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Janet E. Kerr

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# A WALK THROUGH THE CIRCUITS: THE DUTY TO DISCLOSE SOFT INFORMATION

JANET E. KERR\*

## INTRODUCTION

One of the more interesting<sup>1</sup> yet ambiguous areas in federal securities regulation is soft information<sup>2</sup> disclosure. In recent years

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\* Associate Professor of Law and Associate Dean, Pepperdine University School of Law. J.D., Pepperdine University School of Law, 1978; LL.M., New York University, 1979. The author served as a staff attorney in the Division of Enforcement at the Securities and Exchange Commission from 1978-81, and is a member of both the California and New York Bars.

1. See, e.g., Fiflis, *Soft Information, The SEC's Former Exogenous Zone*, 26 UCLA L. REV. 95 (1978); Mann, *Prospectuses: Unreadable or Just Unread? A Proposal to Re-examine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222 (1971); Schneider, *Soft Information Disclosure: A Semi-Revolution*, 1984 INST. ON SEC. REG. 19; Schneider, *Disclosure of "Soft Information,"* 1979 INST. ON SEC. REG. 169; Schneider, *Disclosure of "Soft Information" in SEC Filings*, 28 BUS. LAW. 506 (1973); Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972) [hereinafter *Nits & Grits*]; Schneider & Shargel, *Mandatory Disclosure of Appraisals and Other Soft Information: A Comment on Flynn v. Bass Brothers*, 1985 INST. ON SEC. REG. 237; Note, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 COLUM. L. REV. 1525 (1981); Note, *Mandatory Disclosures of Soft Information in the Market for Corporate Control*, 35 EMORY L.J. 213 (1986); Note, *Target Corporation Disclosure of Soft Information in Tender Offer Contests*, 54 FORDHAM L. REV. 825 (1986); Note, *Disclosure of Soft Information in Tender Offers After Flynn v. Bass Brothers Enterprises, Inc.*, 42 WASH. & LEE L. REV. 915 (1985).

2. "Soft information" is defined as "opinions, predictions, analyses and other subjective evaluations," as distinguished from "hard information," which is defined as "statements concerning objectively verifiable historical facts." Carl W. Schneider described soft information as follows:

Although a comprehensive definition of soft information is not readily apparent, several non-exclusive and non-exhaustive categories can be identified: (1) forward-looking statements concerning the future, such as projections, forecasts, predictions, and statements concerning plans and expectations; (2) statements concerning past or present situations when the maker of the statement lacks the data necessary to prove its accuracy—for example, information on a company's historical share of the market, when it does not have access to precise statistics concerning its competitors; (3) information based primarily on subjective evaluations—for example, representations concerning the competence or integrity of management, the relative efficiency of a manufacturing operation, or the appraised value of assets; (4) statements of motive, purpose, or intention, since it is frequently easier to verify objectively what was done than to determine why it was done—for example, explanation of the reasons for which an auditor has been discharged; (5) statements involving qualifying words, such as "excellent," "ingenious," "efficient" and "imaginative," for which there are no generally accepted objective standards of measurement in most contexts.

the SEC policy on the subject can only be described as one in rapid transition. The SEC has gone from a traditional policy of generally prohibiting the disclosure of soft information, to allowing and encouraging it in some situations, to even requiring its disclosure under certain circumstances.<sup>3</sup>

The circuits' reactions run the gamut in response to the SEC's shifting position. Some circuits cling to tradition,<sup>4</sup> while others, even though recognizing the change in SEC policy, refuse to reflect this change in their decisions.<sup>5</sup> Finally, two circuits appear to embrace current SEC policy on the subject and have developed their own approaches to reflect it.<sup>6</sup>

This article provides a guide to those attempting to navigate the legal mine field of soft information disclosure. In order to fully discuss this area, the article is divided into three parts: past and present SEC policy, a review of the circuits, and problems with the various circuit approaches.

## I. PAST AND PRESENT SEC POLICY

All of those circuits addressing the issue of soft information disclosure devoted at least some discussion to SEC policy in the area.<sup>7</sup> As mentioned previously, the traditional SEC position generally

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*Nits & Grits*, *supra* note 1, at 255.

Schneider further noted the difficulty involved in attempting to classify certain information: " 'Hard' and 'soft' must be recognized as highly relative concepts suggesting no sharp dividing line. Many apparently hard statements have soft cores and vice versa." *Id.* at 256.

In a recent address to the Practicing Law Institute's 18th Annual Institute on Securities Regulations (November 6-8, 1986), Schneider included negotiations as a type of soft information. Address by Carl W. Schneider, 1986 INST. ON SEC. REG. 1639 [hereinafter Address by Schneider].

3. See *infra* Part I.

4. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 292 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980).

5. See *Walker v. Action Indus.*, 802 F.2d 703, 709 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292 n.10 (2d Cir. 1973).

6. See *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241-42 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986); *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 988 (3d Cir. 1984).

7. See, e.g., *Walker v. Action Indus.*, 802 F.2d 703 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987); *Starkman v. Marathon Oil Co.*, 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986); *Flynn v. Bass Bros. Enters.*, 744 F.2d 978 (3d Cir. 1984); *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265 (9th Cir. 1982); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214 (9th Cir. 1980); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973).

prohibited the use of soft information in disclosure documents.<sup>8</sup> This position surfaced in the SEC's comment letter practice<sup>9</sup> as well as in its rulemaking. In 1956 the SEC added a note to rule 14a-9<sup>10</sup> that listed "predictions as to specific future market values, earnings [and] dividends" as "examples of what, depending upon particular facts and circumstances," may be misleading in proxy statements.<sup>11</sup> Additionally, the SEC stated that issuers with securities in registration should not make any projections, predictions, or estimates with respect to income, earnings, or the value of securities.<sup>12</sup>

The reason for the SEC's position was clear. The Commission's internal application of a balancing test resulted in the view that the risks flowing from the disclosure of possibly over-optimistic management predictions and other projections of company performance outweighed any benefits derived by investors. The SEC's perception of the unreliability of soft information, its potential to mislead investors, and the lack of sufficient Commission resources to evaluate its accuracy quickly negated any benefits flowing from the disclosure of such information.<sup>13</sup>

The traditional SEC position came under fire, however, in the early 1970s.<sup>14</sup> Empirical studies disclosed the importance and materiality of certain soft information to an investor making an informed decision with regard to a corporation's future earning power.<sup>15</sup> As a result of these studies, an evolution began in the SEC's policy toward soft information disclosure.

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8. See *Nits & Grits*, *supra* note 1, at 258.

9. *Id.* at 259 n.12.

10. Rule 14a-9 proscribes material misrepresentations or omissions in connection with proxy solicitations. 17 C.F.R. § 240.14a-9 (1987).

11. *Id.* Adoption of Amendments to Proxy Rules, Exchange Act Release No. 5276, Fed. Sec. L. Rep. (CCH) ¶ 76,380 (Jan. 17, 1956).

12. Guidelines for the Release of Information by Issuers, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578-79 (Aug. 16, 1971).

13. See, e.g., *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 408-09 (N.D. Ill. 1964) (discussing the Commission's traditional approach); see also *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 985-87 (3d Cir. 1984); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1294 (2d Cir. 1973); see generally L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATIONS* 163 (1983); *Guides for Disclosure of Projections of Future Economic Performance*, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978).

14. See A. BROMBERG & L. LOWENFILS, *SECURITIES FRAUD AND COMMODITIES FRAUD* § 6.5(431)(3), at 136.123 (1985); T. HAZEN, *THE LAW OF SECURITIES REGULATION* 78 (1985) (citing commentators). See also Mann, *supra* note 1, at 223.

15. See Securities Act Release No. 5992, *supra* note 13, at 81,036-37. See also *Earnings Projections and Rule 14a-9 Amendment*, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461, at 86,201 (Apr. 23, 1976).

In 1975 the Commission shocked the legal community by publishing a series of rule proposals that would allow the disclosure of projections of future economic performance in certain situations.<sup>16</sup> The Commission, shortly thereafter, in 1976, announced formally that its long-standing policy of prohibiting disclosure of soft information may have contravened investors' interest in securing predictive information. Admitting its error, the SEC stated it would not object to the disclosure of projections of future economic or corporate performance in public filings, as long as the disclosure of such information was made in good faith, had a reasonable basis, and was accompanied by information sufficient to permit informed investment decisions.<sup>17</sup> To further underline its changing policy, the SEC amended rule 14a-9, deleting future earnings from the list of examples of potentially misleading disclosures.<sup>18</sup>

Two years later, the Commission made an even more startling move. In 1978 the Commission, based on the "significance attached to projection information and the prevalence of projections in the corporate and investment community," announced that it would encourage voluntary disclosure of management projections.<sup>19</sup> To further enhance the SEC's policy of permissive disclosure of future-oriented information, the Commission adopted rule 175,<sup>20</sup> which provides a "safe harbor" for certain types of issuers<sup>21</sup> who wish to disclose "forward-looking" statements.<sup>22</sup>

Following closely on the heels of rule 175, the Commission announced that in certain circumstances soft information disclosure

16. See, e.g., Proposed Rules on Earnings Projections, Securities Act Release No. 5581, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,167 (Apr. 28, 1975).

17. Securities Act Release No. 5699, *supra* note 15, at 86,200-01.

18. *Id.*

19. Securities Act Release No. 5992, *supra* note 13, at 81,037.

20. 17 C.F.R. §§ 230.175, 240.3b-6 (1986).

21. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979). The purpose of the rule is to encourage voluntary disclosures of projections and other soft information both in Commission filings and elsewhere. The rule protects issuers and management from liability for misleading investors if projections and other soft information are made in good faith and have a reasonable basis. Note, *The SEC Safe Harbor for Forecasts—A Step in the Right Direction?*, 1980 DUKE L.J. 607, 609.

22. The term "forward-looking statement" is defined as:

(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic performance contained in management's discussion and analysis of financial condition results of operations in-

was not only permissive but required. In 1979 the Commission promulgated regulation 240.13e-3, requiring that in going-private mergers, asset appraisals which are received by the issuers and are material to the transaction be disclosed to stockholders.<sup>23</sup> In 1980 the Commission issued a release voicing the staff's insistence upon the disclosure of good-faith, reasonably based appraisals in proxy contests in which the principal issue is the liquidation of all or a portion of the issuer's assets.<sup>24</sup> Finally, in 1982 the Commission amended regulation S-K to permit disclosure of estimates of less-than-proven oil and gas reserves in certain situations.<sup>25</sup>

In addition to the preceding rules and regulations that specifically address the issue of soft information disclosure, this type of disclosure may be required under the antifraud provisions of the federal securities laws.<sup>26</sup> In interpreting how these general catchall provisions relate to soft information disclosure, certain circuits have fashioned various approaches.

## II. REVIEW OF THE CIRCUITS

The present section of this article discusses the various approaches taken by the circuits in addressing disclosure duties involving soft information. Only those circuits having some established position in the area are mentioned.<sup>27</sup>

cluded pursuant to Item 303 of Regulation S-K (§ 229.303 of this chapter) or Item 9 of Form 20-F; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c)(1), (2), or (3) of this section.

17 C.F.R. §§ 230.175(c), 240.3b-6(c) (1986).

23. 17 C.F.R. § 240.13e-3 (1986).

24. Proxy Rules, Exchange Act Release No. 16,833, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,117 (May 23, 1980) (requiring that such appraisals also have a reasonable basis).

25. 17 C.F.R. § 229.102, instruction 5 (1986). *See also* 17 C.F.R. § 210.4-10(k)(5) to -10(k)(6) (1986). Disclosure is permitted only when these types of estimates were provided previously to a person that was engaged in an acquisition of the company or its equity securities. Prior to this amendment, regulation S-K prohibited the disclosure of estimates of oil or gas reserves, unless proved, in any document publicly filed with the Commission. 17 C.F.R. § 229.20, instruction 4 to item 2(b) (1986).

26. For example, section 14(e) of the Williams Act and rules 10b-5 and 14a-9 of the Exchange Act may apply. Section 14(e) of the Williams Act proscribes material misrepresentations or nondisclosures in connection with tender offers. *See* 15 U.S.C. § 78n(e) (1982). Rule 10b-5 prohibits the making of "any untrue statement of material fact" or omission of any "material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1986). For rule 14a-9, see *infra* note 39.

27. Courts in the First, Fifth, Eighth, and Tenth Circuits have, on occasion, addressed the issue of soft information disclosure. For the reason stated above, however,

The Second, Third, Fourth, Sixth, Seventh, and Ninth circuits are examined. Each circuit is discussed separately, with the exception of the Second and Seventh, which are strikingly similar in their approach.

*A. The Second and Seventh Circuits—Holding Fast to Tradition*

The Second and Seventh Circuits are in general agreement on the disclosure obligations for soft information. Both circuits have held that there is no duty to disclose soft information.

*Gerstle v. Gamble-Skogmo, Inc.*<sup>28</sup> stands as authority for the Second Circuit's position that there is no duty to disclose<sup>29</sup> asset appraisals<sup>30</sup> or financial projections.<sup>31</sup> The factual situation in *Gerstle* arose

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they are not included in the body of this article. These circuits warrant a passing mention nonetheless.

The First Circuit, in *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227, 1236 (1st Cir. 1984), held that speculative and misleading asset appraisals need not be disclosed in a proxy statement. The Fifth and Eighth Circuits each have a noteworthy case concerning the duty to disclose purposes, plans, and proposals. See generally *Chromalloy Am. Corp. v. Sun Chem. Corp.*, 611 F.2d 240 (8th Cir.), *aff'g* 474 F. Supp. 1541 (E.D. Mo. 1979) (holding that disclosure of control purpose is required regardless of its indefiniteness; however, the disclosure of nondefinite "plans or proposals" can be misleading); *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075 (5th Cir. 1970) (holding that there is no duty to disclose preliminary merger negotiations). For a good discussion of these cases, see Note, *Mandatory Disclosures of Soft Information*, 35 EMORY L.J. 213, 231-38 (1986). These circuits, however, do not have an established position on the general issue of soft information disclosure. Finally, some courts have cited the Tenth Circuit case of *Sunray DX & Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968), for the position that asset appraisals involving oil reserves are too speculative and, therefore, need not be disclosed. The Tenth Circuit, however, has not recently addressed soft information disclosure; thus, it is unclear what impact, if any, this case has on the circuit.

28. 478 F.2d 1281 (2d Cir. 1973).

29. *Id.* at 1294. For other Second Circuit cases dealing with soft information disclosure, see *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983) (finding no duty to disclose merger negotiations in press release); *Rodman v. Grant Found.*, 608 F.2d 64, 72 (2d Cir. 1979) (finding no duty to disclose speculative financial predictions in proxy statement); *Billard v. Rockwell Int'l Corp.*, 526 F. Supp. 218, 221 (S.D.N.Y. 1981) (holding no duty by tender offeror to disclose predictions of impact of tender offer announcement on market); but see *Hecco Ventures v. Avalon Energy Corp.*, 606 F. Supp. 512 (S.D.N.Y. 1985) (finding no duty to disclose speculative liquidation values in a proxy statement in connection with a merger, but recognizing that in certain rare situations disclosure of soft information may be required). The district court in *Hecco* briefly considered the criteria for mandatory disclosure of soft information, which were outlined in *Flynn v. Bass Bros. Enters.*, 744 F.2d 978 (3d Cir. 1984), but the court found the information too speculative to require disclosure. *Hecco*, 606 F. Supp. at 520. For the *Flynn* criteria, see *infra* text accompanying note 96. The *Hecco* case seems to stand by itself and is not reflective of the current position of the circuit.

30. *Gerstle*, 478 F.2d at 1294. The case specifically addressed the disclosure of this type of soft information.

when Gamble-Skogmo embarked on a plan to gain control of General Outdoor Advertising (GOA).<sup>32</sup> Between April 1961 and March 1962, Gamble-Skogmo acquired 50.12% of GOA's common stock, thereby achieving control over the company.<sup>33</sup>

Shortly thereafter, GOA's dismal 1961 earnings reports came out, disclosing that income from advertising plants had fallen off substantially and that the expected rate of return would continue to decline. The reports reflected the serious financial problems that the outdoor advertising industry as a whole experienced during that time.<sup>34</sup> In reacting to these reports, Gamble-Skogmo decided to sell some of GOA's plants,<sup>35</sup> culminating in the sale of twenty-three of GOA's thirty-six plants.<sup>36</sup> Gamble-Skogmo then proposed a merger with GOA, which the boards of GOA and Gamble-Skogmo approved.<sup>37</sup> GOA's stockholders then received a proxy statement seeking their vote on the merger.<sup>38</sup>

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31. Although the Second Circuit has not specifically addressed the disclosure of financial projections, two district court opinions cited *Gerstle* as authority for the nondisclosure of this type of soft information. See *Strauss v. Holiday Inns, Inc.*, 460 F. Supp. 729, 734 (S.D.N.Y. 1978) (finding no duty to disclose financial projections in registration statement); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1550 (S.D.N.Y. 1985) (finding no duty to disclose financial projections in a proxy statement). See also *Walker v. Action Indus.*, 802 F.2d 703, 708 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987) (predicting that the Second Circuit's position would be in agreement with the *Mendell* case if the issue were specifically addressed). Although not mentioning the *Gerstle* case specifically, the following cases follow the spirit of *Gerstle* in finding no duty to disclose financial projections. See *Fisher v. Plessey Co., Ltd.*, 559 F. Supp. 442 (S.D.N.Y. 1983) (finding no duty to disclose financial projections in tender offer documents); *Caspary v. Louisiana Land & Exploration Co.*, 579 F. Supp. 1105, 1109 (S.D.N.Y. 1983) (finding no duty to disclose financial projections in proxy material), *aff'd*, 725 F.2d 189 (2d Cir. 1984). In reaching its decision, the *Caspary* court quoted *Billard v. Rockwell Int'l Corp.*, 526 F. Supp. 218, 221 (S.D.N.Y. 1981), *aff'd*, 683 F.2d 51 (2d Cir. 1982):

Although the SEC now *permits* disclosure of [certain] projections . . . no company is *required* by the SEC to issue projections . . . . Nor has any court ever imposed liability for failure to include projections in a registration statement, *Strauss v. Holiday Inns, Inc.*, 460 F. Supp. 729 (S.D.N.Y. 1978) (citations omitted) (emphasis in original). Nor does there appear to be any case in which a court has imposed liability for failure to disclose projections in other contexts. "Ordinarily . . . the courts discourage presentations of future earnings, appraisal asset valuations and other hypothetical data in proxy materials." *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

32. *Gerstle*, 478 F.2d at 1284.

33. *Id.*

34. *Id.*

35. *Id.* at 1284-85.

36. *Id.* at 1285.

37. *Id.* at 1286.

38. *Id.* at 1287.



The plaintiffs, minority stockholders of GOA, alleged that the proxy statement violated rule 14a-9.<sup>39</sup> They claimed that it was materially false and misleading because it failed to disclose the appraisals of GOA's remaining unsold plants at the time of the merger and Gamble-Skogmo's intent to realize large profits from the sale of the remaining plants shortly after the merger.<sup>40</sup> The plaintiffs claimed that both the appraisals and Gamble-Skogmo's intent to sell were material to GOA stockholders in deciding whether to retain their shares of GOA or to exchange them in the merger for Gamble-Skogmo convertible preferred stock.<sup>41</sup>

The district court ruled in favor of the plaintiffs on both disclosure issues.<sup>42</sup> With respect to its finding that the nondisclosure of the asset appraisals was actionable, the court primarily relied on the amicus brief filed by the SEC. The brief stated that "although appraisals generally cannot be disclosed because they may be misleading, existing appraisals of current liquidating value must be

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39. Rule 14a-9 was promulgated pursuant to section 14(a) of the Exchange Act of 1934. Section 14(a) makes it unlawful for any person to solicit any proxy "in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors . . ." 15 U.S.C. § 78n(a) (1982). Specifically, rule 14a-9 prohibits solicitation by means of a proxy statement

containing any statement which, at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication . . . which has become false or misleading.

*Gerstle*, 478 F.2d at 1291.

40. *Gerstle*, 478 F.2d at 1295.

41. GAO's earning potential was dismal if it continued with outdoor advertising; however, extraordinary profits would be earned from its potential liquidation. The Gamble-Skogmo convertible preferred stock, on the other hand, was "a security involving much less risk but with a correspondingly reduced interest in the profits potentially available through sales of advertising plants." *Id.* at 1302. The court stated:

Certainly the intent of those in control of GOA would be a significant factor in a reasonable shareholder's decision whether or not to vote for the merger. If Skogmo in fact intended to continue the outdoor advertising business of GOA despite the poor earnings picture, as the Proxy Statement indicated, a reasonable GOA stockholder might well have opted for the down-side protection of the Skogmo convertible preferred stock and been willing to give up some of his interest in the potential plant sales profits, which, it may have appeared, might never be realized. On the other hand, if the Proxy Statement had adequately disclosed Skogmo's true intention to seek to dispose of all the remaining outdoor advertising plants as soon as possible, and its expectation that it could do this on favorable terms, the same stockholder would have realized that there was substantially less risk involved in retaining his GOA stock and would have been more likely to focus on the profits available from the sales of the plants.

*Id.* at 1302-03.

42. *Id.* at 1291.

disclosed if they had been made by a qualified expert and have a sufficient basis in fact.”<sup>43</sup>

On appeal the Second Circuit reversed the lower court’s decision. As to the district court’s findings on the appraisal disclosure issue, the Second Circuit attacked the significance of the SEC’s amicus brief. First, the circuit court argued that the SEC in its brief in effect reaffirmed the Commission’s long-standing policy against the disclosure of appraisals.<sup>44</sup> Second, the court severely criticized the precedent upon which the SEC principally relied for its position favoring disclosure. The SEC cited *Speed v. Transamerica Corp.*,<sup>45</sup> which dealt with an inventory of a commodity (tobacco) about to be liquidated by the buyer of Axton-Fisher.<sup>46</sup> The circuit court distinguished *Speed* from the present case, explaining that tobacco was actually traded in the open market, and, therefore, its value was easily ascertainable.<sup>47</sup> Since no market value appraisal was necessary in *Speed* and the case did not involve proxy statements or the SEC’s policy of not allowing the disclosure of appraisals in proxy materials,<sup>48</sup> the court believed that *Speed* was factually irrelevant: “As has been correctly said, ‘No one, the Commission included, has seriously believed that the *Speed* case stands for the general proposition

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43. *Id.* at 1292. The SEC prefaced this new policy by stating that disclosure is only required in the following situations:

When a balance sheet in a proxy statement for a merger reflects assets of an amount that is substantially lower than their current liquidating value, and liquidation of those assets is intended or can reasonably be anticipated, the textual or narrative portion of the proxy statement must contain whatever available material information about their current liquidating value is necessary to make the proxy statement not misleading.

*Id.* at 1291.

44. *Id.* at 1291-93. The court stated that although the note to rule 14a-9 does not specifically refer to asset appraisals as a possible type of misleading information, the policy embodied in the note has consistently been enforced to bar disclosure of asset appraisals as well as future market values, earnings, or dividends. As support, the court cited to the following excerpt from the Commission’s brief:

The Commission and its staff have traditionally looked with suspicion upon the inclusion of asset appraisals even in the text or narrative portion of proxy statements. It has been our experience that such appraisals are often unfounded or unreliable. For this reason, the Commission’s staff, on a case-by-case basis, has usually requested the deletion of appraisals that have been included in proxy statements.

*Id.* at 1292-93 (citing Brief for the Securities and Exchange Commission as Amicus Curiae, *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973)).

45. 99 F. Supp. 808 (D. Del. 1951), *modified and aff’d*, 235 F.2d 369 (3d Cir. 1956).

46. *Gerstle*, 478 F.2d at 1293.

47. *Id.*

48. *Id.*

that appraisals of assets must be disclosed to the shareholders.’<sup>49</sup>

Finally, while recognizing the change in SEC soft information policy, the court stated that the policy in effect at the time of the 1963 proxy statement was applicable and not any ex post facto modification.<sup>50</sup> In 1963 the Commission had a definite policy against disclosure of asset appraisals in proxy statements. The court further noted that at the time of the 1963 proxy statement the Commission’s examiners were “trained to strike at appraisal values as unacceptable whenever they read them in documents filed with the Commission.”<sup>51</sup>

The *Gerstle* court took particular pains to explain its refusal to apply the SEC’s new policies. It commented that such changes should be promulgated by rule or statement of policy rather than by amicus brief.<sup>52</sup> Further, the court noted the unfairness of retroactive application in light of the long-standing assumption among lawyers specializing in the securities field that appraisals of assets could not be included in a proxy statement.<sup>53</sup> In support of its finding of no duty to disclose, the court cited section 23(a) of the Securities Exchange Act for protecting *Gerstle*’s reliance on SEC policy as it appeared in 1963.<sup>54</sup>

In discussing the second issue on appeal, *Gamble-Skogmo*’s intent to sell the remaining plants after the merger, the court agreed with the district court that disclosure of this information was necessary. The court differentiated between factual and soft information disclosure.<sup>55</sup> According to the court, factual information does not allow any potential overstatement of future business prospects—a major factor in alarming the SEC about appraisals.<sup>56</sup> The court found the intent to sell sufficiently factual and material<sup>57</sup> to mandate

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49. *Id.* (quoting Mann, *Accounting and Administrative Law Aspects of Gerstle v. Gamble-Skogmo, Inc.*, 15 N.Y.L.F. 304, 323 (1969)).

50. *Id.* at 1294.

51. *Id.* at 1293.

52. *Id.* at 1294.

53. *Id.* at 1293. The Commission admitted that its branch chief, in reviewing the *Gamble-Skogmo* proxy statement, had enforced this policy by refusing to consider disclosure of the asset appraisals. *Id.*

54. *Id.* at 1294. Section 23(a) of the Securities Exchange Act provides that “[n]o provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with a rule, regulation, or order of the Commission . . . .” 15 U.S.C. § 78w(a)(1) (1982).

55. *Gerstle*, 478 F.2d at 1294-95.

56. *Id.* at 1295.

57. *Id.* at 1301-02. The court applied the materiality test enunciated by the United States Supreme Court in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), which stated

disclosure of that information.<sup>58</sup>

The Seventh Circuit's position on soft information disclosure is reflected in *Panter v. Marshall Field & Co.*,<sup>59</sup> which held that there is no duty to disclose such information.<sup>60</sup> The plaintiffs, who were stockholders of Marshall Field, claimed that Marshall Field's "rosy" projections for future growth misled them. Marshall Field published the projections in two press releases and a letter disseminated to stockholders in December 1977. At the same time Carter Hawley Hale threatened a hostile takeover of Marshall Field.<sup>61</sup> The plaintiffs alleged violations of section 10(b) of the Exchange Act<sup>62</sup> and section 14(e) of the Williams Act.<sup>63</sup> They claimed that the press releases and in particular the letter, which cited a thirteen percent increase in consolidated net income of the company before ventures and taxes, materially misled shareholders in light of the company's

that a misstatement or omission was material if a reasonable stockholder might have considered it important in deciding how to vote. *Id.* at 384.

58. *Gerstle*, 478 F.2d at 1301-02.

59. 646 F.2d 271 (7th Cir. 1981).

60. *Panter's* factual situation dealt with earning projections; however, the court made it clear that its position related to "projections," "estimates," and "other information." *Id.* at 292. See also *Kademian v. Ladish Co.*, 792 F.2d 614 (7th Cir. 1986) (applying *Panter* in holding that internal valuation studies prepared for use during merger negotiations need not be disclosed); *Bradshaw v. Jenkins*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,719 (W.D. Wash. 1984) (citing *Panter* for proposition that courts have consistently discouraged the inclusion of predictive information in proxy statements).

61. *Panter*, 646 F.2d at 291.

62. Section 10(b) of the 1934 Act prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . ." 15 U.S.C. § 78j (1982).

Pursuant to this section, the SEC promulgated rule 10b-5, which 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).

63. Section 14(e) of the Williams Act provides in part that:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer. . . .

15 U.S.C. § 78n(e) (1982).

undisclosed "five-year projection plan."<sup>64</sup> The plan, an internally prepared document, showed an anticipated decline of seven percent in consolidated net income for the year.<sup>65</sup>

The court held that Marshall Field had no duty to disclose financial projections.<sup>66</sup> The court noted an exception, however, when the company has already partially disclosed such information. It explained that the duty to disclose fully all the facts arises in this situation, if necessary to avoid making such statements misleading.<sup>67</sup> Even if this duty did arise, though, the court noted that the projections, estimates, and other information disclosed required a reasonable basis.<sup>68</sup>

Arguably, Marshall Field had a duty to disclose its five-year plan because its letter had "partially disclosed" the information relating to the expected thirteen percent increase. The court, however, did not impose liability because the "highly tentative" projections lacked reasonable certainty.<sup>69</sup> In support of this conclusion, the court relied heavily on the fact that the five-year plan constituted one of a series of plans updated and prepared for internal use only.<sup>70</sup> Additionally, release of the report might have been actionable as still too "rosy" when compared with the company's actual year-end earnings, which declined twenty-five percent from the prior year.<sup>71</sup>

### B. *The Third Circuit—An Unintended Dual Approach*

The Third Circuit's current position on the duty to disclose soft information is enunciated in *Flynn v. Bass Brothers Enterprises*.<sup>72</sup> However, a prior case, *Kohn v. American Metal Climax, Inc.*,<sup>73</sup> may still be authoritative in some situations. Both cases, therefore, warrant discussion.

The facts in *Flynn* arose when Prochemco, Inc. attempted to

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64. *Panter*, 646 F.2d at 292.

65. *Id.*

66. *Id.* at 293 (citing *Freeman v. Decio*, 584 F.2d 186, 199-200 (7th Cir. 1978)).

67. *Id.* at 292 (citing *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)).

68. *Id.*

69. *Id.* at 292-93 (citing *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980) (financial projections not required to be disclosed)).

70. *Panter*, 646 F.2d at 292-93.

71. *Id.*

72. 744 F.2d 978 (3d Cir. 1984). The *Flynn* opinion enunciated a standard for disclosure of asset valuations and other soft information. The standard is often referred to as the "totality of the circumstances" approach. *See id.* at 988.

73. 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

purchase a controlling share of National Alfalfa.<sup>74</sup> To finance the purchase Prochemco approached Bass Brothers in the hope of acquiring a loan.<sup>75</sup> To present its proposal to Bass Brothers and other potential funding sources Prochemco prepared two reports on National Alfalfa's history and operations. Those reports included an appraisal of National Alfalfa's assets based on alternative hypothetical valuations.<sup>76</sup> Bass Brothers refused to participate, but later purchased its own controlling share of National Alfalfa after Prochemco failed to find financing for the purchase.<sup>77</sup>

In March 1976 Bass Brothers announced a tender offer for the remaining shares of National Alfalfa at \$6.45.<sup>78</sup> In making its tender offer, Bass Brothers did not disclose the asset valuations contained in the Prochemco reports.<sup>79</sup> Instead, Bass Brothers represented in its tender offer that the "offeror did not receive any material non-public information from [National Alfalfa] with respect to its prior acquisition of shares nor . . . does it presently possess any such information."<sup>80</sup> In a supplement to the tender offer Bass Brothers did, however, reveal that the liquidated value of the shares could well be significantly higher than the price offered.<sup>81</sup>

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74. *Flynn*, 744 F.2d at 981.

75. *Id.*

76. These reports stated: "\$6.40 could be realized through 'liquidation [of National Alfalfa] under stress conditions'; \$12.40 could be realized through 'liquidation in an orderly fashion over a reasonable period of time'; \$16.40 represented National Alfalfa's value 'as [an] ongoing venture.'" *Id.* at 982.

77. Bass Brothers purchased 52% of company stock at \$6.47 per share from National Alfalfa's former president. *Id.* at 981.

78. At the time of the tender offer, Bass Brothers had increased its holdings in National Alfalfa to 61.2% through a prior privately negotiated purchase of an additional 9% of the company's stock at \$6.45 per share. *Id.* at 982.

79. *Id.*

80. *Id.*

81. The supplement stated:

While the Offeror has made no independent appraisal of the value of the Company's land and makes no representation with respect thereto, in view of the foregoing factors the aggregate current fair market value of the Company's agricultural land may be substantially higher than its original cost as reflected on the books of the Company. Depending upon the respective market values for such land, stockholders could receive, upon liquidation of the Company, an amount per share significantly higher than the current book value and possibly higher than the price of \$6.45 per Share offered by Offeror in the Offer. The amount received by stockholders upon liquidation of the Company would also be dependent upon, among other things, the market value of the Company's other assets and the length of time allowed for such liquidation. The Offeror has no reason to believe that the Company's management has any present intention of liquidating the Company. As noted on page 8 of the Offer to Purchase under "Purpose of This Offer: Present Relationship of Company and Offeror," Offeror does not currently intend to liquidate the Company.

Several months later, in June 1976, former minority stockholders of National Alfalfa filed a class action suit alleging that Bass Brothers violated section 10(b) of the Exchange Act, section 14(e) of the Williams Act, and rule 10b-5 by failing to disclose the Prochemco reports in connection with the tender offer.<sup>82</sup> Specifically, the stockholders maintained that Bass Brothers had a duty to disclose the asset appraisals because that information was material to National Alfalfa's stockholders in making an informed decision on whether to tender their shares.

The district court granted defendant's motion for a directed verdict, finding that the information provided in the tender offer was not materially misleading. The court explained that the information contained in the Prochemco report lacked a sufficient factual basis and, therefore, was not the type of disclosure normally permitted to shareholders.<sup>83</sup> In addressing the asset disclosure issue on appeal, the Third Circuit stated that it was necessary first to find a duty to speak before requiring disclosure of such information. The court explained that "where a 'duty to speak' exists . . . federal securities law requires the disclosure of any 'material fact' in connection with the purchase or sale of a security under rule 10b-5 or the tendering of an offer under section 14(e)."<sup>84</sup> Without defining the particular circumstance under which a duty to speak arises, the court found this requirement easily satisfied under the facts. Bass Brothers did not deny that at the time of the tender offer it had a duty to make disclosures in its capacity as a majority stockholder of National Alfalfa as well as in its capacity as a tender offeror.<sup>85</sup>

The court next focused its attention on the materiality of the asset valuation omissions.<sup>86</sup> In defining materiality the court adopted the *TSC Industries v. Northway, Inc.*<sup>87</sup> test, applicable in both

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*Id.* at 982.

82. See *supra* notes 62-63.

83. *Flynn*, 744 F.2d at 983.

84. *Id.* at 984 (citing *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (holding that the duty to disclose inside information depends upon special relation between buyer and seller); *Staffin v. Greenberg*, 672 F.2d 1196, 1202, 1205 (3d Cir. 1982) (holding that tender offeror has no duty to disclose preliminary merger discussions when plans are indefinite)).

85. *Flynn*, 744 F.2d at 984. One commentator posits that the "duty to speak" arises only upon a specific statutory specification, or in the context of the antifraud provisions, upon a purchase, sale or statement. See Note, *Mandatory Disclosures of Soft Information in the Market for Corporate Control*, 35 EMORY L.J. 213, 224-25 (1986).

86. The court stated the issue was "whether the alleged nondisclosures were material omissions and thus breached the duty to disclose." *Flynn*, 744 F.2d at 984.

87. 426 U.S. 438, 449 (1976). In *TSC Industries* the Supreme Court held that an omit-

rule 10b-5 and section 14(e) cases.<sup>88</sup>

In discussing the materiality issue the circuit court first surveyed past and present SEC policy, concluding that in recent years the SEC policy had begun to favor more disclosure of soft information.<sup>89</sup> The court pointed out that the evolution in SEC policy was a reaction to increased mergers, proxy contests, and tender offers, which engender the need for more information, whether it be hard or soft.<sup>90</sup> The rationale for the SEC's initial prohibition of soft information disclosure—the fear of purchaser reliance on overly optimistic claims by management<sup>91</sup>—had produced an unintended and unfortunate result: the nondisclosure of valuable information for stockholders faced with the choice of selling or exchanging their shares in a tender offer or merger.<sup>92</sup> When the SEC initially formulated its policy on nondisclosure of soft information, the “present spate of proxy contests and tender offers was not anticipated . . . .”<sup>93</sup>

Recognizing the SEC's new policy regarding disclosure of soft information, the *Flynn* court decided to formulate a new approach that would be concomitant with present SEC policy. First, the court

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ted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

88. The court explained: “This definition of ‘material’ has been adopted for cases involving rule 10b-5 and we see no reason not to utilize the same formulation for evaluating materiality in the context of a tender offer.” *Flynn*, 744 F.2d at 985 (citing *Radol v. Thomas*, 556 F. Supp. 586, 593 n.15 (S.D. Ohio 1983), *aff'd*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 3272 (1986) (employing the *TSC Industries* formulation of materiality in § 14(e) and rule 10b-5 cases)). *Flynn* also cited *Staffin v. Greenberg*, 672 F.2d 1196, 1205 (3d Cir. 1982); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 282 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

89. *Flynn*, 744 F.2d at 986-87. The court mentioned the SEC's 1976 deletion of future earnings from the note to rule 14a-9, which lists examples of potentially misleading disclosures. *Id.* See Securities Act Release No. 5699, *supra* note 15; SEC rule 175, Safe Harbor For Forward Looking Projections, 17 C.F.R. § 230.175 (1986); Exchange Act Release No. 16,833, *supra* note 24 (authorizing disclosure of good faith appraisals made on a reasonable basis in proxy contests in which a principal issue is the liquidation of all or a portion of a target company's assets). For a discussion of each of the items above, see *supra* Section I of this article.

90. *Flynn*, 744 F.2d at 986-87.

91. *Id.* at 987.

92. *Id.* See Kripke, *Rule 10b-5 Liability and “Material” “Facts,”* 46 N.Y.U. L. REV. 1061, 1071 (1971).

93. *Flynn*, 744 F.2d at 987. The court attempted to develop a new approach that was clearly in step with current SEC policy instead of one that retarded the evolution of the law by reflecting only past and outdated SEC policy. The court explained that other circuits had not modernized their approaches because of the time lag between the issuance of a challenged tender offer or proxy statement and when a trial or appellate court rendered a decision. *Id.* at 987 (citing *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973)).



ruled that asset appraisals, as a matter of law, were not immaterial.<sup>94</sup> Second, it found that in appropriate cases disclosure of such information was mandatory.<sup>95</sup> In determining which situations called for mandatory disclosure of soft information, the court adopted a case-by-case approach. This determination could be accomplished:

by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note.

The factors a court must consider in making such a determination are: the facts upon which the information is based; the qualifications of those who prepared or compiled it; the purpose for which the information was originally intended; its relevance to the stockholder's impending decisions; the degree of subjectivity or bias reflected in its preparation; the degree to which the information is unique; and the availability to the investor of other more reliable sources of information.<sup>96</sup>

The Third Circuit, however, refused to apply its new standard retroactively.<sup>97</sup> Instead, it applied the law prevailing in 1976,<sup>98</sup> the time of the alleged violation.

Prior to *Flynn*, the Third Circuit's leading case on the disclosure of soft information was *Kohn v. American Metal Climax, Inc.*<sup>99</sup> The *Kohn* case involved the proposed amalgamation of two mining corporations, Roan Selection Trust Limited (RST), a Zambian corporation, into American Metal Climax (AMAX), a New York corporation and controlling stockholder of RST.<sup>100</sup> The plaintiff, a representa-

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94. *Id.* at 988.

95. *Id.*

96. *Id.*

97. The court noted "that despite our formulation of the current law applicable to corporate disclosure, we are constrained by the significant development in disclosure law since 1976 not to apply the announced standard retroactively but to evaluate the defendants' conduct by the standards which prevailed in 1976." *Id.*

The rationale for the court's decision against retroactive application is supported by similar findings in other cases. *Id.* at 986 n.11 (citing *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1271-72 (9th Cir. 1982)) (see *infra* notes 227-37 and accompanying text for a discussion of this case); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 292-93 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292-94 (2d Cir. 1973); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

98. See *supra* notes 14-18 and accompanying text for details on SEC policy at this time. In general, SEC policy still discouraged the disclosure of soft information.

99. 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1982).

100. *Id.* at 259.

tive of certain RST stockholders, sued under section 10(b) of the Exchange Act and rule 10b-5, alleging that the proxy materials soliciting stockholder votes on the proposed amalgamation failed to provide material information including the value of RST's assets.<sup>101</sup>

The district court agreed with the plaintiffs, holding that a "clear presentation of the values assigned to RST assets . . . and the basis upon which the evaluations were made were crucial to an informed shareholder vote and omission of these facts . . . was material."<sup>102</sup> Moreover, the district court suggested that the omission of the asset values was intentional, as they had been substantially undervalued in the AMAX-RST negotiations.<sup>103</sup>

On appeal the Third Circuit strongly disagreed with the district court's finding on the materiality of the omission. In holding that such a conclusion constituted reversible error, the circuit court never discussed whether the asset valuations were in fact material. Instead, the court pointed to traditional SEC policy as discouraging the disclosure of this type of information in proxy materials. Additionally, the court found that the asset values, a product of the negotiations concerning the amalgamation, were unreliable and, therefore, suspect.<sup>104</sup>

In applying the *Kohn* holding to the *Flynn* case, the Third Circuit emphasized the broad reach of *Kohn* to all types of soft information.<sup>105</sup> Citing *Kohn*, the court stated: "This court in the past has

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101. *Id.* at 260.

102. *Id.* at 265.

103. *Id.*

104. *Id.*

105. The *Kohn* case has been quoted extensively for the position that such information is not required to be disclosed. *See, e.g.,* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 775 n.12 (3d Cir. 1976) (no duty to disclose valuation predictions); Staffin v. Greenberg, 509 F. Supp. 825, 837 (E.D. Pa. 1981), *aff'd*, 672 F.2d 1196 (3d Cir. 1982) (tender offeror has no duty to disclose preliminary merger discussions when plans are indefinite); *see also* Dower v. Mosser, 648 F.2d 183 (3d Cir. 1981) (not citing *Kohn* but expressly adopting its position—no duty to disclose future projections). Two district court cases, Alaska Interstate Co. v. McMillan, 402 F. Supp. 532 (D. Del. 1975), and Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812 (D. Del. 1974), cited to *Kohn* but developed their own tests.

The *Denison* case involved the failure to disclose asset valuations in a proxy statement. The court developed a balancing test to ascertain whether disclosure was required. The court weighed the value and reliability of the data against the potential for misinterpretation in its communication. 388 F. Supp. at 820.

In *Alaska Interstate* the acquiring company, over the objection of the target, included, with proper disclaimers and cautionary remarks, a range of hypothetical liquidation values made by the target's management. The court approved the release of the valuations in spite of the "general rule" discouraging such disclosure. It went on to note that soft information disclosure may even be required depending on certain factors such as

followed the 'general rule' that presentations of future earnings, appraised asset valuations and other hypothetical data are to be discouraged."<sup>106</sup> Following *Kohn's* holding, the Third Circuit found that the appraisal reports in *Flynn* were unreliable<sup>107</sup> because experts did not prepare them,<sup>108</sup> they were virtually "selling documents,"<sup>109</sup> and not adequately based in fact.<sup>110</sup> Additionally, the court concluded that the plaintiff failed to advance enough evidence showing that Bass Brothers relied on the appraisals.<sup>111</sup> Any omission of these reports was, therefore, not actionable.

What is the impact of *Kohn* and *Flynn* on cases that come up for review after the *Flynn* decision? Even though the Third Circuit strongly urged application of the *Flynn* criteria, both retroactively and prospectively, some courts since *Flynn* have viewed the Third Circuit as having two tests applicable to the disclosure of soft information. For cases having factual situations arising prior to the *Flynn* holding, *Kohn* has been applied, finding no duty to disclose soft in-

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(1) the importance of the information; (2) the amount of subjective judgment which the information reflects; (3) the practical difficulties in fashioning a disclosure which would not create "more potential for misunderstanding than enlightenment . . ."; (4) the purpose of its preparation; and (5) whether the information indicated a trend substantially different from that reflected in publicly available information. 402 F. Supp. at 567-68 (quoting *Denison Mines Ltd.*, 388 F. Supp. at 819).

106. *Id.*, 744 F.2d at 986.

107. *Id.* In assessing the reliability of the asset valuations, the *Flynn* court applied the following factors: the qualifications of those who prepared or compiled the appraisal; the degree of certainty of the data; the reason for the preparation of the report; and evidence of reliance on the appraisal. *Id.* The court cited several cases that emphasized these factors in their decisions: *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (finding no need to disclose "tentative estimates prepared for the enlightenment of management with no expectation that they be made public"); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir. 1972) (not requiring disclosure of appraisals that were "advanced by parties during negotiation only and as part of their bargaining strategies"); *Radol v. Thomas*, 556 F. Supp. 586, 588 (S.D. Ohio 1983) (finding that reports "intended to be 'selling documents' for use in attracting more favorable tender offer" are less reliable), *aff'd*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 3272 (1986). For examples of courts that considered, in particular, the element of reliance on appraisals, see *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1272 (9th Cir. 1982); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292-94 (2d Cir. 1973).

108. The court concluded that although Prochemco did have experience in acquisitions, there was little evidence of the company's expertise in appraising assets such as the type of land involved in the case. *Flynn*, 744 F.2d at 988-89.

109. The purpose of the reports was to attract financing for Prochemco's purchase of National Alfalfa stock. *Id.* at 989.

110. There was no clear evidence establishing who specifically prepared the reports or the data used in making the valuations. *Id.*

111. The court commented that reliance on these reports would be insufficient to mandate disclosure in the *Flynn* case. *Id.*

formation.<sup>112</sup> Post-*Flynn* factual scenarios, however, would call for application of the *Flynn* criteria by the Third Circuit and those courts wishing to follow its lead.<sup>113</sup> This unintended<sup>114</sup> dual approach is a result of the Third Circuit's refusal in *Flynn* to apply its own criteria retroactively.<sup>115</sup>

C. *The Fourth Circuit: An Approach Dependent on the Type of Soft Information*

The Fourth Circuit recently decided two cases, *Lockspeiser v. Western Maryland Co.*<sup>116</sup> and *Walker v. Action Industries*,<sup>117</sup> dealing with the issue of mandatory disclosure of soft information. In *Walker*, the more recent case, the Fourth Circuit made it clear that the application of either the *Walker* standard or the *Lockspeiser* standard would depend on the type of soft information in question.<sup>118</sup>

*Lockspeiser* involved a merger of Western Maryland, a timber and mineral leasing concern, into CSX Minerals, Inc., a wholly-owned subsidiary of CSX Corporation.<sup>119</sup> Stockholders of Western Maryland received a proxy statement concerning the proposed merger.<sup>120</sup> A stockholder of Western Maryland brought suit alleging that the proxy statement was misleading under sections 10(b) and 14(a) of the Exchange Act.<sup>121</sup> The proxy statement omitted information relating to the number of tons of coal reserves and the amount of standing board feet of timber, Western Maryland's two most valuable assets.<sup>122</sup>

Finding the omission immaterial, the district court dismissed

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112. See, e.g., *Walker v. Action Indus.*, 802 F.2d 703, 708 (4th Cir. 1986), cert. denied, 107 S. Ct. 952 (1987); and *Fickinger v. C.I. Planning Corp.*, 646 F. Supp. 622, 628 (E.D. Pa. 1986) (no duty to disclose real estate appraisals and rental projections), stating that "*Flynn* standards are not applied retroactively" and citing *Kohn* as authority for the Third Circuit's pre-*Flynn* position.

113. See, e.g., *Hecco Ventures v. Avalon Energy Corp.*, 606 F. Supp. 512, 520 (S.D.N.Y. 1985).

114. The circuit court in *Flynn* in fact urged other courts to apply its criteria to factual situations arising both before and after its holding. *Flynn*, 744 F.2d at 988.

115. See *Walker*, 802 F.2d at 708; *Fickinger*, 646 F. Supp. 622, 628 (E.D. Pa. 1986).

116. 768 F.2d 558 (4th Cir. 1985).

117. 802 F.2d 703 (4th Cir. 1986), cert. denied, 107 S. Ct. 952 (1987).

118. The *Walker* court refused to apply the *Lockspeiser* holding (duty to disclose information relating to coal reserves and amount of standing board feet of timber in a proxy statement) to financial projections and asset valuations, stating that the two cases were factually different. *Id.* at 709.

119. *Lockspeiser*, 768 F.2d at 559.

120. *Id.*

121. See *supra* notes 39 and 62.

122. *Lockspeiser*, 768 F.2d at 560.

the stockholder's claim.<sup>123</sup> On appeal the circuit court found the issue of materiality to be a question for the trier of fact.<sup>124</sup> Furthermore, the court cited the *TSC Industries* materiality test as the applicable standard.<sup>125</sup> The appellees argued vigorously against any application of a materiality test and posited that disclosure of tonnage and board feet estimates would violate the federal securities laws. Western Maryland supported its argument by citing *Kohn* for the proposition that the SEC and the courts discouraged disclosure of asset valuations in proxy materials.<sup>126</sup> Distinguishing *Kohn* on its facts,<sup>127</sup> the Fourth Circuit refused to apply that case because it did not involve reserve disclosure.<sup>128</sup> Furthermore, the court noted *Kohn's* modification by *Flynn*.<sup>129</sup> Ultimately, the Fourth Circuit remanded the case, stating that the trier of fact should determine whether the omissions were material in accordance with the test prescribed in *TSC Industries*.<sup>130</sup>

The second noteworthy case in the Fourth Circuit, *Walker v. Action Industries*,<sup>131</sup> involved financial projections. A former stockholder of Action Industries brought suit against Action alleging violations of section 10(b) and rule 10b-5 based on material omissions in a self-tender-offer statement and a press release issued by Action in 1982.<sup>132</sup> On appeal Walker challenged the jury's verdict

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123. *Id.*

124. The court noted that Western Maryland minority shareholders had the choice of accepting the offer for purchase of the stock or instituting a state proceeding for appraisal. Since no established market existed for the company's stock and there was no independent valuation of the assets, information about timber and coal reserves was significant to stockholders in making their choice. *Id.* at 561.

125. The court observed that sections 10(b) and 14(a) shared the same standard of materiality. *Lockspeiser*, 768 F.2d at 562 (citing *TSC Indus. v. Northway, Inc.*, 426 U.S. at 445-46 n.8; *Seaboard World Airlines v. Tiger Int'l, Inc.*, 600 F.2d 355, 361 n.8 (2d Cir. 1979)). For a statement of the test, see *supra* note 87.

126. *Lockspeiser*, 768 F.2d at 560-61 (citing *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir. 1972)). Appellees also cited *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980), which held that disclosure of financial projections was not required. The court distinguished this case on its facts. *Lockspeiser*, 768 F.2d at 561.

127. *Lockspeiser*, 768 F.2d at 561. In *Kohn* the court did not require disclosure of asset valuations advanced by parties during negotiations as a part of bargaining strategy. For further discussion of this case, see *supra* text accompanying notes 99-104.

128. *Lockspeiser*, 768 F.2d at 561.

129. *Id.* *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 988 (3d Cir. 1984), modified the Third Circuit's position in *Kohn* that disclosure of asset valuations and other soft information is to be discouraged and held that in appropriate cases disclosure is required.

130. *Lockspeiser*, 768 F.2d at 562. At the time of the writing of this article, the district court had not heard the case on remand.

131. 802 F.2d 703 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987).

132. *Id.* at 704-05. On July 16, 1982, Action made a tender offer to purchase 15% of its common stock at \$4.00 per share until August 6th of that year. In connection with

against the 10b-5 action, claiming the lower court erred in its instruction to the jury that "there is no duty on a corporation to disclose future projections. However, it can do so voluntarily."<sup>133</sup>

Walker argued that a proper instruction would have informed the jury that Action had a duty to disclose its financial projections for fiscal 1983 as well as its actual orders and sales for the same period.<sup>134</sup> The press release, based on audited financial statements, and the statements themselves virtually confirmed the statements made in section 14B of Action's tender offer statement.<sup>135</sup> Essentially, the release and statements reported increased sales and decreased earnings.<sup>136</sup> Action's internal reports, however, reflected different financial news.<sup>137</sup>

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the tender offer, Action issued a tender offer statement as required pursuant to rule 13e-4. Rule 13e-4 establishes filing and disclosure requirements for tender offers by a reporting company for its own shares. 17 C.F.R. § 240.13e-4 (1986). Action's tender offer statement was conditionally admitted into evidence and discussed at trial. At the close of plaintiff's case, however, the district court struck the tender offer statement from the evidence and instructed the jury that only the alleged omissions in the press release were actionable. *Walker*, 802 F.2d at 706 n.5. Action issued the press release on August 18, 1982, after the tender offer had terminated. Basically, the press release confirmed the information set forth by Action in its tender offer statement. *Id.* at 705.

133. *Walker*, 802 F.2d at 707.

134. *Id.* Action's fiscal year ran from July through June. Because its 1982 fiscal year had just ended, audited financial statements for that year as well as the first quarter of 1983 were unavailable at the time of the tender offer and August 18th press release. The tender offer statement did, however, disclose audited financial statements for fiscal years 1979, 1980, and 1981. These figures revealed a net loss of \$2,306,900 in fiscal 1979, net earnings of \$372,000 in fiscal 1980, and net earnings of \$731,000 in fiscal 1981. *Id.* at 704. Additionally, Action disclosed unaudited, interim financial statements for fiscal 1982 through March 27, 1982, the end of Action's third quarter. These figures showed a net loss of \$4,014,900 as compared with net earnings of \$1,037,600 for the same period in the previous year. *Id.*

135. *Id.* at 705. Pursuant to § 14B of Action's tender offer statement, a segment entitled "Events Subsequent to March 27, 1982," Action stated in part:

The Company's fiscal year ended on June 26, 1982. Although financial statements have not been prepared or audited, the Company expects results from continuing operations to reflect a sales increase compared with the prior year. However, earnings from continuing operations are estimated to be somewhat lower than last year as a result of lower gross margins on sales and higher operating expenses.

*Id.* at 704-05.

136. *Id.* at 705.

137. Action regularly prepared several types of reports for internal use. A weekly "work projections report" recorded actual orders and identified them as "firm" or "anticipated" depending on their likelihood of cancellation. Monthly "gross sales forecasts" projected both monthly and quarterly sales based on the orders reflected in the weekly work projections. Additionally, Action reported actual financial results in weekly "flash sales reports," which showed sales for the current week, month-to-date sales, and quarter-to-date sales. *Id.*

Prior to Action's tender offer, as early as May 1982, Action's internal financial reports indicated substantial increases in orders and projected sales for the first quarter of fiscal year 1983. As the July tender offer neared and the first quarter of fiscal year 1983 began, subsequent internal reports indicated even greater increases in actual orders and projected sales, as well as increases in actual sales over the prior year. Action, however, did not disclose these reports in its tender offer statement.<sup>138</sup>

Subsequent to Action's tender offer and up until the August 18 press release, the company's internal reports continued to show substantial increases in projected sales, actual orders, and actual sales for the first quarter of 1983. The company's press release did not include these projected increases.<sup>139</sup> Concluding from the August 18 press release that the company's prospects were not favorable, Walker sold all of his Action shares on September 21, 1982, at \$5.25 per share.<sup>140</sup> Subsequently, on October 28, Action announced its first-quarter financial results. The company reported sales seventy-five percent above the one million in sales reported over the same period in the previous year. The company's stock traded the following day as high as 9-7/8 and reached a peak of 15-3/4 per share by November 12, 1982.<sup>141</sup>

In assessing Walker's argument—required disclosure of the financial projections—the court determined that before the issue of materiality is reached<sup>142</sup> in a 10b-5 action concerning omissions, a duty to speak must first be established.<sup>143</sup> The court specifically refused to adopt any of the various approaches used by other circuits on the duty to disclose soft information.<sup>144</sup> By using its own approach the *Walker* court effectively side-stepped any question concerning the materiality of Action's 1983 financial projections. Since the court concluded that Action had no duty to speak, it was unnecessary to go further in its analysis. Four arguments figured prominently in this finding.

First, the court noted the SEC's failure to impose a duty to dis-

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138. *Id.*

139. *Id.*

140. *Id.* Walker did not tender any of his shares to Action in its tender offer.

141. *Id.*

142. The court cited the *TSC Industries* test as the applicable standard in rule 10b-5 cases. *Id.* at 706 n.6.

143. *Id.* at 706 (citing *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986); *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 984 (3d Cir. 1984)).

144. *Id.* at 709 n.11.

close financial projections in rule 13e-4 tender offer statements.<sup>145</sup> Extending this rationale to Action the court stated: "It follows that there was a similar absence of any express duty to disclose financial projections in the . . . press release."<sup>146</sup>

Second, the SEC had not imposed a duty to disclose financial projections in disclosure documents in general. Recognizing that the SEC's disclosure policy on soft information had changed from one of nondisclosure to permissiveness, the court perceived the current SEC environment as "experimental" and "evolutionary." Any further transition in policy from permissiveness to mandatory disclosure, in the court's view, needed SEC or congressional approval.<sup>147</sup>

Third, the court made clear its reluctance to recognize a duty to disclose the particular financial projections in *Walker*<sup>148</sup> because of their uncertainty and potential to mislead investors. The court referred to the volatility of the projections and compared the actual sales increases with those projected for the quarter.<sup>149</sup> In light of the disparity between actual and projected sales, the court concluded that Walker might have sued Action if it had disclosed such overly optimistic information.<sup>150</sup>

Finally, the court viewed the required disclosure of the projections as impractical. Referring once again to the frequency and volatility of these projections, the court found that the "imposition of a duty to disclose . . . would have required virtually constant statements by Action in order not to mislead investors. Under these circumstances . . . projection [was] impractical, if not unreasonable."<sup>151</sup>

In summarizing its position, the court noted that its holding did not pertain to the disclosure of financial projections in all circumstances, only to the particular circumstances of the *Walker* case.<sup>152</sup>

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145. *Id.* at 709.

146. *Id.*

147. *Id.*

148. *Id.* The court did not state that this reason applied to the disclosure of financial projections in general.

149. *Id.* The court explained that monthly projections were changing constantly with each new projection, rendering the last one incorrect. For example, the court cited the May and June projections, arguing that the disclosure of either one would have grossly understated subsequent projections. *Id.* at 709-10.

150. *Id.* at 710.

151. *Id.*

152. *Id.* The court went on to state that its holding was not intended to discourage disclosure of financial projections. Instead the court voiced its support of *voluntary* disclosure of soft information made pursuant to rule 175. *Id.*



The court, however, refused to discuss under what circumstances a duty to speak would arise. Consequently, the court did not address the application of the *TSC Industries* materiality test if such a duty did exist.

In summary, the Fourth Circuit's position on soft information disclosure disfavors disclosure of financial projections while requiring the disclosure of reserve information, if material.<sup>153</sup> Although the *Walker* court noted that its holding did not pertain to financial projections in general, one reason upon which it relied in finding no duty to disclose applies to all financial projection cases and to cases involving other types of soft information disclosure, including asset valuations: the decision to wait for an SEC mandate and not to second-guess the SEC while its policies are in transition.

#### D. *The Sixth Circuit—The Substantially Certain to Hold Test*

The Sixth Circuit enunciated its position on the duty to disclose soft information in *Starkman v. Marathon Oil Co.*<sup>154</sup> *Radol v. Thomas*<sup>155</sup> confirmed and applied this standard. Both cases involved the same general fact situation. Since both cases came down on the same day and in order to give full discussion to the *Starkman* test, it is necessary to discuss these cases together, noting both their similarities and differences.

1. *The Common Factual Scenario.*—In the summer of 1981 Marathon Oil Company became a prime potential takeover target. Marathon's stock was grossly undervalued<sup>156</sup> compared with the

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153. *Lockspeiser* is significant not only for its refusal to apply traditional SEC policy but also its recognition that under certain circumstances disclosure of reserve information is not required but may be if it is material under the *TSC Industries* test. The holding in *Lockspeiser* is probably confined to the disclosure of reserve information. See *supra* note 118.

154. 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986).

155. 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 3272 (1986). The court in *Radol* said that *Starkman* merely reaffirmed its prior decisions on the subject. *Id.* at 252. See *Biechele v. Cedar Point, Inc.*, 747 F.2d 209 (6th Cir. 1984) (finding no duty to disclose financial projections that were little more than predictions of future business success); *James v. Gerber Prods. Co.*, 587 F.2d 324 (6th Cir. 1978) (finding earning figures material only when calculated with substantial certainty); *Marsh v. Armada Corp.*, 533 F.2d 978 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977) (holding failure to disclose projections of future earnings in a freeze-out merger proxy statement not actionable); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.) (holding corporate insider not required to disclose educated guesses or predictions), *cert. denied*, 419 U.S. 830 (1974).

156. For example, the company's stock was trading at around \$63.75, in comparison with appraisal reports that had valued the stock at a much higher level. *Starkman*, 772 F.2d at 234-35.

company's ownership of substantial long-term oil and gas fields. These holdings included the Yates field in west Texas, one of the largest and most productive oil fields ever discovered.<sup>157</sup>

In view of the strong possibility of a takeover, Marathon's top level management met and began to prepare defensive tactics against a hostile takeover bid. The company prepared an internal asset valuation report known as the Strong report.<sup>158</sup> The report estimated the value of Marathon's transportation, refining, marketing, equipment, and structural assets, as well as the value of proven, probable, and potential oil reserves,<sup>159</sup> including exploratory acreage.

The basis for the Strong report's estimates of all three types of reserves was not available to the general public. The valuation of the reserves involved the use of a discounted cash-flow methodology.<sup>160</sup> This valuation method, a standard procedure used for determining the cash value of oil and gas properties, required projections of price and cost conditions twenty years into the future.<sup>161</sup> Based on this methodology, the Strong report valued Marathon's net assets at between \$16 billion and \$19 billion.<sup>162</sup> This resulted in a per-share value between \$276 and \$323. The value of the oil and gas reserves made up \$14 billion of the \$19 billion estimate and \$11.5 billion of the \$16 billion estimate.<sup>163</sup>

In addition to the Strong report, First Boston, at Marathon's request, prepared a similar report. First Boston, an investment banking firm, based its report upon only proven and probable oil reserves. Like the Strong report, First Boston's report constituted a "presentation piece," used only to attract the interest of prospective

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157. *Radol*, 772 F.2d at 247.

158. Harold Hoopman, Marathon's President and CEO, instructed the company's vice presidents to compile a catalog of assets. He and his aide, John Strong, were responsible for combining the information received from the company's various divisions into the final report. *Starkman*, 772 F.2d at 234.

159. The Strong Report defined "proven reserves" as those actually producing, "probable reserves" as reserves for properties where some production had been established and additional production was likely, and "potential reserves" as reserves for properties where production had not yet been established but where geologic evidence supported wildcat drilling. *Id.*

160. Using the discounted cash-flow methodology, the present value of oil reserves is calculated by summing risk-discounted expected net revenues from the particular field over the life of the field, and then discounted into present value by the use of an estimated interest rate. *Id.*

161. *Id.*

162. A range of asset valuation existed because different interest rates were used to discount back to present value. *Id.*

163. *Id.*

bidders for Marathon if a hostile tender offer occurred.<sup>164</sup> The First Boston report placed Marathon's value between \$188 and \$225 per share.<sup>165</sup> Marathon's market value, however, was well below these appraisals.<sup>166</sup> On October 30, 1981, the day before Mobil announced a hostile takeover bid for Marathon Oil, Marathon stock closed at \$63.75 per share.<sup>167</sup>

Mobil's proposed acquisition of Marathon involved two steps. The first step involved a tender offer for up to sixty-eight percent of Marathon's common stock at \$85 per share in cash. The second and final step, a going-private, freeze-out merger, would pay the remaining shareholders of Marathon sinking fund debentures worth approximately \$85 per share.<sup>168</sup> In reaction to Mobil's offer, Marathon's board, on October 31, 1981, unanimously decided that the offer was "grossly inadequate." The board then determined to locate a "white knight" and persuade Marathon stockholders not to tender.<sup>169</sup>

On November 11 and 12 Marathon's board made public statements to its stockholders in the form of a press release and a letter. Both statements recommended rejection of Mobil's bid as "grossly inadequate" and against the best interests of the company.<sup>170</sup> At

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164. *Radol*, 772 F.2d at 247.

165. *Id.*

166. Other appraisals confirmed this. The Herold Oil Industry Comparative Appraisal placed Marathon's appraised values at \$199 per share. Additionally, two reports by security analysts revealed that Marathon's stock had an appraised value of between \$200 and \$210 per share. *Starkman*, 772 F.2d at 234.

167. *Id.* at 235.

168. *Id.*

169. *Id.*

170. *Id.* The press release, issued on November 11, stated:

Our Board of Directors has determined that Mobil Corporation's unsolicited tender offer is grossly inadequate. The offer is not in the best interests of Marathon Oil or its shareholders. It doesn't reflect current asset values and it doesn't permit the long-term investor the opportunity to participate in the potential values that have been developed.

... We plan to do everything we possibly can to defeat this offer. We are determined to stay independent.

*Id.* at 235.

The next day Marathon mailed a letter to its stockholders urging rejection of the offer and stating that it was "convinced that the Mobil offer is grossly inadequate and does not represent the real values of the assets underlying your investment in Marathon." *Id.* at 235. The letter described a number of alternative courses of action under consideration by the Board, including "repurchase of Marathon shares, acquisition of all or part of another company, a business combination with another company, [and] the declaration of an extraordinary dividend and a complete or partial liquidation of the Company." *Id.* at 235-36. The letter ended by once again urging rejection of Mobil's attempt to "seize control of Marathon's assets at a fraction of their value," and it further

the same time, Marathon had contacted thirty to forty companies considered to be reasonable merger candidates. These companies all received copies of both the Strong and First Boston reports.<sup>171</sup>

On November 10 U.S. Steel (Steel) and Marathon had begun negotiations for a possible merger. Steel received both reports on the same day, and on November 12 Marathon delivered five-year earnings forecasts and cash-flow projections to Steel.<sup>172</sup> Negotiations concluded on November 17, with an offer by Steel to purchase up to 31 million shares (about 51%) of Marathon stock for \$125 per share in cash. A freeze-out merger would follow with the remaining Marathon stockholders receiving a \$100 face value, 12 year, 12-1/2% guaranteed note per share of common stock.<sup>173</sup> On November 18 Marathon's board approved the agreement.<sup>174</sup> The next day, November 19, Steel mailed its tender offer to Marathon stockholders.<sup>175</sup> At the same time Marathon mailed a letter to its stockholders recommending acceptance of Steel's offer.<sup>176</sup> After the announcement of Steel's tender offer, the market price of Marathon stock rose and fluctuated between \$100 and \$105 per share from November 19 until December 7.<sup>177</sup>

Steel's offer was successful, with over 91% of the outstanding shares tendered.<sup>178</sup> In February 1982 proxy solicitation materials were sent out to the remaining stockholders seeking approval of the second-stage freeze-out merger.<sup>179</sup> The disclosure of the Strong and First Boston appraisals to stockholders first occurred in the proxy materials seeking approval of the merger.<sup>180</sup> The proxy state-

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stated that "[w]e are convinced that you and our other shareholders would be well served if Marathon remains independent." *Id.* at 236.

Marathon attached a copy of its schedule 14D-9 to this letter. The company also filed the schedule with the SEC pursuant to rule 14d-9, which requires target companies to inform the SEC as to whether the target is recommending acceptance or rejection of the tender offer to its stockholders. 17 C.F.R. § 240.14d-9 (1986). The schedule disclosed that the board was recommending rejection of the offer. *Starkman*, 772 F.2d at 236. None of these disclosures revealed the Strong and First Boston reports. *Id.* at 235-36.

171. *Radol*, 772 F.2d at 248.

172. *Starkman*, 772 F.2d at 235.

173. *Id.*

174. *Id.* Marathon received competing but more tentative proposals from Allied Corp. and Gulf Oil Corp. *Radol*, 772 F.2d at 248.

175. *Starkman*, 772 F.2d at 235.

176. *Radol*, 772 F.2d at 249.

177. *Id.*

178. *Starkman*, 772 F.2d at 235.

179. *Radol*, 772 F.2d at 250.

180. *Id.*

ment discussed the Strong and First Boston reports extensively, as required by rule 13e-3<sup>181</sup> in freeze-out mergers. The materials, however, warned that the First Boston report "should not be regarded as an independent evaluation or appraisal of Marathon's assets."<sup>182</sup> Nor were the two reports "viewed by Marathon's Board of Directors as being reflective of . . . per share values that could realistically be expected to be received by Marathon or its shareholders in a negotiated sale of the Company as a going concern or through liquidation of the Company's assets."<sup>183</sup> Approval of the merger between Marathon and Steel occurred in March.<sup>184</sup>

2. *The Differences.*—The *Radol* and *Starkman* fact patterns varied in a number of ways. Specifically, each case evolved from claims arising at different points in time in the basic factual scenario. In *Starkman* the plaintiff sold his Marathon shares the day before the announcement of Steel's tender offer.<sup>185</sup> The plaintiffs in *Radol*, on the other hand, comprised two groups, stockholders who tendered their shares to Steel and those shareholders frozen-out in the subsequent merger.<sup>186</sup>

A second difference between the two cases relates to the type of soft information covered by the respective plaintiffs' claims. In *Starkman* the plaintiff's claim in his rule 10b-5 claim included not only the nondisclosure of the Strong and First Boston reports but also the five-year earnings forecasts, the cash-flow projections, and the pending negotiations between Steel and Marathon.<sup>187</sup> Specifically, the plaintiff alleged that the omission of this information in the November 11 press release, the November 12 letter to stockholders, and the schedule 14D-9 attachment to that letter was materially misleading.<sup>188</sup> The plaintiff argued that this information's disclosure would have affected a reasonable shareholder's evaluation of the

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181. 17 C.F.R. § 240.13e-3 (1986).

182. *Radol*, 772 F.2d at 250.

183. *Id.*

184. *Id.*

185. *Starkman*, 772 F.2d at 233.

186. *Radol*, 772 F.2d at 250.

187. *Starkman*, 772 F.2d at 236. Not all authorities agree that preliminary negotiations are a type of soft information. See, e.g., *Walker v. Action Indus.*, 802 F.2d 703, 708 n.10 (4th Cir. 1986) (citing *Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986) (finding a duty to disclose merger negotiations)). But see *Address by Schneider*, *supra* note 2.

188. *Starkman*, 772 F.2d at 235-36. For the text of these documents, see *supra* note 170. The plaintiff also contended that Marathon's failure to disclose its search for a "white knight" and its on-going negotiations with Steel made its statement that it might remain independent misleading. *Starkman*, 777 F.2d at 235-36.

likelihood that Marathon would have succeeded in negotiating a higher price takeover.<sup>189</sup>

In comparison, the plaintiffs' claim in *Radol* only involved the nondisclosure of the Strong and First Boston reports. The plaintiffs claimed the omission of this information was actionable not only under section 10(b) and rule 10b-5 but also section 14(e). The plaintiffs claimed such information was material to stockholders in deciding whether to tender their shares.<sup>190</sup>

A further point of distinction between the two cases is the district court findings. In *Starkman* the district court granted summary judgment for Marathon. The basis for the judgment was that all soft information had either been sufficiently disclosed or that such information need not be disclosed, since nondisclosure would not have rendered Marathon's other affirmative public statements materially misleading.<sup>191</sup>

In *Radol* the district court concluded that the *TSC Industries* materiality standard, as relating to the Strong and First Boston asset

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189. *Id.* at 236.

190. *Radol*, 772 F.2d at 251.

191. *Starkman*, 772 F.2d at 242. In granting summary judgment for Marathon, the district court found that the net asset values stated in the Strong and First Boston reports were perfectly consistent with Marathon's public statements (in its November 11 press release, its November 12 letter to stockholders, and schedule 14D-9 attachment) that Mobil's bid was grossly inadequate in light of the true value of Marathon's assets. The district court further stated that rule 10b-5 did not require disclosure of the reports because "disclosure of information which is consistent with other statements made is obviously not necessary in order to make those statements not misleading. Such disclosure would simply reinforce, rather than correct or modify, the statements made." *Id.* at 237.

The district court summarily disposed of the five-year earnings and cash-flow projections claim by concluding that disclosure of such information is simply not required. *Id.* (citing *Marsh v. Armada Corp.*, 533 F.2d 978, 986-87 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 421 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974)).

As to the disclosure of negotiations with Steel, the district court held there was no duty to disclose such information. *Id.* (citing *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196, 1206 (3d Cir. 1982)). The court explained that Marathon's schedule 14D-9 disclosure that the company was considering the acquisition of all or part of another company or merger with another company as an alternative to Mobil's tender offer was sufficient to meet whatever disclosure obligation existed. *Id.*

The court also addressed the allegation that Marathon misled stockholders by stating its determination to remain independent when in fact it was negotiating with Steel in the hope of finding a "white knight." The district court found that this statement was not misleading when placed in the context of the repeated statements by Marathon that Mobil's offer was "grossly inadequate" and that alternatives, including merger into another company, were under consideration. *Id.*

appraisals, was a question "best left to a jury."<sup>192</sup> Upon deliberation, the jury determined that the reports were not material and, therefore, their omission was not actionable under the federal securities laws.<sup>193</sup> The circuit court affirmed the district court's holding; however, it noted that the court had committed error, albeit nonreversible, in sending the issue of materiality to the jury.<sup>194</sup>

3. *The Starkman and Radol Decisions.*—In addressing soft information disclosure obligations, the circuit court in *Starkman* first ascertained that no existing SEC rule or regulation specifically required disclosure of the omitted information.<sup>195</sup> The court then reviewed soft information disclosure under the general antifraud provision of rule 10b-5. In pursuing this issue, the court formulated a three-pronged analysis in discussing soft information disclosure. First, it stated that a duty to speak had to exist under rule 10b-5 before requiring disclosure of material facts.<sup>196</sup> Second, any omission, to be actionable, must meet the *TSC Industries* materiality

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192. *Radol*, 772 F.2d at 251.

193. *Id.*

194. *Id.* at 253.

195. *Starkman*, 772 F.2d at 239. The court concluded that neither rule 14e-2 nor schedule 14D-9 requires disclosure of initial asset appraisals, appraisals done by outside consultants such as First Boston, or earnings and cash flow projections. *Id.*

The court cited *Radol* for the proposition that rule 13e-3, requiring disclosure of asset appraisals in proxy statements in freeze-out merger situations, was inapplicable for determining the disclosure obligations of target management in the first stage of a two-tier tender offer. *Id.* at 240. The court stated further that the SEC did not require the disclosure of earning projections in any context. *Id.*

Finally, the court stated:

that the SEC and the courts have enunciated a firm rule regarding a tender offer target's duty to disclose ongoing negotiations: so long as merger or acquisition discussions are preliminary, general disclosure of the fact that such alternatives are being considered will suffice to adequately inform stockholders; a duty to disclose the possible terms of any transaction and the parties thereto arises only after an agreement in principle, regarding such fundamental terms as price and structure has been reached.

*Id.* at 243 (citing item 7 of schedule 14D-9, 17 C.F.R. § 240.14d-101 (1986); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756-57 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); *Staffin v. Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982); *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983)).

196. *Starkman*, 772 F.2d at 238 (citing *Chiarella v. United States*, 445 U.S. 222, 235 (1980); *Flynn v. Bass Bros. Enters.*, 744 F.2d 978 (3d Cir. 1984); *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982)). The court did not agree with the position of some courts and commentators that rule 10b-5 imposes an affirmative obligation on the corporation to disclose all material information regardless of whether the corporation has made any other statements. *See, e.g.*, *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266 (9th Cir. 1979); *Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 *Geo. L.J.* 935 (1979).

test.<sup>197</sup> Finally, even if the first two prongs were met, the duty to disclose under rule 10b-5 would be imposed “*only* if the nondisclosure of the particular material facts would make misleading the affirmative statements otherwise required by the federal securities laws and SEC regulations.”<sup>198</sup>

Since Marathon clearly had a duty to speak under rule 14e-2, the court focused primarily on whether rule 10b-5 required disclosure of the information in question, the nondisclosure of which would render misleading other statements made by Marathon. Furthermore, the court stated that “the starting point in [the] analysis is the underlying regulatory policy toward disclosure of such information, since regulatory rules reflect careful study of general conditions prevailing in the securities marketplace and provide guidelines upon which corporate officers and directors are entitled to rely.”<sup>199</sup>

Briefly summarizing SEC policy, the court noted the SEC’s recent shift toward allowing the disclosure of appraised asset valuations, projections, and other soft information, as long as the issuer also disclosed the underlying assumptions, hypotheses, and predicted values forming the basis for the soft information.<sup>200</sup> At the time of Steel’s tender offer, however, the SEC actually forbade the disclosure of estimates of probable and potential oil and gas reserves—both major components of the Strong and First Boston appraisals.<sup>201</sup> Fortunately for Marathon, the court could find no

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197. *Id.* at 238. The court noted the applicability of the *TSC Industries* test in cases involving rule 10b-5 in the tender offer context. *Id.* (citing *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 978 (3d Cir. 1984); *Staffin v. Greenberg*, 672 F.2d 1196, 1205 (3d Cir. 1982); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 282 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981)).

198. *Id.* The court prefaced its analysis by saying that its approach related to the structuring of disclosure duties of a tender offer target. Whether this same analysis would be used in other contexts is unclear. Both the *Flynn* and *Walker* cases have used a similar analysis but have only talked about “the duty to speak” and “materiality,” leaving out the last step of the approach in *Starkman*. The *Starkman* court explained that requiring the disclosure of material facts if their nondisclosure would render statements misleading ensured a balance between “the competing costs and benefits of disclosure.” *Id.* at 238-39. The court added that the benefits of disclosure, such as helping stockholders make informed decisions, are weighed against the production of mountains of possibly confusing information resulting from the target’s fear of liability. Such burdensome disclosure obligations might interfere with the negotiation of a higher tender offer and actually reduce the likelihood that a shareholder will benefit from a successful tender offer at a premium over the market. *Id.* at 239.

199. *Id.*

200. *Id.* at 239-40.

201. *Id.* at 241. The court stated that at the time of Steel’s tender offer, regulation S-K, which governed disclosure obligations in documents filed with the SEC, specifically prohibited the disclosure of estimates of probable or possible oil and gas reserves in any



compelling authority to overcome this prohibition and impose liability for failing to disclose asset appraisals "based on hypothetical valuations."<sup>202</sup> Precedent<sup>203</sup> not only failed to provide compelling authority to require disclosure of the reports but affirmatively supported nondisclosure of soft information.<sup>204</sup> The court further explained that an affirmative duty to disclose projections and asset appraisals may exist only if the information is substantially certain to hold.<sup>205</sup>

Applying the "substantially certain to hold" test, the court found the reports to be highly speculative<sup>206</sup> and misleading without "an accompanying mountain of data and explanations."<sup>207</sup> For the same reason, the court found no duty to disclose the five-year earnings and cash-flow projections.<sup>208</sup> As to the last prong of the analy-

document filed with the SEC. Instruction 2 to item 2(b) of regulation S-K (citing Disclosure of Oil and Gas Reserves, Securities Act Release No. 6008, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,768, at 81,104 (Dec. 19, 1978)). The reason for the prohibition was the lack of reliability of this information and, therefore, the accompanying possibility of misleading investors. *Starkman*, 772 F.2d at 240.

The court noted that regulation S-K had been amended in March 1982 to allow disclosure of "estimated" as well as proven reserves when such estimates had previously been given to a person who is offering to acquire or to merge with the target, *see* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, [Accounting Services Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 63,003 (Mar. 3, 1982), but refused to apply it, citing § 23(a) of the Exchange Act, 15 U.S.C. § 78w(a)(1) (1982) (providing that no liability attaches under the federal securities law for "any act done or omitted in good-faith conformity with a rule, regulation or order of the Commission"). The court also cited *Gerstle* in support of its refusal to impose liability on the basis of ex post facto modifications in SEC policy. *Starkman*, 772 F.2d at 240-41.

202. *Starkman*, 772 F.2d at 241.

203. *See supra* note 155.

204. *Starkman*, 772 F.2d at 241.

205. *Id.*

206. *Id.* at 242. Hoopman and Strong both testified that the Strong report was a "selling document" that placed optimistic value on Marathon's oil and gas reserves in order to attract buyers and ensure that Marathon could either ward off a hostile takeover attempt or, at the very least, obtain the best offer available and avoid being captured at a bargain price. *Id.* at 234.

In *Radol* the court noted that the report estimated the present value of the oil and gas properties based on "highly speculative" assumptions that related to the level of prices and costs expected to prevail as far as thirty to fifty years into the future. 772 F.2d at 247.

First Boston cautioned that the results of its asset valuation report did not represent relative market values as evidenced by the large number of companies whose market values were far less than their appraised values. First Boston also noted that the liquidation value would be significantly less than the appraised value because of the relative bargaining positions in a liquidation. *Id.* at 248.

207. *Starkman*, 772 F.2d at 242.

208. *Id.* (citing *Biechele v. Cedar Point, Inc.*, 747 F.2d 209, 216 (6th Cir. 1984); *James v. Gerber Prods. Co.*, 587 F.2d 324, 327 (6th Cir. 1978)).

sis, the asset appraisal, earnings, and cash-flow projections did not require disclosure to ensure that Marathon's other statements were not misleading.<sup>209</sup>

In *Radol* the court recognized and adopted the "substantially certain to hold" test as the Sixth Circuit's approach to the disclosure of soft information.<sup>210</sup> On appeal the plaintiffs had attacked the trial court's jury instructions on materiality and the duty to disclose.<sup>211</sup>

The circuit court affirmed the instructions; however, the court added that the district court may have committed nonreversible error in sending the materiality issue to the jury.<sup>212</sup> Although the lower court correctly stated the *TSC Industries* materiality standard, it erred in its decision to have the trier of fact decide the issue. The district court found "it was conceivable that 'reasonable shareholder[s]' would have accorded the valuations 'actual significance' in [their] deliberations, even if disclosure would not have altered [their] decision[s]."<sup>213</sup> This standard was identical to a materiality standard that the Supreme Court had specifically rejected in *TSC Industries*. Under the rejected standard facts were material if a stockholder *might* have considered them important in making a decision.<sup>214</sup> According to the appeals court, "[t]he purpose of the more stringent 'substantial likelihood' test for materiality is to lessen the uncertainty facing corporate officials in determining what must be disclosed while preserving shareholders' access to all truly factual information."<sup>215</sup>

In summary, the court found the information contained in the Strong and First Boston reports to be too speculative and uncertain, especially in light of the "substantially certain to hold" test in

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209. *Id.*

210. *Radol*, 772 F.2d at 252-53. The merger negotiations did not require disclosure for reasons already stated. See *supra* note 195.

211. *Radol*, 772 F.2d at 252. Specifically these instructions read as follows:

An omitted fact is material if there is substantial likelihood that a reasonable person would consider it important in deciding whether to tender his stock.

Only disclosure of existing material facts is required. Economic forecasts are not.

A failure to make known a projection of future earnings is not a violation of the Federal Securities law.

*Id.*

212. *Id.* at 253.

213. *Radol v. Thomas*, 556 F. Supp. 586, 594 (S.D. Ohio 1983), *aff'd*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 3272 (1986).

214. 772 F.2d at 253.

215. *Id.*

*Starkman*.<sup>216</sup> By citing *Starkman* and relying on its test, the Sixth Circuit adopted a concrete approach to the disclosure of soft information.

*E. The Ninth Circuit: An Established View and a Possible New Trend*

The Ninth Circuit's approach to the disclosure of soft information may be in transition. *Vaughn v. Teledyne, Inc.*<sup>217</sup> and *South Coast Services Corp. v. Santa Ana Valley Irrigation Co.*<sup>218</sup> are cited as authority for the Ninth Circuit's position that there is no duty to disclose soft information.<sup>219</sup> Two recent cases, however, *Plaine v. McCabe*<sup>220</sup> and *Texas Partners v. Conrock Co.*,<sup>221</sup> indicate a possible shift in Ninth Circuit law.

In *Vaughn* Teledyne initiated a series of acquisitions of its own stock through a redemption and numerous tender offers between June 1971 and November 1976.<sup>222</sup> The plaintiffs, former stockholders of Teledyne, alleged that Teledyne violated section 10(b) of the Exchange Act, rule 10b-5, and section 14(e) of the Williams Act in failing to disclose internal projections and forecasts. Teledyne allegedly had the reports prepared during the time it made the series of tender offers for its own stock.<sup>223</sup> Without determining the materiality of the projections,<sup>224</sup> the court summarily decided that no disclosure was necessary: "The SEC does not require a company to disclose financial projections."<sup>225</sup> Additionally, the court noted the

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216. *Id.* at 252-53.

217. 628 F.2d 1214 (9th Cir. 1980).

218. 669 F.2d 1265 (9th Cir. 1982).

219. *See, e.g.*, *Walker v. Action Indus.*, 802 F.2d 703 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1987); *Bradshaw v. Jenkins*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,719 (W.D. Wash. 1984).

220. 797 F.2d 713 (9th Cir.), *superseding* 790 F.2d 742 (9th Cir. 1986).

221. 685 F.2d 1116 (9th Cir. 1982), *cert. denied*, 460 U.S. 1029 (1983).

222. *Vaughn*, 628 F.2d at 1217. During this five-year period, the number of outstanding shares of Teledyne common stock decreased from 38 million to 11 million. Teledyne's earnings, on the other hand, increased dramatically in 1975 and 1976. *Id.*

223. *Id.* at 1217, 1221. Projections were not made for the entire company during that period, but a growing number of Teledyne's operating units had twice annually prepared business plans. These plans contained estimates of such operating units' sales and earnings as well as numerous other factors for the upcoming fiscal year. *Id.* at 1221.

224. Even though the court did not address this issue, it did comment that the proper test would be "whether there is a substantial likelihood that a reasonable investor would consider the fact important in making an investment decision." *Id.* The Ninth Circuit, therefore, recognized the *TSC Industries* materiality test as being applicable to soft information disclosure.

225. *Id.* (citing *Disclosure of Projections of Future Economic Performance*, 38 Fed. Reg. 7220 (1973); *Freeman v. Decio*, 584 F.2d 186, 199-200 (7th Cir. 1978) (finding financial projections not material information in insider trading action); *Marsh v. Ar-*

unreliability of the projections, commenting that there was no evidence that the estimates were made with such reasonable certainty as to even allow them to be disclosed.<sup>226</sup>

The *South Coast* case involved the disclosure of asset appraisals. The lawsuit questioned the adequacy of proxy statements soliciting stockholders' approval to sell the assets of Santa Ana Valley Irrigation (SAVI) to Intercoast Investments, Inc. (Intercoast).<sup>227</sup> The plaintiffs, former stockholders and directors of SAVI, alleged that under rule 14a-9 estimates of the fair market value of SAVI properties must be disclosed.<sup>228</sup> In addition, the plaintiffs alleged that listing the historic book value of the properties without current market information was misleading.<sup>229</sup>

As it had managed to do in *Vaughn*, the Ninth Circuit in *South Coast* skirted the materiality issue by holding that neither the courts nor the SEC required disclosure of asset appraisals—in fact, both discouraged it.<sup>230</sup> The court relied on the note accompanying rule 14a-9 as particularly authoritative,<sup>231</sup> even though the appellants ar-

mada Corp., 533 F.2d 978, 987 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977) (finding disclosure of projections not required under rule 10b-5 in merger proxy statement)).

The court did recognize, however, that partial disclosure of financial projections may make them material facts and that an individual may be liable under rule 10b-5 if those projections thereafter are not disclosed completely and accurately. *Vaughn*, 628 F.2d at 1221 (citing *James v. Gerber Prods. Co.*, 587 F.2d 324 (6th Cir. 1978); *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1046 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489-92 (9th Cir. 1974) (partial disclosure of earnings forecast may be actionable if it makes other statements misleading)).

226. Only one court, the Fourth Circuit in *Walker*, has interpreted this statement to suggest that the disclosure of financial projections is required if they are reasonably certain. The Ninth Circuit's language in *Vaughn*, however, is to the contrary. Disclosure is only allowable, not required, if the projections are reasonably certain. Most courts and commentators have cited *Vaughn* as a mandate against required disclosure of financial predictions. *See, e.g.*, *Bradshaw v. Jenkins*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,719 (W.D. Wash. 1984). *See also Schneider, Soft Information and Appraisal Disclosure*, 18 REV. SEC. & COMMODITIES REG. 215, 218 n.19 (1985); *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265 (9th Cir. 1982) (failing to discuss or recognize the "reasonably certain" test).

227. 669 F.2d at 1267.

228. *Id.* at 1270.

229. *Id.*

230. *Id.* (citing *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292-94 (2d Cir. 1973); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir. 1972); *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812, 819 (D. Del. 1974)). For the court's treatment of the SEC's position, see *infra* note 231.

231. *South Coast*, 669 F.2d at 1271. The court admitted that the note did not refer specifically to appraisals of current market value. It asserted, however, "[w]e agree . . . with the Second Circuit that 'it is clear that the policy embodied in the note to Rule 14a-

gued that a subsequent amendment made it inapplicable.<sup>232</sup> The court "consider[ed] this limited amendment to be insufficient to alter the long-standing policy against appraisal information."<sup>233</sup> The appellants also argued that the circuit court should adopt the SEC policy of allowing and even requiring asset appraisals, as expressed in the SEC amicus brief filed in *Gerstle*.<sup>234</sup> The Ninth Circuit, like the Second Circuit, refused to apply the new SEC policy retroactively.<sup>235</sup>

Even if the court had applied the new SEC policy toward asset appraisals, only appraisals made by qualified experts and having a sufficient basis in fact required disclosure.<sup>236</sup> The SAVI board of directors, which made the valuations, were not experts. Furthermore, the absence of underlying guidelines and standards made the appraisals too speculative.<sup>237</sup> The *South Coast* court therefore followed *Vaughn* in finding no duty to disclose the soft information. The Ninth Circuit in both cases made clear that it perceived traditional SEC policy as having current applicability.

Two Ninth Circuit cases since *Vaughn and South Coast*, *Texas Partners v. Conrock Co.*,<sup>238</sup> and *Plaine v. McCabe*,<sup>239</sup> indicate that there may,

9 has consistently been enforced to bar disclosure of asset appraisals as well as future market values. . . ." *Id.* (quoting *Gerstle*, 478 F.2d at 1292).

232. *Id.* at 1271 n.3. The appellants referred to the 1976 amendment to the note following the rule which deleted future earnings from the list of examples of potentially misleading disclosures.

233. *Id.*

234. *Id.* at 1271.

235. *Id.* (citing *Gerstle*, 478 F.2d at 1294). The appellants interpreted the SEC's position in the *Gerstle* brief as requiring disclosure of reliable appraisals of the current fair market value of assets when a liquidation is contemplated and the assets' liquidation value is substantially higher than the historic book value. *Id.* For a discussion of *Gerstle*, see *supra* notes 28-58 and accompanying text.

236. *Id.* at 1272. The text of the *Gerstle* amicus brief stated that "although appraisals generally cannot be disclosed because they may be misleading, existing appraisals of current liquidating value must be disclosed if *they have been made by a qualified expert and have a sufficient basis in fact.*" *Id.* (citing *Gerstle*, 478 F.2d at 1292 (emphasis added)).

237. *Id.* Judge Fletcher wrote a vigorous dissent, disagreeing with the majority's interpretation of SEC policy as disfavoring asset valuation disclosure. Among other things, he argued that this position is untenable when the nondisclosure of such information would violate rule 14a-9. *Id.* at 1275-76 (Fletcher, J., dissenting). Judge Fletcher argued that information must meet the *TSC Industries* materiality standard before requiring disclosure. *Id.* at 1274. If the information is material, Judge Fletcher explained, the next step is to determine whether the information would mislead investors. *Id.* at 1276. He suggested that a qualifying disclosure, with disclaimer language dissuading undue reliance by investors, would easily assuage any fears on that level. *Id.* at 1277. Because these measures could easily have been taken in *South Coast*, Judge Fletcher concluded that the failure to disclose the appraisal information was a violation of rule 14a-9. *Id.*

238. 685 F.2d 1116 (9th Cir. 1982), *cert. denied*, 460 U.S. 1029 (1983).

239. 797 F.2d 713 (9th Cir.), *superceding* 790 F.2d 742 (9th Cir. 1986).

in fact, be a mandatory duty to disclose soft information in some instances.<sup>240</sup> In *Texas Partners* stockholders of Conrock alleged that Conrock's March 1980 proxy statement soliciting stockholder approval of two antitakeover amendments violated section 14(a) of the Exchange Act and rule 14a-9 in failing to disclose the gross undervaluation of Conrock's assets.<sup>241</sup> Because of a \$200 million undervaluation, Conrock, a real estate related company, was an attractive takeover target. The stockholders contended that the undervaluation information was material in deciding how to vote on the proposed antitakeover proposals. The district court granted summary judgment, but the circuit court held that the district court had erred:

In *South Coast Services Corp. v. Santa Ana Valley Irrigation Co.*, *supra*, we held that disclosure of an estimate of the fair market value of a company's assets by the Board of Directors was not required by Rule 14a-9 or section 14(a) because SEC policy then in effect discouraged disclosure of appraised asset values and because, in any event, the appraisals were neither based on objective, reasonably certain data nor prepared by a qualified expert. 669 F.2d at 1270-73. This does not necessarily foreclose at this stage appellants' argument that at some point in the proxy contest a statement that the assets were substantially undervalued should have been disclosed.<sup>242</sup>

The court went on to state that the appellee's reliance on cases rejecting the disclosure of asset appraisals such as *South Coast* and *Gerstle* was, therefore, inappropriate. The true issue, the court explained, was the materiality of the appraisals, an issue the district court never considered. In light of these findings, the court then remanded the case for further proceedings.<sup>243</sup>

In *Plaine* the plaintiff, a former stockholder of Magma Power Company, alleged violations of section 14(e) of the Williams Act in connection with a tender offer that Natomas Company made for all of the outstanding shares of Magma.<sup>244</sup> Specifically, Natomas made an initial tender offer on March 30, 1981, for all of Magma's shares at \$42 per share.<sup>245</sup> Magma responded by calling the offer "wholly

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240. These cases, when read together with Judge Fletcher's dissent in *South Coast*, may reflect the future position of the Ninth Circuit regarding soft information disclosure.

241. *Texas Partners*, 685 F.2d at 1118, 1121.

242. *Id.* at 1121.

243. *Id.* No further action was taken since the case was withdrawn by the plaintiff from further consideration.

244. 797 F.2d at 715.

245. *Id.*

inadequate" in light of the company's principal asset, the Geysers Projects.<sup>246</sup> This asset, if fully taken into consideration, made Magma's shares worth between \$80 and \$200 per share.<sup>247</sup> Magma retained the investment firm of Smith Barney which rendered an opinion that \$42 per share was "inadequate from a financial point of view."<sup>248</sup>

In April 1981 Natomas and Magma began to negotiate the terms of the original tender offer.<sup>249</sup> In connection with this, Magma hired the investment firm of Drexel Burnham to render advice. The discussions ended with an agreement that Natomas would amend its offer to \$45 per share and Magma would recommend acceptance to its shareholders.<sup>250</sup> The agreement further provided that any stockholders not tendering their shares during the period of the tender offer would receive \$45 in the eventual freeze-out merger.<sup>251</sup> The companies jointly sent all Magma shareholders a "Supplement to the Offer to Purchase" outlining the terms of the agreement. Magma shareholders tendered 83% of their shares during the tender offer, with Natomas receiving the other 17% upon approval of the merger.<sup>252</sup>

The plaintiff opposed the merger and asserted that the "Offer to Purchase" sent with the initial tender offer and the supplement were false and misleading due to the omission of certain information. The omissions included projections of future revenues for the Geysers and the financial opinions rendered by Smith Barney and Drexel Burnham.<sup>253</sup> On appeal<sup>254</sup> the circuit court cited *Texas Partners* and *Flynn* as authority for the required disclosure of financial projections.<sup>255</sup> Determining that the "nature and reliability of the undisclosed information [was] sufficiently in dispute to defeat the

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246. *Id.* This project was the focus of Natomas' interest at the time of the initial offer. Magma was a joint venturer in the Geysers with Natomas and Union Oil. Magma and Natomas each had a 25% interest and Union Oil owned the remaining 50%. *Id.* at 715 n.1.

247. *Id.* at 715.

248. *Id.*

249. *Id.* at 715-16. Magma was unable to find a "white knight." *Id.* at 715.

250. *Id.* at 715-16.

251. *Id.* at 716.

252. *Id.*

253. *Id.*

254. Pursuant to FED. R. CIV. P. 12(c), the district court converted the defendants' motion to dismiss to a motion for summary judgment and ordered judgment for defendants on the grounds that the Commissioner's "fairness" decision collaterally estopped Plaine from proving the injury element of the § 14(e) claim. *Id.*

255. *Id.* at 723.

defendant's motion for summary judgment,"<sup>256</sup> the court remanded the case for further action.<sup>257</sup>

### III. PROBLEMS WITH THE VARIOUS CIRCUIT APPROACHES

All of the circuits discussed in this article have in one way or another acknowledged the general premise that when there is a duty to speak, disclosure of material information is required.<sup>258</sup> Those circuits that have steadfastly clung to traditional SEC policy<sup>259</sup> cite to the common panoply of reasons for disallowing disclosure. The common theme is the SEC's concern that the disclosure of soft information is potentially misleading. Absent a specific rule or regulation requiring disclosure of soft information, these circuits have found no duty to speak. A genuine discussion of the materiality of soft information disclosure is thus conveniently rendered moot.<sup>260</sup>

The position these circuits have taken, however, can be criticized in several ways. First of all, reliance on the traditional SEC approach in the area of soft information defeats the broader SEC policy of protecting investors.<sup>261</sup> Recent SEC policy has, in fact, recognized that total exclusion of such information can work to the detriment of investors by excluding information valuable in making informed decisions.<sup>262</sup> The *Flynn* court explained that the SEC's original policy against the disclosure of soft information was directed primarily at protecting potential *purchasers* of securities from being misled by overly optimistic claims of management.<sup>263</sup> The traditional SEC policy, while supposedly protecting purchasers, harms sellers and other stockholders faced with making disclosure decisions in the context of tender offers, mergers, and proxy

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256. *Id.*

257. As of the writing of this article, the district court had not decided the matter.

258. The Third Circuit in *Starkman* and *Radol* added a further point in its analysis—that no duty to disclose arose unless the nondisclosure of the material facts would make misleading the affirmative statements otherwise required by the federal securities laws and SEC regulations. *Starkman*, 772 F.2d at 238.

259. These circuits include the Second, Fourth, Seventh, and Ninth.

260. The Fourth Circuit in *Lockspeiser* did consider the issue of materiality; however, the case may be limited to its facts. See *supra* notes 118 and 153. Additionally, the Ninth Circuit cases of *Texas Partners v. Conrock Co.*, 685 F.2d 116 (9th Cir. 1982), *cert. denied*, 460 U.S. 1029 (1983), and *Plaine v. McCabe*, 797 F.2d 713 (9th Cir.), *superceding* 790 F.2d 742 (9th Cir. 1986), only indicate a possible trend toward requiring disclosure of material soft information.

261. The purpose of the federal securities law is to protect investors by ensuring "fair and honest" markets. 15 U.S.C. § 78b (1982).

262. See *supra* notes 14-15 and accompanying text.

263. *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 987 (3d Cir. 1984).



contests.<sup>264</sup>

A second problem associated with the use of the traditional SEC approach to soft information is that it defeats another SEC policy: promotion of an efficient market.<sup>265</sup> Efficiency of the market is ensured by the full disclosure of all relevant information.<sup>266</sup> In precluding the disclosure of soft information courts may in fact hamper the efficiency of the market, by failing to determine which soft information is material or relevant and thus requires disclosure.

A third criticism of these circuits is their refusal to acknowledge that there are certain factors that can diminish the possibility of soft information being misleading. The SEC and some courts have recognized that this concern can be greatly alleviated through the use of experts, disclaimers, and qualifying disclosures.<sup>267</sup>

Finally, these circuit courts are too paternalistic. The traditional policies they stubbornly cling to are relics of the crash of 1929.<sup>268</sup> There is a refusal to acknowledge that for the most part investors are no longer unsophisticated. Most investors are financial institutions or individuals who rely on the recommendations of their brokers for investment advice.<sup>269</sup> If information is soft, there is just a natural assumption of the risk. Reasonable investors take this into consideration, especially when the risks are disclosed fully through the use of disclaimers or other disclosure methods. Additionally, many investors have portfolios, in which the risk of one stock is diminished by other investments.<sup>270</sup>

Only two circuits, the Third and Sixth, have recognized that a

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264. *Id.*

265. Note, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 COLUM. L. REV. 1525, 1527, 1529 (1981).

266. *Id.* at 1527. This theory is called the "efficient market hypothesis" and is strongly supported by empirical evidence. See generally J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 270 (1973); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

267. See, e.g., *Flynn*, 744 F.2d at 988; *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812, 819 (D. Del. 1974) (use of disclaimers and experts). See also *supra* notes 20-22 and accompanying text (discussing rule 175 which provides for use of experts who fully disclose the bases of their assumptions).

268. See President Roosevelt's Mar. 29, 1933 Address to Congress, reprinted in, H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

269. Note, *Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend*, 29 STAN. L. REV. 1077, 1083 (1977).

270. See generally R. BREALY, *AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCK* 124-28 (1969); Evans & Archer, *Diversification and Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761, 767 (1968); Fisher & Lorie, *Some Studies of Variability of Returns of Investments in Common Stocks*, 43 J. BUS. 99, 109-34 (1970); Lorie, *Diversification Old and New*, 1 J. PORTFOLIO MGMT. 25, 27 (1975).

duty to speak may exist and, thus, have been able to address the issue of materiality. Even these circuits, however, are confusing and uncertain in their approaches. Neither circuit has delineated the particular situations in which the duty to speak arises. Additionally, it is not clear whether the duty to speak pertains to everyone in a uniform manner.<sup>271</sup>

If a duty to speak exists, both circuits have cited *TSC Industries* as the appropriate test to determine whether soft information is material. Both the Third and Sixth Circuits, however, gave no more than lip service to this test. The "substantially certain to hold" test in *Starkman* and the "totality of circumstances" approach in *Flynn* have in effect supplanted the *TSC Industries* test, not adopted it.

*Starkman*, in fact, developed two tests with respect to soft information disclosure, one more stringent than the other. The "substantially certain to hold" test is the test generally cited as the Sixth Circuit's position. The Solicitor General's brief in the *Radol* case, however, mentioned that the court of appeals in *Starkman* had "articulated a different and potentially more stringent version of its materiality standard."<sup>272</sup> That standard provided that asset appraisals and projections must be disclosed only if the reported values are "virtually as certain as hard facts."<sup>273</sup>

Application of either test, but especially the "hard facts" test, would make it almost impossible to find any soft information to be material. Clearly the spirit of these two tests is to protect investors from being misled by the disclosure of information that is less than "factual."<sup>274</sup> But soft information by its nature is not factual in the

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271. The district court in *Flynn* noted that corporate insiders were held to higher disclosure duties than outsiders, and concluded that for purposes of § 14(e) of the Williams Act a tender offerer's outside status was one factor used in determining whether an omission violated that section. The circuit court, however, did not specifically address these comments in its opinion, leaving the issue unresolved. Additionally, the court did not address whether disclosure duties under rule 10b-5 may be different from those under § 14(e) of the Williams Act. See Note, *Mandatory Disclosure of Soft Information*, 35 EMORY L.J. 213, 248 (1986) (arguing that duties may be different).

272. Brief for the United States as Amicus Curiae at 7 n.6, *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985), cert. denied, 106 S. Ct. 1179 (1986) [hereinafter *Amicus Brief*].

273. *Id.* See also *Howing Co. v. Nationwide Corp.*, 625 F. Supp. 146 (S.D. Ohio 1985). The *Howing* court found no duty to disclose earnings projections in a freeze-out merger proxy statement. *Id.* at 156. The court relied on the "hard facts" test, explaining: "The Court, in *Starkman*, further noted that the disclosure of 'soft' information such as appraisals and earnings projections is required only when 'the reported values are virtually as certain as hard facts,' *Id.* at 241, and that earnings and cash flow projections do not rise to the level of substantial certainty triggering a duty to disclose. *Id.* at 242." *Howing*, 625 F. Supp. at 156.

274. One of the reasons for the court's stringent tests may be that the type of soft

true sense. If it were, the disclosure obligations of hard and soft information would be treated, legally, in the same way. The *Starkman* approach, however, ignores the correct application of the *TSC Industries* test under which information not rising to the level of hard facts can be found material.<sup>275</sup>

In this light the *Starkman* test is in conflict with the *TSC Industries* materiality standard. The existence of this conflict was an issue in *Radol*. Yet the circuit court skirted a discussion of the conflict.<sup>276</sup>

The Third Circuit, on the other hand, with its "totality of circumstances" test, has left the question of materiality wide open. The failure to address how the *TSC Industries* test is reflected in the *Flynn* criteria makes the *Flynn* approach extremely difficult to apply

information disclosure in *Starkman* was highly susceptible to being misunderstood. The Solicitor General explained that the "Commission had long espoused the view that 'investors unfamiliar with the technical aspects of the oil and gas business—and these would likely include most shareholders of major oil companies . . . would ignore or misconstrue the technical but extremely significant differences between 'proved' and 'probable' oil reserves.'" Amicus Brief, *supra* note 272, at 12 n.12, (citing Brief for the Securities and Exchange Commission as Amicus Curiae at 5, *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968)). The Solicitor General went on to state that "[a]s one court explained, estimating probable [or possible or exploratory] reserves involves excessive speculation and guesswork. Recognize [sic] experts disagree as to the proper methods to be used." *Id.* at 13 n.12 (citing *Sunray*, 398 F.2d at 450-51; *Resource Exploration v. Yankee Oil & Gas, Inc.*, 566 F. Supp. 54, 62-64 (N.D. Ohio 1983); *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,670, at 92,294 (S.D.N.Y. July 30, 1976)).

275. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (finding that speculative information as to potential ore bodies may be material).

276. The appellants in *Radol* stated that the following jury instructions were in error. The first instruction discussed the conflict between the "substantially certain to hold" test and the materiality issue:

(1) "Representations concerning future sales, projections, forecasts and the like only rise to the level of materiality when they can be calculated with substantial certainty."

(2) "Only disclosure of existing material facts is required. Economic forecasts are not."

(3) "A failure to make known a projection of future earnings is not a violation of Rule 10b-5."

*Radol*, 772 F.2d at 752.

The circuit court, however, eluded a discussion of the first instruction in its opinion by citing the following instructions as being in contention:

An omitted fact is material if there is a substantial likelihood that a reasonable person would consider it important in deciding whether to tender his stock.

Only disclosure of existing material facts is required. Economic forecasts are not.

A failure to make known a projection of future earnings is not a violation of the Federal Securities law.

*Id.*

with any kind of certainty.<sup>277</sup> One author has posited that the *Flynn* test's vagueness may encourage a burdensome over-disclosure of information.<sup>278</sup>

The problems in both *Starkman* and *Flynn* may stem from the possible inapplicability of the *TSC Industries* standard to soft information disclosure. The Solicitor General in the *Radol* amicus brief recognized this possibility in observing that the *TSC Industries* test was originally developed as a standard for determining the materiality of "facts."<sup>279</sup> Additionally, if application of the *TSC Industries* test rules out the disclosure of soft information in most instances, then this standard must be questioned as possibly prohibiting relevant information from being disseminated into the market.

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277. Schneider, *Soft Information and Appraisal Disclosure*, 18 REV. SEC. & COMMODITIES REG. 215, 219-20 (1985).

278. *Id.*

279. Amicus Brief, *supra* note 272, at 15.