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THE SEC AND THE COURTS' APPROACH TO DISCLOSURE OF EARNINGS PROJECTIONS, ASSET APPRAISALS, AND OTHER SOFT INFORMATION: OLD PROBLEMS, CHANGING VIEWS

BRUCE A. HILER*

I. INTRODUCTION

One of the basic goals of the federal securities laws is to provide investors with full and fair disclosure of significant information concerning the securities in which they invest.¹ Yet for years one type of information potentially of great relevance to investors was almost totally excluded from the disclosure schemes embodied in the Securities Act of 1933² and the Securities Exchange Act of 1934,³ pri-

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1. See Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (1982) (preamble) ("An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof"); Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1982) ("[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with the national public interest which makes it necessary to provide for regulation and control of such transactions... including... to insure the maintenance of fair and honest markets in such transactions."). See also House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., Report of The Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, ch. XIX, at 556-60 (Comm. print No. 95-29, 1977) [hereinafter 1977 Report] (discussing disclosure philosophy behind federal securities legislation).

2. 15 U.S.C. §§ 77a-77mm (1982) [hereinafter Securities Act]. The primary purpose of the Securities Act, as noted in the preamble, see supra note 1, is to provide for disclosure of firm-oriented information concerning securities sold to the public. The disclosure scheme of the Securities Act is accomplished through the requirement that a registration statement containing specified information be filed with the SEC prior to the offer or sale, and be "in effect" prior to the sale, of nonexempt securities in nonexempt transactions. See Securities Act §§ 5-7, and schedules A and B, 15 U.S.C. §§ 77e-77g (setting forth the requirement to file a registration statement, § 5, and the content of such statement, § 7 and schedules A and B); Securities Act §§ 5-4, 15 U.S.C. §§ 77c-77d (exempting certain securities and certain transactions from registration). The SEC has adopted disclosure requirements for the various forms of registration statements which it has promulgated under the Securities Act, in addition to the specific requirements set forth in § 7 and schedules A and B of the Act. These requirements, as to the content of the nonfinancial or textual portions of registration statements, are set forth in

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marily because of Securities and Exchange Commission (SEC) policy. Until recently the SEC prohibited the inclusion in filings of most "soft information," a term that is used to refer generally to certain predictive information, such as earnings projections or asset appraisals.

This SEC prohibition on soft information disclosure was based primarily on the perception that such information, calling for subjective judgments, was inherently unreliable, and on the concomi-

regulation S-K, 17 C.F.R. § 229.10 to -.502 (1986), as incorporated by whatever form is applicable, and in interpretative releases and disclosure guides. The content of financial statements that must be included in registration statements generally is governed by regulation S-X, 17 C.F.R. § 210.1-01 to .12-29 (1986), various interpretative releases, and generally accepted accounting principles [hereinafter GAAP]. See, e.g., Accounting Series Release Nos. 4 ("Administrative Policy on Financial Statements"), 150 ("General Revision of Regulation S-X") (discussing the roles of the SEC and the accounting profession in establishing accounting principles), and 280 ("Statement of Policy and Establishment and Improvement of Accounting Principles and Standards"), ACCOUNTING SERIES RELEASES (CCH) (1981). For a general background discussion of the operation and premise of the Securities Act disclosure system, see 1977 REPORT, supra note 1, ch. XIX, at 566-72.

3. 15 U.S.C. §§ 78a-78kk (1982) [hereinafter Exchange Act]. The basic firm-oriented disclosure scheme of the Exchange Act is designed to provide continuous periodic disclosure by issuers whose securities are widely held or are traded in the securities markets. Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), requires issuers with securities registered pursuant to § 12 of the Exchange Act to file periodic reports with the SEC. Section 15(d), 15 U.S.C. § 78o(d), requires issuers who have issued securities pursuant to a Securities Act registration statement within the prior year to file the periodic reports required by § 13(a) for at least one year, if they are not already subject to those requirements by virtue of a § 12 registration. The form and content of filings under § 13 are also governed by regulation S-K and by regulation 12B, 17 C.F.R. § 240.12b-1 to -37 (1986), as made applicable through the particular filing form involved. Financial statements are governed by regulation S-X, interpretative releases, and GAAP. Rules and regulations governing the content of proxy solicitations and requiring information statements to be filed with the Commission and sent to securities holders in the absence of a solicitation of proxies for a scheduled shareholders meeting have been adopted pursuant to § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a). See SEC regulations 14A, 14E, 17 C.F.R. § 240.14a-1 to -102, § 240.14e-1 to -3. Filings are also required when other persons or, in some cases, the issuer takes some action with respect to the issuer or its securities.

Specifically, filings are required:

(1) in connection with the acquisition of beneficial ownership of equity securities registered pursuant to § 12 of the Exchange Act, see Exchange Act § 13(d), (f), (g), 15 U.S.C. § 78m(d), (f), (g); SEC regulation 13D, 17 C.F.R. § 240.13d-1 to -102;

(2) in connection with tender offers for securities registered pursuant to § 12, see § 14(d), 15 U.S.C. § 78n(d); SEC regulation 14D, 17 C.F.R. § 240.141-1 to -101;

(3) in connection with certain issuer "going private" transactions and issuer tender offers, see § 13(e), 15 U.S.C. § 78m(e); and

(4) when a majority of the directors of the issuer are to be elected or designated pursuant to agreement in certain specified transactions, see § 14(f), 15 U.S.C. § 78n(f).

See also 1977 REPORT, supra note 1, at ch. XIX, at 573-617 (discussing the Exchange Act disclosure system existing at the time).
tant fear that unsophisticated investors would fail to appreciate the uncertainty that soft information involves. But market analysts and other professionals concerned with securities disclosure long have argued that certain soft information is necessary and highly relevant to informed investment decisions. As a result, the SEC’s policy on disclosure of soft information has undergone significant revision over the last ten years.

This article first will explore the SEC’s changing policy concerning disclosure of soft information, particularly earnings projections and asset appraisals, and the judicial response to these views. The second part of the article will discuss the various sources of a duty to disclose soft information under the federal securities laws and will present a proposed standard for determining the materiality of soft information.

II. THE SEC AND THE COURTS’ APPROACH TO DISCLOSURE OF SOFT INFORMATION

A. Early SEC Focus on Predictions of Future Economic Performance in the Securities Registration Process

The term “soft information” has been used to refer generally to information about a particular issuer or its securities that inherently involves some subjective analysis or extrapolation, such as projections, estimates, opinions, motives, or intentions. While it has been pointed out that much of what is considered “hard” (historical or factual) information—either required or permitted to be included in filings with the SEC—contains elements of subjectivity, what has been excluded from those filings as soft information seems to be distinguishable by the degree of subjectivity involved or the extent


to which objective verification is possible.\(^6\)

The SEC developed its traditional policy against disclosure of soft information primarily in the context of considering what constituted appropriate disclosure in registration statements filed under the Securities Act.\(^7\) Early in its history the SEC determined that po-

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6. See, e.g., Mann, supra note 5, at 231-32 ("[A]n analysis of material required or permitted to be included in prospectuses indicates that the distinction between fact and prognostication is more easily stated than applied . . . ."); Schneider, Soft Information Disclosures: A Semi-Revolution, 1984 INST. ON SEC. REG., at 20 [hereinafter Schneider, Semi-Revolution] ("The hard-soft dichotomy is a matter of degree."). Consider, however, the view that "there is a difference almost of kind rather than mere degree between attempting to project future earnings and the estimations that admittedly are involved in such current accounting determinations as estimated bad debts or depreciation." Herwitz, Projections and Forecasts, 1973 INST. ON SEC. REG. 119, 127-28. Herwitz explained, for example, that the "hardness" of the otherwise subjective estimate of bad debt reserves was due to the experience of the issuer and others in its industry and, as to depreciation, a supposedly rational allocation system that has developed under generally accepted accounting principles. Id. at 326. These explanations, however, suggest that any perceived "difference of kind" between certain types of soft and hard information may be based on the development of experience in dealing with the latter type of information and, thus, on the development of acceptable assumptions or reference points for drawing the subjective conclusions on which the information is based. See, e.g., Schneider, Semi-Revolution, supra, at 32-33 (noting that the SEC's current policy of encouraging or requiring certain soft information disclosures may have come about, in part, because "once the Commission and the courts became accustomed to dealing with soft information in Williams Act filings, it was a normal transition to apply a similar approach to other types of disclosure documents . . . ."). The Williams Act of 1968 added to the Exchange Act provisions, which, among other things, require certain disclosures in situations involving potential change of control of an issuer. 15 U.S.C. §§ 78m(d), (e), 78n(d), (e), (f) (1982). See also Gormly, Financial Forecasts: Problems and Considerations, 6 SEC. REG. L.J. 32, 39-40 (1968) ("It has been pointed out that conventional financial statements embody many estimates that are not unlike forecasts, except that the rules governing them have been developed through experience. . . .") (citing Kripke, The SEC, The Accountants, Some Myths and Some Realities, 45 N.Y.U. L. REV. 1151, 1197-1201 (1970) [hereinafter Kripke, Myths]).

7. See Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,666 (Feb. 2, 1973) ("It has been the Commission's long-standing policy generally not to permit projections to be included in prospectuses and reports filed with the Commission."); SEC DISCLOSURE GROUP, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 95-96 (1969) [hereinafter WHEAT REPORT] (discussing policy against including projections and predictions in reports filed with the SEC and concluding that policy should not be changed); 1977 REPORT, supra note 1, at 347-55 (surveying SEC position on disclosure of "soft information" and recommending that the policy be changed to one encouraging the disclosure of management projections and other forward-looking or soft information.) See generally Fiflis, supra note 5 (discussing SEC view and then-current recommendations to change that policy); Gormly, supra note 6 (surveying SEC's and courts' view of financial projections); Heller, Disclosure Requirements Under Federal Securities Regulation, 16 BUS. LAW. 300 (1961) (discussing SEC's disclosure philosophy in general and its application to specific categories of soft information); Mann, supra note 5 (discussing reasons underlying SEC's policy concerning disclosure of projections in prospectuses); Schneider,
potential investors should be given only objectively verifiable facts from which they in turn could extrapolate any relevant forward-looking information. The overriding interest was in protecting new investors from overreaching by persons willing to make unfounded predictions of success and value in what are essentially selling documents.

In this context the SEC was concerned that inclusion in prospectuses of predictions of future economic performance, such as projections of an issuer's sales and earnings or of the future value of its securities, would lead to undue reliance by investors who would tend to attribute an unjustifiable degree of certainty to any statement contained in a filing reviewed by the SEC, regardless of caveats. This fear was exacerbated by the potential for manipulation

Semi-Revolution, supra note 6 (surveying SEC's prior and current views and case law); Schneider, The SEC's Evolving Attitude Toward Soft Information in SEC Filings, 1979 Instr. on SEC. Reg. 176-95; Schneider, Nits, supra note 4 (discussing SEC's policy and suggesting basis for change in the policy); Address by SEC Chairman Casey, National Investors Relations Institute (Oct. 3, 1972), at 2-4, quoted in Schneider, Nits, supra note 4, at 268 n.46.

The Commission's current policy concerning disclosure of financial projections is set forth at 17 C.F.R. § 229.10(b) (1986). See infra note 32.

8. See Wheat Report, supra note 7, at 96 ("It has been the Commission's longstanding policy not to permit projections and predictions in prospectuses and reports filed with the Commission. Such documents are designed to elicit material facts. Their factual character is widely recognized. Investors and their advisors are at liberty to make their own projections based on the disclosures resulting from the Commission's requirements."); see also Heller, supra note 7, at 307 ("[T]he Securities Act . . . is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that [the investor] is as competent as anyone to predict the future from the given facts.").

9. See, e.g., Kripke, Myths, supra note 6, at 1188-89, 1197 n.189 ("[O]ver the years, we have encountered an unscrupulous fringe among promoters whose predictions are pretty far out. We do not want them going [public] under [the SEC's] auspices.") (quoting Phillip Loomis, the Commission's General Counsel at the time); Schneider, Semi-Revolution, supra note 6, at 28; Schneider, Nits, supra note 4, at 258-59, 264 ("The traditional [SEC] practice has been oriented toward the potential new investor, and reflects a policy judgment that it is highly important to protect [the investor] against buying a security which is worse than [the investor] thinks, but relatively less important to protect [the investor] against missing a favorable opportunity.").

10. Wheat Report, supra note 7, at 96 ("A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve."); 1977 Report, supra note 1, at 348 (referring to soft information: "The Commission has excluded certain types of information from SEC filings for fear that such information, although useful and important to knowledgeable constituents of the investment community, might be misunderstood and unduly relied upon by unsophisticated investors."); Heller, supra note 7, at 307 ("[A]tttempts by companies to predict future earnings . . . have almost invariably been held by the Commission to be misleading because they suggest to the
of such information by those creating the data, and by the difficulty of SEC and judicial review of information not objectively verifiable.

An inconsistency is apparent in this reasoning. The premise that investors are only interested in hard facts from which they are capable of drawing their own conclusions about an issuer’s future prospects assumes a high degree of investor sophistication and relatively equal access to information or skilled analysis. Conversely, the concern that potential investors would misinterpret or place undue reliance on such information assumes away a certain level of sophistication. Since the SEC initially directed its disclosure policy at the unsophisticated investor, it resolved this conflict by prohibiting the feared disclosure. Over time, however, it became increasingly difficult to justify the exclusion of certain soft information from SEC filings, especially earnings projections, when market professionals and individual investors alike viewed it as essential to informed investment decisions.  

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11 See 1977 REPORT, supra note 1, at 348; Fiflis, supra note 5, at 105; Heller, supra note 7, at 301 n.6.

12 See, e.g., 1977 REPORT, supra note 1, at 349 (“The investor’s task is to assess future earning power of the corporation.”); Heller, supra note 7, at 304-10 (admitting that the “intrinsic value” of an investment depends upon future earnings, but arguing against disclosure of projections); Herwitz, supra note 6, at 127 (“[F]uture prospects are the real key to the present value of securities . . .”); Libby & Rollinson, Securities Law of Materiality as It May Relate to “Optional” Publication of Projections, 31 BUS. LAW. 701 (1976) (“The single most important aspect of any securities investment is the prospect of earnings.”); Schneider, Nits, supra note 4, at 259 (“the Commission’s view does not deny either the relevance of soft information in making investment decisions, or the fact that soft information is used extensively”); LORIE AND HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 113-22 (1973) (discussing the primacy of earnings in determining the value of an issuer’s securities).

Prior to the SEC’s policy change, various commentators undertook to refute the basis for the SEC’s position or to mollify its concerns. In addition to the issues of unreliability, ease of manipulation, undue investor reliance, and difficulty of review, other arguments presented were that requiring or permitting projections would be excessively costly or cause competitive injury to issuers and that the potential liability from inaccurate projections could cause management to be unduly conservative. These arguments eventually were overcome and will not be discussed at any length in this article. For a discussion of these issues, see generally Herwitz, supra note 6; Mann, supra note 5; Schneider, Nits, supra note 4; Note, Disclosure of Future Oriented Information Under the Securities Laws, 88 YALE L.J. 338 (1978).
Moreover, because issuers generally were not prohibited from public disclosure of soft information in press releases or other materials, it soon became evident that the availability of information such as earnings projections outside of, while prohibited in, SEC public disclosure documents could cause an imbalance in investor access to information.\footnote{13} In such an environment the unsophisticated investor, whom the SEC sought to protect by its policy against disclosure of soft information, would be the most likely to suffer.\footnote{14}

\section*{B. The SEC's Policy Shift on Disclosure of Predictions of Economic Performance}

Ironically, while the SEC's policy against soft information disclosure focused on the perceived unreliability of predictive information such as earnings projections, the obvious significance of such information to investors made it the focal point of a reevaluation of that policy. In 1972 the SEC initiated public rulemaking proceedings to consider specific issues regarding the use of "estimates, forecasts or projections of earnings and revenues . . ."\footnote{15} In 1973, as a result of hearings, the SEC issued a statement that it had determined that "changes in its present policies with regard to the use of projections would assist in the protection of investors and would be in the public interest."\footnote{16} The SEC discussed the importance of such information to investors as follows:

\begin{quote}
\footnotesize
13. See Fiflis, \textit{supra} note 5, at 97 (noting use of soft information outside of prospectuses and other SEC filings); Mann, \textit{supra} note 5, at 226-27, 229-30 (same); Schneider, \textit{Nits, supra} note 4, at 259-60 (same).

In its 1973 release concerning the use of projections, the Commission recognized that projections were "widespread" in the securities markets but expressed concern "that all investors do not have equal access to this material information." Securities Act Release No. 5362, \textit{supra} note 7, at 82,667 (emphasis added).

14. This concern may be even more justifiable today in light of the Supreme Court's recent decision in \textit{Dirks v. SEC}, 463 U.S. 646 (1983). In that case, the Court adopted a rule in an insider trading case that allows insiders to disclose material, nonpublic corporate information selectively without violating the antifraud provisions, as long as the insider does not personally benefit from the disclosure. \textit{Id.} at 654-61. See generally Hiler, \textit{Dirks v. SEC: A Study in Cause and Effect}, 43 M. L. Rev. 292 (1984). The overriding rationale for the Court's opinion is that market efficiency is advanced by allowing analysts and other market professionals access to such information. Thus, while the courts still generally deny shareholder claims that certain soft information should have been disclosed to them in connection with various transactions affecting their investment, see cases cited \textit{infra} notes 51-53, the same information may be viewed as subject to selective disclosure under \textit{Dirks}.


\end{quote}
The Commission recognizes that projections are currently widespread in the securities markets and are relied upon in the investment process. Persons invest with the future in mind and the market value of a security reflects the judgments of investors about the future economic performance of the issuer. Thus projections are sought by all investors, whether institutional or individual.\textsuperscript{17}

The Commission also announced its intention to adopt standards to govern disclosure of projections in filings, including prospectuses, but declared that it had determined "not to require issuers to generate or disclose projections."\textsuperscript{18}

The policy transition that began with the 1973 release was slow in development. A series of rule and form proposals in 1975 relating to permissive disclosure of certain soft information\textsuperscript{19} were withdrawn in 1976 after unfavorable public comment.\textsuperscript{20} In the 1976 release withdrawing the proposal,\textsuperscript{21} the SEC instead issued a policy statement in which it recognized that its long standing policy generally not to permit projections in Commission filings may have acted as an impediment to what it admitted was widespread investor interest in obtaining "management's assessment of future performance."\textsuperscript{22} In the absence of a more specific proposal, the SEC stated that it would not object to disclosure of projections in filings if made in good faith with a reasonable basis.\textsuperscript{23} The SEC was careful to note

\begin{enumerate}
\item[17.] \textit{Id.}
\item[18.] \textit{Id.} (emphasis added).
\item[20.] The 1975 release proposed a complex system for, in effect, continuous disclosure of projections once voluntarily undertaken. It provided for disclosure of underlying assumptions and for comparison with actual results. One commentator summarized the public criticism of the rule as involving "such things as an excessively broad definition of projection, the obvious illusory character of the supposed safe harbor against liability, and the complex cycle of filings and refilings ...." Gormly, supra note 6, at 42.
\item[22.] Id. at 86,202.
\item[23.] Id. The Commission also noted that the projections must be "presented in a reasonable format and accompanied by information adequate for investors to make their own judgments." Id. This is a modification of the strict 1975 proposal, which specifically would have required disclosure of material assumptions underlying the projection. The 1976 policy statement left this issue open to interpretation. As with the 1975 proposal, the 1976 policy statement referred only to projections of future economic performance. The Commission also published for comment proposed Guides expressing its Division of Corporation Finance's views on disclosure of projections in Securities Act and Exchange Act filings.
\end{enumerate}
that it was neither encouraging nor discouraging such disclosure.\textsuperscript{24} It also amended the note to rule 14a-9 under the Exchange Act\textsuperscript{25} by deleting "earnings" and "dividends" from the list, in that note, of information that it considered potentially misleading if included in proxy statements.\textsuperscript{26}

In 1978, in response to recommendations of the Advisory Committee on Corporate Disclosure,\textsuperscript{27} the SEC issued a statement encouraging disclosure of management projections both in filings with the SEC and in general.\textsuperscript{28} This policy shift was based in part on the

\begin{itemize}
\item \textsuperscript{24} Id.
\item \textsuperscript{25} 17 C.F.R. § 240.14a-9, note (a) (1986).
\item \textsuperscript{26} Securities Act Release No. 5699, \textit{supra} note 21, at 86,201, 86,203. Rule 14a-9 prohibits false or misleading statements in proxy solicitation materials. The rule and note presently read, in pertinent part:
\begin{quote}
(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.
\end{quote}

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.
\begin{itemize}
\item (a) Predictions as to specific future market values.
\item (b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.
\item (c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.
\item (d) Claims made prior to a meeting regarding the results of a solicitation.
\end{itemize}

\item \textsuperscript{27} The Advisory Committee on Corporate Disclosure was appointed on Feb. 2, 1976. \textit{See} Solicitation of Public Comments by Advisory Committee on Corporate Disclosure, Securities Act Release No. 5707, \textit{[1975-1976 Transfer Binder]} Fed. Sec. L. Rep. (CCH) ¶ 80,531, at 86,374 (May 18, 1976). The result of its work, the 1977 \textit{REPORT, supra} note 1, was issued November 3, 1977. Among other things, the Advisory Committee recommended that the SEC "encourage issuers to publish forward-looking and analytical information," and that it adopt a safe harbor rule "to provide maximum incentive for disclosure of management projections and other forward-looking information, whether or not filed with the Commission." 1977 \textit{REPORT, supra} note 1, ch. X, at 344.
"significance attached to projection information and the prevalence of projections in the corporate and investment community . . ." 29

At the same time the SEC also proposed a safe harbor rule covering disclosure of "projections of future economic performance," such as earnings and dividends. 30 A final rule was adopted in 1979. 31 It provides a safe harbor based essentially on the standard recognized in judicial decisions prior to that time, that a projection made in good faith and with a reasonable basis will not be actionable under the antifraud provisions of the securities laws. 32

1978). In Securities Act Release No. 5992, the SEC also revised and authorized publication of the Division Guides proposed in Securities Act Release No. 5699, supra note 21. In those guides the Division noted that projections should be made in good faith with a reasonable basis, presented in an appropriate format with accompanying disclosure that "should facilitate investor understanding of the basis for and limitations of projections." Securities Act Release No. 5992, supra, at 81,036. In this regard, although the Division did not take the position that projections disclosed without assumptions are per se misleading, id. at 81,038 n.19, it stated its belief that disclosure of at least the most significant assumptions underlying a projection enhances investor understanding. Id. at 81,038.

29. Securities Act Release No. 5992, supra note 28, at 81,037. The SEC noted its agreement with the Advisory Committee that "the availability of forward-looking and analytical information is important to an investor's assessment of a corporation's future earning power and may be material to informed investment decisionmaking." Id. at 81,036 (citing the 1977 REPORT, supra note 1, at 349-50).


The SEC's proposed safe harbor rule would have covered only projections of revenues, income (loss), earnings (loss) per share, or other financial items. Securities Act Release No. 5993, supra note 30, at 81,041. The final safe harbor rule covered "forward-looking statements," defined to mean statements concerning (i) projections of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, or "other financial items"; (ii) management's plans and objectives for future operations; (iii) future economic performance contained in the then-required management's discussion and analysis of the summary of earnings; and (iv) assumptions underlying or relating to such statements. 17 C.F.R. § 240.3b-6(c) (1986). The rule has been amended on several occasions to comport with the SEC's integrated disclosure system and to add several categories of "information" not otherwise included within the definition of "forward-looking statements" to its coverage, including statements of "the value of proved oil and gas reserves . . . presented voluntarily or pursuant to Item 302 of Regulation S-K . . ." 17 C.F.R. § 240.3b-6(b)(ii)(2). These added categories of information may only be disclosed in documents "filed" with the Commission. Id. As to the defined types of "forward-looking information," the rule applies to statements of such information that are included in documents filed with the Commission, subsequent affirmations of such statements, or statements made prior to a filing that are reaffirmed in a filed document
C. Judicial Approaches to Disclosure of Predictions of Future Economic Performance

1. Early Decisions.—During the period in which disclosure of earnings projections was prohibited in SEC filings, judicial decisions in the area generally involved claims that (1) dissemination of earnings projections in press releases or otherwise outside of SEC filings violated the antifraud provisions of the securities laws because the projections were false or misleading, or (2) failure to disclose earnings projections violated the antifraud provisions by rendering some disclosure misleading.

The early leading cases involving the claim that projections were false or misleading were Dolgow v. Anderson and Marx v. Computer Sciences Corp. Those cases recognized that earnings projections can be “facts” for purposes of the antifraud provisions, but within a reasonable time after the making of the statement. 17 C.F.R. § 240.3b-6(b). The SEC rejected the Advisory Committee’s suggestion that the rule apply to statements outside of filings because the SEC wished to ensure that there was equitable disclosure of such information. The SEC’s present policy on soft information, which, as enunciated in the safe-harbor release, encourages the disclosure of specified soft information pursuant to the safe-harbor rule, is set forth in § 229.10 of regulation S-K, 17 C.F.R. § 229.10, which took the place of Guide 62, under the SEC’s integrated disclosure system. See Adoption of Integrated Disclosure, Securities Act Release No. 6983, [Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 16, 1982).

33. Various antifraud provisions of the federal securities laws make it unlawful in various circumstances “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .” See SEC rule 10b-5, 17 C.F.R. § 240.10-5 (1986). Rule 10b-5 was promulgated under § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1982) [hereinafter § 10b] to cover any statements made in connection with the purchase or sale of any security and using jurisdictional means, i.e., interstate commerce. See infra notes 79-80. For further examples of similar prohibitions, see Securities Act § 17(a), 15 U.S.C. § 77q(a) (1982) (“the offer or sale of any security” using jurisdictional means); Exchange Act § 14(e), 15 U.S.C. § 78n(l) (statements made in connection with any tender offer); SEC rule 14a-9, 17 C.F.R. § 240.14a-9 (proxy soliciting materials); SEC rule 12b-70, 17 C.F.R. § 240.12b-20 (requiring Exchange Act filings to contain all material information necessary to make required statements not misleading). See also Securities Act § 11, 15 U.S.C. § 77k (1982) (providing for private rights of action against various persons for misstatements or omissions in registration statements effective under the Securities Act); Securities Act § 12(2), 17 U.S.C. § 77l(2) (1982) (providing private rights of action against persons offering or selling securities through use of interstate commerce by means of prospectus or oral communication containing misstatements or omissions).

34. See supra note 33.

35. 53 F.R.D. 664 (E.D.N.Y. 1971), aff’d, 464 F.2d 437 (2d Cir. 1972) (per curiam) (claim under rule 10b-5).

36. 507 F.2d 485 (9th Cir. 1974) (claim under rule 10b-5).

37. Id. at 489 (citing G&M, Inc. v. Newbern, 488 F.2d 742 (9th Cir. 1973)). In New-
that they are not actionable as false statements simply because they eventually prove inaccurate. This follows because such statements

ber the court rejected the argument that representations as to future earnings were not actionable under rule 10b-5 because they were mere opinion. See also Priest v. Zayre Corp., Civ. Action No. 86-2411-7 slip op. (D. Mass May 1, 1987) (letter to shareholders contained "combination of specific projections and factual assertions that, if proved inaccurate, are sufficiently material" to support an antifraud claim); King v. E.F. Hutton & Co., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,176 (D.D.C. Mar. 15, 1987) (denying motion to dismiss claim, among others, that earnings predictions by brokerage firm employees were fraudulent); Eichen v. E.F. Hutton & Co., 402 F. Supp. 823, 829 (S.D. Cal. 1975) ("a forecast, essentially a prediction, may be regarded as a 'fact' within the meaning of [rule] 10b-5") (both King and Eichen citing Marx and Newbern).

Cases dealing with predictions as to earnings or future value by broker-dealer firms or their employees also established that opinions and predictions can be actionable under the antifraud provisions. E.g., Gottreich v. San Francisco Inv. Corp., 552 F.2d 866, 867 (9th Cir. 1977) (finding that purportedly expert predictions as to future price of shares "may constitute misstatements of material facts and brokers may be subject to liability for making them") (citing Marx and Newbern); Kahn v. SEC, 297 F.2d 112, 114-15 (2d Cir. 1961) (Clark, J., concurring) (discussing SEC's theory that broker-dealers must have adequate basis for estimates and predictions regarding an issuer's earning or future stock value). The theory in such cases is that "when a broker-dealer goes into business (hangs out his 'shingle') he impliedly represents that he will deal fairly and competently with his customers and that he will have an adequate basis for any statements or recommendations which he makes concerning securities." R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 553 (5th ed. 1982).

Arguably, regardless of whether the speaker has a preexisting relationship or duty to deal fairly with shareholders or investors, the antifraud provisions, which themselves create an obligation to speak truthfully in certain contexts, e.g., in connection with the purchase or sale of a security, see supra note 33, concomitantly can supply the implicit representation that estimates are made in good faith and have a reasonable basis, at least when the speakers should reasonably expect—due to the circumstances under which they are speaking, such as when they purport to have special knowledge of an issuer or special expertise—that investors will rely on them. See, e.g., Rose v. Arkansas Valley Envtl. & Utility Auth., 562 F. Supp. 1100, 1206-08 (W.D. Mo. 1983) (discussing duty to speak truthfully and finding complaint sufficient to state action under § 10(b) for attorney's opinion letter concerning legality of bonds being issued; noting that "[s]ince this is not a true non-disclosure situation, a separate, pre-existing relationship of 'trust and confidence' is not required.") (emphasis in original). But see id. at 1206 n.38 (warning that "it is clear that where there was no reason for the defendant to know or believe that his statements would be communicated to or relied upon by the securities purchaser or seller, he has no 'duty' to that person") (citation omitted); cf. First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), cert. denied, 435 U.S. 592 (1978); Gottreich, 552 F.2d at 867; Milberg v. Western Pac. R.R., [1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,899 (S.D.N.Y.) (refusing class certification and noting little likelihood of success on claim that news publication's own estimate of an issuer's earnings was deliberately inaccurate or recklessly prepared), appeal dismissed, 443 F.2d 1301 (2d Cir. 1971).

38. Marx, 507 F.2d at 489-90; Dolgow, 53 F.R.D. at 670, 678-79 (denying class certification for lack of substantial possibility that plaintiffs would succeed on the merits; finding that projections that proved inaccurate were "reasonable and sound" and accurately reflected the issuer's "best estimates of its future prospects"). See also Goldman v. Belden, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,492, at 96,862 (Aug. 11, 1983) ("Economic prognostication, though faulty, does not, without more, amount to fraud.")(quoting Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 117 (2d Cir. 1982)
are predictive; therefore, the only truly factual elements involved in a projection are the implicit representations that the statements are made in good faith and with a reasonable basis. Thus, when a defendant can show that it has fulfilled those representations, the courts generally find that the projection was not "false" at the time it was disseminated.

What constitutes a "reasonable basis" and to what extent the facts or assumptions underlying or bearing on the accuracy of the projection must be disclosed to avoid rendering that projection misleading present more difficult questions. On the question of reasonable basis, in *Dolgow* the court found that various optimistic predictions, including a projection of record earnings, were not false or misleading at the time issued even though the issuer eventually reported an almost ten-percent decline in earnings.

(emphasis added); *REA Express, Inc. v. Interway Corp.*, 410 F. Supp. 192, 196 (S.D.N.Y. 1976) ("the mere fact that a forecast is inaccurate does not make it fraudulent.") (citing 1 A. Bromberg, SECURITIES LAW: FRAUD, SEC Rule 10b-5, § 513, at 98 (1974)); *Beecher v. Able*, 374 F. Supp. 347, 348 (S.D.N.Y. 1975) ("an earning forecast is not actionable merely because the facts do not turn out as predicted").

39. *Marx*, 507 F.2d at 490 (projection constitutes representation that it is an "informed and reasonable belief" and "implies a reasonable method of preparation and a valid basis"); *id.* at 490 n.7 ("the sole factual elements of a projection should be that it represents management's view, that it was reached in a reasonable fashion and that it is a sincere view") (citing *Kripke, Myths, supra* note 6, at 1199); *REA Express*, 410 F. Supp. at 196 ("projections must be regarded . . . as a representation that [at the time issued] it was the informed, reasonable and sincere belief [of management]").


When the SEC adopted a safe harbor rule in 1979 for predictions of future economic performance, it incorporated a similar standard. *See supra* text accompanying note 32.

It is now settled that some degree of scienter is required for violations of certain antifraud provisions. *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980) (intentional or knowing conduct required for violation of § 10(b) and rule 10b-5 and for § 17(a)(1) but not § 17(a)(2)-(3) of the Securities Act). Thus, there necessarily will be some interplay between the "good faith" standard for projections and the scienter requirement when an action is brought under the antifraud provisions. Of course, if the basis or method of preparation of the projection is sufficiently unreasonable, that may be an indication of recklessness. *See, e.g., Marx*, 507 F.2d at 490 (noting that the untruthfulness of a statement is "inextricably linked" with the scienter requirement of rule 10b-5); *Rose*, 562 F. Supp. at 1207 (noting that if a defendant states something for which there is "so little basis for an honest belief," the scienter standard under rule 10b-5 may be satisfied).

41. *Dolgow*, 53 F.R.D. at 685. The main issue discussed in the opinion was denial of class certification. *See supra* note 38.
ing this conclusion the court found that the projection was based on "carefully prepared and extensively reviewed internal documents." The documentation resulted from an ongoing and well-established budget review process. Although it is not clear that all projections would have to be based on as thorough and ongoing a process as that which the court described at some length in Dolgow, it appears that the court considered it very important that the disclosed projections did not differ from internal information and documentation. Indeed, in Marx, in which an issuer only attained forty-one percent of its prior forecast, the Ninth Circuit reversed the lower court's grant of summary judgment in favor of the defendant because "a jury . . . could reasonably find that [the defendant], by ignoring facts seriously undermining the accuracy of the forecast, failed to meet the duty imposed by § 10(b)." The Ninth Circuit held, in part, that a jury could find that the failure to disclose at the time of the optimistic forecast "facts indicating that [the issuer] was in serious financial trouble . . ." was a material omission.

In general, underlying assumptions or facts should be disclosed if material to an accurate understanding of the projection or if they represent a material qualification of the projection. It is also clear

42. Id. at 678.
43. See id. at 670 ("It is not true that the 'internal data . . . did not justify the issuance of forecasts of substantial earnings gains.'"), 678 (estimates were consistent with, and "fairly and accurately reflected, internal documents").
44. Marx, 507 F.2d at 490.
45. Id. at 492. The holding that the lack of additional factual disclosure could be a material omission apparently was separate from the holding that a jury could also reasonably find on the facts presented that the forecast, regardless of additional factual disclosure, was an "'untrue statement of a material fact,' actionable under Rule 10b-5 . . ." Id. In this regard, perhaps it is significant that the court noted that from its inception, the issuer's principal product had not met internal projections. Id. at 488. Although the court found nothing in the record proving intentional misconduct, it expressed concern that the projections may have lacked a reasonable basis in light of the negative experience of the issuer with its product. Id. at 490.
46. Id. at 490-91 (finding that § 10(b) requires disclosure of facts seriously undermining accuracy of forecasts, but noting that an issuer "need not detail every corporate event . . . which has or might have some effect upon the accuracy of its earnings forecast"); Keinnan v. Homeland, Inc., 611 F.2d 785, 788 (9th Cir. 1980) (failure to discover facts undermining prediction of return on investment could lead to liability under rule 10b-5); Beecher v. Able, 374 F. Supp. 347, 348 (S.D.N.Y. 1975) ("any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a reasonably prudent investor . . . might be deterred from crediting the forecast").

When the SEC initially announced its tolerance of earnings projections, it noted that underlying assumptions would have to be disclosed. See Securities Act Release No. 5362, supra note 7; Securities Act Release No. 5581, supra note 19. The final safe harbor rule, however, does not require disclosure of assumptions to avoid liability, but in adopting the rule the SEC noted its belief that "key assumptions underlying a forward
that changes in underlying facts or assumptions that render a projection materially inaccurate at some point after dissemination must be disclosed as long as the particular prediction remains alive in the marketplace.\textsuperscript{47}

In early cases involving the claim that a filing with the SEC was false or misleading because it omitted disclosure of financial forecasts, the courts generally relied on the SEC's firm policy against disclosure of projections and predictive forecasts in such filings to hold that disclosure was not required.\textsuperscript{48} Most of these cases avoid looking statement are of such significance that their disclosure may be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule.” Securities Act Release No. 6084, supra note 31, at 81,942. See also Fiflis, supra note 5, at 124-27 (noting that “[g]ood faith and reasonableness of the basis cannot suffice in every case to avoid misrepresentation,” if disclosure of assumptions or additional facts is necessary to an informed understanding of the meaning and potential accuracy of the prediction). See also supra note 28 (discussing SEC's views on assumptions in its 1978 safe harbor rule proposal).


The SEC's most recent policy, encouraging predictions of economic performance, found in regulation S-K, notes that: “[W]ith respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition. This responsibility may extend to situations where management knows or has reason to know that its previously disclosed projections no longer have a basis.” 17 C.F.R. § 229.10(b)(3)(iii) (1986). See also Greenfield v. Heublein, Inc., 742 F.2d 751, 758 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985) (“if a corporation voluntarily makes a public statement that is correct when issued, it has a duty to update that statement if it becomes materially misleading in light of subsequent events”); Ross v. A.H. Robins Co., 465 F. Supp. 904, 908 (“It is now clear that there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events. This duty exists so long as the prior statements remain ‘alive,’” i.e., so long as investors could reasonably rely on the statement.), rev’d on other grounds, 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).

\textsuperscript{48} See Marsh v. Armada Corp., 533 F.2d 978, 987 (6th Cir. 1976) (“The failure to make a projection of future earnings of an acquired company in a merger proxy statement is not actionable under Rule 10(b)-5”) (noting SEC's position), cert. denied, 430 U.S. 954 (1977); Straus v. Holiday Inns, Inc., 460 F. Supp. 729, 734 (S.D.N.Y. 1978) (noting that no court had ever imposed liability for failure to include projections in a registration statement, but reading the complaint as alleging failure to disclose facts on which a projection might be based); Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400, 410 (N.D. Ill. 1964) (finding that report deemed to constitute proxy materials and containing earnings and stock value predictions was misleading because, based on SEC policy, “[w]hatever its value for other purposes, it was inappropriate for use in proxy solicitation”). See also Rodman v. Grant Found., 608 F.2d 64, 72 (2d Cir. 1979) (alleging antifraud violations for failure to disclose intent to retain control and need to
any in-depth discussion of the materiality or the importance to investors of such information by accepting the SEC’s view that predictive information need not be disclosed because it tends to mislead investors “by conveying a certitude which inherently [it] cannot possess.”49 This reliance on SEC policy allowed the courts to avoid any discussion of the materiality issue, which more than likely would have led to the curious result that the information was significant to shareholders but, nevertheless, could be denied to them.50

2. Decisions During the SEC’s Policy Change.—Although the SEC’s policy began to change in 1973 to one encouraging disclosure of management’s projections, the courts have been reluctant to recognize the new policy in fact situations that arose before or during the SEC’s reformation of its views.51 Moreover, the SEC policy is permissive, and the courts seem reluctant to hold that disclosure is required under the antifraud provisions if a defendant has complied with all specific disclosure items mandated by SEC regulations. The courts remain troubled by the reliability issue and the difficulty in reviewing the subjective judgments that go into creation of predictive information, and seem concerned over imposing potentially enormous liability for failure to disclose such potentially uncertain information. Thus, most courts rely on the fact that the SEC merely has made disclosure of earnings projections permissible, and refer generally to the speculative nature of projections to hold that there is no obligation to disclose them.52


50. The Ninth Circuit, in discussing whether earnings projections that were publicly disclosed were false or misleading, stated: “Nor can there be any doubt that the forecast of earnings was a ‘material’ fact.... And generally earnings projections of a company constitute a prime factor in estimating the worth of its stock ....” Marx, 507 F.2d at 489.

51. Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1233 (1st Cir. 1984) (“[A]t the time the [defendant’s] proxy statement was issued [1976], the [SEC] frowned on such disclosures.”); Lewis v. Oppenheimer & Co., 481 F. Supp. 1199, 1208 (S.D.N.Y. 1979) (relying on SEC policy against disclosure at time proxy was issued, and stating that even SEC policy would permit such disclosure in 1979: “Financial forecasts or speculations are not required by any statute, case, S.E.C. rule or regulation.”).

52. See, e.g., Walker v. Action Indus., 802 F.2d 703 (4th Cir. 1986), cert. denied, 107 S. Ct. 952 (1987) (refusing to follow materiality standards announced by other circuits, see infra note 53, but finding no duty to disclose projections, based on five factors: absence...
Those cases that discuss the materiality issue in any depth tend to focus on the reliability question, echoing the SEC's early concern over the potential for investor misunderstanding. As a result, they generally enunciate standards that either balance the importance of the information against its uncertainty and its potential to mislead,

of specific disclosure requirement in the filing in question; SEC's policy reversal in experimental stage; general uncertainty of projections; potential to mislead investors; and impracticality of a duty to update; Biechele v. Cedar Point, Inc., 747 F.2d 209, 216 (6th Cir. 1984) (noting that the defendant's schedule 14D-9 contained all of the information required to be disclosed and that § 10(b) does not require volunteering of economic forecasts); Pavlidis, 737 F.2d at 1283 ("Federal securities laws do not require corporate management to speculate about future profitability in proxy statements... "); Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221 (9th Cir. 1980) (noting that "[the SEC does not require a company to disclose financial projections," and observing lack of evidence that the estimates in question were made with "such reasonable certainty even to allow them to be disclosed"); Marsh, 533 F.2d at 987 (noting that in the 1973 policy release, see supra note 16, the SEC stated that it "has never required a company to publicly disclose its projections and does not intend to do so now," and noting no authority for "the proposition that a failure to project higher earnings in a merger proxy statement is actionable under Rule 10b-5") (it is unclear whether any projections in fact existed); Mendell v. Greenberg, 612 F. Supp. 1543, 1550 & n.8 (S.D.N.Y. 1985) (noting that neither the SEC nor the Second Circuit have required inclusion of projections in proxy statements, that the SEC's safe harbor rule does not require disclosure, and that, in any case, plaintiff failed to indicate what statements were rendered misleading without the requested disclosure); Bradshaw v. Jenkins, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,719, at 97,909 (W.D. Wash. Mar. 9, 1984) (no duty to disclose estimates of future loan write-offs and litigation liabilities since "the SEC has not reached the point of requiring the disclosure of financial projections"); Caspary v. Louisiana Land and Exploration Co., 579 F. Supp. 1105, 1110 (S.D.N.Y. 1983), aff'd, 725 F.2d 189 (2d Cir. 1984) (concluding that the securities laws do not generally require disclosure of such necessarily speculative information, and that no statements were made that could be rendered misleading by failure to disclose existing predictions); Fisher v. Plessey Co., 559 F. Supp. 442, 450-51 (S.D.N.Y. 1983) (denying summary judgment for defendant on issue of whether company which made self-tender failed to disclose preliminary earnings reports, because they may be material if calculable with "substantial certainty," but granting summary judgment to defendant as to financial projections because projection disclosure is permitted but not required; characterizing the projections at issue as "conjecture, albeit highly competent conjecture"); Margolis v. Masters, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,855, at 90,289 (E.D.N.Y. Jan. 28, 1981) (failure to provide projection of profitability does not violate securities laws because a company is permitted to make projections "but it is not required to do so"); Billard v. Rockwell Int'l Corp., 526 F. Supp. 218, 221 (S.D.N.Y. 1981), aff'd, 683 F.2d 51 (2d Cir. 1982) (noting policy of requiring factual disclosure only and lack of cases imposing liability for failure to disclose projections or predictions where issue was failure to disclose market impact of announced insider tender offer); Lewis v. Oppenheimer & Co., 481 F. Supp. 1199, 1208 (S.D.N.Y. 1979) (noting that, in context of management buyout, financial forecasts are speculative and not required by any statute, case, SEC rule or regulation; only factual disclosure required); Straus v. Holiday Inns, Inc., 460 F. Supp. 729, 734 (S.D.N.Y. 1978) (noting that the SEC "permits" disclosure of projections, but that no court has imposed liability for failure to include them in a registration statement, therefore reading complaint as alleging failure to disclose facts in a registration statement on which a projection could be based).
or require a degree of certainty that brings the omitted information close to “hard,” factual information.\(^5\)

D. The SEC’s Early Approach to Asset Values

The SEC’s policy against disclosure of asset values developed in the same context and out of concerns similar to those that gave rise to its early prohibition on earnings projections. As Professor Kripke

53. Several cases directly discussed the materiality issue prior to the SEC’s policy change. In Alaska Interstate Co. v. McMillian, 402 F. Supp. 532 (D. Del. 1975), the court addressed a claim based on selective disclosure of projections. The court distinguished cases that had allowed such claims, observing that in those cases “reliability was not a substantial factor and the importance of the information to investors far outweighed any potential for misunderstanding.” Id. at 567. Although the Alaska Interstate court concluded that the general rule against soft information disclosure should control on the facts presented, it seemed to prefer a test for materiality of soft information that would balance investor need against the potential uncertainty of the projection. Id. at 567-68. In Beecher v. Able, 374 F. Supp. 347, 348 (S.D.N.Y. 1975), the court discussed whether disclosed earnings projections were false or misleading and concluded that before projections could be disclosed they must be based on facts that allow investors to conclude that the predicted outcome is “highly probable.”

Also, at least the Second Circuit would find earnings projections or preliminary information material in insider trading cases, without reference to SEC policy on corporate disclosures. See, e.g., Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980) (tip that earnings would be down, based on insider’s knowledge of preliminary figures, could be material information); SEC v. Lums, 365 F. Supp. 1046 (S.D.N.Y. 1983) (tip concerning corporate earnings projections was material). For a discussion of the basis for insider trading liability, see infra notes 228-29 and accompanying text for a discussion of the basis. Some courts, however, have viewed insider trading cases differently from cases of corporate disclosure, stating that information can be material at any earlier stage in an insider trading context. See infra text accompanying notes 301-07.

During or subsequent to the SEC’s policy change, several courts have more clearly enunciated materiality standards. See, e.g., Panter v. Marshall Field & Co., 646 F.2d 271, 292 (7th Cir.), cert. denied, 454 U.S. 1092 (1981) (since projections must be “reasonably certain” before they may be disclosed, failure to disclose five-year plan in letter to shareholders in opposition to outsider’s tender offer did not support 10b-5 claim in that it contained highly tentative projections prepared only for management); James v. Gerber Prods. Co., 587 F.2d 324, 327 (6th Cir. 1978) (no duty to disclose earnings figures in insider trading context because not calculable with “substantial certainty”); Froid v. Berner, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,201, at 95,942-43 (D.N.J. Dec. 19, 1986) (materiality of earnings projections sufficiently shown to defeat motion to dismiss, based on text enunciated by Third Circuit that weighs the potential aid the information will give shareholders against the potential harm it could do); Howing Co. v. Nationwide Corp., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,358, at 92,308 (S.D. Ohio Oct. 18, 1985) (“earnings and cash flow projections do not rise to the level of substantial certainty triggering a duty to disclose”) (citing Gerber Products); Fisher v. Plessey Co., 559 F. Supp. 442, 449-50 (S.D.N.Y. 1983) (raising issue as to whether preliminary earnings reports were calculable with “substantial certainty” and therefore material) (citing Gerber Products); infra notes 200-09 and accompanying text. See also Walker, 802 F.2d at 710 (though rejecting specific materiality tests, stating that “it would appear prudent to release only those projections that are reasonably certain”) (citing Panter).
explained: "The wild unorganized accounting of the 1920's frequently accepted purported values as the basis for security issues, and the result was widespread frauds, deception of investors and losses." In light of the SEC's preference for verifiable "facts," its concern for unsophisticated investors, and the legacy of value accounting, it is not surprising that the SEC opted for historical "cost accounting" for assets in financial statements.

In addition to concerns for reliability and for the unsophisticated investor, however, the SEC's position on accounting for assets arguably could be justified on relevancy grounds. Although the SEC never truly denied the relevance of earnings projections, some commentators advanced the proposition that asset values were irrelevant to investors in a going concern. Others argued that asset values may be as relevant as earnings projections since they in essence represent the present worth of future net cash flows. Additionally, asset values may provide information regarding leverage available to a company. It also can be asserted that existing share-

54. Kripke, Myths, supra note 6, at 1188.
56. See supra note 12.
57. Kripke, Myths, supra note 6, at 1189 n.155 ("[T]here is an argument of some plausibility—at least, this writer was once convinced of it—that the values of fixed assets which are not to be sold are of no relevance. Since the most important thing from the point of view of the investor is the proper determination of income, historical cost and not value is what is relevant because it is cost which should be spread into the income account through depreciation accounting."); Heller, supra note 7, at 308-10 (advancing going concern argument). See also cases cited infra note 141.
58. Kripke, Projections and Appraisals: Analysis of the Case Law, 7 SEC. REG. L. Rev. 93 (1976) [hereinafter Kripke, Projections and Appraisals] ("projections and appraisals . . . are basically the same problem from a different point of view. An appraisal, the current value of an earning asset, is the present worth of the projected future earnings from the asset.") (citing Kripke, Disclosure Policy, supra note 55, at 299-301). See also id. at 296 n.16 ("It isn't the amount of dollars of income that is significant, but rather the rate of earnings—earning power . . . . It needs also be emphasized that it is the percentage of earnings to the current value of the resources utilized, rather than to "cost" or "book value," that is significant.").(quoting W. Paton, Accounting For Goodwill, Accounting Research Study No. 10, 147-48 (1968)).
59. Mann, supra note 5, at 235 (arguing that asset appraisals are relevant even in selling documents, e.g., prospectuses: "unrealized appreciation is relevant in determining the corporation's ability to secure additional funds for expansion through future
holders should be informed of the true value of the assets in which they hold an interest since they could decide to take control of the company and realize that value through liquidation. These various arguments represent the ongoing dialogue between two separate viewpoints on the basic question of accounting for assets in financial statements: the SEC's approach based on historical cost (minus depreciation) and the view known as current value accounting.

Because the issue of asset valuations, unlike the dispute over earnings projections, is more closely tied to the basic accounting system adopted by the SEC, disclosure of asset appraisals or values was not advanced nor specifically addressed in the SEC's early efforts to provide a safe harbor for the use of certain soft information. In its 1972 release, announcing its rulemaking hearings on disclosure of soft information, the SEC stated that the hearings would focus on "projections and estimates of economic performance" and would not include consideration "of such subjects as valuation accounting."

The SEC's 1973 policy statement and the subsequent safe harbor releases focused on "projections of future economic performance." The final safe harbor rule does not directly cover appraisals. And the notorious note to rule 14a-9 under the Exchange Act, which originally listed as examples of potentially misleading statements in connection with a proxy solicitation "[p]redictions as to specific future market values, earnings or dividends," has been amended twice, leaving the reference to specific borrowing, . . . [and] may be more relevant in predicting future earnings than the cost or historical values reflected by the balance sheet") (footnote omitted); Kripke, Myths, supra note 6, at 1193 (discussing several arguments supporting the relevance of asset value disclosure even when a sale of assets is not imminent).

60. Kripke, Projections and Appraisals, supra note 58, at 98-102 (arguing that asset appraisals should be disclosed in various contexts, e.g., merger proxy statements, and may be relevant even when there is no likelihood of sale since disclosure could induce a third party to seek control in order to realize on the value of assets).


future *market values* as the sole example of potentially misleading predictions.66

Nevertheless, even during the early years of its prohibition on disclosure of earnings projections, the SEC argued in certain specific situations that asset values were relevant and, indeed, required disclosure by virtue of the antifraud provisions of the securities laws. While the SEC's bias against disclosure of soft information largely grew out of concern for protecting *buyers* from overly optimistic earnings forecasts and share valuations, the pressure to require asset value disclosure arose in situations in which existing stockholders were being asked to *sell* their shares or to change fundamentally the nature of their investment.67 Even in such situations, the concern for reliability and investor misunderstanding led to seemingly inconsistent positions by the SEC. As discussed below, the courts were not particularly receptive to this apparent conundrum, as they struggled to ensure fairness to shareholders as well as to management in light of the SEC's traditional approach to disclosure of asset values.

**E. Early Judicial Treatment of Asset Values**

Early cases in which the SEC and the courts expressed concern over undisclosed asset values usually involved insiders attempting to acquire control of those assets to capture the excess value for themselves. In 1947 the SEC obtained a permanent injunction against

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67. See Kripke, *Projections and Appraisals*, supra note 60, at 94-98; Kripke, *Facts*, supra note 55, at 1071-72. One SEC Chairman noted:

> where . . . [the SEC's] historical bias [against soft information] has really given way and where it is of great significance to investor relations people is when it has had the effect of under-informing existing shareholders by withholding from them management's opinions and judgments about the future. These shareholders are not necessarily buyers as are those to whom new issue prospectuses are addressed. They need information which will help them to decide whether to hold what they have or sell. If they are not given a full picture they may sell themselves out too cheaply. Thus, when we put restrictions on management passing along to stockholders information about appreciation in the value of assets, the prospects of new discoveries, the development of new technologies and methods and products, we may be putting existing shareholders at a disadvantage in their investment decisions and dealings with those who are able to acquire realistic information in the market place and elsewhere. Opinion, judgment and all future oriented information calls for prudence and care in developing the factual basis and drawing a conclusion but that is no reason for prohibiting it.

Standard Oil Company of Kansas and its president for alleged antifraud violations, based on their repurchase of Standard's stock in the open market and pursuant to an exchange offer without disclosing existing appraisals of the company's oil-producing properties, which greatly exceeded book value.\textsuperscript{68} The injunction was obtained by consent, without findings by the court. The SEC noted in its litigation release announcing the action that the appraisals were prepared by "qualified engineers" and "were required, accepted and relied on by certain banks" in connection with loans extended to the company.\textsuperscript{69} The SEC alleged a scheme to buy back Standard stock and merge the company into a private corporation owned by Standard's president. Although the defendants consented to the injunction, they noted in their Answer to the Complaint that they had conformed with accounting standards prevailing in the oil industry in preparing the balance sheet figures that were presented to shareholders.\textsuperscript{70}

Thus, the SEC early recognized that increased asset values could be important to selling shareholders and that issuers and insiders had a duty to disclose those values even though they had complied with accepted accounting standards, at least in situations

\textsuperscript{68} SEC v. Standard Oil Co. of Kansas, Litigation Release No. 388 (Feb. 26, 1947). The appraisals estimated a present value of 4 to 5 times the balance sheet amount of less than $4 million. They also estimated future net revenue of $33 million to $36 million.

\textsuperscript{69} Id.


In 1978, the SEC adopted disclosure requirements for oil and gas producers allowing use of a prescribed form of either the "full cost" or the "successful efforts" methods. Either method requires disclosure of the present value of future net revenue from the estimated production of "proved" oil and gas reserves. Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Activities, Securities Act Release No. 5966, [Accounting Series Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,275 (Sept. 12, 1978). Proved reserves are those able to be estimated with an acceptable degree of reliability based on actual production and other factors. See infra note 119. Oil and gas reserves present a special problem under the historical cost method of accounting for assets in that the full cost method usually involves listing these reserves at the combined costs of exploration and of acquiring land rights, a number bearing little relation to the value of the oil or gas which may in fact exist in the ground. This problem and the present SEC accounting methods for valuing oil and gas reserves are discussed at infra notes 170-172.
in which a plan existed to take control of the assets.\(^71\) Several early judicial decisions seemed to herald the development of a similar view by the courts.

In *Speed v. Transamerica Corp.*\(^72\) a controlling corporate shareholder purchased stock of the issuer pursuant to a written offer to minority shareholders, without disclosing a substantial appreciation in the value of the issuer's tobacco inventory.\(^73\) The defendant had been given a detailed inventory by the issuer showing its tobacco valued at existing market prices.\(^74\) The latest annual report of the issuer, which the plaintiffs alleged the defendant had "caused to be mailed" to shareholders,\(^75\) listed the inventory in the financial statements at average costs,\(^76\) the accepted accounting standard for SEC filings at the time.\(^77\) The court did not discuss the reliability of the inventory values given to the defendant, which were based upon readily determined market prices.\(^78\) The trial court found that the defendant violated section 10(b)\(^79\) and rule 10b-5\(^80\) in effecting the

\(^{71}\) *Standard Oil* did not involve a specific intent to liquidate the assets once control over them was acquired. Such an intent became a key element in the cases, discussed at infra notes 72-115 and accompanying text, in which several courts recognized an obligation to disclose the appreciated value of assets. Standard's assets consisted almost entirely of oil producing properties, *id.*, and thus were obviously the real target of the stock acquisitions, but there was no indication that the individual defendant intended to dispose of them or the reserves other than in the ordinary course of business. The case could thus be read as expressing a view by the SEC requiring value disclosures in every case where an insider seeks to take control of an issuer. The SEC later limited its view to cases involving an intent to liquidate the assets acquired. *See infra* text accompanying note 107.


\(^{73}\) *Id.* at 828.

\(^{74}\) *Id.* at 823, 828.

\(^{75}\) *Id.* at 812.

\(^{76}\) *Id.*

\(^{77}\) *Id.* at 818 n.6. The court noted that it was "of some importance" that the SEC did not object to the method of carrying the inventory when reviewing a registration statement relating to the acquisition, which was later withdrawn. The SEC did request a tabulation showing liquidation value of the stock to be surrendered. The SEC, which appeared as amicus curiae, pointed out in oral argument that the SEC's then rule 3-06 required disclosure of "material facts not revealed by accepted accounting practices." *Id.* That rule, currently Securities Act rule 408, 17 C.F.R. § 230.408 (1986), provided for disclosure of material facts necessary to make statements made not misleading.

\(^{78}\) 99 F. Supp. at 823.

\(^{79}\) Section 10(b) of the Exchange Act provides:

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

> (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so regis-
stock purchases without disclosing the increased inventory values, in light of the defendant's undisclosed preexisting intent to liquidate the issuer.\textsuperscript{81} The court emphasized that the "crucial finding" was that at the time of the offer to shareholders the defendant planned to "capture" the increased value of the inventory by "merging, dissolving or liquidating" the issuer.\textsuperscript{82}

A result similar to \textit{Speed} was reached in \textit{Feit v. Leasco Data Processing Equipment Corp.},\textsuperscript{83} involving disclosure in a registration statement filed under the Securities Act. The dispute centered on Leasco's

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1968 exchange offer for the common stock of Reliance Insurance Company. The district court noted that the "crucial element" of the takeover bid was Leasco's interest in gaining access to Reliance's "surplus surplus." That term refers to the capital excess of an insurance company over that required by state regulation to be maintained as reserves to guarantee the integrity of the company's insurance operations. The court stated that several reports concerning the value of Reliance's surplus surplus "provided the impetus" for Leasco's takeover bid. One report, prepared by an outside analyst and generally available in the financial community, valued Reliance's redundant capital at $80 million; another, prepared by a Leasco officer, estimated that capital as between $100 million and $125 million. Leasco's plan was to form a holding company for Reliance into which the surplus surplus could be transferred to escape the restrictions of insurance regulations.

After discussions toward a friendly merger with Reliance proved futile, Leasco commenced a hostile tender offer. Reliance's management aggressively opposed the bid. After extended discussions, Reliance entered into an agreement with Leasco not to oppose the takeover or to impair existing surplus surplus, in return for certain concessions to management.

In its registration statement covering the shares to be exchanged, Leasco did not specifically indicate its plan to use surplus surplus, but stated an intention to pursue a plan previously announced by Reliance to form a holding company for which Reliance would "provide the maximum amount of funds legally available . . . ." The district court found that Leasco's failure to include "an
estimate-or-range-for surplus surplus” in the registration statement constituted the omission of a material fact necessary to make other statements made not misleading, thus giving rise to an action under section 11 of the Securities Act.92

Interestingly, the court did not specifically state that the particular estimates that were available had to be disclosed.93 This may be due to the evidence offered concerning their unreliability, although the court’s discussion of materiality does not evince any particular concern for the reliability of either the existing estimates or any that Leasco may have been required to prepare to avoid liability.94 In fact, the court’s discussion of materiality did not focus on the unreliability issue, but rather on the degree of certainty required concerning the effect of the omitted information on a shareholder’s decision to tender.95 The court seemed to assume reliability based on the effect that the available estimates of surplus surplus had on Leasco in reaching its decision to acquire Reliance.96

vide “more flexible operations... and... utilization of financial resources through the Holding Company concept.” Id. at 554. Thus, both parties were vague in their disclosure and neither directly discussed the anticipated use of surplus surplus.

92. Id. at 575. Section 11 provides for a private right of action against issuers and others, under various circumstances, for false or misleading statements which are included in a registration statement.

93. Note that the court held that the violation occurred in the failure to include “an estimate-or-range-of surplus surplus” in the registration statement. Id. at 575. The court stated that “Leasco could have used [the available] estimates or commissioned an independent computation based on public information.” Based on these statements, the source of a duty to disclose is unclear under the court’s analysis. Rather than finding that disclosure of existing estimates was necessary to avoid rendering a statement misleading, it seems that the court may have required Leasco actually to create estimates for disclosure regardless of what was said. The court does cite to language in the registration statement that refers implicitly to surplus surplus, see supra text accompanying note 91, but neither its holding nor reasoning ties the duty to any omission in that language. The court does not discuss the notion of an implied representation of fair price. The remaining possible rationale for the court’s decision is insider trading principles, but even such notions would not require an insider to create material information to disclose.

94. See id. at 552-54 (discussing uncertainties in calculation). Concerning the notion that Leasco may have been required to create an estimate, see supra note 93.

95. Id. at 569-75. The finding of materiality rested primarily on evidence that the quantity of surplus surplus was so important to Leasco in its plan to capture it for use outside of Reliance and that securities professionals were then expressing significant interest in such situations. Id. at 574. The first factor could, of course, go to the reliability of existing estimates. The court also found it significant that after the acquisition, when Leasco filed a registration statement offering its own securities, it included an estimate of surplus surplus. Id.

96. See, e.g., id. at 572 (noting that the surplus surplus was so important to Leasco that it protected it by way of a clause in its agreement with management). The reliability issue was raised, but the court viewed it only as a possible statutory defense under § 11,
The *Feit* case is similar to *Speed* because of a failure to disclose asset values by one who could be considered an insider and whose intent was to capture a valuable asset. The plan to spin-off Reliance's highly liquid surplus surplus, in essence, constituted a "liquidation" of the asset. As in *Speed*, the court was not concerned with the reliability of existing valuations, but with several important differences in the valuations. The valuation in *Speed* apparently was made by calculating inventory amounts at easily determined existing market prices, but the computation in *Feit* required projections and subjective judgments. The *Feit* defendants argued that such a computation required missing inside information to be reliable, but to no avail. The *Feit* court's lack of concern for reliability seemed to emanate from the apparently great degree of reliance by Leasco on the existing estimates. Both the *Speed* and the *Feit* courts applied existing standards of materiality without any special test of reliability.

Two years later, although presented with a similar situation, the Second Circuit rejected the approach of *Speed* and *Feit* in the landmark case of *Gerstle v. Gamble Skogmo, Inc.* The defendant corporation had acquired a controlling interest in General Outdoor Advertising Company (GOA), and thereafter placed its personnel in various director and management positions. Defendant's representatives then spearheaded an announced plan to sell GOA's "less profitable" advertising plants. In pursuit of this goal GOA's personnel prepared several internal studies showing estimated sales values of GOA's plants far in excess of the recorded book value.

When the defendant determined to merge with GOA in a stock-for-stock exchange, GOA filed a proxy statement that failed to dis-
close the existing GOA valuations, but included a statement that previous sales "demonstrated that the market value of a substantial portion of the company's plants was considerably in excess of book value." The district court found that the GOA proxy violated section 14(a) of the Exchange Act and rule 14a-9 by failing to disclose adequately the market value of GOA's plants and the defendant's intent to sell those plants.

The Second Circuit held that the proxy was misleading in its failure to disclose adequately that the defendant intended "to pursue aggressively" a policy of selling GOA's plants. But it declined to require disclosure of the plant valuations.

The SEC had filed an amicus brief in the district court. It took the position that although disclosure of appraisals generally is not allowed in a merger proxy, when there is an intent to liquidate and assets are reflected at substantially lower than current liquidating value, existing valuations must be disclosed if they have been made by a qualified expert and have a sufficient basis in fact, to avoid rendering the proxy misleading under rule 14a-9.

The court of appeals, however, referred to the SEC's longstanding policy against disclosure of asset appraisals and to "the policy embodied in the note to rule 14a-9 [which] has consistently been applied to bar the disclosure of asset appraisals..." Based on this, the court noted that it had long been an "article of faith" among securities lawyers that asset appraisals could not be disclosed in a proxy statement.

103. Id. at 1288. The proxy also disclosed the price received on several prior plant sales and the profit from those sales.

104. Id. at 1291.

105. Id. at 1295, 1298. The proxy statement rather disclosed that GOA intended to continue in business after the merger, although additional plant sales would be considered. Id. at 1288.

106. Id. at 1294.

107. Id. at 1291-92. The SEC's position was more limited than its position in Speed, see supra notes 77, 82, in that it would only allow disclosure of appraisals made by a "qualified expert." If that became the rule, it obviously would be easy to avoid since it would only apply to existing appraisals, and thus the acquiring party could simply avoid using appraisals by a qualified expert. The valuations in Speed and Feit would probably not qualify for disclosure under such a standard. See infra note 115.

108. Id. at 1292. The court recognized that the note does not specifically refer to asset appraisals but rather to predictions of "future market values." Happily, for the defendant, when the issue of whether the proxy should contain discussion of potential profits from future plant sales was brought to the attention of the Commission's Division of Corporation Finance, a supervisor noted his belief that such disclosure would be contrary to SEC policy. Id. at 1288-99.

109. Id. at 1293.
The court rejected the SEC's characterization of its prior approach to appraisals as requiring a case-by-case analysis, and declined to view Speed as authority for its amicus position, since that case involved the value of an actively traded commodity the market value of which could be ascertained with "reasonable certainty on the basis of actual sales." Thus, since no true "appraisal" of market value was required in Speed, the court did not see the result in that case as overcoming the SEC's policy against appraisal disclosure. The court noted that the SEC was in the process of reexamining its general policy against soft information disclosure and that the Commission might determine that the policy deprived potential selling shareholders of "valuable information." But in the final analysis, the court concluded that "we would be loath to impose a high liability on [defendant] on the basis of what we perceive as a substantial modification, if not reversal, of the SEC's position ... by way of its amicus brief . . . ." The Second Circuit thus rejected the SEC's call for asset appraisals in a situation similar to Speed and Feit. It did so without discussing the materiality or the reliability of the appraisals at issue.

One significant problem area, in which the SEC's seemingly inconsistent policy may have contributed to the Second Circuit's rejection of the SEC's position in Gerstle, is valuation of oil and gas reserves. The SEC's amicus position in Sunray Dx Oil Co. v. Helmerich & Payne, Inc. exemplifies the difficulty in this area. That case involved a merger of Sunray with Sun Oil Company. The district court held that the merger proxy was false and misleading in that it failed to disclose, among other things, information concerning oil reserves on properties in which Sunray had recently acquired an interest. The Tenth Circuit rejected this holding based essentially

110. Id.
111. Id.
112. Id.
113. Id. at 1294. Although the court noted that the SEC's policy against appraisal disclosure was based on its distrust of their reliability, it did not separately discuss the reliability of the appraisals at issue.
114. Id. In a footnote, the court stated that the Commission should proceed by "rule or a statement of policy" in order to publicize the change more widely. Id. at 1294 n.13.
115. The court noted that even if it accepted the SEC's position, it would not necessarily require disclosure of the appraisals at issue, because they were internally prepared without the assistance of expert appraisers. Id. at 1292 n.10. See supra note 107.
116. 398 F.2d 447 (10th Cir. 1968).
117. Id. at 450. The Tenth Circuit stated that it appeared that the trial court had held that the omitted material information related to the successful oil operations on a contiguous oil property, owned by a third party, but that the trial judge had also alluded to
on the SEC’s amicus position that only estimates of “proved” reserves could be included in SEC filings. The court noted that proved reserves are those considered proved to a “high degree of certainty” by actual production or various accepted tests. “Possible” and “probable” reserves are less certain and are considered “unproved.” The court concluded that the “sharp conflict” in the expert testimony demonstrated that the reserves in question were outside of the “proved” category.

The SEC’s exposition of its policy concerning oil reserve disclosure, adopted by the Tenth Circuit, was similar to its concern for the uncertainty involved in earnings projections, but included a special degree of concern for unsophisticated investors. The SEC noted that it has “always been very careful in its scrutiny of oil reserves because their proper valuation requires a type of knowledge seldom possessed by those outside of the petroleum industry,” and that investors “would ignore or misconstrue the technical but extremely significant difference between ‘proved’ and ‘probable’ reserves.”

The SEC’s position against disclosure in Sunray was noted by

the failure of Sunray to advise its stockholders of the increased value of its own property. The Tenth Circuit held that based on either foundation, the trial court had erred. Id. The SEC also noted that the district court’s holding was unclear as to the required disclosure and construed the opinion as “requiring the inclusion in the defendants’ proxy material of figures representing number of barrels of Sunray’s “probable” reserves and the anticipated future income from those reserves.” Brief for the Securities and Exchange Commission as Amicus Curiae at 2, Sunray Dk. Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) [hereinafter Amicus Brief] (emphasis added). The latter factor, estimated future earnings from reserves, is usually what is referred to when speaking about the “value” of oil or gas reserves.

118. 398 F.2d at 450. The SEC’s position in Sunray breaks down into two parts. First, an estimate of reserves stated in number of barrels was allowable in SEC filings but only as to “proved” reserves, because any such quantification creates “an aura of certainty, which, except in the case of proved reserves, the Commission believes would be misleading to all but sophisticated investors.” Amicus Brief, supra note 117, at 10. Second, any estimate of future earnings—even from proved reserves—was not allowed. This result was reached by reference to the SEC’s then-existing, broader policy against earnings projections. Id. at 11.

119. 398 F.2d at 450. The SEC, noting that any statement on reserves is necessarily an estimate, defined “proved” reserve as follows: “Proven reserves as to which definite estimates of amounts are appropriate may be developed or undeveloped. The term ‘proven developed reserves’ is used for producing wells where there are sufficient engineering and geological data of oil or gas that is reasonably certain to be ultimately produced by such wells.” Amicus Brief, supra note 117, at 8 n.3 (quoting In re Great Sweet Grass Oils, Ltd., 37 S.E.C. 683, 693 n.11 (1957)) (emphasis in original).

120. 398 F.2d at 450.
121. Id. at 451.
122. Amicus Brief, supra note 117, at 6.
123. Id. at 5.
the Second Circuit in *Gerstle*. The *Gerstle* court rejected the SEC's attempt to distinguish the need for disclosure in *Gerstle* as calling for only "present liquidating values," whereas in *Sunray* the disclosure at issue involved, essentially, the projection of future earnings based upon reserve estimates.\(^{124}\) The *Gerstle* court believed that there was little difference between estimating the selling value of assets in a present liquidation mode and estimating revenues from an ordinary course disposal of a commodity such as oil.\(^{125}\) This may or may not be true, depending on the projected time periods and the complexity of the underlying assumptions involved. Moreover, the SEC's position in *Sunray* does in fact allow disclosure of soft information. Estimating the quantity of even proved reserves, as required by SEC disclosure policy for oil and gas concerns at the time, involves subjective judgments. Indeed, it would appear to be more difficult to estimate the very existence of such an asset than to estimate the selling value of an asset that is known to exist. Taking an estimate of even proved reserve quantities, let alone unproved reserves, to the next level—*i.e.*, estimating future net revenues from extraction of those reserves—would have contravened the SEC's policy at the time of *Sunray* against earnings projections.

The SEC's positions in *Sunray* and *Gerstle* demonstrate the difficulty inherent in applying the SEC's early, blanket prohibition on disclosure of earnings projections and asset appraisals. Resolution of the asset appraisal problem is more difficult because even after doing away with its prohibition on earnings projections in filings, the SEC was confined by its strict cost-based approach to accounting for assets in financial statements.\(^{126}\) The years following *Gerstle* have seen a slow evolution in this area, as well as more formal policy statements concerning asset value disclosure in liquidation and merger situations. This will be discussed in part *F*, below.

While the district court's opinion in *Gerstle*, finding a duty to

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124. *Gerstle*, 478 F.2d at 1292.

125. *Id.* The Second Circuit cited to Professor Kripke's analogy of an appraisal as the present value of future net earnings from an asset to justify its refusal to distinguish the asset appraisals in *Gerstle* from the cash flow projections in *Sunray*. *Id.* (citing Kripke, *Myths*, supra note 6, at 1200). Indeed, the Second Circuit noted that the appraisals in *Gerstle* "hinged" on the ability to pay the purchase price out of projected earnings. *Id.* at 1292. Although the exact basis for the appraisals in *Gerstle* is not disclosed, the defendants made eight-year earnings projections for individual plants available to prospective purchasers, which indicated that if 29% of the purchase price were paid in cash, the remainder could be paid out of future cash flows resulting from depreciation of the stepped-up basis available to the purchaser. *Id.* at 1285 n.2, 1292.

126. See supra note 55 and accompanying text.
disclose asset values, was on appeal to the Second Circuit, an opinion rejecting an obligation to disclose such values was issued by the Third Circuit in *Kohn v. American Metal Climax, Inc.*\(^{127}\) American Metal Climax, Inc. (AMAX) owned 42.3% of RST, a Zambian corporation engaged in copper mining and related activities.\(^{128}\) While RST was negotiating a forced sale of a majority of its mining properties to a government-controlled entity, pursuant to a nationalization policy in Zambia, AMAX approached it to discuss a merger.\(^{129}\) Under the proposal, RST's remaining non-nationalized assets, consisting of, among other things, $60 million in cash, would be externalized by transfer to a non-Zambian entity.\(^{130}\)

In arriving at a value for the consideration to be offered to RST's shareholders, which was to consist of AMAX debentures and warrants, RST and its advisers negotiated with AMAX over values to be assigned to RST's assets.\(^{131}\) These valuations were not disclosed in RST's proxy statement seeking approval of the merger.\(^{132}\) The proxy did include the fairness opinion of RST's investment bankers.\(^{133}\) The district court had found that a "clear presentation" of the values assigned to RST's assets and the basis for those values were "crucial" to a shareholder's decision.\(^{134}\) The district court held that this omission was material and violated rule 10b-5.\(^{135}\)

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130. *Kohn*, 458 F.2d at 259.
131. *Kohn*, 322 F. Supp. at 1345-48. In the merger as eventually effected, AMAX issued $76.2 million of its debentures and warrants to the remaining RST shareholders. RST's investment bankers valued the non-AMAX stockholder's interest in the non-nationalized assets at $75.2 million. Id. at 1345. It is not clear whether this latter figure was disclosed in the proxy.
132. Id. at 1361.
133. Id. at 1363. The district court found that the failure to highlight sufficiently the fact that the investment bankers did not perform an independent evaluation of several important assets violated rule 10b-5 in light of the prominent display of their fairness opinion. Id. at 1354, 1363. This holding was upheld by the Third Circuit. *Kohn*, 458 F.2d at 268.
134. *Kohn*, 322 F. Supp. at 1361. "Proxy materials" were sent to RST shareholders, although the SEC's proxy regulations apparently were inapplicable. RST was a Zambia corporation and did not, apparently, have securities registered under § 12 of the Exchange Act, *supra* note 3. See 322 F. Supp. at 1336.
135. Id. at 1361-62. The district court's 10b-5 findings involved disclosure in an Explanatory Statement and Appendices sent to RST shareholders by RST. The district court found that AMAX, although not a majority shareholder, effectively controlled RST and the outcome of the merger negotiations because of its stock interest and domination of the RST board of directors. Id. *See also* id. at 1352 ("Although it seems clear that
The Third Circuit affirmed the district court's finding of a violation of rule 10b-5 in various aspects, but rejected its holding that asset values should have been disclosed. The court discussed this latter issue in a single paragraph. It simply noted the SEC's traditional policy discouraging soft information in proxy materials, and concluded that "the general rule should apply here." The apparent basis for this conclusion was that "[n]o truly reliable estimates of value ever materialized." The Third Circuit's belief concerning reliability stemmed from the fact that the available figures were advanced during negotiations as part of the parties' bargaining strategies.

The facts in Kohn differ significantly from those in Speed, Feit, and Gerstle. Speed and Gerstle both involved failure to disclose existing asset values in light of an undisclosed intent to liquidate those assets. Feit was similar in that the inadequately disclosed, intended use of surplus involved a spin-off of that asset, which effectively made it "liquid," i.e., readily usable.

In Kohn, however, the assets acquired were to be used in a going concern. Asset values were assigned solely to determine the exchange ratio. In such a context, many of those values were based on projected earnings. Valuations to negotiate a merger price no...
doubt are common. Thus, if the district court's opinion in *Kohn* had stood, it might have been susceptible to a reading requiring disclosure of the basis for determining a price, including earnings projections, in most merger cases. Yet that opinion seems more limited since it involved, in the district court's view, a controlling shareholder taking advantage of its influence by using the lowest values available to impose an unfair price on noncontrolling shareholders, without disclosing existing higher values. This was still a step up

141. In situations where the acquirer intends to continue the operations of the target, courts generally have held that, regardless of reliability or SEC policy, disclosure of asset values is not required because they are viewed as irrelevant. See, e.g., Seaboard World Airlines v. Tiger Int'l Inc., 600 F.2d 355 (2d Cir. 1979) (when market price for stock is available, disclosure of other factors going to asset value is not required if target is to be operated as a going concern); Gerrity v. Chapin, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,241, at 96,717 (S.D.N.Y. Jan. 9, 1980) (disclosures of asset values not required in going concern situation in which proxy proposed equity investment and management agreement by outsider); Christopher v. Time Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,056, at 97,690 (S.D.N.Y. Mar. 31, 1975) (finding no obligation to disclose asset value in merger situation; but conceding need to reevaluate SEC policy concerning valuation of assets of "ongoing concern"); Madonick v. Denison Mines, Ltd., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,550, at 95,907, 95,910 (S.D.N.Y. May 2, 1974) (relying on *Gerste* to hold that there is no obligation to disclose replacement value of assets in anticipated going concern situation even where plaintiffs claimed that they might have rejected merger and sought complete liquidation or a more favorable exchange ratio; however, disclosure of value of tax credit to acquiror may be required); *In re Brown Co. Sec. Litig.*, 355 F. Supp. 574, 584 (S.D.N.Y. 1973) (holding unsupported estimates of value not material in merger where going concern is anticipated). But cf. Texas Partners v. Conrock Co., 685 F.2d 1116, 1121 (9th Cir. 1982) (holding that management proxy relating to antitakeover proposals may have required general statement that assets were undervalued as relevant to shareholders' evaluation of effect of proposals on issuer's attractiveness as a takeover candidate); Evmar Oil Corp. v. Getty Oil Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,358, at 93,228-29 (C.D. Cal. Mar. 17, 1978) (refusing to dismiss or to grant summary judgment because the court could not say that failure to disclose recent appraised values relating to exchange ratio in merger was not material in light of what was said regarding per share high and low prices and book value of stock being acquired); Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 819 (D. Del. 1974) (calling for a case-by-case determination as to disclosure of asset values). To recognize that asset values should be disclosed in a merger situation where a going concern is contemplated would come close to admitting the need for valuation accounting in general. The SEC's proxy rules do not specifically require disclosure of asset values in a normal merger situation. See SEC regulation 14A, 17 C.F.R. §§ 240.14a-1 to .14a-13 (1986).

142. See supra note 135. This position raises the issue, discussed above in connection with the *Speed* decision, whether a failure to disclose the unfairness of a transaction or, at least, to disclose facts indicating that unfairness, constitutes an antifraud violation. See *Sante Fe Indus. v. Green*, 430 U.S. 462 (1977) (mere breach of fiduciary duty or unfairness not actionable under § 10(b) and rule 10b-5). See also SEC schedule 13E-3, 17 C.F.R. § 240.13c-100, item 8 (1986) (requiring disclosure of factors bearing on fairness of certain transactions or of the consideration involved); SEC schedule 14A, 17 C.F.R. § 240.14a-101, item 15.
from Speed and Feit, in which the holdings were clearly limited to situations involving an intent to liquidate.

With the court of appeals' decisions in Kohn and Gerstle, the viability of the Speed and Feit opinions was largely vitiated, and the SEC's apparent attempt to establish, by its amicus positions in Speed and Gerstle, a liquidation exception to its general rule against disclosure of asset appraisals was largely forestalled. Thereafter, the SEC issued various policy statements and rules that clarified, to some extent, its position in various situations.

F. Recent SEC Policy Statements on Disclosure of Asset Values

As the SEC focused its policy reevaluation concerning soft information on disclosure of earnings forecasts and struggled to develop a judicially acceptable policy on asset value disclosure in merger situations such as those involved in Speed and Gerstle, a particular type of corporate buyout transaction in which management interest played a key role appeared prominently on the scene. Low stock prices and a variety of other economic factors in the mid 1970s contributed to the attractiveness of what became known as the leveraged buyout. Leveraged buyouts involve financing the purchase of an issuer's assets or of a controlling interest in the issuer by leveraging the assets over which control is sought. Management involvement in these transactions as part of the purchasing group and as the recipient of various tax advantages, often unavailable to other shareholders, led to SEC concern over potential unfairness to outside shareholders and over the lack of disclosure of increased asset values available for use in financing the transaction.

143. See e.g., A. Borden, Going Private, 3-9 to -15 (1986) ("when the going private phenomenon first came to public attention in the mid-1970s, most transactions involved majority stockholders of small public companies who, disappointed in the public market, perceived in depressed market conditions an opportunity to resume the entire ownership of their companies"); discussing the advantages to majority shareholders in general); Dannen, "LBOs: How Long Can This Go On?, INSTITUTIONAL INVESTOR, Nov. 1986, at 151 (describing the field of leveraged buyouts as an "explosion" which, in scarcely more than twenty years, has seen the size of the largest deals grow from $14 million to over $13 billion, with institutional investors playing an ever-larger role and making "a lot of people wonder whether the shareholders in companies that go the LBO route aren't left holding the short end of the stick"). See also Going Private Transactions, Exchange Act Release No. 14,185, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366 (Nov. 17, 1977) (discussing depressed market conditions and other factors contributing to the rise in such transactions).


145. See A. Borden, supra note 143, at 2-7 to -10, 2-13 to -16; Exchange Act Release
were among the primary concerns expressed in a series of SEC enforcement actions in the late 1970s involving leveraged buyouts, and in the SEC’s proposal and final adoption, in August 1970, of rules 13e-3 and 13e-4 under the Exchange Act, governing “going private” transactions and issuer tender offers.

In February 1979, before the adoption of rules 13e-3 and 13e-4, the Commission responded to disclosure problems in connection with leveraged buyouts by authorizing its Division of Corporation Finance to publish the latter’s views and practices in administering the proxy disclosure rules in the context of such transactions.

In the sale of assets release the Division of Corporation Finance


146. See, e.g., Spartek, supra note 145 (finding failure to comply with § 13 of the Exchange Act in failure to file timely form 8-K concerning transaction; expressing concern over, among other things, failure to disclose in proxy the value of certain assets, including gas reserves, and the tax and employment advantages accruing to management); Woods, supra note 145 (finding failure to comply with §§ 12 and 13 of Exchange Act; expressing concern over, among other things, failure to disclose in proxy the value of certain assets to be sold, the purpose of the transaction, and the failure of investment bankers, who gave fairness opinion, to explore other alternatives).

147. 17 C.F.R. § 240.13e-3 (1986). Rule 13e-3, in general, makes it unlawful for an issuer with equity securities registered under § 12 of the Exchange Act or any affiliate of such issuer, to engage in a “Rule 13e-3 transaction,” unless it complies with specific filing/disclosure requirements with respect to the transaction. 17 C.F.R. § 240.13e-3(b)(2). Rule 13e-3 transactions, essentially, are certain types of transactions by the issuer or its affiliates that are designed to ensure, or make it likely, that the issuer’s securities will cease to be publicly traded or that the issuer will no longer be subject to the periodic reporting requirements of the Exchange Act. See 17 C.F.R. § 240.13e-3(a)(3).

The rule also contains an antifraud provision which essentially tracks the language of rule 10b-5. The rule’s prohibition, however, operates in connection with a rule 13e-3 transaction for an issuer with equity securities registered under § 12 of the Exchange Act or that is a closed-end investment company registered under the Investment Company Act of 1940, or an affiliate of such issuer. 17 C.F.R. § 240.13e-3(b)(1).

148. 17 C.F.R. § 240.13e-4 (1986). Rule 13e-4 is similar in structure to rule 13e-3 in that it also has filing disclosure requirements and an antifraud provision, 17 C.F.R. § 240.13e-4(b)(1)-(2), but which apply to an “issuer tender offer” as defined at 17 C.F.R. § 240.13e-4(a)(1)-(2).


described certain "novel, multistep sales of asset transactions" that had been proposed in proxy solicitations. The described transactions involved the cash sale of substantially all of an issuer's assets to another company that intended to continue the issuer's business under its prior name and to retain the issuer's management under long-term employment contracts. When a significant amount of the purchase price of the assets was borrowed, the assets to be purchased were usually directly or indirectly pledged to secure repayment of a loan. In some cases, the selling issuer became an investment company that thereafter invested in tax-exempt securities; in others, the issuer resold its post-sale assets (cash) to a tax-exempt bond fund in return for shares of the fund. These transactions often were intended and were structured to benefit certain large shareholders who were in high tax brackets and held shares with a low tax basis.

The Division expressed concern in the release that as a result of management's interest in the outcome of such a proposed transaction, "the highest price for the (issuer's) assets may not be obtained." The staff referred to item 16 (now item 15) of schedule 14A under the Commission's proxy regulations, requiring a brief description of "the facts bearing upon the question of fairness of the consideration" in transactions involving the acquisition or disposition of property, to note:

Under certain circumstances, it would be appropriate to disclose information known to management about any assets the fair market value of which is materially greater than their book value and which are (i) not necessary to . . . operations as a going concern and which could be sold by the [purchaser] . . . or (ii) to the knowledge of management are material to [any] lender's decision to finance the purchase price.

151. Id. at 17,621-23. The Division noted: "In some instances employment and other arrangements . . . may be substantially equivalent to ownership interests, . . . " such that the purchaser becomes an affiliate of the seller. Id. at 17,621-24 & n.8.
152. Id. at 17,621-23.
153. Id.
154. Id.
155. Id.
157. Exchange Act Release No. 15,572, supra note 144, at 17,621-6 (emphasis added). The Division noted that in connection with some transactions, independent appraisals had been obtained and disclosed and that the Commission in Woods, supra note 145, had
Although the SEC's staff did not identify specific circumstances that might render value-related disclosure "appropriate," the described situations differ from the situations involving an immediate intent to liquidate such as in *Speed* and *Gerstle*. Yet the policy expressed in the release is consistent with the SEC's position in *Speed* and *Gerstle*, although on a broader scale. That is, although specific value disclosure is not mandated in the sale of assets release, there is concern for situations in which asset values are important to the purpose or the success of the transaction, and therefore to evaluation of the fairness of the consideration paid, even when there is no intent to liquidate. Interestingly, no guidelines were discussed concerning the reliability or materiality of value information that might be disclosed in such contexts. When the SEC adopted rule 13e-3 and schedule 13E-3 in 1979,158 a specific disclosure item was included that requires a summary of any appraisal received from an outside party if the appraisal is materially related to any transaction covered by the rule.159

One year after the 1979 sale of assets release, the SEC authorized an interpretative release (1980 proxy release) concerning proxy contests in which a principal factor was "the disposition of some or all of an issuer's assets or outstanding stock with the proceeds to be made available to shareholders."160 The subject proposals had as a common factor the premise that the existing market price of the issuer's securities did not reflect the value that could be realized through liquidation.161 In connection with such proposals, it was noted, the sponsors projected the dollar amount per share that would result from effectuation of the proposal. In marked contrast to the earlier interpretation of the note to rule 14a-9 as forbidding all predictions of future market value in proxy materials, the SEC's staff noted its concern that the parties to such contests "may not engage in a thorough debate of the merits of such valuations..." due to, among other reasons, the perception of serious risk of liability in attempting to forecast future values and the limited time avail-

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expressed concern about full disclosure. *Id.* at 17,621-27 & n.22. It also noted that the antifraud provisions may necessitate, under certain circumstances, disclosure in addition to that mandated by specific item requirements in schedule 14A or by the proxy rules.

158. See *supra* notes 147, 149.

159. 17 C.F.R. § 240.13e-100, item 9 (1986).


161. *Id.* at 17,621-12.

162. *Id.*
able in which to formulate an estimate. The release was addressed to management’s inclusion of or opposition to valuations in proxy materials. The SEC’s staff did warn that such information was “only appropriate and consonant with Rule 14a-9 . . . when made in good faith and on a reasonable basis . . .” and with adequate disclosure concerning the basis for and the limitations on any projected realizable values. Nevertheless, the release implicitly recognized that rule 14a-9 is not a total prohibition on such disclosure and that it may be desirable to debate fully asset values in certain situations. The 1980 proxy release, therefore, memorializes a dramatic departure from the absolute prohibition on value disclosure that the Gerstle court saw as existing under the note to rule 14a-9.

Indeed, during the time between Gerstle and the 1980 proxy release the SEC and the accounting profession took significant steps toward supplementing the SEC’s traditional, historic-cost-based financial statement requirements with value-related disclosure for certain large issuers. Specifically, the SEC and the accounting profession embraced replacement-cost disclosure in response to the inadequacy of historic-cost accounting for reflecting the effects of inflation and changing prices on earnings and assets. Although

163. Id. The Division noted that the usual expectation would be that the interests of the opposing parties “will generally assure a full airing of the principal issues . . .” Id.

164. Id.

165. Id. at 17,621-12 to -13. In fact, in a recent amicus brief by the United States, in which the SEC participated, the 1980 release is described as requiring appraisals in certain proxy contests:

The Commission in 1980 issued a release reflecting the staff’s insistence upon the disclosure of good-faith appraisals made on a reasonable basis in proxy contests where the principal issue is the liquidation of all or a portion of the issuer’s assets. SA Rel. No. 16833 (May 23, 1980); 45 Fed. Reg. 36374 (1980). Brief for the United States as Amicus Curiae at 11 n.9, Radol v. Thomas, 772 F.2d 244 (6th Cir. 1985) (petition for writ of certiorari), cert. denied, 106 S. Ct. 3272 (1986) (emphasis added). Certiorari was denied in Radol on the issue of the materiality of asset appraisals under the antifraud provisions of the securities laws. See infra text accompanying notes 210-214.

166. “Replacement cost” refers to a method of “current cost” accounting which seeks to measure the value of existing assets by reference to the current cost of replacing them with identical assets or equivalent assets, if the former are unavailable or economically unfeasible. See Burton, Palmer & Kay, Handbook of Accounting and Auditing, ch. 8, at 12-13 (1981) [hereinafter Handbook].

167. In 1976 the SEC adopted rule 3-17 under regulation S-X. Accounting Series Release No. 190, 41 Fed. Reg. 13,596 (1976). Regulation S-X is the repository of the SEC’s requirements, including form and content, for financial statements filed under the various statutes which it administers. 17 C.F.R. Part 210 (1986) (regulation S-X). See supra notes 2, 3. Under rule 3-17 certain large issuers were required to estimate the current replacement cost of inventories and the current cost of replacing property,
the purpose and result of replacement-cost disclosure are somewhat different from true "fair value" accounting, \(^\text{168}\) the experiment with

plant, and equipment with assets of equivalent productive capacity. Sales cost and depreciation expense were also computed based on the current replacement of the goods and services sold and the cost of replacing productive capacity (i.e., property, plant and equipment), respectively. 17 C.F.R. § 210.3-17. Under rule 3-17 these figures were to be disclosed either in a footnote to or as a supplemental part of the financial statements, though they could be unaudited. \textit{Id.}

In 1979 the Financial Accounting Standards Board (FASB), the policy-making body of the accounting industry, issued a statement requiring certain large enterprises to measure inventory, property, plant, and equipment at "current cost." \textit{FINANCIAL REPORTING AND CHANGING PRICES}, Statement of Financial Accounting Standards No. 33 (Fin. Accounting Standards Bd. 1979) [hereinafter SFAS 33]. This term, under SFAS 33, refers to a method of measuring assets and expenses associated with the use or sale of assets at current cost or lower recoverable amount. \textit{Id.} at ¶ 22(b). In addition to requiring disclosure for the specific assets covered by rule 3-17, SFAS 33 required current cost measurements for expenses and net assets, as well as computation of operating income from continuing operations based on current costs. \textit{Id.} at ¶ 35. SFAS 33 required that the disclosure be outside of but supplemental to the financial statements. \textit{Id.} at ¶ 27. Both rule 3-17 and SFAS 33 were "current cost" methods of accounting, but they differed in relative focus. Rule 3-17 considered replacement cost with assets of productive capacity equal to those owned, whereas SFAS 33 looks to the actual assets owned by measuring the cost to acquire assets with the same "service potential," i.e., assets with the same operating capacity and costs. \textit{See HANDBOOK, supra note} 166, \textit{ch. 8}, at 12-13.

After the FASB issued SFAS 33 the Commission rescinded rule 3-17, relying on SFAS 33. \textit{See Accounting Series Release No. 271, 44 Fed. Reg. 62,886} (1979). After 1980 the FASB issued further statements on current cost accounting applicable to various other specific assets. \textit{See SFAS 39} (mining, oil and gas); SFAS 40 (timberlands); SFAS 41 (income-producing real estate); SFAS 46 (motion picture films); SFAS 54 (investment companies); SFAS 69 (amendment regarding oil and gas activities); SFAS 70 (amendment regarding foreign currency translation); SFAS 82 (amendment to eliminate certain disclosures). The resulting pronouncements were incorporated by reference into SEC rules and regulations as part of required supplemental disclosure pursuant to item 302 of regulation S-K. 17 C.F.R. § 229.302. The SEC's 1979 safe-harbor rule covering predictions of future economic performance was expanded to cover these required disclosures as well as information about changing prices that is voluntarily disclosed. Accounting Series Release No. 287, 44 Fed. Reg. 13,988 (1981).

On December 2, 1986, the FASB adopted SFAS 89 which supersedes SFAS 33, and the other changing prices statements (SFAS Nos. 39, 40, 41, 46, 54, 69, 70 and 82; FASB Technical Bulletin No. 81-4). In SFAS 89 the FASB encourages voluntary supplemental disclosure of the effects of changing prices, \textit{id.} at ¶ 3, and notes that "Although the U.S. economy is experiencing little inflation at the present time," if that condition changes, the FASB again may need to require such disclosure, \textit{id.} at ¶ 6. The FASB also stated that entities are "not discouraged" from experimenting with other forms of similar disclosure. \textit{Id.} at ¶ B. In response to the issuance of SFAS 89 the SEC has amended regulation S-K to delete references to SFAS 33 as well as the other changing prices statements. Disclosure of the Effects of Inflation and Changes in Prices, Securities Act Release No. 6681, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,050, at 88,380 (Dec. 18, 1986).

168. "Fair value" generally represents "the exchange price that could be reasonably expected in an arm's-length transaction." \textit{HANDBOOK, supra note} 166, \textit{ch. 37}, at 39. Fair value is the concept that is debated under the general rubric of asset "appraisals" or
the former concept is another indication of the SEC's recognition that asset disclosure based on something other than historic-cost may be appropriate or required under various circumstances.

In the area of oil and gas accounting, the SEC early recognized that disclosure of estimates of proved reserves in the financial statement portion of filings was appropriate. In 1978 the SEC adopted new financial accounting and reporting practices for oil- and gas-producing activities that, in addition to disclosure of proved reserves, required disclosure of "the present value of future net revenues from the estimated production of proved oil and gas reserves . . . ." The SEC had opposed disclosure of such values in its brief in Sunray. In 1982 the SEC amended regulation S-K to allow textual disclosure of estimates of the amount and value of unproved reserves values in cases such as Gerstle. (Technically speaking, one usually thinks of an "appraisal" as a formal, independent valuation). The concept of "economic" or "future exit" value is similar in that it represents the discounted value of future net cash flows. See Hankbook, supra note 166, ch. 8, at 12. These concepts are different from the current cost concepts of rule 3-17 and SFAS 33, but under a current or replacement cost method which measures the cost to replace the asset with an asset of equivalent productive capacity, as depreciated, the result may approximate the fair value of the asset. See SFAS 33, at ¶ 12. See also Exchange Act Release No. 16,833, supra note 160, at 17,621 n.13 (warning that although values disclosed by registrants under the SEC's then-existing replacement cost rules are "relevant information to an assessment of an entity's economic value, . . . [such values] will not necessarily coincide with future realizable value in the context of a given plan for the disposition of assets."). In an inflationary period, measurement of replacement or current cost should generally cause a decline in earnings figured on such a basis, except in industries where production costs fall due to increased efficiencies and technologies.

169. See Brief for the Securities and Exchange Commission as Amicus Curiae at 8 n.3, Sunray Dx Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) (citing Great Sweet Grass Oils, Ltd., 37 S.E.C. 683, 693 n.11 (1957)); Id. at 9 n.4 (noting various filings in which estimates of proved oil reserves were required).

170. Securities Act Release No. 5966, supra note 70 (also adding rule 3-18 to regulation S-X, 17 C.F.R. § 210.3-18 (1986)). See also 17 C.F.R. § 210.3-18(k)(5) and (6). The estimate of future net revenues must be included in the body of the financial statement, the notes thereto, or in a separate schedule or other presentation that is an integral part of the financial statement. Rule 3-17 was redesignated as rule 4-10 in 1980. General Revision of Regulation S-K, Securities Act Release No. 6233, [Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,502 (Sept. 25, 1980). The adoption of these standards recognizes the need to supplement or to vary historic-cost information in different situations.

The SEC also experimented with a form of current value accounting to provide an alternative to information. As a former chief accountant of the SEC has noted, "the SEC believed that none of the currently followed accounting and reporting practices based on historical cost . . . provided sufficient useful information. Accordingly, they proposed an alternative approach, termed reserve recognition accounting (RRA), which is a form of current value accounting." Handbook, supra note 166, ch. 37, at 8. Reserve recognition accounting was abandoned in 1981. Accounting Series Release No. 289, [Accounting Series Releases Transfer Binder] (CCH) ¶ 3,293 (Feb. 26, 1981).
"where such estimates previously have been provided to a person that is offering to acquire, merge or consolidate" with the issuer or otherwise to acquire its securities. The SEC also noted that even though regulation S-K otherwise prohibited disclosure in filings of less-than-proved reserves, its staff’s practice has been to permit such disclosure if the effect of exclusion would be to render a filing misleading.

Despite these changes and policy statements concerning the need for asset value and other soft information disclosure, many recent cases rely on *Gerstle* and *Kohn* or the SEC’s early policy to avoid the difficult issues of reliability and materiality or to create an almost per se rule against disclosure of asset values. This is largely due


> [E]stimates of oil or gas reserves other than proved . . . and any estimated values of such reserves shall not be disclosed in any document publicly filed with the Commission, unless such information is required to be disclosed in the document by foreign or state law; provided, however, that where such estimates previously have been provided to a person that is offering to acquire, merge or consolidate with the registrant or otherwise to acquire the registrant’s securities, such estimates may be included in documents relating to such acquisition.

The admonition against disclosure of other than proved reserve quantities or value was previously in 17 C.F.R. § 229.20, instruction 4 to item 2(b) (1981). Release No. 6383, in which the Commission adopted the SEC’s integrated disclosure system, added the foreign or state law exemption and the proviso. The 1982 release also redesignated the item and moved the instruction.

172. In Proposed Revision of Regulation S-K, Securities Act Release No. 6332, Fed. Sec. L. Rep. (CCH) Report No. 926, Part II (Aug. 6, 1981), the Commission also proposed revising the instruction to item 102 (then item 20) concerning oil and gas disclosure, (then instruction 4), to allow estimates of less than proved reserves and related values when the omission of such information would render the other disclosure misleading. Commentator criticism caused the Commission not to adopt the revision. See *id.* However, the Commission had stated in proposing the release that the proposed revision was consistent with the staff practice at the time. *Id.* See also Staff Accounting Bulletin No. 47 (Sept. 16, 1982) (allowing disclosure of estimated or appraised value of undeveloped lease acreage, *i.e.*, that portion with value other than that attributable to proved reserves).

to the lag between the time the facts of a case develop and the time a final judicial resolution is reached.\textsuperscript{174} Thus, the courts have been able to rely on the \textit{Gerstle} court's finding that although the note to rule 14a-9 does not specifically refer to asset values or even absolutely prohibit any particular type of disclosure, "it is clear that the policy embodied in the note . . . has consistently been enforced to bar disclosure of asset appraisals . . .,"\textsuperscript{175} as well as \textit{Gerstle's} admonition that a substantial modification or reversal of that policy should be done through SEC rule or policy statement, and not merely in an amicus position.\textsuperscript{176} Several courts have discussed this limited basis for \textit{Gerstle}, but concluded that at the time of the events before them there had been no formally announced change in the SEC's position.\textsuperscript{177} Others have interpreted the SEC's position to apply only to liquidation situations,\textsuperscript{178} or have noted the absence of any specific

values in \textit{Dixon}; noting that plaintiffs did not dispute general rule that there is no duty to disclose such internal valuations); \textit{Gerrity v. Chapin, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,241, at 96,717 (S.D.N.Y. 1980) (no duty to disclose asset appraisals in going concern situation; citing \textit{Gerstle}). But cf. Texas Partners v. Conrock Co., 685 F.2d 1116, 1121 (9th Cir. 1982) (pointing to the new SEC policy authorizing the inclusion of asset valuations in proxy statements; but refusing to address whether substantially undervalued assets require disclosure); \textit{South Coast}, 669 F.2d at 1274-78 (Fletcher, J., dissenting) (arguing that the lower court's analysis was "incomplete" because "it failed to take the necessary first step of determining materiality); Sulzer v. Associated Madison Cos., [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,053 (M.D. Fla. 1985) (noting the relaxation of the policy of nondisclosure and holding that the existence and value of tax benefits is not so speculative and uncertain as to preclude its disclosure in proxy materials); Bolton v. Gramlich, 540 F. Supp. 822, 837-38 (S.D.N.Y. 1982) (failure to disclose that some of the trustees had a personal interest in a corporate liquidation would be material for rule 10b-5 purposes, as would nondisclosure as to the value of corporate assets); Evmar Oil Corp. v. Getty Oil Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,358, at 93,228-29 (C.D. Cal. 1978) (materiality of failure to state appraisal values of two corporations in a proxy statement seeking shareholder approval of a merger must be determined by the trier-of-fact); Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 819-20 (D. Del. 1974) (declining to hold asset values immaterial as a matter of law).


176. \textit{Id.} at 1294.


178. See, e.g., \textit{Starkman}, 772 F.2d at 240 n.6 (noting 1980 proxy release as limited instance in which appraisal disclosure is allowed but only if reliable); \textit{Texas Partners}, 685
SEC rule requiring disclosure\textsuperscript{179} or of any expert appraisal in the situations before them.\textsuperscript{180}

These cases evince a tendency by the courts to look to a clear SEC rule or policy statement for guidance before venturing into an area requiring difficult assessments of subjective and expert judgment, the determination of which can result in significant liabilities. Nevertheless, although the SEC's positions in \textit{Speed}, \textit{Gerstle}, and the 1979 sale-of-assets and 1980 proxy releases address only a limited number of situations, clearly, in the words of the \textit{Gerstle} court, "the policy embodied" in those pronouncements, as well as in the Commission's other statements concerning predictions of economic performance and asset values, represents a substantial and well-recognized modification of the position that formed the basis for the \textit{Gerstle} decision. It should be clear to securities professionals and issuers that the SEC's policy will require disclosure of projections or asset values in situations in which they are material to accurate and adequate disclosure in SEC filings. Unreliability and fear of investor misunderstanding, though of concern, should not alone be a sufficient basis for denial of a claim that a disclosure is false or misleading absent disclosure of, at least, existing predictive information. The courts must now venture beyond \textit{Gerstle} toward a more in-depth analysis of the materiality of soft information in particular cases. As discussed below, when the courts have done so, they have focused special attention on the issue of reliability, placing it at the center of at least three differing standards for determining materiality.

\textbf{G. Recent Judicial Decisions}

Recently, in light of the SEC's evolving disclosure policy concerning soft information, several courts of appeals have avoided the analysis of \textit{Gerstle} and its dependence on prior SEC policy and have treated directly the materiality issue in cases involving earnings pro-

\footnotesize{\textsuperscript{179} See, e.g., Starkman, 772 F.2d at 240 (noting, among other things, absence of SEC rule); Biechele v. Cedar Point, Inc., 747 F.2d 209, 216 (6th Cir. 1984) (characterizing investment banker's report as containing "speculative assumptions that were little more than predictions of future business success"); noting compliance with all SEC disclosure requirements in finding no duty to disclose such information under the securities laws).}

\footnotesize{\textsuperscript{180} See, e.g., Flynn v. Bass Bros. Enters., 744 F.2d 978, 988-89 (3d Cir. 1984) (rejecting duty to disclose nonexpert appraisal); \textit{South Coast}, 669 F.2d at 1272 (rejecting need for disclosure because of no change in SEC policy since \textit{Gerstle}, and stating that even if it followed SEC's amicus position in \textit{Gerstle}, the appraisals at issue were not required to be disclosed because they were not prepared by experts).}
jections or asset appraisals. The concern for reliability, however, generally predominates these courts’ analyses and has resulted in the adoption of several varying standards for determining the materiality of soft information.

In a 1981 decision, Panter v. Marshall Field & Co., the Seventh Circuit considered whether a report of improved nine-month earnings results in a letter to shareholders was misleading because it failed to disclose an internally projected year-end decline in net income. The court noted that there is no general duty to disclose earnings projections and that other courts had found that projections must be “reasonably certain” before disclosure was even allowable. In finding that it was not necessary to disclose the projections at issue to avoid misleading stockholders, the court appears to have viewed two factors as particularly significant in considering the reliability or certainty of the projections. First, the court stated that the fact that actual year-end results eventually varied substantially from the undisclosed projections presented a “compelling inference” that those projections were “highly tentative.” Second, the court specifically relied on the fact that the projections were prepared only for management’s use in finding that there was no duty to disclose them. Thus, although it did not specifically adopt a “reasonable certainty” standard, the court appears to have sought guidance from such a standard, looking to objective indicators of the reliability of the projections at issue.

In a more recent decision, involving an alleged misleading proxy disclosure, the Seventh Circuit appears to have followed the general standard of materiality that the Supreme Court enunciated in TSC Industries v. Northway, Inc. In Kademian v. Ladish

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182. Id. at 291-92. Optimistic statements in several press releases were also alleged to be misleading. The plaintiffs alleged various other disclosure deficiencies under §§ 10(b) and 14(e) of the Exchange Act, see supra note 33, in connection with the issuer’s opposition to a hostile takeover attempt. Id. at 282-89. The potential acquiror eventually withdrew an announced tender offer because acquisition plans announced by the issuer created doubt, in the offeror’s view, concerning the earnings potential of the issuer. Id. at 281, 285.
184. 646 F.2d at 292.
185. Id. at 293. “We therefore find that because the projections [which were included in a five-year plan] were tentative estimates prepared for the enlightenment of management with no expectation that they be made public, there was no duty to reveal them.” Id. The Seventh Circuit affirmed the district court’s grant of a directed verdict in favor of the defendants as to the projection claim, as well as on all other aspects of the case.
186. 426 U.S. 438 (1976). TSC Industries held that “[a]n omitted fact is material if
the Seventh Circuit held that several internal valuations of an issuer’s stock were not required to be disclosed in a proxy statement in which management proposed a merger at a lower price, because disclosure of the additional potential values would not change, in the language of TSC Industries, “the ‘total mix’ of information available.” The court based this conclusion on the fact that several other valuations that exceeded the merger price had been disclosed. The court also believed that the undisclosed values were speculative, but it did not feel compelled to formulate a standard that judges the reliability of projections. Since several higher values had in fact been disclosed, the court could simply look to the general “total mix” language of TSC Industries for guidance.

there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. at 449. The Supreme Court elaborated further: This standard is fully consistent with Mills’ [Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970)] general description of materiality as a requirement that “the defect have a significant propensity to affect the voting process.” It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor 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. Put 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.

Id. at 449 (emphasis added). Although this standard was announced in the context of a claim that a proxy statement was misleading in violation of rule 14a-9 of the Exchange Act, it has been applied generally by the lower courts in determining materiality under both §§ 10(b) and 14(e) of the Exchange Act. See, e.g., Rodol v. Thomas, 772 F.2d 244, 252-53 (6th Cir.), cert. denied, 106 S. Ct. 3272 (1986); Flynn v. Bass Bros. Enters., 744 F.2d 978, 985 (3d Cir. 1984); Staffin v. Greenberg, 672 F.2d 1196, 1205 n.10 (3d Cir. 1982); Panter v. Marshall Field & Co., 646 F.2d 271, 289 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Seaboard World Airlines v. Tiger Int'l, Inc., 600 F.2d 355, 358 n.3, 360-61 (2d Cir. 1979).

187. 792 F.2d 614 (7th Cir. 1986).
188. Id. at 625.
189. Id. The court seemed to consider the issue of materiality separate from the issue of reliability: “Aside from the fact that these latter two valuations are as suspect of being speculative as the first two [which were disclosed], their omission is not material.” Id. (footnote omitted). The court quoted Panter for the proposition, which the court stated was undisputed by the parties, that generally there is no duty to disclose internal valuations. The court went on to consider the materiality of the particular valuations at issue, however, because the plaintiff claimed that they were necessary disclosures in light of the disclosure of other valuations. Id. The lower court had relied on Panter, without a specific discussion of materiality, in finding no duty to disclose the valuations. Dixon v. Ladish Co., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,804, at 90,061-62 (E.D. Wis. 1984).

Because of the reliability concern, the “total mix” concept of TSC Industries by itself is not particularly helpful in many soft information cases. Consider the recent decision in Burlington Indus. v. Edelman, Civ. Action No. C-87-274-G, slip. op. (M.D.N.C. Order
In *Flynn v. Bass Brothers Enterprises*\(^{190}\) the Third Circuit announced a standard for determining materiality of soft information based on a balancing approach. Minority shareholders of a target claimed that a tender offeror violated sections 10(b) and 14(e) of the Exchange Act by failing to disclose in its tender offer materials various per-share valuations of the target.\(^{191}\) The defendant had purchased several reports concerning the target prepared by a third corporation that had considered acquiring a controlling block of the target’s shares.\(^{192}\) The reports contained five alternative per-share valuations of the target under hypothetical liquidation and going-concern situations.\(^{193}\)

The court of appeals recounted the evolution of SEC policy regarding disclosure of soft information, noting that a primary reason for the early policy against disclosure was the concern for reliability,\(^{194}\) but that the recent policy shift favoring more soft information disclosure was based on “recognition of shareholders’ need for such information.”\(^{195}\) In an apparent attempt to accommodate these competing interests, the Third Circuit announced a standard for determining the duty to disclose soft information “on a case by case basis, by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note.”\(^{196}\) The

entered June 5, 1987), in which the court, among other things, granted a preliminary injunction for alleged violations of § 14(e) of the Exchange Act and rule 14e-3 thereunder by virtue of an insider’s alleged disclosure of nonpublic information about an issuer to a potential tender offeror. The court, in concluding that the plaintiff showed a reasonable likelihood of success on the merits, noted that the soft information at issue, i.e., valuations of divisions and assets and opinions about potential divestiture, may not be material standing alone, but when combined with certain hard information that was disclosed, may have significantly altered the “total mix” available. Slip op. at 37-38.

190. 744 F.2d 978 (3d Cir. 1984).
191. *Id.* at 981-82. The target’s management was also sued.
192. *Id.* at 981.
193. *Id.* at 982. There apparently was no allegation that the valuations were based on nonpublic information received from the issuer, although one of the valuations was “per Peterson,” who was the ex-President of the target and the party from whom the third corporation had considered purchasing the block of stock. *Id.* at 981; Flynn v. Bass Bros. Enters., 456 F. Supp. 484, 487 (E.D. Pa. 1978). Additionally, the court of appeals discussed a study prepared by a vice-president of the target with land values supplied by the controlling shareholder (the ex-President of the target) and “some ‘unnamed people within or without of the [target].’ ” 744 F.2d at 990. There was no intention to liquidate the target, *id.* at 982, and the highest valuation was one based on the target as a going concern. *Id.* More than half of the total asset value of the target was in its land holdings, apparently consisting of farming operations. *Flynn*, 456 F. Supp. at 487.
194. *Flynn*, 744 F.2d at 985.
195. *Id.* at 987.
196. *Id.* at 988 (footnote omitted).
court then listed seven factors that a court "must consider" in applying the standard, without assigning any particular weight to any of them.\textsuperscript{197} The court declined, however, to apply retroactively the "new" standard to the facts before it,\textsuperscript{198} and instead looked to the state of the law at the time of the tender offer at issue (1976), affirming the district court's conclusion that disclosure was not required.\textsuperscript{199}

The Third Circuit's approach is an attempt to accommodate the competing interests that have been at the center of the soft information dispute: reliability and shareholder need for the information. Whether the court's approach is workable and consistent with \textit{TSC Industries} will be discussed in Section III, below.

More recently, the Sixth Circuit, in two cases arising out of a takeover battle for Marathon Oil Company, enunciated a standard for materiality of soft information predominantly based on the concern for reliability. \textit{Starkman v. Marathon Oil Co.}\textsuperscript{200}} involved a claim that two asset valuations, expressed in price-per-share, and five-year earnings and cash-flow projections were required disclosure under rule 10b-5 to avoid rendering misleading various statements made by Marathon in opposition to Mobil Oil Company's hostile tender offer.\textsuperscript{201} The appraisals at issue, one prepared in-house and the

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\item[197.] \textit{Id.} The factors listed were as follows:
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\item The facts upon which the information is based; the qualifications of those who prepared or compiled it; the purpose for which the information was originally intended; its relevance to the stockholders' impending decision; the degree of subjectivity or bias reflected in its preparation; the degree to which the information is unique; and the availability to the investor of other more reliable sources of information.
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\begin{itemize}
\item But see \textit{Landy v. Amsterdam}, 815 F.2d 925 (3d Cir. 1987) (failure to disclose in merger proxy appraised values of properties previously sold along with the actual sales prices, which were disclosed, did not alter the "total mix" of information available as required for materiality under \textit{TSC Industries}; not discussing the factors listed in \textit{Flynn}).
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\item 198. \textit{Flynn}, 744 F.2d at 988. The court noted that its decision not to apply the standard retroactively was confined to the facts of the case before it, and that it did not mean to imply that the new standard should never be so applied. \textit{Id.} at 988 n.19.
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\item 199. \textit{Id.} at 988-89. The district court had directed a verdict for the defendants. The court of appeals judged the reports at issue by the policy set forth in the SEC's brief in \textit{Gerstle}, (though that standard was enunciated for disclosure in situations in which an intent to liquidate existed, and no such intent was found in \textit{Flynn}. See supra note 193). The \textit{Flynn} court, thus, affirmed the district court as to the appraisals because they "were not prepared by experts, had no adequate basis in fact and were prepared to encourage financing to purchase [the controlling shares]." 744 F.2d at 989. Similarly, the court found that the study prepared by a vice-president of the target was not sufficiently reliable to be disclosable. \textit{Id.} at 990.
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\item 200. 772 F.2d 231 (6th Cir. 1985), \textit{cert. denied}, 106 S. Ct. 1195 (1986).
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\item 201. \textit{Id.} at 233. The plaintiff also claimed that additional disclosure was required re-
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other by Marathon’s investment bankers, largely involved estimating future net revenues from Marathon’s oil and gas reserves, including probable and possible reserves.202

In affirming the lower court’s grant of summary judgment for the defendants, the court of appeals discussed the SEC’s policy on asset value disclosure, noting particularly that at the time of the events at issue the SEC prohibited disclosure in filings of anything other than “proved” reserves.203 Though compelling, this apparently was not definitive since the court went on to consider whether any judicial authority required a contrary result.204

The Sixth Circuit reviewed several previous decisions in which it had considered soft information disclosure205 and concluded:

garding Marathon’s negotiations with its eventual “white knight,” U.S. Steel. Id. The district court granted summary judgment in favor of the defendants on all issues. 202. Id. at 234. For a discussion of “probable” and “possible” reserves, see supra text accompanying notes 119-20. 203. Id. at 240-41. See also Rice v. Hamilton Oil Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,175 (D. Colo. 1986) (tender offer materials must disclose estimates and forecasts with respect to oil and gas discoveries “only if there is a substantial certainty that these estimates will increase ‘proved’ reserves”; citing Starkman and Sunray). For a discussion of “proved” reserves, see supra note 119. 204. Nevertheless, the court’s comment as it undertook such an inquiry was not very favorable for the plaintiffs:

Absent compelling authority to the contrary, we are reluctant to impose liability on Marathon for failing to disclose asset appraisals based on hypothetical valuations which the SEC did not then permit to be disclosed in most contexts, particularly since Section 23(a) of the Securities and Exchange Act, 15 U.S.C. § 78w(a)(l) provides that no liability under the federal securities laws shall be imposed for “any act done or omitted in good faith conformity with a rule, regulation, or order of the Commission.” Starkman, 772 F.2d at 241 (citation omitted). The plaintiff’s claim in Starkman was not limited to disclosure in filings but included allegations that a press release and a letter to shareholders, required by rule 14e-2 to be sent by management faced with a tender offer [17 C.F.R. § 240.14e-2 (1986)], were misleading without the requested disclosure.

The fact that the SEC has promulgated specific item disclosure for specific transactions should not be viewed as dispositive on disclosure issues. Regulations cannot anticipate every situation and, ultimately, the need for disclosure is judged by what is necessary to render statements accurate and not misleading and to fulfill management’s obligation for full disclosure to shareholders. Moreover, even a prohibition on certain reserve disclosure in the normal accounting context of regulation S-K should not allow management to escape liability if statements made are otherwise misleading or where the information becomes relevant to a special action or decision by management. See, e.g., Staff Accounting Bulletin No. 47 (Sept. 16, 1982) (although disclosure of unproven reserves is generally not allowed in SEC filings, such disclosure is permissible if necessary to avoid rendering statements misleading); Securities Act Release, No. 6532, supra note 172 (noting that a proposed amendment to that effect simply would have codified staff practice); Exchange Act Release No. 16,833, supra note 160 (recognizing need for disclosure of appraisals in certain proxy contests).

205. 772 F.2d at 241. In particular, the court noted its decision in James v. Gerber
"Our cases fully support a rule under which a tender offer target must disclose projections and asset appraisals . . . only if the predictions underlying [them] are substantially certain to hold."\(^\text{206}\) The court rejected the balancing test of Flynn as "uncertain and unpredictable."\(^\text{207}\) The court then stated that there was no duty to disclose the appraisals since they were based on "highly speculative assumptions regarding the path of oil and gas prices, recovery rates and the like over a period of thirty to fifty years."\(^\text{208}\) The court also concluded that the five-year earnings information in question did not rise to the level of substantial certainty.\(^\text{209}\)

In Radol v. Thomas,\(^\text{210}\) the companion case to Starkman, the plaintiffs appealed a jury's finding that Marathon and U.S. Steel did not violate sections 10(b) and 14(e) of the Exchange Act\(^\text{211}\) by fail-

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\(^{206}\) 772 F.2d at 241 (emphasis added). The court noted that its approach "focuses on the certainty of the data underlying the appraisal or projection, [and] ensures that the target company's shareholders will receive all essentially factual information." \(\text{Id. at 242}\) (emphasis added). This focus may foretell a strict application of the standard. The court earlier stated: "Our cases formally establish the rule that soft information such as asset appraisals and projections must be disclosed only if the reported values are virtually as certain as hard facts." \(\text{Id. at 241}\). Under such a standard, very little "soft" information would be required to be disclosed. Also, the court is not announcing an affirmative duty to disclose, since it earlier made clear that the target's disclosure obligations are confined to those items mandated by SEC regulations or necessary to avoid rendering statements made misleading. \(\text{Id. at 238}\).

\(^{207}\) \(\text{Id. at 242}\).

\(^{208}\) \(\text{Id.}\)

\(^{209}\) The court noted that Marathon had stated to shareholders its belief that the bid was "grossly inadequate" and that disclosure of the valuations and projections would only have supported this statement. \(\text{Id.}\)

\(^{210}\) 772 F.2d 244 (6th Cir. 1985), \textit{cert. denied}, 106 S. Ct. 3272 (1986).

\(^{211}\) Section 14(e) reads:

\(\text{(e) It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of} \)
ing to disclose the two asset valuations at issue in Starkman during U.S. Steel's "white knight" tender offer, which was endorsed by Marathon. The court referred to its opinion in Starkman as reaffirming its adherence to the "basic rule established by [its] prior decisions" that soft information need only be disclosed if the predictions underlying the information are "substantially certain to hold." The court held that the district court's jury instructions correctly stated the general standard of materiality as set forth in TSC Industries and "the specific rule" in the Sixth Circuit governing this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative. 15 U.S.C. § 78n(e) (1982).

212. Radol, 772 F.2d at 250-52. The district court had granted summary judgment for the defendants on various other federal and state claims, including the claim that U.S. Steel's two-tier tender offer, offering cash for about 51% of Marathon's common stock and U.S. Steel notes for the remaining shares, was manipulative in violation of § 14(e). Id. at 252. All aspects of the grant of summary judgment were upheld by the Sixth Circuit.

213. Radol, 772 F.2d at 252-53. In fact, the earnings and cash flow projections at issue in Starkman were disclosed in U.S. Steel's offer. Moreover, the asset appraisals were disclosed as required by item 9 of schedule 13E-3, 17 C.F.R. § 240.13e-3, item 9 (1986), in proxy materials filed after completion of U.S. Steel's cash tender offer, in connection with the second tier of its offer, a freeze-out merger. Item 9 of the schedule requires a summary of any appraisal received from an outside party that is materially related to a rule 13e-3 transaction.

Rule 13e-3 generally covers "going-private" transactions or "freeze-out" mergers. See supra note 147. When a series of transactions is involved, the schedule is required to be filed generally at the time of the first transaction in the series. 17 C.F.R. § 240.13e-3, instruction A(5). The rule, however, only applies to transactions by an issuer subject to §§ 12 or 15(d) of the Exchange Act or its affiliates. 17 C.F.R. § 240.13e-3(b) to -3(c). Thus, in cases such as Radol in which an unaffiliated party makes a tender offer for control to be followed by a freeze-out merger, schedule 13E-3 and rule 13e-3 are not applicable until after a successful tender offer, i.e., after the offeror becomes an affiliate of the issuer. Affiliate is defined as "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with [the] issuer." 17 C.F.R. § 240.13e-3(a)(1). The definition in fact specifically provides that a tender offeror does not become an affiliate until after termination or extension of the offer. Id. Thus, the court of appeals in Radol found additional reasons to view the plaintiffs' claim unfavorably since, in essence, it was a claim that information that is required by SEC regulations to be disclosed only after U.S. Steel's tender offer is successful, should have been disclosed prior thereto. 772 F.2d at 252.

The Radol decision, however, should not be read to disallow claims for disclosure of certain information alleged as necessary to avoid rendering statements made misleading simply because such information is required by specific SEC regulation at a later time. Any disclosure required to avoid an antifraud violation is in addition to specific disclosure requirements. See infra notes 238-39 and accompanying text. But see Starkman, 772 F.2d at 240 ("[I]n Radol v. Thomas, No. 83-3598, (6th Cir. 1985), we have rejected the position that SEC rules regarding freeze-out mergers and proxies should determine the disclosure obligations of target management in the first stage of a two-tier tender offer.").
the duty to disclose asset appraisals.\textsuperscript{214}

Thus, the Sixth Circuit in \textit{Starkman} and \textit{Radol} clearly enunciated a standard for the future, requiring substantial certainty of underlying predictions before soft information must be disclosed. Although the appraisals at issue were based on price and cost assumptions stretching thirty to fifty years into the future, and thus their reliability could be questioned more easily, the court's language in \textit{Starkman} and \textit{Radol} seems to indicate that it will be difficult to meet this materiality standard in any case. For example, at one point in \textit{Starkman} the court stated that projections and appraisals were required to be disclosed "only if the reported values are virtually as certain as hard facts."\textsuperscript{215} Whether or not the Sixth Circuit's test is consistent with \textit{TSC Industries} will be discussed in Section III below.

The Fourth Circuit recently considered disclosure of earnings forecasts in \textit{Walker v. Action Industries}.\textsuperscript{216} Although the court dis-

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\item \textsuperscript{214} \textit{Radol}, 772 F.2d at 253. The Sixth Circuit noted: "Indeed, if there was an error below on [the asset appraisal] issue, it was in allowing it to reach the jury." \textit{Id.} at 253. The court noted that the purpose of the "substantial likelihood" test of \textit{TSC Industries} is to lessen the uncertainty facing management "in determining what must be disclosed while preserving shareholder's access to all truly factual information." \textit{Id.} Thus, it appears that the court links its materiality standard for soft information to the general test for materiality of \textit{TSC Industries}, and may apply the test rigidly to require disclosure of only that soft information that is very close to fact. \textit{See supra} note 206.
\item \textsuperscript{215} 722 F.2d at 241. \textit{See also} \textit{Howing Co. v. Nationwide Corp.}, 625 F. Supp. 146 (S.D. Ohio 1985). The district court found that a merger proxy statement was not misleading for failing to disclose projected growth rates and increased earnings. In referring to the standard enunciated in \textit{Starkman}, the court quoted the stricter language of the opinion and seemed to interpret it as announcing a per se standard for earnings and cash flow projections:

\begin{quote}
The Court in \textit{Starkman} ... noted that the disclosure of "soft" information such as appraisals and earnings projections is required only when "the reported values are virtually as certain as hard facts." \textit{Id.} at 18, and that earnings and cash flow projections do not rise to the level of substantial certainty triggering a duty to disclose. \textit{Id.} at 21 (citing \textit{Biechele v. Cedar Point, Inc.}, 747 F.2d 209 (6th Cir. 1984) and \textit{James v. Gerber Products, Co.}, 587 F.2d 324, 327 (6th Cir. 1978)). In the companion case of \textit{Radol v. Thomas}, No. 83-3598, the Court specifically approved the instruction that a "failure to make known a projection of future earnings is not a violation of the Federal Securities Laws." \textit{Id.} at 15. Therefore, we conclude that defendants were not required to disclose projected growth rates and future increase of earnings.
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\item \textsuperscript{216} 802 F.2d 703 (4th Cir. 1986). The plaintiff claimed that the issuer should have disclosed earnings projections during its self-tender for 15% of its shares and in a later press release announcing actual results. The tender offer encouraged the plaintiff's interest in the issuer and, without reading the tender offer materials, he purchased more shares instead of tendering. The subsequent press release, reporting a decline in earnings, caused the plaintiff to sell his shares. The next fiscal quarter the issuer reported
cussed the approaches of the Seventh, Third, and Sixth Circuits in *Panter*, *Flynn*, and *Radol*; it declined to adopt any of those standards. The court concluded that under the circumstances of the case before it, there was no duty to disclose projections because the SEC did not require the disclosure; projections in general could mislead investors, and the imposition of a duty to update was impractical. Although these concerns seem to lead ineluctably to a per se rule, the court stated that it was not holding that a duty to disclose projections would never exist under any circumstances.

increased earnings. *Id.* at 705. The district court did not allow the claim on the tender offer to go to the jury and instructed the jury on the press release claim that an issuer has no duty to disclose projections. *Id.* at 705-06 & n.5. The Fourth Circuit affirmed.

217. The court read *Panter* as apparently taking a strict position that there is no duty to disclose financial projections. *Walker*, 802 F.2d at 707. *But see supra* note 185 and text accompanying notes 183-85. The court also seemed to put the Second Circuit in the same category, at least as to asset appraisals. *Id.* at 708 (citing *Gerstle v. Gamble Skogmo*, Inc., 478 F.2d 1281, 1294 (2d Cir. 1973)). The Second Circuit, however, has not considered that issue in light of present SEC policy.

218. *Walker*, 802 F.2d at 708. The court included the Ninth Circuit as apparently following the Sixth Circuit’s approach in *Radol*. *Id.* at 708-09 (citing *Vaughan v. Teledyne*, Inc., 628 F.2d 1214, 1221 (9th Cir. 1980) (no duty to disclose projections absent evidence that they were “made with reasonable certainty”)). This standard does in fact appear to differ to a significant degree from the *Starkman* “substantial certainty” test. Moreover, in *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1271 (9th Cir. 1982), the Ninth Circuit later adopted a strict non-disclosure approach, based on the reasoning of *Gerstle*. *See supra* note 173. The court in *South Coast* also noted that even if it applied the SEC’s amicus position in *Gerstle*, the requirements that the appraisals be by a qualified expert and have a sufficient basis in fact were not met. *Id.* at 1272.

219. *Walker*, 802 F.2d at 703 n.11.

220. The court noted that there was no requirement to disclose projections under rule 13e-4, 17 C.F.R. § 240.13e-4 (1986), *see supra* note 148, which governed disclosure in the “issuer tender offer” out of which the case arose. *See supra* note 216. The court also noted that the SEC has not imposed a duty to disclose projections generally. 802 F.2d at 709.

221. 802 F.2d at 710. The issuer prepared various internal projections on a weekly, monthly, and quarterly basis. *Id.* at 704-05. However, the issuer would only be required to update as to material changes and only so long as a prior statement was alive in the market place. *See supra* note 47 and accompanying text. No doubt many issuers that regularly disclose earnings projections generate projections on a similar basis as the issuer in *Walker*. In adopting its safe harbor for projections, the SEC reminded issuers of the obligation to update projections that become materially inaccurate. Securities Act Release No. 6084, *supra* note 31.

222. 802 F.2d at 710. The court stated that those projections which are voluntarily disclosed should be “reasonably certain.” *Id.*
III. An Approach to Disclosure of Soft Information

A. The Duty Issue

As discussed previously in this article, the courts often relied on the SEC's early policy to conclude in a particular case that there was no duty to disclose soft information, thus avoiding the difficult materiality issue.223 With the recent SEC policy shift and the apparent recognition by the courts that such information may be material, the courts must now first consider whether there is a legally recognized source for a duty or an obligation to disclose the information; if so, only then do they need to determine whether it is material.224 In discussing this issue, it is helpful to consider persons who may have disclosure obligations in two general groups, “insiders” and “outsiders.” Generally, insiders are those persons who are officers, directors, or controlling shareholders of an issuer and other persons who may be in a position affording access to nonpublic information from the issuer.225 Outsiders are all other persons.

Although there is some disagreement among commentators, the courts have been reluctant to hold that issuers and insiders have

223. See cases cited supra notes 48, 51, 53, 173, 177 and accompanying text.

224. See, e.g., Levinson v. Basic Inc., 786 F.2d 741, 746 (6th Cir. 1986) (under rule 10b-5, must begin with analysis of whether a duty to disclose exists), cert. granted, 107 S. Ct. 1284 (1987); Flynn v. Bass Bros. Enters., 744 F.2d 978, 984 (3d Cir. 1984) (when a duty to speak exists the securities laws require disclosure of material facts); Staffin v. Greenberg, 672 F.2d 1196, 1202 (3d Cir. 1982) (first step is to determine whether there is a duty to disclose).

225. See generally Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1979); In re Cady, Roberts & Co., 40 S.E.C. 907, 917 (1961) (in addition to traditional insiders, an insider's duty may be imposed on persons with access to corporate information); Feldman v. Simkins Indus., 679 F.2d 1299, 1304 (9th Cir. 1982) (following Cady, Roberts access test to define insider status, but finding no liability). Under Dirks outsiders can acquire an insider's status, or “become a fiduciary” if they have “entered” into a special confidential relationship in the conduct of the business of the [issuer] and are given access to information solely for corporate purposes.” Dirks, 463 U.S. at 654-55 & n.14. See, e.g., SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986) (outsider can become “temporary insider” by “legitimately being given access to confidential corporate information solely for corporate purposes”). In Tome the defendant who was deemed to have become a “temporary insider” had developed a relationship affording access based primarily on friendship with an insider, although he also informally became an adviser to the corporation. The precise nature of the confidential relationship requirement is unclear at this time. See Hiler, The Judiciary Considers the Nature of Confidential Relationships in Insider Trading Cases—A Look at United States v. Reed, 13 SEC. REG. L.J. 128 (1985). An outsider can also inherit an insider’s fiduciary obligation with respect to public information if the outsider receives the information in breach of a duty by the insider. Dirks, 463 U.S. at 659-64. See infra note 244. This article will refer to “insiders” generally as including the issuer, traditional insiders, and persons who have access to inside information due to some relationship or confidence with the issuer or traditional insiders.
an "affirmative duty" to disclose material information. That is, even an issuer and its insiders have no general obligation to disclose facts as they become material, absent some action or circumstances that will trigger the duty to disclose. Once a duty to disclose is triggered, however, the issuer or the insiders involved in the triggering event will be obliged to disclose all material facts. This does not mean that they must disclose all facts that would be significant in any context, for the notion of "materiality" contains some notion of relevance, as will be evident in the discussion below and in the next section.

Various events trigger an insider's duty to disclose. First, even when an issuer or insider is silent, i.e., makes no statement, trading


227. See, e.g., Levinson, 786 F.2d at 746 ("If the defendants were under a duty generally, and if the undisclosed facts were material, a violation has occurred if the other requisite 10b-5 factors . . . are also present."); Flynn, 744 F.2d at 984 (if duty exists, disclosure of "any" material facts is required). In Flynn the court's statement is quite broad: "Where a 'duty to speak' exists, therefore, federal securities law requires disclosure of any 'material fact' [under the antifraud provisions]." 744 F.2d at 984. Several commentators have questioned whether an outsider who has a duty to disclose, or who is required to or voluntarily makes some statement, must disclose material information that is not based on information received from the issuer or insiders or specifically required by SEC rule or regulation. See, e.g., Schneider and Shargel, Soft Information and Appraisal Disclosure, 18 REV. SEC. REG. 215, 217 (1985) (discussing Flynn). Based on the rule in Chiarella that there can be no general duty to disclose absent a confidential relationship, it would seem that an outsider's obligation, absent inside information, is limited to making specifically mandated disclosures and such additional disclosures required so that the disclosures made are not misleading. See infra note 234. It also seems clear that the court's statement in Flynn was made in the context of the court's determination that the tender offeror had a duty to disclose in "its capacity as a majority shareholder," 744 F.2d at 984, and not simply in its capacity as a tender offeror required to comply with the provisions of SEC regulations governing tender offers. Id. at 984 n.5.
by the insider in the issuer's securities will trigger a duty to disclose material facts. This rests on the general proscription of the various antifraud provisions under the federal securities laws against fraudulent and deceptive conduct, coupled with the common-law notion that it is fraudulent for a fiduciary to have an informational advantage over the beneficiary with whom the fiduciary trades.

Second, if the issuer or insider undertakes to make statements, the antifraud provisions generally provide—in various contexts—an obligation to speak truthfully and to make such additional statements as are necessary to avoid rendering the statements made, in the light of the circumstances under which they are made, misleading. Finally, insiders will have to correct or amplify any statements that they made in the past but that have become false or misleading due to intervening events. This duty lasts as long as the statements are "alive"; that is, as long as the statements are relevant, and under

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228. See, e.g., Dirks, 463 U.S. at 654-55; Chiarella, 445 U.S. at 228, 232; SEC v. Texas Gulf Sulphur Co., 401 F.2d 839, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 376 (1969). This duty also applies to the outsider who has been "tipped" inside information by an insider in breach of the insider's fiduciary duties. See infra note 244.

229. See, e.g., Chiarella, 445 U.S. at 227-35 (duty to disclose under rule 10b-5 arises from existence of fiduciary relationship; adopting the reasoning of Cady, Roberts, which based duty on access to nonpublic corporate information and unfairness of allowing person with access to take advantage of that information vis a vis uninformed stockholders). The Chiarella decision was based on subsections (a) and (c) of rule 10b-5, prohibiting any "device, scheme, or artifice to defraud" or engaging in any practice "which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 445 U.S. at 226-27 (citing 17 C.F.R. § 240.10b-5(a), (c) (1986)).

230. See Texas Gulf Sulphur, 401 F.2d at 862 (issuer's statements must be not "so incomplete as to mislead"). An explanation of the scope of this duty is found in Block, Barton, & Garfield, supra note 226, at 1250-51 (footnotes omitted):

[T]his rule has not been construed to create an affirmative duty to disclose all material information every time an issuer makes any disclosure. As the Third Circuit explained in Staffin v. Greenberg: "[W]e do not believe that the intent of the [Texas Gulf Sulphur] court was to create a doctrine requiring a corporation to reveal every material corporate fact known to it every time it makes a public statement." Rather, an issuer must only ensure that when it does have a duty to disclose specific information, the information it discloses is sufficiently complete so as not to mislead.

This disclosure obligation will also arise under any of the other antifraud provisions having similar language but applicable to other contexts. See, e.g., Flynn, 744 F.2d at 984 (duty to disclose under § 14(e) of the Exchange Act, supra note 211, prohibiting misleading statements or "fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer."). See supra note 33 (listing of various antifraud provisions).

existing circumstances, it would be reasonable to rely on them.232

Outsiders also generally have the latter two disclosure duties described above.233 In situations in which outsiders are totally silent, however, they usually will not have a duty to disclose material facts because they do not have a fiduciary or confidential relationship with the issuer's shareholders, which is necessary to render such silence "fraudulent" or "deceptive," as the Supreme Court has interpreted those terms under the antifraud provisions of the securities laws.234

There is another source of a duty to disclose that may apply to both insiders and outsiders. Certain sections of the federal securities statutes and certain rules and regulations promulgated by the SEC require specific disclosures in various situations.235 These obligations are generally imposed by way of line-item disclosures required to be made in various filings with the Commission. Thus, for example, any person making a tender offer for registered equity securities of certain issuers must make specified disclosures regardless of the offeror's relationship to the issuer.236 Similarly, disclosure requirements are imposed upon a person soliciting proxies for se-

232. See supra note 47.
233. First Va. Bankshares v. Benson, 559 F.2d 1307, 1317 (5th Cir. 1977) ("[A] duty to speak the full truth arises when a defendant undertakes to say anything."); Rowe v. Maremont Corp., 650 F. Supp. 1091 (N.D. Ill. 1986) (interpreting rule 10b-5 as creating obligation to speak truthfully even if party who undertakes to speak is not an insider or a fiduciary); Rose v. Arkansas Valley Envtl. and Utility Auth., 562 F. Supp. 1180, 1206 n.38, 1206-08 (W.D. Mo. 1983) (duty to speak truthfully and so as to avoid being misleading may be imposed on persons not issuers or insiders, under rule 10b-5, if they undertake "the affirmative act of communicating or disseminating information," with the intent or knowledge that it may be relied upon in purchasing or selling a security; also includes duty to correct).
234. See Chiarella, 445 U.S. at 235. See also supra note 229. The court in Chiarella held that, as to an outsider, mere possession of material information does not create a duty to disclose. The court reasoned that a "duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" Id. at 230 (brackets in original) (citing RESTATEMENT (SECOND) OF TRUSTS § 551(2)(a) (1976)) (additional citations omitted). In addition, the court recognized that "[s]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under 10(b) . . . [b]ut such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Id. An outsider who receives nonpublic corporate information from an insider in breach of the insider's fiduciary duty, however, will inherit the insider's duty to disclose, or abstain from trading with respect to that information, even absent a separate confidential relationship between the outsider and the issuer or its shareholders. See infra note 244.
235. See supra notes 2-3.
curities of certain issuers, regardless of the person's status. This information must be disclosed regardless of whether it otherwise would be deemed material. Moreover, certain of the SEC's schedules and forms, or the rules specifically applicable to them, require disclosure of all other material facts necessary to avoid rendering the required statements misleading. Finally, the prohibition in the antifraud provisions against misleading statements applies to statements or half-truths made in SEC schedules or forms, and also creates a duty to correct statements therein that become misleading.

Applying these rules to the usual types of cases in which soft information disclosure is at issue, one can say generally that when issuers or insiders are involved in a transaction with shareholders, such as a leveraged buyout or a merger that they recommend to stockholders, they will have a duty to disclose material facts to which they have access, even if they are otherwise silent. Of course, regardless of their interest in the transaction, once they make any statements, such statements must be truthful and complete, that is, not misleading or half-truths.

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238. See, e.g., SEC rule 12b-20, 17 C.F.R. § 240.12b-20 (1986) (additional material information as necessary to avoid rendering statements and reports filed under Exchange Act §§ 12(b), 12(g), 13, and 15(d) misleading); SEC schedule 14D-1, item 10(f), 17 C.F.R. § 240.14d-100, item 10(d) (additional material information as necessary to avoid rendering statements made in schedule 14D-1 misleading); SEC rule 14a-9, 17 C.F.R. § 240.14a-9 (prohibiting false or misleading statements as to materials and communications used to solicit proxies); SEC schedule 13E-3, item 16, 17 C.F.R. § 240.13e-100, item 16 (additional information necessary to avoid rendering statements made in schedule 13E-3 misleading); SEC rule 408, 17 C.F.R. § 230.408 (additional material information as necessary to avoid rendering Securities Act registration statement misleading).


240. There is authority for the proposition that an insider may not avoid liability for nondisclosure of material facts to which he merely has access by consciously avoiding acquiring actual knowledge of such facts. See, e.g., Flynn v. Bass Bros. Enters., 744 F.2d 978, 984 n.5 (3d Cir. 1984) ("While not central to our discussion in the present case, we note that a policy of conscious ignorance cannot eliminate the fiduciary duty a majority shareholder owes to the minority shareholders.").

241. See supra note 230 and accompanying text.
As to outsiders who, for example, make a tender offer for the issuer's securities, they generally will acquire a duty to disclose all material facts only if they become a controlling shareholder or otherwise take on the status of an insider. In such situations, because they acquire an insider's fiduciary-type relationship to shareholders, they will have to disclose material information that they receive from the issuer or to which they have access, as well as, arguably, any relevant information that they generate independently of information gained from the issuer. Under certain circumstances, even if the outsider does not take on the status of an insider, the outsider may still be required to disclose material information acquired from the issuer. If, however, the outsider receives no inside information and does not take on the status of an insider, a duty to disclose will exist only by reference to any applicable, specific SEC disclosure requirement and the antifraud proscription against half-truths.

B. Materiality of Soft Information: TSC Industries, Recent Standards, and a Proposal

Based on the notions of duty discussed above, the most significant difference in the disclosure obligations of insiders and outsiders occurs when dealing with an issuer's shareholders. When an issuer or insider is involved in a transaction with shareholders, such as in a leveraged buyout, an issuer tender offer, or simply a purchase or sale of the issuer's securities, a duty to disclose material facts is triggered even absent specific SEC disclosure rules and even if the issuer or insider otherwise remains silent. An outsider trading in or

242. See supra notes 225, 234 and accompanying text.
243. See supra notes 227, 230.
244. An outsider who receives material, nonpublic information from an insider in breach of the insider's fiduciary duties can be liable for failure to disclose such information if the outsider trades in the issuer's securities. The outsider becomes a "tippee" whose duty is derived from the tipping insider's duty. See Dirks v. SEC, 463 U.S. 646, 657-58 (1983). Of course, in a customary situation in which an outsider is bargaining with the issuer as to a merger or other transaction, the issuer usually will authorize the release of certain nonpublic information. Under such circumstances, the outsider may not acquire the duties of an insider as to that information. See id. at 659-60 (requiring a breach of insider's duty before outsider can inherit or assume the duty of an insider); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985) (discussing circumstances under which an outsider may assume a confidential relationship to insider, and thereby acquire duty of loyalty, i.e., not to misappropriate or use to his personal benefit nonpublic information received from the insider); cf., Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980) (investment banking firm did not acquire common-law fiduciary duty of insider by receiving nonpublic information from issuer during arms-length negotiations). Of course, issuers may require confidentiality agreements.
proposing to purchase an issuer's shares, however, has no such general duty. Thus, in transactions proposed by an issuer or insiders asset valuations and earnings projections could be discloseable in all situations in which they are material.

For example, earnings projections, it would seem, always would be relevant to shareholders when they are asked to change fundamentally the nature of their investment in the issuer. Asset valuations could be considered relevant in most situations, even when a proposed transaction will leave the issuer operating as a going concern. Many issuers constantly generate internal forecasts and budgets. Asset valuations may also be frequent, especially if a corporate restructuring or merger is contemplated. The specter of possibly creating a disclosure issue or a de facto line item requirement for existing earnings projections and asset valuations whenever the issuer or insiders propose or recommend a transaction to shareholders may underlie the courts' reluctance to undertake consideration of the materiality of such information.

Arguably, if the issuer or insiders have such information and it is significant and relevant, then there is no valid reason to withhold such information from the true owners of the corporation, the shareholders. Yet the courts have advanced various reasons for not requiring such disclosure, such as the unreliability of soft information, the lack of specific SEC disclosure requirements, or the perceived irrelevance of certain soft information. This section focuses on whether these reasons and the standards for materiality of soft information recently enunciated by several courts of appeals are consistent with the Supreme Court's current interpretation of the concept of materiality, and whether one standard can suffice for disclosure of both hard and soft information.

1. The Materiality Standard of TSC Industries.—The concept of materiality is central to disclosure under the federal securities laws. In addition to information expressly required to be disclosed in the various forms and schedules filed with the SEC, the Commission's rules require that in certain of those forms and schedules "there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." Moreover, as discussed earlier, misstatements or omissions of material facts may vio-

245. See supra notes 12-13.
246. See supra notes 58-60, 67 and accompanying text.
late the antifraud provisions, as can a failure to disclose material facts when a person has a duty to speak.\footnote{248}

Before 1976 the SEC and the courts struggled with various verbal formulations in an attempt to find a simple, "objective" standard for materiality. The different articulations generally focused on the potential effect that the fact as stated or omitted could have on a reasonable shareholder or investor in making the relevant decision, \textit{e.g.}, to buy, sell, or tender securities, or to exercise voting rights.\footnote{249} This focus reflects general agreement that materiality should be judged through the eyes of those whom the disclosure policy of the federal securities laws was designed to protect.\footnote{250} A dispute developed, though, concerning the degree of certainty that should be required about whether a fact would affect a shareholder's decision before that fact would be considered legally material.

In 1976 the Supreme Court decided this issue in \textit{TSC Industries}, which involved facts omitted in a proxy statement, allegedly in violation of rule 14a-9 promulgated under the Exchange Act.\footnote{251} The Court held that in the proxy context materiality required that there be "a substantial likelihood that a reasonable shareholder \textit{would consider} [the fact] important in deciding how to vote."\footnote{252} The Court of Appeals for the Seventh Circuit had reversed the lower court's denial of the plaintiff's motion for summary judgment on its rule 14a-9 claims, holding that the omitted facts were material as a matter of law under a standard that covered "all facts which a reasonable

\footnote{248. See supra notes 227-32 and accompanying text.}
\footnote{249. See, \textit{e.g.}, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), \textit{cert. denied}, 394 U.S. 976 (1969) (Materiality, "of course, encompasses any fact ... which in reasonable and objective contemplation \textit{might} affect the value of the corporation's stock or securities.'') (quoting \textit{List v. Fashion Park}, Inc., 340 F.2d 457, 462 (2d Cir.), \textit{cert. denied}, 382 U.S. 811 (1965)) (emphasis added); \textit{Fashion Park}, 340 F.2d at 462 ("The basic test of 'materiality' ... is whether a reasonable man \textit{would} attach importance ... in determining his choice of action in the transaction in question.") (emphasis added); \textit{In re Investors Management Co.}, 44 S.E.C. 633, 642 (1971) (a fact is material if it is of "such importance that it could be expected to affect the judgment of investors") (quoting \textit{In re Merrill, Lynch, Pierce, Fenner & Smith}, Inc., 43 S.E.C. 933, 937 (1968); \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907, 911 (1961) (violation of rule 10b-5 for trading while in possession of information "which, if known, would affect [a shareholder's] investment judgment.").}
\footnote{250. See, \textit{e.g.}, \textit{TSC Indus. v. Northway}, Inc., 426 U.S. 438, 445 (1976). ("The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. Variations in the formulation of a general test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment.").}
\footnote{251. See supra note 186.}
\footnote{252. 426 U.S. at 449 (emphasis added).}
shareholder might consider important.’”

Although the Supreme Court in TSC Industries chose a standard that it believed “best comports with the policies of Rule 14a-9 . . . ,” the language of that rule is fairly common among the antifraud provisions, and the policy of the proxy rules—as with the securities laws in general—is disclosure-oriented. In fact, the lower courts have applied the standard of TSC Industries in determining materiality under various other antifraud provisions, and have even stated that this standard is applicable to all provisions of the securities laws. Moreover, the SEC has amended the definition of “material” in the rules that it has promulgated under certain of the statutes it administers to conform to the language of TSC Industries.

In TSC Industries the Supreme Court did not question the premise that the test for materiality should be based on the significance of a fact to a reasonable investor. It has been suggested, however, that any verbal formulation based on a determination of the potential effect of a fact on a hypothetical reasonable investor is too uncertain and subjective, and that some mathematical percentage of a relevant base amount, such as earnings or assets, or a specified dollar amount should be used to define materiality. But attempts to

254. 426 U.S. at 449.
255. Id. at 448 (explaining that purpose of rule 14a-9 is “to ensure disclosures by corporate management in order to enable the shareholders to make an informed choice.”). See supra notes 26, 33, 80, 99, 211 (language of other antifraud provisions).
257. Austin v. Loftsgarden, 675 F.2d 168, 176 & n.17 (8th Cir. 1982); see also SEC v. Research Automation Corp., 585 F.2d 31, 35 (2d Cir. 1978).
259. 426 U.S. at 438 (“The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.”).
260. See, e.g., Jennings, Beckers & Kneer, Concepts of Materiality and Disclosure—Can the Disciplined Practitioners Agree?, 12 Sec. Reg. L.J. 337 (discussed infra note 261). Cf. Kripke, Facts, supra note 55, at 1075 (suggesting that if certain facts “cannot be ascertained with any degree of certainty” the notion of materiality is “comparatively unimportant,” and
substitute an across-the-board judgment of an authoritative body for what is material under a wide range of possible circumstances would prove unworkable and artificial.\textsuperscript{261}

the standard should be "whether, after reasonable investigation under the circumstances, the persons accused of misrepresentation reasonably believed that the presentation which they made was a fair one") (emphasis in original). An as yet unresolved dispute has raged for some time over whether the concept of materiality is a purely quantitative one, or whether some qualitative analysis is also appropriate. See generally Ferrara, Starr & Steinberg, Disclosure of Information Bearing on Management Integrity and Competency, 76 Nw. U.L. Rev. 555 (1981). The areas in which proponents of qualitative materiality recently have lost the most ground involve management integrity or unadjudicated illegal or questionable conduct. See, e.g., United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986) (no criminal prosecution for failure to disclose uncharged criminal conduct in proxy materials). Regardless of the outcome of the dispute as to certain specified situations, there is a need for consideration of the quality of disclosure in any determination of materiality. E.g., AICPA, Professional Standards No. AU 150.03 (in determining materiality "[o]ne factor to be considered is the dollar magnitude of the effects. However, materiality does not depend entirely on relative size; the concept involves qualitative judgments."); AICPA, Professional Standard No. AU § 312.06-.07 (noting that SFAC 2, supra, "recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations," and stating in § 312.07, "[a]s a result of the interaction of quantitative and qualitative considerations in materiality judgments, errors of relatively small amounts detected by the auditor could have a material effect on the financial statements"). Thus, the concept of materiality contains some consideration of how a particular false or omitted fact fits into the overall context and circumstances of disclosure, or alters the "total mix" of information available. A strict percentage method or non-user oriented standard would not easily accommodate this concern.

261. But see Jennings, Reckers & Kneer, supra note 260. The authors examined the views of various groups, such as judges, auditors, lawyers and bankers, concerning standards for materiality of various facts and events, based on percentages or dollar amounts and merely concluded that there may be mutual ground for agreement on some more objective, unspecified standard. Id. at 363-65. The authors specifically discussed the FASB's attempt in 1975 to investigate and to establish a more objective, universal standard for materiality, and its acknowledgement, in QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, § 131 (Fin. Accounting Standards Bd. 1986) [hereinafter SFAC 2] that it was unable to devise an acceptable standard which could take into consideration all potential factors which could affect a decision-maker. Jennings, Reckers & Kneer, supra note 260, at 340. See also Discussion Memorandum, Criteria for Determining Materiality 8 (1975). The FASB was thus left with a general user-oriented statement:

The essence of the materiality concept is clear. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

SFAC 2, at ¶ 132. See also the 1977 REPORT, supra note 1, in which the Committee concluded:

Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the Commission is to avoid this quest for certainty and
An investor-oriented standard is more consonant with the investor-protection and full-disclosure policies of the federal securities laws than a "legislated" percentage or dollar amount test. The Supreme Court implicitly accepted this notion by its unhesitating endorsement of a user-oriented basis for its materiality standard in *TSC Industries.*²⁶²

Indeed, the Court refused to decide the ultimate issue of whether the omissions were in fact material and reversed the court of appeals for so deciding, concluding that the determination of materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these inferences to him, and these assessments are peculiarly ones for the trier of fact."²⁶³

It was the attempt to substitute a broad policy-based rule against soft information disclosure for a case-by-case determination of materiality that led to much of the confusion in dealing with disclosure of soft information. This contributed to the bias against soft information disclosure that continues to pervade the case law in this area.

2. Materiality of Soft Information Under *TSC Industries.*—a. Should Soft Information Ever Be Considered Material?—Under a user-oriented standard of materiality, the answer to the question of whether soft information is in fact material is obvious.²⁶⁴ The SEC recognized the significance to investors of soft information such as earnings projections and asset appraisals even while it refused to encourage, and initially prohibited, disclosure of such information.²⁶⁵ The rule against disclosure of soft information was not a result of judging it "immaterial" to investors. It was premised, rather, on a policy concern for the potential of such information to mislead investors. That policy has rightly been repudiated. In effect, the approach in *Flynn* of balancing the potential value against the potential harm of disclosing possibly unreliable soft information has been done on a

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²⁶² See supra note 259.
²⁶³ 426 U.S. at 450 (footnote omitted).
²⁶⁴ See, e.g., Fiflis, supra note 5, at 103 ("Given the fact that traditional investment analysis has been fundamental analysis [i.e., analysis of risk and potential return], the materiality of soft as well as hard information to investment decisionmaking is evident.") (footnote omitted).
²⁶⁵ See supra note 12 and accompanying text.
policy level. The result has been that the courts and the SEC have recognized that the significance of such information may indeed outweigh the potential for shareholder misunderstanding, and that the information therefore should be judged under some concept of materiality rather than be subject to a per se exclusionary rule.

A total exclusion of soft information from the boundaries of any materiality standard because of a policy grounded in fear of investor misunderstanding is unwarranted in light of the recognition of the importance of this information. Such a policy would also ignore the realities of the present-day marketplace and the role of analysts and sophisticated investors in pricing securities in the major markets. Indeed, although the Court in *TSC Industries* recognized that "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good," nothing in the opinion intimates that entire categories of information should be excluded from consideration. The risk of shareholder misunderstanding is far outweighed by the need for and the relevance of various types of soft information.

b. Recent Standards in the Courts of Appeals.—As discussed previously, several federal courts of appeals recently have enunciated standards for determining the materiality of soft information. These standards are inconsistent with *TSC Industries* and place undue emphasis on the reliability issue, creating a built-in bias against disclosure of soft information, with too little regard for investor need for and the potential value of such information.

*The Third Circuit*—In *Flynn* the Third Circuit began its analysis of materiality by stating that in dealing with materiality in the context of a tender offer and alleged violations of section 14(e) of the Exchange Act, it would follow the standard set forth in *TSC Industries*. The court discussed the SEC's early prohibition of soft information disclosure and the federal courts' reliance on that policy in creating a rule that did not require disclosure, even when a duty to speak existed. The *Flynn* court concluded that in light of the SEC's recent policy change and the evolution of the law in the

266. See, e.g., 1977 Report, supra note 1, at 347-50. See also Flamm v. Eberstadt, 814 F.2d 1169 (7th Cir. 1987) (although holding that preliminary merger discussions are not material based on policy reasons, court rejected the argument that disclosure of soft information should not be required because of the tendency to confuse investors); infra note 318.
267. 426 U.S. at 448.
268. 744 F.2d. at 985.
269. Id. at 985-86.
area of soft information, the Third Circuit would no longer consider asset appraisals immaterial as a matter of law. 270 The Third Circuit then announced a standard that requires a court to balance "the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note." 271

On close analysis, this standard does little to change the existing bias against soft information. The courts in early decisions could not avoid an implicit consideration of shareholder need, yet they consistently ruled against disclosure, based on the concern for unreliability. The Flynn standard still allows a court to place undue emphasis on the potential unreliability of soft information and, therefore, allows this to become a predominate concern, as it was under previous court decisions. 272

But the difficulty with the standard runs deeper. The Flynn court, although stating that it would follow TSC Industries, in fact did not expressly reconcile its test with the Supreme Court's standard. The Flynn test is inconsistent with the user-oriented approach of TSC Industries. The test substitutes a court's judgment about whether the information will aid or harm a shareholder for the analysis, required by TSC Industries, of what a reasonable investor's judgment would be concerning the significance of the information in such an investor's decisionmaking process. Certainly, under TSC Industries a court is called upon ultimately to use its own judgment in making this latter determination. Yet, a determination of whether the potential aid of information outweighs its potential harm or uncertainty, as suggested in Flynn, too easily allows the result to be dictated by the particular court's view of the reliability issue in general.

In order for the Flynn test to be consistent with TSC Industries, it must be true that before there is a substantial likelihood that a reasonable investor would consider information important, the investor would determine that the "aid" of the information outweighs its potential to mislead or to harm. But an investor will attempt to un-

270. Id. at 988.
271. Id. See supra text accompanying notes 190-99.
272. If, however, the court emphasizes the clause in the Flynn test that requires consideration of the effects of disclosure "with a proper cautionary note," id., disclosure could be favored, depending on the court's view of shareholder sophistication. See, e.g., Schneider & Shargel, Soft Information and Appraisal Disclosure, 18 REV. SEC. REC. 215, 219 (1985) (expressing concern that the Flynn test may encourage counsel to opt for "over-disclosure").
understand the uncertainties of information and factor any risk associated with those uncertainties into a determination about the value of the information. The Flynn test, thus, does not accurately reflect the core philosophy of TSC Industries, which looks to the effect of the information on the investor decisionmaking process. Flynn focuses not on the potential risk of return represented by the information, but on the potential for an investor to misunderstand or to be misled by the information. In reality, an investor may well determine to accept a great risk of misunderstanding the information because of the potential for a large return if that information is interpreted accurately. Attempts to determine, through Flynn, the point at which the potential size of the return outweighs the risk of misunderstanding would prove difficult.

The Sixth Circuit—The Court of Appeals for the Sixth Circuit also recently confronted the issue of materiality of soft information. In Starkman the Sixth Circuit considered the materiality of valuations of oil and gas properties. The specific valuations at issue were based, in part, on “possible” or “probable” reserves. The court found that cases in the Sixth Circuit “firmly establish the rule that soft information such as asset appraisals and projections must be disclosed only if the reported values are virtually as certain as hard facts.” It further stated: “Our cases fully support a rule under which a tender offer target must disclose projections and asset appraisals based upon predictions regarding future economic and corporate events only if the predictions underlying the appraisal or projection are substantially certain to hold.” The court held that the issuer was not required to disclose the valuations at issue in its public statements made in opposition to a hostile tender offer. The Starkman rule was followed in the companion case of Radol, in which the court held that the same valuations were not required to be disclosed in tender offer materials used by a subsequent friendly suitor or in the issuer’s filing in support of that offer.

273. See infra notes 289-90 and accompanying text.
274. Indeed, since hard facts are readily available, it has been noted, for example as to projections, that “[t]he value to the investor—i.e., the materiality—of management’s projections is roughly inversely proportionate to the certitude with which projections can be prepared.” Libby & Rollinson, supra note 12, at 703.
275. 772 F.2d at 234. See supra text accompanying notes 200-09.
276. 772 F.2d at 240-41.
277. Id.
278. Id.
279. Id. at 242.
The Starkman/Radol standard is clearly inconsistent with TSC Industries. The "substantial likelihood" test of TSC Industries focuses on the likelihood that the information will affect a shareholder's decision. The "substantial certainty" test of Starkman and Radol focuses on the likelihood that the information will prove to be accurate. It reflects the court's judgment that in all cases soft information will be substantially likely to affect a shareholder decision only if the information is substantially certain to prove true. This unsupported assumption is at odds with the observations in TSC Industries that the determination of materiality is best left to a jury and requires a "delicate assessment" of the potential inferences an investor might draw from a particular set of facts. The rule of Starkman does not allow for an analysis of the information's effect on a reasonable shareholder or on the "total mix" of information under the specific circumstances at hand until the information is "virtually as certain as hard facts."

It seems clear that an important concern of the Sixth Circuit is to give comfort to management in its disclosure decisions. In Radol the court described the purpose of the "substantial likelihood" test of TSC Industries as "to lessen the uncertainty facing corporate officials in determining what must be disclosed while preserving shareholders' access to all truly factual information." But the court's rule does not present a test for assessing a reasonable shareholder's view of soft information that is consistent with TSC Industries, and the desire to comfort management in disclosure decisions cannot justify this deviation. The Starkman/Radol standard subjugates shareholder need for soft information to a concern for certainty. Moreover, although it provides more certainty for management, the standard still allows for substantial litigation over materiality issues. The added degree of protection at the expense of disclosure is not justifiable, even absent the mandate of TSC Industries.

281. See supra notes 186, 250, 259.
282. See 426 U.S. at 450.
283. 772 F.2d at 241.
284. Id. at 253. Although the TSC Industries Court was concerned with subjecting management to liability for "insignificant omissions or misstatements," 426 U.S. at 448, this was not the core concern of the Court in enunciating its standard, and nothing in the opinion intimates that only "truly factual information" need be disclosed. See infra note 285. The Court's main concern was to ensure disclosure of information "to enable shareholders to make an informed choice." Id. at 448.
285. See 426 U.S. at 448 ("And particularly in view of the prophylactic purpose [of rule 14a-9] and the fact that the content of the proxy statements is within management's control, it is appropriate that . . . doubts [as to the need for omitted information] be resolved in favor of those the statute is designed to protect.").
ment is in a unique position to judge the value of soft information, and thus the need for disclosure. Management also controls the context of disclosure and can provide appropriate qualifying language to avoid liability for uncertain information. And, if management discloses soft information that fails to hold, it need only have acted in good faith and have had a reasonable basis for the information—not a substantially certain one—in order to avoid liability.286

3. A Materiality Standard for Soft Information.—These criticisms of the Flynn and Starkman/Radol standards are not simply based on rhetorical differences between the language of these opinions and TSC Industries. There are obvious difficulties in attempting to find a verbal formulation that provides an objective standard suitable for the myriad of situations in which the materiality issue arises. The search for an appropriate standard, however, is not a mere exercise in semantics. Rather, the standard, for all its ineluctable inadequacies, should seek to advance the disclosure philosophy of the federal securities laws.

In TSC Industries the Court finally settled on a user-oriented standard because it believed that such a standard was most consistent with the policies to be served under the proxy rules.287 In light of the full-disclosure policy of the federal securities laws, the SEC's current policy encouraging disclosure of soft information,288 and the obvious relevance to investors of forward-looking and valuative information, the standard for judging the materiality of such information should also encourage its disclosure, or at least should not discourage it.

The standard for soft information, as with hard facts, should be user-oriented, consistent with TSC Industries. It should also allow for consideration of the reliability issue, which is somewhat unique to soft information. Yet to advance the policy of full disclosure, the standard should provide a formula that directs the courts and management to give adequate consideration to the relevance of such information, while it protects against providing an avenue for the reliability issue to become the dominant concern.

Since the initial concern in developing a standard is that it be user-oriented, the search should begin with an analysis of the investor decisionmaking process that the disclosure scheme of the federal

286. See supra notes 38-40 and accompanying text.
287. See supra text accompanying note 254.
securities laws seek to enhance. The general theory of investment analysis upon which the SEC's mandated disclosure system is based, and which provides a logical, objective framework for investor decisions, is "fundamental analysis." This method of investment decisionmaking involves analysis of available data to determine the potential return on specific investments and the concomitant risk that the expected return will vary. Evaluation of risk versus return is necessarily a future-oriented inquiry.

The standard of TSC Industries provides an appropriate basic structure for inquiring into the specific risk/return analysis that an investor will make in a given situation. Determining whether a specific piece of information has a significant propensity to affect a shareholder's decision or, in the words of TSC Industries, presents a "substantial likelihood that a reasonable [investor] would consider it important," necessarily involves an inquiry into the possible effect that the addition of that information to the "total mix" available will have on an investor's analysis of potential risk and return. Thus, the

289. See, e.g., Fiflis, supra note 5, at 102-04 (discussing the importance to investors of analysis of risk versus return; noting SEC's acceptance of fundamental analysis in administering the disclosure system of the federal securities laws). See also supra note 264, infra note 290.


When [an] allocation decision relates to investment the benefit [sought to be maximized] is usually defined in terms of "return," that is, either income or increase in value of the amount allocated to the investment. Essential to investment decisions are perceptions with respect not only to return but to risk as well; investment portfolio theory has made significant contributions to the development of these concepts and the nature of their relationship.

Id. at pp. XIV-XV.

"Investment portfolio theory" involves the attempt to minimize risk through portfolio diversification. See generally J. Lorie & M. Hamilton, The Stock Market, Theories and Evidence (1973) (cited and discussed in the 1977 Report, supra note 1, Introduction). Finally, in discussing whether theories of investment analysis support the need for a mandatory system of corporate disclosure, the Committee on Corporate Disclosure stated:

[I]ncreasingly portfolio managers were attentive to the so-called "beta coefficient" which was a measure of risk. Emerging portfolio theory suggested that sensible investment policy entailed a judgment with respect to the degree of risk desired in the portfolio and the investment of the portfolio resources in securities having beta coefficients which would average out to the desired degree of risk. These theories do not militate against a mandatory disclosure system. If anything they suggest a maximization of the quantity and quality of disclosure through a mandatory component in order that the beta of securities may more accurately reflect the degree of risk.

Id. at pp. XL-XLI.
TSC Industries standard is properly based in the theory of fundamental analysis.

When "hard" information is at issue, the standard provides a general framework for a more specific factual analysis that focuses on what the information means in the totality of the issuer's operations, i.e., what return on investment is indicated. But when the "fact" at issue is forward-looking or soft information, an investor's specific evaluation of potential risk will include an initial analysis of whether the "fact" will or will not occur or hold. In making this analysis, it is reasonable to assume that the greater the potential return in the event the information proves accurate, the greater the risk of nonoccurrence a reasonable investor may be willing to bear. The smaller the potential return, the smaller the acceptable risk. A verbal formulation that expresses this relationship already exists and has been applied by the courts in insider trading cases involving soft information.

In the seminal case of SEC v. Texas Gulf Sulphur Co. a central issue was whether the test results of an exploratory drill hole were material for purposes of section 10(b) and rule 10b-5. The results indicated "the possibility . . . of the existence of a [copper] mine of vast magnitude . . . ." In determining whether a reasonable investor would attach importance to this "possibility," the court stated that materiality "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 company activity." Applying this test the Second Circuit found that the information was material despite expert testimony at trial that "one drill core does not establish an ore body much less a mine . . . ." Thus, in an early case involving soft information—the evaluation of a drilling test that indicated the possibility of a valuable ore mine—the Second Circuit had little difficulty in finding materiality, at a time when the courts and the SEC declined to impose an

292. Id. at 848-52. The court was discussing materiality to determine whether insiders who possessed the information were prohibited by rule 10b-5 from trading in the issuer's securities. The appellate court also considered whether a press release issued by the company was materially false and misleading, but did not discuss the materiality of the release as such. Id. at 862-64. The Second Circuit remanded this issue for a determination of "whether the release was misleading to the reasonable investor . . . ." Id. at 864.
293. Id. at 849.
294. Id.
295. Id. at 851.
obligation to disclose soft information in other contexts, based on policy concerns.

In a subsequent decision the Second Circuit applied the probability/magnitude test to another type of future-oriented information in an insider trading case. In \textit{SEC v. Shapiro}\textsuperscript{296} the Second Circuit affirmed the lower court's determination that preliminary merger discussions were material and that trading in the target's securities by certain persons privy to those discussions violated rule 10b-5.\textsuperscript{297}

Discussing materiality, the court stated: "Facts are material for purposes of rule 10b-5 if a 'reasonable investor might have considered them important in the making of [an investment] decision.'\textsuperscript{298} "Whether facts relating to a future event are material depends 'upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'\textsuperscript{299}

Even though the target had formally rejected the initial overture by the potential merger partner, the court found that the merger discussions were material because of two significant "events" that occurred shortly prior to the purchases. First, pro forma financial statements were compiled that projected a significant earnings increase if the merger were consummated; and second, one director agreed to raise again the issue of a merger with members of the target's board of directors. In applying the balancing test to these events the court stated: "Although the negotiations had not jelled to the point where a merger was probable, the possibility was not so remote that, when considered in the light of a projected increase of at least 600% in [the issuer's] earnings per share, it might not have influenced a reasonable investor."\textsuperscript{300}

\textsuperscript{296} 494 F.2d 1301 (2d Cir. 1974).
\textsuperscript{297} Id. at 1307.
\textsuperscript{298} Id. at 1305 (citations omitted). The court used a "might have" standard, quoting and citing several Supreme Court decisions which had used that language. In \textit{TSC Industries}, however, the Supreme Court refused to rely on the language of those cases, and adopted a "would have" standard. \textit{See supra} text accompanying notes 249-53. The Court distinguished the language of the cases cited in \textit{Shapiro}, noting that it had specifically declined to consider the issue in one of the cases, \textit{Mills v. Electric Auto-Lite Co.}, 396 U.S. 375 (1970), and that its reference to materiality in the other case, \textit{Affiliated Ute Citizens v. United States}, 406 U.S. 128 (1972) was merely "to give a 'sense' of the notion," in order to reach the primary issue in that case. \textit{TSC Industries}, 462 U.S. at 446-47 & n.9.
\textsuperscript{299} 494 F.2d at 1305-06 (citing \textit{Texas Gulf Sulphur}).
\textsuperscript{300} Id. at 1306-07. Although the degree of certainty that these events would influence an investor must be greater after \textit{TSC Industries}, \textit{see supra} note 298, the basic ele-
The probability/magnitude test clearly is grounded in the process of fundamental analysis upon which reasonable investment decisions are based. It balances the potential return (the magnitude of the event) with the potential risk that the return will vary or will not materialize (the probability of occurrence). The reliability issue is encompassed within the risk side of the test. Yet the test safeguards against making the reliability issue dominant, because the test recognizes the reality of investor decisionmaking: that the greater the potential return, the less probability or certainty is required before an investor's decision is likely to be affected. The test considers whether one of the two elements is great enough to overcome the weakness of the other in its potential impact on an investor.

The probability/magnitude test is not a substitute for the general standard of *TSC Industries*, but rather it is a more specific application of that standard to situations involving future events and soft information. That is, it is a method of determining whether forward-looking information in a specific case presents, as required by *TSC Industries*, a reasonable likelihood that it would affect a shareholder's decision.

Because most of the decisions in which courts have applied the probability/magnitude test are insider trading cases, the question arises whether the test is appropriate in other contexts. Several courts have expressed the view that information becomes material at an earlier stage in an insider trading context. For example, in *SEC v. Geon Industries*, in finding even "embryonic" merger discussions material, the Second Circuit stated:

> In cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in a publicly disseminated press release...; the information takes on an added charge just because it is inside information.  

301. 531 F.2d 39 (2d Cir. 1976).

302. *Id.* at 47.

303. *Id.* at 48 (citations omitted).
The district court in *Levinson v. Basic Inc.*,\(^\text{304}\) in holding that the merger discussions at issue in that case were not material for purposes of a target’s public disclosure, in fact distinguished the finding of materiality in *Geon* because it was an insider trading case.\(^\text{305}\)

Information may indeed be more significant in a case of selective disclosure, but the probability/magnitude test is uniquely able to take into consideration any “added charge” that an insider trading context might give to soft information while remaining suitable for other contexts.

For example, in the insider trading context, when a security is trading at $40 per share and nonpublic preliminary merger negotiations are occurring, an insider who has this information could buy the security at $40 and await the announcement of a merger—or even simply the fact of negotiations—to cause the market price to rise. The only “risk” involved is that if such an announcement is not made, the insider will have to resell at $40, bearing only the normal market risk in the interim that the price will fall due to other factors. Under such circumstances, the insider may be willing to buy the security even if the information is extremely tentative and would not otherwise be considered important enough to disclose. Thus, the information, simply because it is able to be used before being made public, has an “added charge.”

The somewhat “riskless” nature of the insider’s transaction can be factored into the probability/magnitude test. The *Geon* court’s view that information “takes on an added charge just because it is inside information,”\(^\text{306}\) is another way of saying that an insider is willing to trade based on the information because the financial risk of losing money is minimal, or at least is not tied to the occurrence or nonoccurrence of the possible event of which the insider has knowledge. The *Geon* view is open to criticism because, it can be argued, the materiality of information to all investors generally should not be judged by a different standard simply because an insider possesses that information and plans to take a long-shot by trading.\(^\text{307}\)

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\(^{305}\) *Id.* at 90,015 n.11.

\(^{306}\) 531 F.2d at 48.

\(^{307}\) *See,* e.g., Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227 (1st Cir. 1984). In refusing to apply a lower standard for materiality to proxy disclosure drafted by insiders interested in the subject transaction, the First Circuit stated: “A fact does not become more material to the shareholder’s decision because it is withheld by an insider, or because the insider might profit by withholding it.” *Id.* at 1231. Neverthe-
Regardless of the merits of the issue, however, a court following *Geon* can simply factor the risklessness of the insider’s transaction into the probability/magnitude analysis.

The probability/magnitude balancing test is also well suited for general corporate disclosure situations. In fact, the SEC has advanced the test in dealing with forward-looking information in the corporate disclosure context. In a recent amicus brief in *Basic Inc. v. Levinson* the SEC urged the Supreme Court to reject the materiality standard followed by the Sixth Circuit in *Levinson* as well as the conflicting standard adopted by the Third Circuit in *Staffin v. Green*.

less, the context of disclosure may affect the point at which a particular fact becomes material. Consider the solution reached in *Pavlidis*:

This is not to say, however, that court [sic] must ignore the interests of the parties who drafted the proxy statement in deciding whether they have met their obligation to disclose material facts. Certain facts might be material in the context of a one-sided transaction that would not be material in the context of an adversarial transaction. Therefore, although the same standard of materiality would apply to both kinds of transactions, the standard might identify different facts as material in each transaction.

*Id.* (emphasis in original).

308. See, e.g., SEC v. Mize, 615 F.2d 1046 (5th Cir.), cert. denied, 449 U.S. 901 (1980) (applying test to failure to disclose in registration statement discussions concerning proposal to require control of subsidiary). In contrast, the federal district court for the Southern District of New York refused to apply the balancing test of *Texas Gulf Sulphur* where it was charged that the issuer violated § 14(e) of the Exchange Act, by failing to disclose earnings projections in its self-tender offer materials. The court distinguished *Texas Gulf Sulphur* as involving the disclosure of “events that were likely to occur in the future,” whereas, in the court’s view, earnings projections involve personal “interpretation” of facts and “analysis of the possible effects on the company’s future operations.” *Fisher v. Plessey Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,129, at 95,466 (S.D.N.Y. Sept. 21, 1983) (emphasis in original). Nevertheless, the court stated that in the context of a claim of inadequate corporate disclosure, to the extent that a claim by the defendants concerning the issuer’s failure to disclose new contracts and new telephone equipment under development involved “future events,” the probability/magnitude test should be applied. *Id.* at n.14. The court accordingly declined to decide the materiality of such information on the motion for summary judgment that was before it.

The *Fisher* court’s distinction does not appear to be unwarranted. At issue in *Texas Gulf Sulphur* was the meaning of test results. In one sense such results were “events” or “facts”, but in another, the insiders’ knowledge of and the issuer’s announcement concerning the results involved analysis and interpretation of technical readings concerning ore content and grade. Analysis and interpretation were required by those with the test results in order to render the results meaningful. Moreover, although an insider does not have to disclose the fruits of his own personal analysis, projections prepared for corporate use or based upon nonpublic information are on different footing, rightfully belonging to the issuer and its stockholders.


310. 786 F.2d 741 (6th Cir. 1986).
berg 311 and Greenfield v. Heublein, Inc. 312 and by the Seventh Circuit in Flamm v. Eberstadt. 313 Those cases involved the issue of at what point preliminary merger discussions become material under rule 10b-5 for purposes of corporate disclosure.

In Staffin the Third Circuit held that merger negotiations are "immaterial as a matter of law" until an agreement in principle is reached. 314 In Heublein the court reaffirmed its holding in Staffin and noted that agreement on price and structure are "typically critical aspects of any merger." 315 It indicated that these elements are necessary if merger negotiations are to be considered material. 316 Based on this standard, the Heublein court found that a public statement that the company was "aware of no reason" that would explain increased market activity in its stock was not materially misleading in failing to include disclosure of ongoing preliminary merger discussions. 317

In Flamm the Seventh Circuit accepted the price/structure standard to affirm a jury verdict in favor of defendants in a case involving failure to disclose the corporation's efforts to attract a merger partner in the face of a hostile tender offer. 318 The court did not rest its decision on any perceived insignificance of preliminary merger discussions. 319 Rather, it adopted the strict rule of Staffin, based on dual policy concerns for management's need of a bright-line materiality test when involved in preliminary merger negotiations and the tendency of "premature disclosure," in the court's

311. 672 F.2d 1196 (3d Cir. 1982).
312. 742 F.2d 751 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985).
313. 814 F.2d 1169 (7th Cir. 1987).
314. 672 F.2d at 1205-07.
315. 742 F.2d at 756-57.
316. Id. at 757.
317. Id. at 757, 759.
318. At issue were the jury instructions. The court of appeals, although questioning the propriety of the instructions, id. at 1173-74, looked beyond that issue and affirmed on the "alternative ground" that the defendants' motion for summary judgment on the issue of materiality should have been granted. Id. at 1174. No new briefs were requested. Id. See also id. at 1181-82 (Cudahy, J., concurring in judgment and concurring in part) (noting lack of argument on the issue decided and lack of opportunity for SEC amicus position).
319. Indeed, the court stated: "From one perspective this conclusion [that a search for a merger partner is immaterial] is simply another cause for wonderment at the legal mind." Id. at 1174. The court later remarked: "[S]ome information is almost always preferable to none. Investors, who appreciate the necessary omissions, can deal with risk." See also Rowe v. Maremount Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,239, at 96,158 (N.D. Ill. June 3, 1986) (stating that the Seventh Circuit noted in a case prior to Flamm that the policy underlying the price/structure rule "is not that merger discussions are unimportant to investors").
view, to inhibit or frustrate such discussions.\textsuperscript{320}

In Levinson the Sixth Circuit reversed the district court’s grant of summary judgment on the rule 10b-5 claim and found that an issuer’s specific public denial of merger negotiations and its two denials of any corporate developments that would explain increased market activity in its stock were materially false or misleading.\textsuperscript{321} The court held that “information concerning ongoing acquisitions discussions becomes material by virtue of [a] statement denying their existence.”\textsuperscript{322}

In its amicus brief in Levinson, the SEC disagreed with both the Levinson and the Staffin/Heublein/Flamm standards. Relying on the general standard set forth in TSC Industries, the SEC advanced the probability/magnitude test enunciated in Texas Gulf Sulphur for determining the materiality of a “future, uncertain event,” such as a merger.\textsuperscript{323}

\begin{itemize}
  \item \textsuperscript{320} Flamm, 814 F.2d at 1178. The court treated the case before it as one involving an omission in various statements made by the target management in opposition to the unsolicited tender offers. \textit{Id.} at 1179. The case thus differs from Levinson and Heublein in which the issuers made public statements denying the existence of merger discussions or of any material corporate developments. The Flamm court, therefore, did not choose between the Levinson view—that otherwise immaterial discussions become discloseable by virtue of a statement denying their existence, \textit{see supra} text accompanying note 322—and the Heublein view that a denial of such discussions is acceptable. Flamm, 814 F.2d at 1179. However, the Flamm court suggested: “If by hypothesis silence is the best course for investors, then it may be necessary to condone evasive answers, as the Third Circuit did in Greenfield, to put pursuers off the scent for a time.” \textit{Id.} at 1178 (citations omitted). \textit{But cf.} Rowe v. Maremount Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) \# 93,239, at 96,158 (N.D. Ill. June 3, 1986) (in a case prior to Flamm, noting Seventh Circuit's discussion of the policy underlying the price/structure rule in a previous case and refusing to apply the rule in a case involving affirmative misstatements.).
  \item \textsuperscript{321} 786 F.2d at 747-48, 751. The lower court had held that although two of the statements were false and misleading, they were not material. \textit{See supra} text accompanying notes 304-05. The court of appeals affirmed the lower court’s class certification and remanded for further proceedings. \textit{Id.} at 751.
  \item \textsuperscript{322} \textit{Id.} at 748 (emphasis in original).
  \item \textsuperscript{323} Amicus Brief, \textit{supra} note 309, at 5, 8-15.

In general, the SEC viewed the policy considerations advanced for the price/structure rule—(i) potential for investor misunderstanding, (ii) inhibition of merger discussions, and (iii) need for a bright-line test—as overstated, not justifying misleading statements, and unrelated to the standard of TSC Industries. The SEC considered the bright-line test to be inconsistent with the “discerning inquiry” required by TSC Industries. \textit{Id.} at 14-18.

The SEC found the Levinson court’s test faulty in its “apparent equating of falsehood with materiality,” which “has no basis under \textit{TSC Industries}.” \textit{Id.} at 18-19.

\textit{See also} Memorandum of the Securities and Exchange Commission as Amicus Curae, Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987) (attaching the amicus brief of the United States on petition for writ of certiorari in Levinson and stating that the Commission “strongly disagrees with the Third Circuit test of materiality,” \textit{at p. 3} which was applied by the lower court in Jordan); Brief for the United States as Amicus
The approach of the Third and Seventh Circuits in the area of preliminary merger negotiations, favoring a per se or strictly defined rule based on the degree of certainty or the "hardness" of the negotiations, is similar to the early approach to earnings projections in the concerns for reliability and the potential to mislead shareholders. To support the price/structure rule the Third Circuit posited that disclosure of tentative merger discussions could do more harm than good if such disclosure causes increased investor speculation and, thereafter, an agreement fails to materialize. This argument, however, fails, as it did in the case of earnings projections, in light of the importance of the information to investors. The user-oriented standard of *TSC Industries* requires, ultimately, that the information be judged by its importance to investors. The probability/magnitude test allows for proper consideration under such a standard of whether a reasonable shareholder would view the information as so speculative or as evidencing such uncertainty that it would not likely affect the decisionmaking process.

It has been correctly observed that "[t]he general premise of

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324. See Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982) ("The reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may itself be misleading."). See also Michaels v. Michaels, 767 F.2d 1185, 1195-96 (7th Cir. 1985), cert. denied, 106 S. Ct. 797 (1986); Reiss v. Pan Am. World Airways, 711 F.2d 11, 14 (2d Cir. 1983) ("Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned."); Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075, 1084-85 (5th Cir. 1970) (failure to disclose consideration of plan to merge in schedule 13D).

The Seventh Circuit specifically rejected this argument as a basis for the rule: It assumes that investors are . . . unable to appreciate—even when told—that mergers are risky propositions up until the closing. To attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, implies that they should not be told about new plants, new products, new managers, or any of the other changes in the life of the corporation. These new events—things with the potential for boom or bust—are exactly the news on which sophisticated investors make most decisions . . . .

Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987).
the securities laws is to give investors all relevant information, and rely on them to make their own evaluations.”325 Thus, management should not be allowed to withhold important relevant information based on fear of investor misunderstanding. Management controls the content and, to a great extent, the timing of disclosure, and can provide appropriate cautionary language or disclose the uncertainty of outcome.326 Experience must be gained in providing proper cautionary legends. As the Commission has recognized in the financial statement context, “[i]n a business world characterized by uncertainty, it is necessary to recognize that [information] based on subjective judgments must be included [in corporate disclosure] and that appropriate means of describing the uncertainties and the lack of precision in the data must be found.”327

A more compelling argument advanced to justify a strict standard for merger negotiations, and for materiality of future-oriented information in general, is that there should be more certainty for management, especially in light of the potential for substantial liability for misleading corporate statements.328 Yet in their quest to

325. Kripke, Nits, supra note 4, at 268 (also noting: “In effect, the traditional view on soft information is based on the paternalistic view that certain investors may misuse such information.”).

326. For example, in rejecting the argument that the potential to mislead investors can justify a bright-line or per se immateriality standard for preliminary merger discussions in an amicus position in Michaels, the SEC argued:

The Commission does not agree with this reasoning. As noted, the obligation to disclose even material merger negotiations only arises in certain situations that are largely in the corporation’s control, such as where it is trading in its stock or has made a public statement. Disclosure is necessary in most cases to correct a potentially misleading situation already created by the corporation. In such situations, it should be a relatively simple matter for a corporation to disclose that it is engaged in preliminary talks toward a possible merger, that there is no agreement to merge, and that the results of the talks cannot be predicted.

Memorandum of the Securities and Exchange Commission as Amicus Curiae at 7, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985) (in connection with pending petition and suggestion of rehearing en banc), cert. denied, 106 S. Ct. 797 (1986) [hereinafter Michaels Memorandum]. See also Amicus Brief, supra note 309, at 15-16.


328. An additional argument advanced in Flamm that is specifically applicable to disclosure of preliminary merger discussions is that disclosure prior to an agreement in principle will frustrate or inhibit the discussions since potential acquirors do not wish to negotiate “in the glare of publicity.” 814 F.2d at 1176. The Flamm court ultimately justifies keeping admittedly significant information about a potential merger from shareholders because those shareholders who are not “hair-trigger sellers” will reap benefits from the eventual merger price—if a merger materializes. Id. If not allowed to negoti-
provide certainty and to resolve the reliability issue objectively, the

te in secrecy, the argument goes, potential acquirors will not bid for fear of being
forced into a bidding war in which they will pay too much or lose the opportunities that
they discovered. Id. at 1177.

The fear that potential “white knights” or other bidders—sophisticated and power-
ful market players—will pay too much and therefore will learn their lesson and stay out
of the market seems an overstatement of the trepidation of this usually sturdy lot. In-
deed, this should not be a cause for alarm in an efficient market. The bidder who repeat-
edly would overpay should be weeded out. If, however, the target is worth that much,
then let the bidder pay. In between these extremes is the fear that our craven bidder will
not bid if not guaranteed a deal negotiated comfortably and privately with management.
In such situations, management’s interests conflict with those of shareholders. See, e.g.,

At this point, we do well to remember Brandeis’ oft quoted maxim, “Sunlight is said to
be the best of disinfectants; electric light the most efficient policeman.” L. BRANDEIS,
OTHER PEOPLE’S MONEY 62 (1981). We should be careful not to douse or weaken those
lights, glaring though they may be, until we are certain that the streets are fairly safe for
all.

In fact, these arguments on the whole seem to advance a policy of preserving the
market for only the “big players,” rather than to provide a means of ensuring that (all?)
mergers succeed for the benefit of “most” shareholders. The major premise of this
policy—that mergers are to be encouraged—is and should remain open to discussion
rather than being substituted for full disclosure as the major goal of the securities laws.
Short-term returns to “most” shareholders may not be the best or even the largest re-
turns for individual shareholders—or for society as a whole. See, e.g., Why is No One Safe?,
FORBES, Mar. 11, 1985, at 134. The article explains:

Conventional wisdom notwithstanding, a target’s shareholders are often better
off if a tender offer fails. We studied 39 cases in which companies successfully
resisted hostile tenders. In 17 cases, the value of the target’s stock at year-end
1984 exceeded what a shareholder would have if the offer had succeeded and
the proceeds had been reinvested in the S&P’s 500 Index. Id. at 319.

The SEC also has rejected the argument that disclosure may inhibit discussions:

In our view, this concern is overstated, and does not justify deeming such talks
not material. In the first place, in many cases even material negotiations need
not be disclosed, and many of the situations where disclosure is required—such
as where the company is engaged in trading or has already made a corporate
statement—are in the control of the corporation. If a company refrains from
trading in its stock, and does not otherwise make statements regarding corpo-
rate developments, it should usually be able to negotiate in secrecy. Second,
even if some facts regarding negotiations have to be disclosed, many details,
including the identity of the other party to the talks and the precise terms dis-
cussed, may often remain secret.

Michael’s Memorandum supra note 326, at 8 (footnote omitted). See also Amicus Brief, supra
note 309, at 16-18 (same effect).

Likewise, in In the Matter of Carnation Co., Exchange Act Release No. 22,214,
stated its belief that “Heublein was wrongly decided,” id. at 87,596 n.8, and noted that
issuers confronted with requests for explanations from the press in the face of unusual
market activity in its stock or takeover rumors may respond with “no comment” in ap-
propriate circumstances, id. at 87,595 n.6. Although a “no comment” may be viewed as
an affirmation of suspicions that there is in fact an event pending, the alternative is to
allow a denial which could be clearly false or misleading. This result cannot be tolerated
courts not only have developed varying standards between different circuits, but they have employed different standards for different types of soft information within the same circuit. For example, in the Third Circuit, under *Staffin* and *Heublein*, preliminary merger discussions are not material until an “agreement in principle” has been reached, whereas, under *Flynn*, the materiality of asset appraisals is determined by balancing the potential harm against the need for disclosure. Moreover, these attempts at certainty still allow much under the securities laws. Moreover, if explanations for price movement are being requested, the need for disclosure is probably acute, whereas the 'information' given by a "no comment" response should cause minimal concern to those who view the advancement of merger negotiations as paramount. 

Moreover, the *Flamm* standard does not apply even in all cases in the Seventh Circuit involving merger negotiations. Prior to *Flamm*, in Michaels v. Michaels, 767 F.2d 1185, 1194-97 (7th Cir. 1985), cert. denied, 106 S. Ct. 797 (1986), the Seventh Circuit held that the policy considerations which had been articulated by other courts to support a price/structure rule do not apply to disclosure of merger negotiations to the other party to a privately negotiated transaction where the issuer’s securities are not publicly traded. After *Flamm* the Seventh Circuit reaffirmed the *Michaels* holding in *Jordan v. Duff & Phelps*, Inc., 815 F.2d 429, 434 (7th Cir. 1987), because “[a] closed corporation may disclose to an investor without alerting the public at large, so that disclosure does not injure investors as a whole,” i.e., potentially frustrate merger negotiations. This rationale would apply in any face-to-face transaction, regardless of whether the issuer’s securities are publicly traded. *Id.* at 451 (“the face-to-face negotiations allow the investor to elicit the information he requires . . . while permitting the firm to extract promises of confidentiality that safeguard the negotiations.”). Thus, the *Flamm* rationale, based on policies that the Seventh Circuit sees as significant—rather than the user-oriented disclosure standard of *TSC Industries*—creates potential exceptions and confusion. *See Jordan*, 815 F.2d at 444-52 (Posner, J., dissenting) (arguing that no duty to disclose anything existed because the plaintiff was under a contractual obligation as an employee of the company to resell his stock at book value when he left the company’s employ and he could be fired at will). 

Moreover, the policy considerations that form the basis for *Flamm* arguably do not apply to any insider trading situation, since an insider is forbidden to trade and to disclose the information. Thus, the issuer is not in need of the price/structure rule in order to keep negotiations secret in the case of insider trading. *See Amicus Brief, supra* note 309, at 15 n.15:

The policy considerations articulated by the Third and Seventh Circuits do not apply in all fraud cases. In particular, they do not apply in an insider trading case, since a corporate insider need not make disclosure at all (indeed, it probably would be a breach of duty to do so), but can simply refrain from trading. *See, e.g.*, *Chiarella* v. United States, 445 U.S. at 227. Thus, a separate objection . . . to skewing the definition of materiality on account of these policy consider-
room for disagreement and litigation, especially since they encourage not disclosure, but testing the waters by venturing close to the line before making disclosure. Finally, at some point, a concern for certainty for management becomes inconsistent with a user-oriented standard and the full-disclosure philosophy of the federal securities laws.331

The probability/magnitude test recognizes the realities of investor decisionmaking and provides a user-oriented standard for determining the materiality of all types of soft information. It is flexible and may be applied in any context and to all types of future-oriented information. The test allows consideration of the reliability issue, yet provides a structure that should safeguard against this issue's dominating the primary inquiry. That inquiry, consistent with TSC Industries, should be into the likelihood that the information would be considered significant by a reasonable shareholder.

IV. Conclusion

Despite a wealth of relevant SEC policy statements and federal court decisions, soft information disclosure remains a controversial topic. The early prohibition on the use of soft information in SEC disclosure documents focused on concern over the reliability of information based on subjective judgments. The SEC was also concerned that soft information, even if reasonably reliable, would cause investor misunderstanding and, because of its subjectivity, would prove difficult to review. The Commission's policy was routinely cited by the courts as the basis for rejecting claims for disclosure. The judiciary thus gained little experience in exploring the materiality of soft information in early decisions.

atations is that doing so would make the same facts material in some legal contexts but not others, a result for which there is no warrant. The alternative, applying the agreement in principle test in all cases, would allow insider trading on highly significant information about pending acquisitions.

331. See supra text accompanying notes 284-86. The SEC echoed these concerns in its amicus brief in Levinson:

Some measure of uncertainty is inherent in the Northway [TSC Industries] test of materiality because decisions about whether corporate information is material depend on all the circumstances. Any rule that makes a single event (such as the reaching of an agreement in principle) the conclusive determinant of materiality in all cases will either excuse some falsehoods about significant matters or impose liability on account of misstatements of trivial information, a result against which Northway cautioned.

Amicus Brief, supra note 309, at 16 (footnote omitted). See also 1977 REPORT, supra note 1, at 327 (advising the SEC "to avoid the quest for certainty and to continue consideration of materiality on a case-by-case basis").
Unable to deny the significance of forward-looking information, the SEC reevaluated and reversed its policy, thus undermining the basis for prior judicial decisions. In light of this development, growing investor sophistication, the efficiency of present-day markets in pricing securities and evaluating soft information, and the increasing number of corporate takeovers and other unique and complex corporate transactions, the courts should now strive to develop a materiality standard for future-oriented information that is consistent with the full and fair disclosure goals of the federal securities laws.

The probability/magnitude materiality test, already accepted in various judicial decisions and by the SEC, is consistent with the disclosure goals of the securities laws and provides an investor-oriented analysis of the potential risk and return that a particular item of future-oriented information may indicate under different circumstances. Since this test provides a realistic appraisal of the investor decisionmaking process, it should not be difficult for corporate management to apply in making disclosure decisions. Management itself no doubt makes such an analysis in considering whether to pursue a particular business opportunity. Moreover, so long as management's disclosure is in good faith and has a reasonable basis, liability will not attach to predictive statements that do not eventuate.

Future-oriented and soft information can be extremely relevant to investors. Neither the outdated policy concerns once advanced to prohibit disclosure of such information nor the more realistic concern for management liability can justify incomplete or misleading disclosure. The judiciary must now move beyond the SEC's prior policy concerns and develop a user-oriented standard of materiality that assures investors that they will receive the full disclosure they need to judge the future potential—and thus the present worth—of their investment.