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Articles

ISSUER AFFIRMATIVE DISCLOSURE OBLIGATIONS—AN ANALYTICAL FRAMEWORK FOR MERGER NEGOTIATIONS, SOFT INFORMATION, AND BAD NEWS

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I. INTRODUCTION

Questions relating to an issuer's obligation to disclose merger negotiations, soft information, and bad news frequently present the corporate lawyer with difficult counseling decisions.[1] These dilemmas are not resolved by the Securities and Exchange Commission (the SEC or the Commission) disclosure rules regarding the affirmative duty to disclose, and the few judicial decisions on the subject lack uniformity. This article reviews the relevant case law and SEC regulations, provides a synthesis of divergent viewpoints, and offers a framework for analysis.

Despite cogent arguments in favor of an affirmative duty to disclose,[2] neither the courts nor the SEC has been willing to recognize such a general mandate.[3] Affirmative disclosure obligations, however, clearly exist in a number of specific circumstances. For exam-

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1. For related articles, see Block, Barton & Garfield, *Affirmative Duty to Disclose Material Information Concerning Issuer's Financial Condition and Business Plans*, 40 BUS. LAW. 1243 (1985); Sheffey, *Securities Law Responsibilities of Issuers to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem*, 57 NOTRE DAME LAW. 755 (1982).

2. *See* Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

3. *See* Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); Texas Partners v. Conrock Co., 685 F.2d 1116, 1120 (9th Cir. 1982); South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1271, 1273 (9th Cir. 1982). *But see* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 519 (10th Cir.) (en banc) (per curiam) (indicating that corporation can violate § 10(b) in certain circumstances, such as undue delay in making disclosure), *cert. denied*, 414 U.S. 874 (1973). *See generally* M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 2.03 (1986) (discussing affirmative duty to disclose). For an analysis of

ple, an issuer must affirmatively disclose when: (1) SEC rules and regulations require disclosure of specified information;[4] (2) the issuer is purchasing or selling its stock in the securities markets;[5] (3) the issuer previously has made a public statement that, although accurate when made, has become false or misleading as a result of subsequent events;[6] and (4) information has been leaked by, or rumors in the marketplace are attributable to, the issuer.[7]

In other situations the law is less clear as to the existence and scope of an affirmative duty to disclose, such as in the case of merger negotiations, soft information, and bad financial news.[8] Because issuers and their counsel increasingly must determine whether affirmative disclosure is required, this article examines these more uncertain situations.

II. DUTY TO DISCLOSE MERGER NEGOTIATIONS

A. *Disclosure of Merger Negotiations Generally*

A number of questions concerning an issuer's duty to disclose

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alternative sources of the duty to disclose and liability under the stock exchange rules, see Bauman, *supra* note 2, at 976-88.

4. The Securities Act of 1933 (Securities Act), 15 U.S.C. §§ 77a-77mm (1982), and SEC regulations thereunder, provide comprehensive specific disclosure requirements, reflected in the requirements set forth in the various forms of registration statements. Under the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §§ 78a-78kk (1982), required reports and filings include: (1) annual reports on form 10-K; (2) quarterly reports on form 10-Q; and (3) current reports on form 8-K.

5. *See Heublein*, 742 F.2d at 756; Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Memorandum of the Securities and Exchange Commission as Amicus Curiae, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, 106 S. Ct. 797 (1986) [hereinafter *Michaels Memorandum*]. An issuer also should be required to affirmatively disclose when it has reason to know that an insider is trading in the stock or when the issuer lacks adequate internal control mechanisms to regulate insider trading practices. *See infra* note 39.

6. *See* Ross v. A.H. Robins Co., 465 F. Supp. 904, 908 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

7. *See* Zuckerman v. Harnischfeger Corp., 591 F. Supp. 112, 119 (S.D.N.Y. 1984); State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278, 292-93 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 654 F.2d 843, 850 (2d Cir. 1981). *See also* In the Matter of Sharon Steel Corp. as it Relates to Prompt Corporate Disclosure, Exchange Act Release No. 18,271, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,049 (Nov. 19, 1981).

8. The SEC has commented that an affirmative duty to disclose negotiations only arises in limited situations, and that otherwise a company "should usually be able to negotiate in secrecy" and need not disclose even material negotiations. *See* Brief for the Securities Exchange Commission as Amicus Curiae at 24-25, Levinson v. Basic Inc., 786 F.2d 741 (6th Cir. 1986) (No. 84-3730), *cert. granted*, 107 S. Ct. 1284 (1987) [hereinafter *Levinson Brief*]. This position may be overly broad. *See infra* notes 26-61 and accompanying text.

merger negotiations continue to challenge the perspicacity of the securities bar, the SEC, and academia. These issues include whether there is an affirmative duty to disclose preliminary merger negotiations and "firm offers." Also, to determine the scope of any disclosure mandate, materiality and timing questions must be resolved. This section addresses these important and recurring issues.

Merger negotiations often have extremely significant consequences for shareholders and the securities markets. As the Second Circuit pointed out in *SEC v. Geon Industries,*[9] "a merger in which it is bought out is the most important event that can occur in a . . . corporation's life, to wit, its death . . . ."[10] Irrespective of the veracity of this assertion, courts generally are reluctant to impose an affirmative duty to disclose merger negotiations.[11]

A number of courts reason that, before there is a "firm offer"[12] or "an agreement in principle encompassing fundamental terms,"[13] merger discussions are "inherently fluid and . . . shrouded with uncertainty."[14] Additionally, a premature public pronouncement might quash the deal or mislead the investing public as to likely corporate activity.[15] Attempting to protect the investing public in these

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9. 531 F.2d 39 (2d Cir. 1976).

10. *Id.* at 47.

11. *See supra* note 3.

12. *See* South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1273 (9th Cir. 1982).

13. Greenfield v. Heublein, Inc., 742 F.2d 751, 759 (3d Cir. 1984). *See also* Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir. 1987) (holding that corporation has no duty to disclose ongoing merger negotiations until agreement is reached on price and structure of deal).

14. *See* Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983).

15. *See Heublein*, 742 F.2d at 757. The SEC's position is that the Third Circuit's concerns were "overstated." *See Michaels Memorandum, supra* note 5, at 9. *See also* Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1084-86 (5th Cir. 1970) (finding no obligation to disclose a unilateral offer to negotiate a merger). *See generally* Comment, *Corporate Disclosure of Merger Negotiations—When Does the Investor Have a Right to Know?*, 36 SYRACUSE L. REV. 1155 (1985):

> One reason that premature disclosure of merger negotiations might be detrimental to investors is that, if word of a pending merger became public, investors would tend to bid up the price of the corporation's stock closer to the expected tender offer price . . . [making the tender offer unattractive to shareholders, and consequently the merger may be quashed].
>
> A second reason for nondisclosure of ongoing merger negotiations is that release of information about a tentative plan may disrupt the market by encouraging uninformed speculation.
>
> Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left "holding the bag" on a stock whose value was inflated purely by an inchoate

circumstances, however, may be unduly paternalistic. Rather, unless it can be argued that sufficient business justification for maintaining confidentiality is shown, all significant company and market information within an issuer's knowledge should be disseminated to the public in order to facilitate informed decisionmaking and market reaction. Investors and financial professionals should not be denied important information merely because the unsophisticated might attach too much weight to it.

On the other hand, even though preliminary merger discussions may be an important factor in investor decisionmaking, a rigid rule mandating disclosure is inappropriate. Mergers, including friendly takeovers and other negotiated acquisitions, are now essential components of the financial scene. Generally, the possibility of a friendly merger between two unaffiliated entities begins as an idea developed through a careful feeling-out process. Normally, one company seeks to acquire another because it believes that it can be more productive with the subject company's assets than its present management, perhaps as a result of more efficient operation, synergy benefits, or a turn-around in the economy.[16] Because jobs, pride, and, of course, money are at stake, delicate negotiation often is the key, both to ultimate success and to keeping the acquisition costs down.[17] An information leak can be devastating. If a company is "not in play," meaning that there are no offers or rumors of a prospective offer circulating in the marketplace,[18] a rule mandating disclosure of preliminary merger negotiations could have a chilling

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

Id. at 1159-60 n.27 (quoting Staffin v. Greenberg, 672 F.2d 1196, 1207 (3d Cir. 1982)).

16. *See generally* K. DAVIDSON, MEGAMERGERS: CORPORATE AMERICA'S BILLION-DOLLAR TAKEOVERS 321-32 (1985) (discussing economic functions of mergers).

17. *See generally* Elkind v. Liggett & Myers, Inc., 472 F. Supp. 123, 126-29 (S.D.N.Y. 1978), *aff'd in part, rev'd in part*, 635 F.2d 156 (2d Cir. 1980) (stating that in the absence of insider trading or a material misstatement (or omission), an issuer has no duty to disclose information until it has made a good faith determination that the information is material and ripe for publication).

18. Once an offer has been made, shareholders and the markets ought to know whether the subject company's management is negotiating with another party. SEC schedule 14D-9, item 7 recognizes this point, calling for a subject company's management to disclose merger negotiations even though the potential offeror's identity need not be revealed if the negotiations are in a preliminary stage. *See* 17 C.F.R. § 240.14d-101 (1986). *See generally* Note, *Disclosing the White Knight—When Does the Duty Arise?*, 42 WASH. & LEE L. REV. 1045 (1985).

effect on merger discussions and, consequently, upon the entrepreneurial spirit that fuels our capital markets.

These arguments against an affirmative duty to disclose are less compelling once an agreement in principle has been reached. Although a number of courts have indicated that merger negotiations may become material well before an agreement in principle has been reached,[19] others have established an agreement in principle as the materiality threshold.[20] In *Greenfield v. Heublein, Inc.*[21] the Third Circuit espoused a bright-line test for materiality,[22] holding that information regarding merger negotiations is not material until there is an agreement in principle encompassing fundamental terms, namely, agreement as to price and structure. Until then, the court reasoned, the merger negotiations have not ripened to the point of materiality and, therefore, are immaterial as a matter of law.[23]

In view of judicial authority to the contrary, the Third Circuit's position may be overbroad.[24] Furthermore, the SEC strongly disagrees with *Heublein's* bright-line test. The Commission has asserted that the materiality of merger negotiations depends on the significance the merger would have for the company and its shareholders, as well as on the probability that the merger will actually take place.[25] From a consistency standpoint, the SEC's position appears

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19. *See, e.g.*, SEC v. Geon Indus., 531 F.2d 39, 47-48 (2d Cir. 1976); SEC v. Shapiro, 494 F.2d 1301, 1305-06 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); SEC v. Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985); Schlanger v. Four-Phase Sys, Inc., 582 F. Supp. 128, 133-34 (S.D.N.Y. 1984); American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 744-45 (E.D. Va. 1980).

20. *See* Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987); *Heublein*, 742 F.2d at 757. The Third Circuit's *Heublein* decision is especially significant because of the paucity of judicial analysis of the issue.

21. 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985).

22. *Id.* at 756-59.

23. *Id.* Moreover, in Staffin v. Greenberg, 672 F.2d 1196, 1205-07 (3d Cir. 1982), the court held that until an agreement in principle, or its functional equivalent, is actually reached, not merely reasonably certain, merger negotiations do not become material. *See also South Coast Servs. Corp.*, 669 F.2d at 1273 ("There is no duty to disclose inquiries or indications of interest that do not fall within the category of firm or definite offers.").

24. *See* cases cited *supra* note 19; *infra* notes 25-26.

25. *See Levinson Brief, supra* note 8, at 7. On appeal the Commission criticized the district court's holding that, because the discussions would not imminently result in an agreement in principle, the statements denying significant corporate events were not materially misleading. *Id.* at 6. The Sixth Circuit in *Levinson* ultimately agreed with the SEC. *Cf.* Levinson v. Basic Inc., 786 F.2d 741, 749 (6th Cir. 1986) ("In analyzing whether information regarding merger discussions is material such that it must be af-

to be correct. For example, the insider trading provisions prohibit a corporate fiduciary from purchasing stock based upon knowledge of merger negotiations, even if those negotiations are preliminary.[26] Otherwise, insiders, or the corporation itself, being privy to the negotiations, could take advantage of uninformed shareholders. As the Supreme Court emphasized in *Chiarella v. United States*,[27] such conduct violates the obligations of corporate fiduciaries in the insider trading context. Hence, it may be argued that if information concerning preliminary merger negotiations is sufficiently important so that insiders may not trade (or tip) on it, then such information also should be considered material for purposes of requiring disclosure to the marketplace as a whole.[28]

On the other hand, it may be contended that, while such information may be important, it might not be sufficiently ripe for disclosure to the marketplace for at least two reasons. First, the information frequently is unreliable.[29] Second, even though knowledge of preliminary merger negotiations may be important to an individual's investment decision,[30] public revelation may cause the market to react as if the negotiations were finalized—a consequence that could result in large investor losses if the deal were to collapse.[31]

A bright-line test is desirable because it provides a degree of certainty in an area that has enormous liability risks.[32] Without such

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firmatively disclosed . . . , the discussions and their progress are the primary considerations."), *cert. granted*, 107 S. Ct. 1284 (1987).

26. *See, e.g.*, SEC v. Shapiro, 494 F.2d 1301, 1306-07 (2d Cir. 1974).

27. 445 U.S. 222 (1980) (holding that corporate insiders breach their fiduciary duty, and hence violate § 10(b) of the Exchange Act, when they trade on material, nonpublic information).

28. *Cf.* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote [or invest]."). The availability of information regarding merger negotiations will allow the marketplace and constituents of the securities markets, either themselves or with the aid of advisers, to evaluate the information disclosed.

29. *See infra* text accompanying note 58.

30. *Cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (finding that knowledge of remarkably rich ore drill core, upon which insiders traded, was material inside information), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

31. *See supra* notes 12-15. *Cf.* "Goodyear Tire to Buy Interest from Sir James," Wall St. J., Nov. 21, 1986, at 3, col. 1, ("Speculators already reeling from losses [stemming from the collapse of takeover stocks] in the wake of the Boesky scandal said Goodyear's announcement [stating that the Goldsmith takeover bid had been thwarted] was a painful blow.").

32. The SEC criticized this test as "unrealistic." *See Michaels Memorandum*, *supra* note 5, at 5. Considerable authority exists for the proposition that materiality is a question of

a standard, one is left with the uncertainty of trying to determine at what point negotiations become material. Thus, an uncertain materiality test creates difficult counseling situations and liability concerns, particularly given that any adjudication will be determined with the benefit of hindsight.

The SEC, despite its criticism of the bright-line materiality threshold, has asserted that, in the absence of an SEC regulation or judicial principle mandating disclosure, even material merger negotiations need not be disclosed.[33] This contention is misleading. Although correct as a general statement of the law, the more specific situations in which disclosure is required tend to make the general proposition overly broad. For example, even though corporations may have no general duty to disclose even material information, this freedom from disclosure may be short-lived. Because the antifraud provisions prohibit materially misleading statements,[34] and statements must be made in certain well-defined circumstances,[35] including the various periodic reports a company is required to file,[36] the proposition often is correct only for a limited period of time.[37]

Moreover, as a matter of public policy, the SEC's contention that even material merger negotiations need not be disclosed is overstated. First, unless there exists a legitimate business justification for nondisclosure, such as a loss of potential revenue or strong indication that the deal would be scuttled due to premature announcement,[38] shareholders and the markets are entitled to such information. Second, as a practical matter, once the parties have

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fact to be determined by the circumstances of each case. *See TSC Industries*, 426 U.S. at 449 (stating that information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making his investment decision).

33. In its amicus brief in *Levinson* the SEC stated:

> In urging that merger negotiations may become material before there is certainty of an agreement, we are not suggesting that material merger negotiations therefore have to be disclosed to the public as a matter of course. We agree with the court below that corporations ordinarily have no duty to disclose even material merger negotiations . . . .

Levinson Brief, *supra* note 8, at 7. *See also Michaels Memorandum*, *supra* note 5, at 3 n.2 ("[I]n general, if a company is not responding to a tender offer, does not trade in its own stock, and neither issues a public statement about corporate developments nor is responsible for word leaking into the market, it need not disclose even material negotiations.").

34. *See, e.g.*, Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982); SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1986).

35. *See supra* notes 4-7 and accompanying text.

36. *Id. See also infra* notes 124-134 and accompanying text.

37. *See infra* Section III's discussion regarding disclosure of bad news.

38. *Cf.* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981) (finding issuer not required to disclose when terms of new contract required confidentiality).

reached a firm agreement to merge, public disclosure of the offer's terms usually occurs promptly. Under such circumstances, there usually is no business reason to keep the information confidential. During the period in which the negotiations are kept confidential, insider trading by either company or their fiduciaries is forbidden. Because such trading may be attributable to the company[39] and because issuers are concerned with maintaining continued good relations with media sources, disclosure of agreements in principle ordinarily occurs promptly after they are made.

Finally, the SEC's position that material merger information need not be disclosed may adversely affect shareholders and the securities markets. An example is when a prospective offeror, who is interested in consummating a merger transaction only on friendly terms, makes a "firm offer" directly to incumbent management, who rejects it. Such an offer clearly is material and, according to a number of courts, must be disclosed to shareholders.[40] Yet it seems that the SEC would not require disclosure.[41] Consequently, shareholders and the markets are denied the opportunity to ascertain that an unaffiliated party is willing to pay at least a certain price for the company, a valuable indicator of true market value of the company's stock.[42] In addition, shareholders are denied the opportunity to ascertain whether incumbent management is unreceptive to offers, either because such offers pose a threat to management's position or due to management's undisclosed desire to maintain the company as an independent entity.[43] The Commission's position is puzzling because it undermines investor protection and conflicts with

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39. If the company does not have adequate procedures in place to protect against insider trading, it arguably may be held liable as a controlling person. *See* Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1982). In some jurisdictions, the company may be held liable under the doctrine of *respondeat superior*. *See generally* M. STEINBERG, *supra* note 3, §§ 10.03-.04 (and cases discussed therein).

40. *See* Texas Partners v. Conrock Co., 685 F.2d 1116, 1120 (5th Cir. 1982); South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1273 (9th Cir. 1982); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294-95 (2d Cir. 1973).

41. *See Levinson Brief*, *supra* note 8.

42. *Cf.* Weinberger v. UOP, Inc., 457 A.2d 701, 711-12 (Del. 1983) (indicating that under certain circumstances, disclosure is necessary to satisfy directors' duty of fair dealing); Steinberg & Lindahl, *The New Law of Squeeze-Out Mergers*, 62 WASH. U.L.Q. 351, 403-12 (1984) (and sources discussed therein).

43. *Cf.* Panter v. Marshall Field & Co., 646 F.2d 271, 290-91 (7th Cir. 1981) (stating that although target management must disclose defensive actions, there is no duty to disclose subjective motivation). *See generally* Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901 (1979).

respectable case law requiring disclosure.[44]

B. *Duty to Disclose Versus Duty Not to Mislead*

Another issue regarding disclosure of merger negotiations, raised in the Third Circuit's opinion in *Heublein*, is the failure of some courts to distinguish the duty to disclose from the duty not to mislead.[45] In *Heublein*, when the New York Stock Exchange (NYSE) asked the issuer to comment on the significant increase in the trading of its stock that day, the company released the following public statement: "The company was aware of no reason that would explain the activity in its stock trading on the NYSE today."[46] In fact, merger negotiations were taking place at that time. The Third Circuit reasoned that, because an agreement in principle encompassing fundamental terms had not yet been reached, the negotiations had not ripened to the point of materiality, and, therefore, Heublein had no affirmative duty to disclose the merger negotiations.[47] Instead of considering whether the public statement violated the antifraud provisions, section 10(b) of the Securities Exchange Act and rule 10b-5,[48] the Third Circuit concluded that because Heublein had no duty to disclose the merger negotiations, the public statement, as a matter of law, "was not false, inaccurate, or misleading."[49] Judge Higginbotham dissented vigorously, pointing out that the duty not to mislead exists "*whether or not*" there is a duty to disclose.[50]

The majority's failure to recognize this distinction drew harsh criticism from the SEC, which bluntly opined that *Heublein* "was wrongly decided."[51] In the *Carnation* release[52] the Commission warned that it would take enforcement action against issuers who

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44. *See supra* notes 1-7, 40 and accompanying text.

45. *See* Greenfield v. Heublein, Inc., 742 F.2d 751, 758-62 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985).

46. *Id.* at 758.

47. *Id.* at 758-59.

48. *See supra* note 34.

49. 742 F.2d at 759. The court reached this conclusion despite finding that the corporation's executives "clearly knew of information that might have accounted for the increase in trading . . . ." *Id.* The majority reasoned that "there was no indication that any of this privileged information had leaked or that they knew of, or had, information that insiders were engaged in trading." *Id. See also* Etshokin v. Texasgulf, Inc., 612 F. Supp. 1212, 1217 (N.D. Ill. 1984) (finding that duty was to ascertain whether company knew of reason for trading activity, not to ascertain whether there actually was a reason); *but see* cases cited *supra* note 19.

50. 742 F.2d at 760 (Higginbotham, J., dissenting) (emphasis in original).

51. *See* In the Matter of Carnation Company, Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 n.8 (July 8,

made such materially misleading public statements.[53] Counsel would be well advised to heed the SEC's position, particularly because other courts are in general agreement with the Commission on this issue.[54] In its *Carnation* release the SEC stated:

> Whenever an issuer makes a public statement or responds to an inquiry from a stock exchange official concerning rumors, unusual market activity, possible corporate developments or any other matter, the statement must be materially accurate and complete. If the issuer is aware of nonpublic information concerning acquisition discussions that are occurring at the time the statement is made, the issuer has an obligation to disclose sufficient information concerning the discussions to prevent the statements made from being materially misleading . . . . Thus in the Commission's view, an issuer statement that there is no corporate development that would account for unusual market activity in its stock, made while the issuer is engaged in acquisition discussions, may be materially false and misleading.[55]

In *Carnation* the SEC also noted that "an issuer that wants to prevent premature disclosure of nonpublic preliminary merger negotiations can, in appropriate circumstances, give a 'no comment' response to press inquiries concerning rumors or unusual market activity."[56] However, "[a] 'no comment' response would not be appropriate

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1985) [hereinafter *Carnation* release]. *Accord Levinson Brief, supra* note 8; Schlanger v. Four-Phase Systems, Inc., 582 F. Supp. 128, 132 (S.D.N.Y. 1984).

52. *Carnation* release, *supra* note 51, at 87,597.

53. In view of the cost and inconvenience of challenging the SEC's position, the Commission's *Carnation* release effectively nullifies *Heublein.*

54. *See e.g.*, Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (1987); Schlanger v. Four-Phase Sys., Inc., 582 F. Supp 128 (S.D.N.Y. 1984). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968) (en banc) (stating that one purpose underlying the Exchange Act is to protect investors against inequities in trading, particularly when trading has been "stimulated by the publication of false or misleading corporate information releases"), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

The fact that negotiations are taking place must be disclosed in the company's schedule 14D-9, which requires disclosure of merger negotiations that are taking place during the time that a third-party tender offer has been made, even if the final price and other material terms have yet to be negotiated. 17 C.F.R. § 240.14d-101 (1986). *See* In the Matter of Revlon, Inc., Exchange Act Release No. 23,320, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986) [hereinafter *Revlon* release] (finding company statement that it "may undertake negotiations," when in fact negotiations were underway, was misleading since such a statement implied that negotiations had not yet begun).

55. *Carnation* release, *supra* note 51, at 87,595-96.

56. *Id.* at 87,596 n.6.

where, *inter alia*, the issuer has made a statement that has been rendered materially false or misleading as a result of subsequent events or market rumors attributable to leaks from the issuer."[57]

Public pronouncements clearly are intended to influence investors and, if inaccurate or incomplete, may mislead investors as to likely corporate and market activity. This consequence is precisely what the antifraud provisions are designed to prevent. The concept of materiality, therefore, should focus on the specific matter at hand. In the case of merger negotiations, materiality generally should be measured in terms of ripeness, meaning that, until the discussions are sufficiently advanced, the likelihood and terms of a merger are too uncertain to expect investors reasonably to rely on such information in their decisionmaking. On the other hand, in the case of public statements actually made, materiality refers to the significance such statements are likely to have on investor decisionmaking.[58] Once a public statement is made, it must be accurate and complete. If the details are not yet ripe, the issuer simply can state that the terms still are being negotiated and that an agreement in principle has or has not been reached, as the case may be.[59]

C. *Summation*

As the preceding analysis indicates, there are respectable arguments both for and against an affirmative duty to disclose preliminary merger negotiations. On balance, however, requiring disclosure of merger negotiations would not ordinarily benefit in-

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57. *Id.* Evidently, the SEC relied heavily on Schlanger v. Four-Phase Sys., Inc., 582 F. Supp. 128 (S.D.N.Y. 1984), which was decided on facts similar to those in *Heublein*.

One disadvantage of a "no comment" response is that investors may interpret it as a corporate device to withhold information concerning significant developments. This problem may be ameliorated by the issuer's adopting a policy of not commenting on rumors in the marketplace. In any event, the SEC's position likely will encourage no-comment responses, a consequence that fails to promote timely disclosure to the capital markets. On the other hand, John J. Phelan, Chairman of the New York Stock Exchange, has asserted that " 'no comment' today means: 'I didn't know it was that serious,' " and that the "no comment" response usually signals the market that a material event may be occurring. *See Little Can Be Done to Stop Rumors, Exchange Officials, Others Tell Forum*, 18 Sec. Reg. & L. Rep. (BNA) 253 (1986). It is questionable, however, whether a "no comment" response furthers the disclosure goals of the securities laws. One alternative would be for the Commission to establish (by rulemaking) standards calling for disclosure of merger negotiations. *See id.* at 253(comments of Royce Griffin, President of the North American Securities Administrators Association).

58. *Cf. Revlon* release, *supra* note 54, at 88,146 (finding that target's amendment of schedule 14D-9 on October 2, 1985, did not discharge duty to do so "promptly"; schedule should have been amended and information disseminated at least before the market opened on September 30).

59. *See Carnation* release, *supra* note 51, at 87,595-97.

vestors or issuers, because the negotiations have not ripened sufficiently so as to create a reasonably certain expectation that the merger will be consummated (*i.e.*, reasonable marketplace reliance). However, the SEC's contention that the *Heublein* test is too rigid is not without merit, because there are times when preliminary merger information can be particularly critical to investor decisionmaking.[60] Unfortunately, the SEC's criticism does not offer any workable guidelines, and, therefore, is unresponsive to the problem. If the Commission believes that under certain circumstances merger negotiations may be material before an agreement in principle is reached, the prudent route would be for the SEC to promulgate specific rules, as it did in the tender offer context,[61] to remedy any disclosure deficiency.

In sum, once a firm offer has been made or an agreement in principle has been reached, there is little reason to withhold disclosure absent proof by the issuer of a valid business justification. The bright-line test advocated in *Heublein* provides an effective guideline for both the courts and the industry. Agreement on the fundamental terms, encompassing price and structure, is a straightforward requirement, and essential to the mutually successful negotiation of any business transaction. Hence, from a counseling as well as an enforcement standpoint, the advantages of a clear rule in this setting, rather than an ad hoc standard, normally will benefit both issuers and investors.

III. DUTY TO DISCLOSE "SOFT" INFORMATION

Traditionally, the securities laws have required disclosure of "hard" information, that is, factual, objectively verifiable data.[62] "Soft" information, on the other hand, predominantly focuses on forward-looking statements, such as projections, forecasts, and predictions.[63] Moreover, soft information need not necessarily relate to expectations regarding the future, but may include any statement that cannot be factually supported, whether due to a lack of substantiating data or because the information consists primarily of subjec-

60. *E.g.*, SEC v. Shapiro, 494 F.2d 1301, 1306-07 (2d Cir. 1974) ("Although the negotiations had not jelled to the point where a merger was probable, the possibility was not so remote that, when considered in the light of a projected increase of at least 60% in [the issuer's] earnings per share, it might have influenced a reasonable investor.").

61. *See* SEC schedule 14D-9, item 7, 17 C.F.R. § 240.14d-101 at 205 (1986).

62. *See generally* Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938 (June 25, 1979).

63. *Id.*

tive evaluations or opinions.[64]

The area of soft information presents a classic example of the tensions between the duty to disclose and the duty not to mislead. Although the issuer generally has a duty to disclose information that reasonable shareholders would consider important in their investment decisionmaking,[65] the duty to do so accurately and completely so as not to mislead investors often is a task fraught with complications. Difficulties inherent in the disclosure obligation include accurately interpreting the scope of this duty in a given situation, the pressure of providing such disclosure within the desired time constraints, and ensuring the protection of the issuer's business interests. A rule mandating disclosure of soft information could exacerbate these difficulties because of the often subjective, speculative nature of such information.

Until the mid-1970s the SEC and the courts discouraged and even prohibited the disclosure of soft information.[66] The major concern has been that investors, particularly the unsophisticated, might attach too much significance to information that is of questionable reliability.[67] On the other hand, the flow of soft information to the marketplace may enable sophisticated investors more intelligently to evaluate the total mix of information influencing their decisionmaking.[68]

Merger mania has brought the issue of disclosing soft information into current focus. For example, in a departure from its traditional view that forward-looking information is untrustworthy and, hence, discouraged, the SEC adopted rule 175,[69] which encourages

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64. *See* Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 255 (1972) (discussing five categories of "soft" information).

65. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976); *supra* notes 4-7 and accompanying text.

66. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294 (2d Cir. 1973); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 265 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972); Guidelines for the Release of Information by Issuers Whose Securities Are in Registration, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192 (Aug. 16, 1971). *But see* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971) (advocating disclosure).

67. *See, e.g.*, South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1271 (9th Cir. 1982).

68. *See generally* Note, *Corporate and Insider Disclosure of Asset Appraisals Under Rules 10b-5 and 14a-9*, 61 B.U.L. REV. 683, 707-12 (1981). *See also* Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 820 (D. Del. 1974).

69. 17 C.F.R. § 230.175 (1986). *Accord* SEC rule 3b-6, 17 C.F.R. § 240.3b-6 (1986); SEC regulation S-K, item 10(b), 17 C.F.R. § 229.10(b) (1986) (encouraging use of "management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format").

issuer use of financial projections and establishes a "safe harbor" for parties who invoke the rule.[70] While a small number of courts have extended this position to require issuer disclosure of forward-looking statements in certain circumstances,[71] others continue to adhere to the traditional philosophical concerns as a basis for not imposing liability upon issuers who decline to disclose soft information.[72] Due to the potentially massive liability consequences and the

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70. Rule 175 creates "a safe harbor from the applicable liability provisions of the federal securities laws for statements relating to or containing (1) projections of reserves, income (loss), earnings (loss) per share or other financial items, such as capital expenditures, dividends, or capital structure, (2) management plans and objectives for future company operations, and (3) future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements." Safe Harbor Rule for Projections, *supra* note 62, at 81,938. Rule 175 precludes liability on the basis of an issuer's forward-looking statement unless the plaintiff establishes that "such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." 17 C.F.R. § 230.175(a) (1986). *See generally* Fiflis, *Soft Information: The SEC's Former Exogenous Zone*, 26 UCLA L. REV. 95 (1978); Note, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 COLUM. L. REV. 1525 (1981); Note, *The SEC Safe Harbor for Forecasts—A Step in the Right Direction?*, 1980 DUKE L.J. 607; Note, *Disclosure of Future-Oriented Information Under the Securities Laws*, 88 YALE L.J. 338 (1978).

71. *See, e.g.*, Flynn v. Bass Bros. Enters., 744 F.2d 978 (3d Cir. 1984).

72. *See, e.g.*, Starkman v. Marathon Oil Co., 772 F.2d 231 (6th Cir. 1985); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1980); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1974). Although the Sixth Circuit has held that soft information must be disclosed if the predictions underlying the information are substantially certain to happen, *see* Radol v. Thomas, 772 F.2d 244, 252-53 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 3272 (1986); *Starkman*, 772 F.2d at 241, the substantial certainty requirement appears quite similar to the SEC's policy that presently known data may be required to be disclosed. *Compare* SEC regulation S-K, item 303(a), instructions to ¶ 303(a), no. 7 ("presently known data which will impact upon future operating results . . . may be required to be disclosed") *with Starkman*, 772 F.2d at 241 (example of "substantially certain" information is "fixed plan of [future] corporate activity") *and* Arber v. Essex Wire Corp., 490 F.2d 414, 421 (6th Cir.) (distinguishing fixed plan of future corporate activity from educated guesses or predictions), *cert. denied*, 419 U.S. 830 (1974).

Recently, in Walker v. Action Indus., Inc., 802 F.2d 703 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952 (1986), the Fourth Circuit held that in certain circumstances there is no duty to disclose financial projections. Mr. Walker alleged, *inter alia*, that Action Industries' failure to disclose in tender offer statements certain sales projections prepared for its internal use violated rule 10b-5. After reviewing the approaches taken by the Seventh, Third, Sixth, and Ninth Circuits, the *Walker* court cautioned that "[w]e do not specifically adopt any of the various positions held by other circuits regarding whether a duty exists to disclose financial projections." *Id.* at 709 n.11. Instead, the court held that due to the following circumstances, Action Industries was not required to disclose its internal financial projections:

(i) The SEC has declined to impose a duty to disclose financial projections in the context of Rule 13e-4 tender offer statements.

(ii) The SEC has declined to impose a duty to disclose financial projections in disclosure documents generally. Because "the current SEC regulatory environment [is in] an experimental state regarding financial projections disclosures . . . further transi-

lack of clear guidance in many jurisdictions, this area poses troublesome concerns for the securities practitioner. A helpful approach to synthesizing the law and extracting a framework of analysis is to examine the pertinent SEC regulations and the rationale underlying court decisions, both before the SEC reconsidered its view discouraging the disclosure of soft information as well as subsequent SEC and judicial action.

The SEC's traditional position discouraging soft information may be best understood by reference to the historical context in which that policy was adopted. Viewed in this setting, the securities laws were an attempt, at least in part, to ameliorate abuses that were everyday occurrences in the financial marketplace, including the trading by insiders (and their tippees) on confidential information and the practice of stock manipulation.[73] These abuses ultimately contributed to the great market crash of 1929.[74] As a result, Congress designed the securities laws to prohibit certain insider prac-

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tion, from permissive disclosure to required disclosure, should be occasioned by congressional or SEC adoption of more stringent disclosure requirements for financial projections, rather than by the courts." *Id.* at 709.

(iii) The financial projections at issue were uncertain and frequently changing, and thus potentially misleading to investors. Indeed, disclosure could have prompted a lawsuit for material misstatements.

(iv) Because of the frequency (at least monthly) and volatility (forecasts changed substantially) of the projections at issue, disclosure would have required virtually constant updates and therefore, would have been impractical, if not unreasonable.

The *Walker* court carefully noted, however, that "[w]e do not hold that there is no duty to disclose financial projections under any circumstances. To that extent the district court's instruction arguably was in error." *Id.* at 710. Nevertheless, the court warned that "it would appear prudent to release only those projections that are reasonably certain." *Id.*

73. *See, e.g.*, Securities Act § 17(a), 15 U.S.C. § 77q(1) (1982); Exchange Act §§ 9, 10(b), 16, 15 U.S.C. §§ 78i, 78j(b), 78p (1982). Although recent events indicate that insider trading still prevails as a market abuse, the frequency of trading on material confidential information by corporate fiduciaries apparently has been reduced. *See generally* Report of the Task Force on Regulation of Insider Trading, 41 BUS. LAW. 223 (1985).

74. SUBCOMM. ON OVERSIGHT & INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, FEDERAL REGULATION AND REGULATORY REFORM, H.R. Doc. No. 134, 95th Cong., 2d Sess. 18 (1976) ("As bankruptcies exposed abusive corporate financing and trading practices and appalling losses to individual investors and the American public, President Franklin Roosevelt and the Congress responded with the [federal securities laws]."); H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, item 18, at 13 (1973) ("A renewal of investors' confidence in the exchange markets can be effected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage.").

tices; to maximize timely, accurate, and complete disclosure of factual, verifiable data; and to prevent the dissemination of information that might be materially misleading.[75] Because soft information is uncertain and potentially misleading to investors, the SEC adopted a position disfavoring its disclosure.[76] But, as the shock of the stock market collapse dissipated, the increased sophistication of the securities industry along with the recurrence of disclosure issues in the merger and other acquisition contexts signified that the potential value to investors of certain soft information warranted a reassessment of the Commission's nondisclosure position.[77]

In view of these changed circumstances, the Commission recognized that certain forward-looking disclosures may be more helpful than harmful to investor interests.[78] Accordingly, the SEC permitted issuers to use projections in their registration statements (under the 1933 Act) and in periodic filings (under the 1934 Act).[79] In opting for a voluntary disclosure framework with respect to soft information, the SEC made clear that sufficient detail must be provided to enable investors to evaluate intelligently the soft information disclosed.[80] The Commission also warned against disclosures being misleading and pronounced that issuers have a duty to correct filings that originally contained materially incorrect or misleading information. Similarly, when information, although initially accurate, becomes false or misleading due to subsequent events, it must be updated.[81]

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75. *See, e.g.*, Empirical Research Project, *Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 689, 698-700 (1982).

76. *See supra* notes 62, 66.

77. *See supra* notes 62-70 and accompanying text; *infra* notes 78-87 and accompanying text.

78. *See* Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756, at 81,036 (Nov. 7, 1978) ("[T]he availability of forward-looking and analytical information is important to an investor's assessment of a corporation's future earning power and may be material to informed investor decision-making.").

79. *See* Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461, at 86,201-02 (Apr. 23, 1976).

80. *Id.* Some commentators have advocated mandatory disclosure of projections because of the significance of future earnings information. *See* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 25 (1979); *see also supra* note 70.

81. *See* Safe Harbor Rule for Projections, *supra* note 62, at 81,943-44. *Accord* Panter v. Marshall Field & Co., 646 F.2d 271, 292 (7th Cir. 1980) ("While it is true there is no duty upon management or directors to disclose financial projections, . . . it is also axiomatic that once a company undertakes partial disclosure of such information there is a duty to make the full disclosure of known facts necessary to avoid making such state-

Wary of liability should disclosed projections not become reality, issuers exercised caution, resulting in the infrequent disclosure of soft information.[82] In 1979 the SEC addressed this concern by creating a safe harbor rule. Generally, rule 175 provides protection against liability for issuer forward-looking statements that do not bear fruition, provided they were made in good faith and with a reasonable basis.[83] Likewise, the SEC has become more receptive toward disclosure of appraisals.[84] For example, in 1980 the SEC authorized disclosure of asset appraisals when all or part of the subject company's assets were to be liquidated.[85] This information is particularly significant in the context of mergers and related transactions, because asset valuations are a critical factor in shareholder decisionmaking. More recently, in *Flynn v. Bass Brothers Enterprises*[86] the Third Circuit, taking its cue from these SEC pronouncements regarding disclosure of soft information, established (on an ad hoc basis) an affirmative duty to disclose soft information.[87] However, before turning to the recent decisions on point, because of the paucity of case law it is instructive to examine the rationale underlying some of the earlier cases.

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ments misleading."); SEC regulation S-K, item 10(b), 17 C.F.R. § 229.10(b)(3)(iii) (1986) ("With respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition.").

82. *See* Safe Harbor Rule for Projections, *supra* note 62, at 81,939.

83. Under rule 175, the plaintiff has the burden of proving that the "soft" information disclosed did not have a reasonable basis and was not made in good faith. *See* 17 C.F.R. § 230.175(a) (1986).

84. *See* 17 C.F.R. § 241.16833 (1986) (authorizing disclosure of good faith appraisals made with a reasonable basis in proxy contests involving proposals for the liquidation of all or a portion of a subject company's assets); Brief for the Securities and Exchange Commission as Amicus Curiae, Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969), *modified*, 478 F.2d 1281 (2d Cir. 1973).

85. *See* Interpretive Release Relating to Proxy Rules, Exchange Act Release No. 16,833, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,117, at 17,621-12 (May 23, 1980). *See also* SEC schedule 13E-3, item 9, 17 C.F.R. § 240.13e-100 (1986) (with respect to going private transactions, "[s]tate whether or not the issuer or affiliate has received any . . . appraisal from an outside party which is materially related to the Rule 13e-3 transaction . . ." and "[f]urnish a summary concerning such . . . appraisal which shall include, but not be limited to, the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the issuer or affiliate; and any limitation imposed by the issuer or affiliate on the scope of the investigation."). For a discussion of the concern that investors might be misled, see Kripke, *Rule 10b-5 Liability and "Material" "Facts"*, 46 N.Y.U. L. REV. 1061, 1071-72 (1971). *See generally* Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 792-803 (1985); Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

86. 744 F.2d 978 (3d Cir. 1984).

87. *Id.* at 988.

Prior to *Flynn* the leading case on appraisal disclosure was *Gerstle v. Gamble-Skogmo, Inc.*[88] In *Gerstle* the subject companies disclosed only the book value of the assets in the proxy statement issued prior to the merger. The plaintiffs contended that by failing to disclose the appraised asset values, a material fact had been omitted in violation of rule 14a-9.[89] Under the merger agreement, shareholders were to receive only the stock's book value, which was significantly less than the appraised value (which proved to be more accurate).[90] The Second Circuit held that, because "[i]t has long been an article of faith among lawyers specializing in the securities field that appraisals of assets could not be included in a proxy statement," there was no duty to make such disclosure.[91] Similarly, in *Kohn v. American Metal Climax, Inc.*[92] the Third Circuit concluded that asset appraisals prepared for purposes of negotiating a merger were not "truly reliable."[93] In support of its holding, the court relied on the positions of other courts and the SEC discouraging the inclusion of asset appraisals in proxy statements.[94] Consequently, the general rule prior to *Flynn* was that issuers would not be liable for declining to reveal projections and asset appraisals. It is significant that rather than analyzing whether, under the circumstances of the case, the soft information would have been important to shareholder decisionmaking, these decisions were based upon precedent and the historical rationale for nondisclosure. Indeed, this view continues to represent the prevailing approach.[95]

On the other hand, a minority of courts prior to *Flynn* treated soft information as being material in certain circumstances. Generally in those cases, insiders were trading in the stock and the soft information was considered peculiarly reliable. For example, in *Speed v. Transamerica Corp.*[96] the court imposed liability under rule 10b-5 on corporate insiders who used inside soft information relating to the increased value of the issuer's tobacco inventory to buy out minority shareholders at book value. Because tobacco is an ac-

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88. 478 F.2d 1281 (2d Cir. 1973).

89. *Id.* at 1289. *See also* 17 C.F.R. § 240.14a-9 (1986).

90. 478 F.2d at 1286-87.

91. *Id.* at 1293. *See also id.* at 1292 (stating that "the policy embodied in the note to Rule 14a-9 has consistently been enforced to bar disclosure of asset appraisals").

92. 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

93. *Id.* at 265.

94. *Id.* (citing Union Pac. R.R. v. Chicago & NW. Ry., 226 F. Supp. 400, 408-09 (N.D. Ill. 1964)).

95. *See* cases cited *supra* note 72.

96. 99 F. Supp. 808 (D. Del. 1951), *aff'd in relevant part*, 235 F.2d 369 (3d Cir. 1956).

tively traded commodity with a readily ascertainable market price, the value of the tobacco inventory (and disclosure thereof) would not have involved much speculation or conjecture.[97] *SEC v. Texas Gulf Sulphur Co.*[98] involved insiders who traded on a visual evaluation of a drill core sample from a new mining site, which indicated "the existence of a mine of . . . vast magnitude."[99] They were found liable under rule 10b-5, the rationale being that, if corporate insiders treated the appraisal as significant, then such information, despite its speculative nature, may be material.[100]

While soft information historically has been treated as immaterial as a matter of law, an emerging, although still minority, view clearly suggests that this is no longer so.[101] The leading case for the proposition that there is an affirmative duty to disclose soft information when certain indicia of reliability are present is *Flynn v. Bass Brothers Enterprises.*[102] In that case the Third Circuit canvassed the events marking what it considered to be the emergence of a new public policy favoring the disclosure of soft information, spawned "in response to developing corporate trends, such as the increase in mergers,"[103] and held:

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97. *Id.* at 812, 825-27.

98. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

99. *Id.* at 849.

100. *Id.* at 848-53. *See also* Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970) (finding that once disclosure of estimate of future revenues from oil wells was disclosed, lower estimates of independent appraisals should have been disclosed); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977) (finding that tender offeror selectively disclosed only the lowest estimate of target's net asset value). One of the older cases that is contrary to the prevailing view is Feit v. Leasco Data Processing Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), in which the court, despite finding the valuations of an insurance company's "surplus surplus" to be based upon subjective judgments, held that disclosure was mandatory. *Id.* at 522-24, 563-66. The court reasoned that because of the significant variation in estimates (between $50 and $125 million), which formed the primary reason underlying the takeover bid, all the estimates were material to shareholders in evaluating the value of their shares, and should have been disclosed. *Id.* at 563-66.

101. For cases indicating that projections and appraisals may be material see Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221-22 (9th Cir. 1980) (partial disclosure case); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1046 (7th Cir.) (partial disclosure case), *cert. denied,* 434 U.S. 875 (1977); SEC v. Stuart, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,908 (N.D. Tex. 1985). Professor Kripke points out that, in certain respects, reasonable projections of future earnings may be more significant to investment decisionmaking than past earnings because historical earnings rarely have predictive value. *See* Kripke, *A Search for a Meaningful Securities Disclosure Policy,* 31 BUS. LAW. 293, 298, 311-12 (1975).

102. 744 F.2d 978 (3d Cir. 1984).

103. *Id.* at 986.

> In order to give full effect to the evolution in the law of disclosure, . . . today we set forth the law for disclosure of soft information as it is to be applied from this date on. Henceforth, the law is not that asset appraisals are, as a matter of law, immaterial. Rather, in appropriate cases, such information must be disclosed. Courts should ascertain the duty to disclose asset valuations and other soft information on a case by case basis, 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 stockholders' impending decision; 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.[104]

Sharply contrasting *Flynn* is the Sixth Circuit's approach in *Starkman v. Marathon Oil Co.*,[105] in which the court declined to recognize a mandatory obligation to disclose asset appraisals or financial projections, unless "the predictions underlying the appraisal or projection are substantially certain to hold."[106] Criticizing the Third Circuit's approach in *Flynn*, the Sixth Circuit reasoned:

> By its very nature . . . this sort of judicial cost-benefit analysis [referring to *Flynn*] is uncertain and unpredictable, and it moreover neglects the role of the market in providing shareholders with information regarding the target's value through competing tender offers. Our approach, which focuses on the certainty of the data underlying the appraisal or projection, ensures that the target company's shareholders will receive all essentially factual information, while preserving the target's discretion to disclose more

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104. *Id.* at 988. *See generally* Note, *Disclosure of Soft Information in Tender Offers After Flynn v. Bass Brothers Enterprises, Inc.*, 42 WASH. & LEE L. REV. 915 (1985); *cf.* Radol v. Thomas, 556 F. Supp. 586, 593-94 (S.D. Ohio 1983) (denying summary judgment because appraisals prepared in anticipation of hostile tender offer might have been material under the Sixth Circuit's "substantial certainty" test), *aff'd on other grounds*, 772 F.2d 244, 253, (6th Cir. 1985) (dictum) ("District court should have ruled that the reports were not material and removed them from the jury.").

105. 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 106 S. Ct. 1195 (1986).

106. *Id.* at 241.

> uncertain information without the threat of liability, provided appropriate qualifications and explanations are made.[107]

Flynn represents an approach aimed at addressing investor concerns, whereas *Starkman* illustrates the disclosure concerns from an issuer's perspective. Both views have merit, but each is too one-sided. The cost-benefit analysis advocated by the Third Circuit does not promote certainty, because the approach calls for a court to determine the qualitative value of the enumerated factors with the benefit of hindsight and on an ad hoc basis. Under this approach, judicial guidelines may well have little stability, because the subjective nature of the inquiry is likely to result in the factors being applied differently under an ad hoc analysis. In addition, the Third Circuit's desire "to give full effect to the evolution in the law of disclosure"[108] overlooks the fact that, while the securities laws are designed to protect investors, they are not intended to impose undue hardship upon issuers. The issuer's duty to disclose should be based on what is fair and reasonable from both an investor's and an issuer's perspective.[109]

On the other hand, the Sixth Circuit's approach in *Starkman* is

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107. *Id.* at 242. The Sixth Circuit further explained:

> Under this standard, Marathon plainly had no duty to disclose the Strong and First Boston reports, because these reports contained estimates of the value of probable, potential and unexplored oil and gas reserves which were based on highly speculative assumptions regarding the path of oil and gas prices, recovery rates and the like over a period of thirty to fifty years. Disclosure of such estimated values could well have been misleading without an accompanying mountain of data and explanations. There is no reported case actually holding that disclosure of appraised values of oil and gas reserves is required, and several which agree with our decision that such disclosure is not required.
>
> Similarly, Marathon had no duty to disclose the five-year earnings and cash flow projections given to Steel and First Boston. This information does not rise to the level of substantial certainty triggering a duty to disclose.

Id. (footnote omitted). *See* Radol v. Thomas, 772 F.2d 244 (6th Cir. 1985) (holding that SEC rule 13e-3 does not apply to merger consummated within one year of tender offer when same price paid as in tender offer), *cert. denied*, 106 S. Ct. 3272 (1986); Biechele v. Cedar Point, Inc., 747 F.2d 209 (6th Cir. 1984) (finding no duty to disclose appraisal prepared as a selling document in on-going merger discussions).

108. Flynn v. Bass Bros. Enters., 744 F.2d 978, 988 (3d Cir. 1984).

109. Merger and related acquisition negotiations impose considerable pressure on the subject corporations' managements. The potential impact of proposals and counterproposals often must be quickly and thoroughly evaluated. Moreover, there may be one or more competing offers to consider. In friendly acquisitions, confidentiality and timing usually are critical, both with regard to price and to consummation of the transaction. *See generally* TENDER OFFERS: DEVELOPMENTS & COMMENTARIES (M. Steinberg ed. 1985).

too rigid.[110] Disclosure, a key concept underlying the securities laws, is subordinated to the perceived need to avoid imposing liability in circumstances in which certainty cannot be assured. The *Starkman* court's concern is misplaced, because an important policy underlying the disclosure doctrine is issuer fair dealing through the sharing of information that is material to investor decisionmaking. Congress, the SEC, and the courts require issuers to make accurate and complete disclosure of available material information in order to enhance the level of investor decisionmaking and to ensure that the information disclosed is not materially misleading.[111] All that should be required in the context of soft information is that the available material data be accurately disclosed; it need not be certain.

Clearly, there is a need for an approach that embraces both investor and issuer concerns. While an affirmative duty to disclose has been held to exist only in certain well-defined situations,[112] consistent application of the disclosure principle underlying the securities laws requires that, to ensure investor decisionmaking based on a flow of accurate information between the issuer and the financial markets, soft information must be affirmatively disclosed in certain circumstances. Hence, the following two-prong test should be adopted for establishing when there is an affirmative duty to disclose soft information: (1) the information must be material and ripe for disclosure and (2) the failure to disclose must be fundamentally unfair to stockholders.

In seeking to establish the ripeness element of materiality under the first prong, one should bear in mind that certainty, in reality, is a matter of degree. Although soft information, by definition, lacks the objective certainty that customarily gives rise to a duty to disclose, such information can be highly informative and significant to investors.[113] Thus, it seems specious to deny investors access to valuable information merely because the veracity of the data cannot be proved by hard facts. If the information objectively may be viewed as significant to investors and not likely to cause investors to place undue detrimental reliance thereon,[114] then it is material and

110. *See supra* text accompanying notes 105-107.

111. *See* M. STEINBERG, CORPORATE INTERNAL AFFAIRS: A CORPORATE AND SECURITIES LAW PERSPECTIVE 28-38, 73-98, 163-98 (1983).

112. *See supra* notes 4-7 and accompanying text.

113. *See supra* notes 78-87, 101-104 and accompanying text. *See also* Brown, *supra* note 85, at 797 & n.252.

114. *Cf. supra* notes 24-31 and accompanying text.

ripe for disclosure. Concerns about investors being misled due to the "softness" of the information may be overcome in most instances by ensuring that the facts upon which the information is based are fairly presented with an appropriate cautionary note. The factors enumerated in *Flynn* provide a helpful guide.[115] Sophisticated investors should not be deprived of significant information merely to protect the unsophisticated. In view of the frequency of mergers, the increased flow of information to the financial markets, and the greater sophistication of the investing public, the concerns that in the past may have justified, or at least explained, judicial paternalism are no longer convincing.

After establishing that the soft information was ripe for disclosure, to establish the second prong a plaintiff must prove that by not disclosing the soft information at the time it is alleged such information should have been disclosed, corporate management acted in a manner fundamentally unfair to stockholders.[116] In particular, nondisclosure would be fundamentally unfair (1) if the issuer's board of directors did not consider the interests of stockholders, or (2) if the board of directors did consider the interests of stockholders, but, under all the circumstances, (a) the decision clearly is not supported by the facts, or (b) no significant identifiable corporate interest is reasonably likely to be advanced by withholding the information. A board of director's omission to document in detail its deliberations and reasoning should constitute prima facie evidence that the board acted in a manner fundamentally unfair to stockholders. In view of the importance of such a decision to investors, one can hardly be sympathetic to objections grounded on undue burdens being imposed on corporate management. This is precisely the kind of effort directors are expected to exert in fulfilling their disclosure obligations under the federal securities laws.[117]

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115. *See supra* text accompanying note 104.

116. This argument, premising federal disclosure obligations on the nature of fiduciary duty relationships, is consistent with the Supreme Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980). In a private damages action under § 10(b) for nondisclosure of soft information, reckless misconduct, as construed by the lower federal courts, satisfies § 10(b)'s scienter requirement. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); M. STEINBERG, *supra* note 3, at § 7.02 (and cases cited therein). If the alleged violation is of the reporting requirements under §§ 13(a) or 15(d) of the Exchange Act (most likely in an SEC enforcement action), then negligent conduct may well be sufficient to impose liability. Moreover, in those jurisdictions that recognize a private right of action for damages under § 17(a) of the 1933 Act, negligence may constitute sufficient culpability to impose liability. *See infra* note 140.

117. *Cf.* Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980) (recognizing directors' structural bias), *cert. denied*, 450 U.S. 1029 (1981); Smith v. Van Gorkom,

This section illustrates that when soft information is both highly significant to investor decisionmaking and ripe for disclosure, it should be disclosed unless there is a reasonable business justification for withholding the information. Although the imposition of an affirmative duty to disclose soft information may expose issuers to considerable liability risks, closer analysis of the duty indicates that issuers are expected to do no more than consider and act in the best interests of the company and its stockholders. Only material information that is ripe for disclosure need be disclosed, and if a rational, good faith disclosure of available data with appropriate cautionary notation is provided, the issuer will have satisfied its disclosure obligations.[118]

IV. DUTY TO DISCLOSE BAD NEWS

"Bad news" usually refers to circumstances having an adverse financial impact upon the corporation, such as the loss of one or more major customers or valuable contracts, the initiation of a significant lawsuit or SEC enforcement action, events giving rise to troubling liquidity problems, impending changes in corporate management, or the loss of special advisers upon whom corporate management has come to rely.[119] Although disclosure of bad news may result in investor over-reaction, possibly causing substantial harm to the subject corporation's business, bad news is precisely the kind of disclosure that is essential to maintaining informed financial markets.

The reasons for issuer reluctance to disclose bad news concerning the company are axiomatic. Equally obvious is the significance of such information to investors. The periodic reports that issuers are required to file under the Exchange Act are comprehensive,[120] and one generally cannot omit bad news without violating the securities laws.[121] However, certain disclosure loopholes exist, because

488 A.2d 858 (Del. 1985) (finding that director has duty under Delaware law to exercise informed business judgment); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981) (similar duty under New Jersey law).

118. For a discussion relating to this subject and generally to issuer affirmative disclosure obligations, see M. STEINBERG, SECURITIES REGULATION, 637-71 (1986).

119. Certain of these disclosures, such as the resignation of the issuer's certifying accountant, must be promptly disclosed by filing a form 8-K. *See infra* note 130.

120. *See infra* notes 124-133 and accompanying text.

121. *See infra* note 128; *cf.* Segal v. Coburn Corp. of Am., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,002 (E.D.N.Y. 1973) (finding that company need not disclose its decision to withdraw from installment finance business because it reasonably feared negative impact on the collectibility of its paper and its credit relations, and that business may be forced into sudden liquidation).

there is no specific SEC rule mandating disclosure of material, adverse financial information *between* periodic reports. This section considers whether an affirmative duty to disclose bad news arising between periodic reports should be imposed. The discussion does not encompass situations in which an affirmative disclosure obligation already has been established, such as with the duty to update or correct prior disclosures. For example, if an issuer has disclosed the identity of a major customer (and the amount of business transacted with that customer) in a disclosure document previously filed with the SEC or disseminated to shareholders,[122] the irretrievable loss of that customer's account should be promptly disclosed pursuant to the duty to update.[123]

The affirmative disclosure issue relating to adverse financial information normally arises during an interval in which the issuer is not required to file a periodic report with the SEC. Under the Exchange Act an issuer is required, *inter alia*, to file annual reports on form 10-K,[124] quarterly reports on form 10-Q,[125] and current reports on form 8-K.[126] The regulations that mandate the filing of these reports are very specific as to what is required to be disclosed in the various line items. For example, form 10-K requires, among other things, an extensive discussion of the issuer's business, audited financial statements, disclosures regarding certain legal proceedings, and a management discussion and analysis (MD&A).[127] With respect to the MD&A, mandated disclosures include identifying "any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way . . ." and a description of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[128]

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122. *See* SEC Regulation S-K, item 101, 17 C.F.R. § 229.101(c)(1)(vii) (1986).

123. *Cf.* Ross v. A.H. Robins Co., 465 F. Supp. 904, 908 (S.D.N.Y.) (holding that manufacturer had duty to correct statements projecting promising market future for Dalkon Shield), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979).

124. 17 C.F.R. § 249.310 (1986) (annual report pursuant to §§ 13 or 15(d) of the Exchange Act).

125. 17 C.F.R. § 249.308a (1986) (quarterly report under §§ 13 or 15(d) of the Exchange Act).

126. 17 C.F.R. § 249.308 (1986) (current report).

127. SEC form 10-K, items 1-3, 6-9, 14, 17 C.F.R. § 249.310 (1986).

128. *Id.* item 7 (calling for information required by item 303 of regulation S-K). The SEC has instituted enforcement actions for an issuer's failure to adhere to the disclosures required by the MD&A. *See, e.g.*, In the Matter of Ronson Corp., Exchange Act

Quarterly reports (on form 10-Q) also must contain an MD&A and other extensive disclosures, including unaudited interim financial information prepared in accordance with generally accepted accounting principles (GAAP).[129] In addition, periodic disclosure on form 8-K is required to facilitate current disclosure of certain significant events. A key problem with the form 8-K disclosure obligation is that it is mandatory only with respect to certain specified events.[130] Disclosure of other events is permissive.[131] Although the Commission has issued a number of releases urging corporate managements to review their disclosure policies "and endeavor to set up procedures which will insure that prompt disclosure be made of material corporate developments both favorable and unfavorable, so that investor confidence can be maintained in an orderly and effective securities market,"[132] the Commission has declined to mandate affirmative disclosure of bad news arising between quarterly reports. Also, there is a dearth of judicial authority on the issue. Thus, because there currently is no general affirmative duty to disclose even material information regarding the issuer except in certain specific circumstances,[133] issuers' disinclination to make such disclosure is not surprising.

Accordingly, the central issue in this context is one of timing.[134] Issuers understandably wish to delay disclosure of adverse news as

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Release No. 19,212, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,275 (Nov. 4, 1982). *See also* 1 M. STEINBERG & R. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 2:16 (1985) (discussing SEC enforcement actions brought for financial fraud).

129. SEC form 10-Q, part I, items 1-2, 17 C.F.R. § 249.308a (1986).

130. The following items are mandatory under form 8-K: changes in control of registrant (item 1), acquisition or disposition of assets (item 2), bankruptcy or receivership (item 3), changes in registrant's certifying accountant (item 4), and resignations of registrant's directors (item 6).

131. *See*, SEC form 8-K, item 5, 17 C.F.R. § 249.308 (1986) ("The registrant may, at its option, report under this item any events, with respect to which information is not otherwise called for by this form, that the registrant deems of importance to security holders.").

132. In the Matter of Sharon Steel Corp. as it Relates to Prompt Corporate Disclosure, Exchange Act Release No. 18,271, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,049, at 84,615 (Nov. 19, 1981). *See also* In the Matter of Fidelity Fin. Corp. and Fidelity Sav. & Loan Ass'n, Exchange Act Release No. 18,927, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,239 (July 30, 1982) (SEC, in a § 21(a) report, criticizing corporation's year-end press release announcing losses for the year but not indicating impact of continued losses on future operations when losses substantially affected short-term viability; statement reporting "business as usual" in such circumstances raised antifraud problems).

133. *See supra* notes 4-7 and accompanying text.

134. *See generally* SEC forms 10-K, 10-Q, 17 C.F.R. §§ 249.308a, 310 (1986) (items enumerated therein).

long as possible. For example, during the interim before the next form 10-Q must be filed, perhaps new major contracts can be procured to replace the ones that were terminated. Immediate disclosure, according to management, could have a "snowball" effect, depressing the company's business and the price of its stock in the securities markets.

Generally, there is little authority to support an affirmative duty to disclose adverse news during the period between SEC-required reports. Courts have held that the timing of disclosure is a matter of business judgment.[135] Under this concept disclosure may be deferred until the information is ripe, or withheld if a valid business reason exists, such as when premature disclosure would jeopardize a contract.[136] On the other hand, if the material information clearly is ripe and the business justifications proffered are not compelling, there is a plausible case for imposing liability for nondisclosure. A court should balance the potential impact of disclosing the bad news against the fiduciary duty owed to shareholders.[137]

Although an issuer's refusal to disclose bad news for fear of investor reaction does not justify withholding disclosure, there are a number of legitimate arguments against the blanket imposition of an affirmative duty to disclose bad news. Coping with the vicissitudes of business is what entrepreneurship is all about. Corporate management needs the flexibility to find means of overcoming setbacks. Stockholder confidence in management's ability to do so presumably is why shareholders elected to invest in that enterprise. Furthermore, the securities laws were not intended to stifle corporate management's ability to run the company's daily business operations. In recognition of these interests, the current SEC periodic reporting requirements require comprehensive disclosure at speci-

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135. *See, e.g.*, Billard v. Rockwell Int'l Corp., 683 F.2d 51, 54, 56 (2d Cir. 1982); State Teachers Retirement Bd. v. Fluor, 654 F.2d 843, 853 (2d Cir. 1981); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518-22 (10th Cir.) (en banc) (per curiam), *cert. denied*, 414 U.S. 874 (1973). Under the business judgment rule, disclosure may be deferred if premature disclosure would jeopardize a contract or until the information is ripe. *See, e.g.*, Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983) (disclosure of nonmaterial negotiations "is a matter of corporate discretion"); Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 162-64 (2d Cir. 1980) (no duty to disclose dismal internal projections); SEC v. Geon Indus., 531 F.2d 39, 50 (2d Cir. 1976) (generally no duty to disclose "raw, unverified" information); *Financial Indus. Fund*, 474 F.2d at 519 ("To be ripe . . . the contents must be verified sufficiently to permit the officers and directors to have confidence in their accuracy . . . and there [can be] no valid corporate purpose which dictates the information be not disclosed.").

136. *See supra* note 135.

137. See *supra* notes 101-104 and accompanying text.

fied intervals but also leave corporate management some flexibility in the interim.[138] Given an opportunity to reflect, the issuer may be able to salvage or replace the "lost" contracts, or to resolve the problem and reverse the setback. Mandating immediate disclosure may result in panic selling, depressing the company's business and the price of its stock.

On the other hand, there is a need to ensure that bad news that undoubtedly will have an adverse impact on the company is disclosed without undue delay. In such instances, the issue is primarily materiality rather than timing. If there is no reasonable prospect of avoiding the adverse impact of whatever event transpired, there is no justification for delaying disclosure until the next periodic report. In that event the only issue should be whether the information is material, referring to the importance of such information to investors. The information is ripe for disclosure, because it is certain that there will be an adverse impact. Investors are entitled to know what has happened so that they can protect their financial interests as they see fit. Prompt disclosure often is critical, because even a slight delay can have catastrophic consequences for investors and the integrity of the financial markets.

By letting issuers elect not to disclose this material bad news, the SEC has neglected investors and its own responsibility to promote the disclosure objectives underlying the securities laws. To remedy this deficiency the Commission should amend form 8-K to require prompt disclosure of any event that the issuer knows or has reason to know will have a material, adverse impact on the enterprise. Mandated disclosures, for example, would include (if financially material): the irretrievable loss of customer contracts; known problems that raise liquidity concerns; and the occurrence of any event that affects the issuer's net sales, revenues, or income.[139]

There may exist circumstances under which an issuer has legitimate business justifications for declining to disclose the mandated information. Requiring disclosure, irrespective of the existence of valid business reasons for confidentiality, is likely to injure the company and its shareholders. Therefore, an issuer should be able to invoke an affirmative defense of legitimate business justification for nondisclosure. Hence, under the suggested framework an issuer's failure to disclose the adverse financial news, as required under the

138. *See supra* notes 124-133 and accompanying text.

139. *Cf. id.*

amendments to form 8-K, would be a prima facie violation.[140] The issuer may avoid liability by establishing that (1) it had reasonable and identifiable grounds for believing that the potential consequences of the adverse event could be neutralized, (2) it diligently pursued a considered plan for accomplishing this objective, and (3) disclosure would have presented a substantial, identifiable threat to the continued viability of the company's business. The issuer must point to concrete conditions that posed a legitimate threat to the company's business in order to establish its affirmative defense. Unsubstantiated fears of future loss of business are insufficient.

Under the proposed framework issuers normally may protect themselves by acting reasonably and carefully documenting their deliberations and decisions. Generally, if the issuer acted in a responsible manner, no liability should ensue. This proposed framework provides an equitable balance between the shareholders' right to be informed promptly of material developments and the legitimate interest of issuers to maintain confidentiality if necessitated by legitimate business reasons.

V. CONCLUSION

Questions concerning issuer affirmative disclosure obligations raise difficult public policy issues. In seeking a proper balance, legitimate concerns of both issuers and investors should be addressed. On the one hand, issuers should be required to affirmatively disclose only if there are sufficiently clear guidelines in

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140. The prima facie violation would be that of the reporting requirements of §§ 13(a) and 15(d) of the Exchange Act. Of course, if scienter were proven, a § 10(b) right of action may also exist. *See* Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See also supra* note 116 and accompanying text. Whether shareholders have an implied right of action for damages based on violation of the reporting requirements remains an open issue, although most courts have declined to imply such a remedy. *See* Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 556, 594-98 (1982) (and cases cited therein). The article states:

> [T]he primary objective of [the reporting] provisions is to mandate the filing of certain pertinent information, rather than to provide an anti-fraud prohibition. [Moreover], to authorize an implied remedy for damages under section 13(a) or 13(d) would indirectly circumvent the purchaser-seller requirement under section 10(b), thereby permitting allegedly aggrieved parties to bring suit on the theory that they would have purchased [or] sold their stock if the filed information had been accurate. Such a result would raise the possibility of vexatious litigation, the very consequence that the Supreme Court sought to alleviate. In this regard, if the plaintiff is a purchaser or seller, he has an adequate remedy under section 10(b) . . . .

Id. at 596.

effect and only if legitimate business interests will not be impeded by such disclosure. On the other hand, investors and the marketplace should be entitled to all material financial information that is ripe for disclosure, in a manner that is not misleading to investors, and that does not impose an unduly rigorous burden upon issuers. This article offers a practical, analytical framework for accommodating the different interests in the varying contexts in which questions concerning issuer affirmative disclosure obligations arise.

Generally, merger negotiations should be disclosed if the information is ripe for disclosure, that is, if there is a firm offer or an agreement in principle encompassing fundamental terms, or, alternatively, if there is an SEC rule that specifically requires disclosure. Preliminary merger discussions usually are too indefinite for reasonable investor reliance and, therefore, are not ripe for disclosure. Materiality should not be applied uniformly as a generally applicable concept, because the materiality threshold differs in different situational contexts.[141] Moreover, it is inequitable to subject issuers to both the burden of disclosure and the risk of liability by mandating disclosure in the absence of definitive guidelines as to when disclosure is required. The requirement that there be a firm offer or an agreement in principle encompassing fundamental terms, such as price and structure, provides a pragmatic yardstick for measuring ripeness.

The area of soft information disclosure is especially complex. A number of courts, through judicial paternalism, have denied investors vital information, a consequence at variance with the protections that the securities laws were designed to afford. Investors have reached a considerably higher level of sophistication in the financial markets than they had at the time the securities laws were enacted. Consequently, there is a need for the fullest practicable flow of information to the financial markets. It is accuracy, not certainty, that prevents investors from being misled. Generally, if soft information is ripe for disclosure and it would be fundamentally unfair not to disclose, disclosure should be mandatory. An appropriate caution-

141. At first blush, this proposition seems to conflict with the Supreme Court's statement that information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making his investment decision. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). However, the Court merely addressed the type of information that a shareholder (or investor) may consider material, and not whether that information necessarily has to be disclosed. Thus, materiality in the context of an affirmative duty to disclose largely should be measured by the concept of ripeness. Ripeness, in turn, incorporates both the significance of the information and its reliability.

ary notation can direct investors to the uncertainties reflected in such information. There should be no liability if the board of directors makes a good faith determination that a significant identifiable business interest will be advanced by withholding disclosure and acts pursuant to a reasonable business plan to achieve that benefit.

Similarly, there should be an affirmative duty to disclose certain bad financial news that arises in the interval between periodic reports. Unless the issuer can show that there are legitimate business justifications for not disclosing the bad news, the issuer should be required to disclose. Liability for nondisclosure should not be imposed if there are reasonable and identifiable grounds for believing that the setback is reasonably likely to be neutralized or reversed, the issuer pursues a plan for accomplishing that objective, and premature disclosure would create a substantial threat to the continued viability of the company. Absent these circumstances, shareholders and the financial markets are entitled to prompt disclosure. Delay, however short, can have catastrophic consequences.