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## SEC NONACQUIESCENCE IN JUDICIAL DECISIONMAKING: TARGET COMPANY DISCLOSURE OF ACQUISITION NEGOTIATIONS

DOUGLAS M. BRANSON\*

The Securities and Exchange Commission (SEC) has recently announced that it believes a recent decision by the United States Court of Appeals for the Third Circuit to have been “wrongly decided.”<sup>1</sup> That decision dealt with the duty to disclose and timing of disclosure of merger negotiations and, in turn, had drawn on several other federal court decisions.<sup>2</sup> The SEC also announced that it would “[t]ake appropriate enforcement action against issuers which fail to comply” with the SEC’s view of the law’s requirements.<sup>3</sup> Subsequently, an SEC Commissioner opined that the SEC announcements had been an Internal-Revenue-Service-like statement of “nonacquiescence” in those judicial decisions.<sup>4</sup>

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1. In the Matter of Carnation Co., Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,596 n.8 (July 8, 1985) [hereinafter *Carnation* release] (commenting on *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985)).

2. *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985) (citing, *inter alia*, *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982)).

3. *Carnation* release, *supra* note 1, at 87,597. The Commission has become quite zealous on the point. In a recent case involving privately-held companies, the SEC filed an amicus brief on petition for rehearing by one of the parties, urging deletion of a dictum in the court’s earlier opinion. See Memorandum of Securities and Exchange Commission as Amicus Curiae at 6-8, *Michaels v. Michaels*, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, 106 S. Ct. 797 (1986). The dictum had stated that merger negotiations by a publicly held company are not material as a matter of law unless at least an agreement in principle has been reached. See 767 F.2d at 1195-96. See also Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 785 (1985) (noting that the SEC has consistently disagreed with restrictive definitions of “materiality” in this context).

4. Grundfest, *Carnation Revisited: Toward an Optimal Merger Disclosure and Rumor Response Policy*, Address to the Federal Regulation of Securities Committee, American Bar Association (Apr. 15, 1986), at 8, summarized in 18 Sec. Reg. & L. Rep. (BNA) 521 (1986). Of course, agency nonacquiescence in judicial decisionmaking is more frequent than is commonly believed, but bold announcement of nonacquiescence has generally been confined to a few agencies and executive departments, such as the Internal Revenue Service. See generally Maranville, *Nonacquiescence: Outlaw Agencies, Imperial Courts, and the Perils of Pluralism*, 39 VAND. L. REV. 471 (1986) (discussing increasing incidence of agency nonacquiescence and resulting problems).

Besides leaving issuers of securities torn between fundamental and irreconcilable precedent on disclosure of acquisition negotiations, the SEC position also indicates nonacquiescence in recent Supreme Court decisions on the proper policy perspective for viewing the securities laws' general antifraud provisions.<sup>5</sup> The Commission position also seems to indicate nonacceptance of the bulk of state judicial opinion concerning the effect of negotiations and preliminary agreements on possible business combinations. Most importantly of all, however, the SEC position reveals nonacquiescence in, or lack of knowledge about, the reality of a world in which greenmailers and arbitragers roam, eager for any indication that a company may be for sale or can be put "in play," or fodder with which they can manufacture rumors to that effect.

The purpose of this article is to add flesh to the arguments presented in this introduction. In particular, the article attempts to outline the costs and benefits to a target company of disclosure as mandated by the SEC position. From a weighing of costs and benefits, rather than merely a close examination of the law, may come the guidance that, in view of conflicting precedent and the SEC's nonacquiescence, companies desperately need.

## I. JUDICIAL AND SEC DECISIONS

### A. *The Third Circuit*

In *Greenfield v. Heublein, Inc.*<sup>6</sup> Heublein had been under seige by a hostile suitor, General Cinema Corporation. Confidential negotiations were ongoing with R.J. Reynolds Co. as a potential "white knight."<sup>7</sup> A tenfold increase in Heublein share volume during the negotiations prompted a New York Stock Exchange (NYSE) inquiry. A Heublein spokesperson replied that the "company was aware of no reason that would explain the activity of its stock in trading . . . ."<sup>8</sup> The Third Circuit accepted the statement as literally true since Heublein was not itself trading and seemed to be unaware of any information leaks, two events in Heublein's control that could

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5. See *infra* notes 60-86 and accompanying text.

6. 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985).

7. A "white knight" is "a partner in a friendly acquisition who rescues the target from the clutches of the hostile bidder." L. SOLOMON, D. SCHWARTZ & J. BAUMAN, *CORPORATIONS: LAW AND POLICY* 332 (1982 & Supp. 1986).

8. 742 F.2d at 754. By one measure, an "aware of no reason" response to an inquiry could be viewed as belonging to that family of relatively benign, noncommittal responses that includes the "no developments" and the "no comment" responses. See *infra* notes 107-119 and accompanying text.

have explained an increase in trading volume. Implicit in the court's analysis is the assumption that Heublein's internal information-handling procedures were adequate. If the procedures were adequate, no leak of acquisition negotiations would have been probable. Absent insider trading, merger discussions cause unusual market activity only when leaked to other investors. Knowing neither of leaks nor of insider trading, Heublein's "aware of no reason" response was literally true.

The Third Circuit went on to hold that preliminary merger negotiations are immaterial as a matter of law, because negotiations ordinarily become material only when fundamental agreement has been reached as to the price and structure of the acquisition.<sup>9</sup> The court explicitly rejected any "intent of the parties to merge" standard of materiality.<sup>10</sup>

In the latter matter the *Heublein* court was assisted by its earlier holding in *Staffin v. Greenberg*.<sup>11</sup> In that case the court had expounded at length:

The reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may itself be misleading. A substantial body of opinion suggests that disclosure of preliminary discussions would, by and large, do more harm than good to shareholders and the values embodied in the antifraud provisions of the Act.<sup>12</sup>

The court followed with additional explanation:

Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left "holding the bag" on a stock whose value was inflated purely by an inchoate hope. If the announcement is withheld until an agreement in principle on a merger is reached, the greatest good for the greatest number results. If the merger occurs, all of the company's shareholders usually benefit; if no merger agreement is reached, the stock performs as it would have in any event.<sup>13</sup>

Important to note, however, is that the *Heublein* court's reliance on *Staffin* may have been, to a degree, misplaced. In *Staffin* target com-

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9. *Id.* at 756 (citing *Staffin v. Greenberg*, 672 F.2d 1196, 1206 (3d Cir. 1982)).

10. *Id.* at 757.

11. 672 F.2d 1196 (3d Cir. 1982).

12. *Id.* at 1206 (citation omitted).

13. *Id.* at 1207 (footnote omitted).

pany Bluebird, Inc. made no statements whatsoever. In that situation it is now generally conceded that, absent trading in its own stock, no duty to speak exists.<sup>14</sup> As a matter of technical disclosure law, *Heublein* stands on a different footing: Once a target such as Heublein does speak it must not do so in an incomplete or misleading way.

### B. *The SEC Position*

A major Carnation Company shareholder began the sequence of events that lead to the SEC's pronouncements in *In the Matter of Carnation Co.*<sup>15</sup> Dissatisfied with Carnation's stock's performance, the shareholder had approached an investment banker about a possible acquisition of Carnation by another company. Nestle, S.A. surfaced as a potential purchaser. One of Nestle's first acts was to inform Carnation management that Nestle would terminate discussions if Carnation made any public disclosure of Nestle's contacts with Carnation.<sup>16</sup>

One month later unusual activity in Carnation's stock caused a rise of 4 5/8 in price and the first of two public announcements. The treasurer of Carnation, whose responsibilities included responding to media inquiries but who had no knowledge of any acquisition discussions, stated that "[t]here is no news from the company . . . that would account for the stock action."<sup>17</sup> Two days later the negotiators were still far apart, with Nestle offering \$75 per share and Carnation senior officials thinking of \$90.

Twelve days later Carnation's stock price surged again, to a high of 71 1/2. The uninformed Carnation spokesperson spoke again, in qualified terms: "[T]o the best of my knowledge there is nothing to substantiate either [rumor of Carnation's being acquired]." He added, "We are not negotiating with anyone."<sup>18</sup> Two weeks later Nestle and Carnation announced agreement for Carnation to be acquired at \$83 per share.

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14. See, e.g., *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128, 132-33 (S.D.N.Y. 1984). *Schlanger* is discussed in *infra* notes 34-46 and accompanying text. See also Brown, *supra* note 3, at 750-53 (discussing the general rule of nondisclosure); Sheffey, *Securities Law Responsibilities of Issuers to Respond to Rumors and Other Publicity: Reexamination of a Continuing Problem*, 57 NOTRE DAME LAW. 755, 756-66 (1982) (noting that affirmative disclosure obligation turns on whether rumors are "attributable" to the issuer).

15. *Carnation* release, *supra* note 1, at 87,593.

16. *Id.* at 87,593. Such secrecy is, of course, in the purchaser's interest to prevent rises in the target's stock price.

17. *Id.* at 87,594.

18. *Id.*

The SEC position accepts that an issuer has no duty voluntarily to come forth with disclosure of acquisition discussions, save when the issuer is trading in its own shares.<sup>19</sup> If an issuer chooses to make a statement or respond to an inquiry, however, then the SEC position is that the statement must be absolutely accurate. "Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit an issuer from making public statements that are false or that . . . make the statements made, in light of the circumstances under which they are made, not misleading."<sup>20</sup> Thus, "[w]henver an issuer makes a public statement or responds to an inquiry . . . the statement must be materially accurate and complete."<sup>21</sup> Last of all, "[a]n 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. . . . The Commission believes that *Heublein* [with its contrary conclusion] was wrongly decided."<sup>22</sup>

According to the SEC, the Carnation Company treasurer's statements that Carnation was not negotiating with anyone or that to the "best of his knowledge" there was nothing to substantiate the rumors, innocent though they may have been, were materially false and misleading and deserving of enforcement action.<sup>23</sup>

The only appellate decision the SEC cited in *Carnation*, and the principal decision upon which the commentators rely, is *SEC v. Texas Gulf Sulphur Co.*,<sup>24</sup> the decision that astounded the corporate world by presaging open-ended liability for a corporation that had misspoken but had neither traded nor engaged in any other activity even remotely described as nefarious.<sup>25</sup> After a vast mineral discovery

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19. See, e.g., *Brown*, *supra* note 3, at 750-53, 761-72. The Commission also recognizes that its only authority for requiring disclosure is the ubiquitous and opaque rule 10b-5, 17 C.F.R. § 240.10b-5 (1986). *Id.* at 747. *Accord* Sheffey, *supra* note 14, at 760-64 ("[T]he most persuasive aspect of these decisions is that . . . even during the climate of the ever-expanding jurisprudence of 10b-5, not one court held that there was an affirmative general obligation to disclose." (footnote omitted)).

20. *Carnation* release, *supra* note 1, at 87,595 (paraphrasing clause (2) of rule 10b-5).

21. *Id.*

22. *Id.* at 87,596 & n.8.

23. *Id.* at 87,596-97.

24. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

25. See *id.* Nearly a generation of lawyers has now read *Texas Gulf Sulphur* without being aware of or reflecting upon just how astounding the case was when first decided or about how astounding it still may be. For a contemporaneous account, see Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 Nw. U.L. REV. 872, 894-95 (1967) (arguing that elimination of any privity or semblance of privity means "liability to vast numbers of plaintiffs may result"; liability should at least be limited to defendant's illicit gains, if any).

Texas Gulf Sulphur issued a press release, to abate rumors and buy time in which to decide upon a proper course of action.<sup>26</sup> The press release was literally true. It stated that Texas Gulf Sulphur for a number of years had been engaged in exploration activity in northern Ontario but had largely discovered only barren pyrite and similar worthless minerals. Approximately five days later Texas Gulf issued another, more accurate press release, revealing what was said to be "one of the most impressive drill holes completed in modern times."<sup>27</sup> The literal truth of the first press release availed Texas Gulf Sulphur naught. The company's potential liability ran to \$390 million,<sup>28</sup> even though the company had not traded and arguably had in no other way benefited from the errant press release.

*Texas Gulf Sulphur*, then, stands for two propositions. First is the obvious aspect upon which the SEC relies: When an issuer does choose to speak, statements by it must be materially complete and not misleading, even though there had been no duty to speak in the first place. Second, and less obvious, is that the literal truth of the statement does not end the analysis. Thus, qualifiers added to statements to make them literally true, such as the "aware of no reason" qualifier accepted in *Heublein*, or the "to the best of my knowledge" qualifier rejected in *Carnation*, do not free the issuer of liability or enforcement action.

### C. Other Prior Decisions

Two earlier cases often appear in discussions regarding disclosure of acquisition negotiations. In *Reiss v. Pan American World Airways*<sup>29</sup> the Second Circuit considered a suit against an acquiring corporation rather than the target. At the start of a program to redeem Pan Am convertible debentures, Pan Am failed to disclose that simultaneously it was engaged in acquisition negotiations with National Airlines. That acquisition would have been viewed as quite favorable for Pan Am, giving it significant domestic route capacity for the first time in many years. One week later Pan Am did disclose

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26. The purpose of the press release was to abate rumors in order to facilitate the acquisition of additional mining claims in the region of its discovery; by the time of the erroneous press release, however, the company had apparently largely completed that process. See 401 F.2d at 843-44.

27. *Id.* at 850.

28. See Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. REV. 423, 429 (1968) (noting the \$390 million potential liability, approximately \$150 million more than the net worth of the Texas Gulf Sulphur Co. at that time).

29. 711 F.2d 11 (2d Cir. 1983).

the National merger negotiations but did not tie that disclosure specifically to the redemption program.<sup>30</sup> The following week Pan Am announced that it was expanding, and later completed the redemption program.

Judge Winter declined to find a duty for Pan Am to have disclosed its acquisition negotiations at the earlier point when the debenture redemption program had begun. The plaintiffs, he found, confused disclosure of material facts under the securities laws with "consistency in corporate public relations decisions."<sup>31</sup> Although the former is by law required, the latter is not. In addition, materiality in merger negotiations is not lightly to be implied:

It does not serve the underlying purposes of the securities acts to compel disclosure of merger negotiations in the not unusual circumstances before us. Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned. . . . We have no doubt that had Pan Am disclosed . . . and had those negotiations failed, we would have been asked to decide a section [sic] 10b-5 action challenging that disclosure.<sup>32</sup>

*Reiss* thus evidences a robust skepticism toward plaintiffs' claims that acquisition negotiations should have been disclosed or were disclosed in a misleading way and has been cited for that proposition.<sup>33</sup>

*Schlanger v. Four-Phase Systems, Inc.*<sup>34</sup> precedes the SEC release in *Carnation* but follows *Heublein* in time, although decidedly not in spirit. In his opinion Judge Briant shows an obvious sympathy for plaintiffs, an utter lack of empathy for corporate officials, and none

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30. *Id.* at 13.

31. *Id.* at 13-14.

32. *Id.* at 14 (citations omitted). Judge Winter went on to find that Pan Am lacked the scienter, or state of mind, that *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), requires. 711 F.2d at 14.

33. Viewed in one light, however, *Reiss* is only a silence or nondisclosure case, in which no duty to disclose has been authoritatively asserted. See *supra* notes 19-22 and accompanying text. Viewed another way, though, the case does involve incomplete disclosure, and the court declined to invoke the *Texas Gulf Sulphur* proscription of disclosure in a literally true but incomplete manner. The first Pan Am press release announcing the redemption program was literally true, but in the larger frame of things it was incomplete. However, Judge Winter's statement that the law does not require consistency in corporate communications indicates that he probably did not adopt the latter view. Logical consistency might have forged a link between the redemption program and the acquisition negotiations, but Judge Winter and his colleagues refuse to link the two as a matter of law.

34. 582 F. Supp. 128 (S.D.N.Y. 1984).



of the skepticism for plaintiffs' claims that *Heublein*, *Staffin*, and *Reiss* exhibit.

Early in 1981 defendant Four-Phase approached its investment banker and began a process of attempting to be acquired. General Dynamics Corp., McDonnell Douglas Corp., and Motorola all expressed an interest in acquiring Four-Phase.<sup>35</sup> The search for a partner went forward over a number of months and in fits and starts.<sup>36</sup>

In October and November of 1981 Four-Phase's investment banker concentrated its efforts on Motorola, and the other potential acquirers drew out of sight. The putative partners exchanged increasingly detailed information. On November 23 and 24 Motorola's chairman visited Four-Phase's headquarters. No offer, however, had yet been made. On December 2 Four-Phase trading volume on the NYSE increased the telltale tenfold, and the price increased 6 1/2 points.<sup>37</sup> The treasurer of the company then disseminated a *Heublein*-like announcement that "[t]he Company is not aware of any corporate developments which would affect the market of its stock."<sup>38</sup> On December 8 the NYSE halted trading. On December 10 Four-Phase announced a stock-for-stock transaction with Motorola valued at \$45 per share. As is typical in these cases, plaintiff brought a class action seeking damages on behalf of all those who sold subsequent to the allegedly misleading press release and thereby forewent the eventual, more dramatic gain.<sup>39</sup>

The Four-Phase defendants argued that merger negotiations are "inherently fluid" and, therefore, are not material. More pragmatically, a disclosure requirement would make merger negotiations "virtually impossible."<sup>40</sup> Wasting no time, Judge Briant "at the outset" found the *Heublein* decision to be "wrong, essentially because it fails to distinguish between cases involving false or misleading statements, and situations involving a decision merely to remain silent . . . ."<sup>41</sup> From that point of departure the case became for Judge Briant cut and dried:

[T]his Court concludes . . . that defendants, having chosen

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35. *Id.* at 131.

36. At one point, all discussion ceased as Four-Phase sold a public offering of debentures.

37. *Id.* at 130. The price increase in *Heublein* also resulted from a nearly tenfold increase in trading volume. 742 F.2d at 754 n.1.

38. 582 F. Supp. at 129.

39. *Heublein*, *Staffin*, *Reiss*, and *Texas Gulf Sulphur* were all class actions of that nature.

40. 582 F. Supp. at 131.

41. *Id.* at 132.

to issue a public statement . . . , were required to include in that statement . . . every "material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."

Plaintiff apparently concedes, and the Court agrees, that Four-Phase could have remained silent . . . .<sup>42</sup>

The court went on to recite the *Texas Gulf Sulphur* rubric: "While the federal securities laws do not impose a general duty upon an issuer to disclose . . . when it is not trading in its own securities, it does have a duty to make certain that any statement it does issue is truthful and complete . . . ."43

The judge also swiftly dismissed remaining defenses, such as the absence of scienter that *Ernst & Ernst v. Hochfelder* and its progeny<sup>44</sup> demand:

[C]onclusory statements that high volume and sudden price rises had occurred before, or that the company did not have direct knowledge of leaks . . . , or that there was no information indicating a "breach of confidentiality" regarding the negotiations with Motorola [do not] lead inevitably to the conclusion that the defendants acted without scienter. The trier of fact . . . could find that defendants acted recklessly, because they were aware of unusual market activity in Four-Phase's stock . . . and no other possible concurrent causative event or fact was known to them . . . .<sup>45</sup>

Thus, the two prior decisions reviewed seem to line up firmly in one camp or the other, despite the *Four-Phase* court's confident distinguishing of *Reiss* and *Staffin* as silence cases.<sup>46</sup> The latter two fit nicely with *Heublein* in exhibiting an empathy for target company officials and a skepticism for plaintiffs' claims. On the other hand, the *Four-Phase* opinion fits nicely with *Carnation*, viewing these matters as essentially cut-and-dried applications of a rule of complete truth when any disclosure is undertaken at all.

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42. *Id.* (quoting rule 10b-5).

43. *Id.* at 133 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).

44. 425 U.S. 185 (1976). For a review of *Hochfelder's* progeny, see Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087, 1100-08 (1984).

45. 582 F. Supp. at 135 (citations omitted).

46. *Id.* at 133-34.

*D. Subsequent Decisions*

So, too, do the reported cases subsequent to *Carnation* come down firmly in one camp or the other. Much like the *Four-Phase* decision, *Levinson v. Basic Inc.*<sup>47</sup> involved protracted, and at times desultory, acquisition negotiations. In fact, Combustion Engineering, Inc. had first indicated an interest in acquiring Basic in 1965 or 1966. In 1976 the Federal Trade Commission redefined the relevant product market, making such an acquisition less problematic from an antitrust standpoint.<sup>48</sup> A Combustion Engineering group vice-president then began a series of contacts with Basic that were to last until the announcement of an acquisition two years and three months later. During that time Combustion's interest rose from prices of \$18-22 per Basic share to the eventual acquisition price of \$46 per share.<sup>49</sup> Also, during this protracted period, there were several short bouts of trading activity in Basic shares. Each was met by Basic's response that it was "unaware of any present or pending corporate development that would result in the abnormally heavy trading activity."<sup>50</sup>

The Sixth Circuit adopted the SEC and *Texas Gulf Sulphur* cut-and-dried approach: There may be no duty to disclose, but once any disclosure is made, complete truth and accuracy must prevail.<sup>51</sup> More interesting is the court's treatment of materiality and the background of more than fourteen years' interest by the acquirer.

Basic's statement that "no negotiations" were occurring was . . . misleading, if not patently untrue. Basic argues that the denial was technically correct because no discussions occurred which would satisfy the legal definition of "negotiations." The average investor does not necessarily know the technical and legal definition of these words . . . . A statement that "no negotiations" were occurring could reasonably be read to state that no contacts of any kind whatsoever regarding merger had occurred. Be-

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47. 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (1987).

48. *Id.* at 743.

49. The district court opinion takes 35 pages to recite and review the twists and turns and lengthy nature of the discussion and negotiation that finally led to the acquisition. See *Levinson v. Basic Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,801, at 90,011-46 (N.D. Ohio Aug. 3, 1984).

50. 786 F.2d at 745. In addition, the acquiring company made the following statement early in its two-and-a-half year approach: "[T]he company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger." *Id.* at 744.

51. *Id.* at 746 (citing, *inter alia*, the SEC's position in the *Carnation* release, *supra* note 1).

cause of the "Strategic Plan" of [acquirer] Combustion regarding Basic, had there been only one telephone call . . . this statement would have been clearly untrue.<sup>52</sup>

The Sixth Circuit thus seems to go a step beyond a no-fault approach and makes the target also bound by the acquirer's activity and intentions. Additionally, contrary to *Heublein*, which held that acquisition discussions or negotiations do not become material until there has been an agreement in principle to merge,<sup>53</sup> the Sixth Circuit opines that even the earliest contacts with a would-be acquirer may rule out use of noncommittal target company responses.<sup>54</sup>

Diametrically opposed to *Levinson's* approach is that of Judge Shadur in *Guy v. Duff & Phelps, Inc.*<sup>55</sup> "[D]isclosure is mandated only when agreement, or at least an 'agreement in principle,' has been achieved." Moreover, "[n]o 'agreement in principle' is reached until the parties have at least agreed on both price *and* the structure of the deal."<sup>56</sup> Later in his opinion Judge Shadur elaborates, seemingly with the benefit of a real world perspective:

Jeffries' [the acquirer's representative] testimony indicates a tentative agreement as of July 29, 1983 on the total purchase price and the fact the deal would be for cash rather than stock. Jeffries spoke *only* of those terms. Nothing in his testimony could lead to an inference the myriad other aspects of the deal had been worked out. And of course anyone who has handled major corporate acquisitions knows a \$50 million transaction necessarily involves much more than the bottom-line number to reflect the "agreement in principle" that triggers disclosure.<sup>57</sup>

*Guy* involves no public pronouncement, errant or otherwise, and thus is a silence case rather than an allegedly misleading disclosure case.<sup>58</sup> On the issue of materiality, however, *Guy* stands in stark

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52. *Id.* at 747.

53. 742 F.2d at 758. *See supra* notes 6-10 and accompanying text.

54. Indeed, the Sixth Circuit opinion can be read to say that an affirmative disclosure, complete truth obligation may arise at that early point, even against the background of ten years' unfocused interest by the acquirer.

55. 628 F. Supp. 252 (N.D. Ill. 1985).

56. *Id.* at 255 (citing *Heublein*, 742 F.2d at 756; *Reiss v. Pan Am. World Airways*, 711 F.2d 11 (2d Cir. 1983)). On the following page Judge Shadur quotes *Reiss* as explaining "[w]hy disclosure is not required—why instead it is actually improper in securities law terms—before all the significant components of a deal have been worked out. . . ." 628 F. Supp. at 256.

57. 628 F. Supp. at 259 (citation to deposition omitted) (emphasis in original).

58. Plaintiff nonetheless stated a claim because the corporation had been trading in its own shares. In fact, in those trades the plaintiff had been the seller to the corpora-

contrast to *Levinson*. In fact, the two cases widen further the already considerable distance between the two lines of authority of which each is a part.<sup>59</sup>

Seldom will a lawyer see two such clear lines of authority so rapidly developed, far apart, and diametrically opposed. That is true both on the issue of when acquisition negotiations become material and therefore must be disclosed if the target breaks its silence, and the related issue of when literally true target company responses, intended to be noncommittal, become misleading. Ordinarily, an irreconcilable split between lines of authority might be of no moment outside of the litigation context. Preventive law advice would be to follow the most conservative approach: Disclose earlier rather than later. If error is possible, err on the side of accuracy and completeness.<sup>60</sup> But that easy preventive law advice cannot be given in this context, because it does not take into account the other great pressures and conflicting duties that law, markets, and the reality of a modern world place upon target companies—pressures of which the SEC and some courts seem blissfully unaware.

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tion. Nonetheless, the facts of this case give rise to little sympathy for plaintiff, a Duff & Phelps employee who had been competing with his employer on a moonlighting basis. Given a choice of his competing business or continued employment, he chose the former and had to sell Duff & Phelps shares back to the company.

59. In the nearly contemporaneous case of *Jordan v. Duff & Phelps, Inc.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,724 (N.D. Ill. 1986), another departing Duff & Phelps employee sued, alleging nondisclosure of the Security Pacific negotiations. Finding lack of materiality—based upon the Third Circuit approach in *Heublein*, the Second Circuit in *Reiss*, and Judge Shadur in *Guy v. Duff & Phelps*—Judge Leinenweber found no duty to disclose and granted summary judgement for defendants. *Id.* at 93,517. The Seventh Circuit reversed, holding that the price-and-structure materiality rule was inapplicable to close corporations because the same concern about information leaks did not exist and because a stronger fiduciary duty existed in cases of face-to-face dealings with employee shareholders. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 434-36 (7th Cir. 1987). Thus, the Seventh Circuit has taken an in-between position. Compare *Flamm v. Eberstadt*, 814 F.2d 1169, 1177 (7th Cir. 1987) (“[s]ilence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time”) with *Jordan*, 815 F.2d at 431 (“Things are otherwise for closely held corporations.”). But see *Jordan*, 815 F.2d at 444-52 (Posner, J., dissenting).

60. See, e.g., M. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES*, §§ 2.12.3 to 3.14.4 (1986) (“Counsel would be ill-advised to rely on *Heublein*. The decision is contrary to the position taken by a number of other courts as well as the SEC. . . . From a counseling point of view, the SEC’s release in *Carnation* in effect nullifies *Heublein*.”) (footnotes omitted). Strictly as a matter of current law, Professor Steinberg is undoubtedly correct.

## II. LACK OF CONGRUENCE WITH THE SUPREME COURT'S POLICY PERSPECTIVE IN THE SECURITIES LAW AREA

The linchpin for the SEC's and the Sixth Circuit's complete-truth point of view is the decision in *Texas Gulf Sulphur*.<sup>61</sup> Hence, it is necessary to give additional scrutiny to that landmark decision and to examine its congruence with the more recent Supreme Court decisions, especially in regard to its findings concerning the corporate issuer's liability. In *Texas Gulf Sulphur* Judge Waterman paid sonorous allegiance to "accurate and truthful divulgence of detailed results."<sup>62</sup> In remanding the case to the district court for a finding on the issue of whether the press release had been misleading, Judge Waterman seemed to have prejudged the issue. "The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency" and "It would have been more accurate to have stated that the situation was in flux" were his conclusions on the matter.<sup>63</sup> From a policy standpoint, Judge Waterman viewed the strict truth-and-accuracy approach necessary to avoid the temptation for corporate officials to use evasive and noncommittal responses to mask illicit activity.<sup>64</sup> It was not necessary that any insider had traded or intended to do so, for the Second Circuit designed its approach using the prospect of astounding corporate liability to remove even a temptation for corporate officials to trade.<sup>65</sup> In turn, removal of any temptation to trade was a ramification of the Court's beginning premise: "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ."<sup>66</sup>

In its two leading decisions on rule 10b-5 the Supreme Court has explicitly rejected that premise:

[T]he SEC's theory of . . . liability in both [Supreme Court] cases appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that

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61. See *supra* notes 24-28 and accompanying text.

62. 401 F.2d at 864.

63. *Id.*

64. *Id.* at 858-59 (citing H.R. REP. No. 1383, 73d Cong., 2d Sess. 11 (1934)). This part of the House Report, however, does not address the catchall antifraud rule, but rather the affirmative disclosure and reporting sections of the Securities Exchange Act of 1934. See 401 F.2d at 885 (Moore, J., dissenting).

65. 401 F.2d at 860-62. This becomes doubly evident when the court's view on state of mind is examined. See *infra* notes 69-72 and accompanying text.

66. *Id.* at 848.

only some persons, under some circumstances, will be barred from trading while in possession of material, non-public information. Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: "[T]he 'information' theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws."<sup>67</sup>

Use of the equality-of-information theory to police not those who trade but only those who have a possible temptation to trade, and to do so through the prospect of Draconian liability for the nontrading corporate issuer, seems doubly dissonant with the Supreme Court's finding.<sup>68</sup>

The *Texas Gulf Sulphur* decision is also out of step with much of the Supreme Court's discussions of scienter, or state of mind, under the rule. The *Texas Gulf Sulphur* court seemed completely outcome-oriented:

[W]e must again underscore at the risk of repetition that the investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance. . . . Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.<sup>69</sup>

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67. *Dirks v. SEC*, 463 U.S. 646, 657 (1983) (footnote omitted) (discussing *Chiarella v. United States*, 445 U.S. 222 (1980)).

68. See 463 U.S. at 654:

In examining whether *Chiarella* had an obligation to disclose or abstain, the Court found that there is no general duty to disclose before trading . . . and held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." Such a duty arises rather from the existence of a fiduciary relationship.

Not "all breaches of fiduciary duty in connection with a securities transaction," however, come within the ambit of Rule 10b-5. *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977). There must also be "manipulation or deception." *Id.* at 473 (footnote omitted; citations omitted).

69. 401 F.2d at 861-62 (footnote omitted; citation omitted). The court also stated: To render the Congressional purpose ineffective by inserting into the statutory words the need of proving not only that the public may have been misled by the release, but also that those responsible were actuated by a wrongful purpose

Subsequently, the Supreme Court has twice made clear that a private plaintiff or the Commission must prove scienter in section 10(b) actions,<sup>70</sup> and has also gone out of its way to condemn precisely the outcome-oriented reasoning found in *Texas Gulf Sulphur*.<sup>71</sup> In fact, the argument can be made that if an allegedly misleading disclosure occurs when the defendant had no legal obligation to disclose, as in the acquisitions context, the scienter or state of mind requirement should scale upward.<sup>72</sup>

### III. LACK OF CONGRUENCE WITH THE REALITIES OF CORPORATE LIFE TODAY

Cutting against the more exacting standard of the SEC and the Sixth Circuit and against a finding that the requisite state of mind is present is the factual setting in which these cases arise. The pressures on a target company can be great. If disclosure is made and

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when they issued the release, is to handicap unreasonably the Commission in its work.

*Id.* at 861.

70. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (damages); *SEC v. Aaron*, 446 U.S. 680 (1980) (injunctive relief).

71. Compare *Texas Gulf Sulphur*, 401 F.2d at 860:

Congress . . . intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon . . . There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the [securities laws] unless they engaged in a related securities transaction or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public . . . would be seriously undermined by applying such a gloss onto the legislative language. . . . [T]he investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose.

with *Hochfelder*, 425 U.S. at 198-99:

The Commission . . . reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.

72. See, e.g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300 (2d Cir. 1973) (comparing voluntary press release with proxy statement required by law). This type of sliding-scale analysis is prevalent in rule 10b-5 cases, particularly in the Second and Ninth Circuits. See, e.g., Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327, 350-55 (1986); Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50, 55-66, 91-95 (1977).



the acquisition does not take place, the target company fears that it may be sued by those investors who had purchased in anticipation of the transaction.<sup>73</sup>

Although in theory these disappointed purchasers have the requisite standing and a seemingly prima facie cause of action,<sup>74</sup> such is not evident in the reported cases. Instead, it is internally generated corporate pressure, rather than the threat of suit by disappointed purchasers, that tends to cut against disclosure at an early point. Even though suits by disappointed purchasers are not common, corporations undoubtedly treasure whatever credibility they have in the markets. Premature disclosures can erase whatever stock of credibility a company may have accumulated.

Another pressure is the confidentiality requirement participants in negotiations put upon themselves for a number of reasons. One reason for this pressure is to reduce or eliminate the possibility of insider tipping or trading. A second reason is to retain credibility in the markets. The third reason is to preserve a less pressured environment for negotiation of all the material elements of the bargain, which can often include much more than the price and structure to which courts have referred.<sup>75</sup> Integration of the corporations' senior managements, plant closings and elimination of duplicate staff and facilities, and similar details may be key ingredients in the bargaining process.<sup>76</sup> The limelight that disclosure generates may increase beyond the breaking point the already considerable pressure to reach an agreement.

A third pressure is the pledge of confidentiality the acquiring company often will put upon the target.<sup>77</sup> As with best efforts and no-shop clauses, breakup or cancellation fees, and leg-up and lock-up options,<sup>78</sup> the acquirer swears the target company to secrecy in

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73. Several courts have noted this problem. See, e.g., *Staffin v. Greenberg*, 672 F.2d 1196, 1206-07 (3d Cir. 1982).

74. Since they have purchased, they have the standing requisite for rule 10b-5 plaintiffs. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1953).

75. See, e.g., *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985) (explaining that acquisition negotiations ordinarily become material when agreement has been reached as to price and structure).

76. See Mitchell, Stewart & Paul, *International Paper to Buy Hammermill: Agreement for \$1.1 Billion Tops an Unwanted Offer by Bilzerian-Led Group*, Wall St. J., Aug. 12, 1986, at 3, col. 3-4 (noting that retention of target company headquarters in Erie, Pa. was deemed an essential element of the transaction).

77. This occurred in the *Carnation* case. See *supra* note 16 and accompanying text.

78. A lock-up or leg-up option has been defined as:

An advantage obtained by a bidder designed to preclude competitive bids or

order to guard against any untoward rise in the target share price. Confidentiality also prevents or delays an auction for the target from developing. Overuse of these devices, however, has led courts to rule that the fiduciary duties of target company directors override the contractual provision implementing the device, particularly when use of the device is seen as chilling rather than facilitating the bidding process.<sup>79</sup> The key for acquirers then will become the use of some of the devices to inhibit development of an auction without seeming to do so. But a by-product of that development will be even additional acquirer pressure to maintain confidentiality as a replacement for reduced permitted use of the other devices used in negotiated acquisitions to favor one bidder over any other. The longer confidentiality can be maintained, the less time there will be for an auction to develop.

A fourth pressure is target-company generated. Once disclosure of acquisition negotiations takes place, arbitrageurs move into the target company stock.<sup>80</sup> Although individual investors might be quite sensible in selling shortly after an initial announcement, target company managers abhor the resulting accumulation of stock in arbitrageurs' hands. Managers may claim a preference for receipt of the entire gain by faithful shareholders and not by fickle arbitrageurs. Managers' real fear, however, is the current market milieu in which, with good reason, arbitrageurs and other market professionals believe that they can make something happen. The target company

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furnish an edge over other bidders. The lock-up may, for example, consist of an option or shares . . . . An option on 50% of the target shares would, for example, preclude competition. A lock-up may also consist of a crown jewel option or purchase, especially at a bargain.

SOLOMON, SCHWARTZ & BAUMAN, *supra* note 7, at 329.

No-shop and best efforts clauses are discussed at *infra* notes 87-96 and accompanying text. Hello and goodbye fees, also known as engagement and cancellation fees, and their use, are described in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 269 (2d Cir. 1986). These devices have received varied treatment upon legal attack. See *infra* notes 88-103 and accompanying text.

79. See *infra* notes 92-100 and accompanying text.

80. As has been recently learned, however, arbitrageurs often move into target company stock before disclosure of the agreement or other announcement. See, e.g., Stewart & Hertzberg, *Spreading Scandal: Fall of Ivan F. Boesky Leads to Broader Probe of Insider Information*, Wall St. J., Nov. 17, 1986, at 1, col. 6.

It is surprising how many individual and other investors are content with the gain in price an initial announcement produces. Many investors are content to give up the remaining increment of potential gain, along with the risk that the acquisition may fall through, to risk arbitrageurs. See Jensen, *Don't Freeze the Arbs Out*, Wall St. J., Dec. 3, 1986, at 26, col. 4-6 (arguing that arbitrageurs "provide risk-bearing services for investors who do not wish to bear the great uncertainty that occurs between the announcement and final outcome of a takeover bid or restructuring").

that makes a premature disclosure only to have the acquisition fall through will be faced with another, less friendly proposal.<sup>81</sup>

“[R]umors start to fly, the money managers sell when the stock reaches a certain level above what they paid for it, it's grabbed up by speculators, and the company is in play.”<sup>82</sup> Once a company is in play the belief is that a bustup or takeover is “inevitable.”<sup>83</sup> These beliefs and the pressures thereby generated give target managers an incentive to prevent leaks and rumors. They also create an incentive to disclose negotiations later rather than sooner, and make more understandable target managers' felt need to make noncommittal “no developments” or “aware of no reason” replies to press or other inquiries concerning possible acquisition negotiations.<sup>84</sup> Finally—Judge Briant's comments in the *Four-Phase* case to the contrary<sup>85</sup>—the pressures that target company managers feel is underscored by the state of mind requirement the Supreme Court has so emphatically demanded for liability under rule 10b-5.<sup>86</sup>

#### IV. LACK OF CONGRUENCE WITH RECENT STATE LAW DEVELOPMENTS

A cost of compliance with the SEC's and Sixth Circuit's complete-truth, sooner-rather-than-later approach is that such a call for disclosure cuts against trends emerging under state law. In the state law realm, the case that has received widest publicity is *Texaco, Inc. v. Pennzoil Co.*<sup>87</sup>

In *Pennzoil* plaintiff Pennzoil Co. entered into a preliminary agreement, an agreement in principle, or some sort of arrangement to acquire working control of Getty Oil Co.—or so Pennzoil had thought. Versions of what had taken place varied, as did the charac-

81. That proposal may be for another acquisition, or for the purchase by the target company of an arbitrager's or other takeover player's shares in a greenmail transaction. Greenmail payments inevitably produce adverse publicity, travail, and litigation, despite respectable theoretical arguments to the contrary. See Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985); Sandler, *Greenmail Is Infuriating Many Stockholders, but Fighting It Still Offers Little Satisfaction*, Wall St. J., Dec. 11, 1986, at 67, col. 3-4.

82. 16 Sec. Reg. & L. Rep. (BNA), 1721 (Nov. 2, 1984) (reporting remarks of Andrew C. Sigler, chairman and chief executive officer of Champion Int'l Corp.).

83. *Id.*

84. See *infra* notes 107-119 and accompanying text.

85. See *infra* note 45 and accompanying text.

86. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-15 (1976).

87. 729 S.W.2d 768 (Tex. Ct. App. 1987). See also *Texaco, Inc. v. Pennzoil Co.*, 784 F.2d 1133 (2d Cir. 1986).

terizations of any agreement that may have resulted.<sup>88</sup> Agreement did exist that whatever had been reached resembled more of a handshake deal than a definitive agreement. Despite whatever agreement existed, however, Texaco wrested Getty Oil away from Pennzoil by offering better terms.<sup>89</sup> Pennzoil then sued Texaco for \$7.5 billion actual and \$3 billion punitive damages for Texaco's interference.<sup>90</sup> At trial Pennzoil recovered all that it had sought. Handshake deals, or agreements in principle, were held to be enforceable and interference with them was perceived by the jurors as having "violated the ethical code of the oil patch."<sup>91</sup>

Thus, under *Pennzoil* merger negotiations may result in a binding contract and become material at an earlier point. If the target company then breaks its silence for any reason, the SEC's complete-truth approach requires disclosure of the merger negotiations. By far the greater weight of emerging state law, however, finds that corporate directors' fiduciary duties in effect override any contract and require directors to commit to any specific acquisition proposition only at the last possible moment.

For example, while *Pennzoil* was receiving wide publicity, a nearly identical case was winding its way through the Nebraska courts.<sup>92</sup> On the second merger attempt the boards of directors of bidder ConAgra, Inc. and target MBPXL, Inc. executed a letter of intent for a stock-for-stock merger. A short time later the two companies executed a definitive merger agreement. The agreement pledged the target's and its board of directors' best efforts to effec-

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88. See, e.g., Lippman, *Pennzoil Chairman to Take Woeful Tale into Courtroom; Executive Claims Getty Oil Deal Was Killed by Texaco Intervention*, Wash. Post, July 7, 1985, at K3, col. 1 (discussing dispute about effect of tumultuous 25 hour meeting of board of directors of Getty Oil).

89. *Id.* Texaco offered \$125 for every Getty share, while Pennzoil had agreed only to pay \$112.50 for three-sevenths of the Getty shares.

90. *Id.* Pennzoil did not join Getty Oil, Gordon Getty, and the Getty Museum because Texaco had agreed to indemnify those participants for any liabilities arising from their dealings with Texaco. *Id.* Any recovery from Getty interests, then, would ultimately come from Texaco. For that and other tactical reasons Pennzoil decided to proceed directly against Texaco and that source alone, although Pennzoil had obvious claims against target Getty.

91. Lippman, *Jury Awards \$10.53 Billion to Pennzoil in Texaco Case*, Wash. Post, Nov. 20, 1985, at A1, col. 2. The verdict was viewed as having done "everybody in this country a favor by reaffirming the standards by which American businesses and individuals are expected to conduct their business transactions." *Id.* (statement of Pennzoil Chairman J. Hugh Liedtke).

92. *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 382 N.W.2d 576 (1986). See generally Kalish, *ConAgra, Inc. v. Cargill, Inc., An Interpretive Essay: A Target Corporation May, But Need Not, Agree That Its Directors Serve as Auctioneers for Its Shareholders*, 65 NEB. L. REV. 823 (1986).

tuate the transaction. MBPXL's counsel, however, specifically bargained for and obtained a limitation on that contract language: "Provided, however, nothing herein contained shall relieve either Boards of Directors of their continuing duties to their respective shareholders."<sup>93</sup> Almost simultaneously with the execution of that agreement, two influential MBPXL shareholders approached Cargill, which had been observing the ConAgra-MBPXL dealings.

The approach to Cargill ultimately resulted in a \$27 per share cash offer, evaluated by MBPXL's investment banker as superior to the ConAgra merger offer.<sup>94</sup> The MBPXL board then voted to negotiate a mutual termination of the ConAgra merger and to recommend the Cargill bid to MBPXL shareholders. At that time ConAgra already had pending a suit against Cargill and MBPXL for injunctive relief and damages. Ultimately, the Nebraska trial court awarded ConAgra \$16 million in damages for tortious interference with contractual relations.<sup>95</sup> The Supreme Court of Nebraska reversed *per curiam*:

Once the directors of MBPXL learned of the competing Cargill offer, the "best efforts" clause in the ConAgra proposal could not relieve the MBPXL directors of their duties to act in the shareholders' best interests. They had an obligation at that point to investigate the competing offer, and if, in the exercise of their independent good faith judgment, they found that the Cargill offer was a better offer for the MBPXL shareholders, they were bound to recommend the better offer.<sup>96</sup>

Increasingly, courts have looked askance at no-shop and best efforts clauses and leg-up and lock-up options designed to aid a favored bidder.<sup>97</sup> They have done so particularly when the devices infringe on the voting rights of shareholders or chill the bidding

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93. 382 N.W.2d at 582. Of course, prior and subsequent decisions have held that such a provision would be an implied term of any agreement to merge or otherwise sell a company. *See, e.g.,* Great W. Producers Coop. v. Great W. United, 200 Col. 180, 613 P. 2d 873, 878 (1980) (finding that, in the absence of evidence to the contrary, best efforts clause in contract for sale of stock did not impose obligation that would conflict with directors' duties to security holders). *Cf. Jewel Cos. v. Pay Less Drug Stores N.W.*, 741 F.2d 1555, 1564 (9th Cir. 1984) (finding that target board can bind company to forbear from accepting competing offers until shareholders have opportunity to consider proposal, regardless of later, higher offer).

94. 382 N.W.2d at 585.

95. *Id.* at 579.

96. *Id.* at 588.

97. These terms are discussed, in part, at *infra* note 78.

process.<sup>98</sup> Once a decision to sell the company has been made, directors' fiduciary duties cause their role to "[c]hange from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders . . . ."<sup>99</sup> Hence, "[a] no-shop provision, like the lock-up option, while not *per se* illegal, is impermissible . . . when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder."<sup>100</sup>

Thus, under state law and contrary to the much publicized Texas decision in *Pennzoil*, in the mergers and acquisitions area "it ain't over until its over," to paraphrase a famous baseball player's line. The point at which discussions and negotiations move from a state of flux to taking shape, and possibly become material, is now much later in the process than has traditionally been thought.

As has been seen, however, some commentators<sup>101</sup> and most courts<sup>102</sup> opine that the directors' duty is to facilitate or conduct an auction once a decision has been made to sell the company. Early disclosure of the decision to sell or of the first bid, rather than non-disclosure or late disclosure, comports with the emerging state law duty to facilitate the bidding process. But such early disclosure should be viewed as ancillary to or required by state corporation law rather than federal securities law. Companies should remain free to test the acquisition waters or to speak to a potential bidder who approaches them, without putting their companies "in play" or being required to make disclosures at the first sign of inordinate trading in their stock. Thus, the *Heublein*, *Reiss*, and *Staffin*<sup>103</sup> views on disclosure and the flexibility they bestow, and not the SEC and Sixth Circuit view, fit more neatly with duties and costs imposed by state law.

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98. See, e.g., *Thompson v. Enstar Corp.*, 509 A.2d 578 (Del. Ch. 1984) (explaining that lock-up agreements should be carefully scrutinized to insure that they serve the best interests of the shareholders).

99. *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986).

100. *Id.* at 184. Of similar ilk are *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274 (2d Cir. 1986) (striking down target company's granting of lock-up option and holding that the "role of the court in an action to enjoin takeover measures is to allow the forces of the free market to determine the outcome to the greatest extent possible within the bounds of the law"); *Smith v. Van Gorkom*, 488 A.2d 858, 878-80 (Del. 1985) (viewing no-shop clause and leg-up option with skepticism).

101. Two leading pieces are *Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982), and *Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

102. See *supra* notes 96-100 and accompanying text.

103. See *supra* notes 6-14, 29-33 and accompanying texts.

## V. AN ANALYSIS OF ALTERNATIVE COURSES OF CONDUCT FOR ISSUERS

### A. *No Comment Responses*

Advocates of the SEC and Sixth Circuit point of view see responses of the "no comment" variety as preferable to what they view as the dissembling "aware of no developments" response.<sup>104</sup> No-comment responses, however, seem a certain tip to arbitragers, greenmail candidates, and other sophisticated professionals. Those players will treat a no-comment response as probative of the matter denied. Perhaps the only individuals who will be fooled by a no-comment response will be individual investors. No-comment responses thus will exacerbate inequality among investors, if not inequality of information among investors, a condition that the Commission continues to bemoan, Supreme Court admonitions to the contrary.<sup>105</sup>

### B. *The Matter of Corporate Policy Response*

A variant on the no-comment response is the corporate-policy response. In answer to an inquiry an issuer can state that "as a matter of policy the Company does not comment on acquisition negotiations or upon market rumors relating to acquisition negotiations." If the issuer has in the past been freely forthcoming with the media and with analysts, of course, a no-comment policy will have little credibility. In fact, the no-comment policy response may have the same reverse effect that a simple no-comment response is likely to produce. Put into place and consistently adhered to over months and years, however, a no-comment policy would gain credibility. Market professionals would become less able or willing to guess what lies beyond the no-comment facade.<sup>106</sup> The undesirable side effect, though, would be that the need to adhere consistently to the policy would prevent the company from making some communications it sorely wants to make. In that way, a no-comment policy would be antithetical to the goal of the securities laws, which is to promote a free flow of corporate disclosures.

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104. See, e.g., Brown, *supra* note 3, at 791; Grundfest, *supra* note 4, at 521 (reporting views of others); Sheffey, *supra* note 14, at 787-88.

105. See *supra* notes 66-68 and accompanying text.

106. But as Judge Easterbrook has noted: "No corporation follows the CIA's policy of saying 'no comment' to every inquiry; every firm regularly confirms or devises rumors as the securities laws and the stock exchanges' rules require." *Flamm v. Eberstadt*, 814 F.2d 1169, 1178 (7th Cir. 1987) (emphasis in original).

*C. Noncommittal Responses*

In this category fall the literally true "aware of no developments" responses the Third Circuit accepted in *Heublein*.<sup>107</sup> Often the maker of such a response is without guile or fault, or, alternatively, no fault is demonstrated. As discussed, the pressures on the target company to maintain confidentiality are considerable. The source of the leak or tip, which produces appreciation in the target's stock price and the resulting inquiry as to developments, could well be, and probably often is, an investment banking firm involved in the negotiations.<sup>108</sup> Alternatively, the source of the leak or tip could be the acquiring firm.<sup>109</sup> Yet, since selling plaintiffs' foregone gains occurred in the target company's stock, it is always the target company that becomes a defendant in a lawsuit.<sup>110</sup>

If target companies are at fault, as Judge Briant intimated in the *Four-Phase* case,<sup>111</sup> the fault is not grievous fault. Instead, the actions of target companies are quite understandable in light of the considerable pressures to maintain confidentiality and to disclose later rather than sooner.<sup>112</sup> Additionally, target companies have probably viewed "aware of no developments" as but a variation on the no-comment response. A corroboration of that view is contained in the New York Stock Exchange rule that calls for companies

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107. See *supra* notes 6-13 and accompanying text.

108. See, e.g., SEC v. Levine, 18 Sec. Reg. & L. Rep. (BNA) 709, 709 (S.D.N.Y. May 12, 1986) (charging managing partner of major takeover investment banking firm with reaping \$12.6 million in illicit profits by trading or tipping others to trade in 54 nonpublic merger, tender offer, leveraged buyout, and other corporate transactions). Indeed, it has come to light that in *Carnation* itself the source of the leaks was the investment banker and the purchaser of shares, none other than Ivan Boesky. See *Japlin v. Boesky*, No. 87C1186, reported at 19 Sec. Reg. & L. Rep. (BNA) 332 (S.D.N.Y. Mar. 6, 1987) (class action filed on behalf of Carnation shareholders who sold). See also Dorfman, *Arbitrators Face Investors' Suits on Inside Trades*, Wall St. J., Mar. 5, 1987, at 25, col. 3.

109. Again, however, as with the target company, the acquirer has an incentive to maintain confidentiality. Confidentiality will result in a lower acquisition cost for any toe-hold position the acquirer accumulates. Most acquirers do acquire toe-hold positions, in part, as a partial insurance policy against the possibility of a successful competing offer. The acquirer will at least earn a profit on sale of the toe-hold. In the event of a successful transaction, the acquisition of a toe-hold will result in lower overall average costs per share for the acquirer. Maintaining confidentiality for as long as possible is also believed to keep acquisition costs low by minimizing the chance of a rival bidder emerging.

110. But see *Litton Indus. v. Lehman Bros. Kuhn Loeb, Inc.*, 18 Sec. Reg. & L. Rep. (BNA) 1237 (S.D.N.Y. Aug. 19, 1986) (acquirer suit against investment banking firm for trading and tipping by employee, allegedly adding \$30 million to cost of target company stock).

111. See *supra* note 45 and accompanying text.

112. See *supra* notes 75-81 and accompanying text.



to respond in precisely those “aware of no developments” terms if a company either has no response or chooses to make no comment.<sup>113</sup> Quite ironically, companies that have taken the time to comply with NYSE or other self-regulatory organizations’ rules and have done so too literally have found themselves defending lawsuits for hundreds of millions of dollars.<sup>114</sup>

That prospect of astounding liability is to be contrasted with the degree of fault involved, and also with the potential liability of the defendant who actually does trade or tip. As Dean Ruder long ago observed,

[I]t would seem unjust to impose liability on a defendant who has not engaged in a securities transaction because he failed to disclose material information which he withheld in good faith for sound business reasons. Yet the latter result might be reached if one accepts the proposition that privity is not required, that good faith is not a defense, and that an affirmative duty to disclose exists.<sup>115</sup>

In the case of defendants who have actually traded or tipped, and thus clearly had the requisite state of mind, the courts have gradually come to limit damages. At first, courts required some causal connection between plaintiff’s alleged loss and defendant’s

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113. New York Stock Exchange Listed Company Manual § 202.03, *reprinted in* 3 Fed. Sec. L. Rep. (CCH) § 23,517 (1985).

114. The scope and nature of self-regulatory organizations’ rules, including those of the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers Automated Quotation (NASDAQ) systems are beyond the scope of this article. For a summary, see Brown, *supra* note 3, at 772-78; Sheffey, *supra* note 14, at 757-62. Those rules are further beyond the scope of this article because, a few early decisions to the contrary, violation of those rules has universally been held to not necessarily give rise to liability to investors. *Compare* *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 142 (7th Cir.) (whether a violation of exchange or dealer rules gives rise to federal civil liability depends on the nature of the particular rule and its place in the regulatory scheme), *cert. denied*, 396 U.S. 838 (1969) with Brown, *supra* note 3, at 776 n.144 (cases cited therein). The matter of a violation is between the self-regulatory organization and the company.

115. Ruder, *supra* note 25, at 899. *See also* Ruder, *supra* note 28, at 441:

[W]hen privity of contract is eliminated as an element in recovery . . . the real difficulty in justifying results occurs. When the misrepresenting or nondisclosing defendant has engaged in a securities transaction but not with the plaintiff (no privity), allowing recovery raises drastic implications since the defendant’s liability may far exceed the profit he made in his own transaction. If liability is justified on the ground that the defendant should bear the risk of misrepresenting, . . . his state of mind becomes crucial in assessing the fairness of such liability.

When the defendant has engaged in no transaction at all, as with target company defendants in these cases, unlimited liability seems doubly drastic and state of mind more crucial yet.

gain.<sup>116</sup> Later, although not returning to a strict privity requirement, courts limited the sum of all plaintiffs' recovery to the gain made or the loss foregone by the trading or tipping defendant.<sup>117</sup> Later decisions have narrowed the measure of damages still further, at least in selected cases.<sup>118</sup>

By contrast, and principally on the authority of *Texas Gulf Sulphur*, the nontrading, nontipping corporate defendant remains potentially liable for astounding amounts. The amounts can be so astounding that defendants settle before any court has the opportunity to relate the measure of damages to the relative lack of fault involved in these cases.<sup>119</sup> Courts have not had the opportunity to fashion some reasonable limitation on damages, as they have in cases of seemingly more culpable trading or tipping defendants.

## VI. CONCLUSION

Practical realities and considerable real world pressures thus lead to the conclusion that acquisition negotiations should be viewed as material later rather than sooner in the acquisition process. As a result, when target companies do speak, disclosure of any negotiation or possible agreement in principle should be required later rather than sooner. Courts should also permit target companies increased latitude to make truthful but noncommittal responses to media, analyst, and other inquiries, as did the Third Circuit in *Greenfield v. Heublein, Inc.*

More radically, the Securities and Exchange Commission should refrain from intervention or pronouncements in this complex area. So, too, courts should refrain from ruling on target company disclosures, at least on the basis of federal securities laws and in less than egregious cases. Alternatively, courts should strike out

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116. See, e.g., *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977) (holding that plaintiffs who traded on the impersonal market were unaffected by defendant's wrongful acts and were therefore not entitled to recover).

117. The leading case adopting this disgorgement-only approach is *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

118. See, e.g., *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983) (holding that insider need only disgorge that part of the profit attributable to the material investment information withheld rather than all profits made in the transaction). Cf. *Smith v. Van Gorkom*, 488 A.2d 858, 889 (Del. 1985) (rejecting, in the context of a state law duty of care violation, the view "that [liability] may result in a multi-million dollar class award against the defendants for having made an allegedly uninformed business judgment in a transaction not involving any personal gain, self-dealing, or claim of bad faith").

119. See, e.g., R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS*, 1085 (5th ed. 1982); Mullaney, *Theories of Measuring Damages in Securities Cases and the Effects of Damages on Liability*, 46 *FORDHAM L. REV.* 277, 277-79 (1977).

to limit the measure of damages for a target company that might be viewed as having misspoken in connection with acquisition negotiations. At present the potential liability is astounding and out of all proportion to the degree of fault involved.

Perhaps the most preferable of the alternatives is for courts and agencies to relegate disclosure of acquisition negotiations to state corporate law and the rules of self-regulatory organizations. State law fiduciary duties, and the auction model that state law is beginning to incorporate, will produce disclosure that best accommodates all the interests involved, including target company managers, shareholders who sell, and those who do not. Emerging state law concepts and duties in the acquisition context may produce the optimal amount of disclosure. From a legal realist perspective, state court common-law decisions and the trends evident in those decisions, viewed broadly, can be seen as a product of market forces far preferable to a federal agency's unilateral pronouncements, or agency reaction to judicial decisionmaking with which the agency does not happen to agree.