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Line-Item Disclosure Provisions and the Materiality of Preliminary Merger Negotiations After *In re* George C. Kern, Jr.

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COMMENTS

LINE-ITEM DISCLOSURE PROVISIONS AND THE MATERIALITY OF PRELIMINARY MERGER NEGOTIATIONS AFTER *IN RE* GEORGE C. KERN, JR.*

INTRODUCTION

Securities and Exchange Commission ("SEC" or "Commission") Rule 14d-9[1] requires that when the target of a tender offer recommends that its shareholders either accept or reject the offer, the target must file a Schedule 14D-9[2] with the SEC. Schedule 14D-9 contains specific "line-item" provisions requiring disclosure of information that the SEC deems important in the context of a tender offer. For example, Item 7(a)(1) of Schedule 14D-9 requires a target company to disclose negoti-

* Exchange Act Release No. 29,356, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

1 17 C.F.R. § 240.14d-9 (1993).

2 17 C.F.R. § 240.14d-101 (1993); *see infra* note 195. Rule 14d-9 and Schedule 14D-9 were promulgated under the authority granted to the SEC by Congress in § 14(d)(4) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78n(d)(4) (1988) ("Any solicitation or recommendation to the holders of . . . a security to accept or reject a tender . . . shall be made in accordance with such rules and regulations as the Commission may prescribe."). Section 14 is part of the Williams Act (codified at sections 12, 13 and 14 of the 1934 Act, 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1988)); which amended the 1934 Act and was enacted mainly to provide shareholders with sufficient time and information with which to make informed investment decisions. It did so by mandating disclosure in certain, statutorily enumerated contexts and by granting the SEC broad authority to promulgate rules requiring additional disclosure. For a discussion of the Williams Act and the various rules and disclosure schedules promulgated thereunder, see *infra* notes 73-124 and accompanying text.

ations[3] undertaken in response to a tender offer that would lead to certain significant corporate events such as a merger or a reorganization,[4] while Item 7(b) requires the target company to disclose any board resolution adopted, or agreement in principle reached, with respect to those significant events.[5] Furthermore, Rule 14d-9(b)[6] requires that, "[i]f any *material change* occurs in the information set forth in the Schedule 14D-9," the target company must disseminate that change to shareholders and promptly file an amendment to its Schedule 14D-9 with the SEC.[7]

To date, most of the scholarly literature concerning a corporation's duty to disclose preliminary merger negotiations has focused on the antifraud provisions of section 10(b)[8] and Rule 10b-5[9] promulgated thereunder.[10] By contrast, line-item provisions such as Item 7 of Schedule 14D-9, which create an affirmative duty to disclose preliminary merger negotiations, have received surprisingly little attention. Indeed, very few commentators and even fewer courts have discussed in any detail the concept of materiality as it relates to a target

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[3] For the meaning of the term "negotiations," see *infra* notes 221-34 and accompanying text.

[4] *Id.* (Item 7); *see infra* notes 193-94 and accompanying text.

[5] *Id.*

[6] 17 C.F.R. § 240.14d-9(b) (1993).

[7] *Id.* (emphasis added).

[8] 15 U.S.C. § 78j(b) (1988).

[9] 17 C.F.R. § 240.10b-5 (1993). Under Rule 10b-5, a corporation must disclose material negotiations when it trades in its own stock or to correct a previous, voluntary statement that was misleading when issued, or to correct one that has become misleading by virtue of subsequent corporate events. *See* Peter C. Pappas, Comment, *The Expanding Scope of Materiality and the Duty to Disclose:* Basic, Inc. v. Levinson, *108 S. Ct. 978 (1988), Removes a Safe Harbor*, 26 AM. CRIM. L. REV. 295, 297-99 (1988).

[10] *See* C. D. Ewell, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 YALE L.J. 547 (1987); Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218 (1987); Thomas L. Hazen, *Rumor 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 (1987); Pappas, *supra* note 9; Robert H. Rosenblum, *An Issuer's Duty Under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 CATH. U. L. REV. 289 (1991); Noreen R. Weiss, Note, *Rule 10b-5 and the Corporation's Duty to Disclose Merger Negotiations: A Proposal for the Safe Harbor from the Storm of Uncertainty*, 55 FORDHAM L. REV. 731 (1987) (all discussing the duty to disclose material preliminary merger negotiations under Rule 10b-5).

company's affirmative duty of disclosure under such line-item provisions.[11] Specifically, whether or not Item 7(a)(1) of Schedule 14D-9 requires disclosure of negotiations which, under the traditional test of materiality,[12] might *not* be considered material, remains subject to debate.[13] But Item 7 appears to require disclosure of preliminary merger negotiations *irrespective* of their materiality.[14] This raises an important question because Rule 14d-9(b) requires disclosure of only *material changes* in the information previously divulged. Should a person responsible for deciding whether to amend the target company's original Item 7(a) disclosure be permitted, under Rule 14d-9(b), to assess independently the materiality of the new information, despite the fact that Item 7(a)(1) itself does not predicate disclosure on materiality?[15] In *In re George*

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[11] *See* J. Robert Brown, Jr., *Corporate Secrecy, the Federal Securities Laws, and the Disclosure of Ongoing Negotiations*, 36 CATH. U. L. REV. 93, 106-07 (1986) (discussing Schedule 14D-9, Item 7's disclosure requirements but declining to assess whether Item 7 information is *per se* material); Daniel L. Goelzer, *Disclosure of Preliminary Merger Negotiations—Truth or Consequences?*, 46 MD. L. REV. 974, 982 (1987) (duty to disclose under Item 7 is absolute and is not predicated on materiality); Joseph I. Goldstein et al., *Disclosure of a Potential Change in Corporate Control*, 19 SEC. & COMM. REG. 133, 142 (1986) (discussing Item 7 and suggesting that the focus should be on compliance with the line-item provision and not on the materiality of the information).

[12] Whether preliminary merger negotiations are material for Rule 10b-5 purposes involves a balancing of the probability that a merger will occur against the magnitude of the event in light of the totality of company activity. Basic, Inc. v. Levinson, 485 U.S. 224, 238 (1988) (citing SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) [hereinafter *TGS*]). The *Basic* court also expressly adopted the materiality test it propounded in the context of a proxy statement omission in TSC. Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding whether to vote). *See infra* notes 23-72 and accompanying text.

[13] Goelzer, *supra* note 11, at 981-82 ("The obligation to disclose preliminary merger negotiations pursuant to item 7(a) is absolute in the sense that no separate duty to disclose is necessary . . . . Materiality is not an issue."); *see* Brown, *supra* note 11, at 101 n.34 ("Whether the failure to disclose information specifically required by a Commission rule is always material has not been resolved . . . . While not all line item disclosure requirements would be necessarily material under the standard set forth in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), an argument can be made that because investors have an expectation of receiving the information, its omission would be material."); *see also infra* note 191.

[14] Goelzer, *supra* note 11, at 982. In other words, those individuals charged with making disclosures may not assess independently the materiality of the negotiations; they must simply disclose them as the rules require.

[15] *Id.* It would seem incongruous that Rule 14d-9(b) requires the disclosure of

C. Kern, Jr.,[16] the SEC recently chose to forego a unique opportunity to address this issue.

In *Kern* an SEC Administrative Law Judge ("ALJ") concluded that a prominent Sullivan & Cromwell partner, George Kern, had caused[17] Allied Stores Corp. ("Allied") to violate Rules 14d-9 and 14d-9(b) by failing to disclose promptly certain negotiations that had taken place in connection with Allied's attempt to stave off a hostile bid by Campeau Corp. ("Campeau").[18] Mr. Kern, who was outside counsel to and a board member of Allied, had been delegated the sole responsibility of making required SEC disclosures. Applying the materiality test adopted in *Basic, Inc. v. Levinson*,[19] the ALJ concluded that the negotiations at issue were material and, thus, constituted a "material change in the information" requiring disclosure.[20] But the SEC's Division of Enforcement ("Division"), which prosecuted the charges against Mr. Kern, had attempted to argue that in promulgating Schedule 14D-9, the SEC had already concluded that negotiations occurring in response to a tender offer are *per se* material. Implicit in the Division's argument, therefore, is the conclusion that *Basic*'s materiality test was inapplicable to the negotiations under scrutiny in *Kern*.[21] This fundamental difference in philosophy

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only material information whereas Item 7 requires disclosure of negotiations without regard to the materiality of the information. *See infra* notes 235-48 and accompanying text.

[16] Exchange Act Release No. 29,356, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

[17] Under § 15(c)(4) of the 1934 Act, 15 U.S.C. § 78o(c)(4) (1988 & Supp. II 1991), the SEC may publish its findings and issue an order requiring "*any person who was a cause of the failure to comply* due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or to take steps to effect compliance," with sections 12, 13 or 14 of the 1934 Act (emphasis added).

[18] *In re* George C. Kern, Jr., Administrative Proceeding File No. 3-6869, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14, 1988) [hereinafter *Initial Decision*].

[19] 485 U.S. 224 (1988).

[20] *Initial Decision, supra* note 18, at 89,583, 89,585, 89,587-88. Applying the same test, Mr. Kern argued that the probability of the negotiations leading to a significant corporate event was too low to be disclosed and that their disclosure would have misled the market. Thus, he contended, the negotiations were not material. *See infra* note 156 and accompanying text.

[21] The Division took this position in its Pre-trial Brief (Pre-trial Brief of the Division of Enforcement at 1, on file with the author); at the beginning of the hearing, Hearing Transcript 33-34; in its Post-hearing Memorandum (Post-Hearing

was one of the central issues in the *Kern* case.

The full Commission, however, after deciding *sua sponte* to review the ALJ's decision, failed to rule on the merits, concluding only that the Division had no authority to seek orders requiring (general) future compliance with tender offer rules under section 15(c)(4) of the 1934 Act.[22] As a result, the Commission missed an important opportunity to resolve an apparent conflict between the disclosure requirements under Rule 14d-9 and the amendment requirements under Rule 14d-9(b).

This Comment argues that, in determining that the negotiations at issue in *Kern* constituted a "material change in the information," the ALJ's analysis of those negotiations under *Basic*'s materiality standard was incorrect for three reasons. First, preliminary merger negotiations occurring during the pendency of a tender offer, which are specifically required to be disclosed under line-item provisions such as Item 7(a)(1) of Schedule 14D-9, are always "material" under generally accepted tests of materiality. Thus, the onset of any negotiation specifically required to be disclosed under Item 7(a)(1) is *per se* material and, by logic, constitutes a material change in the information as a matter of law for Rule 14d-9(b) purposes. Second, the SEC's rules explicitly state that the *Northway* standard is to be applied to the word "material" when it is used to qualify the furnishing of information. Thus, the ALJ similarly erred in applying *Basic* to the negotiations at issue in *Kern*. Finally, and as a matter of common sense, because Item 7(a)(1) does not predicate disclosure on materiality, no person should be permitted to inject a materiality threshold by subjectively withholding what he or she believes to be immaterial information simply because the words "material change" appear in the amendment rule. Simply put, the occurrence of even a *non*-material event which is specifically required to be disclosed under a line-item provision, but which occurs after

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Brief of the Division of Enforcement at 23-24, on file with the author); and in its Memorandum of Law before the full Commission (Memorandum of Law of the Division of Enforcement at 26, on file with the author) [hereinafter numbers preceded by "HT" refer to the transcript of the administrative hearing held on January 19, 1988, et *seq.*]. As for why the Division's argument did not prevail, see *infra* note 242.

[22] *In re* George C. Kern, Jr., Exchange Act Release No. 29,356, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,005 (June 21, 1991).

the initial schedule has been filed, also must constitute a *per se* material change in the information requiring disclosure.

Part I of this Comment briefly surveys the development of the materiality standard as it pertains to preliminary merger negotiations, and provides a brief overview of the Williams Act and its underlying rationale. Part II then reviews the facts of the *Kern* case, the ALJ's Initial Decision, and the Opinion of the Commission. Finally, Part III proposes a general framework for analyzing the materiality of information specifically required to be disclosed under the SEC's line-item provisions and provides several examples of line-item provisions (including Schedule 14D-9, Item 7) that call for the disclosure of information that is material *per se*. To avoid the sort of disagreement that arose in the *Kern* case, Part III suggests that the SEC clarify Rule 14d-9(b)—and all such similar amendment provisions—so that the "material change in the information" language would not leave filing entities free to assess, under either *Basic* or *Northway*, the materiality of information that is either material as a matter of law or specifically required to be disclosed irrespective of its materiality.

I. BACKGROUND

A. *The Materiality Standard Applicable to Preliminary Merger Negotiations*

Although the concept of materiality in securities law has in some cases been elusive,[23] the analysis of what constitutes

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[23] Indeed, the difficulty in defining materiality is comparable to attempts to define the concept of proximate cause in negligence law suits. In one case, Nobles v. First Carolina Communications, Inc., 929 F.2d 141 (4th Cir. 1991), the Fourth Circuit affirmed the dismissal of a suit by Nobles, an investor, who had bought limited partnership units under a Partnership Agreement that gave the investor no right to object to the dissolution of the Partnership. When the general partners agreed to dissolve the Partnership two years later, the investor sued the general partners claiming that their proxy solicitations contained several material misrepresentations and omissions. Specifically, Nobles claimed that the Schedule 13E-3 filed in connection with the dissolution of the partnership failed to comply with the general instructions for completing the Schedule. The court held that even if the allegations of omissions were true, those omissions were immaterial as a matter of law because Nobles had no choice to sell his limited partnership interest. *Id.* at 145. Clearly, the Fourth Circuit confused materiality with causation. Whether or not Nobles had any power to affect the transaction has no bearing on

material information is not inherently complicated. In *Basic, Inc. v. Levinson*,[24] the Supreme Court adopted a test for assessing the materiality of preliminary merger negotiations, drawing on two landmark securities law cases—*TSC Industries, Inc. v. Northway, Inc.*[25] and *SEC v. Texas Gulf Sulphur* ("*TGS*").[26] *Northway* established a straightforward materiality test for the disclosure of information under the rule prohibiting material misstatements and omissions in proxy statements,[27] and that standard has applied with equal force to the disclosure requirements of the SEC's tender offer rules.[28] *TGS* established a balancing test for evaluating the materiality of contingent information in the context of a Rule 10b-5 antifraud suit. The *Basic* standard reveals that informed investor decisionmaking is central to the Court's reasoning.[29]

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whether the information in the Schedule 13E-3 was *material*—or important—to him. If the general partners had disclosed information truthfully, Nobles might have had sufficient information with which to pursue a state law claim for breach of fiduciary duty. *See, e.g.*, Howing Co. v. Nationwide Corp., 972 F.2d 700 (6th Cir. 1992) (holding that in a freeze-out merger, material omissions by the majority shareholders that force the minority shareholders to forego their state law remedies are sufficient to establish causation even though the minority shareholders did not have enough votes to block the merger), *cert. denied*, 113 S. Ct. 1645 (1993).

[24] 485 U.S. 224 (1988).

[25] 426 U.S. 438 (1976).

[26] 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

[27] Rule 14a-9, 17 C.F.R. § 240.14a-9 (1993).

[28] THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 11.4, at 487 (2d ed. 1990) ("The materiality requirement has necessarily carried over to the antifraud provisions of the securities laws and, of course, is also found in the affirmative disclosure requirements of . . . the 1934 Exchange Act.") (footnote omitted).

[29] The finance theory underlying in the disclosure requirements and the materiality standard is not inherently difficult. The Efficient Capital Market Hypothesis ("ECMH") posits that share prices fully and accurately reflect all available information. Christopher P. Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). "The mechanism of price formation somehow captures information about and predicts the future payout of a security (dividends, interest, and capital gain or loss)." Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 770-71 (1985). Thus, implicit in the ECMH is the proposition that all relevant information will be available to the market, which will instantaneously digest and reflect that information. *Id.* at 771. Since all relevant information concerning a company will be available to the public, share prices will quickly react to any abnormal trading activity, thereby denying abnormal returns to all investors. *See* Saari, *supra*, at 1046. Therefore, according to prevailing finance theory, any definition of materiality must

1. *TSC Industries, Inc. v. Northway, Inc.*

In *TSC Industries, Inc. v. Northway, Inc.*,[30] a minority shareholder of TSC Industries sued TSC and National Industries, Inc. for alleged material omissions in a joint proxy statement issued by the companies that recommended acceptance of National's proposed buy-out of TSC.[31] Northway claimed that the companies had violated Rule 14a-3[32] by omitting required information from their Schedule 14A.[33] Northway sued the companies under section 14(a) of the 1934 Act[34] and Rule 14a-9[35] promulgated thereunder.[36] The Court of Appeals for the Seventh Circuit reversed the district court's denial of Northway's motion for summary judgment on the Rule 14a-9 claim, holding that certain omissions were material as a matter of law.[37]

The Supreme Court reversed, holding that whether or not a fact is material is a mixed question of law and fact. The Court also cautioned against resolving the issue of materiality on a motion for summary judgment.[38] The Court defined a

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start with the premise that share prices will accurately reflect all public information "of obvious interest" to the market. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 55-56 (1984). *See generally* James Harlan Koenig, Comment, *The* Basics *of Disclosure: The Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1051-52 (1989).

[30] 426 U.S. 438 (1976).

[31] *Id.* at 441.

[32] 17 C.F.R. § 240.14a-3 (1993). Rule 14a-3 prohibits the solicitation of proxies without providing to solicited shareholders a proxy statement containing the information specified in Schedule 14A. 17 C.F.R. § 240.14a-101 (1993).

[33] *Northway*, 426 U.S. at 441. Specifically, Northway claimed that the companies had failed to include information required by Item 5(e) of Schedule 14A, which requires the issuer to disclose whether or not a change in control of the issuer had occurred since the beginning of the fiscal year, the name of the person(s) acquiring control, and the transaction which resulted in the change in control. *Northway*, 426 U.S. at 442.

[34] 15 U.S.C. § 78n(a) (1988). Section 14(a) prohibits the solicitation of proxies "in contravention of such rules and regulations as the Commission may prescribe." *Id.*

[35] 17 C.F.R. § 240.14a-9 (1993). Rule 14a-9 is nearly identical to Rule 10b-5. *See supra* note 8. It forbids the solicitation of any proxy by means of a proxy statement containing a statement that "is false and misleading with respect to any material fact, or which omits to state any material fact." *Id.*

[36] *Northway*, 426 U.S. at 441-42.

[37] *Id.* at 443.

[38] *Id.* at 450. The Court explained that:

standard that represented a compromise between other courts' definitions of materiality (including the Seventh Circuit's formulation in *Northway*), which set too low a threshold for materiality, and its recognition that Rule 14a-9 was intended to provide shareholders with sufficient information with which to make an informed decision. That standard, which is now widely quoted by courts in securities disputes, provides:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . It does *not* require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable shareholder to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.[39]

The Court continued, "[p]ut another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[40]

This standard is not intrinsically difficult to apply. By using a "reasonable shareholder" standard, it provides an objective test for assessing the significance of information and whether the information would have been important to a shareholder in light of all available information.[41] The *Northway* Court concluded that none of the omissions alleged by Northway were so significant as to warrant an entry of

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> The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. Only if the established omissions are "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment.

Id. (citations omitted).

[39] *Id.* at 449 (emphasis added). The court rejected the Seventh Circuit's formula for materiality which held that an omitted fact is material if shareholders *might* consider it important as setting too low a materiality threshold: "some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." *Id.* at 448.

[40] *Id.* at 449.

[41] The SEC essentially codified *Northway*'s materiality standard in Rule 12b-2, 17 C.F.R. § 240.12b-2 (1993), which defines terms used in forms and statements required to be filed pursuant to the 1934 Act. For the full text of Rule 12b-2, see *infra* note 201-02 and accompanying text.

summary judgment in his favor.[42]

2. *SEC v. Texas Gulf Sulphur*

In *SEC v. Texas Gulf Sulphur*,[43] which predated *Northway* by eight years, the Second Circuit established a two-part balancing test for assessing the materiality of events that might affect the probable future of a company. The SEC sought injunctive relief against several corporate insiders for trading on certain nonpublic information in violation of section 10(b) and Rule 10b-5[44] promulgated thereunder.[45] The information in question was the discovery by TGS, after exploratory drilling, of a potentially major ore reserve.[46] During further exploratory drilling, and before issuing a press release to reveal its discovery, several TGS insiders purchased shares in the company and "tipped off" several people as to the discovery.[47] The district court found that two corporate insiders had violated Rule 10b-5.[48]

The Second Circuit affirmed the district court's decision. In so doing, the court established the "probability/magnitude" test for the materiality of information that might affect the proba-

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[42] *Northway*, 426 U.S. at 463-64. Clearly, if a line-item provision calls for the disclosure of information that would always be material (under *Northway*), then that information is material as a matter of law. Indeed, the *Northway* court hinted that a complete failure to include in the proxy statement information indicative of a change in control—information specifically required under Schedule 14A, Item 5(e)—would have constituted a *per se* violation of Rule 14a-9:

> We emphasize that we do not intend to imply that facts suggestive of control need be disclosed only if in fact there was control. If, for example, the proxy statement in this case had failed to reveal National's 34% stock interest in TSC and the presence of five National nominees on TSC's board, these omissions would have rendered the statement materially misleading as a matter of law, regardless of whether National can be said with certainty to have been in "control" of TSC.

Id. at 453 n.15. Implicit in the court's reasoning is the conclusion that Item 5(e) calls for the disclosure of information that is *per se* material because materiality is a crucial element of a Rule 14a-9 violation. The implications of the Court's dicta for the *Kern* case are immense. *See infra* notes 191-209 and accompanying text.

[43] 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) [hereinafter *TGS*].

[44] *See supra* notes 10-11.

[45] *TGS*, 401 F.2d at 833.

[46] *Id.* at 843-44.

[47] *Id.*

[48] SEC v. Texas Gulf Sulphur, 258 F. Supp. 262 (S.D.N.Y. 1966).

ble future of the company: "In each case, then, whether facts are material within Rule 10b-5 . . . will depend at any given time 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."[49] The court went on to conclude that knowledge of the discovery would have been important to a reasonable investor "and *might* have affected the price of the stock."[50] *Northway* neither accepted nor rejected *TGS*, and most lower courts have relied on the *Northway* definition of materiality in connection with suits arising under the Williams Act.[51]

3. *Basic, Inc. v. Levinson*

The materiality of preliminary merger negotiations or similar "inchoate" plans has caused widespread debate and presents a more difficult analysis.[52] This is due in large part to competing policy objectives.[53] On the one hand, a philosophy of full disclosure permeates the securities laws and, thus, militates in favor of earlier disclosure.[54] On the other hand, premature disclosure of preliminary negotiations may tend to mislead the market and jeopardize potential deals.[55] Accord-

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[49] *TGS*, 401 F.2d at 849.

[50] *Id.* at 850 (emphasis added) (footnote omitted). Interestingly, the court used the "might affect" test for materiality later specifically rejected in *Northway*. *See supra* note 39 and accompanying text.

[51] *See* HAZEN, *supra* note 28, § 11.4, at 487.

[52] *See, e.g.*, Brown, *supra* note 11, at 117; Pappas, *supra* note 9, at 296-97. *See generally* HAZEN, *supra* note 28, § 11.4, at 490.

[53] Douglas M. Branson, *SEC Nonacquiescence in Judicial Decisionmaking: Target Company Disclosure of Acquisition Negotiations*, 46 MD. L. REV. 1001, 1015-18 (1987); Brown, *supra* note 11, at 93-96; *See also* John R. Gailey III, Comment, *A Critical Survey of Target Company Disclosure Obligations Under the Williams Act*, 59 TEMP. L.Q. 1189, 1189 (1986); Goelzer, *supra* note 11, at 985-86; Hazen, *supra* note 10, at 961; James J. Moylan, *Exploring the Tender Offer Provisions of the Federal Securities Laws*, 43 GEO. WASH. L. REV. 551, 564-66 (1975); Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations: An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923, 925-26 (1987); H. Frasier Ives, Note, *Disclosing the White Knight—When Does the Duty Arise?*, 42 WASH. & LEE L. REV. 1045, 1048 (1985); Pappas, *supra* note 9, at 296, 307-312 (all acknowledging that the materiality of preliminary merger negotiations puts the benefits of informed decisionmaking squarely in conflict with the drawbacks of premature disclosure).

[54] *See infra* notes 73-125 and accompanying text.

[55] Commentators have noted that during a tender offer a target company's

ingly, under the *Northway* standard, while some negotiations may alter the "total mix" of information available to shareholders, whether or not those negotiations would be considered important in deciding to buy or sell a particular security has been the subject of considerable debate.[56] As a result, prior to *Basic* some courts held that preliminary negotiations were immaterial as a matter of law until parties had reached an agreement in principle.[57] In other words, those courts deter-

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share price becomes extremely volatile, reacting to even the slightest piece of information. Hazen, *supra* note 10, at 956. Thus, they conclude, premature disclosure of negotiations may lead investors to believe that a deal is imminent, causing them to purchase the target company's shares. This, in turn, pushes the price of the shares up and may make the putative deal prohibitively expensive for the potential acquiror. *Id.*; Brown, *supra* note 11, at 145; Koenig, *supra* note 29, at 1023. Furthermore, many potential acquirors insist on negotiating in secrecy; premature disclosure therefore could potentially interfere with the progress of acquisition negotiations. Goelzer, *supra* note 11, at 992; Hazen, *supra* note 10, at 954; Steinberg & Goldman, *supra* note 53, at 926-27.

[56] *See* Goelzer, *supra* note 11, at 992; HAZEN, *supra* note 28, § 11.4, at 490-91.

[57] Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir.) *cert. denied*, 484 U.S. 853 (1987); Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); Reiss v. Pan Am. World Airways, 711 F.2d 11 (2d Cir. 1983); Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982). In *Staffin*, the Third Circuit held that preliminary negotiations were immaterial as a matter of law until the parties had reached an agreement in principle because "disclosure of them may itself be misleading . . . . 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' . . . . " *Id.* at 1206-07. Citing *Staffin*, the Second Circuit, in *Reiss*, held that:

> It does not serve the underlying purposes of the securities acts to compel disclosure of merger negotiations in the not unusual circumstances before us . . . . Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned.

Reiss, 711 F.2d at 14 (citations omitted). In *Greenfield*, the Third Circuit extended its *Staffin* ruling to affirmative misstatements by a company such that, pursuant to an inquiry from a stock exchange, it could deny the existence of preliminary negotiations, even though negotiations were actually underway. *Greenfield*, 742 F.2d at 754-57. The Commission, in *In re* Carnation Co., Exchange Act Release No. 22,214, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985), announced its belief that *Greenfield* had been wrongly decided, cautioned issuers that some preliminary negotiations may become material prior to an agreement-in-principle, and warned that it would institute enforcement proceedings against any company that affirmatively denied the existence of material negotiations when such negotiations were in fact underway. *Id.* at 87,596 n.8. In *Flamm*, the Seventh Circuit held that the preliminary negotiations were immaterial as a matter of law until the parties had reached an agreement on price and structure. The court concluded that premature disclosure could hinder negotiations, perceiving what it believed was a need for a bright-line rule to guide disclosure obligations.

mined that until parties had reached an agreement on the price and structure of a deal, no reasonable shareholder who wished to purchase or sell shares in a corporation would consider it important that the corporation was negotiating for a merger or disposition of its assets.

Thus, it is not surprising that the Supreme Court, in *Basic, Inc. v. Levinson*,[58] rejected the agreement-in-principle, bright-line standard. *Basic* involved a Rule 10b-5 "duty not to mislead" case brought by a class of shareholders who claimed that three separate statements by Basic during 1977-78 were materially misleading and caused them to sell their shares in Basic at an artificially depressed price.[59] Specifically, with regard to two inquiries into unusual trading activity in its shares, Basic publicly stated that no negotiations were underway and that it knew of no reasons for the unusual activity.[60] However, since September 1976 Basic had been negotiating with Combustion Engineering, Inc. for a possible merger.[61] On December 18, 1978, Basic announced that it had been approached concerning a merger and, two days later, its board of directors accepted Combustion's forty-six dollars per share offer.[62] On the issue of materiality, the district court ruled that any misstatements were immaterial as a matter of law.[63] The Court of Appeals for the Sixth Circuit reversed, holding that under *TGS*, Basic's statements were misleading and that even if the negotiations normally would not be material, they became so by the company's very denial of their existence. The Sixth Circuit explicitly rejected the bright-line, agreement-in-principle standard.[64]

Flamm, 814 F.2d at 1174-75.

The Supreme Court, in Basic, Inc. v. Levinson, 479 U.S. 1083 (1987), granted certiorari to resolve the split in the various courts of appeal as to the correct standard of materiality to be applied to preliminary merger negotiations.

[58] 485 U.S. 224 (1988).

[59] *Basic*, 485 U.S. 224 at 227-29.

[60] *Id.* at 227-28.

[61] *Id.*

[62] *Id.*

[63] Levinson v. Basic, Inc., [1984-85 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 91,801 (N.D. Ohio Aug. 3, 1984). The district court adopted a presumption, premised upon the fraud on the market theory, that the plaintiffs had relied on the alleged misstatements and certified their class. *Id.* The fraud-on-the-market theory is a corollary of the Efficient Capital Market Hypothesis, *see supra* note 29; an efficient market *inaccurately* reflects all material omissions or misstatements.

[64] Levinson v. Basic, 786 F.2d 741 (6th Cir. 1986). The Sixth Circuit affirmed

The Supreme Court reversed. Although it agreed with the Sixth Circuit in unanimously rejecting the bright-line, agreement-in-principle test for materiality,[65] the Court rejected the notion that a corporation's denial of a fact it knows to be true renders the fact material. Instead, the Court adopted a fact-specific, case-by-case test for materiality that drew from both its prior *Northway* decision and the Second Circuit's *TGS* probability/magnitude test.[66] The Court reviewed the policies underlying its *Northway* decision, noting that the application of the *Northway* test to preliminary merger negotiations was not "self-evident."[67] The Court firmly rejected, however, the three rationales offered in support of the agreement-in-principle standard, stating that "none of these policy-based rationales . . . purports to explain why drawing the line at agreement-in-principle reflects the significance of the information upon the investor's decision."[68]

The Court held, therefore, that whether or not preliminary negotiations were material is a fact-specific inquiry, and adopted the *TGS* probability/magnitude test for materiality.[69] Per-

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the lower court's class certification relying on the presumption of reliance.

[65] Basic v. Levinson, 485 U.S. 224 (1988).

[66] *Id.* at 230-39.

[67] *Id.* at 232 ("Where . . . the event is contingent or speculative in nature, it is difficult to ascertain whether the 'reasonable investor' would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into [that] category.").

[68] *Id.* at 234. This acknowledgement was crucial, for it explained precisely why a bright-line rule limiting materiality to agreements-in-principle is completely unworkable: it substitutes a court's personal belief as to what information is important for that of the reasonable shareholder. In effect, it shifts *Northway*'s test from an objective standard to a subjective one.

More significantly, the *Basic* Court cited to the Seventh Circuit's opinion in Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir.), *cert. denied*, 484 U.S. 853 (1987), in which the court rejected as weak the justification that premature disclosure may confuse investors: "'It assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing.' Disclosure, not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress." *Basic*, 485 U.S. at 234 (quoting *Flamm*, 814 F.2d at 1175).

[69] *Basic*, 485 U.S. at 239. The Court suggested ways of evaluating the probability and magnitude of future events:

> [I]n order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. Without attempting to catalog all such factors, we note by way of example that board resolutions, instructions to investment

haps most significantly, the Court quoted a passage from the Second Circuit's decision in *SEC v. Geon Industries, Inc.*:[70]

> Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.[71]

In sum, the *Basic* Court explicitly rejected the bright-line, agreement-in-principle test for materiality of preliminary merger negotiations, opting instead for a more fact-specific, case-by-case analysis. Implicit in the Court's holding in *Basic* is the inescapable conclusion that preliminary merger negotiations can become material well before the parties reach any agreement on price and structure.[72]

B. *The Williams Act*

The Williams Act's[73] overriding purpose is to provide shareholders sufficient time and information with which to make informed investment decisions. The Williams Act achieves this goal in one of two ways: it either mandates that certain, statutorily enumerated information be disclosed (along with any additional information as the SEC may require), or it simply grants to the SEC broad authority to pass rules requiring disclosure of specific information in certain contexts.

> bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer . . . a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.

Id.

[70] 531 F.2d 39 (2d Cir. 1976).

[71] *Basic*, 485 U.S. at 238 (quoting *Geon*, 531 F.2d at 47-48).

[72] Some have expressed displeasure with the uncertainty that the new standard could cause. *See* Pappas, *supra* note 9, at 311-12 (criticizing *Basic* for failing to provide corporate managers with a bright-line rule to guide them, and for failing to abate burgeoning insider trading).

[73] 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1988).

1. Legislative Intent

The Williams Act, passed in 1968 as an amendment to the 1934 Act,[74] was intended to close a significant gap in the disclosure requirements of the 1934 Act.[75] Prior to 1968, federal law regulated proxy contests for corporate control and stock-for-stock exchange mergers, but cash tender offers were virtually unregulated.[76] Except for the antifraud provisions of section 10(b), section 14(e) and Rule 10b-5, no provision of the 1934 Act required disclosure by the bidder or, for that matter, by the target company.[77] As a result, a target's shareholders lacked both sufficient time and information with which to evaluate an offer.[78] One commentator went so far as to characterize cash tender offers as "the last uncivilized frontier on the corporate takeover landscape."[79] When finally passed, the Williams Act was based largely on the proxy regulations already in place.[80]

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[74] Senate Bill Number 510, sponsored by Senator Harrison Williams (D. N.J). Pub. L. No. 90-439, 82 Stat. 454 (codified at sections 13 and 14 of the 1934 Act, 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1988)).

[75] James F. Jorden and David R. Woodward, *An Appraisal of Disclosure Requirements in Contests for Control Under the Williams Act*, 46 GEO. WASH. L. REV. 817, 825-26 (1978); William C. Tyson, *The Proper Relationship Between Federal and State Law in the Regulation of Tender Offers*, 66 NOTRE DAME L. REV. 241, 242-43, (1990). Courts also acknowledged the gap in the disclosure requirements. *See* Finnegan v. Campeau Corp., 915 F.2d 824, 829 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 1624 (1991); Prudent Real Estate Trust v. Johncamp Realty, 599 F.2d 1140, 1144-45 (2d Cir. 1979); General Aircraft Corp. v. Lampert, 556 F.2d 90, 94 (1st Cir. 1977); GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972); Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 945 (2d Cir. 1969); Koppers Co., Inc. v. American Express Co., 689 F. Supp. 1371, 1383 (W.D. Pa. 1988).

[76] *See* Tyson, *supra* note 75, at 249.

[77] Jorden & Woodward, *supra* note 75, at 825 (existing law did not require bidder to disclose identity, source of funds, or plans for target company once it was acquired); Tyson, *supra* note 75, at 249 (cash tender offeror could operate in almost complete secrecy, with no obligation to make disclosures to target company's shareholders when making bid).

[78] Jorden & Woodward, *supra* note 75, at 825-26; Tyson, *supra* note 75, at 249-50.

[79] Jorden & Woodward, *supra* note 75, at 825 (quoting Benjamin Vandegrift, *Section 13(d) Disclosure: Guidelines for Group Therapists*, 16 B.C. IND. & COM. L. REV. 459, 460 (1975)).

[80] Tyson, *supra* note 75, at 251. Some questioned the wisdom of basing regulation of cash tender offers on existing proxy rules because, unlike a proxy contest where the shareholder retains his investment in the company, the shareholder in

The bill originally introduced by Senator Harrison Williams[81] was criticized because it avowedly favored incumbent management.[82] However, after extensive hearings revealed that a hostile tender offer was the most effective way to flush out "entrenched, inefficient management," a different bill stressing neutrality between bidders and target management was passed.[83] Senator Williams explained, "We have taken extreme care to avoid tipping the scales in favor of management or in favor of the person making the takeover bids."[84]

It is now widely accepted that, by setting forth an extensive disclosure scheme, Congress's two main objectives in passing the Williams Act were to protect investors by requiring full and fair disclosure, and to "preserv[e] the vitality of the tender offer process through regulatory neutrality."[85] Stated otherwise, the disclosure scheme enacted by the Williams Act and the tender offer rules promulgated by the SEC thereunder provide a target company's shareholders sufficient time and information with which to make informed decisions as to whether to tender their shares.[86] To a large extent, the goals

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the cash tender offer will give up part or all of his investment. As a result, some argued, requiring information about the bidder and future management would be unnecessary. Jorden & Woodward, *supra* note 75, at 827. This argument was rejected because shareholders who had to make the initial decision as to whether to tender their shares would base their decision on the nature and quality of future management—information provided only in mandatory disclosure documents. *Id.*

[81] S. 2731, 89th Cong., 1st Sess. (1965).

[82] *See* Jorden & Woodward, *supra* note 75, at 827-28 (citing 111 CONG. REC, 28,257 (1965) (statement of Senator Williams); Tyson, *supra* note 75, at 250.

[83] Jorden & Woodward, *supra* note 75, at 827 (citing S. REP. NO. 550, 90th Cong., 1st Sess. 3 and H.R. REP. NO. 1711, 90th Cong., 2d Sess. 4 (1968); Tyson, *supra* note 75, at 251.

[84] Tyson, *supra* note 75, at 252 (citing 113 CONG. REC. 24,664 (1967)) (statement of Senator Williams). Courts, too, recognize the neutrality of the Williams Act in emphasizing that Congress intended neither to impose unrealistic disclosure requirements on bidders nor to give target company management a weapon with which to defeat the offer. *See* Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58-59 (1975); Finnegan v. Campeau Corp., 915 F.2d 824, 829 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 1624 (1991); General Aircraft Corp. v. Lampert, 556 F.2d 90, 95 (1st Cir. 1977); IU Int'l v. NX Acquis. Corp., 840 F.2d 220, 222 (4th Cir. 1988); Koppers Co., Inc. v. American Express Co., 689 F. Supp. 1371, 1383 (W.D. Pa. 1988).

[85] Tyson, *supra* note 75, at 252; *see* Jorden & Woodward, *supra* note 75, at 826; Kenneth M. Tallering, Note, *Target Corporation Disclosure of Soft Information in Tender Offer Contests*, 54 FORDHAM L. REV. 825, 826 (1986).

[86] J. Robert Brown, *Corporate Communications and the Federal Securities Laws*, 52 GEO. WASH. L. REV. 741 (1985) (goal of Williams Act was to reduce pressure

of the Williams Act mirror the goals of the 1934 Act. Indeed, in *SEC v. Capital Gains Research Bureau*,[87] the Supreme Court held that a fundamental purpose of the 1934 Act was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*."[88] Full and fair disclosure, however, was intended to enable shareholders to make informed investment decisions, not to enable them to litigate the substantive fairness of the transaction.[89]

2. Substantive Provisions: Sections 13(d), 14(d) and 13(e)

Section 13(d)[90] and the regulations promulgated thereunder require any person who acquires directly or indirectly beneficial ownership of more than five percent of an issuer's securities to file a disclosure schedule with the SEC within ten days of crossing the five-percent threshold.[91]

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on target's shareholders so that investors could make informed decisions about whether to tender their shares).

[87] 375 U.S. 180 (1963).

[88] *Id.* at 186; *accord* Santa Fe Indus. v. Green, 430 U.S. 463, 477-78 (1977); Taylor v. First Union Corp. of South Carolina, 857 F.2d 240, 246 (4th Cir. 1988), *cert. denied*, 489 U.S. 1080 (1989). As recently as Basic v. Levinson, 485 U.S. 224 (1988), the Court reiterated that the 1934 Act was intended to provide material information to shareholders: "Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress." *Id.* at 234.

[89] Litigating the substantive terms of a transaction arises most frequently in the context of a Rule 13E-3 or "freeze-out merger." 17 C.F.R. § 240.13e-3 (1993). In a freeze-out merger, a corporation which is the majority owner of its stock makes a tender offer for its remaining shares. Rule 13e-3 requires that shareholders receive certain information concerning the merger, including the fairness of offer. *See infra* notes 120-21 and accompanying text. Frequently, minority shareholders will sue the corporation claiming that the offer price is unfair, and that the corporation filed a false and misleading proxy statement by claiming in its proxy statement the offer price was fair. *See generally* Santa Fe Indus. v. Green, 430 U.S. 463, 479 (1977) (unfairness of freeze-out merger should be litigated in state courts); Nobles v. First Carolina Communications, Inc., 929 F.2d 141, 145 (4th Cir. 1991) (limited partner's inability to affect buy-back of his interest rendered misstatements in proxy statement immaterial as a matter of law); *In re* Craftmatic Sec. Litig., 890 F.2d 628, 639 (3d Cir. 1989) ("The line between a material nondisclosure and the nondisclosure of mere mismanagement is often difficult to draw."); Taylor v. First Union Corp. of South Carolina, 857 F.2d at 246 ("Federal securities law was not intended to provide a federal forum for every intracorporate squabble . . . ."). *But cf.* Plane v. McCabe, 797 F.2d 713, 722 (9th Cir. 1986) (disclosure violations going to fairness actionable under securities laws).

[90] 15 U.S.C. § 78m(d) (1988).

[91] Some commentators are critical of the ten-day window because the acquiror may continue to acquire the issuer's stock until it files its disclosure schedule. *See*

Congress explicitly required that certain information enumerated in the statute be disclosed in the schedule,[92] but gave the SEC broad authority to require "such additional information . . . as necessary or appropriate in the public interest or for the protection of investors."[93] Pursuant to this authority, the SEC promulgated regulations[94] requiring the filing of Schedule 13D,[95] which contains numerous line-item disclosure provisions.[96] "Section 13(d)'s filing requirements are aimed at creeping acquisitions and open market or privately negotiated large block purchases."[97] The reason for requiring such disclosure is clear: a person or corporation that acquires large amounts of shares in a corporation may intend either to seek control of the corporation, or simply to make an investment in the corporation. Public disclosure of such information may tend to affect the corporation's share price by reflecting the attractiveness of that corporation either as a long-term investment opportunity or as a potential takeover target.[98]

Section 14(d)[99] "establishes the primary disclosure obligations of the tender offeror."[100] It requires that all tender offer material for equity securities be filed with the SEC, along with appropriate disclosures similar to those required under Section 13(d),[101] and such other information as the SEC might re-

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HAZEN, *supra* note 28, § 11.10, at 515.

[92] Section 13(d)(1), 15 U.S.C. § 78m(d)(1) (1991). Congress specifically required disclosure of: (A) the background, identity and nature of beneficial ownership; (B) the source and amount of funds used to purchase the shares; (C) if the purpose of the purchase is to gain control of the company, any plans or proposals the acquiror has for the company; and (D) the number of shares beneficially owned or for which there exists a right to acquire.

[93] *Id.*

[94] Rule 13d-1(a), 17 C.F.R. § 240.13d-1(a) (1993).

[95] 17 C.F.R. § 240.13d-101 (1993).

[96] *See* 17 C.F.R. § 240.13D-100 (1993). Schedule 13D's line-item provisions mandate disclosure of: the Security and Issuer (Item 1); Interest in Securities of the Issuer (Item 5); Contracts, Arrangements, Understandings or Relationships with Respect to Securities of the Issuer (Item 6); and, Material to be Filed as Exhibits (Item 7).

[97] HAZEN, *supra* note 28, § 11.13, at 527.

[98] Accordingly, a reasonable shareholder would consider the fact that a person or corporation has acquired at least five percent of the issuer's shares important—or material—in deciding whether to sell, hold or acquire more shares in the issuer.

[99] 15 U.S.C. § 78n(d) (1988).

[100] Tyson, *supra* note 75, at 255.

[101] *See supra* note 92 and accompanying text.

quire.[102] Pursuant to the authority granted to it under Section 14(d)(1), the SEC promulgated rules[103] requiring that the bidder file a Schedule 14D-1[104] with the SEC. Like the requirements of Schedule 13D, Schedule 14D-1 contains line-item provisions requiring the disclosure of specifically enumerated information.[105] Section 14(d) also added certain procedural requirements regarding the conduct of tender offers which, when supplemented by the SEC's rules, substantively ameliorated the rights of the target's shareholders.[106]

Section 14(d)(4) of the 1934 Act[107] governs the disclosure obligations of the target company by requiring that "[a]ny solicitation or recommendation to the holders of . . . a security to accept or reject a tender . . . shall be made in accordance with such rules and regulations as the Commission may prescribe."[108] Significantly, section 14(d)(4) is one of two Williams Act tender offer provisions that do not enumerate spe-

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[102] Section 14(d)(1), 15 U.S.C. § 78n(d)(1) (1988). HAZEN, supra note 28, § 11.14, at 534-35; Tyson, *supra* note 75, at 255.

[103] 17 C.F.R. § 240.14d-3(b) (1993).

[104] 17 C.F.R. § 240.14d-100 (1993).

[105] *See, e.g., supra* note 96.

[106] Jorden & Woodward, *supra* note 75, at 819; Moylan, *supra* note 53, at 564-66; Tyson, *supra* note 75, at 258-59. For instance, section 14(d)(5) of the 1934 Act, 15 U.S.C. § 78n(d)(5) (1988), permits shareholders to withdraw shares tendered within seven days of the commencement of the offer, and anytime after the expiration of sixty days from the date of the offer if the bidder has not paid for shares tendered prior to that time. Section 14(d)(6) of the 1934 Act, 15 U.S.C. § 78n(d)(6) (1988), requires that, if the tender offer is for less than all the outstanding shares of the target company, the bidder must accept pro rata any shares tendered within the first ten days of the offer. Section 14(d)(7) of the 1934 Act, 15 U.S.C. § 78n(d)(7) (1988), requires a bidder who changes the terms of the offer by increasing the amount of consideration to pay the higher price to all tendering shareholders, regardless of whether they tendered their shares prior to or after the increase was announced. *See* Moylan, *supra* note 53, at 566; HAZEN, *supra* note 119, § 11.14 at 540; Tyson, *supra* note 75, at 259 n.85. Finally, the SEC, in Rule 14d-10, 17 C.F.R. § 240.14d-10 (1993), adopted two additional substantive requirements which were intended to prevent offerors from discriminating among target shareholders.

From the foregoing, it would appear that some of the tender offer provisions of the Williams Act, when augmented by the SEC's rules, have as much to do with regulating the substantive fairness of the offer itself as they do with ensuring full and fair disclosure. Nevertheless, by requiring fair and equal treatment of all shareholders, the interplay between the Williams Act and the SEC's rules allows shareholders to make informed investment decisions, which is the preeminent purpose of the Williams Act and the 1934 Act. *See* Tyson, *supra* note 75, at 260.

[107] 15 U.S.C. § 78n(d)(4) (1988).

[108] *Id.*

cific, statutory disclosure obligations. Instead, in these two areas, the SEC has nearly plenary authority to establish disclosure requirements.[109]

Pursuant to section 14(d)(4), the SEC promulgated Rule 14d-9,[110] which requires any person or corporation to file a Schedule 14D-9[111] as soon as practicable[112] after recommending that the target's shareholders either accept or reject the offer.[113] Like Schedules 13D and 14D-1, Schedule 14D-9 contains various line-item provisions calling for the disclosure of certain information. Section 14(d)(4) and the rules promulgated thereunder are a perfect example of the Williams Act's attempt to maintain regulatory neutrality between bidders and target management. By requiring the bidder as well as the target to make disclosures, shareholders are far better equipped to make informed investment decisions.[114]

Finally, section 13(e)(1) of the 1934 Act[115] gives the SEC

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[109] *See generally* Brown, *supra* note 11, at 102 ("securities laws provide the Commission with exceedingly broad, almost plenary, authority to impose affirmative disclosure requirements.") (footnote omitted). Section 13(e), 15 U.S.C. § 78m(e) (1988), also gives the SEC broad authority to regulate certain types of tender offers without requiring specific, statutory disclosure requirements. By contrast, sections 13(d) and 14(d), while giving the SEC authority to promulgate *further* disclosure requirements, contain statutory disclosure requirements.

[110] 17 C.F.R. § 240.14d-9 (1993). Rule 14d-9 provides, in relevant part:

> (a) *Filing and Transmittal of Recommendation Statement.* No solicitation or recommendation to security holders shall be made by any person described in paragraph (d) of this section with respect to a tender offer . . . unless as soon as practicable on the date such solicitation or recommendation is first published or sent or given to security holders such person complies with the following sub-paragraphs.
>
> (1) Such person shall file with the Commission eight copies of a Tender Offer Solicitation/Recommendation Statement on Schedule 14D-9.

[111] 17 C.F.R. § 240.14d-101 (1993).

[112] Rule 14e-2, 17 C.F.R. § 240.14e-2 (1993), requires that the target company send a statement concerning its position on the tender offer within ten days of when the offer is announced. Because this statement is a solicitation/recommendation statement within the meaning of Rule 14d-9, the company is thus obligated to file a Schedule 14D-9 in accordance with Rule 14d-9(a). *See* Amanda Acquis. Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis.), *aff'd*, 877 F.2d 446 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989); Newell Co. v. Vermont Am. Corp., 725 F. Supp. 351, 369 (N.D. Ill. 1989).

[113] 17 C.F.R. § 240.14d-9 (1993). Rule 14d-9 is not limited to the target company itself. Any person or corporation recommending that an offer either be accepted or rejected must file a Schedule 14D-9. *See* Tyson, *supra* note 75, at 257-58.

[114] *Id. See also* Gaillard, *supra* note 53, at 1189; Moylan, *supra* note 53, at 564.

[115] 15 U.S.C. § 78m(3)(1) (1988).

broad authority to regulate an issuer's repurchases of its stock. Section 13(e)(1) makes it unlawful for an issuer to purchase its own stock unless it complies with such rules as the SEC may promulgate.[116] Pursuant to this authority, the SEC promulgated Rules 13e-1 to 13e-4.[117] Rule 13e-1[118] prohibits an issuer from purchasing its own stock after a tender offer has been made unless the issuer files with the SEC a disclosure statement.[119] Rule 13e-3[120] pertains to "going private"—or "freeze-out"—transactions,[121] and prohibits the company from engaging in a Rule 13e-3 transaction without filing with the SEC a Schedule 13E-3.[122] Finally, Rule 13e-4[123] requires an issuer that is the subject of a tender offer to file a Schedule 13E-4[124] before launching a tender offer for its own stock.[125]

In sum, the regulatory scheme that the SEC has enacted under each major section of the Williams Act provides for the filing of a disclosure statement with the SEC. These requirements, apart from any attempt to regulate the substantive fairness of tender offers, have but one clear objective: they provide shareholders with sufficient information with which to make informed investment decisions. Sections 13(d) and 14(d)(1) each require disclosure of specific information that Congress obviously considered crucial to an informed investment decisions; those requirements have been incorporated into the SEC's mandatory disclosure statements. Sections 14(d)(4) and 13(e) do not contain similar statutory disclosure requirements. Nevertheless, by giving the SEC broad authority to regulate in those areas, it is evident that Congress perceived a need for further regulation—including disclosure—in these areas.

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[116] *Id.*

[117] 17 C.F.R. §§ 240.13e-1-.13e-4 (1993).

[118] 17 C.F.R. § 240.13e-1 (1993).

[119] *Id.*

[120] 17 C.F.R. § 240.13e-3 (1993).

[121] A "going private" transaction (freeze-out merger) is a purchase or tender offer by the issuer of its shares that would lead to the cessation of reporting obligations under the 1934 Act. Rule 13e-3(a)(3)(ii), 17 C.F.R. § 240.13e-3(a)(3)(ii) (1993); *see* HAZEN, *supra* note 28, § 11.17, at 553-54.

[122] Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1993).

[123] Rule 13e-4, 17 C.F.R. § 240.13e-4 (1993).

[124] Schedule 13E-4, 17 C.F.R. § 240.13e-101 (1993).

[125] HAZEN, *supra* note 28, § 11.17, at 553.

II. THE *KERN* CASE

A. *The Facts*[126]

On September 4, 1986, Allied issued a press release revealing that Robert Campeau, Chairman of the Board and Chief Executive Officer of Campeau, had sent a letter to Thomas Macioce, the Chief Executive Officer of Allied, offering to acquire Allied in a negotiated merger transaction by exchanging cash and securities for Allied's common stock.[127] On September 11, 1986, Allied issued a press release announcing that its board of directors had rejected Campeau's invitation.[128] The next day Campeau launched a tender offer for sixty percent of Allied's shares at fifty-eight dollars per share, a deal worth $1.74 billion.[129]

In response to the hostile offer, Allied's investment banker, Goldman, Sachs, Co. ("Goldman Sachs"), began to consider various defensive tactics.[130] Among the options considered was a recapitalization plan that would have involved the sale of several of Allied's shopping centers and a special dividend for Allied's shareholders. Representatives of Allied—including Mr. Kern—and the Edward J. DeBartolo Corporation ("DeBartolo") met to discuss the sale of Allied's shopping centers to DeBartolo.[131] Over the next week, the parties engaged in negotiations concerning the identity and the price of the

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[126] The facts described in this section are culled mainly from the Division's Order Instituting Proceedings, *In re* George C. Kern, Jr., Admin. Proc. File No. 3-6869, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,142 (June 29, 1987) [hereinafter *Order Instituting Proceedings*], and from Judge Blair's findings of fact, which were reported in his Initial Decision, *supra* note 18.

[127] *Allied Stores Comments on Campeau Offer*, PR Newswire, Sept. 4, 1986, *available in* LEXIS, Nexis Library, WIRES File; *Order Instituting Proceedings*, *supra* note 126, at 88,764, ¶ 10; *Initial Decision*, *supra* note 18, at 89,581.

[128] *Allied Stores Does Not Accept Campeau Offer*, PR Newswire, Sept. 11, 1986, *available in* LEXIS, Nexis Library, WIRES File; *Order Instituting Proceedings*, *supra* note 126, at 88,764, ¶ 11; *Initial Decision*, *supra* note 18, at 89,581.

[129] *Campeau Launches Takeover Bid for Allied Stores*, Reuters Ltd., Sept. 12, 1986, *available in* LEXIS, Nexis Library, WIRES File; *Order Instituting Proceedings*, *supra* note 126, at 88,764, ¶ 13; *Initial Decision*, *supra* note 18, at 89,581.

[130] *Order Instituting Proceedings*, *supra* note 126, at 88,764, ¶ 13; *Initial Decision*, *supra* note 18, at 89,581.

[131] *Order Instituting Proceedings*, *supra* note 126, at 88,764-65, ¶¶ 13, 17-20; *Initial Decision*, *supra* note 18, at 89,581-82.

shopping centers.[132] On September 24, 1986, Allied issued a press release indicating that its Board of Directors had determined that the tender offer was not in the best interests of its shareholders and recommending that shareholders not tender their shares to Campeau.[133] On the same day, Allied filed with the SEC its Schedule 14D-9.[134] By September 25, 1986, Edward J. DeBartolo, Sr., head of DeBartolo, had agreed to pay $405 million for six shopping centers, contingent on a report on the quality of the malls in question.[135] On September 29 and 30, 1986, Goldman Sachs and several of Allied's representatives approached various banks with respect to the proposed recapitalization. Previously, however, on September 29, 1986, Campeau had increased its offer to sixty-six dollars per share for eighty percent of Allied's common stock.[136] Thus, the recapitalization was no longer more attractive to Allied's shareholders than the Campeau offer, and Allied in-

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[132] *Id.*

[133] *Allied Stores Campeau Offer not in Allied's Best Interest*, PR Newswire, Sept. 24, 1986, *available in* LEXIS, Nexis Library, WIRES File.

[134] Item 7(a) of Allied's original Schedule 14D-9 stated:

> At its September 23, 1986 meeting, the Board considered and reviewed the feasibility and desirability of exploring and investigating certain types of possible transactions, including without limitation, a change in the present capitalization of the Company, the public or private sale of Shares or other securities of the Company to another company or person, the acquisition by the Company of Shares by tender offer or otherwise, the acquisition by the Company of all or part of the business of another company or person, and the acquisition of one or more of its significant business segments of the Company or of certain of its assets or a portion of its Shares by another company or person. After considerable discussion, the Board resolved that it was desirable and in the best interests of the Company and its stockholders *to continue to explore and investigate*, with the assistance and advice of Goldman Sachs, such transactions, although the Board noted that the initiation or continuation of such activities may be dependent upon future actions with respect to the Offer. There can be no assurance that these activities will result in any transaction being recommended to the Board or that any transaction which may be recommended will be authorized or consummated. The Proposal or consummation of any transaction of the type referred to in this Item 7 may have an impact on the Offer.

Allied's Schedule 14D-9 filed with the SEC (Sept. 23, 1986) (emphasis added).

[135] *Id.* Moreover, Thomas Macioce was prepared to recommend to Allied's board of directors that they accept the $405 million offer. *Initial Decision*, *supra* note 18, at 89,582.

[136] *Campeau Raises Offer for Allied Stores*, PR Newswire, Sept. 29, 1986, *available in* LEXIS, Nexis Library, WIRES File; *Order Instituting Proceedings*, *supra* note 126, at 88,765, ¶ 27; *Initial Decision*, *supra* note 18, at 89,584.

stead began to discuss the viability of a "white knight"[137] merger with DeBartolo.[138]

Over the next four days, representatives—including outside counsel—of Allied, DeBartolo and Paul Bilzerian, a well-known corporate raider, engaged in intensive negotiations concerning the terms of the proposed merger between Allied and an entity jointly owned by DeBartolo and Bilzerian.[139] Goldman Sachs provided Shearson Lehman Brothers ("Shearson"), DeBartolo's investment banker, with nonpublic information so that Shearson could better evaluate the deal between DeBartolo and Allied.[140] During these negotiations, the parties discussed a sixty-five dollars per share tender offer for Allied's common stock, the all-cash nature of the second step merger, break-up fees if the deal failed to materialize and the fate of Allied's employee stock option and profit-sharing plans. By October 1, 1986, the parties exchanged drafts of the merger agreement in anticipation of another meeting the next morning.[141] On October 2, 1986, the parties met to discuss the final price of the merger and, after Goldman Sachs and Shearson presented various alternatives, the parties finally agreed on a price of sixty-seven dollars per share.[142]

On Friday, October 3, 1986, Allied's Board of Directors unanimously approved the merger and authorized Allied's management to execute the merger agreement, contingent upon DeBartolo's receipt of financing commitments necessitated by the agreement.[143] That evening, Allied learned that DeBartolo had encountered difficulty obtaining financing. Over the weekend, DeBartolo met with various lenders, who informed the parties that the lenders would meet early Monday

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[137] A "white knight" is a friendly third-party bidder who agrees to acquire the target company, thereby foiling the hostile bidder's takeover attempt. *See also Initial Decision*, *supra* note 18, at 89,584 n.10.

[138] *Order Instituting Proceedings*, *supra* note 126, at 88,765, ¶ 28; *Initial Decision*, *supra* note 18, at 89,584.

[139] *Order Instituting Proceedings*, *supra* note 126, at 88,765-66, ¶¶ 29-33; *Initial Decision*, *supra* note 18, at 89,584.

[140] *Id.*

[141] *Id.*

[142] *Order Instituting Proceedings*, *supra* note 126, at 88,766, ¶ 39; *Initial Decision*, *supra* note 18, at 89,586.

[143] *Order Instituting Proceedings*, *supra* note 126, at 88,766, ¶ 40; *Initial Decision*, *supra* note 18, at 89,586-87.

morning to determine whether the financing arrangements were satisfactory.[144]

Finally, on Tuesday evening, October 7, 1986, DeBartolo received the necessary financing commitments, and Allied and DeBartolo executed the merger agreement.[145] The next day, Allied filed with the Commission an amendment to its Schedule 14D-9, again advising shareholders to reject Campeau's offer, disclosing the meeting at which the merger was approved some five days earlier and disclosing the subsequent execution of the merger agreement on October 7.[146]

The Division alleged that four separate developments should have been disclosed promptly in an amendment to Allied's Schedule 14D-9: (1) the negotiations concerning the recapitalization;[147] (2) the negotiations with DeBartolo concerning a white knight acquisition;[148] (3) the agreement in principle that the parties reached on October 3, 1986;[149] and

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[144] *Order Instituting Proceedings, supra* note 126, at 88,767, ¶ 45; *Initial Decision, supra* note 18, at 89,587. Since Allied and DeBartolo anticipated that they would consummate the merger on Monday morning, October 6, 1986, Allied requested a halt in the trading of its shares in anticipation of the announcement of the merger agreement. After Allied learned that DeBartolo's troubles with the lenders persisted, however, trading resumed and no announcement was made. *Id.*

[145] *Order Instituting Proceedings, supra* note 126, at 88,767, ¶ 46; *Initial Decision, supra* note 18, at 89,587.

[146] *Edward DeBartolo, Allied Stores Merge*, PR Newswire, Oct. 8, 1986, *available in* LEXIS, Nexis Library, WIRES File; *Order Instituting Proceedings, supra* note 126, at 88,767, ¶ 47; *Initial Decision, supra* note 18, at 89,587. Eventually, the merger with DeBartolo collapsed because Campeau, in a "street sweep," succeeded in purchasing a majority of Allied's shares on the open market. *See* Isadore Barmash, *Judge Bars Campeau's Allied Step*, N.Y. TIMES, Oct. 25, 1986, at A33 (revealing that a federal court had enjoined the second step of Campeau's tender offer, and that Campeau, which had been involved in litigation with Allied to block the merger with DeBartolo, had bought a majority of Allied's stock on the open market). All legal disputes were eventually settled and Campeau, which by then held a large majority of Allied's shares, voted them in favor of the merger.

[147] The Division contended that Schedule 14D-9, Item 7(a)(2) required that these negotiations be disclosed in that they concerned the sale of a "material amount of [the company's] assets." *Order Instituting Proceedings, supra* note 126, at 88,765, ¶ 24.

[148] The Division alleged that Schedule 14D-9, Item 7(a)(1) required that these negotiations be disclosed in that they concerned "an extraordinary transaction such as a merger or reorganization." *Order Instituting Proceedings, supra* note 126, at 88,765, ¶ 36.

[149] The Division claimed that Schedule 14D-9, Item 7(b) required that this development be disclosed because it was an agreement in principle which pertained to an item that must be disclosed under Rule 14d-9, Item 7(a). *Order Instituting Proceedings, supra* note 126, at 88,766-67, ¶¶ 39, 44-48.

(4) Allied's October 3, 1986, Board Resolution authorizing the execution of a merger agreement with DeBartolo contingent upon DeBartolo's obtaining the requisite financing commitments.[150]

B. *The Administrative Hearing*

The SEC commenced an administrative proceeding against Allied and Mr. Kern under section 15(c)(4) of the 1934 Act.[151] The SEC sought to demonstrate that Mr. Kern, as *decisionmaker* for Allied, had caused Allied to violate section 14(d)(4) of the 1934 Act and Rules 14d-9 and 14d-9(b). The SEC also sought an order requiring Mr. Kern to comply generally with securities laws in the future.

The testimony adduced at the Hearing revealed that there was a fundamental dispute between Mr. Kern's interpretation of Rule 14d-9(b)'s "material change" language as it relates to Item 7(a)(1) of Schedule 14D-9, and the Division's interpretation of those rules. In its opening argument, the Division anticipated Mr. Kern's defense that the events under scrutiny were not material:

> The Respondent will argue, we believe, that the fact of the negotiations, and the agreement in principle, and the board resolution were not material. But the Commission has determined that negotiations, agreements in principle, and board of directors resolutions by a company subject to a tender offer are *per se material*. That determination is clearly expressed in the instructions to Schedule 14D-9. It is not, we submit, for individual regulated parties to substitute their judgment for that of the Commission.[152]

Mr. Kern, by contrast, argued that Allied's original Schedule 14D-9[153] already disclosed that negotiations might be underway that could lead to a merger or a recapitalization.[154] Since DeBartolo's financing commitments were not in place—either for the shopping center deal or for the white

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[150] *Id.*

[151] *See supra* note 17.

[152] HT. 33-34 (emphasis added).

[153] *See supra* note 134. Allied's original Schedule 14D-9, Item 7(a) disclosed that "[a]fter considerable discussion, the Board resolved that it was desirable and in the best interests of the Company and its stockholders *to continue to explore and investigate . . . such transactions*." *Id.* (emphasis added).

[154] HT. 44-45.

knight merger—the probability of a merger occurring was extremely low. Thus, the negotiations did not constitute a material change in the information already disclosed, according to Mr. Kern.[155] With respect to what "material" meant for purposes of a "material change in the information," senior Sullivan & Cromwell litigation partner Marvin Schwartz argued:

> What does "material" mean? The Commission, itself, and the courts in case after case, in dealing with merger and acquisition situations, sales of assets situations, and, indeed, the Solicitor General in his recent brief on behalf of the Commission in the Supreme Court in *Basic v. Levinson*, have told us quite clearly what "material" means in those contexts. It means that a transaction or discussions or negotiations are material when a transaction is probable as a result of those discussions or negotiations. That, I submit to your honor, is the law.[156]

Mr. Schwartz further argued that whether or not a merger was probable called for judgment on the part of the person charged with disclosure decisions.[157]

Therein lay the fundamental difference between the positions of the Division and Mr. Kern. The Division believed that Item 7 of Schedule 14D-9 left Mr. Kern no room for judgment—he should have disclosed the negotiations when they occurred, as the rule apparently requires. By contrast, Mr. Kern argued that because Rule 14d-9(b) required disclosure of only material changes, he was obligated to assess the material-

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[155] HT. 45-46.

[156] *Id.*

[157] HT. 46. Mr. Schwartz asked, "What could clearly be more a matter of *judgment* than an assessment today of the probability of an event occurring two weeks hence or even two days hence? That is what this case is about." *Id.* (emphasis added). In light of the Division's argument that section 15(c)(4)'s "knew or should have known" language required only a showing of negligence—an argument that Judge Blair ultimately accepted—Mr. Kern's argument that Rule 14d-9(b) called for him to exercise judgment by performing an independent materiality analysis took on great significance. By showing that his *judgments* were in line with those of other securities practitioners, Mr. Kern asserted that he had acted with a reasonable degree of professional care. Thus, he concluded, he could not have negligently caused Allied's disclosure violations. HT. 46-47; Post-Hearing Brief of respondent George Kern at 85-86 (on file with the author). Some of the most well-respected securities practitioners in the field, Martin Lipton, Professor Louis Loss, Robert Mundheim and former SEC Commissioner Francis Wheat, testified that Mr. Kern's actions as a professional were reasonable under the circumstances. HT. 555, 764-65, 797-800 and 822-23.

ity of the information constituting the change, using the accepted tests for materiality set forth in the case law. Aside from the SEC's authority to bring the proceeding in the first instance, this difference in interpretation was one of the most important legal issues that arose in *Kern*. Although the ALJ found Mr. Kern liable, he adopted Mr. Kern's argument that Rule 14d-9(b) required him to apply *Basic*'s materiality test to the negotiations at issue, a decision which, this Comment asserts, was erroneous.

C. *The Initial Decision*

In his Initial Decision, Chief SEC Administrative Law Judge Warren Blair found that Mr. Kern was the cause of Allied's failure to amend its Schedule 14d-9.[158] Judge Blair also concluded that section 15(c)(4)'s "knew or should have known" language[159] required a showing of only negligence on Mr. Kern's part, and that Mr. Kern had "neglected to give due care and consideration to the need for amendment."[160]

Judge Blair employed a two-tiered analysis for each corporate event that the Division contended should have been disclosed. First, he analyzed the language of Allied's original Item 7 disclosure, comparing it to the subsequent events at issue.[161] Judge Blair concluded that Allied's original Item 7 disclosure failed to reveal the negotiations in connection with the sale of the shopping centers, and the board resolution and agreement in principle related to the white knight merger.[162] Significantly, in response to Mr. Kern's argument that Allied's original Item 7(a) disclosure was sufficient to inform the market that negotiations concerning the corporate events at issue were occurring, Judge Blair noted that:

> Allied's disclosure in Item 7(a) of its Schedule 14D-9 that Allied's Board had "resolved that it was desirable and in the best interests of the Company and its stockholders to continue to explore and investigate" certain types of transactions including acquisition by another company of one or more of Allied's business segments did *not* encom-

[158] *Initial Decision, supra* note 18, at 89,592-93.
[159] *See supra* note 17.
[160] *Initial Decision, supra* note 18, at 89,592-93.
[161] *Id.* at 89,582-83, 89,585-86, 89,586-87.
[162] *Id.*

pass what must be deemed negotiations for the shopping centers that took place on September 25 . . . . The words "explore" and "investigate" imply efforts by Allied to locate transactions in keeping with the Board's resolution, but do *not* suggest that a specific transaction of the magnitude of the sale of Allied's shopping centers would become the subject of on-going negotiations on September 25 . . . .[163]

Second, having concluded that the corporate events at issue were not disclosed in Allied's original Item 7 disclosure, Judge Blair then proceeded to assess whether the events in question were material "within the meaning of Rule 14d-9(b)."[164] He concluded that *Basic, Inc. v. Levinson*[165] provided the "controlling guidelines."[166] Applying the tests for materiality adopted in *Basic*,[167] Judge Blair concluded that the events in question were material and, thus, should have been disclosed.[168]

Judge Blair discontinued the proceedings, however, without entering an order against Mr. Kern. He concluded that he did not have the authority under section 15(c)(4) to order a respondent who no longer represented a company, the disclosures of which he had caused to be deficient, to comply generally with the securities laws in the future.[169] Instead, he reasoned that section 15(c)(4) would allow only the entry of an order directing a respondent to correct a past, erroneous filing. Since Mr. Kern no longer represented Allied, and because Allied was no longer a public company, no order could be entered against Mr. Kern.[170]

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[163] *Id.* at 89,582-83 (emphasis added). Judge Blair reached a similar conclusion with respect to the white knight negotiations. *Id.* at 89,585.

[164] *Id.* at 89,583, 89,585, 89,587-88.

[165] 485 U.S. 224 (1988).

[166] *Initial Decision*, *supra* note 18, at 89,583. Agreeing with Mr. Kern—and disagreeing with the Division—Judge Blair apparently assumed that the word "material" in Rule 14d-9(b) permitted persons charged with disclosure decisions under Rules 14d-9 and 14d-9(b) to assess the significance of information contemplated for disclosure. *See infra* notes 235-36 and accompanying text.

[167] *See supra* notes 52-72; *see also supra* note 12.

[168] *See supra* note 164.

[169] *Initial Decision*, *supra* note 18, at 89,593.

[170] *Id.* at 89,595. At the time, the only method that the SEC could have used to obtain an order requiring Mr. Kern to comply with securities laws in the future would have been a suit in district court for injunctive relief under § 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1988). But in such a suit, the SEC would have been required to show that Mr. Kern possessed a level of culpability higher than mere

D. *The Appeal to the Full Commission*

Under an internal appeal provision, the full Commission decided *sua sponte* to review all questions of law and fact raised in the ALJ's decision.[171] In his brief, Mr. Kern argued, as he had previously, that section 15(c)(4) did not authorize the entry of an order requiring general future compliance. In addition, Mr. Kern vigorously attempted to portray the proceeding as an attack on his professional judgment, and an improper attempt by the SEC to subject his good faith legal judgments to scrutiny.[172] The Division responded to that assertion by arguing that Mr. Kern's actions as a *decisionmaker*, not his legal advice as an attorney, were being questioned. This became one of the central issues at oral argument before the Commission.[173]

With regard to the merits, Mr. Kern repeated his argument that his original Item 7(a) disclosure was sufficient to apprise investors that negotiations regarding the sale of Allied's shopping centers and white knight negotiations were underway.[174] Mr. Kern further argued that, because the prob-

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negligence. *See, e.g.*, HAZEN, *supra* note 28, § 9.5 at 358-59.

[171] The Commission made this decision under Rule 17(c) of its Rules of Practice, 17 C.F.R. § 201.17 (1993). *SEC to Review Decision to End Proceeding Against Attorney Kern*, 21 Sec. Reg. & L. Rep. (BNA) 3 (Jan. 6, 1989).

[172] *See* Brief Before the Commission of Respondent George C. Kern at 29-36 [hereinafter *Respondent's Appellate Brief*] (on file with the author). Indeed, this aspect of Mr. Kern's argument has received considerable attention in the scholarly literature. *See* James R. Doty et al., *The Professional as Defendant*, 755 P.L.I./CORP. 681 (1991); Daniel L. Goelzer & Susan Ferris Wyderko, *Rule 2(e) Securities and Exchange Discipline of Professionals*, 85 NW. U. L. REV. 652, 670-73 (1991); Eldon Olson, *SEC Sanctions of Securities Counsel*, 765 P.L.I./Corp. 473 (1992); Harvey L. Pitt et al., *SEC Enforcement Actions An Overview of SEC Enforcement Proceedings and Priorities*, C700 A.L.I.-A.B.A. 167 (1991); Harvey L. Pitt & Dixie L. Johnson, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 Provisions and Implications of the New Remedies Available to the SEC*, 718 P.L.I./CORP. 7 (1990); Richard H. Rowe, *Trends in Potential Liability Under the Federal Securities Laws for Rendering Legal Opinions in Securities Transactions*, 725 P.L.I./CORP. 473 (1991); Marc I. Steinberg, *Attorney Liability Under the Securities Laws*, 45 SW. L.J. 711 (1991); David B. Wilkins, *Who Should Regulate Lawyers*, 105 HARV. L. REV. 799 (1992).

[173] Appeal Transcript at 10-19, 38, 48-57 [hereinafter numbers preceded by "AT" refer to the transcript of the oral argument before the full Commission, dated June 8, 1989]. *See also Kern's Status as Attorney is Central Issue at SEC Oral Argument*, 21 Sec. Reg. & L. Rep. (BNA) 847 (June 9, 1989).

[174] *Respondent's Appellate Brief*, *supra* note 172, at 48-51. Mr. Kern previously

ability of the negotiations leading to a significant corporate event was low, and because DeBartolo lacked the necessary financing to effectuate a white knight tender offer, there was no material change in the information requiring disclosure.[175]

The Division weakly contended, as it had previously, that Item 7's requirement that certain information be disclosed rendered the information material *per se*.[176] The Division also argued much more forcefully that the information that Mr. Kern had declined to disclose was material under the *Basic* standard.[177] At oral argument, though, the Division confined itself to its initial position that Item 7 creates an affirmative obligation to disclose the commencement of negotiations regardless of their materiality, and that Allied's original Item 7 had failed to disclose the events under scrutiny. There was no argument by the Division, nor did the Commission question the Division, as to the materiality of the corporate events in issue.[178]

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made this argument at the hearing and in his post-hearing Brief. HT. 44-45; Post-Hearing Brief of Respondent George C. Kern at 19-27 (on file with the author).

[175] *Respondent's Appellate Brief*, *supra* note 172, at 53-63; AT. 33, 70-72. Again, Mr. Kern argued that the appropriate test for materiality was the *Northway/TGS* test adopted in *Basic*. *Id.* at 10-11, 55; AT. 22-24.

[176] Memorandum of Law of the Division of Enforcement at 26 (on file with the author).

[177] *Id.* at 30-39. Perhaps this tactic is best explained as an attempt by the Division to "beat Mr. Kern at his own game," especially in light of the ALJ's decision adopting the *Northway/TGS* standard for which Mr. Kern had argued. *See supra* notes 165-68 and accompanying text.

[178] Indeed, a review of the record reveals that most of the Commission's questions during the Division's argument centered on whether Allied's original Item 7 disclosed the existence of negotiations. AT. 44-48.

Only at one point during the Commission's questioning of the Division's lawyer, Mark Kreitman, did the issue of a "material change in the information" arise. Commissioner Fleischman asked whether the Commission's decision in *In re* Revlon Inc., Exchange Act Release No. 23,320, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986) (consent decree finding that Revlon had violated Rule 14d-9 and 14d-9(b) by failing to disclose the commencement of negotiations where its original Item 7 disclosed only that Revlon's management would continue to explore alternatives), had decided the issue of whether, subsequent to the filing of the original 14d-9, the onset of negotiations referred to in Item 7(a)(1) or (2) was a material change requiring disclosure (AT. 46-47). Mr. Kreitman responded, "Absolutely, Commissioner Fleischman. We think the language that Revlon used to disclose, which the Commission found to be insufficient to disclose the commencement of negotiations is equally insufficient with the language in Allied." *Id.*

Commissioner Fleischman's implication that *Revlon* should be read as holding that, as a matter of law, the onset of negotiations is a *per se* material change in the information, is not so readily apparent. *Revlon* is much more instructive for its

E. *The Opinion of the Commission*

Although seven different issues were presented for its review,[179] the Commission decided only one, holding that the SEC had no authority to seek orders of general future compliance under section 15(c)(4).[180] With respect to the merits of the case, the Commission ruled, "[i]n view of our determination not to impose orders of general future compliance under section 15(c)(4), we affirm solely the law judge's determination to discontinue these proceedings and reach none of the other matters addressed therein."[181]

Whether or not the Commission was correct in concluding that the Division had no authority to seek prospective relief under section 15(c)(4) has been rendered moot by recent amendments to federal securities laws.[182] While many ap-

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definition of the term "negotiations" as that term is used in Item 7(a) of Schedule 14d-9. *See infra* notes 222-33 and accompanying text.

[179] George Kern argued on appeal that:

> (1) Section 15(c)(4) Does Not Authorize the Issuance of the Order Sought; (2) This Proceeding Is an Inappropriate Attempt to Regulate the Legal Profession; (3) Judge Blair Applied the Wrong Legal Standard; (4) Kern Exercised Reasonable Professional Judgment; and (5) The Proceeding Violates Kern's Constitutional Right to a Fair Hearing.

Respondent's Appellate Brief, *supra* note 172, at i-ii.

The Division argued on appeal that:

> (1) The Evidence at Trial Established that Allied Violated Rule 14d-9(b), that Kern Was a Cause of the Violation, and that Kern Should Have Known his Conduct Would Contribute to Allied's Violation; (2) Section 15(c)(4) Authorizes the Commission to Enter an Order Directing Kern to Comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9; and (3) The Law Judge Erred in Excluding Kern's Well's Submission From Evidence.

Memorandum of Law of the Division of Enforcement, *supra* note 21, at i-ii.

[180] *In re* George C. Kern, Jr., Exchange Act Release No. 29,356, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

[181] *Id.* at 82,008. Two inferences can be drawn from the Commission's failure to reach the merits. The Commission may have considered its decision as a dismissal on jurisdictional grounds, thereby rendering the ALJ's decision a nullity. On the other hand, the Commission may have viewed its decision as merely a procedural interpretation, which would not result in the dismissal of the prior decision, especially if it believed that the ALJ had applied the correct law to the facts. This Comment assumes that the Commission's failure to reach the merits constitutes neither an affirmance nor a rejection of the ALJ's factual and legal conclusions. Thus, the ALJ's decision stands as binding precedent on the securities bar.

[182] *See* The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (codified at Section 21C(a) of the 1934 Act, 15 U.S.C. § 78u-3(a) (Supp. III 1991)), which gives the SEC broad authority to issue cease and desist orders and

plauded the SEC's decision actually *limiting* its own authority—an exceedingly rare event in the field of Administrative Law—the decision left many in the securities bar without any guidance on one of the most important issues presented to the Commission for review:[183] Are the negotiations required to be disclosed under Item 7(a)(1) of Schedule 14D-9 material *per se* and does Rule 14d-9(b)'s "material change" language permit the target company to assess the materiality of merger negotiations specifically required to be disclosed under Item 7(a)(1) when deciding whether to amend its Schedule 14D-9?

III. ANALYSIS

Three separate and distinct grounds exist for finding that both Mr. Kern and the ALJ were incorrect in using *Basic* or any materiality test to determine, for purposes of amendment, the materiality of the negotiations at issue. The one with the deepest implications for securities laws, however, is that the SEC, in promulgating Item 7(a) of Schedule 14D-9, had already concluded that preliminary merger negotiations occurring during the pendency of a tender offer are material.[184] Ac-

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to order respondents to comply with the securities laws. Moreover, the scope of the SEC's authority to sanction securities lawyers has been the subject of many scholarly articles. *See supra* note 172; *see also* William R. McLucas & Laurie Romanowich, *SEC Enforcement Proceedings under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145 (1985); William R. McLucas et al., *Remedies Available in SEC Enforcement Actions*, 528 P.L.I./CORP. 857 (1986).

[183] *See* Harvey L. Pitt & Dixie L. Johnson, *Justice Delayed, Justice Denied: Observations on the SEC's 'Kern' Decision*, N.Y. L.J., July 11, 1991, at 1 (expressing the authors' dismay at the Commission's failure to reach the merits of the case, which had been decided adversely to Mr. Kern). Moreover, the entire four-year ordeal drew staunch criticism from many in the securities bar who viewed the SEC's actions as improperly attempting to discipline an attorney who had made what he believed were good-faith legal judgments. *See supra* note 172. Indeed, this may well be quintessential example of "regulation by prosecution." *See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION (1982), in which former SEC Commissioner Karmel attributed her numerous dissents from the institution of enforcement proceedings by the SEC to the SEC's apparent policy of performing its mandate of regulating the securities industry by enforcement actions instead of through its rule-making authority: "I felt the SEC's enforcement program was overly concerned with novelty and morality, and was losing its professionalism. I believed that the Commission's disclosure policy had become an adjunct of the SEC's enforcement program and was in need of reform." *Id.* at 30.

[184] For the two alternative arguments, see *infra* notes 239-47 and accompanying text.

cordingly, because the negotiations in *Kern* were material *per se*, they necessarily constituted a *per se* material *change* in the information for purposes of Rule 14d-9(b). Crucial to the viability of this argument is the fundamental assumption that the negotiations required to be disclosed under Item 7 of Schedule 14D-9 are material *per se*. Support for this assumption can be found in the releases proposing and adopting Item 7 and in cases and administrative proceedings where violations of Item 7 have been adjudicated.[185]

A. *Line-Item Disclosure Requirements and Materiality*

There are essentially two distinct types of line-item provisions. The first type requires disclosure of specific information without regard to materiality.[186] Thus, the filing entity would have no discretion to determine, using the *Northway* (or *Basic*) test, that certain information should be withheld as immaterial.[187] The second type of line-item requirement explicitly

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[185] *See infra* notes 193-204 and accompanying text.

[186] Consider several provisions contained in Schedule 13D, Item 4:

> Describe any plans or proposals which . . . relate to or would result in:
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> (a) The acquisition by any person of additional securities of the issuer, or the disposition of securities of the issuer;
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> (b) An extraordinary corporate transaction, such as a merger, reorganization or liquidation involving the issuer or any of its subsidiaries;
>
> . . . .
>
> (d) Any change in the present board of directors or management of the issuer, including any plans or proposals to change the number or term of directors or to fill any existing vacancies on the board;
>
> . . . .
>
> (g) Changes in the issuer's charter, by laws or instruments corresponding thereto or other actions which may impede the acquisition of control of the issuer by any person;
>
> (h) Causing a class of securities of the issuer to be delisted from a national securities exchange or to cease to be authorized to be quoted in an inter-dealer quotation system of a registered national securities association;
>
> (i) A class of equity securities of the issuer becoming eligible for termination of registration pursuant to Section 12(g)(4) of the Act; or
>
> (j) Any action similar to any of those enumerated above.

17 C.F.R. § 240.13d-101 (Item 4) (1993).

[187] Therefore, with respect to Item 4(d) of Schedule 13D, *id.*, the filing entity could not decide to withhold its plan to remove one member of the issuer's board

predicates disclosure of certain information on its materiality.[188] In those provisions, the *duty* to disclose the information is premised upon the *materiality* of the information itself. By contrast, in the former case, the rule itself creates an affirmative duty of disclosure[189] and the filing entity's only responsibility is to ensure complete and accurate disclosure in compliance with the line-item provision.[190] But that leaves open an extremely significant question: is the information required to be disclosed under line-item provisions that do *not* premise

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of directors as being immaterial to shareholders; the rule specifically requires disclosure of the plan to change the board of directors regardless of the filing person's subjective belief as to the information's materiality.

[188] Consider several additional provisions contained in Schedule 13D, Item 4:

> Describe any plans or proposals which . . . relate to or would result in
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> (c) A sale or transfer of a *material* amount of assets of the issuer or any of its subsidiaries; . . .
>
> . . . .
>
> (e) Any *material* change in the present capitalization or dividend policy of the issuer; or
>
> (f) Any other *material* change in the issuer's business or corporate structure, including but not limited to, if the issuer is a registered closed-end investment company, any plans or proposals to make any changes in its investment policy for which a vote is required by section 13 of the Investment Company Act of 1940 . . . .

17 C.F.R. § 240.13d-101 (Item 4) (1993) (emphasis added). *See* Goelzer, *supra* note 11, at 976 n.5 ("In some cases, line-item requirements are qualified by a materiality standard—responsive information need only be disclosed if material. In other cases, responsive information must be disclosed regardless of materiality."); City Capital Assoc. v. Interco, Inc., 860 F.2d 60 (3d Cir. 1988) (discussing "materiality" requirement in Schedule 14D-1, Item 9); Prudent Real Estate Trust v. Johncamp Realty, 599 F.2d 1140, 1146 (2d Cir. 1979) (same); Grumman Corp. v. LTV Corp., 527 F. Supp. 86, 99-100 (E.D.N.Y.) (discussing "materiality" requirement in Schedule 14D-1, Item 10(c)), *aff'd*, 665 F.2d 10 (2d Cir. 1981).

[189] *See* Brown, *supra* note 11, at 101-02:

> Unlike the antifraud provisions, the line item [provisions] . . . are intended to provide a certain degree of informational parity among investors. These requirements essentially insure that all investors have certain specified information deemed necessary for informed decisionmaking, such as whether to buy or sell securities, execute a proxy, or tender in response to a tender offer.

Id. Professor Brown's observation is both interesting and confusing; on the one hand, he acknowledges that many line-item provisions require certain information "deemed necessary for informed decisionmaking," *id.*, which suggests that he believes (as this Comment suggests) that they call for *material* information. On the other hand, though—and in the very same article—he questions whether the information required by the line-item provisions to which he refers would be material under the *Northway* standard. *See id.* at 101 n.34; *see also infra* note 191.

[190] *See* Goldstein et al., *supra* note 11, at 142.

disclosure on materiality (the first type of line-item provision referred to above), in fact, material? This is an important question, because its answer could very well be determinative of the materiality issue in SEC enforcement proceedings and in civil suits for damages in which omissions from the line-item provisions are alleged and materiality is a crucial element.

There are several ways of approaching this issue. The first—and most appropriate—method of viewing the weight to be accorded to line-item provisions that do not predicate disclosure on materiality is that the information required to be disclosed is material *per se*.[191] According to this view, the SEC

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[191] Some commentators have suggested that information required to be disclosed under the SEC's line-item provisions is always material. *See* Victor Brudney, *A Note on Materiality and Soft Information under the Federal Securities Laws*, 75 VA. L. REV. 723, 727 (1989) ("The particular items of information mandated to be disclosed in the schedules . . . under sections 12, 13 and 14 of the 1934 Act are presumably automatically deemed to be 'material.'"). Professor Brown, however, asserts that although not all information required to be disclosed under the line-item provisions would necessarily meet the *Northway* materiality standard, the line-items nevertheless create an expectation among shareholders that certain information will be provided. Thus, he believes, its omission would be material. Brown, *supra* note 11, at 101 n.34; *see also supra* note 13. This suggestion, however, seems to confuse materiality with the *duty* to disclose. Materiality deals only with what reasonable shareholders would consider *important* in deciding what to do with their shares. *Northway* makes this clear. *See supra* notes 30-42 and accompanying text. If certain line-items provide information that, as Professor Brown suggests, is immaterial under the *Northway* standard, then merely creating an expectation among shareholders that they will be provided with immaterial information ought not, in and of itself, to make that information material. On the other hand, if the importance of the information *in and of itself* to an informed investment decision creates an expectation of receiving information specifically required by a line-item provision, then the information is implicitly material. Therefore, although requiring disclosure of immaterial information *may* be helpful to shareholders, that duty to disclose does not—and cannot—mandate a finding of materiality.

Steinberg and Goldman argue that "materiality in the context of an affirmative duty to disclose largely should be measured by the concept of ripeness. Ripeness, in turn, incorporates both the significance of the information and its reliability." Steinberg & Goldman, *supra* note 53, at 952 n.141. This suggestion is also unworkable because an affirmative duty of disclosure, such as a line-item provision, leaves no discretion to assess "ripeness." What Steinberg and Goldman suggest is simply that line-item requirements should not require disclosure of information that is not material. That argument is better suited toward a petition directed at the SEC to change its rules. But their argument should not leave filing entities free to incorporate selectively or omit information simply because they have a subjective belief that the information is insufficiently significant to disclose to the market.

Finally, other commentators have recognized that line-items create affirmative employed its expertise in promulgating specific line-item requirements, concluding that certain information is so significant to the reasonable shareholder that its disclosure is required in order to insure an informed investment decision. Accordingly, that information should be viewed as *per se* material.[192]

Perhaps the clearest example of a line-item provision that requires the disclosure of information that is material *per se* is Item 7 of Schedule 14D-9 (the line-item at issue in the *Kern* case).[193] Item 7 requires disclosure of "certain negotiations and transactions by the subject company."[194] Item 7(a) requires disclosure of "any negotiation . . . being undertaken or . . . underway . . . in response to the tender offer" that would lead to one of four corporate events[195] similar to those

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disclosure duties while taking no position on whether or not the information required to be disclosed is material. *See, e.g.*, Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1170-71 (1987) ("Certain . . . rules and regulations promulgated by the SEC require specific disclosures in various situations . . . . This information must be disclosed regardless of whether it otherwise would be deemed material.") (footnotes omitted).

[192] This Comment does not argue that all line-item disclosure requirements in all SEC disclosure schedules require information that is *per se* material. This Comment does argue, however, that many of the line-item provisions promulgated under the Williams Act—especially those requiring disclosure of merger negotiations during the pendency of a tender offer—require the disclosure of information that is *per se* material. A securities practitioner would know that a particular line-item does or does not call for information that is *per se* material by scrutinizing the line-item provision, any instruction thereto and by reading the SEC's releases proposing and adopting that line-item. Of course, this analysis is limited to those instances in which the practitioner must determine whether a "material change in the information" has occurred after the initial Schedule is filed. *See, e.g., infra* notes 235-48 and accompanying text.

[193] *Cf.* Goelzer, *supra* note 11, at 981-82 ("The obligation to disclose preliminary merger negotiations pursuant to Item 7(a) is absolute in the sense that no separate duty to disclose is necessary . . . . Materiality is not an issue."). Mr. Goelzer's assertion that "materiality is not an issue" for purposes of Item 7 disclosure is indeed true. Both he and Professor Brown, *supra* note 11, however, failed to take the argument one step further to determine whether information required under Item 7 is *always* material. This issue represents a gap in the current literature, *see supra* note 191 and accompanying text, and its resolution is one of the fundamental purposes of this Comment.

[194] 17 C.F.R. § 240.14d-101 (Item 7) (1993).

[195] *Id.* Item 7(a) of Schedule 14D-9 provides in relevant part:

> [S]tate whether or not any negotiation is being undertaken or is underway by the subject company in response to the tender offer which relates to or would result in:

included in Item 3(b) of Schedule 14D-1[196] and Item 4(b) of Schedule 13D.[197]

In determining whether Item 7(a)(1) requires disclosure of negotiations that, under accepted tests of materiality, are always material, the SEC's release proposing Item 7 is instructive: "Efforts by the subject company such as those described in proposed Item 7 can have a determinative effect on the outcome of a tender offer and therefore are *material* to a security holder who is faced with making an investment decision . . . ."[198] Moreover, the SEC's release adopting Item 7 into its current form is conclusive: "The major developments referred to in Item 7 can be one of the *most material* items of information received by security holders."[199] Because of these statements, an extremely important question arises as to the correct definition of the word "material" as used in the SEC's releases proposing and adopting Item 7. In Rule 12b-2,[200] the SEC essentially codified *Northway*'s materiality standard:

> [t]he term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information

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> (1) An extraordinary transaction such as a merger or reorganization, involving the subject company or any subsidiary of the subject company;
> (2) A purchase, sale or transfer of a material amount of assets by the subject company or any subsidiary of the subject company;
> (3) A tender offer for or other acquisition of securities by or of the subject company; or
> (4) Any *material* change in the present capitalization or dividend policy of the subject company.
>
> *Instruction*:
>
> If no agreement in principle has yet been reached, the possible terms of any transaction or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuation of such negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient.

Id. (emphasis added).

196 *See infra* note 203.

197 *See supra* note 186.

198 Proposed Tender Offer Rules and Schedule, Exchange Act Release No. 15,548, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,935, at 81,236 n.106 (June 30, 1979) (emphasis added) [hereinafter *Proposed Rules*].

199 Tender Offers, Exchange Act Release No. 16,384, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,373, at 82,594 (Nov. 29, 1979) (emphasis added).

200 17 C.F.R. § 240.12b-2 (1993).

> required to those matters to which *there is a substantial likelihood that a reasonable investor would attach importance* in determining whether to buy or sell the securities registered.[201]

Because the SEC requires filing entities to apply *Northway* to the term "material" when it appears in the SEC's rules and disclosure schedules, it is logical to conclude that the SEC's definitive statement that Item 7 negotiations are material was informed by the *Northway* definition.[202] Item 7, therefore, provides the clearest example of a line-item provision that requires the disclosure of information that, under *Northway*, is *always* material;[203] according to the SEC's expert judgment,

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[201] *Id.* (emphasis added).

[202] This assertion, however, appears to highlight a potential conflict between the Supreme Court's holding in Basic, Inc. v. Levinson, 485 U.S. 224 (1988), and the SEC's classification of preliminary merger negotiations occurring in response to a tender offer as material. Although the *Basic* court explicitly adopted *Northway*'s materiality standard in the Rule 10b-5 context, *see supra* notes 66-67 and accompanying text, it also explicitly adopted *TGS*'s fact-specific probability/magnitude test for contingent events such as preliminary merger negotiations. *See supra* note 69 and accompanying text. At first glance, the *Basic* court's holding—that the assessment of whether or not negotiations are material requires a case-by-case assessment—appears to reject the SEC's conclusion that all preliminary merger negotiations conducted by a target company during a tender offer are material. Nevertheless, *Basic* in no way overrules or undermines the SEC's conclusion; *Basic* is a Rule 10b-5 case and its applicability should be limited to that context. Similarly, the SEC's conclusion that all preliminary merger negotiations occurring in response to a tender offer are *per se* material is naturally entitled to great weight and should not be disturbed "unless . . . arbitrary, capricious, or manifestly contrary to the statute." United States v. Chestman, 947 F.2d 551, 556 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992) (quoting Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-44 (1984)); *see also* Batteron v. Francis, 432 U.S. 416, 425-26 (1977); Securities Indus. Ass'n v. Board of Governors, 468 U.S. 137, 143 (1984). No argument could be advanced that the SEC exceeded its statutory mandate in classifying the negotiations referred to in Item 7 as material. Section 14(d)(4), 15 U.S.C. § 78n(d)(4) (1988), the enabling statute for Rule 14d-9 and Schedule 14D-9, provides "[a]ny solicitation or recommendation to the holders of . . . a security to accept or reject a tender . . . shall be made in accordance with such rules and regulations as the Commission may prescribe." This is an extremely broad grant of authority, giving the SEC both the power to define materiality as it sees fit and to classify whole groups of information as *per se* material. *Cf.* Chestman, 947 F.2d at 558 (SEC has rulemaking authority to define certain conduct as fraudulent and proscribe it as such even though conduct does not amount to common-law fraud).

[203] Item 3(b) of Schedule 14D-1, which requires disclosure of past contracts, transactions or negotiations with the target company concerning "[a] merger, consolidation or acquisition; a tender offer or other acquisition of securities; an election of directors; or a sale or other transfer of a material amount of assets," 17 C.F.R. § 240.14d-100 (Item 3(b)) (1993), provides another example of information

the negotiations referred to in Item 7 are material *per se*.[204]

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that the SEC has determined is *per se* material. In promulgating Item 3(b), the SEC recognized past dealings with the target company, in the context of a tender offer, to be material information:

> Item 3 recognized that a tender offer may not be an isolated event in the corporate histories of the bidder and the subject company. Disclosure concerning certain events which occurred, either directly or indirectly, between these parties in the recent past is *material* to an investment decision by a security holder in the context of a tender offer.

Filing and Disclosure Requirements Relating to Tender Offer, Exchange Act Release No. 13,787, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,256, at 88,376-77 (July 21, 1977) (emphasis added).

In the only enforcement proceeding to deal with an alleged violation of Item 3(b), *In re* RIT Acquisition Corp. and Robert I. Toussie Ltd. Partnership, Exchange Act Release No. 30,732, 1992 SEC LEXIS 1201 (May 22, 1992), the SEC found that the bidder had failed to disclose that it had commenced what amounted to negotiations with the target company, the Lionel Corporation, subsequent to the filing of its Schedule 14D-1, in violation of Rule 14d-6. *Id.* at *6-9. Rule 14d-6, like Rule 14d-9(b), requires prompt disclosure of any material change in the information set forth in the original schedule. 17 C.F.R. § 240.14d-6 (1993). Significantly the SEC made no finding as to materiality for purposes of a "material change in the information." The SEC's conclusion that the onset of negotiations required an amendment without any reference to *Basic* or *Northway* implicitly recognized that the omitted information was material *per se*.

204 "Once an offer has been made, shareholders and the markets ought to know whether the subject company's management is negotiating with another party. SEC schedule 14D-9, Item 7 recognizes this point . . . . " Steinberg & Goldman, *supra* note 53, at 926 n.18; *see also* Brown, *supra* note 11, at 106 ("The commencement of negotiations constitutes a material development . . . ."); *see also* Gailey, *supra* note 53, at 1211 ("In Item 7, the target must disclose certain material negotiations and actions that are undertaken in response to [a tender] offer."); H. Frasier Ives, Note, *Disclosing the White Knight—When Does the Duty Arise?*, 42 WASH. & LEE L. REV. 1045, 1066-67 (1985) ("A target corporation clearly must disclose its white knight merger activities when subject to the formal disclosure requirements of the federal securities laws."). In arguing that shareholders ought to know that the target company is engaging in preliminary negotiations referred to in Item 7, these commentators appear to have assumed that Item 7 information is *per se* material. Although, they have not attempted to justify their position, logically they would not have argued so forcefully in favor of disclosure if such information were not material.

Significantly, before Schedule 14D-9 was promulgated in 1979, its predecessor, Schedule 14D, did not require disclosure of preliminary merger negotiations. Thus, the target management's only disclosure obligation was under section 14(e), 15 U.S.C. § 78n(3) (1988). One commentator called for more extensive disclosure by target management, arguing that the target should be required to disclose its position on the offer, and its material activities with respect thereto. Peter C. Hein, Note, *A Proposal for Affirmative Disclosure by Target Management During Tender Offers*, 75 COLUM. L. REV. 190, 200-207 (1975).

This Comment argues that Item 7 information is material because the SEC concluded that, under *Northway*, such information is *always* material, no matter how tentative or inchoate the negotiations may be. But, even if one refuses to ac-

Despite the logic of this argument, few other courts have held that information specifically required to be disclosed under the SEC's line-item provisions is *per se* material. In *Otis Elevator Co. v. United Technologies Corp.*,[205] for instance, the district court held that "[i]t is agreed by both sides and clear to the court that a merger plan, if present, is *per se* material under [Schedule 13D, Item 4 of] the Williams Act."[206] But on-

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cept at face value that Item 7(a)(1) negotiations are material *per se* simply because the SEC says that they are, it simply cannot be disputed that during a tender offer there exists a substantial likelihood that reasonable shareholders would consider important a target company's negotiations with either the hostile bidder or a white knight concerning a merger or a recapitalization in deciding what to do with their shares. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 448 (1976). Indeed, evidence from finance journals detailing the effects of both successful and unsuccessful tender offers on target companies' share prices persuasively reveals that the target's share price earns extremely abnormal, positive returns merely when an offer is announced. Without a doubt, a significant increase (or decrease) in a target company's share price before and immediately following the announcement of an offer is strong evidence of the materiality of negotiations that could lead to a completed transaction. *See* Koenig, *supra* note 29, at 1028, 1052 nn. 38 & 136.

[205] 405 F. Supp. 960 (S.D.N.Y. 1975).

[206] *Id.* at 969. Significantly, the court accepted the *per se* argument for merger plans under the previous version of Item 4, which did not provide a specific list of transactions for which existence of plans must be disclosed, and which required disclosure of any plans or proposals only if the purpose of the purchase was to acquire control of the issuer. For the current version of Schedule 13D, Item 4, see *supra* notes 186 & 188.

When Item 4 was originally promulgated, it essentially tracked the language of section 13(d)(1)(C), 15 U.S.C. § 78m(d)(1)(C) (1988). In 1978, Item 4 was substantially modified into its current form. In adopting the modification, the SEC stated:

> Unlike old Item 4, new Item 4 requires disclosure of plans in the nature of those described in the Item *regardless* of whether one of the purposes of the purchase is to acquire control of the issuer . . . . In this regard, plans or proposals which result in or relate to extraordinary corporate transactions have been made a separate item of disclosure, as in Schedule 14D-1. This is to obviate the possible limitation on disclosure . . . as a result of the placement in the proposal of the term "extraordinary corporate transactions" prior to the list of enumerated disclosures. The Item has also been expanded to require disclosure about types of plans of the purchaser not specifically required by old Item 4 . . . .

Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 14,692, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,571, at 80,314 (Apr. 21, 1978) (emphasis added). While the SEC did not expressly state that the information required in Item 4 was material, the fact that Congress, in section 13(d)(1)(C), 15 U.S.C. § 78m(d)(1)(C) (1988), originally required disclosure of the purchaser's plans and proposals is indicative of the importance of that information to shareholders. Moreover, that the SEC expanded the disclosure provisions ly a few other courts have been willing to go so far.[207] On the contrary, most courts that find omissions of information specifically required to be disclosed proceed to evaluate the materiality of such information on a case-by-case basis.[208] In many

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to require disclosure of plans or proposals relating to one of several significant corporate transactions *irrespective* of the purpose of the transaction is further evidence that the Item requires disclosure of material information. Thus, the court's decision in *Otis Elevator* was correct.

[207] *See, e.g.*, Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1238 (1st Cir. 1984) ("[I]t might be argued that the Commission's guidelines create a *per se* rule that the nondisclosure of compensating balances in excess of 15% of liquid assets constitutes a material omission."); Maldonado v. Flynn, 597 F.2d 789, 796-97 (2d Cir. 1979) (allegations of self-dealing not reported under applicable line-item provisions of Schedule 14A are material *per se*); Kaufman v. Cooper Cos., 719 F. Supp. 174, 179-80 (S.D.N.Y. 1989) (omission from line-item provision requiring disclosure of updated financial information constitutes a *per se* violation of section 14(a)); SEC v. World-Wide Coin Inv. Ltd., 567 F. Supp. 724, 756 (N.D. Ga. 1983) (terms of agreement between former controlling shareholder and person to whom majority ownership was transferred "[w]ere clearly material . . . since such disclosure was specifically required by items 6 and 7 of Schedule 13D and by items 7 and 9 of Schedule 14D-1"); Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 632 (D. Md. 1982) (holding that financial condition of tender offeror is assumed material; focus is on adequacy of disclosure); Lewis v. Dansker, 357 F. Supp. 636, 641 (S.D.N.Y. 1973) (omission of information required by Item 11(a) of Schedule 14A is *per se* violation of Rule 14a-3 and section 14(a)); *see also In re* Craftmatic Sec. Litig., 890 F.2d 628, 641 n.17 (3d Cir. 1989) ("Disclosures mandated by law are presumably material.") (citation omitted). *Cf.* USG Corp. v. Wagner & Brown, 689 F. Supp. 1483, 1489 (N.D. Ill. 1988) ("Section 13(d) requires a potential bidder only to disclose material information."). The court in USG was clearly mistaken because it is not unreasonable to assume that Congress and the SEC may require filing entities to disclose information that is not material under *Northway* (or *Basic*).

[208] For instance, in Camelot Indus. Corp. v. Vista Resources, Inc., 535 F. Supp. 1174 (S.D.N.Y. 1982), the District Court for the Southern District of New York looked to *Northway* before holding that Vista's failure to disclose that it had reached a voting agreement with one of Camelot's largest shareholders—information specifically required to be disclosed under Item 6 of Schedule 13D—was a material omission. The court concluded that "[t]here is a substantial likelihood that a reasonable shareholder in deciding whether or not to tender would consider significant the knowledge that Heine, the largest single shareholder, and Vista . . . had agreed to vote against the proposals." *Id.* at 1180. It would seem self-evident that the SEC specifically required disclosure of such contracts because they are *without question* material to shareholders. *See, e.g.*, Finnegan v. Campeau Corp., 915 F.2d 824, 830 (2d Cir. 1990) (SEC justified in requiring disclosure under Schedule 14D-1, Item 7 (same as Schedule 13D, Item 6) agreement among two rival bidders with respect to target), *cert. denied*, 111 S. Ct. 1624 (1991).

Courts have applied similar reasoning to disputes involving Schedule 13D, Item 3, 17 C.F.R. § 240.13d-101 (1993) (and Schedule 14D-1, Item 4) which requires filing parties to disclose the source of funds used to finance stock purchascases, this separate materiality analysis of information that appears to be *per se* material effectively second-guesses the SEC's rule-making authority.

One way that some courts in civil suits have avoided this sort of second-guessing is to find that the SEC's line-item provisions establish a rebuttable presumption of materiality. Under this view, courts, as a matter of administrative law, would be obligated to presume that information that the SEC requires be disclosed is in fact material unless the defendant can demonstrate that the particular information at issue is immaterial.[209] While several courts have implicitly recognized such a rule, the Sixth Circuit, in *Howing Co. v. Nationwide*

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es. *Compare* A. P. Green Indus. v. East Rock Partners, 726 F. Supp. 757, 761 (E.D. Mo. 1989) (focusing on materiality of alleged omission from Schedule 13D, Item 4, instead of on compliance or non-compliance) *with* IU Int'l v. NX Acquisition Corp., 840 F.2d 220, 223 ("[t]he existence of a financing contingency is a material term of an offer and the fact of contingency must be stated, how the financing will ultimately occur is not essential to an offer."), *aff'd on reconsideration*, 840 F.2d 229 (4th Cir. 1988) (en banc) (per curiam), Koppers Co. v. American Express Co., 689 F. Supp. 1371, 1393 (W.D. Pa. 1988) ("SEC regulations recognize that the nature and terms of financing arrangements are highly material to the decisions of investors.") *and* Management Assistance, Inc. v. Edelman, 584 F. Supp. 1021, 1030-31 (S.D.N.Y. 1984) (holding that Schedule 13D, Item 4, does not require corporate borrowings used to conduct ordinary business be disclosed; loan was not used to finance purchases of issuer's stock).

Finally, courts have engaged in a separate materiality analysis in cases involving violations of certain line-item provisions under the proxy rules that appear to call for information that is *per se* material. *See* Gladwin v. Medfield Corp., 540 F.2d 1266, 1270 (5th Cir. 1976) ("[Item 4(b) of Schedule 14A] requires a list of the purchases and sales of Medfield stock made within the past two years . . . . The purchases were not disclosed in Medfield's proxy material . . . . While the district court made no finding on materiality[,] we think that there was a substantial likelihood that knowledge of these purchases 'would have assumed actual significance in the deliberations of the reasonable shareholder.'") (citation omitted); Lewis v. Dansker, 357 F. Supp. 636, 641 (S.D.N.Y. 1973) ("The question, therefore, narrows to whether the admitted omission to state the market price [as required by Schedule 14A, Item 11(a)] was material as to the approval of stock sale.").

[209] Where an SEC release adopting a line-item provision specifically states that the information is material (as in the case with Item 7), that determination should be given preclusive effect in subsequent civil litigation. *See generally* United States v. National Ass'n of Sec. Dealers, 422 U.S. 694, 718-19 (1975) (as agency charged with oversight of the securities markets, SEC's judgment on matters within its expertise should be accorded great deference). Thus, for instance, a 10b-5 defendant who is charged with failing to disclose negotiations specifically required by Schedule 14D-9, Item 7, would have to demonstrate that the SEC's determination that such information is always material is arbitrary and capricious. *See generally id.* Otherwise, the court should award the plaintiff summary judgment on the issue of materiality.

Corp.,[210] did so explicitly.

In *Howing*, the Sixth Circuit reversed the district court's grant of summary judgment[211] to the defendant on the issue of materiality, holding that the factors upon which the company based its belief as to the fairness of the going private transaction,[212] and which were specifically required to be disclosed

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[210] 927 F.2d 263 (6th Cir.), *vacated on other grounds*, 112 S. Ct. 39 (1991), *on remand*, 972 F.2d 700 (6th Cir. 1992), *cert. denied*, 113 S. Ct. 1645 (1993).

[211] The *Howing* case is a veritable procedural monster. In 1985, the district court dismissed Howing's complaint finding no Schedule 13E-3 violations. Howing Co. v. Nationwide Corp., 625 F. Supp. 146 (S.D. Ohio 1985). The Sixth Circuit reversed, finding that Nationwide had violated the disclosure provisions of Schedule 13E-3 and remanded to the district court to determine whether the omissions were material. Howing Co. v. Nationwide Corp., 826 F.2d 1470 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988). On remand, the district court granted summary judgment to the defendant, Nationwide, concluding that under the *Northway* standard the omissions were immaterial as a matter of law. Howing Co. v. Nationwide Corp., [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,858 (S.D. Ohio Nov. 16, 1989). The Sixth Circuit again reversed, holding that the omissions were presumptively material. Howing Co. v. Nationwide Corp., 927 F.2d 263 (6th Cir. 1991). The Supreme Court, in light of its decision in Virginia Bankshares v. Sandberg, 111 S. Ct. 2749 (1991), vacated on grounds pertaining to causation and to Howing's state law claims. Nationwide Corp. v. Howing, 112 S. Ct. 39 (1991). On remand, the Sixth Circuit held that the Supreme Court's decision in *Virginia Bankshares* did not affect its Schedule 13E-3 materiality holding and, once again, remanded the case to the district court. Howing Co. v. Nationwide Corp., 972 F.2d 700 (6th Cir. 1992). As of this writing, the case was pending in the district court.

[212] Item 8 of Schedule 13E-3 (Fairness of the Transaction) provides:

> (a) State whether the issuer or affiliate filing this schedule reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders . . . .
>
> b) Discuss in reasonable detail the *material* factors upon which the belief stated in Item 8(a) is based and, to the extent practicable, the weight assigned to each such factor. Such discussion should include an analysis of the extent, if any, to which such belief is based on the factors set forth in instruction (1) to paragraph (b) of this Item . . . .
>
> *Instructions.* (1) the factors which are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, which should be given to them in a particular context will vary. Normally such factors will include, among others, . . . whether the consideration offered to unaffiliated security holders constitutes fair value in relation to
>
> (i) Current market prices
> (ii) Historical market prices
> (iii) Net book value
> (iv) Going concern value
> (v) Liquidation value . . . .
>
> . . . .
>
> (2) Conclusory statements, such as "The Rule 13e-3 transaction is fair to unaffiliated security holders in relation to net book value, going

under Item 8(b) of Schedule 13E-3,[213] were presumptively material:

> Although we agree with the District Court that the general [*Northway*] standard of materiality is applicable to transactions governed by Rule 13e-3, the clear and specific language of the instructions to Item 8 creates in effect a presumption that discussion of book, going concern and liquidation value in the proxy statement would be material to a reasonable shareholder. The presumed fact—that the investor would likely find disclosure of such information significant—follows from Item 8's insistence that the information be stated.
>
> . . . .
>
> . . . The likelihood that the factors the SEC enumerated in Item 8(b) will be material is sufficiently strong that omission of such factors without explanation of the reason for the omission will result in a rebuttable presumption of their materiality.[214]

Although the *Howing* court is the only one to create affirmatively a rebuttable presumption for materiality for information

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> concern value and future prospects of the issuer" will not be considered sufficient disclosure in response to Item 8(b).

17 C.F.R. § 240.13e-100 (Item 8) (1993) (first emphasis added).

[213] 17 C.F.R. § 240.13e-100 (1993).

[214] *Howing*, 927 F.2d at 265-66. The district court's opinion, holding that the factors listed in Item 8(b) were immaterial as a matter of law because the different values were all *less* than the price being offered to shareholders and thus, would be unimportant to their decision, was properly rejected by the Sixth Circuit. In *In re* Meyers Parking System, Inc., Exchange Act Release No. 26,069, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,333 (Sept. 12, 1988), the SEC, in a consent decree, emphasized the importance of full Item 8 disclosure in a 13e-3 transaction. In *Meyers* the company had simply provided a laundry list of factors considered without discussing their weight or importance:

> The book value of the stock . . . is only $3.77 per share, as compared with the an offering price in the merger transaction of $29.50 per share. An adequate response to Item 8(b) with respect to book value would include discussion of the reasons and extent to which book value is or is not an accurate reflection of the Company's value and therefore was accepted or rejected as a criterion for judging the fairness of the transaction.

Id. at 89,498; *accord* Plaza Sec. Co. v. Fruehauf Corp., 643 F. Supp. 1535 (E.D. Mich. 1986). *But see* Radol v. Thomas, 534 F. Supp. 1302 (S.D. Ohio 1982) (concluding that 13e-3 proxy statement must simply provide factors fairness opinion relied upon; shareholders will determine for themselves what weight to accord those factors), *aff'd*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 447 U.S. 903 (1986); *but cf.*, Gans v. Filmways, Inc., 453 F. Supp. 1116 (E.D. Pa. 1978) (pre-Schedule 13D-3 case holding that book value would be immaterial as a matter of law to reasonable shareholder's decision in a freeze-out merger), *aff'd*, 595 F.2d 1212 (3rd Cir. 1979).

required by a line-item provision,[215] the Third Circuit noted in *In re Craftmatic Securities Litigation v. Kraftsow*[216] that "[d]isclosures mandated by law are presumably material."[217] Simply put, the line-item provisions provide a framework so that the *minimum* amount of material information reaches shareholders.[218]

Finally, some courts have held that line-item provisions simply constitute evidence that the information required to be disclosed under them is material. Recently, in *United States v. Bilzerian*,[219] the Second Circuit considered a criminal prosecution for insider trading premised, in part, upon violations of Schedule 13D's line-item requirements. It rejected the proposi-

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[215] It must be noted that unlike Item 7 of Schedule 14D-9 (the provision at issue in *Kern*), Item 8(b) of Schedule 13E-3 explicitly lists various *material* factors on which the fairness valuation might be based. Indeed, that is the proper justification for imposing a rebuttable presumption of materiality. The *Howing* court's further rationale—that the presumption of materiality flows from Item 8's insistence that the information be disclosed—is wide of the mark. Mandating that certain information be disclosed cannot, in and of itself, render that information material. *See supra* notes 13 & 191.

[216] 890 F.2d 628 (3d Cir. 1989).

[217] *Id.* at 641 n.17 (citation omitted). For another example of a court presuming that information specifically required to be disclosed under the SEC's line-item provisions is material, see, e.g., Sea Containers, Ltd. v. Stena AB, 741 F. Supp. 236 (D.D.C. 1989) (criminal convictions and civil or administrative adjudications pertaining to securities laws violations occurring within five years of bid (required under Items 2(e) and (f) of Schedule 14D-1) are presumptively material). *But see* Raybestos-Manhattan, Inc. v. Hi-Shear Indus., Inc., 503 F. Supp. 1122, 1127-28 (E.D.N.Y. 1980) (omission from Item 2(f) of Schedule 14D-1 of a five-year old judgment that enjoined a bidder from future violations of securities laws was immaterial as a matter of law). *Raybestos-Manhattan* provides a classic example of a court second-guessing the SEC's rule-making authority. By purporting to apply *Northway*'s materiality standard, the court's personal view that the information simply could not have been important to shareholders eviscerated the clear and specific requirements of Schedule 14D-1. This sort of paternalistic, subjective assessment was roundly criticized by the Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224, 234 (1988) ("Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress.").

[218] *See* Maldonado v. Flynn, 597 F.2d 789, 796 n.9 (2d Cir. 1979) (Schedule 14A sets out minimum disclosure standards. Compliance with this Schedule does not necessarily guarantee that a proxy statement satisfies Rule 14a-9.") (citations omitted); *see also* United States v. Matthews, 787 F.2d 38, 47-49 (2d Cir. 1986) (concluding that failure to admit guilt of allegations being investigated by a grand jury in proxy statement is not a material omission and insufficient to support *criminal liability* because SEC rules do not require such information to be disclosed); Bertoglio v. Texas Int'l. Co., 488 F. Supp. 630, 647 (D. Del. 1980) (Schedule 14A sets only minimum disclosure standards).

[219] 926 F.2d 1285 (2d Cir.), *cert. denied*, 112 S. Ct. 63 (1991).

tion that certain information was material *per se* simply because section 13(d) calls for its disclosure:

> We decline to hold that the information required to be disclosed in [Schedule] 13D is material *per se* for purposes of § 10(b) simply because such disclosure is required under the securities laws. But the fact that [such] information is required to be revealed under section 13(d) is evidence of its materiality.[220]

Even though these approaches may better respect the SEC's expertise than a case-by-case approach, they nevertheless would operate in an enforcement proceeding to second-guess the SEC's rule-making authority. In an SEC enforcement proceeding such as *Kern*, the omission from a disclosure statement of information specifically required by line-item provisions such as Item 7 of Schedule 14D-9—information which the

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[220] *Id.* at 1298 (citation omitted). While the court's reluctance to accept a *"per se* materiality" argument in a criminal case is quite understandable, its reliance on SEC v. Levy, 706 F. Supp. 61 (D.D.C. 1989), however, highlights the circuitous nature of the materiality analysis in many courts and the need for guidance on the issue of materiality and line-item disclosure provisions. In *Levy* the SEC sued for an injunction claiming that the defendant had violated the insider trading provisions of Rule 10b-5 by failing to disclose that its stock purchases were funded by borrowed money, thereby violating the reporting requirements of Schedule 13D, Item 3, 17 C.F.R. § 240.13d-101 (Item 3) (1993) (Source and Amount of Funds). The district court, in granting the SEC's motion for summary judgment, held that the defendant's failure to disclose that his stock purchases were funded by borrowed money—information specifically required to be disclosed under section 13(d) and in Schedule 13D—was a material omission under *Northway*. *Levy*, 706 F. Supp. at 72. The court reasoned "the fact that defendant purchased his IDI stock largely from borrowed funds rather than from personal funds would have assumed actual significance in the deliberations of a reasonable shareholder." *Id.* at 72. This reasoning is pervasively circular. In requiring that an acquiror of more than five percent of an issuer's shares disclose the source and amount of funds used to purchase the shares and any loan agreements with respect thereto, Congress and the SEC implicitly had already determined under the *Northway* test that such information is material to the issuer's shareholders. *See* Koppers Co., Inc. v. American Express Co., 689 F. Supp. 1371, 1393 (W.D. Pa. 1988) ("SEC regulations recognize that the nature and terms of financing arrangements are highly material to the decisions of investors."); *see also* Beneficial Ownership, *supra* note 207, at 80,314 ("New Item 3, concerning disclosure of the source of funds used or to be used in making the acquisitions, is similar to old item 3. The reference of consideration used or 'to be used' is added to assure that financing arrangements are disclosed."). That the SEC broadened the requirements of Item 3 disclosure is evidence of its importance to shareholders. Therefore, the *Levy* court's holding that under *Northway* the information would have assumed actual significance in shareholders' deliberations is redundant: in essence, that is the very reason that Congress and the SEC required disclosure of financial information in the first place.

SEC itself considers material—must necessarily constitute a material omission. Since the SEC is best suited to interpret the rules it promulgates, such a finding would be justified and should be encouraged.

B. *Judge Blair's Analysis under* Basic *of the Negotiations Required to be Disclosed Under Item 7(a)(1) was Improper*

The ALJ's materiality analysis, under *Basic*, of the negotiations that Mr. Kern declined to disclose was clearly improper for three separate and distinct reasons. Before setting forth those arguments, though, the threshold issue of whether or not Allied and DeBartolo were engaged in "negotiations" within the meaning of Schedule 14D-9, Item 7(a)(1), must be addressed.

1. The *Revlon* Decision: What Constitutes "Negotiations"

Item 7's requirement that the *existence* of negotiations be disclosed gives rise to an important question: what constitutes a "negotiation" within the meaning of Item 7?[221] In *In re Revlon, Inc*,[222] the SEC considered this questions and whether the commencement of negotiations represents a material change in the information if the target's original Item 7 disclo-

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[221] Indeed, one might argue that the answer to this question effectively collapses the "materiality *per se*" issue on which this Comment extensively focuses, for if no "negotiation" is under way within the meaning of Item 7(a), then any information concerning mere contacts or preliminary "discussions" between the target and potentially interested third parties is *per se* immaterial. Thus, the argument would conclude, the focus is not on materiality but on compliance; if "negotiations" are underway, then they must be disclosed regardless of materiality. The "materiality *per se*" argument does not collapse, however. On the contrary, it is reinforced: by distinguishing between negotiations and preliminary contacts, the SEC has recognized that past a certain level, target company activity in response to a tender offer is significant enough to require its disclosure. Thus, that the focus under Item 7 shifts to what constitutes a negotiation simply confirms that negotiations in general are material *per se*. Asking "what constitutes 'negotiations'" is separate and distinct from asking, "are the negotiations material," because the SEC has recognized that, in the context of a tender offer, all "negotiations" are material, whether they have recently commenced or are nearing an agreement in principle.

[222] Exchange Act Release No. 23,320, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986). Revlon entered into a consent decree with the SEC, neither admitting nor denying wrongdoing, but agreeing to comply with Rule 14d-9(b). *Id.* at 88,147.

sure did not indicate that negotiations were underway.[223] Revlon was the subject of a hostile tender offer by Pantry Pride. Revlon opposed the offer, and in its September 24, 1985 Schedule 14D-9, stated in Item 7 that it "*may* undertake negotiations which relate to or could result in" one of the corporate events listed in Item 7(a).[224] Eight days later Revlon publicly announced that it was *considering* a number of alternatives to the Pantry Pride offer, including a leveraged buy-out. The next day, Revlon amended its Schedule 14D-9, Item 7, disclosing a merger agreement with leveraged buy-out specialists Forstmann Little & Co. and disclosing the sale of Revlon's domestic beauty group to Adler & Shaykin.[225] After increasing its offer and after a crucial court decision, Pantry Pride eventually gained control of Revlon.

The SEC brought an enforcement proceeding under section 15(c)(4) of the 1934 Act,[226] alleging that Revlon had failed to amend promptly its Schedule 14D-9 to reveal that negotiations had commenced that could lead to a merger. The commencement of negotiations, thus, was a material change in the information, triggering the duty to amend promptly.[227] The SEC reiterated that the information in Item 7 can be one of the most material items of information received by securityholders, and found that Revlon's Item 7 disclosure that it "may" undertake negotiations implied that no negotiations were underway.[228] The SEC further noted: "The term "negotiations" should not be interpreted in a technical and restrictive manner. As used in Item 7(a), the 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."[229] The SEC concluded that the discussions[230] between the parties had rip-

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[223] *Id.* at 88,142.

[224] *Id.* at 88,143 (emphasis added). Revlon had not included in its Item 7 a response that "currently . . . no negotiations are underway," a phrase that it had included in a Schedule 14D-9 filed in connection with a prior tender offer, which Pantry Pride ultimately withdrew. *Id.*

[225] *Id.* at 88,145.

[226] *See supra* note 17.

[227] *Revlon*, at 88,146.

[228] *Id.*

[229] *Id.* (citation omitted).

[230] For further proof that the SEC considers the difference between "negotia-

ened into negotiations on September 26, 1985, two days after Revlon had filed its initial Schedule 14D-9, but six days before it had disclosed that it was considering a leveraged buyout.[231]

Most significantly, the SEC's conclusions make no finding with respect to materiality for purposes of Rule 14d-9(b)'s language requiring disclosure of any material change in the information. Apparently, the SEC assumed the materiality of the information, concluding that the existence of negotiations was a material change because Revlon had previously indicated that no negotiations were underway. Interestingly, while *Revlon* is one of two administrative proceedings—aside from *Kern*—to consider Item 7,[232] it appeared to conflict with a de-

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tions" and "discussions" significant, see Weinberger v. UOP, 457 A.2d 701 (Del. 1983). In describing the facts of the case, the *Weinberger* court noted that "[i]n the original draft of the proxy statement the word 'negotiations' had been used rather than 'discussions.' However, when the Securities and Exchange Commission sought details of the 'negotiations' as part of its review of [those] materials, the term [negotiations] was deleted and the word 'discussions' was substituted." *Id.* at 707. No indication is given as to why the SEC insisted on this change.

[231] By that time, the 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 . . . to the Revlon management group. Shaykin presented an offer to Revlon, Lazard and Forstmann Little on September 29 which, although rejected, became the basis on which the parties negotiated . . . .

Revlon, at 88,147.

[232] Only one other SEC enforcement proceeding, *In re* The Lionel Corporation, Exchange Act Release No. 30,121, [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,908 (Dec. 30, 1991), focused on the disclosure duty under Item 7 of Schedule 14D-9. *Lionel* dealt with the target company's failure to disclose that it had engaged in negotiations with the hostile bidder. *Id.* at 82,365-66. Citing *Revlon*, the SEC concluded that certain telephone conversations between the bidder and the target pertaining to the cessation of litigation between the two parties and finding a third party to buy the bidder's shares in the target, constituted "negotiations" within the meaning of Item 7(a). *Id.* The SEC also concluded that Lionel violated Item 7(b) by failing to disclose a board resolution authorizing management to negotiate with the bidder to end the litigation, which would result in the acquisition of securities required to be disclosed under Item 7(a)(3). *Id.* Once again, in concluding that the commencement of these negotiations was a "material change in the information," the SEC made no reference to materiality or to *Basic*.

In *In re* Heights Fin. Corp., Exchange Act Release No. 20,354, 29 SEC Docket (CCH) 106 (1983), the SEC noted that negotiations by Heights with a third party for a right of first refusal to the exercise of warrants for its stock "are required to be disclosed in filings on Schedule 14D-9 . . . if entered into in response to a tender offer." *Id.* at 107 n.1. The SEC did not actually allege, though, that Heights had violated Rule 14d-9.

cision by the Sixth Circuit, which is the only appellate court to analyze Item 7's disclosure requirements.[233]

Clearly, then, Mr. Kern's assertion that Allied's original

Other courts have dealt with Item 7, but have not resolved the central issue crucial to the fundamental dispute in *Kern*: whether the negotiations required to be disclosed under Item 7(a)(1) are material *per se*. In Southdown, Inc. v. Moore McCormack Resources, Inc., 686 F. Supp. 595 (S.D. Tex. 1985), a district court held that a target company's failure to detail fully a proposed recapitalization plan "may not have amounted to a *material* misrepresentation designed to manipulate the market" and thus, was insufficient to give rise to injunctive relief. *Id.* at 604-05 (emphasis added).

[233] In Starkman v. Marathon Oil, 772 F.2d 231 (6th Cir. 1983), *cert. denied*, 475 U.S. 1015 (1986), former shareholders of Marathon sued the company under Rule 10b-5, claiming that Marathon's Schedule 14D-9, Item 7 disclosures were materially false and misleading. In a Schedule 14D-9 filed in response to a hostile bid by Mobil Oil, Marathon disclosed in Item 7 that its Board had considered "exploring and investigating" certain responses to the tender offer, including "a business combination between [Marathon] and another company." *Id.* at 236. However, at the time of the Item 7 disclosure, Marathon had in fact contacted a number of companies concerning a possible merger and had commenced negotiations with U.S. Steel. One week later, U.S. Steel announced that it had agreed to acquire Marathon. *Id.* at 235-36.

The Sixth Circuit, relying on an erroneous perception of the SEC's policy with respect to the disclosure of on-going negotiations during a tender offer, concluded that Marathon was not liable because Marathon's Item 7 disclosure of the *possibility* of a merger was sufficient for Rule 10b-5 purposes:

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

Id. at 243 (citation omitted). The *Starkman* court's holding was erroneous in two respects. First, the Sixth Circuit completely misstated the SEC's policy concerning disclosure of negotiations inasmuch as it declined to look to the releases proposing and adopting Item 7. Second, the court improperly associated Rule 10b-5's materiality-based disclosure with the Item 7's affirmative duty of disclosure. *See* Brown, *supra* note 11, at 110 ("[I]n interpreting the provision, the court mischaracterized the Commission's position. The Commission had never indicated that a list of alternatives would suffice when actual negotiations were taking place."); Goelzer, *supra* note 11, at 983 ("The difficulty with the *Starkman* opinion is that it confuses the limitation in item 7(a) on the disclosure of preliminary merger negotiations with the obligation under Rule 10b-5 to refrain from making materially incomplete or misleading statements."); Goldstein et al., *supra* note 11, at 144-45 ("The Sixth Circuit's decision . . . highlights the current confusion with respect to disclosure of preliminary merger negotiations . . . . *[S]tarkman* did not consider whether Marathon violated Rule 14d-9. *Starkman* only held that Marathon had no affirmative duty under Rule 10b-5 where its public statements were not materially misleading.").

Item 7 disclosure was sufficient to inform shareholders of the dealings between Allied and DeBartolo—an argument that Judge Blair properly rejected—is untenable. "Exploration and investigation," the words used to describe Allied's defensive efforts,[234] are tantamount to discussions that, as *Revlon* made clear, need not be disclosed under Item 7. However, when Allied and DeBartolo began to discuss the price and structure of the putative deal, the discussions ripened into "negotiations," regardless of the status of the financing commitments. Accordingly, so long as the onset of those "negotiations" constituted a material change in the information for purposes of Rule 14d-9(b), Mr. Kern was under a duty to amend Allied's Schedule 14D-9.

2. The Negotiations in *Kern* Constituted a *Per Se* Material Change in the Information Requiring Amendment

The fundamental question raised by *Kern* is how to view one's duty to *amend* Item 7 in light of Rule 14d-9(b)'s language mandating that "*material change[s]* . . . in the information"[235] be disclosed. Does the word "material" in this context require an assessment of the materiality of the negotiations? If so, does Rule 12b-2, *Northway* or *Basic*'s definition of materiality control? These questions can be answered in three different ways, none of which supports Mr. Kern's argument or Judge Blair's legal analyses.

Both Mr. Kern and Judge Blair erroneously assumed, that Rule 14d-9(b) requires an assessment of the materiality of the information being considered for disclosure in an amendment.[236] As demonstrated above, however,[237] because Item 7(a)(1) requires the disclosure of merger negotiations that are *per se* material, the occurrence of negotiations required to be disclosed under Item 7(a)(1) subsequent to the filing of the

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[234] *See supra* note 134.

[235] 17 C.F.R. § 240.14d-9(b) (1993) (emphasis added).

[236] By arguing that *Basic* controlled, both Mr. Kern and Judge Blair assumed that the word "material" in Rule 14d-9(b) permitted Mr. Kern to assess the significance of the negotiations before deciding whether to amend Allied's Schedule 14D-9.

[237] *See supra* notes 193-204 and accompanying text.

original Schedule 14D-9 constitutes a *per se* material change in the information. The sudden occurrence of a *material* event is, by definition, a *material* change.[238]

Moreover, even accepting that Rule 14d-9(b)'s "material change" language permitted Judge Blair and Mr. Kern to assess the materiality of the negotiations, they erroneously concluded that *Basic* should provide the controlling guidelines.[239] In doing so, they failed to observe that Rule 12b-2[240] commands filing parties to apply the equivalent of *Northway*'s materiality standard to the word "material" when it is used to qualify the furnishing of information.[241] Thus, both Mr. Kern and Judge Blair should have applied Rule 12b-2 to the negotiations at issue. Indeed, by applying *Basic*, Judge Blair made a fundamental legal error. *Basic* was a Rule 10b-5 "duty not to mislead" case in which liability could be established *only* if the negotiations at issue were material. It is well settled, however, that the duty to disclose information (or to refrain from making misleading statements) under Rule 10b-5 is linked part and parcel to the materiality question. But by applying *Basic* in the Rule 14d-9 context, where the duty of disclosure is an affirmative one, Judge Blair's ruling implies that *Basic*'s adoption of the case-by-case, probability/magnitude test for Rule 10b-5 cases somehow negated the SEC's categorical pronouncements that Item 7 calls for information that is material *per se*. This assumption is manifestly incorrect.[242] As argued above,

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[238] In other words, because *Northway* contemplates the disclosure of information when there is a substantial likelihood that a reasonable shareholder would consider it important, the occurrence of an event that the SEC itself has deemed to be material is, by logic, a *per se* material change in the information. Consequently, Judge Blair's initial analysis should have focused on whether Item 7 calls for the disclosure of information that is material *per se*.

[239] *See supra* notes 156 & 166 and accompanying text.

[240] 17 C.F.R. § 240.12b-2 (1993). For the full text of the SEC's materiality definition, see *supra* note 201.

[241] *Id.*

[242] A review of the briefs and memoranda submitted by the Division indicates that it, too, had not considered whether Rule 12b-2 should control Judge Blair's analysis. Indeed, while the Division made passing reference to Rule 12b-2 as the "applicable test" for materiality, Memorandum of Law of the Division of Enforcement, *supra* note 21, at 9, the primary support for its argument that the events at issue were material was *Basic*. *Id.* at 30. In so doing, the Division actually limited the controlling force of its rules and regulations; it permitted Judge Blair to rule that *Basic*'s case-by-case analysis, and not Rule 12b-2 (*Northway*), applied to Rule 14d-9(b)'s "material change" language.

the SEC not only has the authority to define the word "material" either more or less expansively than the Supreme Court's definition,[243] it also may categorize a whole class of information (preliminary merger negotiations conducted in response to a tender offer) as material and require its disclosure.[244] Because the SEC had already concluded that Item 7 negotiations are *per se* material, they constituted a "material change in the information" as a matter of law for Rule 14d-9(b) purposes.

Finally, the most simplistic way of analyzing whether information constitutes a "material change in the information" requiring amendment is to focus simply on the duty to disclose created by the line-item, without regard to materiality. Where line-item provisions such as Item 7(a)(1) do not premise disclosure on materiality, the *occurrence* of an event specifically required to be disclosed should likewise be deemed a *per se* material change in the information, regardless of whether the information itself is material under *Northway* or *Basic*.[245] Ap-

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Similarly, the Division's strongest argument—that the Commission had already determined that the negotiations required to be disclosed under Item 7 were *per se* material—was not advanced with any degree of conviction. Indeed, the Division's assertion that "[t]he Commission's announcement that [Item 7 information is] material . . . is sufficient by itself to establish . . . materiality," *Id.* at 26 (internal quotation marks and citation omitted), was advanced in the "Legislative History" section of its Memorandum of Law, and not in the "Argument" section. This litigation strategy is questionable: the Division was willing to forego its strongest Administrative Law argument and permit Judge Blair to diminish the SEC's authority by applying *Basic* in order to prevail on the merits. While it is undisputed that Judge Blair ultimately found that the undisclosed events were material under *Basic*, the SEC may have "won the battle but lost the war." By not pushing the "*per se* materiality" argument to its logical extreme, the Division has risked that, like Mr. Kern, others will refrain from disclosing negotiations which they subjectively believe to be immaterial even though the Commission has stated very clearly that such negotiations are *always* material; that is precisely what Judge Blair's ruling permits.

[243] *See supra* note 202 and accompanying text.

[244] *See id.*

[245] This is by no means a concession that Item 7(a) might require disclosure of non-material information (although the SEC has the authority to do so). On the contrary, Item 7 in one clear example of a line-item provision that calls for the disclosue of information that is *per se* material. *See supra* notes 193-204 and accompanying text. But there are line-items that do require disclosure of non-material information. In those instances, when deciding whether information required to be disclosed initially under such a line-item provision constitutes a "material change in the information," practitioners should not be permitted to withhold what they believe is immaterial information. Events normally required to be disclosed (regardless of their materiality) in an initial Schedule must logically be disclosed

plied to *Kern*, the occurrence of negotiations, which Mr. Kern contended were not material under *Basic*, but which were specifically required to be disclosed under Item 7(a)(1), constituted a *per se* material change in the information.[246] This method of analysis would effectively prevent those who complain that some line-item provisions require disclosure of otherwise immaterial information from arguing, as did Mr. Kern, that such information cannot constitute a material change simply because the information itself is not material.[247]

Additionally, the concerns voiced by Mr. Kern and many other securities practitioners that premature disclosure of negotiations (i.e., disclosure of immaterial negotiations) would do more harm than good[248] are inapposite because those con-

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in an amendment if those events occur after the initial Schedule has been filed.

[246] The difference between this method of analysis and the first method—that the negotiations are *per se* material—is subtle. The following illustration may be helpful. The examples assume that the line-item provision in question, like Item 7(a)(1), does not predicate disclosure on materiality. Under the first method of analysis, the argument would proceed as follows: negotiations concerning a white knight merger have just commenced; Item 7(a)(1) requires disclosure of negotiations leading to a white knight merger; we did not disclose negotiations in our original Schedule 14D-9 because none were underway; because the Commission has concluded that Item 7 negotiations are always material, the negotiations must be material; therefore, the negotiations must constitute a *per se* material change in the information requiring amendment. Under the second method of analysis (Item 7 information might not be material), the argument would proceed as follows: negotiations concerning a white knight merger have just commenced; Item 7(a)(1) requires disclosure of white knight negotiations; we did not disclose the negotiations in our original Schedule 14D-9 because no negotiations were yet underway; because the negotiations only recently commenced, they may or may not be material under Rule 12b-2 (or *Basic*); nevertheless, because Item 7 requires their disclosure, the existence of even immaterial negotiations where no negotiations existed before constitutes a *per se* material change in the information requiring prompt amendment.

[247] If a line-item provision does indeed call for the disclosure of otherwise immaterial information that is harmful to investors, the proper course of action is to petition for a change of the rules—not the withholding of information that the SEC has specifically required be disclosed. *See infra* note 257-61 and accompanying text.

[248] Premature disclosure of preliminary negotiations may tend to mislead the market and jeopardize potential deals. Commentators have noted that during a tender offer a target company's share price becomes extremely volatile, reacting to even the slightest piece of information. Hazen, *supra* note 10, at 956. Thus, they conclude, premature disclosure of negotiations may lead investors to believe that a deal is imminent, causing them to purchase the target company's shares. This, in turn, pushes the price of the shares up and may make the putative deal prohibitively expensive for the potential acquiror. *Id.*; Brown, *supra* note 11, at 145; Koenig, *supra* note 29, at 1023. Furthermore, many potential acquirors insist on

cerns—concerns that ultimately caused the *Basic* court to adopt the Second Circuit's probability/magnitude test—were addressed in the Instruction to Item 7(a):

> If no agreement in principle has yet been reached, the possible terms of any transaction or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuation of such negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient.[249]

Perhaps the most significant aspect of this instruction is that in response to arguments that the premature disclosure of negotiations would be harmful, the SEC merely limited the breadth of the required disclosure. It did *not*, however, concede that negotiations that were in their formative stages were immaterial. On the contrary, the SEC believed that the mere fact that negotiations were occurring was sufficient reason to require their disclosure. By permitting target companies to withhold the terms of and parties to the negotiations, the SEC resolved the policy concerns addressed in and ultimately resolved by *Basic*.[250]

While Mr. Kern should have known that disclosure under Item 7(a) is not premised on materiality, Rule 14d-9(b)'s use of the word "material" is sufficiently confusing so as to place some blame with the SEC. Indeed, the SEC itself is guilty of

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negotiating in secrecy; premature disclosure therefore could potentially interfere with the progress of acquisition negotiations. Hazen, *supra* note 10, at 954; Steinberg & Goldman, *supra* note 53, at 926-27; Goelzer, *supra* note 11, at 992.

[249] Schedule 14D-9, 17 C.F.R. § 240.14d-101 (Item 7) (1993). When Item 7 was originally proposed, it required disclosure of "*any* negotiation or transaction being undertaken" in relation to significant corporate events. *Proposed Rules*, *supra* note 198, at 81,235 (emphasis added). However, the SEC acknowledged that the proposed Rule might lead to the harm that caused several Courts of Appeal to adopt a bright-line rule for materiality:

> The proposal was criticized by commentators who were concerned that [Item 7] would elicit premature disclosure of negotiations with competing bidders which could dissuade them from making an offer . . . . The Commission recognizes that premature disclosure of matters contemplated by the proposal may be detrimental to the interests of security holders. The effective representation of the interests of security holders may at times require management to maintain confidentiality during the formative stages of negotiations.

Tender Offers, Exchange Act Release No. 16,384, *supra* note 199, at 82,594.

[250] *See* Brown, *supra* note 11, at 106-07.

imposing a materiality requirement in the amendment context where none is required for initial disclosure. Thus, even the SEC has managed to second-guess its own requirements. In *In re Merry Land & Investment Co.*[251] the SEC found that the respondent had violated Schedule 13D, Items 4(b) and 4(d), which do not predicate disclosure on materiality,[252] and Rule 13d-2(a) by failing to disclose a material change in its control intent:

> Contrary to the stated purpose publicly disclosed in its Schedule 13D, Knox's statements at the September 21, 1987 meeting with Osteen reflect that, at least by that date, [Merry Land] had formed an intent to initiate or support hostile activities against [the issuer's] management. The Commission concludes that the events of September 21, 1987 were of such a nature as to have "significantly altered the total mix of information made available" regarding [Merry Land's] intent not to initiate or support activities against the wishes of the [issuer's] management, and thus, "would have been considered to be important by a reasonable shareholder."[253]

If the SEC had followed in *Merry Land* the method of analysis proposed in this Comment, its decision would have reasoned that, since control intent is material information, any change therein is a *per se* material change in the information requiring amendment. The SEC's analysis in *Merry Land* suffers from the same deficiency as Mr. Kern and Judge Blair's analysis in *Kern*: they both do a disservice to the SEC line-item provisions by second-guessing the importance of the information required to be disclosed thereunder. However, because of the obvious confusion caused by Rule 14d-9(b)'s "materiality" requirement, whether Mr. Kern negligently[254] caused Allied's failure to comply with Item 7 is questionable.[255] It may be unfair to hold that Mr. Kern knew or should have known that, in analyzing the materiality of the negotiations at issue in *Kern* under *Basic* or *Northway*, he would be causing Allied to violate securities laws, especially when the Commission itself

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[251] Exchange Act Release No. 26,410, 1988 SEC Lexis 2606 slip op. (Dec. 30, 1988).

[252] *See supra* note 186.

[253] *Merry Land*, slip op. at *15-16 (quoting TSC Indus., Inc. v. Northway, 426 U.S. 438, 449 (1976)). The court also cited to Basic v. Levinson, 485 U.S. 224 (1988).

[254] *See supra* note 159 and accompanying text.

[255] *See supra* note 160 and accompanying text.

has employed the same erroneous analysis.[256]

C. *A Proposal For Modifying Rule 14d-9(b)*

As previously discussed, Mr. Kern's principal reason for not amending Allied's Schedule 14D-9 to reflect the negotiations that had occurred between Allied and DeBartolo was that those negotiations were not "material" under the standard enunciated by the Supreme Court in *Basic*.[257] But nowhere does Schedule 14D-9, Item 7(a)(1) predicate disclosure on the materiality of the negotiations described therein. Therefore, Mr. Kern essentially usurped Rule 14d-9(b)'s "material change" language, which he assumed permitted him to perform a materiality analysis of the negotiations under *Basic*, by withholding what he believed to be immaterial information.[258] This Comment has suggested, however, that even non-material negotiations occurring after the target company has filed its Schedule 14D-9 also constitute a material change in the information for Rule 14d-9(b) purposes.[259]

Therefore, to avoid the sort of dispute that arose in *Kern*, Rule 14d-9(b) should be modified by adding an instruction. The instruction should emphasize that, for line-item provisions that do *not* predicate disclosure on materiality, any event specifically required to be disclosed in the original Schedule, but which occurs subsequent to its filing, constitutes a *per se* material change in the information, which must be disclosed in an amendment regardless of whether or not the event or information is material.[260] Such an instruction would ensure that

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256 *See supra* note 254 and accompanying text.

257 *See supra* note 155 and accompanying text.

258 This Comment has argued vehemently that all negotiations required to be disclosed under Item 7(a)(1) of Schedule 14D-9 are implicitly material under the *Basic* standard. By logic, therefore, the occurrence of a material event must necessarily constitute a *per se* material change in the information.

259 *See supra* notes 185 & 245 and accompanying text.

260 This instruction should be added to all rules requiring amendment of SEC Schedules promulgated under the Williams Act because those rules contain the same wording as Rule 14d-9(b). *See, e.g.*, Rule 13d-2(a), 17 C.F.R. § 240.13d-2(a) (1993) (requiring amendment of Schedule 13D to reflect any material change in the information); Rule 13e-3(e)(2), 17 C.F.R. § 240.13e-3(e)(2) (1993) (requiring amendment of Schedule 13E-3 to reflect any material change in the information); Rule 14d-6(d), 17 C.F.R. § 240.14d-6(d) (1993) (requiring amendment of Schedule 14D-1 to reflect any material change in the information).

non-material information which is required to be disclosed in the original Schedule 14D-9 would also have to be disclosed in an amendment to the Schedule; it prevents filing parties such as Mr. Kern from injecting a materiality standard into a line-item provision where none actually exists.[261]

CONCLUSION

This Comment has argued that preliminary merger negotiations required to be disclosed under Item 7(a)(1) of Schedule 14D-9 are material *per se*. That argument is amply supported by the SEC's releases proposing and adopting Item 7, and simply by acknowledging on a common-sense level the significance of such information to a reasonable shareholder. Accordingly, no filing entity should be permitted to use Rule 14d-9(b)'s "material change" language to assess, under *Basic*, the materiality of negotiations that occur subsequent to the filing of the company's original Schedule 14D-9. The existence of negotiations that are material *per se* must necessarily constitute a *per se* "material change in the information" for purposes of Rule 14d-9(b).

Clearly, then, the ALJ in *Kern* erroneously relied on *Basic* in assessing the materiality of the information that Mr. Kern had subjectively decided to withhold. Moreover, because the Commission let stand this erroneous legal conclusion, it remains binding precedent on the securities bar. This Comment urges the Commission to clarify its amendment rules to reflect that its "material change" language does not impose on otherwise mandatory disclosure requirements—requirements that do not predicate disclosure upon materiality—a materiality

[261] This solution would not render the word "material" in Rule 14d-9(b) meaningless. On the contrary, where a line-item specifically predicates disclosure on materiality, an issuer would have to assess the materiality of any information that might be required to be disclosed thereunder. Thus, where negotiations were taking place when the original Schedule 14D-9 was filed that did not pertain to a "material amount of assets" (*see* Schedule 14D-9, Item 7(a)(3)), but subsequently negotiations are focused on the sale of over half of the company's assets, a material change has occurred under Rule 14d-9(b), triggering the duty to amend. Similarly, Rule 14d-9(b)'s "material change" language is important for analyzing whether subtle changes in the information previously disclosed—as opposed to the sudden occurrence of an event ordinarily required to be disclosed—must be reported in an amendment.

threshold. The amendment requirements should emphasize that where a filing entity has no discretion to withhold information as immaterial in its original schedule, it may not do so when deciding whether to amend; if the information is required under the line-item provision it must be disclosed irrespective of its materiality.

Finally, the *Kern* case also raises a more fundamental question as to the weight to be accorded to the SEC's judgment and expertise. As the agency charged with promulgating disclosure requirements, the SEC is entitled to state that a particular line-item provision calls for the disclosure of material information. When it does so, neither filing entities nor courts should be permitted to second-guess the SEC by assessing independently the materiality of information that the SEC itself believes to be material. This sort of second-guessing undermines the SEC's primary goal of investor protection and diminishes its unquestionably broad authority to define certain classes of information as *per se* material.

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