

5-1-1989

The Basics of *Disclosure*: The Market for Information in the Market for Corporate Control

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COMMENTS

The *Basics* of Disclosure: The Market for Information in the Market for Corporate Control

| | |
|---|------|
| I. INTRODUCTION | 1022 |
| II. CONGRESSIONAL INTENT AND THE MARKET FOR INFORMATION | 1025 |
| A. <i>The Policies Underlying Early Securities Legislation</i> | 1025 |
| B. <i>The Market for Information</i> | 1027 |
| 1. PROPERTY RIGHTS IN NONPUBLIC INFORMATION | 1032 |
| 2. THE SPECIAL CASE OF MERGERS AND ACQUISITIONS UNDER THE FREE MARKET THEORY | 1038 |
| C. <i>The Continuing Relevance of Full Disclosure</i> | 1040 |
| III. THE EVOLUTION OF CASE LAW DEFINING "MATERIALITY" | 1041 |
| A. <i>The Old Bright-Line Rule: Agreement-In-Principle</i> | 1042 |
| B. <i>The Supreme Court: Materiality is Fact Sensitive</i> | 1044 |
| IV. <i>BASIC RULING CREATES ADDITIONAL PROBLEMS</i> | 1045 |
| A. <i>Managers Do Not Know How to Behave</i> | 1046 |
| B. <i>Insider Trading Flourishes</i> | 1048 |
| V. DISCLOSURE: IS A MARRIAGE OF FAIRNESS AND EFFICIENT MARKETS POSSIBLE? | 1050 |
| A. <i>Disclose When an Agreement-In-Principle is Reached</i> | 1053 |
| 1. BENEFITS | 1054 |
| a. Protects Individual Investors from an Avalanche of Information ... | 1054 |
| b. Reduces Speculative Investing | 1054 |
| c. Preserves Confidentiality Preventing a Bidding War for the Stock of the Target Company | 1056 |
| 2. COSTS | 1057 |
| a. Individual Shareholders Unwittingly Sell | 1057 |
| b. Investors Lose Confidence in the Market | 1057 |
| B. <i>Early, Full Disclosure of Preliminary Takeover Discussions</i> | 1060 |
| 1. BENEFITS | 1060 |
| a. Investors Intelligently Evaluate Risk | 1060 |
| b. Inspires Investor Confidence and Market Integrity | 1061 |
| 2. COSTS | 1062 |
| a. Uncertainty in Defining "Negotiations" | 1062 |
| b. The Burden and Cost of Disclosure | 1063 |
| C. <i>Intermediate Disclosure Options and Alternatives</i> | 1064 |
| 1. RESPONDING "NO COMMENT" TO ALL INQUIRIES | 1065 |
| 2. BASING DISCLOSURE ON THE OCCURRENCE OF CERTAIN EVENTS COMMON TO ALL TAKEOVERS | 1067 |
| 3. DISCLOSING AT THE TIME WHEN INSIDER TRADING REGULATIONS ARE TRIGGERED | 1068 |
| D. <i>Summary of Costs, Benefits, and Consequences of Various Disclosure Standards</i> | 1069 |
| 1. AGREEMENT-IN-PRINCIPLE DISCLOSURE | 1072 |

| | |
|--|------|
| 2. EARLY, FULL DISCLOSURE | 1072 |
| 3. A "NO COMMENT" POLICY | 1074 |
| 4. DISCLOSURE MADE AT THE TIME WHEN INSIDER TRADING REGULATIONS ARE TRIGGERED | 1074 |
| 5. DISCLOSURE BASED ON THE OCCURRENCE OF CERTAIN EVENTS COMMON TO ALL TAKEOVERS | 1076 |
| VI. CONCLUSION | 1078 |

I. INTRODUCTION

The underlying purpose of the Securities Act of 1933 (1933 Act)¹ and the Securities and Exchange Act of 1934 (1934 Act)² is to provide investors with full disclosure of corporate information.³ Under this consumer protection framework, preliminary merger or acquisition negotiations must be disclosed when a corporation is under a duty to disclose and negotiations are deemed "material" within the meaning of Rule 10b-5 as promulgated under the 1934 Act.⁴ Despite the prodisclosure philosophy underlying securities laws and regulations, corporate managers intentionally withhold news of preliminary negotiations.⁵ The lack of a clear "materiality" standard requiring disclo-

1. 15 U.S.C. §§ 77a-77aa (1982) [hereinafter 1933 Act].

2. 15 U.S.C. §§ 78a-78lll (1982) [hereinafter 1934 Act].

3. For the legislative history of the 1933 and 1934 Acts, see *infra* notes 24-36 and accompanying text.

4. For the text of Rule 10b-5, see *infra* note 34 and accompanying text. By its terms, Rule 10b-5 does not require disclosure of preliminary merger negotiations or any other specific information. A regulatory disclosure requirement may be imposed, however, in certain circumstances:

The question of whether a particular fact must be disclosed under rule 10b-5 requires the analysis of two distinct issues. First, is there a duty to disclose the fact, and second, is the fact material. Much of the confusion in the case law stems from the failure of the courts to distinguish between these inquiries.

Goelzer, *Disclosure of Preliminary Merger Negotiations—Truth or Consequences*, 46 MD. L. REV. 974, 975 (1987). This Comment focuses on how the definition of materiality affects the timing of disclosure. For a discussion of the specific duties that trigger the regulatory disclosure requirement, see *infra* note 97.

Failure to conform to SEC imposed disclosure requirements is actionable under the anti-fraud provisions of the 1934 Act—Section 10(b) and Rule 10b-5. *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988) (holding that a private cause of action exists for a violation of Section 10(b) and Rule 10b-5, and that such lawsuits constitute an essential tool for enforcement of the 1934 Act's requirements). The Supreme Court previously has addressed several elements of a Section 10(b) or Rule 10b-5 claim. See, e.g., *Dirks v. SEC*, 436 U.S. 646 (1983) (duty to disclose); *Chiarella v. United States*, 445 U.S. 222 (1980) (duty to disclose); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) ("manipulative or deceptive" requirement of the statute); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter, intent to deceive, manipulate, or defraud); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("in connection with the purchase or sale" requirement of the Rule). Violations of SEC rules, however, do not necessarily create a private right of action. See *In re Penn Cent. Secs. Litig.*, 494 F.2d 528, 540 (3d Cir. 1974) (denying existence of a private cause of action under Section 13(a) of the Exchange Act).

5. Managers refrain from making disclosures either to facilitate a transaction or to use

sure has exacerbated the paucity of information reaching the market.⁶ As a result, competition for takeover information is widespread.⁷

The determination of "materiality" and, consequently, the timing of when preliminary takeover discussions must be disclosed significantly affect the competing interests of all the participants in the national securities markets.⁸ Initially, corporate managers are affected by the timing of disclosure because, as long as information remains undisclosed, they can benefit personally by trading on their insider knowledge.⁹ Moreover, in order to facilitate a merger or an acquisition, corporate managers prefer to delay disclosure, thus preventing a bidding war with another suitor and discouraging speculative purchasers from driving up the target stock price.¹⁰ Individual stockholders and market professionals¹¹ are also affected by the timing of disclosure because they compete for potential takeover stock premiums.¹² By spotting revealing trends in market behavior, market professionals identify a potential target company and aggressively purchase its stock before unsuspecting individual investors become informed.¹³ If merger or acquisition negotiations were disclosed at an early stage, however, individual investors likely would be privy to the same information as their institutional counterparts and thus would

the nonpublic information for their own benefit. For a discussion of the need for confidentiality during merger or acquisition negotiations, see *infra* notes 154-62 and accompanying text. For a discussion of managers' self-interest during preliminary takeover negotiations, see *infra* notes 60-77 and accompanying text.

6. For a discussion of manager uncertainty as to when to disclose information due to the lack of a readily followed and enforced materiality standard, see *infra* notes 112-22 and accompanying text.

7. For a discussion of the market for information, see *infra* notes 37-80 and accompanying text.

8. See generally Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980) (discussing the daily abnormal returns to stockholders of suitor and target companies in both completed and cancelled merger proposals that result in response to public announcements).

9. For a discussion of the empirical evidence demonstrating the vast extent of insider trading, see *infra* notes 123-31 and accompanying text.

10. For a discussion of the costs and benefits associated with concealing the existence of negotiations, see *infra* notes 154-61 and accompanying text.

11. As discussed in this Comment, "market professionals" refers to underwriters and investment bankers, such as arbitrageurs. Generally, "market professionals" refers to anyone who has an informational advantage, by virtue of costly in-house research, over individual investors.

12. For a discussion of takeover premiums, see *infra* note 38 and accompanying text. For a discussion of the competition between individual investors and market professionals for the spoils of the battles for corporate control, see *infra* note 44 and accompanying text.

13. For a discussion of the shift in stock ownership from individual investors to arbitrageurs preceding the disclosure of a potential merger or acquisition, see *infra* notes 44, 48 and accompanying text.

not be at such a competitive disadvantage.¹⁴

The ideal disclosure model is one that addresses several concerns. Such a model must provide a clear definition of materiality that can be easily followed by corporate managers. The ideal standard also must ensure parity of information among all investors, limit the time that insiders and market professionals can benefit on their nondisclosed information, and promote investor confidence by the fair and efficient operation of the securities markets. In *Basic Inc. v. Levinson*,¹⁵ the United States Supreme Court stated that "[a]n omitted fact [concerning negotiations] is material if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest]."¹⁶ The *Basic* definition of "materiality" has a direct impact on the flow of information to investors, the efficiency of securities markets, investor confidence, and the proliferation of insider trading. Moreover, because this definition does not offer a bright-line "materiality" standard,¹⁷ various questions concerning when preliminary negotiations are "material" arise at each step in the fast-paced battle for corporate control.¹⁸

This Comment analyzes the various models of disclosure of preliminary merger negotiations, their effect on the securities markets, and their relation to the congressional objective of full disclosure. Section II examines the competition for information regarding merger and acquisition negotiations and the legislative intent underlying the disclosure provisions of the 1933 Act, 1934 Act, and modern securi-

14. For a discussion of the costs and benefits associated with an early disclosure standard, see *infra* note 171-87 and accompanying text.

15. 108 S. Ct. 978 (1988).

16. *Id.* at 983 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

17. For a discussion of corporate management's practical need for a "materiality" standard in the form of a bright-line rule, see *infra* notes 112-22 and accompanying text.

18. Professors Jensen and Ruback view the market for corporate control as the arena in which management teams compete for the right to manage corporate resources. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 5 (1983). In their article, they state that there are three basic forms of a takeover—mergers, tender offers, and proxy contests. Jensen and Ruback explain:

In mergers or tender offers the bidding firm offers to buy the common stock of the target at a price in excess of the target's previous market value. Mergers are negotiated directly with target manager's [sic] and approved by the target's board of directors before going to a vote of target shareholders for approval. Tender offers are offers to buy shares made directly to target shareholders who decide individually whether to tender their shares for sale to the bidding firm. Proxy contests occur when an insurgent group, often led by a dissatisfied former manager or large stockholder, attempts to gain controlling seats on the board of directors.

Id. at 6-7.

ties legislation.¹⁹ Section III explores the evolution of the case law concerning disclosure of preliminary negotiations.²⁰ Section IV then examines the effect of the Supreme Court's decision in *Basic*.²¹ In addition, Section V analyzes the costs and benefits of various disclosure standards.²² Finally, Section VI concludes that a disclosure standard triggered by specific events common to all takeovers increases certainty among corporate managers, maximizes shareholder value, and embodies the congressional objective of full disclosure.²³

II. CONGRESSIONAL INTENT AND THE MARKET FOR INFORMATION

A. *The Policies Underlying Early Securities Legislation*

Prior to the 1933 Act and during the stock market crash of 1929, investors generally purchased securities under the philosophy of caveat emptor.²⁴ Because there were no federal enactments or adequate state laws safeguarding investors from fraudulent practices, securities frequently were offered without any disclosure of facts relevant to the buyer's investment decision.²⁵ The 1933 Act responded to this need for information and had three objectives: 1) to provide investors with full disclosure of material information concerning initial public offerings of securities; 2) to protect investors against fraud; and 3) to promote ethical standards of honesty and fair dealing through the imposition of specified civil liabilities.²⁶

19. See *infra* notes 24-87 and accompanying text.

20. See *infra* notes 88-109 and accompanying text.

21. See *infra* notes 110-31 and accompanying text.

22. See *infra* notes 132-229 and accompanying text.

23. See *infra* notes 230-43 and accompanying text.

24. The fraudulent and deceptive retailing of securities to finance the country's railroad network following the American Civil War provided the impetus for the creation of securities laws. Mofsky, *Reform of the Florida Securities Law*, 2 FLA. ST. U.L. REV. 1, 1-3 (1974). Many of these railroad securities were either worthless, diluted, or sold based upon the false promise that the railroad would pass through the buyer's small town. *Id.* Subsequently, a few states began adopting securities legislation designed to protect investors from promoters of highly risky securities. *Id.* Yet it was not until 1929, following the crash of the stock market, that members of Congress recognized that many of these state laws were inadequate. Consequently, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.

25. See Mofsky, *supra* note 24, at 3-4.

26. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933). Commenting on one of the early pieces of "New Deal" legislation, President Roosevelt said that the 1933 Act was "but one step in our broad purpose of protecting investors." *Id.* at 1-2. Additionally, a Representative from the House commented that "[t]he theory upon which [the 1933 Act] has been drawn is to give the public complete information as to the security offered for sale." 77 CONG. REC. 2931 (1933). This philosophy of full disclosure is also the basis of the 1934 Act. See *infra* notes 27-31 and accompanying text.

Although the 1933 Act provided for disclosure of information regarding initial public offerings of securities, there was still a need to protect investors regarding those securities transactions that occurred after initial offerings. Thus Congress enacted the 1934 Act largely to protect investors from manipulation of stock prices.²⁷ To prevent such manipulation, the 1934 Act regulates transactions on the securities exchanges and imposes reporting requirements on companies whose stock is listed on national exchanges.²⁸ The 1934 Act also was intended to protect the public by providing for full disclosure in securities transactions.²⁹ By requiring more complete disclosure, Congress intended to create securities markets that operated with a sense of fairness³⁰ and parity of information among all investors.³¹

As part of the 1934 Act, Congress created the Securities and Exchange Commission (SEC), which is charged with administering the federal securities laws, and provided with an arsenal of flexible

27. See S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934).

28. *Id.*

29. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 1 (1934).

30. The notion of fairness in the securities markets is not limited to the idea that all investors receive the same information. One court explained that fairness embodies a larger concept:

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital.

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-52 (2d Cir. 1968).

The idea of fairness or equity is largely the policy basis underlying insider trading regulations. If insider trading exists, individual investors will not entrust their resources to a marketplace they do not believe is fair. For a discussion of the importance of limiting insider trading in order to foster confidence in market integrity, see *infra* notes 165-70 & 179-81 and accompanying text.

31. Subsequent to the passage of the 1934 Act, the United States Supreme Court, in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), acknowledged that ensuring full disclosure was a fundamental purpose underlying many securities regulatory enactments. *Id.* at 186 (referring to the following statutes: 1933 Act; 1934 Act; Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6; Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbb; and Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52); accord *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). *Capital Gains* involved an investment adviser who, after having purchased shares of a particular stock, sent out an investment letter recommending that his clients buy the stock. *Capital Gains*, 375 U.S. at 182-83. The adviser did not tell his clients that he himself had purchased such stock. *Id.* After the clients began buying the stock and the price went up, the adviser sold his nondisclosed shares at a profit. *Id.* Specifically, the Court held that the adviser had breached his fiduciary duty to his clients, and that, in the Securities legislation, Congress intended to replace the initial market philosophy of caveat emptor with full disclosure. *Id.* at 189 (referring to H. R. REP. NO. 85, 73d Cong., 1st Sess. 2, quoted in *Wilko v. Swan*, 346 U.S. 427, 430 (1953)).

enforcement powers.³² Under the rule-making authority provided by Section 10(b),³³ the SEC created Rule 10b-5 to regulate, among other things, the disclosure of preliminary merger and acquisition negotiations. Rule 10b-5 provides, in relevant part:

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

....

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

....

in connection with the purchase or sale of any security.³⁴

Rules such as 10b-5 can be promulgated under Section 10(b) only if they are designed to protect consumers.³⁵ Thus, the consumer protection objective of Section 10(b) reveals the intent of Congress to replace the initial market philosophy of caveat emptor with full disclosure.³⁶

B. *The Market for Information*

Complicated takeover bids, leveraged buy-outs, and mergers are redefining the perceived limits of a Wall Street "megadeal."³⁷

32. See 1933 Act §§ 8, 19, 20, 15 U.S.C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21; 15 U.S.C. §§ 78i, 78s, 78u.

33. Section 10(b) of the 1934 Act provides, in relevant part:

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

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982).

34. 17 C.F.R. § 240.10b-5 (1987).

35. Section 10(b) authorizes the creation of rules and regulations "necessary or appropriate in the *public interest* or for the *protection of investors*." 15 U.S.C. § 78j (1982) (emphasis added).

36. H. R. REP. NO. 85, 73d Cong., 1st Sess. 2, (1933).

37. Until recently, the largest acquisition in history was Chevron Corp.'s \$13.2 billion purchase of Gulf Oil Corp. in 1984. See Smith & Anders, *Year of the Megadeal Is Upon Us*, Wall St. J., Oct. 21, 1988, at C3, col. 3. In 1986, Kohlberg, Kravis, Roberts & Co. (KKR) completed the largest leveraged buy-out of Beatrice Companies for \$6.2 billion. See Helyar,

Because they often generate substantial stock price premiums,³⁸ these transactions have stirred speculation in many takeover target compa-

Morris & Swartz, *RJR Nabisco Chief Considering Buy-Out of Concern for \$17.6 Billion, or \$75 a Share*, Wall St. J., Oct. 21, 1988, at A3, col. 1.

But in 1988, the "year of the megadeal," several transactions came close to and surpassed these previous records. For instance, Kraft accepted a \$13.1 billion offer from Phillip Morris. See Freedman & Gibson, *Kraft Accepts a Sweetened Offer of \$13.1 Billion From Phillip Morris*, Wall St. J., Oct. 31, 1988, at A3, col. 1. The most highly publicized megadeal of 1988, however, was a record-setting takeover contest for RJR Nabisco Inc. won by a group led by KKR. The struggle for corporate control began when RJR's management announced it was contemplating a \$17.6 billion buy-out bid. See Burrough & Helyar, *RJR May Get a Third Offer, Topping Others*, Wall St. J., Nov. 7, 1988, at A3, col. 1. In response, KKR made a \$20.6 billion tender offer, which, in turn, triggered a management bid of \$21.16 billion. *Id.* Subsequently, management proposed an even higher bid of \$23 billion, while a group led by First Boston Corp. and Resource Holdings Ltd. said it would organize a proposal valued at over \$27.14 billion. See Burrough & Helyar, *First Boston's RJR Offer Has Tight Timetable*, Wall St. J., Nov. 22, 1988, at A3, col. 4. Finally, RJR Nabisco Inc.'s outside directors rebuffed a management offer worth \$25.76 billion and accepted KKR's bid valued at \$25.07 billion. See Burrough & Helyar, *Buy-Out Bluff: How Underdog KKR Won RJR Nabisco Without Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6.

Merger and acquisition activity has continued throughout 1989 at a robust pace. After a protracted legal battle instigated by Paramount Communications Inc. and disgruntled Time Inc. shareholders, the Delaware Supreme Court refused to block Time Inc.'s attempt to buy Warner Communications Inc. for \$14 billion. See Hilder & Landro, *Paramount Withdraws Its Hostile Offer As Time Begins Its Purchase of Warner*, Wall St. J., July 25, 1989, at A3, col. 1. Consequently, Paramount Communications Inc. withdrew its \$12.2 billion hostile takeover attempt for Time Inc., announcing that it had no plans to make a run at the combined Time Warner Inc. *Id.* Additionally, in what could accelerate a wave of corporate restructurings in Europe, Anglo-French corporate raider Sir James Goldsmith, British financier Jacob Rothschild, and Australian businessman Kerry Packer organized a \$21.2 billion offer to buy B.A.T. Industries PLC. *B.A.T.-Man Caper: Predator Becomes Prey As Goldsmith Seeks British Conglomerate*, Wall St. J., July 12, 1989, at A1, col. 6. The proposed buy-out as currently structured would not only be the second biggest corporate-finance transaction, next only to the \$25.07 billion acquisition of RJR Nabisco Inc., but it would also be four times larger than any other takeover attempted in Europe. *Id.*

38. In a takeover, shareholders of the target company ordinarily receive a premium—a substantial, short-term return on their stock. Several researchers have quantified the average takeover stock price change—net of market-wide price fluctuations—that mergers and acquisitions effect on the stock prices of participating firms. One study reports that, in the first quarter of 1988, successful takeover bidders in cash tender offers paid an average premium of 54.8% over the pretakeover stock price. *Predictable Business Values*, MERGERS & ACQUISITIONS, Sept./Oct. 1988, at 25. The figures were obtained from an unpublished report by P. Michael Kelly, Vice President of American Appraisal Associates Inc. *Id.* Historically, Nathan and O'Keefe find that takeover premiums during 1974-85 were approximately twice as large as those occurring during 1963-73. Nathan & O'Keefe, *The Rise in Takeover Premiums: An Exploratory Study*, 23 J. FIN. ECON. 101, 101 (1989) ("The mean cash tender takeover premium rose from 41% to 75%, the mean cash merger premium rose from 29% to 70%, and the mean stock merger premium rose from 32% to 67%.").

Additionally, Professors Jensen and Ruback empirically found 13.3% to 33.96% historical, abnormal returns for target companies in a takeover. Jensen & Ruback, *supra* note 18, at 7-8. Specifically, Jensen and Ruback reported the following percent changes in the stock prices of the firms involved in successful and unsuccessful takeover attempts:

nies,³⁹ have riveted the attention of individual investors, and have caused market professionals at investment banks to scrutinize carefully rumors and news of merger negotiations.⁴⁰ Accordingly,

| | STOCK PRICE PREMIUMS | | | |
|----------------------|----------------------|--------|--------------|--------|
| | SUCCESSFUL | | UNSUCCESSFUL | |
| | Target | Bidder | Target | Bidder |
| Tender Offers | 30% | 4% | -3% | -1% |
| Mergers | 20% | 0% | -3% | -5% |
| Proxy Contests | 8% | n/a | 8% | n/a |
| n/a = Not Applicable | | | | |

Id. From Jensen and Ruback's evidence, in a successful merger, for example, Target Co. hypothetically merges and becomes part of Bidder Co. Ordinarily, in order to entice Target Co.'s shareholders and directors to agree to the merger with Bidder Co., Bidder Co. presents Target Co., on average, with a 20% premium—an offer 20% greater than the price of Target Co. stock prior to any merger discussions. When the merger is complete, Jensen and Ruback do not notice any resultant effect, either positive or negative, on the valuation of Bidder Co. This indicates that the primary financial gain immediately resulting from a merger is realized by the shareholders of target companies in the short run. See also Bradley, Desai & Kim, *Synergistic Gains from Corporate Acquisitions and their Division Between the Stockholders of Target and Acquiring firms*, 21 J. FIN. ECON. 3, 31 (1988) (Competition among bidding firms increases the returns to targets and decreases the returns to acquirers to a level that is not significantly different from zero.). In the end, however, the bidder may realize an increase in value reflecting the perceived greater ability of the merged corporation to utilize combined resources and create higher earnings. *Id.* For a discussion of the financial gains associated with synergy, see *infra* notes 134, 136 and accompanying text. On the other hand, if merger negotiations fail between Bidder Co. and Target Co., the stock of Target Co. will fall 3% below the market price before negotiations were entered into, while Bidder Co. stock falls 5% below the prenegotiations level. Jensen & Ruback, *supra* note 18, at 7-8.

Although acquiring firms usually prefer tender offers because they provide a timing advantage over the other two methods, all three forms are used to accomplish the same end—corporate control. Freund explains that “the principal advantage of using . . . tender offers to accomplish negotiated deals is for the purchaser to gain control of the seller faster. Time is precious here; the quicker control shifts, the surer the deal is to happen, the less likely [the purchaser will be injured if] competing bids . . . surface.” Freund, *Mergers and Acquisitions*, NAT'L L.J., Nov. 11, 1985, at 13, 23, col. 3 (Freund prepared the article as a ten-year update to his book ANATOMY OF A MERGER.). Freund, however, does not take into consideration that competitive bidding, while potentially damaging to the initial bidder, may increase the eventual sales price and maximize target shareholder investment value.

Although all three methods are used to achieve corporate control, this Comment primarily addresses disclosure of preliminary merger negotiations. While provisions of the Williams Act specifically attack some abuses associated with disclosure of tender offers, no such particular legislative enactment regulating mergers exists. See 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982); Comment, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5*, 62 WASH. L. REV. 81, 91-92 n.68 (1987) [hereinafter Comment, *Disclosure*].

39. Apparently, the size of a transaction is no longer seen as a limitation to attempting a takeover. Shortly after the multi-billion dollar RJR Nabisco and Kraft transactions, there was speculation in the stocks of companies long considered too large to be acquired. See Smith, *Size as Takeover Immunity Dies a Sudden Death*, Wall St. J., Oct. 25, 1988, at C1, col. 3. Investors recently have been considering Sears, K Mart, J.C. Penney, Chrysler, Mobil, Eastman Kodak, and Digital Equipment. *Id.*

40. When the management of RJR Nabisco announced it was considering a \$75 a share

although corporate managers intentionally delay disclosure of ongoing negotiations,⁴¹ information concerning takeover bids and mergers is of critical importance to all investors.⁴²

While corporate managers seek to maximize stock value to avoid becoming targets of takeover attempts,⁴³ stockholders and market professionals compete for potential merger stock premiums.⁴⁴ In theory, limited public information regarding potential takeovers is equally available to both individual investors and market professionals. Under current market conditions, however, there is no such parity of knowledge.⁴⁵ Market professionals gain an informational advantage through extensive in-house research.⁴⁶ By either tracking unusual market activity created by insider trading or receiving non-public information from corporate insiders, market professionals can identify undervalued corporations and often can anticipate takeovers before a public announcement regarding preliminary negotiations.⁴⁷

leveraged buy-out, the disclosure sent RJR Nabisco stock soaring \$21.75, from \$54.875 to \$76.625, amid speculation of higher offers. Thus, without an actual offer, stock speculators bid up the price of RJR Nabisco above the proposed offer price. See Wall St. J., Oct. 21, 1988, at A1, col. 2.

41. For a discussion of the benefits of keeping preliminary negotiations confidential, see *supra* notes 154-61 and accompanying text.

42. See *infra* note 44 and accompanying text.

43. For a discussion of when the interests of corporate managers often are diametrically opposed to those of shareholders, see *infra* notes 60, 77 and accompanying text.

44. See Brown, *Corporate Secrecy, The Federal Securities Laws, and the Disclosure of Ongoing Negotiations*, 36 CATH. U.L. REV. 93, 149 n.207 (1986). Although 60% of the shares of publicly traded companies are owned by individual investors, in a takeover, shareholders sell to arbitrageurs and other speculators. Ricks, Murray, Power & Steptoe, *Taking Stock: Changes Since Crash Can't Prevent a Repeat, But Might Soften One*, Wall St. J., Oct. 17, 1988, at A1, col. 6. In fact, market professionals, rather than individual investors, generally tender between 60% and 90% of the shares received by a suitor. See Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L.F. 269, 294 n.101 (1969).

There are two periods during which individual investors are most likely to sell their shares during the course of a takeover—before and after disclosure of preliminary takeover discussions. If shares are sold after disclosure, an individual investor is presumed to be making an informed investment decision based on a balancing of the risks and rewards of the potential takeover.

If individual investors sell their shares before public disclosure, however, their actions are not based on any ascertainable or rational fact or theory. In fact, when initially purchasing shares, many individual investors place automatic stop loss or sell orders with their brokers to be exercised when the stock value falls below or exceeds a certain value. If brokers are not made aware of a potential takeover from either their own or their company's in-house research, the shares of an individual investor automatically will be sold without the individual investor ever being informed of a potential takeover premium.

45. For a discussion of the abnormal returns earned by market professionals, see *infra* note 38 and accompanying text.

46. For a discussion of how market professionals gain valuable investment information through market "noise," see *infra* note 47 and accompanying text.

47. Market participants trade either on the basis of knowledge that relates specifically to the financial prospects of a corporation, or in reaction to snippets of information called

Information is critical; therefore, the timing of public disclosure of merger negotiations determines who will have an informational advantage and who will be the recipient of potential takeover premiums.

"noise"—information that does not directly relate to the corporation, but rather to unusual trading activity in its stock. See Black, *Noise*, 41 J. FIN. 529, 529 (1986). Black explains that trading on noise rather than on firm-specific information generally is unprofitable:

In my model of financial markets, noise is contrasted with information. People sometimes trade on information in the usual way. They are correct in expecting to make profits from these trades. On the other hand, people sometimes trade on noise as if it were information. If they expect to make profits from noise trading, they are incorrect.

Id. at 529. Professors Larcker and Lys, however, contend that noise trading based specifically on the market activity of corporate insiders provides traders with incentives for costly "noise" information acquisition. Larcker & Lys, *An Empirical Analysis of the Incentives to Engage in Costly Information Acquisition—The Case of Risk Arbitrage*, 18 J. FIN. ECON. 111, 124-25 (1987).

Profitable, insider noise information is available in two principal forms. First, valuable information can be learned by following the market activity of corporate insiders. See, e.g., Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410 (1974) (examining the performance of a security subsequent to either a transaction by an insider, a large transaction of an insider, or months in which many insiders of a company transact); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. LAW & ECON. 35 (1968) (investigating stock performance following months of intensive trading in which there are at least two more buyers than sellers or at least two more sellers than buyers among the insiders of a company). Following the trading activity of corporate insiders may become more difficult under a current SEC proposal that would require trading filings of only the officers listed on a company's proxy statement, instead of the current reporting of all officers. See, e.g., Dorfman, *Some Investors See Red in SEC's Plan to Modify Insider Reporting*, Wall St. J., Feb. 22, 1989, at C1, col. 3 ("Some investors are up in arms about a Securities and Exchange Commission proposal they say would reduce the usefulness of a widely used stock-picking tool.").

Second, traders can be tipped-off as to possible upcoming events by tracking the bid-ask spread in the stock of a particular corporation. See, e.g., Glosten & Harris, *Estimating the Components of the Bid/Ask Spread*, 21 J. FIN. ECON. 123, 140-41 (1988) (providing empirical evidence that the bid/ask spread is positively correlated with the exposure of market-makers to traders who are better informed); Glosten & Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985) (concluding that a bid-ask spread implies a divergence between observed returns and realizable returns, if observed returns are approximately realizable returns, plus what the uninformed anticipate losing to the insiders); Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 190-91 (1986) (confirming a positive relation between profitable market activity by insiders and the bid-ask spread in that security). Professor Seyhun explains how the bid-ask spread provides significant information:

[Commentators suggest that there is] a positive relation between the informed traders' [insiders'] abnormal profits and the bid-ask spread in that security. Profitable trading by informed traders imposes abnormal losses on all opposing traders, including the market-maker. Consequently, the market-maker is forced to charge a higher bid-ask spread to all traders to help offset his systematic losses to informed traders.

Id. at 190-91. Consequently, an increase in the bid-ask spread—the cost that market-makers impose on non-insiders to protect themselves from insider trading—provides valuable predictive suggestions.

1. PROPERTY RIGHTS IN NONPUBLIC INFORMATION

Nonpublic information is valuable and can be considered a capital good or an asset that can be transferred, sold, or exchanged.⁴⁸ In the absence of voluntary corporate disclosures, market participants can obtain needed investment information by conducting or purchasing independent research.⁴⁹ Under the law and economics theory, the possession and exploitation of an informational advantage creates valuable property rights and has resultant macroeconomic effects.⁵⁰ Thus the allocation of the initial property rights in nonpublic information to either insiders, market professionals, or individual investors has various macroeconomic ramifications that should be examined in determining the appropriate timing of regulatory disclosures.⁵¹

Market participants have varying access to firm-specific information that potentially affects stock prices.⁵² For example, insiders have the best access to information regarding corporate developments that have not been publicly disclosed. After insiders, market professionals, through the use of costly, in-house research, have a better opportunity than do individual investors to discern likely corporate activities. Yet, no matter where the law initially allocates the property rights to valuable information through disclosure regulation, market participants will exploit or reallocate those rights, by selling such information to the most productive user or highest bidder, so that the value of the nonpublic information is maximized and exhausted.⁵³ The imposition of an early disclosure requirement on public corporations disturbs the equilibrium which provides a flow of information to the most productive user by limiting the value of the informational advantages that insiders casually acquire through their positions and that market professionals obtain through a deliberate and costly search.⁵⁴ The alloca-

48. See Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683 (1980); see also Carlton & Fischel, *Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866 (1983); Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 21, 64 (1980); Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 94-95 (1987).

49. See Kitch, *supra* note 48, at 716-23; Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 15-16 (1981); Morgan, *supra* note 48, at 95, 99-101.

50. See Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (Papers and Proceedings 1967).

51. See, e.g., Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377 (1989) (analyzing the regulation of insider trading by examining the allocation of initial property rights in firm-specific information).

52. See generally Haddock & Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1449 (1986) (describing how information is efficiently transferred among market participants based on allocation efficiency).

53. See Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

54. See, e.g., Kronman, *supra* note 49, at 15 ("A duty to disclose is tantamount to a

tion of information affects the wealth of all market participants, the incentive to search for and discover nonpublic information, and the efficiency of accurate stock pricing.⁵⁵

There are various economic consequences of either allocating the property rights in nonpublic information to corporate insiders or requiring that the intrinsic value of material, nonpublic information be shared by all market participants through an early, full disclosure requirement. For instance, several commentators assert that, if corporate managers were partially compensated by being allowed to utilize the value of the nonpublic information that they discover through their positions, the corporation and its shareholders would benefit due to the generation of certain managerial incentives.⁵⁶ By increasing the value of the corporation through new developments or product ideas, corporate managers also would be able to receive a profit by trading on the basis of this positive insider information. Professor Cox explains how allowing corporate managers to trade on nonpublic information would benefit managers, stockholders, and the general economy:

[M]anagers who are free to trade will be stimulated to generate new information in order to provide themselves with further opportunities to gain by trading prior to disclosing the value-increasing event. The owners [shareholders] also benefit because such value-enhancing information means new developments, new markets, and other corporate events that increase the value of the firm.⁵⁷

Thus insider trading may stimulate management productivity, crea-

requirement that the benefit of the information be publicly shared and is thus antithetical to the notion of a property right which . . . always requires the legal protection of private appropriation.”).

55. See, e.g., *id.*

56. See Cox, *Insider Trading and Contracting: A Critical Response to the “Chicago School,”* 1986 DUKE L.J. 628, 649 (1986) (discussing insider trading as a means of extraordinary compensation that provides productivity inducements for corporate managers) [hereinafter Cox, *Insider Trading and Contracting*]; Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 WASH. U.L.Q. 475, 475 (1984) (same) [hereinafter Cox, *Insider Trading Regulation and the Production of Information*]. Compare Carlton & Fischel, *supra* note 48, at 869-72 (advocating insider trading as a form of managerial compensation) with Cox, *Insider Trading and Contracting, supra*, at 652-53 (“Because [corporate bonus programs] already confer large financial rewards upon managers, it is extremely doubtful that those in the managerial ranks feel that they are seriously undercompensated and are clamoring for insider-trading profits as an incentive reward for further efforts.”); Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUB. POL’Y 101, 104 (1988) (“[A]ll the positive incentive qualities of insider trading can in fact be matched by other tools—and these other tools, such as stock options, [explicit bonuses, promotions, and lateral job opportunities,] are explicit and calculable by employers, or shareholders, and are therefore preferable to insider trading.”).

57. Cox, *Insider Trading and Contracting, supra* note 56, at 649.

tivity, and motivation, while providing resultant macroeconomic rewards.

On the other hand, allowing managers to control and utilize non-public information creates several problems. First, although managers are motivated to create and disclose positive information, negative information will rarely reach the market,⁵⁸ thus reducing market efficiency due to inaccurate stock pricing. Managers have a disincentive to announce adverse information because the "bad news" may threaten their job security and reduce the value of their corporate stock holdings by generally lowering the market price of the corporations' stock.⁵⁹ Second, if managers can conceal positive information or engage in strategically unprofitable "bad behavior" to intentionally cause a downturn in the corporation's stock price, the managers will have created a unique personal opportunity to purchase their consequently undervalued corporation through a leveraged buy-out (LBO).⁶⁰ Although the "self-interested LBO" represents the extreme of management misconduct, there is still a great temptation for managers to manipulate artificially the price of corporate stock to benefit personally from volatile price swings.⁶¹

Moreover, mergers and acquisitions are unique situations where insider-trading compensation incentives do not apply. Unlike new corporate projects or research, takeovers do not increase the current value of the corporation; that is, the net asset value of the target corporation is not increased. Specifically, the takeover premium only represents either the existing hidden value in a corporation not reported in financial statements, positive information concealed by managers, or the possible synergy value that might be generated in the

58. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 785 (1985) ("At some point, the company's short-run wish to maintain a high stock price will create a strong temptation to impose a wall of secrecy, to the detriment of persons buying the stock.").

59. *Id.*

60. Levmore, *supra* note 56, at 104-07. While considering the efficiency of leveraged buy-outs or "going private," Professor Levmore explains:

[A]fter the firm "goes private," the managers will own all the equity in the firm, and may, therefore, work harder. . . . [T]hese managers may have waited until they developed information that good fortune was around the corner before booting the public shareholders whose funds helped develop this information and employ these managers in the first place. "Going private" is, after all, simply a huge trade by insiders.

Id. at 106. "Going private" refers to a transaction in which shareholders are convinced to accept cash for their shares, while the business is continued by officers, directors, or large shareholders. A leveraged buy-out (LBO) is a specific method of "going private." In an LBO, management acquires all the shares of a public corporation through a privately held, outside corporate entity.

61. *Id.* at 104-07.

future by a combination with a suitor.⁶²

Although allowing managers to control the dissemination of information regarding preliminary takeover negotiations may create inefficient incentives for self-interested transactions, commentators suggest that insider trading is an indirect method of communicating information to the securities markets.⁶³ By trading on signals created by insider trading, market professionals promote general market efficiency by acquiring and consequently bidding-up undervalued stock.⁶⁴ Specifically, arbitrageurs promote market efficiency by purchasing shares of corporations that are undervalued and predisposed to a takeover. Moreover, some commentators are opposed to disclosure regulation because it removes market professionals' informational advantage and, consequently, the incentive to engage in the costly informational search that fosters efficiency.⁶⁵

This fear that mandatory disclosure rules may harm market efficiency by removing the financial incentive for market professionals to search for nonpublic information, however, is unwarranted. Market

62. For a discussion of takeover premiums and takeover synergy, see *infra* notes 38, 136 and accompanying text.

63. Compare Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. SEC*, 13 HOFSTRA L. REV. 127, 133 (1984) (advocating that insider trading is a valuable and flexible communications device) with Cox, *Insider Trading and Contracting*, *supra* note 56, at 646 ("Certainly price changes will occur more quickly and efficiently through disclosure of the material nonpublic information than through the manager's use of personal resources and time to trade in his firm's stock."). For a discussion of how market professionals obtain investment information from market "noise" created by insider trading, see *supra* note 47 and accompanying text.

64. See Diamond & Verrecchia, *Information Aggregation in a Noisy Rational Expectations Economy*, 9 J. FIN. ECON. 221 (1981); Glosten & Milgrom, *supra* note 47. Compare H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 80-90 (1966) (The increase in accurate public information from "noise" and thus market efficiency is the principal justification for allowing insiders to trade on confidential information.); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565 (1970) (same) [hereinafter Manne, *Insider Trading and the Law Professors*] with Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 707 (1988) ("The cases of insider trading and index futures trading illustrate how, in many circumstances, the current preoccupation with nurturing efficient stock market pricing seems unwarranted, . . . at least misdirected.").

65. See, e.g., Morgan, *supra* note 48, at 100. Professor Morgan stated:

[By either using] the information for his or her own trading benefit . . . or . . . by deciding to mount a takeover bid for the target company, . . . the ability of the analyst to profit from the analysis and conclusions that he or she has produced will depend on the ability of the analyst to use the information while it is still secret, for once the information becomes widely known whatever trading advantage it would have provided (and whatever value it once had) is lost.

Id.; see also Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973) (arguing that market professionals should have property rights in the information that they discover and produce because the information is created by their own efforts).

professionals have superior access to nonpublic information and possess a profitable economic incentive to engage in costly information acquisition regardless of disclosure rules. Even under the late disclosure practices during the period from 1977 to 1983, one empirical study reports that arbitrageurs were profitable and had significant economic incentives for engaging in informational searches based solely on their own trading following the disclosure of takeover negotiations.⁶⁶ Specifically, in the time period between the first public announcement of a takeover proposal and the final disclosure of a consummated deal, arbitrageurs were generating substantial positive returns through superior information discovered via in-house research.⁶⁷ Although an early, full disclosure requirement would eliminate their informational advantage during the time preceding public disclosure of ongoing negotiations, market professionals would continue to promote market efficiency by engaging in costly in-house research because the period following disclosure still offers a significant economic opportunity. Consequently, the usual "property rights" justifications for allowing insider trading—performance motivations for management and informational search incentives for market professionals—are not germane to the special case of mergers and acquisitions.

On the other hand, there are beneficial market effects that would be noticed if individual investors, by virtue of mandatory disclosure regulations, were allowed to have access to what has heretofore been nonpublic information in the context of corporate control battles. By making preliminary takeover negotiations public information, the benefits of confidential information will be short-lived, if not illegal. Moreover, there will be a greater likelihood of parity of information

66. Larcker & Lys, *supra* note 47, at 111.

67. Professors Larcker and Lys explain that, even following disclosure of negotiations or an initial takeover proposal, considerable economic incentives exist for market professionals:

Our results indicate that [arbitrageurs] are able to acquire information that is superior to public information about the outcomes of acquisition proposals. . . . [Arbitrageurs] generate substantial positive returns on their portfolio position. This empirical evidence is consistent with the proposition that security prices are sufficiently noisy to provide traders with incentives for costly information acquisition. . . .

The uncertainty surrounding corporate reorganizations (e.g., merger, tender offer, or voluntary liquidation proposals) produces a spread between the share price at formal announcement date and the price per share offered in the proposal. . . . [Arbitrageurs] engage in costly information acquisition to resolve some of the uncertainty associated with the value of the firm undergoing a reorganization. In particular, [arbitrageurs] attempt to generate information that enables them to assess the "correct" security price of a company being reorganized.

Id. at 112-13.

among individual investors, market professionals, and corporate insider traders. Additionally, mandatory disclosure promotes efficiency and benefits all investors by providing market information about obscure corporations not widely followed.⁶⁸

Although mandatory disclosure seems to be a means of generating vital market information, many commentators argue that securities laws, like disclosure rules, produce few benefits and considerable costs.⁶⁹ Specifically, under the free market for information theory, regulation is costly and unnecessary because corporate managers, seeking to maximize shareholder value, will release information voluntarily up to the point that the marginal benefits of disclosure equal the marginal costs.⁷⁰ Because market participants desire information to make investment decisions and "assume the worst" in the absence of released information, a company that wishes to raise capital through public markets has an incentive to and can profit by providing voluntary disclosures.⁷¹ Additionally, subscribers to this theory

68. Langevoort, *supra* note 58, at 784. One commentator proposed a disclosure convention that operates by each publicly traded corporation having a "public relations answer person." This corporate representative would have access to all high-level corporate executives and would be responsible for quickly and accurately responding publicly to virtually all inquiries from the press, individual investors, market professionals, and the Securities and Exchange Commission. Note, *Corporate Officers' Duty to Speak Truthfully in Response to Market Rumors: Levinson v. Basic, Inc. Holds Preliminary Merger Negotiations to Be Material Facts*, 18 U. TOL. L. REV. 627, 654-55 (1987). The problem with this disclosure convention is that it is triggered by an inquiry. Obscure issues may escape public scrutiny, while larger corporations will be bogged down with administrative implementation. In general and in the context of mergers and acquisitions, mandatory disclosure generates market information about all publicly traded corporations.

69. See, e.g., Bentson, *Required Disclosure and the Stock Market: An Evaluation of the Securities and Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (advocating the free market theory) [hereinafter Bentson, *Required Disclosure*]; Bentson, *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471 (1979) (same) [hereinafter Bentson, *Required Periodic Disclosure*]; Bentson, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515 (1969) (same); Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1209 (1987) (discussing whether the compliance costs associated with mandatory disclosure are justified when securities prices reflect the impact of the information before it is filed with the SEC); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 683 (1984) (advocating the free market theory) [hereinafter Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*].

70. Cox, *Insider Trading Regulation and the Production of Information*, *supra* note 56, at 475 n.3 (and sources cited therein.).

71. Easterbrook and Fischel provide the following example of a company that wants to issue new securities to illustrate corporate managements' motivation to provide voluntary disclosures:

The firm has a project . . . that it expects to be profitable. If the firm simply asked for money without disclosing the project and managers involved, however, it would get nothing. Investors would assume the worst, because, they would

believe that the principles underlying mandatory disclosure are empirically not supported.⁷²

2. THE SPECIAL CASE OF MERGERS AND ACQUISITIONS UNDER THE FREE MARKET THEORY

Commentators disagree as to whether, in the absence of regulation, the free market theory would provide the investing public with sufficient "soft information,"⁷³ such as appraisals of assets, projected dividends, and future earnings.⁷⁴ The free market theory, however, should not be applied to disclosure of preliminary merger and acquisition negotiations because takeover discussions differ from ordinary soft information in two important aspects. First, unlike other types of

reason that if the firm had anything good to say for itself it would do so. Silence means bad news. A firm with a good project, seeking to distinguish itself from a firm with a mediocre project (or no project at all), would disclose the optimal amount of information. That is, it would disclose more and more so long as the cost of disclosure . . . was worthwhile to investors as a whole. . . . The process works for bad news as well as for good. Once the firm starts disclosing . . . [i]t must disclose the bad news with the good, lest investors assume that the bad is even worse than it is.

Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, *supra* note 69, at 683. Cf. Bentson, *Required Disclosure*, *supra* note 69 (discussing the economic principles and motivations underlying voluntary disclosure); Grossman & Hart, *Disclosure Laws and Take-over Bids*, 35 J. FIN. 323 (1980) (same).

72. Specifically, beginning with the seminal research of Professor Bentson, the free market theorists have argued that securities regulation does not provide increased public confidence in the markets by preventing fraud, protection for unsophisticated investors, and an increased supply of truthful information. Bentson, *Required Disclosure*, *supra* note 69, at 153; see also Fishman & Hagerty, *Disclosure Decisions by Firms and the Competition for Price Efficiency*, 44 J. FIN. 633, 643 (1989) (suggesting that the competition for the attention of traders provides firms with the incentive to disclose too much information, and that mandatory disclosure of additional information only aggravates the problem).

73. Professors Steinberg and Goldman explain the difference between "soft" and "hard" information:

Traditionally, the securities laws have required disclosure of "hard" information, that is, factual, objectively verifiable data. "Soft" information, on the other hand, predominantly focuses on forward-looking statements, such as projections, forecasts, and predictions. 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 subjective evaluations or opinions.

Steinberg & Goldman, *Issuer Affirmative Disclosure Obligations—An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923, 934-35 (1987).

74. Compare Bentson, *Required Periodic Disclosure*, *supra* note 69, at 1471 (advocating the "free market" theory); Dennis, *supra* note 69, at 1209 (same); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, *supra* note 69, at 683 (same) with Coffee, *Market Failure and the Need for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (a critique of the empirical evidence supporting the "free market" theory); Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 4 n.22 (1983) (same).

soft information, takeovers commonly involve an abnormal, short-term stock premium.⁷⁵ This significant financial reward creates a temptation for insider trading⁷⁶ and, consequently, undermines the basic assumption of the free market theory—that corporate managers try to maximize shareholder wealth in deciding whether to disclose information and that they do not act for their personal benefit.⁷⁷ Second, although investors may or may not utilize the soft information currently provided in required disclosures,⁷⁸ news of a takeover dra-

75. For a discussion of the substantial premiums associated with mergers and acquisitions, see *supra* note 38 and accompanying text.

76. For a discussion of the empirical evidence supporting the existence of insider trading before the disclosure of a potential takeover, see *infra* notes 123-31 and accompanying text.

77. Professors Mikkelsen and Ruback explain that the interests of corporate managers often are diametrically opposed to those of shareholders. Managers who have small shareholdings may resist a takeover due to self-interest:

These managers profit less from a successful takeover and therefore other factors, such as the prospect of losing their job, provide an incentive to oppose takeovers that are in the stockholders' interests. This suggests that opposition to takeovers can be remedied by increasing share ownership by the management team.

Mikkelsen & Ruback, *Takeovers and Managerial Compensation: A Discussion*, 7 J. ACCT. ECON. 233, 238 (1985). As a result, because they often depose current management, takeovers may serve as an external control mechanism that limits managerial departures from maximization of stockholder wealth. Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303, 331 (1974) (Merger activity is a way of eliminating less efficient, unproductive corporations.) Despite this beneficial effect, the Bush administration is considering "major tax-law changes to combat last year's binge of corporate acquisitions financed with high-yield, high-risk 'junk' bonds." Birnbaum, *Congressional Action on LBOs Slows to Dragging Feet*, Wall St. J., March 9, 1989, at C1, col. 3. Professor Mandelker warns against such governmental action: "Efforts to limit merger activity may result, therefore, in misallocation of resources, and regulation may lead to a less efficient economy." Mandelker, *supra*, at 331. *But see supra* note 60 (a discussion of managers' self-interested LBOs).

Furthermore, Professors Jensen and Warner assert that management, acting out of self-interest, also implements defensive tactics in response to takeover bids which actually injure shareholder returns: "Evidence on management actions taken to forestall takeovers is inconsistent with the view that management always acts in shareholders' interest. Share prices decline on target-manager announcements of defensive restructuring in response to hostile takeovers and on announcement of poison-pill antitakeover measures." Jensen & Warner, *The Distribution of Power Among Corporate Managers, Shareholders, and Directors*, 20 J. FIN. ECON. 3, 4 (1988). For a discussion of other effects of management self-interest, see Friend & Lang, *An Empirical Test of the Impact of Managerial Self-Interest on Corporate Capital Structure*, 43 J. FIN. 271, 280 (1988) ("It is shown that the level of [corporate] debt decreases as the level of management investment (shareholding) in the firm increases, reflecting the greater nondiversifiable risk of debt to management than to public investors for maintaining a low debt ratio.").

78. Compare Bentson, *Required Disclosure*, *supra* note 69, at 153 (Corporate SEC filings and disclosures do not produce significant stock price fluctuations or adjustments.); Rendleman, Jones & Latane, *Empirical Anomalies Based on Unexpected Earnings and the Importance of Risk Adjustments*, 10 J. FIN. ECON. 269, 269 (1982) ("[R]oughly 50% of the adjustment of stock returns to unexpected quarterly earnings occurs over a 90-day period after the earnings are announced.") with Reinganum, *Misspecification of Capital Asset Pricing*, 9 J. FIN. ECON. 19, 19 (1981) (Examining unexpected quarterly earnings information led to a finding that subsequent abnormal investor returns were not observed.).

matically affects the stock price unlike any other type of information⁷⁹ and, when provided, undoubtedly is used by investors in making investment decisions.⁸⁰ As a result, the benefits of a mandatory disclosure system are intensified in the context of mergers and acquisitions because market participants consistently hunger for and actually utilize this type of information. Consequently, in this Comment, the free market theory is discussed when appropriate, but is not given primary consideration.

C. *The Continuing Relevance of Full Disclosure*

Congress' enactment of the Insider Trading Sanctions Act of 1984 (ITSA)⁸¹ and the Williams Act in 1968⁸² demonstrates the continuing legislative commitment to furthering the philosophy of fairness and full disclosure embodied in the 1933 and 1934 Acts. The stated purpose of ITSA, for example, is to uphold "the public's expectations of honest and fair securities markets where all participants play by the same rules."⁸³ To achieve this purpose, ITSA provides for injunctions and penalties, both civil and criminal, to prevent insider trading.⁸⁴ Similarly, in order to provide all participants in the securities markets with greater information, Congress passed the Williams Act to broaden disclosure requirements for tender offers.⁸⁵ Thus the

79. For a discussion of the substantial premiums associated with mergers and acquisitions, see *supra* note 38 and accompanying text.

80. For a discussion of how approximately half of the market reaction to a takeover occurs on the day of the first public disclosure, see Keown & Pinkerton, *infra* note 127, at 866.

Professor Ng accurately characterized the tension between the objective of fostering an efficient allocation of information and promoting parity among all market participants:

Our analysis suggests that if information is disclosed to only a selected few, it would be much easier for the government (as a knowledgeable outsider) to influence resource allocation. Although the distribution of resources may be Pareto-optimal, it is possible for a particular group of individuals to continually benefit at the expense of other individuals. The issue . . . becomes a trade-off between Pareto-optimality and other measures of social welfare.

Ng, *Information Accuracy and Social Welfare Under Homogeneous Beliefs*, 2 J. FIN. ECON. 53, 69-70 (1975).

81. 15 U.S.C. § 78u(d) (1984).

82. 15 U.S.C. §§ 78l(i), 78m(d), 78m(e), 78n(d)-(f) (1982).

83. H.R. REP. NO. 355, 98th Cong., 1st Sess. 1, 2 (1983).

84. See 15 U.S.C. § 78u(d) (1984).

85. Cf. *Hanson Trust PLC v. SMC Corp.*, 774 F.2d 47, 54 (2d Cir. 1985). Concerning the problem solved by the disclosure requirements of the Williams Act and the need for full disclosure, the *Hanson* court stated:

Without knowledge of who the bidder is and what he plans to do, the shareholder cannot reach an informed decision. He is forced to take a chance. For no matter what he does, he does it without adequate information to enable him to decide rationally what is the best possible course of action.

Id. at 55 (quoting S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967)); see generally *Hazen, Rumor*

original objectives underlying the 1933 and 1934 Acts and, in particular, Section 10(b) serve as the touchstones of modern securities legislation.

The two major stock exchanges, through the formulation of rules patterned after the congressional intent of fairness and parity of information, also advocate full disclosure. The New York Stock Exchange, for instance, imposes a duty upon every listed company to "release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."⁸⁶ The rules of the American Stock Exchange take a similar approach: "The exchange considers that the conduct of a fair and orderly market requires every listed company to make available to the public information necessary for informed investing; and to take reasonable steps to ensure that all who invest in its securities enjoy equal access to such information."⁸⁷

III. THE EVOLUTION OF CASE LAW DEFINING "MATERIALITY"

Although congressional enactments and the two major securities exchanges recognize the importance of early disclosure of "material" information, including information regarding preliminary merger negotiations, the courts generally have been hesitant to require such early disclosure.⁸⁸ In *Basic Inc. v. Levinson*,⁸⁹ however, the United States Supreme Court provided the foundation for a requirement of earlier disclosure. In *Basic*, the plaintiff Max Levinson sold his shares in Basic Inc. at the same time that Basic was falsely denying that preliminary merger negotiations were underway.⁹⁰ When a subsequent merger between Basic Inc. and Combustion Engineering, Inc. was consummated, Levinson sued Basic Inc. alleging a violation of Rule 10b-5 for falsely responding to inquiries concerning the merger negotiations.⁹¹ The Supreme Court held that preliminary negotiations are "material" and thus must be disclosed if there is "a substantial likelihood that a reasonable [investor] would consider [the existence of such negotiations] important in deciding how to

Control and Disclosure of Merger Negotiations or Other Control-Related Transactions: Full Disclosure or "No Comment"—The Only Safe Harbors, 46 MD. L. REV. 954, 955 (1987) ("The major thrust of the Williams Act . . . is disclosure in order to assure an informed market.").

86. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 202.05 (1986).

87. AMERICAN STOCK EXCHANGE COMPANY GUIDE § 401 (1983).

88. Courts generally have required disclosure only when a deal has been nearly finalized; that is, when the price and structure of the forthcoming transaction have been determined. See *infra* notes 95-101 and accompanying text.

89. 108 S. Ct. 978 (1988).

90. *Id.* at 981.

91. *Id.*

[invest]."⁹² The Court remanded *Basic* to the Sixth Circuit for a ruling on when the merger discussions became material in this particular case.⁹³

By requiring the disclosure of tentative information, like preliminary negotiations, in those instances in which a corporation had recently been allowed to remain silent, *Basic* represents a substantial departure from past judicial interpretation of Rule 10b-5.⁹⁴ In order to better understand *Basic*, this Comment explores the evolution of case law construing the "materiality" of merger negotiations for disclosure purposes.

A. *The Old Bright-Line Rule: Agreement-In-Principle*

Prior to *Basic*, a conflict existed among the federal courts of appeals as to when merger negotiations became material. Some courts considered preliminary merger negotiations immaterial as a matter of law until there was "an agreement in principle . . . on the price and structure . . . [of the] proposed merger."⁹⁵ Under this standard, corporations did not inform shareholders of ongoing negotiations until extremely late in the process. Such late disclosure, however, appealed to corporate management for two reasons. First, the "agreement-in-principle" standard was a bright-line rule affording

92. *Id.* at 983 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

93. *Basic*, 108 S. Ct. at 993.

94. In the years immediately preceding *Basic*, although never advocated by Congress, some courts considered preliminary negotiations material and thus ripe for disclosure only when an agreement-in-principle had been reached. See *Flamm v. Eberstadt*, 814 F.2d 1169, 1174-78 (7th Cir.), *cert. denied*, 108 S. Ct. 157 (1987); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196, 1205-07 (3d Cir. 1982). *Basic*, of course, did not adopt the agreement-in-principle standard.

Before the agreement-in-principle cases, the primary case defining the scope of protection afforded by Rule 10b-5 was *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In *Texas Gulf Sulphur*, the Second Circuit held that corporate managers owe a duty to reasonable and speculative investors to disclose possibilities, as well as established facts. *Id.* at 849-50. The Court stated that "information is material when knowledge of [a] possibility . . . would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold." *Id.* at 849-50 (emphasis added). *Basic* departs from *Texas Gulf Sulphur* by limiting both the disclosure duty and the class of investors to whom the duty is owed: "[a]n omitted fact is material if there is a *substantial likelihood* [rather than a "possibility"] that a *reasonable* [not "speculative"] [investor] would consider it important in deciding how to [invest]." *Basic*, 108 S. Ct. at 983 (emphasis added) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Consequently, *Basic* departs from both recent cases and past judicial precedent.

95. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); see also *Flamm v. Eberstadt*, 814 F.2d 1169, 1174-78 (7th Cir.), *cert. denied*, 108 S. Ct. 157 (1987); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196, 1205-07 (3d Cir. 1982).

managers maximum flexibility to entertain preliminary negotiations without making disclosure, while providing certainty regarding the boundaries of their respective disclosure duties and related liabilities.⁹⁶ Although the corporation may have been under a duty to disclose, preliminary takeover negotiations could be hidden from the public as information that was not material, and thus not ripe for disclosure.⁹⁷ Second, this standard arguably facilitated mergers or acquisitions by allowing vital information of a pending transaction to remain confidential.⁹⁸ Nonetheless, the Second Circuit⁹⁹ and several lower courts¹⁰⁰ held, similar to the holding and standard of *Basic*, that

96. See *infra* notes 112-22 and accompanying text.

97. The determination of whether a public disclosure is mandated requires a two part analysis: whether the corporation is under a duty to disclose and whether the information in question is material. See *supra* note 4. Aside from the issue of materiality, a disclosure obligation arises generally in four particular circumstances. See Goelzer, *supra* note 4, at 975-76. Goelzer asserts that, "[a]lthough there are some exceptions, a public company is generally entitled to maintain confidentiality, even if the negotiations are material." *Id.* at 975-76.

The first circumstance that gives rise to a duty to disclose is when the SEC rules and regulations require disclosure of certain information. The 1934 Act requires three reports and filings. 15 U.S.C. § 78m (1982). Registered corporations must file Form 10-K annually with the SEC within ninety days of the end of a fiscal year. 17 C.F.R. §§ 240.13a-1, 240.15d-1, 249.310 (1988). Corporations also must file Form 10-Q within forty-five days of the end of a quarter. 17 C.F.R. §§ 240.13a-13, 240.15d-13, 249.308a (1988). Finally, corporations must file Form 8-K within 15 days after the occurrence of certain events: change in control, acquisition or disposition of a significant amount of assets, bankruptcy or receivership, change of certifying accountant, and resignation of directors. 17 C.F.R. §§ 240.13a-11, 240.15d-11, 249.308a (1988). Item 5 of Form 8-K requires a company to report any information that would be of material importance to securities holders. For a discussion of specific line item disclosure requirements, see generally Brown, *supra* note 44, at 101-14.

The second circumstance that gives rise to a duty to disclose occurs when issuers trade their own stock. See *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984); *Fridrich v. Bradford*, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). For a more complete description of this obligation, see *infra* notes 206-07 and accompanying text.

The third circumstance for disclosure occurs when prior public announcements, although true when made, become false or misleading. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-62 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). Similarly, courts have held that once a corporation makes a statement, a duty exists to correct those statements still "alive" in the market. 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).

The fourth circumstance is when market rumors are attributable to the issuer. 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). Specifically, this obligation arises when corporate insiders disclose material information to selected individuals, who subsequently trade on the nonpublic information. In such a circumstance, a corporation may be under a duty to disclose the same information to the entire market.

98. See *infra* notes 154-61 and accompanying text.

99. See *SEC v. Shapiro*, 494 F.2d 1301, 1305-06 (2d Cir. 1984); *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849-50 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

100. See *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128, 133-34 (S.D.N.Y. 1984)

merger negotiations crossed the materiality threshold prior to an "agreement-in-principle."¹⁰¹

B. *The Supreme Court: Materiality is Fact Sensitive*

Prior to *Basic*, tension existed between the original congressional mandate of early disclosure of information for the protection of investors and the subsequent judicial tolerance of late disclosure for the benefit of corporate managers and their suitors. In considering the question of when merger negotiations become "material" under Rule 10b-5, the *Basic* Court recognized this tension and adopted the "materiality" standard used in evaluating proxy solicitation provisions under Section 14(a) of the 1934 Act.¹⁰² This standard had been enunciated in *TSC Industries, Inc. v. Northway, Inc.*,¹⁰³ the leading case in the proxy area, involving omissions on a proxy statement, in which the Court concluded that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."¹⁰⁴

(finding that a statement denying knowledge of merger discussions could be materially misleading) (dicta); *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 439 F. Supp. 721, 744-45 (E.D. Va. 1980) (same); *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. April 15, 1985) (same); *In re Carnation Co.*, Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985) (same) [hereinafter *Carnation Release*].

101. Although an earlier disclosure standard would protect small investors from the market power exerted by market professionals, such a standard should also provide corporate managers with clear guidance as to their duty to disclose. For a discussion of the need for a bright-line materiality standard for use by corporate management, see *supra* notes 112-22 and accompanying text.

102. *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988) ("We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context."). Moreover, prior to *Basic*, two courts of appeals had applied the definition of materiality of Section 14(a), as amended, of the 1934 Act to Section 10(b) and Rule 10b-5. See *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 & n.4 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

103. 426 U.S. 438 (1976). In *TSC Industries*, National Industries bought 34% of TSC Industries common stock and put five persons on the TSC board of directors (including the chairman of the board and chairman of the executive committee). *Id.* at 440. Next, National proposed to buy the remainder of TSC in a stock-for-stock exchange. *Id.* at 440-41. The board of TSC approved the transaction while the five National directors abstained. *Id.* As a shareholder of TSC, Northway, Inc. brought a cause of action alleging that the joint proxy statement issued by TSC and National to solicit TSC shareholder approval was false and misleading and in violation of Rules 14a-3 and 14a-9. *Id.* at 442-43. Although the Supreme Court eventually held that the statements or omissions were not material, the complaint alleged that the proxy statement failed to disclose that: 1) the President of National was the chairman of the board of TSC, *id.*; 2) the vice president of National was the chairman of the TSC executive committee, *id.*; and 3) National may have been in "control" of TSC by virtue of National owning 34% of TSC's common stock. *Id.* at 441-42.

104. *Id.* at 449.

The *Basic* Court applied the *TSC Industries* materiality standard to takeover investment decisions. The standard, however, does not provide guidance as to whether and when a "reasonable investor" would consider preliminary merger negotiations significant in investment decisions. The *Basic* Court tried to address this problem, recognizing that "materiality" will depend upon "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."¹⁰⁵ The more probable a takeover or the greater its potential magnitude, the more likely it is that the information will have to be disclosed.

This balancing standard does not provide a bright-line rule for management, but depends upon the particular facts of each case. Initially, to assess the probability that a transaction will occur, the *Basic* Court first suggested that the factfinder look to certain indicia of interest in the transaction at the highest corporate levels.¹⁰⁶ Accordingly, supporting evidence may include instructions to investment bankers, board resolutions, and actual negotiations between principals or their intermediaries.¹⁰⁷ These events, common to all takeovers, are objective questions of fact and, unlike the factors weighing upon the magnitude of the transaction, provide useful guidance to managers as to when disclosure may be appropriate.¹⁰⁸ Second, in considering the magnitude of the transaction, the Court observed that the factfinder should analyze the size of the corporate entities involved and the size of potential premiums over market value.¹⁰⁹ Because the issues of the size of the entities and of potential premiums are subjective questions of fact, the "materiality" of particular transactions inevitably will vary from case to case.

IV. *BASIC* RULING CREATES ADDITIONAL PROBLEMS

The *Basic* standard has several practical problems. Under this new fact-sensitive materiality test, corporate managers will not know how to act. Thus the standard creates uncertainty as to when preliminary negotiations must be disclosed and therefore leaves corporate managers without clear guidance as to the potential for civil and crim-

105. *Basic*, 108 S. Ct. at 987 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)).

106. *Id.*

107. *Id.*

108. Although a determination as to whether such events have actually occurred is an objective exercise, until a court addresses precisely which indicia of interest are relevant or meaningful, the selection of the specific bright-line events will be subjective.

109. *Basic*, 108 S. Ct. at 987.

inal liability for withholding information.¹¹⁰ Additionally, this materiality standard does nothing to avert the alarming increase in insider trading activity.¹¹¹

A. *Managers Do Not Know How to Behave*

The materiality standard adopted by the Supreme Court in *Basic* creates confusion among corporate managers. The bright-line "agreement-in-principle" test rejected by the Court appealed to corporate managers because it provided clear guidelines and boundaries. The standard was also easy to enforce.¹¹²

Under *Basic*, however, materiality is a question of fact to be determined by the circumstances of each case. Although they have no clear guidance as to when negotiations become material, corporate managers must make decisions that implicate enormous liability risks.¹¹³ As one commentator observes, "an uncertain materiality test creates difficult counseling situations and liability concerns, particularly given that any adjudication will be determined with hindsight."¹¹⁴ Management liability based on an uncertain, case-by-case determination of materiality may create a disincentive for corporations to enter into takeover negotiations, especially given the painstaking efforts that are required to adhere to unclear disclosure rules and the potential for enormous liability. If managers decide not to pursue takeover discussions when appropriate and in the best interests of their corporations, shareholders will seek alternative investments that will maximize their return, and investors generally will place less reliance on the securities markets.

Under the probability/magnitude balancing test inherent in the *Basic* standard, a corporate manager must consider the magnitude of

110. Because there is little case law defining this new materiality threshold, the conditions or circumstances giving rise to a duty to disclose material information regarding preliminary negotiations have yet to be fully developed. Although this paucity of relevant case law should be temporary, the ad hoc nature of the *Basic* test limits corporate managements' incentive to enter negotiations because of the uncertainty regarding potential, immense liability.

111. For a discussion of how the *Basic* probability/magnitude standard fails to limit the time during which insiders can exploit the value of their nonpublic information, see *infra* notes 123-31 and accompanying text.

112. See *A Tough Call on Disclosure*, MERGERS & ACQUISITIONS, July/Aug. 1988, at 21; Ehlinger, *Can Merger Negotiations Still Be Kept Under Wraps?*, MERGERS & ACQUISITIONS, Sept./Oct. 1988, at 45; *Roundtable: Weaving Communications in the Acquisition Process*, MERGERS & ACQUISITIONS, July/Aug. 1988, at 24 [hereinafter *Roundtable*].

113. In addition to criminal and civil liability under Rule 10b-5 for failing to disclose information, managers also can be held liable for undue delays committed in bad faith. See *Financial Indus. Fund v. McDonnell Douglas Corp.*, 474 F.2d 514, 519 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

114. Steinberg & Goldman, *supra* note 73, at 929.

the transaction and the probability that the transaction will occur, in order to determine if preliminary merger negotiations must be disclosed.¹¹⁵ Regarding the magnitude component of the test, the *Basic* Court suggested no clear method for managers to measure the magnitude of the transaction except for stating that managers should consider the size of the merging corporate entities and the potential stock price premium.¹¹⁶ Measuring the size of a corporate entity is problematic because there are many different standards which can be utilized. Such measurement, for example, could be based upon the number of employees, the number of shareholders, the amount of gross earnings, or the value of corporate assets. Similarly, the measurement of a potential takeover premium—either the dollar amount of price fluctuation or the percent ratio of change in original stock price¹¹⁷—is problematic because its assessment is a subjective determination based largely on market uncertainties.

Furthermore, by requiring an evaluation of the expected stock price premium, the Court set too low a threshold of materiality. In most cases, the potential premium will be so large that any investor will want to be aware of any activity that could dramatically affect the stock price.¹¹⁸ Indeed, considering the potential stock premium alone, all merger negotiations may be considered material.¹¹⁹ Judge Friendly, in considering the magnitude of a transaction under the *SEC v. Texas Gulf Sulphur Co.*¹²⁰ probability/magnitude approach,

115. The *Basic* Court stated that materiality depends upon "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Basic Inc. v. Levinson*, 108 S. Ct 978, 987 (1988) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).

116. *Id.*

117. *Id.*; see also *supra* notes 38, 120 and accompanying text (discussing takeover premiums and the difficulty in their measurement).

118. See *supra* note 38 and accompanying text (empirical data concerning the magnitude of the abnormal returns received by target shareholders). The stock of RJR Nabisco Inc., for example, received a 96.8% takeover premium — the difference between the Kohlberg, Kravis, Roberts & Co. (KKR) \$108 per share offer and the stock price of \$54.875 thirty-nine days before the KKR deal was finalized. See Burrough and Helyar, *Buy-Out Bluff: How Underdog KKR Won RJR Nabisco Without Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6.

119. There are also several problems with measuring the potential premium. A stock premium can be defined by either a certain dollar or percentage gain in a particular stock. Moreover, the realized gain can be attributed to several different periods—a one-day stock price rise or a two-week period to account for insider trading which may not be accounted for in one-day snapshots. The definition must account for the fact that approximately half of the market reaction to a takeover occurs before the public announcement, and most of the remaining increase is realized on the day of the announcement. For a discussion of empirical evidence reflecting the vast proportions of insider trading, see *infra* notes 123-31 and accompanying text.

120. 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

wrote:

Since a merger in which [a corporation] is bought out is the most important event that can occur in a . . . corporation's life, to wit, its death, we think that inside information, as regards a merger . . . can become material at an earlier stage . . . even though the mortality rate of mergers in such formative stages is doubtless high.¹²¹

Thus, in the context of a potential stock price premium, mergers could and should be deemed material as a matter of law once there is any possibility of a combination. The importance of a merger or acquisition and its potential impact on the stock price compels such a result. If such a proposal were adopted, only the probability of a specific takeover, as determined by the relevant indicia of interest in the transaction, would be examined to determine if disclosure was necessary.

Because managers must adhere to the law and thus to the *Basic* holding, they cannot wait for the courts to clarify the duty to disclose preliminary takeover negotiations as redefined by *Basic*. Therefore, managers must either make complete disclosure, possibly generating great costs at the expense of shareholder earnings,¹²² or withhold disclosure, at the risk of incurring substantial liability. This dilemma may restrain corporate managers from engaging in mergers or acquisitions. Moreover, if managers do not seek to consummate mergers or acquisitions when appropriate, shareholders may unwittingly forgo stock price premiums that they might have realized had there been a combination.

B. *Insider Trading Flourishes*

Rule 10b-5 prohibits insider trading by establishing a fiduciary duty prohibiting an issuer from gaining a profit through the use of nonpublic corporate information at the expense of its shareholders.¹²³ According to Rule 10b-5, an issuer in possession of material, nonpublic information may not trade its own stock.¹²⁴ Thus, if preliminary merger negotiations are "material," issuers must either abstain from

121. SEC v. Geon Industries, 531 F.2d 39, 47-48 (2d Cir. 1976).

122. For a discussion of the costs associated with making a disclosure, see *infra* notes 185-87 and accompanying text.

123. For a discussion of the relationships that give rise to a duty to disclose material information or to refrain from trading, see *infra* notes 206-07 and accompanying text.

124. See *Carpenter v. United States*, 108 S. Ct. 316, 321 (1987); *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987); *Staffin v. Greenberg*, 672 F.2d 1196, 1203 (3d Cir. 1982); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974); *State Teachers Retirement Bd. v. Flour Corp.*, 500 F. Supp. 278, 291 (S.D.N.Y. 1980), *aff'd in relevant part*, 654 F.2d 843 (2d Cir. 1981).

trading their stock or disclose the negotiations.¹²⁵

Under the philosophy of full disclosure, many insiders, outsiders, investment bankers, and their respective employees have been the target of recent SEC enforcement efforts.¹²⁶ Despite these enforcement efforts, insider trading flourishes. Professors Keown and Pinkerton statistically confirm that merger negotiations are poorly held secrets, and that trading on this nonpublic information by insiders and market professionals abounds.¹²⁷ Specifically, they report that "uncontrolled abuse of Rule 10b-5" begins five to eleven days prior to the announcement date of a takeover.¹²⁸ The impact is widespread, with approximately half of the market reaction to a takeover occurring before the first public announcement.¹²⁹ Thus insider trading is rampant and negatively affects those investors not in possession of this critical information.¹³⁰

125. See *Fridrich v. Bradford*, 542 F.2d 307, 314-18 (6th Cir. 1976); *Fischer v. Plessey Co.*, 559 F. Supp. 442, 449 (S.D.N.Y. 1983). Corporate insiders trading stock for their personal account are under a duty to disclose all material facts to prospective purchasers or sellers. This "disclose or abstain" rule is derived from an interpretation of the anti-fraud rules stemming from *In re Cady Roberts*. 40 S.E.C. 907 (1961).

126. See, e.g., *SEC v. Tome*, 833 F.2d 1086 (S.D.N.Y. 1986); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984); *In re Drexel Burnham Lambert Inc.*, No. 88-6209 (S.D.N.Y. 1988) (settlement discussions ongoing); *SEC v. Seigel*, 19 Sec. Reg. & L. Rep. (BNA) 247 (S.D.N.Y. Feb. 13, 1987); *SEC v. Cecola*, No. 86 Civ. 9735, slip op. (S.D.N.Y. Dec. 22, 1986); *SEC v. Pomerantz*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,008 (S.D.N.Y. Dec. 11, 1986); *SEC v. Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986); *SEC v. Wilkis*, 18 Sec. Reg. & L. Rep. (BNA) 962 (S.D.N.Y. July 1, 1986); *SEC v. Sokolow*, 18 Sec. Reg. & L. Rep. (BNA) 962 (S.D.N.Y. July 1, 1986); *SEC v. Levine*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,761 (S.D.N.Y. June 5, 1986); *SEC v. Thayer*, 17 Sec. Reg. & L. Rep. (BNA) 841 (N.D. Tex. May 7, 1985).

Congress enacted the Insider Trading Sanctions Act of 1984, 15 U.S.C. 78u(d) (1984), to discourage insiders from using material nonpublic information. Another statute, the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, recently was passed, creating still stronger penalties against insider trading. See Goelzer, *Legislative Developments in the 100th Congress Affecting the Work of the Securities and Exchange Commission*, ALI-ABA, NINTH ANNUAL SOUTHERN FEDERAL SECURITIES INSTITUTE 272, 286-87 (1989) (discussing the Insider Trading and Securities Fraud Enforcement Act of 1988). This enactment, among other things, doubles the maximum prison sentence for insider trading from five years to ten years and increases the maximum criminal fine from \$100,000 to \$1 million for individuals, and from \$500,000 to \$2.5 million for corporations and partnerships. *Id.* at 286. The statute also empowers the SEC to seek treble damages from employers who fail to properly supervise employees who engage in insider trading. *Id.* Moreover, under the new law, the SEC is free to create a bounty program to reward informants whose assistance leads to insider trading penalties. *Id.* The bounty could be as much as 10% of the fines imposed. *Id.*

127. See Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 4 J. FIN. 855 (1981).

128. *Id.* at 866.

129. *Id.* Most of the remaining market reaction occurs on the day of disclosure, with only 5% occurring the following day. *Id.*

130. Jensen and Ruback attack Keown and Pinkerton's findings on the basis that the latter disregard the "plausible alternative hypothesis" that price changes are caused by responses to

Because of extensive insider trading, investors' fortunes depend on how early they discover the negotiations and the extent to which they draw accurate conclusions from increased market activity. The earlier that disclosures are made or required, the less time that insiders will have to capitalize on their nonpublic information. Although *Basic* provided the foundation for earlier disclosure requirements, the *Basic* probability/magnitude materiality standard will not impede significantly insider trading because this standard is fact sensitive and will vary from case to case. As a result, the amount of time insiders will have to act on their nonpublic information will not be limited in every case, and the SEC will not have the benefit of bright-line enforcement guidelines.

A potential problem, one that still exists after *Basic*, arises when an issuer knows of negotiations that are not yet material, but purchases the stock knowing or speculating that the merger, or at least the announcement of negotiations, will eventually and dramatically impact the stock price.¹³¹ Although such "informed speculation" may be considered legal, it is hypocritical to suggest that the information giving rise to such speculation truly is not material.

V. DISCLOSURE: IS A MARRIAGE OF FAIRNESS AND EFFICIENT MARKETS POSSIBLE?

Stock price fluctuations generally can be explained by the efficient capital market theory.¹³² Under this theory, the capital markets

public information that increase the probability of a takeover. Jensen & Ruback, *supra* note 18, at 14 n.6. Jensen and Ruback contend that an announcement of a merger or acquisition is not a one-day event, but rather a series of events increasing the probability of a takeover.

Jensen and Ruback's position also has been questioned:

Up until about two weeks before the public announcement, [their] conclusion seems warranted. It is unlikely, however, that public information would produce the dramatic price increases and abnormal returns that take place for two weeks prior to disclosure.

Furthermore, even if effective public announcement is prolonged over several days, that state of affairs involves a significant amount of unfairness to investors who are not in a position to know about events preceding public disclosure on the national level.

Comment, *Disclosure*, *supra* note 38, at 83 n.17.

131. Goelzer, *supra* note 4, at 977. Goelzer stated: "[I]f the merger negotiations are not material (the company, at least as a matter of Rule 10b-5 law) may presumably purchase its own shares from investors, even though the company is aware of the possibility that the inchoate merger will dramatically increase the value of those shares." *Id.*

132. Under the efficient capital market theory, all available public information about a publicly traded company is reflected fully in the price of its stock. See, e.g., Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (discussing stock market efficiency). Some commentators believe that investors use all available information to estimate, and subsequently to bid-up, the value of stock. See Fauma, *Efficient*

currently exhibit semi-strong characteristics; that is, stock market prices reflect an evaluation of all publicly available information.¹³³ As a result, the corporate announcement of ongoing merger negotiations immediately affects the corporation's stock price. Estimating the value of the potential merged corporation, investors bid the stock price up or down until it reaches the estimated value, as discounted by

Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970); Friend, *The Economic Consequences of the Stock Market*, 62 AM. ECON. REV. 212 (1972); Note, *The Efficient Capital Market Hypothesis, Economic Theory, and Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). Other commentators, however, contend that investors speculate given increased information signaled by vigorous market activity and, thus, cause volatile swings in the price of stock. See Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986).

Gilson and Kraakman suggest that it is desirable for capital markets to act efficiently. Gilson & Kraakman, *supra*, at 549-50. They explain that, in an efficient market, if companies freely disclose information, stocks are neither over or undervalued because investors bid up or down the stock price based on predictions made from publicly available information. *Id.* As more or conflicting information is released, stock prices are affected incrementally. *Id.* These moderate shifts in stock value allow individual investors sufficient time to evaluate new information and make investment decisions to buy, sell, or hold particular securities. When material information is announced at one time, rather than gradually, the market reacts with volatility to the latest information. With wide swings in stock price, individual investors lose confidence in the market and, consequently, place less of their resources in the market. With a decreased influx of capital, companies have less funds available to finance current operations or expansion. *Id.* at 609-26. Moreover, when investment funds are not readily available, interest rates increase, thus reducing the capacity of the entire economy. *Id.*

133. Efficient market theorists describe the capital market response to information in three ways. First, under the "weak form," the market reflects only historical price data. Fauma, *supra* notes 132, at 388. Second, a "semi-strong form" reflects all publicly available information. *Id.* Third, a "strong form" reflects all public and nonpublic information. *Id.*

In a semi-strong form market, for example, if a company has discovered but has not disclosed a new lower cost manufacturing process, but has announced the signing of new profitable production contracts, the stock price will increase based solely on the public information of the profitable contracts. The manufacturing process, not known by the public market, will not affect the stock price. If the strong form efficient market theory were valid, the disclosure of pretakeover activity would be inconsequential because all information, public and nonpublic, already would be efficiently reflected in the capital market. That is, by the time the information can be disseminated, it already has been reflected in the price of the stock. Studies of the strong form have demonstrated that the market has semi-strong characteristics rather than strong. If capital markets truly operate under the semi-strong form, possessors of market trends or inside information trade at a distinct advantage. See Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 3 n.9 (1978); Seligman, *supra* note 74, at 4 n.22. Additionally, the Supreme Court of the United States implicitly adopted the semi-strong form of the Efficient Capital Market Theory:

An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

Basic Inc. v. Levinson, 108 S. Ct. 978, 991-92 (1988).

the possibility that the merger will not be consummated.¹³⁴ Put another way, stockholders and purchasers base their investment decisions upon the "total mix"¹³⁵ of publicly available information. Merger negotiations are a crucial component of this "total mix."

When companies merge, the stock value of the target company typically increases substantially, reflecting the perceived greater ability of the merged corporation to utilize combined resources and create higher earnings.¹³⁶ The highest bidder in the battle for corporate control—individual investors, market professionals, insurance companies, other institutional funds, or corporate raiders—realizes this synergy. Once merger negotiations are rumored or announced, buyers, often market professionals, assume the risk that negotiations may fail when they purchase target company stock from individual investors.¹³⁷ When negotiations are disclosed, current stockholders are given the opportunity to evaluate the new information and the option of either selling their stock at the premerger escalated price or not selling if they anticipate further increases in the market price.

In the absence of disclosure, an individual investor who is unaware of any rumors may forgo a potential takeover premium by prematurely selling his stock. By purchasing shares from these uninformed investors, insider traders bid up the price of the stock. Subsequently, market professionals either who notice the increased stock activity or who may be in possession of nonpublic information

134. See Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51 (1983); Brown, *supra* note 44, at 148 n.205.

135. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

136. Jensen and Ruback explain that there are various sources of increased value created by takeovers:

Potential reductions in production or distribution costs, often called synergies, could occur through realization of economies of scale, vertical integration, adoption of more efficient production or organizational technology, increased utilization of the bidder's management team and reductions of agency costs by bringing organization-specific assets under common ownership.

Jensen & Ruback, *supra* note 18, at 23 (citations omitted). Notwithstanding the various theoretical benefits of synergy value, commentators are not in agreement as to whether these benefits of synergy actually are realized. Compare Shay, *Setting the 'Right' Premium in an Efficient Market*, MERGERS & ACQUISITIONS, Spring 1981, at 23 (asserting that improvements to the combined cash flows of two firms in excess of the simple sum can be attributed to more efficient utilization of corporate assets and resources) with Penn, *Premiums: What Do They Really Measure?*, MERGERS & ACQUISITIONS, Fall 1981, at 33 (concluding that the increased value that investors perceive in the target firm is only an accounting result from increased information known about the target company). Yet, when initial takeover bids are made, analysts' consensus earnings forecasts for any group of takeover targets does not change significantly. Pound, *The Information Effects of Takeover Bids and Resistance*, 22 J. FIN. ECON. 207, 226 (1988). This finding is consistent with the synergy view of merger value and inconsistent with the proposition that firms are undervalued due to a lack of information.

137. Asquith, *supra* note 134, at 51.

also capitalize on individual investors' lack of knowledge by purchasing shares. Individual investors sell because the stock price is inflated due to purchases by insiders and market professionals. Insiders and market professionals are willing to pay the elevated price because they expect higher returns based on the undisclosed information. As a result, individual investors who make an uninformed decision to sell their stock forgo a potential takeover premium.

An early disclosure policy, however, would not be without problems. Investor protection in the form of early, full disclosure, for example, creates costs that directly reduce the return of all corporate shareholders.¹³⁸ Additionally, forcing a corporation and all its shareholders to incur the financial burden associated with disclosure may not be justified by protecting those investors who may sell prematurely.¹³⁹ Under a free market philosophy, affording protection to those who suffer losses may not justify imposing costs on those who do not. In any event, individual investors may not even utilize the additional information.

The latter portion of this Comment examines late, early, and intermediate disclosure models and attempts to identify the costs and benefits of each. Only by balancing the interests of corporate managers, market professionals, and individual investors can one find a sound marriage of fairness and free, efficient markets. The ideal disclosure system is one that is consistent with the legislative intent of full disclosure and addresses the need for clear management guidelines and corporate efficiency. Under such a system, market professionals and corporate managers would continue to be allowed to operate efficiently, but without an unfair informational advantage.

A. *Disclose When an Agreement-In-Principle is Reached*

Prior to *Basic*, many courts¹⁴⁰ considered preliminary merger negotiations immaterial as a matter of law until there was "an agreement in principle encompassing fundamental terms,"¹⁴¹ that is, until the price and structure of the transaction had been determined.¹⁴²

138. For a discussion of the costs associated with disclosure and their impact on corporate earnings, see *infra* notes 185-87 and accompanying text. See also Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

139. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (discussing costs and benefits of additional market information).

140. See *infra* notes 94-95 and accompanying text.

141. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985).

142. *Id.* at 757; see *Flamm v. Eberstadt*, 814 F.2d 1169, 1178 (7th Cir. 1987) (affirming the price and structure rule).

Corporate managers preferred this late disclosure standard because it was a bright-line rule easily comprehended and followed, and because it was one that ordinarily allowed negotiations to be concealed from investors and speculators.¹⁴³

1. BENEFITS

Requiring disclosure of negotiations only after an agreement-in-principle has been reached protects investors and facilitates transactions. This higher threshold of materiality protects investors from an avalanche of inconclusive information and from market gyrations caused by speculation based on tentative information. The agreement-in-principle standard also allows a target and a suitor to negotiate in privacy without public reaction driving up the price of the target shares during the negotiations phase of the transaction.

a. Protects Individual Investors from an Avalanche of Information

Not all information regarding corporate developments is useful. Indeed, some information is of "dubious significance."¹⁴⁴ Individual investors and market professionals cannot digest effectively an abundance of meaningless corporate information.¹⁴⁵ Thus the *Basic* Court was careful not to set too low a threshold of materiality when adopting the probability/magnitude test.¹⁴⁶ The Court recognized that too low a "minimum standard might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.'"¹⁴⁷ By providing a higher threshold of materiality before disclosure is required, the agreement-in-principle standard avoids this surfeit of often useless information.

b. Reduces Speculative Investing

Although, in theory, increased information should lead to wiser, more efficient investment choices,¹⁴⁸ several commentators have sug-

143. It may be suggested that corporate managers prefer to conceal takeover negotiations in order to facilitate a merger and to prevent speculative investors from driving the price of the target company beyond the reach of the suitor. This proposition should not take into account, however, that disclosing takeover negotiations may maximize the return to target company shareholders by attracting other suitors who may be willing to pay more for control of the target company. For a discussion of the bidding war for control of RJR Nabisco, Inc., see *supra* notes 37, 118 and *infra* note 187.

144. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976).

145. *Id.* at 448-49.

146. *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988).

147. *Id.* (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

148. See *supra* notes 132-34 and accompanying text.

gested that disclosure of preliminary merger negotiations creates inefficient, volatile price swings by misleading the public as to perceived corporate activity.¹⁴⁹ In today's market, extraordinarily high takeover premiums motivate individual investors and market professionals to speculate vigorously in the stock of takeover candidates before or just after the announcement of a possible transaction.¹⁵⁰ When preliminary merger negotiations are announced, some investors bid up the price of the stock as if the deal had been finalized. By reacting to rumors or news of potential combinations, speculators create volatile price swings by overpricing stock. Later, if there are any indications that the takeover may not be consummated, speculators dump their shares hoping to limit their losses. Therefore, with the present market thirst for discovering takeovers and other similar transactions, disclosure of preliminary merger or acquisition negotiations may lead to less, rather than more, efficient capital markets.¹⁵¹

This quest for finding "deals" creates short-term speculation for stock premiums, rather than placing emphasis on a corporation's long-term prospects. Reserving the announcement of merger negotiations until the price and structure of the transaction have been determined prevents buyers from treating preliminary negotiations as finalized and thus from investing speculatively.¹⁵² Consequently, if negotiations were to collapse, investors would not be injured by having purchased rumor-inflated stock.¹⁵³

149. See Hazen, *supra* note 85, at 956-57 ("The short-term emphasis on the takeover, corporate restructuring, and going private markets, combined with investor's ignorance as to takeovers and mergers in their early planning stages, has led to volatile markets that are significantly affected by rumors."); Steinberg & Goldman, *supra* note 73, at 925 ("[A] premature public pronouncement might quash the deal or mislead the investing public as to likely corporate activity.").

150. See *supra* note 38 and accompanying text.

151. *Id.*

152. A release of information about a tentative plan may disrupt the market by encouraging uninformed speculation. The United States Court of Appeals for the Third Circuit in *Staffin v. Greenberg* stated:

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.

Staffin v. Greenberg, 672 F.2d 1196, 1206-07 (3d Cir. 1982).

153. In practice, however, inefficient markets are already being created because people currently trade on rumors. For a discussion of the lack of absolute confidentiality of negotiations, see *supra* notes 127-29 and accompanying text, and for a discussion of current market inefficiencies and the semi-strong form characteristics, see *supra* notes 132-33 and accompanying text.

c. Preserves Confidentiality Preventing a Bidding War for the Stock of the Target Company

Under the business judgment rule, corporate managers are afforded wide discretion to control the disclosure of nonpublic information.¹⁵⁴ The only caveat is that managers must act reasonably and have a legitimate business rationale.¹⁵⁵ Prior to "an agreement in principle encompassing fundamental terms,"¹⁵⁶ merger negotiations are "inherently fluid and . . . shrouded in uncertainty."¹⁵⁷ Premature disclosure may mislead investors or disrupt a potential deal.¹⁵⁸ Suitor companies fear that, if merger negotiations are revealed, speculators will bid up the stock price of the target company,¹⁵⁹ possibly placing the target company on the auction block and out of the financial reach of the suitor.¹⁶⁰ Confidential negotiations arguably are crucial both to

154. See, e.g., Wander, *Timely Disclosure After Basic*, 21 REV. SEC. & COM. REG. 109, 111 (1988), reprinted in ALI-ABA, NINTH ANNUAL SOUTHERN FEDERAL SECURITIES INSTITUTE 50, 52 (1989) (discussing materiality and the balance between timely disclosure and the business judgment rule).

155. ALI-ABA, NINTH ANNUAL SOUTHERN FEDERAL SECURITIES INSTITUTE 52 (1989). In considering how the business judgment rule affects timely disclosure, one commentator explained:

The judiciary recognizes that to require absolute and immediate disclosure of all material information concerning crucial corporate developments may often undermine corporate success. Therefore, the courts have left the timing of disclosure largely to the discretion and business judgment of management. The nondisclosure decisions share an underlying premise that issuers act reasonably and have some legitimate reason for delaying disclosure: e.g., an earlier announcement would risk losing a valuable corporate opportunity.

Id.

156. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984) (holding that merger negotiations need not be disclosed until an agreement is reached on the price and the structure of the transaction).

157. *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987) (quoting *Reiss v. Pan American World Airways*, 711 F.2d 11, 14 (2d Cir. 1983)).

158. See *Heublein*, 742 F.2d at 757.

159. For a discussion of how speculators bid up the target company's stock, see Asquith, *supra* note 134, at 51.

160. One example was the monumental auction for control of RJR Nabisco. For a review of the suitors and their escalating bids, see *supra* notes 37, 118 and *infra* note 187. Additionally, Freund commented:

It's a jungle out there!

So, how do lawyers (and others charged with getting deals done) operate today in the public-acquisition area? In a nutshell, they negotiate in private in order to arrive at a point where, when the world finds out something's happening, it's as close to a done deal as possible—with the undone parts getting taken care of posthaste. Put another way, the overriding goal of the parties is to make it very tough for anyone to crash the party.

Freund, *supra* note 38, at 13, col. 3.

Putting a target company up for public auction, however, does not necessarily harm the shareholders' interests. Although the specific transaction with the original suitor becomes less

the ultimate success of the takeover negotiations and to minimizing acquisition costs.¹⁶¹

2. COSTS

a. Individual Shareholders Unwittingly Sell

Market professionals and individual investors compete for takeover premiums.¹⁶² Individual investors, not having the benefit of extensive in-house research, are unaware of many corporate developments, including takeover discussions. Market professionals, employing in-house research and privy to some nonpublic information, are aware of such corporate developments and thus have an advantage over individual investors.¹⁶³ Under a late disclosure model, such as the agreement-in-principle standard, arbitrageurs and insiders are afforded ample time to capitalize on their informational advantage. As a result, uninformed investors are exploited; they sell without knowing that the stock price may increase significantly due to subsequent takeover activity.¹⁶⁴

b. Investors Lose Confidence in the Market

Fear of investor exploitation erodes confidence in the securities markets.¹⁶⁵ Investors, especially those of moderate financial means,

likely to be consummated, new bidders entering the arena often are willing to pay more to the target shareholders. See *infra* note 187 and accompanying text.

161. See *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) (holding that an issuer is not required to disclose information until it makes a good faith determination that the information is material and ripe for publication).

162. For an empirical study of this competition, see Hamilton, *supra* note 44, at 294. Hamilton estimates that, when a takeover is finally complete, 60% to 90% of company shares are tendered by arbitrageurs who, having gained an informational advantage through in-house research, have purchased the stock from individual investors. *Id.*

163. See Gilson & Kraakman, *supra* note 132, at 572.

164. *Id.* at 579-89.

165. The American Bar Association, Committee on Federal Regulation of Securities, recognizes the damage that the fear of insider trading and other forms of exploitation could cause:

In our society, we traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. A spitball pitcher, or a card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play. These commonsense observations suggest that two of the traditional bases for prohibitions against insider trading are still sound: the "fair play" and "integrity of the markets" arguments. The first relies on the basic policy that cheating is wrong and on the traditional sympathy for the victim of the cheat. The second rests on the oft-repeated argument that people will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed. . . . [I]f investors do not anticipate fair treatment,

withdraw their capital from the market when they fear they may be exploited by better-informed traders.¹⁶⁶ If less capital flows into the securities markets, corporations will be forced to borrow funds to finance their expansion plans. This competition for limited funds will drive up interest rates and be detrimental to the economy as a whole.¹⁶⁷

A late disclosure standard will only exacerbate current erosion of investor confidence. In fact, many investors may withdraw from the securities markets solely from feeling, in this time of golden

they will avoid investing in securities. As a result, capital formation through securities offerings will become less attractive and more difficult.

ABA, Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Anti-fraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 227-28 (1985).

166. Mendelson, Book Review, 117 U. PA. L. REV. 470, 477-78 (1969). Although this argument seems intuitively sound, because it is based on subjective investment behavior and motivations of individual investors, there is no empirical evidence to support the practical validity of this theory. See, e.g., Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, *supra* note 69, at 693 ("All we can say is that after fifty years, the proponents of regulation have no scientifically-accepted evidence of a favorable cost-benefit ratio for any disclosure rule that rests on the benefits of . . . increasing confidence."); Manne, *Insider Trading and the Law Professors*, *supra* note 64, at 577 ("[T]he public has never shown any signs of losing confidence in the stock market because of the existence of insider trading."). Cf. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1227 (1981) ("[I]nvestors already disregard a large body of evidence indicating that it is difficult for even the most sophisticated institutions to outperform the stock market averages.") [hereinafter Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets*].

Although it is empirically difficult to measure the effect that investor confidence has on general market conditions, Professors Klein and Bawa find that individual investors, in comprising their personal portfolios, tend to purchase securities about which they believe there is sufficient public information. Klein & Bawa, *The Effect of Limited Information and Estimation Risk on Optimal Portfolio Diversification*, 5 J. FIN. ECON. 89, 91-92 (1977). Consequently, in the context of promoting liquidity in the securities markets, mandatory disclosure should help investors feel confident that they have and will receive timely, relevant information concerning any security that they may purchase.

167. Mendelson, Book Review, *supra* note 166, at 477-78. The increased cost of capital comes from three different sources. First, Mendelson contends that individual investors, fearing exploitation by insider traders, create a shortage of investment capital and drive up interest rates when they withdraw from either a specific corporation or the securities market generally. *Id.* Second, Professor Brundy asserts that some market participants, instead of refraining from investing in the market, will incur substantial, investigatory costs to ensure that they are not investing in a corporation whose directors trade on nonpublic information. Brundy, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law*, 93 HARV. L. REV. 322, 355-56 (1979). Third, when market-makers lose confidence and try to protect themselves from the presence of insider trading, the bid-ask spread of a corporation's stock will increase, raising the share price and lowering the return to investors. See Seyhun, *supra* note 47, at 109-91. For a further explanation of how numerous factors, including investor exploitation, affect the flow of capital into the markets, see Gilson & Kraakman, *supra* note 132, at 549.

parachutes,¹⁶⁸ that they have not been treated fairly. Although individual investors could seek alternative investments or place their money in mutual funds,¹⁶⁹ Congress never intended to limit participation in the securities markets to insiders and market professionals.¹⁷⁰

168. A golden parachute is a lucrative contract that usually provides corporate executives with additional benefits in case the company is taken over and the executives are forced to, or voluntarily, leave the target company. A golden parachute may include stock options, generous severance pay, or a bonus payable at the end of the executive's employment at the company. F. Ross Johnson, for example, the ex-president and CEO of RJR Nabisco, received \$25.7 million in cash and securities under KKR's \$25.07 billion offer. Morris, *Defeated RJR Chief Johnson Won't Be Short of Consolations*, Wall St. J., Dec. 2, 1988, at A10, col. 5 (For several years, Mr. Johnson will receive "his salary and bonuses, which totaled \$1,736,700 last year, through the end of 1991. . . . [and his] retirement benefits, starting January 1, 1992."). *Id.*

169. See, e.g., Manne, *Insider Trading and the Law Professors*, *supra* note 64, at 578. Professor Manne explains that individual investors do not need to directly participate in the securities markets:

It is [a] questionable assumption that there is some clear social interest in having people channel their savings into investments in the stock market. Of course, stock exchanges, brokers, and underwriters are benefited by any encouragement a government agency can give their particular efforts, but that is not necessarily true for the public. Any savings will eventually become invested, and the money does not have to be channeled through the stock market to effect this. Commercial banks or any number of other intermediaries might serve as well. . . . In principle, at least, the SEC should be indifferent to whether the public prefers stock savings accounts or mutual funds to brokers.

Id.

170. Instead of allowing insiders and market professionals to allocate informational rights in a laissez-faire, free market, Congress, in creating the 1934 Act, was particularly concerned with ensuring the integrity of market prices of securities so that individual investors could have sufficient confidence to enter the market:

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the market as indices of real value. There cannot be honest markets without honest publicity.

H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934).

In *Basic*, the Supreme Court echoed the congressional intent to heighten market integrity and investor confidence. Specifically, in adopting the fraud-on-the-market theory, the Court gave paramount importance to individual investors' reliance on, and thus confidence in, securities prices and the market:

In drafting the [1934] Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets. . . . [I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game? . . . An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.

Basic Inc. v. Levinson, 108 S. Ct. 978, 991-92 (1988) (citations omitted). Consequently, by

Disclosure rules that seek to equate access to information among all investors are instrumental in trying to overcome these problems.

B. *Early, Full Disclosure of Preliminary Takeover Discussions*

Under a standard of early, full disclosure of preliminary negotiations, corporate developments, such as takeover discussions, would be announced to the public as soon as they occur. Companies could no longer delay disclosure until an agreement-in-principle is reached. This Section will analyze the costs and benefits associated with early, full disclosure.

1. BENEFITS

Early, full disclosure is beneficial because it promotes more informed decisionmaking by investors and heightens public confidence in the securities markets. Under the efficient market theory, when individual investors and market professionals are provided with a steady stream of current information, stock prices progressively reflect such information.¹⁷¹ The unfettered flow of information reduces volatile price swings. With less market volatility due to reduced insider trading or market professional speculation, investor confidence is renewed. Consequently, more liquidity is provided to the capital markets by the influx of individual investor participation.¹⁷²

a. Investors Intelligently Evaluate Risk

Under a system of early, full disclosure, stockholders are presented with all the information that may affect the value of their stock. Under the pre-*Basic* agreement-in-principle disclosure rules, as merger plans are disclosed, the stock price of a target company rises to the amount of the expected premium, discounted by the risk that the deal may not materialize.¹⁷³ Evaluating the risks associated with preliminary negotiations merely means employing an even greater discount factor than the one used in estimating the strength of agree-

allowing an investor's reliance on the integrity of a security's market price to be presumed, the Court implicitly rejected creating "property rights" in nonpublic information and intended to heighten market integrity and investor confidence so that individual investors may directly participate in the stock market.

171. See *supra* notes 132-34 and accompanying text.

172. See *supra* notes 132 & 165-70 and accompanying text; see also *infra* notes 179-81 and accompanying text.

173. Asquith, *supra* note 134, at 51.

ments-in-principle. Both courts¹⁷⁴ and commentators¹⁷⁵ agree that investors can responsibly evaluate information. In *Flamm v. Eberstadt*,¹⁷⁶ for example, Judge Easterbrook stated:

[It is wrong to believe that] . . . disclosure may confuse investors rather than illuminate their choices. . . . It assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing. . . . To attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, implies that they should not be told about new plants, new products, new managers, or any of the other changes in the life of a corporation.¹⁷⁷

The 1933 and 1934 Acts were intended to protect investors not from their alleged lack of financial sophistication, but from fraudulent misrepresentations inducing the purchase of stock.¹⁷⁸ Individual investors should be considered able to accurately assess disseminated corporate information. Under a system of early, full and complete disclosure, rather than delayed or incomplete announcements, stock prices should react more moderately and thus more efficiently.

b. Inspires Investor Confidence and Market Integrity

In the wake of the market crash of 1987,¹⁷⁹ investors withdrew much of their savings portfolios from the stock market and sought alternative investments.¹⁸⁰ To ensure that investors eventually rein-

174. See, e.g., *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987) (Individual investors are sophisticated and can intelligently evaluate risk.).

175. Steinberg & Goldman, *supra* note 73, at 923. Steinberg and Goldman suggest:

Attempting to protect the investing public . . . 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 decision making and market reaction. Investors and financial professionals should not be denied important information merely because the unsophisticated might attach too much weight to it.

Id. at 925-26.

176. 814 F.2d 1169 (7th Cir. 1987).

177. *Id.* at 1175.

178. See Mofsky, *supra* note 24, at 1-3 (describing historical events that gave rise to securities regulation).

179. On October 19, 1987, the Dow Jones Industrial Stock Portfolio suffered a 22.6% loss in value, falling 508 points from 2246.74 to 1738.74. Metz, Murray, Ricks & Garcia, *Stocks Plunge 508 Amid Panicky Selling*, Wall St. J., Oct. 20, 1987, at A1, col. 6.

180. Small investors are withdrawing from the stock market in search of more stable investment vehicles. Anders & McMurray, *Taking Stock: Changes Since Crash Can't Prevent a Repeat, But Might Soften One*, Wall St. J., Oct. 17, 1988, at A1, col. 6. The *Wall Street Journal* reported: "Though [individual investors] . . . still account for about 60% of U.S. stockholdings, they are dropping out of daily trading, leaving that to Wall Street Firms and their big institutional clients. According to the Securities Industry Association, individuals

vest in the stock market and provide capital through stock ownership, the perception of the integrity of the securities markets must be enhanced and preserved through accurate and complete issuer disclosure. If individual investors "cannot rely upon the accuracy and the completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike."¹⁸¹

2. COSTS

Although an early, full disclosure standard theoretically leads to more efficient capital markets, there are problems and costs associated with this standard. Even if negotiations must be disclosed when initiated, it is extremely difficult to determine exactly when negotiations have, in fact, commenced. Furthermore, the benefits of early, full disclosure do not necessarily offset the substantial corporate costs involved in preparing and disseminating this information.

a. Uncertainty in Defining "Negotiations"

Under an early, full disclosure standard, preliminary negotiations would be revealed when initiated. Yet, as with the definition of "materiality," there is no universally accepted meaning of the term "negotiations." For example, at a luncheon, a corporate executive from Company *A* may suggest to an executive from Company *B* the possibility of considering a merger. No agreement is reached. No future plans or meetings are arranged. Should that luncheon encounter be disclosed? What if the executives agree to discuss the possibility at some undetermined later date? What if they subsequently have lunch to discuss unrelated business matters, and the subject of a merger arises again? When do these incidents become ripe for disclosure as "negotiations"?

Perhaps the term "negotiations" is best left undefined.¹⁸²

accounted for just 26.9% of daily trading in 1988's first eight months." *Id.* Although the withdrawal of individual investors from the stock market can be empirically observed, it is difficult to differentiate between individuals who withdraw seeking alternative investment vehicles and those who withdraw due to a lack of confidence in the market.

181. *Carnation Release*, *supra* note 100, at ¶ 87,595.

182. The term "negotiations" has been defined in different ways. Under Item 7(a) of schedule 14D-9, for example, the SEC set forth circumstances constituting negotiations in *In re of Revlon, Inc.*, Exchange Act Release No. 23,320, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986). The SEC stated: "The term 'negotiations' should not be interpreted in a technical and restrictive manner. . . . [T]he term 'negotiations' includes not only final price bargaining, but also applies to substantive discussions between the parties or their legal and financial advisers concerning a possible transaction." 35 SEC Docket at 1543.

The SEC concluded that discussions constituted "negotiations" in *Revlon* because "[t]he

Although managers are in great need of clear guidance, legislative definitions restrict the courts. Without a specific legislative definition, courts are free to interpret appropriate contours for the meaning of "negotiations."¹⁸³ If not bound by a specific definition, courts will have flexibility to vary the definition of "negotiations" in accordance with their interpretation of the original legislative intent favoring disclosure of material information.¹⁸⁴

b. The Burden and Cost of Disclosure

Mandatory disclosure rules force companies to incur disclosure costs. First, companies must compile, verify, and disseminate information and incur printing and mailing costs.¹⁸⁵ Second, and more

parties had established contact, had begun and concluded their initial reviews of confidential financial information, had retained counsel to discuss between and among themselves the structure and timing of the acquisitions, and had discussed the percentage of equity to be offered." *Id.*

A similar approach was taken in *Carnation*. *Carnation Release*, *supra* note 100. Material negotiations were found because "Carnation senior management . . . knew that one meeting and several telephone conversations between senior officers of Carnation and Nestle concerning Nestle's interest in a possible acquisition of Carnation had occurred and another such meeting was scheduled to occur in two days." *Id.* at 878.

Additionally, one commentator discussed the problem of determining whether initial discussions should constitute "negotiations" in SEC filings. The commentator wrote:

May a company properly omit a filing in response to a line item calling for a disclosure of "negotiations," on the ground that exploratory discussions about mutual interest in a deal (though not material) had not ripened into "negotiations"? (If the company made a "no-negotiations" statement, to prevail on this approach it would have to establish two points—(1) the discussions had not yet become "negotiations," and (2) the statement made was not a materially incomplete half-truth.)

Schneider, *Soft Information Disclosure—Recent Developments*, ALI-ABA, NINTH ANNUAL SOUTHERN FEDERAL SECURITIES INSTITUTE 95, 179-80 (1989).

183. Similarly, the term "insider trading" has not been legislatively defined. Although insider trading generally is prosecuted under Sections 10(b) or 14(e) of the 1934 Act, and under Rules 10b-5 and 14e-3 promulgated thereunder, these sanctions and rules do not explain or use the term "insider trading." See 15 U.S.C. §§ 78j, 78n(e) (1982); 17 C.F.R. §§ 240.10b-5, 240.14e-3 (1986); see generally Comment, *The Seventh Amendment Right to Jury Trial in Civil Penalties Actions: A Post-Tull Examination of the Insider Trading Sanctions Act of 1984*, 43 U. MIAMI L. REV. 361 (1989) (discussing how the lack of legislative restrictions enables judges and juries to play a central role in defining legislation that is extremely broad in application) [hereinafter Comment, *The Seventh Amendment Right to Jury Trial*].

184. See Comment, *The Seventh Amendment Right to Jury Trial*, *supra* note 183, at 393-97.

185. Meanwhile, due to enforcement efforts regarding a company's failure to disclose material facts or its announcement of misleading information, the SEC generates litigation expenses borne by both the government and the parties appearing before the agency.

Moreover, because of the new *Basic* probability/magnitude standard, corporations will incur additional costs defending shareholder suits that allege disclosure violations. See Block & Hoff, *Materiality of Preliminary Merger Negotiations*, in BASIC DISCLOSURE: NEW PRINCIPLES FOR PUBLIC COMPANIES AFTER THE SUPREME COURT DECISION 3 (1988). Block & Hoff suggest that the *Basic* case-by-case approach to determinations of materiality

significantly, early, full disclosure results in substantial opportunity costs to corporations because of the increased time that would be spent by all of the participants in the disclosure process—corporate executives, lawyers, and staff. Their time would be allocated to the preparation of disclosure documents rather than to other corporate affairs. Even excluding opportunity costs, two economists estimate that American companies incurred over one billion dollars in disclosure expenses in 1980.¹⁸⁶ Under an early, full disclosure standard, these costs, in addition to the costs of failed mergers due to a lack of confidentiality and bidding wars, would proliferate.¹⁸⁷

C. *Intermediate Disclosure Options and Alternatives*

Other disclosure models embody attributes of both early and delayed disclosure. Instead of disclosing material information, one such model would have companies maintain secrecy by giving a response of "no comment" to all inquiries.¹⁸⁸ Such a "safe-harbor" response would insulate the corporation from liability by neither con-

may generate costly, protracted legal battles that might have been resolved easily under a bright-line standard: "[The Court's] holding in *Basic* may have certain undesirable consequences. The holdings with respect to materiality and fraud-on-the-market are likely to encourage litigation and certainly will make its termination short of trial more difficult." *Id.* at 16.

186. S. Phillips & J. Zechar, *THE SEC AND THE PUBLIC INTEREST* 27-51 (1981).

187. The escalation of disclosure costs is a reasonable assumption. No empirical estimates have been made to estimate corporate expenses incurred under an early, full disclosure standard.

With regard to the costs and benefits of placing a company up for public auction, there has been much debate. One philosophy suggests that putting a target company up for public auction does not necessarily harm anyone's interests. See Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, 2 J. LAW, ECON. & ORGANIZATION 253 (1986); Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1985); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Gilson, *Seeking Competing Bids Versus Pure Passivity in Tender Offer Defenses*, 35 STAN. L. REV. 51 (1982). Although the specific transaction with the original suitor becomes less likely to be consummated, new bidders entering the arena often are willing to pay more to the target shareholders.

Another school of thought suggests that, although competing bids maximize the benefit and return to target stockholders for a specific transaction, the loss of substantial sunk costs incurred by the initial suitor will generally discourage bidder firms from entering the arena for corporate control and especially from making the first offer. See Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). RJR Nabisco shareholders, for example, originally were going to receive \$72 per share under management's initial leveraged buy-out offer. See Burrough & Helyar, *Buy-Out Bluff: How Underdog KKR Won RJR Nabisco Without Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6. Following a public bidding auction, they ultimately received \$108 per share. *Id.*

188. For a discussion of the "no comment" standard, see *infra* notes 191-202 and accompanying text.

firming nor denying the existence of negotiations. Alternatively, an affirmative duty to disclose preliminary merger negotiations could arise either upon the occurrence of certain steps in the negotiating process¹⁸⁹ or whenever corporate insiders would be prohibited from trading in company stock because of insider trading prohibitions.¹⁹⁰

1. RESPONDING "NO COMMENT" TO ALL INQUIRIES

A suggested alternative to full disclosure is for corporations to answer "no comment" in response to inquiries made by the exchanges, securities analysts, the public, and the press.¹⁹¹ Prior to *Basic's* probability/magnitude materiality standard, courts applying the various disclosure rules tolerated the injection into the market of half-truths and misleading information when a corporation concealed preliminary merger negotiations because the courts viewed the negotiations as immaterial until an agreement-in-principle had been reached.¹⁹² Investors reacted to rumors or snippets of information and often exacerbated market volatility.¹⁹³

Permitting safe-harbor "no comment" responses would provide several benefits to corporate managers, market professionals, and individual investors. Corporate managers could answer "no comment" to avoid liability while continuing negotiations in privacy.¹⁹⁴ This privacy would further merger efforts by minimizing speculation in the corporation's stock.¹⁹⁵ Eventually, if the merger were consummated, either those who were shareholders at the time of the "no comment" response and who did not sell their shares, or market professionals who subsequently purchased stock, would realize the merger premium.¹⁹⁶ Although the "no comment" rule would benefit corporate

189. For a discussion of the standard that would require disclosure upon the occurrence of certain events common to all takeovers, see *infra* notes 203-04 and accompanying text.

190. For a discussion of the standard that would require disclosure at the point at which insider trading sanctions are triggered, see *infra* notes 205-09 and accompanying text.

191. See, e.g., Hazen, *supra* note 85, at 954-55 (discussing benefits of a "no comment" standard).

192. For a discussion of the duty to correct misleading statements and the lack of an affirmative duty to disclose preliminary merger negotiations, see *supra* notes 4, 97 and accompanying text.

193. See Hazen, *supra* note 85, at 961 ("[A]ny disclosure has the potential for being received by the market more optimistically than warranted because of the current unlimited thirst for takeover candidates.").

194. *Id.* at 972.

195. *Flamm v. Eberstadt*, 814 F.2d 1169, 1178 (7th Cir. 1987) ("If by hypothesis silence is the best course for investors, then it may be necessary to condone evasive answers . . . to put pursuers off the scent for a time.").

196. For an empirical review of the competition for stock premiums among individual investors, see Hamilton, *supra* note 44, at 294.

managers and risk arbitrageurs, it would provide no protection to individual stockholders. Some investors, unaware of the existence of ongoing merger negotiations, might sell their shares to keen market professionals and not realize the potential for a merger stock premium.

"No comment" responses may add to, rather than correct, current inefficient market volatility. Traditionally, corporate managers have attempted to inspire investor confidence and to avoid volatile stock swings by disclosing significant information whenever possible.¹⁹⁷ Ordinarily, a corporation will reply honestly to inquiries by the securities exchanges, securities analysts, the public, and the press. Under a "no comment" standard, however, unless a corporation answers "no comment" to all questions, an occasional response of "no comment" will be deemed an admission of merger negotiations, which could lead to investor speculation.¹⁹⁸

In *Basic*, the Supreme Court stated that a steadfast "no comment" policy regarding merger talks might be considered an acceptable response to inquiries in certain cases: "Silence, absent a duty to disclose, is not misleading under Rule 10b-5. 'No comment' statements are generally the functional equivalent of silence."¹⁹⁹ Because of this statement in the otherwise prodisclosure *Basic*, companies have been adopting "no comment" policies to avoid creating a duty to disclose.²⁰⁰ Thus, by instituting a "no comment" policy, corporations that have launched new material developments can avoid making a public disclosure. As a result, investors have been receiving less infor-

197. See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (Many companies have well-developed publicity relationships with analysts at investment banks to provide information that will promote the company's stock.).

198. See, e.g., *Flamm*, 814 F.2d at 1178. In *Flamm*, the court stated:

Suppose a firm is engaged in negotiations that are best kept quiet, and the Exchange asks whether new developments account for activity in its stock. If the firm says yes and says why, the cat is out of the bag; if the firm says no, it faces liability for fraud; if the firm says "no comment" that is the same thing as saying "yes" because investors will deduce the truth. No corporation follows the CIA's policy of saying "no comment" to every inquiry; every firm regularly confirms or denies rumors, as the securities laws and the stock exchanges' rules require. The exchanges' rules require a response, not a refusal to respond, to inquiries.

Id.

199. *Basic Inc. v. Levinson*, 108 S. Ct 978, 987 n.17 (1988). Although certain information may be material, there also must be a specific duty to disclose before a corporation must make a public announcement. See *supra* notes 4, 97 and accompanying text.

200. Before an obligation to disclose information arises, a corporation must be under a duty to disclose, and the information must be material. See *supra* notes 4, 97 and accompanying text. By adopting a "no comment" policy, a corporation can avoid announcing information that is nonetheless material.

mation than under the pre-*Basic* rules.²⁰¹

Although a "no comment" standard is a clear guideline which would limit manager liability under the Securities Acts, this standard should be rejected for three reasons: 1) investor speculation based on occasional "no comment" responses conflicts with the corporate objectives of building investor confidence and market efficiency; 2) investors will make less informed investment decisions with less available public information; and 3) the "no comment" standard, by allowing corporate managers to conceal important information, contravenes the congressional intent of full disclosure.²⁰²

2. BASING DISCLOSURE ON THE OCCURRENCE OF CERTAIN EVENTS COMMON TO ALL TAKEOVERS

Alternatively, the requirement of disclosure of preliminary discussions could be triggered by events common to the negotiating process of all mergers and acquisitions. In determining the probability that a merger will occur, for example, the *Basic* Court suggested several factors that could serve as indicia of an intent to merge: "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries."²⁰³ Although not mentioned by the Court, the sharing of confidential information or projections between suitor and target companies could also serve to trigger the requirement of disclosure. When any two of the above events have occurred, for example, the negotiations could be deemed material, and a rebuttable presumption could be created in favor of disclosure.²⁰⁴

201. Many managers have been adopting "no comment" policies and providing less information to investors:

I defer to lawyers in such things [as disclosure], but the implication to us is that there is a definite need to take the information content out of the corporate response. We must, in effect, say nothing consistently in all related situations until the lawyers tell us to do otherwise. When we say no comment, it should not have information significance.

Roundtable, supra note 112, at 24 (quoting Michael Seely, President of Investor Access Corp.). "In my opinion, [a disclosure policy] should be a consistent policy and it should not give any information." *Id.* (quoting Neil Call, Executive Vice President of D.F. King & Co.).

202. It should be noted that the current industry trend is heading dangerously toward instituting "no comment" public relations programs which give little information, but reduce corporate liability. *See supra* notes 200-01 and accompanying text.

203. *Basic Inc. v. Levinson*, 108 S. Ct. 978, 987 (1988). *But cf.* *Reiss v. Pan American World Airways*, 711 F.2d 11, 13 (2d Cir. 1983) (holding not material a merger resolution by Pan Am's board of directors).

204. Alternatively, in order to avoid speculation and market volatility, rather than announce that a merger possibility exists upon the occurrence of one of the "materiality" signals, corporate managers could reveal only the particular step achieved. Investors could use the knowledge of the specific development to gauge for themselves the probability that the

A disclosure rule triggered by specific events is appealing. Managers could plan corporate behavior given the clear, bright-line guideposts. Additionally, consistent with congressional intent, individual investors would be informed at an early point in the negotiations and would be able to make more informed decisions. Market professionals and insider traders would have less of an informational advantage and, consequently, would be less able to exploit individual investors.

3. DISCLOSING AT THE TIME WHEN INSIDER TRADING REGULATIONS ARE TRIGGERED

Another alternative would be to require disclosure of preliminary merger negotiations at the moment when corporate insiders would no longer be allowed to trade company stock. Specifically, this disclosure convention is based on disclosing information when it becomes material, regardless of whether or not a duty to disclose has been triggered.²⁰⁵ A corporate fiduciary is prohibited from trading stock based on inside knowledge of merger negotiations, even of preliminary merger negotiations.²⁰⁶ Like the disclosure requirements of Section 10(b) of the 1934 Act, the duty to disclose or to refrain from trading imposed by the provisions prohibiting insider trading are based on the legislative principles of parity of information and full disclosure.²⁰⁷ Commentators have suggested that, if preliminary merger negotiations trigger insider trading sanctions, then such information should also be deemed material in determining the appropriate point to disclose the information to stockholders or to the market.²⁰⁸ Synchronizing the time when disclosure is required with the time when insider trading sanctions are triggered seems appropriate because both the disclosure rules and the insider trading sanctions are rooted in the congressional objective of protecting investors.²⁰⁹

transaction will occur. Consequently, the market would evaluate and efficiently reflect the additional information. See Asquith, *supra* note 134, at 51. Knowing that these common events are very tentative indications of a transaction, investors will attribute various, but larger, discount factors when determining the potential premium associated with a combination. Using larger discount factors should create more efficient, less volatile markets.

205. Currently, a corporation is under an obligation to disclose information if it is under a duty to disclose and the information is material. See *supra* notes 4, 97 and accompanying text.

206. See, e.g., *Chiarella v. United States*, 445 U.S. 22 (1980) (holding that based on Rule 10b-5, there is a breach of fiduciary duty and of Section 10(b) of the Exchange Act, when insiders trade on material, nonpublic information); *SEC v. Shapiro*, 494 F.2d 1301, 1306-07 (2d. Cir. 1974) (holding that there was a breach of fiduciary duty when an insider traded on material, nonpublic information regarding takeover negotiations).

207. For a discussion of the congressional intent underlying the securities laws, see *supra* notes 24-36 & 81-87 and accompanying text.

208. See Steinberg & Goldman, *supra* note 73, at 927-28.

209. Requiring disclosure at the point when corporate insiders are no longer allowed to

Absent congressional intervention, the public disclosure of sensitive corporate information is a policy question to be decided by the courts. With late disclosure, corporate management would be able to withhold information, negotiate in private, and sometimes trade shares using nonpublic information. Without speculation spurred by rumors, late disclosure theoretically would create a less volatile, more efficient market which would benefit market professionals over individual shareholders. Early disclosure, on the other hand, would create a market in which everyone trades with the same information, although with increased market volatility and administrative costs.

D. *Summary of Costs, Benefits, and Consequences of Various Disclosure Standards*

In *Basic*, the Supreme Court rejected the previously accepted agreement-in-principle standard and adopted a probability/magnitude test of "materiality."²¹⁰ Because the *Basic* test does not provide a bright-line rule or readily applied criteria, lower courts will have to clarify the *Basic* standard which will be used to determine when preliminary negotiations must be disclosed. This Section uses the facts of *SEC v. Shapiro*²¹¹ to illustrate the differences between 1) early disclosure, 2) agreement-in-principle disclosure, 3) disclosure made at the time when insider trading regulations are triggered, 4) a "no comment" policy, and 5) disclosure based on the occurrence of certain events common to all takeovers.

trade their company's stock has some disadvantages. Although requiring earlier disclosure would dampen insider trading by limiting the insider's informational advantage, and thus protect the interests of individual investors, the market professionals would lose the value of, or receive a lower yield on, their in-house research investment.

Some commentators argue that insider trading is beneficial. See Carlton & Fischel, *supra* note 48; Cox, *Insider Trading and Contracting*, *supra* note 56; Cox, *Insider Trading Regulation and the Production of Information*, *supra* note 56; Morgan, *supra* note 48. An indirect means of information regarding corporate developments benefits the marketplace. Investors benefit by the prevailing stock price moving in the direction of the actual value. See *supra* notes 63-65 and accompanying text; see also Carlton & Fischel, *supra* note 48, at 868. Corporate managers benefit by being provided with a means of extraordinary compensation for their developmental efforts on behalf of the enterprise. See *supra* notes 56-57 and accompanying text; see also Carlton & Fischel, *supra* note 48, at 869-72; Cox, *Insider Trading Regulation and the Production of Information*, *supra* note 56, at 475. Finally, corporations benefit because their shareholders and managers receive these benefits. See H. MANNE, *supra* note 64; Carlton & Fischel, *supra* note 48, at 857; Manne, *Insider Trading and the Law Professors*, *supra* note 64; Morgan, *supra* note 48, at 79; Ross, *The Determination of Financial Structure: The Incentive-Signalling Approach*, 8 BELL J. ECON. 23 (1977). But see Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets*, *supra* note 166.

210. *Basic Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988).

211. 494 F.2d 1301 (2d Cir. 1974).

Shapiro involved an enforcement action brought by the SEC against, among others, Harris Shapiro and Norman Berman.²¹² Shapiro and Berman, partners in a firm specializing in arranging corporate mergers and acquisitions, were accused of trading in stock while in possession of nonpublic information concerning the existence of merger negotiations.²¹³ The facts of *Shapiro* can be summarized as follows:²¹⁴

October 1970: Shapiro and Berman began efforts on behalf of the target company, Ridge Manor Development (Ridge Manor), to arrange a merger with the suitor, Harvey's Stores, Inc. (Harvey's).

December 11, 1970: Harvey's rejected the initial proposals made by Shapiro and Berman.

Late December, 1970: Ridge Manor shared nonpublic information with Shapiro to estimate future earnings of merged companies.

January 6, 1971: 1) The Ridge Manor president, who is the major shareholder, with Shapiro and Berman, held first face-to-face negotiations with a director of Harvey's; 2) Ridge Manor shared with Harvey's the nonpublic information given earlier to Shapiro and Berman; 3) Director from Harvey's indicated that other directors of Harvey's would oppose the transaction, but that he viewed it as favorable; 4) Following the meeting, Berman purchased 100 shares of Harvey's stock at \$7.25.²¹⁵

January 21, 1971: Berman and Shapiro met with several directors of Harvey's to discuss merger terms.

January 25, 1971: 1) Harvey's, through Shapiro, offered Ridge Manor a merger proposal that detailed a specific price and transaction structure; 2) Following the meeting, Berman

212. *Id.* at 1301.

213. *Id.* at 1301-02.

214. The detailed description of the facts can be found in the body of the opinion. *Id.* at 1303-05.

215. Before an obligation to disclose, information arises, a corporation must be under a duty to disclose, and the information must be material. *See supra* notes 4 & 97 and accompanying text. In the instant case, when Berman purchased stock based on the nonpublic information given to him directly by and because of his relationship with Ridge Manor, Ridge Manor was under a duty to disclose the same information to the market. *Shapiro*, 494 F.2d at 1305. The only unresolved issue that would trigger a disclosure requirement is whether the information was material. *Id.* In this case, the finding of materiality would determine when the public should have become aware of the preliminary negotiations. Yet, if the information was deemed immaterial, Ridge Manor would not have had to make a disclosure, and Berman could have traded with impunity.

purchased 400 shares of Harvey's stock ranging from \$7.125 to \$7.375.

January 26, 1971: 1) Shapiro contacted a potential financier of the merger; 2) Berman, through a stock broker, purchased 400 shares of Harvey's stock at \$8.50.

January 27, 1971: Stock broker from above made the first of several purchases of Harvey's stock for this broker's personal account.

January 28, 1971: Three members of Harvey's executive committee met with Shapiro and the financier.

January 29, 1971: 1) Liberty Circle Corp. (Liberty Circle), another potential target company of Harvey's, adopted an internal resolution to attempt a merger with Harvey's; 2) Merger discussions between Liberty Circle and Harvey's began and continued throughout the following week.

February 5, 1971: A public announcement disclosed that Harvey's was conducting merger negotiations with two unidentified companies.

February 8, 1971: Berman sold 600 shares of Harvey's stock at prices ranging from \$18 to \$18.75.

February 9, 1971: A "letter of intent" between Harvey's and Ridge Manor was drafted, but not signed.

February 10, 1971: A public announcement disclosed that Ridge Manor was one of the companies conducting merger negotiations with Harvey's.

February 16, 1971: Berman purchased 500 shares of Harvey's stock and two calls at \$22.

February 18, 1971: 1) Harvey's reached and announced an agreement-in-principle with Ridge Manor; 2) Berman purchased 500 shares of Harvey's stock at prices ranging from \$23.625 to \$23.75.

February 24, March 8, and March 9, 1971: Berman sold his entire Harvey's holdings at prices ranging from \$21 to \$22.50.

Mid-March 1971: Ridge Manor questioned the wisdom of the merger with Harvey's.

April 3, 1971: Harvey's agreed to merge with Liberty Circle.

April 5, 1971: Ridge Manor withdrew from the deal with Harvey's.²¹⁶

216. Subsequently, Shapiro and Berman were charged and convicted of insider trading. *Shapiro*, 494 F.2d at 1302.

1. AGREEMENT-IN-PRINCIPLE DISCLOSURE

The judicial definition of "materiality" must create a disclosure standard that satisfies the legislative objective of full disclosure. The agreement-in-principle standard is inconsistent with congressional intent because it generally allows information to be concealed.

In *Shapiro*, the use of an agreement-in-principle disclosure standard would not have provided investor protection, would have created volatile price swings, and would have allowed insider trading to proliferate. First, by the time the agreement-in-principle between Ridge Manor and Harvey's was reached and announced on February 18, individual investors were unaware of five months of ongoing negotiations. Thus these investors may have sold their shares not realizing the possibility of an eventual merger premium. Second, when the first news of a merger between Ridge Manor and Harvey's was released on February 18, the stock price jumped approximately \$16.50, or 228% (February 18 postdisclosure price range of \$23.625 to \$23.75 over January 25 predisclosure price range of \$7.125 to \$7.375). Third, if not for the fact that Berman was caught for insider trading, the agreement-in-principle standard would have afforded him sufficient time to capitalize on his knowledge of nonpublic information.²¹⁷ Although, under the agreement-in-principle standard, managers would know precisely when to issue a public statement, this bright-line rule would injure investors, cause market inefficiency, and allow insider trading to flourish.

2. EARLY, FULL DISCLOSURE

Early, full disclosure is consistent with the congressional intent of full disclosure of information. Yet requiring a corporation to issue a public statement whenever it enters into "negotiations," directly or through an agent, is overly burdensome. In *Shapiro*, under an early, full disclosure standard, Harvey's may have had to disclose when it was approached by Shapiro and Berman (October-December 11), while Ridge Manor would have had to make an announcement either when it retained Shapiro and Berman (October), or when Shapiro and Berman, as agents for Ridge Manor, contacted Harvey's (October-December 11).²¹⁸

217. Note the trades made on January 6, 25, 26 (note Berman's tip to, and subsequent trading by, the stock broker), February 8, 16, and 18. *Id.* at 1304-05. Market professionals would advocate an agreement-in-principle standard because their in-house research to identify potential takeover companies relies heavily on market signals provided by increased stock activity caused by such insider trading. For a discussion of how market specialists react to market signals called "noise," see *supra* note 47 and accompanying text.

218. This disclosure is dependent not only on the materiality of the information, but also on

Requiring disclosure at the onset of any negotiations would have few benefits and would generate considerable administrative costs which would have to be paid from corporate earnings. Because public statements regarding very tentative information would be released so frequently, individual investors would not be able to practically digest and utilize the overabundance of information which would be provided. Although increased information should lead to more informed investment decisions and more efficient markets, the new increased information provided under an early, full disclosure standard would be considerably less reliable.²¹⁹

If the markets had been flooded with inconclusive statements regarding potential mergers in *Shapiro*, investors might have ignored the corporate disclosure that Ridge Manor had entered into merger negotiations and, as a result, would have failed to bid up the Ridge Manor stock from \$7.25 (January 6 undervalued price) to approximately \$20 (rough average of the stock price once investors learned of the potential merging with Harvey's). Although the Liberty Circle merger was eventually consummated, many investors might have been injured by treating the public announcements of merger negotiations between Harvey's and Ridge Manor as a finalized deal. Furthermore, under an early, full disclosure standard, investor confusion would have been exacerbated because there would have been a surplus of information. Consequently, investors could not have made an informed investment decision based solely on the ordinarily unreliable corporate information. Because an early, full disclosure standard would not provide a reliable source of publicly available information

the existence of a duty to disclose. In the instant case, the duty to disclose did not arise until January 6 when Berman traded in Ridge Manor stock. This is an example of how the duty precondition to disclosure acts as a safeguard to premature public statements. For the purposes of this discussion, however, it will be assumed that both Harvey's and Ridge Manor were under a prior duty to disclose. It can be assumed, for example, that Harvey's and Ridge Manor had issued statements denying the existence of merger negotiations, similar to the statements made in *Basic*. *Basic Inc. v. Levinson*, 108 S. Ct. 978, 981 (1988).

219. In *Shapiro*, for example, investors could have been confused by various conflicting disclosures: "negotiations are taking place" (October-before December 11); "negotiations have broken down" (December 11); "negotiations are being undertaken again" (January 6). Additionally, investors would place little value on the disclosed information because companies would commonly be connected with many possible transactions that never would be consummated. In *Shapiro*, following the many disclosures that Harvey's would have been required to make under an early disclosure standard during its unsuccessful negotiations with Ridge Manor, investors would not have placed significant value on the disclosure that merger negotiations existed between Harvey's and Liberty Circle. Investors would become unresponsive to released information because there would be many announcements linking Harvey's with several possible merger candidates. Market professionals, however, might be able to employ their in-house research to evaluate the validity of the information contained in corporate disclosures by tracking market "noise." See *supra* note 47 and accompanying text.

regarding possible corporate activities, an erratic, volatile market would develop due to many different investors reacting to different pieces of information. Consequently, investor confidence and thus capital investment in the securities markets would wane.²²⁰

Moreover, an early, full disclosure standard would not be favored by corporate management. Because there is no clear definition of when "negotiations" begin, it would be difficult for managers to determine when a disclosure would have to be made. In *Shapiro*, there was no definitive time or action before December 11, 1970 that would have triggered the requirement of disclosure of negotiations. Thus, although early, full disclosure is consistent with congressional intent and may reduce insider trading, this standard would generate excessive amounts of unreliable information which would harm investor confidence and market efficiency.

3. A "NO COMMENT" POLICY

The use of a "no comment" policy in response to inquiries is detrimental because it leads to the withholding of information. Instead of actively promoting the dissemination of information, as is congressionally intended, this standard would create a bright-line rule that shields corporate managers from liability in those circumstances in which they choose to conceal ongoing negotiations. Because the facts of *Shapiro* do not include any inquiries from the public, there is no difference between the "no comment" policy and that of the agreement-in-principle standard when applied to the facts of *Shapiro*.²²¹ There would only be late disclosure. If Berman had not traded in corporate stock and Harvey's had implemented a "no comment" policy, it is not clear when Harvey's would have been required to disclose the pending merger, at least in the period prior to the agreement-in-principle stage.

4. DISCLOSURE MADE AT THE TIME WHEN INSIDER TRADING REGULATIONS ARE TRIGGERED

The United States Court of Appeals for the Second Circuit in *Shapiro* held that Berman violated Rule 10b-5 by trading on the basis of nonpublic, material information, without disclosing the information to those with whom he traded.²²² In examining Berman's first trade on January 6, the court used the same probability/magnitude

220. An early disclosure standard, however, would virtually eliminate the time during which insiders could use nonpublic information for their personal benefit.

221. See *supra* note 68 and accompanying text.

222. *Shapiro*, 494 F.2d at 1307.

“materiality” test that was adopted by the Supreme Court in *Basic*.²²³

Under *Basic*, if a disclosure announcing preliminary negotiations were triggered in *Shapiro* on January 6, investors would have been protected, efficient capital markets would have prevailed, and insider trading would have been limited. If informed on January 6 of the existence of preliminary negotiations, shareholders would have been able to make an informed decision as to whether to sell or to retain their Harvey's stock as the merger negotiations progressed.²²⁴ If investors have more accurate information and can make better informed decisions, the market price of the stock will be valued more accurately and, thus, efficiently.²²⁵ Because investors are informed at an early stage that preliminary merger negotiations are occurring, the time that insiders can benefit by trading on the basis of nonpublic information is limited. In *Shapiro*, if investors had been informed of negotiations on January 6, investors would have bid up the price of Harvey's stock based on this new information. Consequently, Berman would not have been able to purchase Harvey's stock at the significantly undervalued price of \$7.25. Instead, under the efficient market theory, Berman's insider knowledge would have been worthless because the price of Harvey's stock would have reflected Berman's knowledge at the time the negotiations had been disclosed.

The problem with *Basic*'s (and *Shapiro*'s) probability/magnitude standard is that its application varies from case to case. For example,

223. Specifically, the *Shapiro* court stated that the materiality of a future event is determined by “a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” *Id.* at 1305-06.

224. Market professionals would not favor such a disclosure standard. Under a mandatory disclosure system, the effectiveness of market professionals' in-house research would diminish as individual investors are provided with, at no direct cost, the same information that gave market professionals, at great cost, their informational advantage. Free market theorists would argue that this type of disclosure standard would remove market professionals' incentive to search for market information that incidentally promotes market efficiency. This argument ordinarily is persuasive. Yet information concerning takeovers is of such unique interest and financial significance that the rationales supporting the free market theory are not applicable. Specifically, mergers and acquisitions are so profitable that market professionals are rewarded for their informational search based on their trading which occurs solely after a public announcement. See Larcker & Lys, *supra* note 47, at 124-25; see also *supra* note 47 and accompanying text.

225. There was a dramatic price swing in Harvey's stock on February 5 when merger negotiations were announced. *Shapiro*, 494 F.2d at 1304-05 (from \$8.50 on January 26 to between \$18 to \$18.75 on February 8). If these negotiations had been announced on January 6, the day the court determined the information concerning the potential merger became material, investors over the following three months either would have bid up the stock price as the merger became more probable or would have let the stock price fall as the merger agreement fell apart. With increased, reliable information, there would have been a more gradual movement in the price of the stock.

in analyzing the magnitude, the *Shapiro* court found significant a 600% increase in the earnings per share of Harvey's stock.²²⁶ In examining the probability of the transaction, the court found important the fact that, on January 6, a director of Harvey's reacted favorably to a merger proposal and promised to propose the merger to Harvey's board.²²⁷ The court, in analyzing Berman's information, tilted the probability/magnitude test in favor of "materiality" because of the substantial increase in earnings per share.²²⁸ Another court, however, may have felt the need for a greater indication that the merger would be consummated, rather than a mere heart-felt approval of a corporate manager. As a result, although Harvey's was under a duty to disclose because Berman was trading stock as of January 6, there might have been no disclosure because the negotiations may not have been considered material under the probability/magnitude test. This test, for example, may have required disclosure on January 25 when Harvey's expressed its intent to merge by making a counter offer to Ridge Manor. Still another court may have believed that the potential premium would have been so substantial that disclosure would have been required in early December when the two companies first entertained, through Shapiro and Berman, the thought of merging.

This lack of clear, consistent guidelines would inhibit corporate management. Unsure of their potential liability, corporate managers would not act in the best interests of their shareholders because they would be reluctant to enter into takeover negotiations. Although it is not consistent with the congressional intent of full disclosure, the agreement-in-principle standard was created and adopted out of the need to provide managers with easily understood and enforced guidelines. Standards that are not in the form of a bright-line rule, like the probability/magnitude test, fail to provide managers with the flexibility and freedom necessary to maximize shareholder value by entering the arena for corporate control.

5. DISCLOSURE BASED ON THE OCCURRENCE OF CERTAIN EVENTS COMMON TO ALL TAKEOVERS

Disclosure based on the occurrence of certain events common to all takeovers has the same qualities as disclosure of information based

226. *Id.* at 1307.

227. *Id.* at 1306.

228. In balancing the probability and the magnitude, the court said that "[a]lthough 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 [the] . . . increase . . . in Harvey's earnings per share, it might not have influenced a reasonable investor." *Id.* at 1306-07.

on a probability/magnitude standard, except that the common events serve as easily identifiable guidelines for management. A list of common guidelines that could trigger the requirement of disclosure includes board resolutions, instructions to investment bankers, actual negotiations between principals or their intermediaries,²²⁹ retention of counsel, arrangements for financing, the signing of a confidentiality agreement, and the sharing of confidential information or projections. When any two of the above elements are present, a rebuttable presumption could be created that negotiations are to be deemed material. In *Shapiro*, the common events test is easily applied: On January 6, the Ridge Manor president held the first face-to-face negotiations with a director of Harvey's (First Event) and shared nonpublic information concerning Ridge Manor's own projected future earnings (Second Event). Unlike the varying probability/magnitude standard, the common events test can be easily followed and enforced. Consequently, not only does the common events test accord with congressional intent, provide investor protection, and stimulate market efficiency, it also satisfies the practical concerns of corporate managers. The common events test comes closest to embodying the ideal disclosure model.

The following chart summarizes the costs and benefits associated with each of the disclosure models analyzed in this Comment and demonstrates the superiority of the common events test:

229. These three common elements were mentioned in *Basic Inc. v. Levinson*, 108 S. Ct. 978, 987 (1988).

| | DISCLOSURE STANDARDS | | | | |
|---|----------------------|------|------------------|---------------|----------------------|
| | EARLY | LATE | COMMON EVENTS | NO COMMENT | INSIDER SANCTIONS |
| I. CONSISTENT WITH CONGRESSIONAL INTENT | YES | NO | YES | NO | YES |
| II. MORE INFORMATION TO THE MARKET CREATING . . . | | | | | |
| A) EFFICIENT MARKETS | NO | NO | YES | NO | YES |
| B) INVESTOR PROTECTION | YES | NO | YES | NO | YES |
| C) REDUCED INSIDER TRADING | YES | NO | YES | NO | YES |
| D) INVESTOR CONFIDENCE | YES | NO | YES | NO | YES |
| III. BRIGHT-LINE RULE FOR MANAGERS | NO | YES | YES | YES | NO |
| IV. MARKET PROFESSIONALS HAVE INCENTIVE TO SEARCH FOR MARKET INFORMATION | YES | YES | YES | YES | YES |

VI. CONCLUSION

The congressional intent underlying all securities legislation and regulations advocates the full disclosure of information to protect investors.²³⁰ In recent years, however, the courts have tolerated exceedingly late disclosure of vital information. As a result, individual investors have foregone potential takeover stock price premiums by prematurely selling their shares to others having an unfair informational advantage—usually insider traders and market professionals.

In *Basic Inc. v. Levinson*,²³¹ the Supreme Court held that corporate managers must disclose material information concerning mergers and merger negotiations.²³² The Court established a probability/magnitude standard of materiality,²³³ which may lead to a requirement of earlier disclosure. Yet, because this standard requires a case-by-case determination of materiality, it does not provide clear guidelines to corporate managers. The standard's utility is further undermined by a

230. See *supra* notes 24-36 & 81-87 and accompanying text.

231. 108 S. Ct. 978 (1988).

232. *Id.* at 983-84.

233. *Id.* at 983.

footnote²³⁴ that encouraged many corporate managers to adopt a "no comment" policy in response to inquiries. When a corporate manager uses a "no comment" policy to avoid being under a duty to disclose, public statements will not be required, material information can be concealed, and investor access to information will be reduced further than prior to *Basic*.

For a semi-strong form capital market to operate efficiently and to avoid dangerous price volatility, there must be a steady stream of information to the public. Despite the additional administrative costs incurred in making disclosure, earlier disclosure is consistent with congressional intent, allows investors to make more informed decisions, and heightens confidence in the market by limiting the predis-closure time, during which insiders and market professionals can use their informational advantage at the expense of uninformed individual investors. Although market professionals have a right to participate in the securities markets, Congress never intended to establish or to preserve their timing and informational advantage.

Because the Supreme Court has remanded *Basic* to the United States Court of Appeals for the Sixth Circuit for a determination as to when merger discussions became material under the facts in *Basic*, there is hope that clearer judicial guidelines for managers will be forthcoming. In considering the possible disclosure conventions, the "no comment" standard is inadequate because it contravenes the policy of full disclosure underlying Rule 10b-5. Moreover, to require disclosure at the point that dealing in company stock is considered insider trading fails to provide clear guidelines for corporate management. Of all the disclosure standards examined in this Comment, only disclosure based on the occurrence of certain events common to every takeover satisfies all competing interests. Indeed, the common-events test protects individual investors, curbs insider trading, promotes investor confidence, provides managers with a bright-line rule, and allows for efficient operation of the capital markets.

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234. *Id.* at 987 n.17. See *supra* notes 191-202 and accompanying text.