT INADEQUACY OF REASON IN *KAHN V. VIRGINIA RETIREMENT SYSTEMS*

The *Kahn* court applied the fact intensive *Basic Inc.* materiality inquiry to the subject transaction.<sup>144</sup> Although the Fourth Circuit's reasoning remains incomplete, the pro-disclosure result supports a sound policy rationale.<sup>145</sup> Additionally, the reasoning is consistent with the *Basic Inc.* probability and magnitude analysis.<sup>146</sup>

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panies— on the one hand, require public disclosure of a material event such as a proposed tender offer and on the other, treat the required disclosure as the commencement of a tender offer which would thereby cause other transactions by the company to violate the federal securities laws.

*Kahn v. Virginia Retirement Sys.*, 783 F. Supp. 266, 270 (E.D. Va. 1992), *aff'd*, 13 F.3d 110 (1993), *cert denied*, 114 S. Ct. 1834 (1994).

143. *Kahn*, 13 F.3d at 117. The Fourth Circuit noted that it was ill-advised to include the statements of RF&P, VRS, and CSX in the press release. *Id.* Such statements indicated that the release was joint and not made on behalf of VRS and CSX. *Id.*

144. *Id.* at 116-17. *Kahn* involved a three-way transaction which resulted in a stock sale and a corporate restructuring. *Id.* at 111-12. For further discussion of the transaction and restructuring, see *supra* notes 96-108 and accompanying text.

145. *Kahn*, 13 F.3d at 116-17. The purpose of federal securities laws is to provide investors relevant information for informed decision-making. J. Robert Brown, Jr., *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 751 n.23 (1985). See generally Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723 (1989) (noting that investors should not be denied relevant information in insider trading context); Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations - An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923 (1987) (concluding that corporations should have duty to disclose bad news between periodic corporate reports); Jude Sullivan, *Materiality of Predictive Information After Basic: A Proposed Two-Part Test of Materiality*, 1990 U. ILL. L. REV. 207, 230 (1990) (concluding that SEC policy encourages disclosure of predictive information). Believing the worst abuses come from investor's lack of information, Congress sought to remedy this problem via a scheme providing investors with the information necessary to make informed decisions. *Id.* Congress repeatedly referred to the significance of disclosure when enacting the 1933 and 1934 Acts. See, e.g., H.R. REP. NO. 1383, 73d Cong., 2d Sess., at 11 (1934) (discussing how true and accurate corporate reporting is critical in maintaining proper function of public exchanges); S. REP. NO. 47, 73d Cong., 1st Sess., at 1 (1933) (stating that one aim of 1933 Act involves providing investors true and accurate information).

146. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988). To appraise takeover probability, the Supreme Court recommended finding an indicia of interest at the highest corporate levels. *Id.* at 239. Examples of such indicia include "board resolutions, instructions to investment bankers and actual negotiations between principals or their intermediaries . . ." *Id.* However, the Supreme Court did not intend for this list to be exhaustive. *Id.* Other courts have identified additional factors demonstrating the probability of a merger's occurrence. See, e.g.,

A. *The Duty to Disclose*

Rule 10b-5 cases traditionally begin with an analysis of whether a general duty to disclose exists.<sup>147</sup> Neither judicial nor statutory rules require

*Taylor v. First Union Corp. of S.C.*, 857 F.2d 240, 244 (4th Cir. 1988) (holding merger negotiations immaterial though two banks agreed in principle to merge when interstate banking became legal), *cert. denied*, 489 U.S. 1080 (1989); *SEC v. Fox*, 855 F.2d 247, 251 (5th Cir. 1988) (endorsing materiality test based on "substantial certainty"); *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1229 (7th Cir. 1988) (noting that potential acquirer had retained law firm specializing in acquisitions, had hired brokerage firm to help acquire stock and had met with target executives to discuss acquisition); *Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 728-30 (2d Cir. 1987) (noting that company retained investment bank to consider selling subsidiary and investment bank discussed sale with company executives without board proposal), *cert. denied*, 485 U.S. 1007 (1988); *Flynn v. Bass Bros. Enter.*, 744 F.2d 978, 988 (3d Cir. 1984) (balancing information's potential aid against its potential harm to investors when assessing materiality); *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974) (noting that defendant purchased shares knowing that company's president wanted to merge, that firms commenced merger discussions and that director for other company had reacted favorably to merger).

When considering the magnitude of the transaction, the Supreme Court noted that a possible merger is a momentous occurrence for any corporation. *See Basic Inc.*, 485 U.S. at 238. Nonetheless, information does not automatically become material because it relates to a sale or a merger. *See, e.g., Reiss v. Pan Am World Airways, Inc.*, 711 F.2d 11, 13 (2d Cir. 1983) (stating that courts must view claim that disclosure was required "in the light of the facts existing at the time of the release") (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968)); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (noting that duty to disclose material information exists only when disclosure is reasonably certain to substantially impact market), *cert. denied*, 394 U.S. 976 (1969); *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1128 (D. Del. 1988) (balancing substantial impact of transaction with low probability of occurrence and concluding that information was not material under Rule 10b-5).

147. *Basic Inc.*, 485 U.S. at 239 n.17. *See also Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987) (concluding corporation has no duty to disclose ongoing merger negotiations before analyzing materiality of such negotiations); *Walker v. Action Indus., Inc.*, 802 F.2d 703, 709 (4th Cir. 1986) (holding omissions from press release not material because SEC has not imposed general duty to disclose financial projections), *cert. denied*, 479 U.S. 1065 (1987); *Flynn*, 774 F.2d at 988 (noting disclosure of material facts only required if duty to speak exists); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.) (recognizing that corporation has no duty to disclose financial projections before assessing materiality of non-disclosure), *cert. denied*, 454 U.S. 1092 (1981); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214 (9th Cir. 1980) (recognizing no duty to disclose financial projections unless made with reasonable certainty). Under federal securities laws, courts have no duty to disclose material inside information or material corporate developments. *See Brown*, *supra* note 145, at 750. Courts typically permit corporate management to decide the timing and content of disclosure and view such redundant issues as an internal corporate affair. *See, e.g., Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 518 (10th Cir.) (holding that corporate directors and officers are not liable for mistakes resulting from events requiring exercise of judgment, such as deciding when to disclose corporate information, where such director or officer acts in good faith), *cert. denied*, 414 U.S. 874 (1973); *Texas Gulf*, 401 F.2d at 850 (stating that "the timing of the disclosure of material facts . . . is a matter for the business judgement of the corporate officers entrusted with the management of the corporation").

an issuer to disclose material information.<sup>148</sup> Nonetheless, a limited exception to this general non-disclosure rule requires publication of material facts before a company trades in its own securities.<sup>149</sup> The Fourth Circuit's rationale in *Kahn* lacks completeness because the court fails to identify the scope of RF&P's duty to disclose.<sup>150</sup> However, the informa-

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148. *Basic Inc.*, 485 U.S. at 240 n.18. Articulated as follows, the "disclose or abstain exception" constitutes the earliest exception to the general rule of non-disclosure:

[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgement. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.

*In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *see also* *Speed v. Transamerica Corp.*, 71 F. Supp. 457, 458 (D. Del. 1947) (noting that plaintiff's allegation of defendant's failure to disclose material fact was sufficient to defeat motion for summary judgement). Despite the information's materiality, no liability arises under Rule 10b-5 unless a duty exists to disclose it. *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

149. *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22 (1st Cir. 1987). Essentially, a company cannot purchase or sell its stock without fully and completely disclosing all material inside information. *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) (stating that courts should construe "sale" broadly to effectuate purposes of 1934 Exchange Act); *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982) (noting that courts have defined "purchase" and "sale" broadly, to include transactions that do not resemble conventional common-law purchases and sales); *Alley v. Miramon*, 614 F.2d 1372, 1380 (5th Cir. 1980) (noting that term "sale" applies to individuals who may not be sellers in common-law sense); *Fridrich v. Bradford*, 542 F.2d 307, 314-18 (6th Cir. 1976) (examining "abstain or disclose rule" relating to insider trading), *cert. denied*, 429 U.S. 1053 (1977); *Swanson v. Wabash*, 577 F. Supp. 1308, 1316-17 (N.D. Ill. 1983) (holding that exchange of stock options for money constitutes purchase); *Fisher v. Plessey Co.*, 559 F. Supp. 442, 449 (S.D.N.Y. 1983) (noting that corporation has greater obligation to disclose during pendency of tender offer of its securities than for normal business operations). Before insiders can trade, information must be disclosed "in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information." *In re Faberge Inc.*, 45 S.E.C. 249, 255 (1973); *see also* *Texas Gulf*, 401 F.2d at 854 n.18 (stating that "where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination"), *cert. denied*, 394 U.S. 976 (1969). Beyond these general pronouncements, there has been little guidance on how disclosure should be made or how long disclosure insiders must wait before trading. *See* 17 C.F.R. § 240.13e-4(f)(6) (1985) (requiring issuers to wait 10 business days before repurchasing their shares following termination of tender offer). The opinion rendered in *Dirks v. SEC*, 463 U.S. 646 (1983), provides a critique of this absence of guidance. *Dirks*, 463 U.S. at 678 (Blackmun, J., dissenting) (stating that "Commission tells persons with inside information that they cannot trade on that information unless they disclose; it refuses, however, to tell them how to disclose"); *see also* *Texas Gulf*, 401 F.2d at 854 n.18 (calling on Commission to provide guidance for companies in determining proper timing of insider transactions).

150. *See* *Kahn v. Virginia Retirement Sys.*, 13 F.3d 110, 116 (4th Cir. 1993),

tion included in the June 18, 1991 press release triggered RF&P's duty to disclose.<sup>151</sup>

### B. Tender Offer

The Fourth Circuit concluded that RF&P's June 18, 1991 press release did not constitute a tender offer, but failed to apply any of the conven-

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*cert. denied*, 114 S. Ct. 1834 (1994). Before analyzing the materiality of the information, plaintiff must allege a duty to disclose. See *Basic Inc.*, 485 U.S. at 239 n.17 (noting "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5"). The Fourth Circuit delves into a materiality analysis upon mentioning Rule 10b-5. *Kahn*, 13 F.3d at 116. The court notes that merger and other like negotiations must be disclosed at some time. *Id.* (citing *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982)). Nevertheless, the court fails to identify RF&P's specific duty to disclose the transaction and restructuring information included in the June 18, 1991 press release. See *id.* at 116-17.

Requiring an inquiry into materiality, before identifying a duty to disclose, is logically skewed. See Kenneth S. Fife, *Mandatory Disclosure of Soft Information in the Market for Corporate Control*, 35 EMORY L.J. 213, 253 (1986) (concluding that disclosure requirements cannot rest purely on "materiality"). The inquiry into materiality as an analytic matter and a conclusion that information is material cannot be distinguished from the duty to disclose. *Id.* The duty does not arise unless that information is material. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (stating that "the duty to disclose arises when one party has information that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them") (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 640 & n.16 (3d Cir. 1989) (noting that statutes and regulations do not require corporate disclosure of all material information); *Roeder*, 814 F.2d at 22 (stating analytically material information need not always be disclosed).

The duty to disclose can arise at some point because developing events reach a degree of relevance and reliability where the benefits of disclosure outweigh the costs, even to a non-transacting party. Compare *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1128-29 (D. Del. 1988) (holding no duty to disclose exists, absent specific statutory, regulatory, or fiduciary duty, or rumors that can be traced to company) with *Flamm*, 814 F.2d at 1174-78 (implying disclosure of merger negotiations required when agreement in principle is reached).

151. *Kahn*, 13 F.3d at 112 & n.2. RF&P disclosed information relating to the sale of their stock in the press release. *Id.* The SEC has characterized a sale as any securities transaction requiring shareholders to make a new investment decision. See 17 C.F.R. § 230.145 preliminary note (1985). The preliminary note states:

The thrust of the rule is that an "offer," "offer to sell," "offer for sale," or "sale" [sic] occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security.

*Id.* Courts have repeatedly held that corporate reorganizations involving the issuance or redemption of stock, such as mergers, consolidations, exchanges and liquidations, involve the purchase or sale of securities and thereby trigger a duty to disclose. See, e.g., *Bryan v. Brock & Blevins Co.*, 490 F.2d 563, 568 (5th Cir. 1974) (merger); *Swanson v. American Consumer Indus.*, 415 F.2d 1326, 1330 (7th Cir. 1969) (exchange); *Mader v. Armel*, 402 F.2d 158, 161 (6th Cir. 1968) (merger), *cert. denied*, 394 U.S. 930 (1969); *Susman v. Lincoln Am. Corp.*, 578 F. Supp. 1041, 1056 (N.D. Ill. 1984) (consolidation); *Bolton v. Gramlich*, 540 F. Supp. 822, 839 (S.D.N.Y. 1982) (liquidation). For a further discussion of this press release and its pertinent text, see *supra* note 103 and accompanying text.



tional judicial tests in reaching this conclusion.<sup>152</sup> The RF&P press release met only two of the prongs included in the "Eight Factor" test<sup>153</sup> used by several courts.<sup>154</sup> Thus, application of the "Eight Factor" test to the RF&P press release demonstrates that RF&P did not make a tender offer.<sup>155</sup> Fur-

152. See *Kahn*, 13 F.3d at 114-16. These judicial tests include the "Eight Factor" test and the totality of circumstances test. See *Weeden v. Continental Health Affiliates, Inc.*, 713 F. Supp 396, 402-03 (N.D. Ga. 1989) (analyzing judicial tender offer tests). For a further discussion of the "Eight Factor" test and the totality of circumstances test, see *supra* notes 35-36 and accompanying text. The Fourth Circuit analyzed the RF&P press release in light of SEC Release 34-16623. *Kahn*, 13 F.3d at 115. Additionally, the court used case law cited by the plaintiff shareholders to refute their argument. *Id.* The plaintiffs argued that this press release constituted a tender offer made by RF&P on behalf of VRS based on the Second Circuit's decision in *Field v. Trumpp*. *Id.* The Fourth Circuit used the *Field* case to support its holding. *Id.* For a detailed discussion of how the Fourth Circuit analyzed *Field*, see *supra* notes 126-30 and accompanying text.

Finally, the Fourth Circuit noted that classifying the June 18, 1991 press release as a tender offer detracts from the purpose of Rule 14d-2, which provides bidders with certainty regarding potential tender offers. *Id.* at 116. For a detailed discussion of the Fourth Circuit opinion, see *supra* notes 117-43 and accompanying text.

153. For a list of the eight factors comprising the "Eight Factor" test, see *supra* note 35. RF&P's press release did not constitute a solicitation to shareholders, but was a proposal to the Board of Directors. *Kahn*, 13 F.3d at 112 n.2. Thus, the release failed the first prong of the tender offer test. See *Zuckerman v. Franz*, 573 F. Supp. 351, 358 (S.D. Fla. 1983) (listing widespread shareholder participation as first requirement). The press release met the second prong because the proposal involved almost all of RF&P's outstanding shares of stock. *Kahn*, 13 F.3d at 113; *Zuckerman*, 573 F. Supp. at 358 (requiring solicitation of substantial percentage of stock to fulfill second prong). Similarly, the RF&P release satisfied the third prong because the \$39 proposed price included a premium over the \$28 book value. *Kahn*, 13 F.3d at 112-13 n.3; *Zuckerman*, 573 F. Supp. at 358 (requiring premium to satisfy third prong). However, the Board of Directors had rejected several of the Committee's previous restructuring recommendations. *Kahn*, 13 F.3d at 112. Thus, because the terms were not firm, the press release failed to satisfy the fourth prong. *Id.*; *Zuckerman*, 573 F. Supp. at 358 (requiring firm term to fulfill fourth prong). Additionally, the press release failed the fifth, sixth and seventh prongs of the test. *Kahn*, 13 F.3d at 112; *Zuckerman*, 573 F. Supp. at 358 (outlining fifth, sixth and seventh prongs). The press release did not set a specific time limit on the \$39 per share offer. *Kahn*, 13 F.3d at 112 n.2. Additionally, the transaction was not contingent on the tender of a fixed number of shares. *Id.* Thus, no pressure was exerted for the shareholders to make decisions. *Id.* Finally, a rapid accumulation of RF&P stock did not follow the June 18, 1991 public announcement. *Id.* at 112-13.

154. See, e.g., *Zuckerman*, 573 F. Supp. at 358 (noting that cash merger proposal met factors and fell within tender offer definition); *Hoover Co. v. Fuqua Indus., Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,107 (1979) (using eight factors recommended by SEC to determine whether publication constituted tender offer); *Brscan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 791-92 (S.D.N.Y. 1979) (specifying eight criteria to consider whether acquisitions constitute tender offer under Williams Act); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) (applying "Eight Factor" test to determine existence of tender offer), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

155. See *Weeden*, 713 F. Supp. at 402 (holding that letter offering to acquire target corporation through merger or similar negotiated transaction did not commence tender offer period). In a case where a letter to a targeted corporation's

ther, applying the "totality of circumstances" test<sup>156</sup> to the RF&P press release does not convert the June 18, 1991 public announcement into a tender offer.<sup>157</sup>

### C. Rule 10b-5 Analysis

In assessing the materiality of the press release, the actual negotiations that occurred between the parties from 1986 to 1991 supported the probability that the transaction would occur.<sup>158</sup> Additionally, because the Special Committee members retained control over approval of the transaction, the probability of its occurrence was high.<sup>159</sup> Finally, the state issued a budget directive, which became law in May, 1991, that was integral in effectuating the three-way transaction.<sup>160</sup>

The transaction's significance is evidenced by the separate committee established to structure the transaction, and the disclosure of the specifics

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board of directors met only prongs two and three of the "Eight Factor" test, the United States District Court for the Northern District of Georgia held that the letter did not commence a tender offer. *Id.* In *Kahn*, the distribution of factors met and factors failed is the same as *Weeden*. See *Kahn*, 13 F.3d at 112-14. Accordingly, the result regarding tender offer status should also be the same.

156. 774 F.2d 47 (2d Cir. 1985).

157. See *Kahn*, 13 F.3d at 112-14. The circumstances surrounding RF&P's Special Committee recommendation do not indicate that RF&P shareholders were pressured into a hasty decision regarding their stock due to incomplete information. *Id.* For a further discussion on the totality of circumstances test, see *supra* note 36 and accompanying text.

158. See *Kahn*, 13 F.3d at 112 n.2. Between 1986 and 1991, the Committee proposed and the Board rejected a sale, an asset exchange, a cashout merger and a tender offer. *Kahn*, 783 F. Supp. at 267. These proposals and rejections reflect negotiations between the Committee and Board. See *Taylor v. First Union Corp.* of S.C., 857 F.2d 240 (4th Cir. 1988) (noting series of offers and counter-offers constitutes actual negotiations). In *Taylor*, Southern offered to buy Bennie and Patricia Taylor's (the Taylors) shares at the market price of \$16 per share. *Id.* at 242. The Taylors counter-offered with an offer of \$18 per share. *Id.* Such counter-offer was rejected by Southern, so the Taylors sold their shares to First Union at \$18 per share. *Id.* Similarly, in *Kahn*, each committee proposal is an offer and each board decision is a rejection. See *Kahn*, 13 F.3d at 112.

159. See *Kahn*, 13 F.3d at 112. The Special Committee was comprised of voting members of the RF&P Board of Directors. *Id.* In assessing the probability of a merger, contingent events beyond the parties' control constitute relevant factors. *Taylor*, 857 F.2d at 244. At the time First Union purchased the plaintiff's stock, the Supreme Court had not ruled on the constitutionality of interstate banking and no merger could take place until such legislation was enacted in both North Carolina and South Carolina. *Id.* In *Kahn*, the proposed transaction did not hinge on contingent events, thereby increasing the probability of the transaction occurring. See *Kahn*, 13 F.3d at 112.

160. *Kahn*, 783 F. Supp. at 267. The directive involved VRS transferring \$71 million to the Commonwealth for title to the 3.5 million shares of RF&P stock. *Id.* at 268. This exercise of the Commonwealth's appreciation rights gave VRS free and clear title to the RF&P shares. See *id.* Therefore, the transaction specified in the June 18, 1991 press release became more probable upon the budget directive's approval. See *id.*

of the transaction.<sup>161</sup> Based on the probability and magnitude analysis of the June 18, 1991 press release, the information contained therein was material and warranted disclosure under Rule 10b-5.<sup>162</sup>

When scrutinizing these two conflicting SEC regulations, a decision favoring information disclosure comports with the overall purpose underlying both Rule 10b-5 and the Williams Act.<sup>163</sup> The *Kahn* decision increases the quantity and improves the quality of corporate information available to investors.<sup>164</sup> The pro-disclosure outcome also facilitates an eq-

161. *Kahn*, 13 F.3d at 112. Many corporations frequently express the concern of a possible acquisition, even though there are no concrete offers or specific discussions. *Jacknovy v. Rhode Island Hosp. Trust Fin. Corp.*, 873 F.2d 411, 415 (1st Cir. 1989). Such evidence reveals nothing more than vague expressions of interest. *Id.* As a result, any reasonably sophisticated securities investor buying shares in a large corporation would expect that other corporations might express an interest in buying shares. *Id.* Corporate directors might also be in a position to address how to entertain such offers. *Id.* For large corporations to make public announcements every time directors discuss vague merger interests or receive "tentative feelers" would more likely confuse investors than inform the market. *Id.* Nevertheless, the specific price and transactions highlighted in the June 18, 1991 press release raised the potential transaction beyond the speculative stage. *See Kahn*, 13 F.3d at 112 & n.2. The transaction's magnitude is also evident because the proposed transaction resulted in VRS owning substantially all of RF&P's stock. *Id.* at 113.

162. *See Hartford Fire Ins. Co. v. Federated Dep't Stores, Inc.*, 723 F. Supp. 976, 987 (S.D.N.Y. 1989) (noting that information readily accessible to public weighs against finding of materiality and requiring disclosure). Potential knowledge of the information by the shareholders at the time of the release remains a factor to address, but is not allocated substantial weight. *Id.* As the Second Circuit has noted: "There are serious limitations on a corporation's ability to charge its stockholders with knowledge of information omitted from a document such as a proxy statement or prospectus on the basis that the information is public knowledge and otherwise available to them." *Kronfield v. Trans World Airlines, Inc.*, 832 F.2d 726, 736 (2d Cir. 1987) (citing *Spielman v. General Host Corp.*, 538 F.2d 39, 40-41 (2d Cir. 1976) (per curiam)). The Supreme Court has stated that insider trading can indicate materiality, but does not by itself establish materiality. *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988).

163. *Basic Inc.*, 485 U.S. at 240 n.17. For a detailed discussion of the pro-disclosure philosophy of Rule 10b-5, see *supra* notes 1-4 and accompanying text. For an analysis of the pro-disclosure philosophy of the Williams Act, see *supra* notes 9-12 and accompanying text.

164. *See Kahn*, 13 F.3d at 116-17 (requiring RF&P to disclose terms of corporate restructuring on date of press release). Pro-disclosure decisions facilitate intelligent investment decisions and promote the efficiency of the securities markets in pricing securities and in allocating financial capital to real capital. *See H.R. REP. NO. 1383*, 73d Cong., 2d Sess. 11 (1934) (noting that hiding important information obstructs operation of markets as indicators of real value); Allison G. Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 353 (1974) (concluding that SEC's main task of providing useful information outweighs goal of protecting unsophisticated investors); Brown, *supra* note 145, at 751 (noting that rule of non-disclosure conflicts with general purpose of federal securities laws); Brudney, *supra* note 145, at 735 (stating important justification for duty to disclose involves improving the amount and content of information available to investors); Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334 (1979) (noting that pur-

uitable distribution of information among investors, and reduces the possibility that a few investors may yield large profits by trading on inside information unavailable to others.<sup>165</sup>

#### V. THE *KAHN* DECISION'S FAILURE TO PROVIDE MUCH NEEDED GUIDANCE TO BUSINESS LAWYERS

Although the Fourth Circuit's reasoning in *Kahn* appears incomplete, the ultimate result supports the overall purpose of the SEC regulatory scheme — full disclosure of material information.<sup>166</sup> The *Kahn* decision

pose of requiring disclosure under Rule 10b-5 involves creating an efficient information flow and enabling investment decisions to reflect relevant market facts and expectations); Sharon Sutter, *Basic Inc. v. Levinson: The Standard for Materiality Under Rule 10b-5*, 21 U. TOL. L. REV. 290, 291 (1989) (emphasizing importance of fair and free information exchange on market). Another justification favoring disclosure is denying persons having exclusive access to certain kinds of information an advantage over others with whom they transact, but cannot legally obtain the same information. See Anderson, *supra*, at 353-67 (stating that disclosure obligations rest with persons possessing a lawful monopoly of material information).

165. See Brudney, *supra* note 145, at 735 (noting that desire to create fairness between investors and attempt to increase quantity and improve quality of available corporate information are two primary justifications for duty to disclose information relevant to stock price). Typically, information regarding significant undisclosed corporate developments leaks to select individuals on the market, who trade and profit from this exclusive information. See Brown, *supra* note 145, at 751. A 1985 *Business Week* study examined the stock prices of 229 exchange listed companies involved in mergers, takeovers or leveraged buyouts. *Id.* at 751 n.24 (citing Laderman, *The Epidemic of Insider Trading*, BUS. WK., Apr. 29, 1985, at 78-79). The study compared stock prices one month and one day prior to the transaction's announcement to determine if information leaks increased stock prices. *Id.* The study concluded that stock prices increased in 72% of the cases, 20% above the market average of 52%. *Id.*; see also Jones, Rendleman & Latane, *Earnings Announcements: Pre-and-Post Responses*, J. PORTFOLIO MGMT., Spring 1985, at 28, 31 (stating that results of study on impact that announcement of abnormal earnings has on stock prices suggests that market adjusts before and on earnings announcement days); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855, 866 (1981) (stating that study of daily stock price movements indicate that pending merger announcements are not secret, and trading on this information is common); Penman, *Insider Trading and the Dissemination of Firm's Forecast Information*, 55 J. BUS. 479, 501 (1982) (concluding that corporate insiders time trades depending on when firm releases earnings prospects).

166. See Brown, *supra* note 145, at 751. The drafters of the Securities and Exchange Act sought to protect the integrity of the securities market by encouraging fair and free information exchange. Sutter, *supra* note 164, at 291. Only if market participants have access to the same accurate information can market integrity be sustained. *Id.* Such disclosure requirements, derived from the general anti-fraud provisions of the 1934 Act, require disclosure of material information either expressly or implicitly.

The 1934 Act remains unclear on whether either Rule 10b-5(2), which refers to material information, or 10b-5(3), which does not make reference to materiality, prohibit "mere silence." See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (stating that investor's duty to disclose is limited to "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the

demonstrates that the principles of timely disclosure and materiality which govern preliminary merger cases apply equally to other contingent corporate developments.<sup>167</sup> The Fourth Circuit's holding, however, remains narrow and fails to establish a clear rule specifying when business negotiations become material.<sup>168</sup>

As illustrated by *Kahn's* generally accepted tests, a direct approach to determine the scope and timing of a corporate board of directors' affirmative disclosure duties does not appear to exist.<sup>169</sup> Instead, the Supreme Court has examined numerous factors, including the text of section 10(b) and Rule 10b-5, the legislative history of section 10(b) and the Exchange Act, common-law principles of fraud, and SEC interpretations of Section 10(b) and Rule 10b-5.<sup>170</sup>

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extraordinary situation is] disclosed"), *cert. denied*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (noting implicit requirement to disclose material information).

167. *See Kahn*, 13 F.3d at 116-17. Other contingent corporate developments include internal estimates of a corporation's future performance (i.e. projections of earnings, revenues, sales, or stock prices) which if disclosed would relieve the investor of the need to rely solely upon his or her own inferences about future company performance. Brudney, *supra* note 145, at 723 n.2 (discussing types of "soft" or "future oriented" information). Additionally, information that estimates the present value of non-liquid assets providing the public investor with expert inferences, drawn from internal corporate information, constitutes another contingent corporate development. *Id.* Finally, information about potential merger negotiations is referred to as "soft" and indicates a contingent corporate event's occurrence. *Id.* Unlike the internal corporate estimates, information regarding potential merger negotiations does not embody any expert estimates about the likelihood that contingent events will occur. *Id.* As a result, such information is similar to a statement of back orders or of accrued depreciation or expenditures made on research and development, reflecting corporate estimates of contingent events but not estimating the quantitative impact on market price. *Id.* The various reasons for distinguishing between merger negotiations and other kinds of information concern the unusual and discrete character of a merger, the probable and significant impact on the price of securities, and the wholly contingent character. *Id.*

168. *Kahn*, 13 F.3d at 117. In holding that the June 18, 1991 press release did not constitute a tender offer, the *Kahn* court stated that "[w]e do not decide when the disclosure of such negotiations was required, because we are of the opinion that the disclosure of them at the time of the press release was appropriate to meet the disclosure requirements of the Exchange Act." *Id.* As a result, the decision is limited to the precise facts of *Kahn* and the June 18, 1991 press release. *Id.*

169. Robert H. Rosenblum, *An Issuer's Duty Under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 CATH. U. L. REV. 289, 296 (1991) (noting that no direct approach exists for establishing a corporate board of directors' affirmative duty to disclose).

170. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 226-29 (1980) (finding that under both common law and SEC interpretations of section 10(b) and Rule 10b-5, insiders have duty to disclose material, nonpublic corporate information prior to trading); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976) (concluding that administrative history and plain language of section 10(b) are dispositive of appropriate standard of liability); *cf. Dirks v. SEC*, 463 U.S. 646, 660-63 (1983) (relying in part on SEC Commissioner's concurring opinion in administrative decision). The *Chiarella* Court, for example, considered some of these sources

Justice Blackmun criticized the SEC's lack of guidance in his dissenting opinion in *Dirks v. SEC*.<sup>171</sup> Justice Blackmun noted that although the SEC forbids trading on undisclosed, inside information, it does not instruct investors on how or when to disclose such information.<sup>172</sup> The Second Circuit also requested that the SEC provide instruction on when corporations should disclose insider transactions.<sup>173</sup>

Based on the lack of legislative or judicial guidance on when to disclose business negotiations, if a corporation has any doubt concerning the negotiations' materiality, it should disclose the required information.<sup>174</sup> Additionally, corporate management must develop procedures assuring that corporate personnel, familiar with the current state of public information, pre-approve all insider trades.<sup>175</sup> Corporations should also establish securities law compliance programs to ensure the complete, accurate and

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in concluding that a duty to disclose material, nonpublic information prior to trading stems from the fiduciary relationship between corporate insiders and corporate shareholders. *Chiarella*, 445 U.S. at 226-30. The Court noted that neither the legislative history nor language of section 10(b) discussed this potential duty. *Id.* at 226. The Court has also specified other considerations such as "longstanding acceptance by the courts [of a reasonable interpretation of section 10(b)], coupled with Congress' failure to reject [that interpretation], . . . argues significantly in favor of [its] acceptance." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975). The Court also considers "what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Id.* at 737.

171. *Dirks*, 463 U.S. at 678 (Blackmun, J., dissenting).

172. *Id.* at 678 n.17 (Blackmun, J., dissenting). In the oral argument, the SEC alleged that even if *Dirks* reported the information to the SEC, his disclosure obligation would remain unsatisfied. *Id.* (Blackmun, J., dissenting). This position would conflict with a safe harbor rule allowing investors to trade a fixed period after disclosing the inside information to the SEC. *Id.* (Blackmun, J., dissenting). Because this safe harbor or a similar rule describing how to disclose inside information do not exist, insiders must refrain from trading. See *In re Faberge*, 45 S.E.C. 249, 256 (1973) (finding that disclosure requires public release through public media designed to reach investing public generally).

173. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 n.18 (2d Cir. 1968). The court called upon the SEC to use its rule-making power to "provide some predictability of certainty for the business community." *Id.*

174. Committee on Corporate Laws, *Corporate Director's Guidebook — 1994 Edition*, 49 A.B.A. BUS. LAW. 1247, 1276 (1994). Insider trading law violations trigger significant sanctions. *Id.* The violator's liability includes profits earned or losses avoided. *Id.* A court may also assess a treble damage (three times the earned profits or avoided losses) penalty or criminal sanctions against the insider trader. *Id.*

175. *Id.* These procedures may require directors to contact corporate counsel, the chief financial officer, or the corporate secretary before trading. *Id.* The NYSE-Listed *Company Manual* suggests restricting insider trading to fixed periods following disclosure of quarterly and annual financial results. *Id.* Many corporations, rather than create safe harbor periods, prohibit insiders from trading their corporate securities for the two to three weeks preceding the release of quarterly financial statements. *Id.*

timely disclosure of material information.<sup>176</sup> Nevertheless, absent clear standards of when a duty to disclose arises or when a transaction becomes material, even carefully structured insider trading procedures or compliance programs will not consistently satisfy Rule 10b-5.

The premise underlying securities law and securities regulation involves a free market with investors making choices from fully disclosed material facts.<sup>177</sup> Through full disclosure and complete information, the market will efficiently incorporate all data and set a market price.<sup>178</sup> Based on the significance of materiality in the federal regulation schemes, coupled with the lack of guidance from the Commission, courts interpreting the materiality of a corporate transaction should aggressively fashion a legal framework specifying when a corporation must disclose the subject transaction.

The *Kahn* decision does not provide any guidance for corporations seeking to avoid early disclosure of significant corporate transactions.<sup>179</sup> Did the February 1991 Virginia budget directive, which approved the sale of Virginia's appreciation rights on 3.5 million restricted RF&P shares, trigger RF&P's duty to disclose their corporate restructuring?<sup>180</sup> Or did this duty to disclose arise when the governor approved the budget directive in May, 1991? The Fourth Circuit failed to answer the underlying question of when Rule 10b-5 required RF&P to disclose their negotiations with CSX and VRS.<sup>181</sup> As a result, the opinion ultimately contributes to the lack of much needed instruction faced by corporate boards of directors and business lawyers attempting to avoid early disclosure of merger negotiations or other large corporate developments.

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176. *Id.* at 1279. These programs also aid compliance with insider trading laws. *Id.* A well-designed and administered compliance program may also help satisfy a director's due diligence obligations under the securities laws. *Id.*

177. *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1987). The incentive for investors to monitor corporate disclosures reflects their motivation to make money, not their attempt to sustain a cause of action under Rule 10b-5. *Id.* at 246 n.23. Congress does not need to dismantle the federal, mandatory disclosure scheme to reconcile investor market reliance with their expectations. *Id.*

178. *Id.* at 246-47. Market professionals generally consider most publicly announced material statements regarding companies. *Id.* at 246-47 n.24. Therefore, such statements directly impact stock market prices. *Id.* One court noted "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Id.* at 248. (quoting *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

179. *Kahn v. Virginia Retirement Sys.*, 13 F.3d 110, 117 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1834 (1994). For a detailed discussion of this narrow holding, see *supra* note 168 and accompanying text.

180. For details regarding this three-part restructuring, see *supra* notes 105-08 and accompanying text.

181. *Kahn*, 13 F.3d at 117.