

THE OVERUSED AND UNDER-DEFINED NOTION OF “MATERIAL” IN SECURITIES LAW

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Core doctrine in federal securities law¹ rests on a single word—*material*. Federal statutes and agency anti-fraud rules and disclosure requirements contain the term as an essential qualifier and identifier.² *Facts* or *information* must be *material* before a legal obligation to disclose attaches.³ In other words, the term *material* has an unrivaled position in the center of all of securities law.⁴ Agency rules and court decisions applying the term necessarily establish the fundamental scope and bite of securities regulation. A study of close to 800 cases in which a federal court applies the term to specific facts finds that the case-law is quixotic at best, and fickle at worst.⁵ An argument on the proper breakdown of the cases begins here.

The term *material* and its doctrinal counterpart, *materiality*, connote importance.⁶ The Securities and Exchange Commission (SEC) takes a

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1. Congress established, at its core, a securities regulatory system based on the mandatory disclosure of information by the major participants in our securities markets, issuers, underwriters, national exchanges, broker-dealers, and insiders. *See, e.g.*, Universal Camera Corp., Securities Act Release No. 33-3076, 1945 WL 26104 (June 28, 1945) (containing an early SEC explanation of federal securities regulation).

2. *See infra* notes 11–23. The state blue sky laws also use the material qualifier in their anti-fraud and disclosure provisions. State courts often look to federal courts for an application of the term; *see, e.g.*, *Andrews v. Browne*, 662 S.E.2d 58, 62 (2008) (noting that “[w]hen engaged in interpretation of a term used in the Virginia Securities Act, it is appropriate for [Virginia courts] to look to the federal courts’ interpretation of the same term”); *Marram v. Kobrick Offshore Fund, Ltd.*, 809 N.E.2d 1017, 1026–27 (2004) (citing cases by the 6th, 7th and 10th circuits).

3. *See infra* notes 16–24 and accompanying text.

4. *See, e.g.*, Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 318 (2007) (noting that “[t]he importance of the materiality standard has increased in recent years”).

5. *See infra* note 109 and accompanying text.

6. The term comes from the common law definition of actionable fraud. Only false *material* facts support a holding of common law fraud. *See, e.g.*, RESTATEMENT (SECOND)

strategic approach to defining the term. The agency writes hundreds of pages of confounding, cross-referenced disclosure requirements in schedules and rules, backstopped by an additional requirement of a disclosure of all *other material* information, and then does not define the term.⁷ Federal courts, left to define the general term in application in multiple settings, produce holdings that are maddeningly imprecise and often fickle. While the securities markets and their regulators seem content with the imprecision, academics have long been critical of the vagueness of the standard.⁸

In this article, I revisit the wandering path of the federal case law on the definition of materiality. There is much to catch one's attention. The Supreme Court's first comment⁹ came thirty-seven years after the passage of the first Federal Securities Act. Soon thereafter, due to careless language in the opinion, the Court had to take a second case to fix the tangled thicket of law emerging in the lower court cases.¹⁰ The correcting opinion locks in another mistake, however, crafting an abstract standard

OF TORTS § 538 (1977) ("Reliance upon fraudulent misrepresentation is not justifiable unless the matter misrepresented is material."). The concept is also used widely in contracts, *see, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS, § 237 (1981) (noting that only a material breach justifies a refusal to perform), and criminal law; *see* 18 U.S.C. § 1001 (2008) (prohibiting false material statements to the federal government); 18 U.S.C. §§ 1341 (mail fraud), 1343 (wire fraud), and 1344 (2008) (bank fraud); *see also* United States v. Gaudin, 515 U.S. 506 (1995) (defining materiality under § 1001); Neder v. United States, 527 U.S. 1 (1991) (materiality is an element under mail, wire, and bank fraud statutes).

7. *See infra* notes 19–25 and accompanying text.

8. *See, e.g.*, Tom C. W. Lin, *Undressing the CEO: Disclosing Private, Material Matters of Public Company Executives*, 11 U. PA. J. BUS. L. 383, 383–85 (2009) (arguing that in some cases private information about executives, like their health, is material and should be disclosed); Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 341 (2008) (arguing that surveys of shareholders should be employed to determine what is material in a given case); Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures That Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927, 928–29 (2007) (arguing that courts should not dismiss complaints not disclosing the bottom line as immaterial solely because shareholders failed to add up the numbers and figure out the bottom line on their own); Patrick Hall, *The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit's Interpretation of Materiality in Employer-Teamster v. America West*, 2004 B.Y.U. L. REV. 863, 864–65 (2004) (arguing that Congress and the courts need to clarify materiality so that there is less of a burden on plaintiffs to demonstrate materiality); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1135 (2003) (arguing that there needs to be more clarity and specific guidance in the materiality standard in the context of insider trading); James D. Redwood, *Qualitative Materiality Under the SEC Proxy Rules and the Fifth Amendment: A Disclosure Accident Waiting to Happen or Two Ships Passing in the Night?* 1992 WIS. L. REV. 315 (1992) (arguing that the SEC should force companies to disclose unadjudicated illegal activity under the materiality standard).

9. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970).

10. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

that is too inclusive. A third Supreme Court case compounds the mistake with another, expanding the application of the over-inclusive test unnecessarily to a hundredfold larger category of cases.¹¹ The lower courts adapt by citing the general abstract language of the Supreme Court and, when necessary, by refusing to apply the language literally to the facts of particular cases.¹²

Simply put, the abstract formulation of the materiality standard frequently does not fit the holdings on the facts. The reason becomes obvious as the case law accumulates¹³—the concept as defined explicitly by the Supreme Court is over-broad and the courts are crafting specific exclusions. But the courts that do so often take great pains to not explicitly call their holdings legal exemptions, creating a disconnect between the language of the doctrine and the holdings of the cases. The paper concludes with an argument for explicit exceptions, which are common in United States stock exchange listings and other countries.¹⁴

I. MATERIALITY DEFINED BY THE SUPREME COURT

General fraud prohibitions are sprinkled throughout the statutes and rules of our federal securities laws. The materiality qualifier first appeared explicitly in various sections of the Securities Act of 1933.¹⁵ In Section 17(a), for example, Congress wrote:

It shall be unlawful for any person in the offer or sale of any securities . . .

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.¹⁶

The language of subsections (1) and (3) refers to the common law definition of fraud, which has long included materiality as an element of

11. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

12. *See Sauer, supra* note 4, at 321 (“[t]he . . . standard is general and abstract, establishing a framework for analysis rather than a formula for deciding specific cases”); *Heminway, supra* note 8, at 1135 (noting that the standard gives “no specific disclosure content guidance”).

13. *See infra* note 106.

14. *See infra* note 139–43 and accompanying text (discussing stock exchange rules).

15. 15 U.S.C. § 77; *see also* §§ 8–12, 16, 19, 23–24.

16. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2010).

the offense.¹⁷ Subsection (2), which has become the accepted formulation of the federal standard, expanded on the common law definition of fraud in place at the time by declaring misleading half-truths to be actionable.¹⁸

It is the language of subsection (2) that the Securities and Exchange Commission returns to whenever they exercise rule-making authority to define fraudulent activity in specific settings. The best-known example is Rule 10b-5, expanding the application of the language in Section 16 to purchases as well as sales of securities.¹⁹ One should also note Rule 14a-9 (proxy materials), Rule 13e-3(b) (going private transactions), and Regulation M-A, Item 1011(b) (mergers and acquisitions).²⁰ Congress also recycled the language of subsection (2) in later legislation. Examples include Section 14(e) of the Securities and Exchange Act of 1934 (tender offers), Section 34 of the Investment Company Act of 1940 (investment company reports) and Section 203(e) of the Investment Advisors Act of 1940 (investment advisor reports).²¹

One also finds materiality in the general catchall provisions that supplement the pages of specific items in our modern disclosure Schedules and Forms. For example, Rule 408(a), part of Regulation C on Registration under the Securities Act of 1933—and explicitly referenced in the various registration Forms—notes that “[i]n addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.”²² Similarly Rule 12b-20, part of Regulation 12B and governing all reports, forms and schedules filed under the Securities and Exchange Act of 1934, has a similar catchall materiality requirement for information additional to the specifics of the filings.²³

Although there are scattered SEC rules that purport to define materiality, the rules were redrafted²⁴ well after the 1976 Supreme Court

17. *Id.* §§ 17(a)(1) and (3).

18. *Id.* § 17(a)(2). The language is also in Sections 12 and 24 of the 1933 Act. Congress early on crafted an alternative formulation of fraud in the Securities and Exchange Act of 1934, which is found in Section 18. It does not explicitly include the omission language (“ . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact”). The alternative language has not been repeated.

19. 17 C.F.R. § 240.10b-5 (2011).

20. *Id.* §§ 240.14a-9, 240.13e-3 (2011), Reg. M-A.

21. Securities Act of 1934 § 14(e), 15 U.S.C. §§ 78(n), 80a-33, 80b-3(e) (2011).

22. 18 C.F.R. § 385.408 (2011).

23. 17 C.F.R. § 240.12b-20 (2011).

24. The original definition in Rule 405 was promulgated in June of 1947 and said: “The term ‘material,’ when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.”

case on the subject. By adding little to the Supreme Court’s definitional gloss, the rules simply cede power to the federal courts in defining the term. Rules 405 under the 1933 Act and 12b-2 under the 1934 Act, for example, define *material* as “those matters to which there is a substantial likelihood that a reasonable investor would attach importance”²⁵

The first major Supreme Court case to define materiality, *TSC Industries, Inc. v. Northway, Inc.*,²⁶ was not *sui generis*; it followed *Mills v. Electric Auto-Lite Co.*,²⁷ a case in which the materiality of the omitted information was assumed²⁸ and the issue before the court was causation.²⁹ Both cases dealt with proxy solicitations on a merger approval vote.³⁰ In *Mills*, Justice Harlan, writing for a unanimous Court, held that the plaintiff did not have to prove that the defect in the proxy statement had a decisive effect on the vote.³¹ The court reversed the Seventh Circuit, which had held that plaintiffs did have such a burden and that, because actual inquiry into the minds of thousands of voters was impossible, a substitute test—proof of the fairness of the merger itself—would suffice.³² The *Mills* Court decided that proof of materiality, which was given, was also sufficient proof of causation if the proxy solicitation was necessary to the transaction.³³

Note the three doctrinal maneuvers of the *Mills* Court. First, the court largely eliminated causation and reliance as tests independent of materiality in voting cases.³⁴ The causation and reliance tests can apply individually with split results in a few cases with unusual facts, but in the vast majority of cases a finding of materiality is also a finding on causation and reliance. Materiality became the super-test.

Second, the Court held, in essence, that materiality does not mean that the information omitted had, more likely than not, a decisive effect on the vote.³⁵ It was something less. This was a major deviation from normal

25. 17 C.F.R. §§ 230.405, 240.12b-20 (2011). The amendment picking up the Supreme Court’s reasonable investor standard came in 1982.

26. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

27. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970).

28. *Id.* at 384. The allegation was that the board of directors had a conflict of interest; all eleven members of the board were nominated by a shareholder with over fifty percent of the shares, who was also the other party to the merger. *Id.* at 378.

29. *Id.* at 385. Causation and reliance were intertwined in the language of the opinion. The defendants argued that without collective reliance of enough shareholders to change the vote results, there was no causation—the wrong could not cause any injury. *Id.* at 382 n.5.

30. *Id.* at 378; *TSC Indus.*, 426 U.S. at 440–42.

31. *Mills*, 396 U.S. at 385.

32. *Id.* at 382, 385.

33. *Id.* at 385.

34. *Id.* at 382 n.5, 385.

35. See, e.g., *Campbell Connell, Howing Co. v. Nationwide Corp.: The Sixth Circuit Provides the “Solution” to the Virginia Bankshares Causation Query*, 82 KY. L.J. 285, 297–

understanding of the meaning of the term material. Note that sophisticated parties in modern deal contracts continue to define materiality in its long-held conventional sense—the significance of the information “affects a decision.”³⁶ Why did Justice Harlan relax the meaning? The court, worried about proof problems in large plaintiff class actions, sought to devise a test that would level the playing field in favor of plaintiffs. This was an unfortunate move that plagues us today. Rather than defining materiality for all cases, in individual as well as class action cases, and then addressing the problems unique to class actions, the court took the reverse tack—defining materiality for class action cases and then extending the definition to all cases.

What is materiality then if its existence does not depend on any actual effect on the outcome of a voting decision? In his third step, Justice Harlan, in dicta, took a stab at defining materiality but authored some very carelessly inclusive language. He wrote that a judicial finding that a defect in disclosure is material “indubitably embodies a conclusion that the defect was of such a character that it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote.”³⁷ He also added that the materiality standard is not met if a defect was “trivial, or . . . unrelated to the transaction for which approval is sought”³⁸ A *not trivial* test is a very low bar for plaintiffs attorneys. The word *might* in the definitive phrase in the text noted above, the most careless bit of dicta of it all, roiled the lower courts³⁹ and had to be jettisoned by the Supreme Court in its next opinion.⁴⁰ What does it mean for a disclosure defect to meet the standard, it *might* (as opposed to *would* or *likely*) *have been considered important* by a reasonable investor?

In a footnote to the definitional phrase noted in the previous

99 (1994) (describing the *Mills* decision as easing causation requirements for plaintiffs by holding that a proxy statement with material misstatements or omissions must only be an “essential link in the accomplishment of the transaction” rather than the cause in fact of the injury); Mark V. Wilson, *Reliance and Causation Under The Federal Securities Laws When Minority Shareholders Are Forced Out*, 26 WAKE FOREST L. REV. 403, 427–28 (1991) (explaining the same and adding that under *Mills* plaintiffs need not show reliance on material misrepresentation or omission to prove their claim).

36. See Kenneth Adams, *What Does “Material” Mean?*, DEAL LAWYERS, SEPT.–OCT. 2007, at 4 (explaining that the leading case on materiality in the M&A context, *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), adopts the *affects a decision* definition of materiality).

37. *Mills*, 396 U.S. at 384 (emphasis added).

38. *Id.*

39. Compare *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973) (using *too suggestive of mere possibility* as the standard), with *Kohn v. Am. Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972) (using the *might* standard).

40. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (rejecting the *might* formulation by describing it as “too suggestive of mere possibility, however unlikely”).

paragraph, Justice Harlan gave an example using the facts of the case. The failure to disclose a serious conflict of interest while on the board of directors was, he wrote, material because “adequate disclosure of this relationship would have warned the stockholders to give more careful scrutiny” to the deal even if it did not change the vote of a reasonable investor.⁴¹ The footnote is not a model of reasoning; the discussion mixed action by a plurality with action by a single investor and mixed actual in-fact reliance with reasonable (objective) reliance. Did the information at issue have to lead a *plurality of (actual or reasonable) shareholders* to give more *careful scrutiny* to a deal or to lead a single *reasonable investor* to give more *careful scrutiny*? We do not know. All we know is that the information, at some level, does not have to be result- (i.e., vote-) changing.

Earlier in the opinion, Justice Harlan also gave pause as to how to gauge the acts of a *reasonable investor* when he noted in another footnote aside that:

[t]here is no justification for presuming that the shareholders of every corporation are willing to accept any and every fair merger offer put before them [I]n view of the many other factors that might lead shareholders to prefer their current position to that of owners of a larger, combined enterprise, it is pure conjecture to assume that the fairness of the proposal will always be determinative of their vote.⁴²

In *TSC Industries, Inc. v. Northway, Inc.*, the Court revisited Justice Harlan’s language in *Mills* and attempted to clean it up. Justice Marshall wrote the opinion for a united Court. It was his job to rework Justice Harlan’s holding and dicta in *Mills*. Justice Marshall did his best and left us with general language that dominates the materiality test to this day.

After tactfully discussing the problems in Justice Harlan’s language, Justice Marshall reminded us that the language was dicta and did not “foreclose further inquiry into the meaning of materiality.”⁴³

Justice Marshall’s new definition starts with a paragraph of theory and purpose:

As an abstract proposition, the most desirable role for a court in a suit of this sort, coming after the consummation of the proposed transaction, would perhaps be to determine whether in fact the proposal would have been favored by the shareholders and consummated in the absence of any misstatement or omission. But . . . such matters are not subject to determination with certainty. Doubts as to the critical nature of information

41. *Mills*, 396 U.S. at 384 n.6.

42. *Id.* at 382 n.5.

43. *TSC Indus.*, 426 U.S. at 447.

misstated or omitted will be commonplace.⁴⁴

In other words, the Court was looking for a *second best* test. The perfect inquiry, rounding up thousands of shareholders and getting truthful answers on how they would have voted had they known all the correct facts, is impossible. Moreover, shareholders should get the advantage in the formulation of any surrogate rule. “[I]n view of the prophylactic purpose of the Rule and the fact that the content of the proxy statement is within management’s control, it is appropriate that these doubts be resolved in favor of those the statute is designed to protect.”⁴⁵

Before considering what Justice Marshall did with a new definition, note what he could have done, but did not do. First, Justice Marshall could have used a shifting burden of proof, common in corporate law,⁴⁶ to require that management prove that the vote was sound once the plaintiffs presented a plausible claim of a disclosure defect. Second, Justice Marshall could have elevated the standard of proof from *more likely than not* to something more difficult, also common in corporate law,⁴⁷ to require, for example, that management prove *with clear and convincing evidence* the soundness of the vote.

Third, the Court could have used a robust, objective reasonable independent investor test on the decision of how to vote. Testimony on a reasonable investor would substitute for testimony on the actual hypothetical acts of the actual investors. The voting test could be individual, implying the collective vote, or explicitly collective. For the individual test the court would ask: Would a reasonable independent shareholder have voted differently with full and accurate knowledge? For a

44. *Id.* at 448.

45. *Id.* See also Richard A. Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73, 82–84 (1986) (describing problems with this aspect of the *TSC Industries* test and arguing that a test revolving around whether votes were actually affected—perhaps using statistical means—would be better, thus reaching the same conclusion as this article).

46. See, e.g., *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 500–02 (Del. Ch. 1990) (shifting the burden of proving the fairness of a merger from the parent company to the plaintiffs challenging a parent-subsidary merger when the transaction was ratified by an informed majority of the subsidiary’s minority shareholders); *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648, at *14–15 (Del. Ch. Apr. 17, 1990), *reprinted in* 16 DEL. J. CORP. L. 851, 861–62 (1991), *aff’d*, 586 A.2d 1202 (Del. 1990) (shifting the burden of proof from the board of directors of the corporation to the plaintiffs when the company had an independent subcommittee ratify a deal).

47. See *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1183 (Del. Ch. 2006) (describing Ohio law as requiring *clear and convincing evidence* to show that a director has committed certain breaches of fiduciary duty), *abrogated by* *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 n.44 (2006) (noting that the discussion in *Big Lots Stores* was dicta and “is also inconsistent with and precluded by our holding in this opinion.”).

collective test the court would ask: Would a group of reasonable shareholders, large enough to change the result, have voted differently with full and accurate knowledge? This decision, of course, would have reversed more of Justice Harlan’s explicit dicta to the contrary.

An argument for a test based on one (or a minority of) misled, reasonable shareholder(s) rather than a test based on a collective majority of reasonable shareholders would stand or fall on whether an individual shareholder who votes *yes* suffers damages when losing the opportunity to vote *no* on full, accurate disclosure, even though she would otherwise be outvoted by those whose votes would not change on the accurate disclosure.⁴⁸ The loss of an individual appraisal remedy may suffice.⁴⁹ If there is no appraisal remedy, the argument is more difficult and would have to rest on the loss of a favorable opportunity to sell the stock or on some ethereal sense of the value of a lost right to vote *correctly*. Otherwise, the test should be based on whether the disclosure reverses the result of the vote totals.

Indeed, the Court could have used all three of the possible decisional techniques together: For example, once the plaintiffs present a plausible claim of a disclosure defect, the defendant managers must prove, with clear and convincing evidence, that reasonable investor shareholders who voted affirmatively would not have voted differently had they known the true facts.

The Court used none of the three choices because it was acting in the shadow of *Mills*. The Court chose not to overrule the holding of *Mills* on causation, which bound the court to hold that a disclosure defect does not have to affect the actual vote to be material.⁵⁰

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote.⁵¹

Leaving *Mills* intact meant that Justice Harlan necessarily constrained Justice Marshall’s choices. Justice Marshall had to develop a sense of *important* that did not refer to *affecting the results of the vote* and yet was

48. This is assuming straight voting.

49. See DEL. CODE ANN. tit. 8, §262 (2010) (detailing stockholder appraisal rights in the M&A context). In many states, dissenting shareholders are entitled to go to court and have a judge structure a buy-out based on the *fair value* of their shares, provided they gave notice to the corporation before voting against the deal and follow the other strict requirements of the statute.

50. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). The Court should have arguably overruled *Mills* and started from scratch, using all three of the tests noted in the previous paragraph.

51. *Id.*

not trivial.⁵² He sought to reach the “proper balance between the need to insure adequate disclosure and the need to avoid the adverse consequences of setting too low a threshold.”⁵³ He did his best, defining materiality not once but twice:

What the standard does contemplate is [1] 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 [2] 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.⁵⁴

For some reason, courts and commentators cite the second, *total mix* test more frequently than the first whenever only one of the tests appears.⁵⁵ In a footnote Justice Marshall admitted that he had deferred largely to the language submitted the Securities and Exchange Commission in its *Amicus Curiae* brief.⁵⁶

The standard appears on its face to be very, very inclusive. Most reasonable investors, if asked about what information they would like to know before voting on a merger, would say simply “tell me everything that is available to senior management about both constituent firms,” or “tell me everything that is available and I will decide what is significant.” It is hard to imagine what categories of potentially relevant information a reasonable investor would turn down before any vote. The test appears to be that anything potentially relevant to a reasonable investor is material and should be disclosed.

Then reality hits like a splash of cold water in the case—the actual holding on the facts does not seem to comport with the language of the materiality test. The plaintiffs claimed that two categories of facts omitted from the proxy statement were material. First, the proxy statement for the selling firm did not disclose the facts about the buyer’s control of the

52. *See id.* (adopting a broader view by focusing on the total *significance* of the information).

53. *Id.* at 449 n.10.

54. *Id.* at 449.

55. *See, e.g.,* Holly McCann, *Securities Exchange Act—Breach of Corporate Fiduciary Duty*, 31 DUQ. L. REV. 231, 235 (1992) (discussing court’s use of *total mix* test to define material under §10(b) and Rule 10b-5 in *Lewis v. Chrysler Corp.*, 949 F.2d 644, 650 (3d Cir. 1991)); Lynn L. White, *Securities Regulations—The Disclose or Abstain Rule—Tippee Liability*, 51 TENN. L. REV. 359, 361 (1984); Bradley D. Ross & Beverly Tillett, *Recent Ninth Circuit Developments in Securities Law*, 107 LOY. L. A. L. REV. 985, 1026 (1979).

56. *TSC Indus.*, 426 U.S. at 449 n.10. The Court, however, did not follow the SEC position on the facts of the case. The SEC brief supported the finding of the Seventh Circuit. Brief for the SEC as *Amicus Curiae* at 25, *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1975) (No. 74-1471).

seller.⁵⁷ Second, the proxy statement did not disclose facts needed to evaluate the favorability of terms of the proposed transaction.⁵⁸ The Court of Appeals, sensitive to the conflicted nature of the deal because a controlling parent had bought the company, had granted summary judgment for the plaintiffs on the claims and the Supreme Court reversed, holding that the case had to go to trial.⁵⁹ If the case was a normal summary judgment reversal due to contested facts, it would be unremarkable, but the case was not reversed due to contested facts. The facts were agreed upon and the Court reversed based on potential contested *inferences* drawn from facts: “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 those inference to him, and these assessments are peculiarly ones for the trier of fact.”⁶⁰

On the first category of disclosure defects in the case, the buyer’s control of the seller, the Court argued reasonably that the two omitted facts may not be significant in light of what was disclosed.⁶¹ The proxy statement did not state that the chairman of the selling firm’s board of directors was the chief executive officer of the buyer and that the chairman of the board’s executive committee was the buyer’s executive vice president.⁶² Nor did the proxy statement state that the buyer was a *parent* of the seller as defined in SEC Rules.⁶³ The proxy statement did state that the buyer owned 34 percent of the seller, that no other shareholder owned more than 10 percent, and that five of ten members of the seller’s board of directors were buyer nominees and buyer officers.⁶⁴ The Court held, in essence, that it was a matter of dispute over whether a reasonable shareholder would have failed to understand that this was not an arm’s length deal.⁶⁵

The Court’s holding on the second category of disclosure defects, evaluating the fairness of the deal, contained the shock. The deal featured a target board of directors that was highly conflicted; the controlling shareholder, who had nominees on the board, was buying out all other shareholders.⁶⁶ There was no special negotiating committee of independent disinterested directors.⁶⁷ The only protection a minority shareholder had in

57. *TSC Indus.*, 426 U.S. at 450.

58. *Id.* at 450–51.

59. *Id.* at 443–44, 464.

60. *Id.* at 450.

61. *Id.* at 452–53.

62. *Id.* at 451.

63. *Id.*

64. *Id.* at 452.

65. *Id.* at 452–53.

66. *Id.* at 441.

67. The case, decided before the special negotiating committee, became popularized by

the squeeze-out was through a vote in dissent. The minority shareholders could refuse to ratify the deal (and seek appraisal rights) if the price was too low. The minority shareholders had to use the facts disclosed by their company, with disclosure also under control by the controlling shareholder, to come to their own valuation of the company's worth. The risk in such situations is that the controlling shareholder may extract value unfairly from the minority shareholders by under-pricing what it will pay for the minority stock. The under-pricing can be due to undisclosed positive value in the subsidiary⁶⁸ or, in a stock-for-stock exchange, as was in issue in *TSC Industries*, due to undisclosed negative value in the parent.

In this case, the proxy statement omitted two facts regarding valuation. First, the investment-banking firm that supplied a fairness opinion to the selling firm board had sent a second letter to the board that lowered its calculation of the percentage of the premium over stock prices that the terms of the deal represented for the selling firm shareholders.⁶⁹ The second letter was not disclosed.⁷⁰ Second, a mutual fund, with buyer firm executives in controlling positions, had purchased substantial amounts of buyer firm stock during the time the acquisition exchange rates were set.⁷¹ Since it was a stock-for-stock deal,⁷² the mutual fund's purchases could have increased the price of the buyer stock used in the exchange, diluting the number of buyer shares received by the selling firm shareholders.⁷³ The conflicted mutual fund purchases were not disclosed.⁷⁴

It is stunning for the Court to hold, as it did, that a trier of fact could decide that these two defects, in a conflicted deal, were not material.⁷⁵ Any follow up communication from an investment banker altering a fairness opinion would surely be of interest to a reasonable investor.⁷⁶ The

the Delaware Supreme Court in conflicted deal cases (e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (1983) (suggesting that the courts might look at fairness differently if the deal was negotiated by a committee of independent directors)).

68. For example, there is good news for the subsidiary's future earnings (or its asset value) or another buyer appears and may pay more.

69. *TSC Indus.*, 426 U.S. at 455–56. The second letter noted that the premium as a percentage of market price had dropped, based on current market prices, for preferred shareholders from twenty-seven percent to nineteen percent and for common shareholders from twenty-two percent to fourteen percent. *Id.* at 456, 459.

70. *Id.*

71. *Id.* at 460–61.

72. One share of common stock in the seller was exchanged for 0.5 shares of common stock in the seller and 1.5 warrant. One share of preferred stock in the seller was exchanged for 0.6 shares of common in the seller and one warrant. *Id.* at 441 n.1.

73. *Id.* at 461.

74. *Id.* at 460.

75. *Id.* at 461–63.

76. The Court noted that shareholders could recalculate the reduced premium themselves and that even a nineteen and fourteen percent premium could be called “substantial.” *Id.* at 459.

investment bank was obviously getting cold feet because buyer stock prices⁷⁷ had dropped significantly after the exchange ratio had been set and the investment bank had also realized that it potentially had under-valued the effect of substantial dilution on the price of the stock warrants used in the exchange.⁷⁸ Furthermore, any potential claim, whether established or not, of market price manipulation of buyer stock price in a stock-for-stock swap, similarly would be of substantial interest to a reasonable investor. Though alleged and not proven, such a rumor, if backed with evidence (as it was in this case), is of substantial interest to any minority shareholder in the seller. Put the two facts together—an investment banker getting cold feet due to buyer stock price drops and a controlling shareholder heavily in the market during the finalization of the exchange rate—and one gets a pretty clear picture of a deal that has been oversold intentionally to minority shareholders. When the Court held both defects to be of debatable significance, one had to hear jaws drop up and down Wall Street (and at the SEC).

Were I an investor in the seller, with these additional facts, I would have voted against the deal; most selling firm shareholders in a healthy firm demand at least a twenty percent premium in conflicted, friendly deals. The over twenty percent premium was advertised and then not delivered. The Court seemed swayed by the fact that there was, in the end, some premium in the closing price: “[w]e certainly cannot say as a matter of law that these premiums were not substantial.”⁷⁹ Indeed, one gets the sense that even though the Court held onto the *Mills* Court’s refusal to use a deal’s fairness as a touchstone for causation that indeed,⁸⁰ the *TSC Industries* Court was heavily influenced by its ill-informed belief that the buyout in the case was at a fair price.

The Court sought to find a definition of significance that is a surrogate for *decisively affects the vote*, but crafted a second-best test that does not require proof of effect on the vote so as to further the public purposes of the securities anti-fraud rules. It then applies the new *lower* standard to a case laden with conflicts of interest in which the defects were highly likely to have affected the vote of the minority shareholders, and then holds astonishingly that no summary judgment is appropriate because reasonable

77. Specifically the value of the stock warrants used in the exchange had dropped from \$5.25 to \$3.50. *Id.* at 456.

78. The investment bank had valued the stock warrants at \$5.25 in the first letter and \$3.50 in the second. The investment bank’s cover argument in the second letter was patently makeweight. It argued in the second letter that using the \$3.50 valuation, there was still a “substantial premium” and this is what it really meant by “substantial premium” in the first letter, even though the proxy statement itself (referred to in the first letter) used a calculation of the premium with the stock warrants’ then-trading value of \$5.25. *Id.*

79. *Id.* at 459.

80. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 385 (1970).

minds could disagree on the inferences from un-contradicted disclosure omissions. The disconnect between the holding on facts of the case and the open-ended language of the materiality test in *TSC Industries* has proven to foreshadow things to come. The materiality test crafted in *TSC Industries* has an odd history in its application in the federal courts. As a discussion of the subsequent cases will show, the lower federal courts are often uncomfortable with the inclusiveness of the standard and their approach is to cite the *TSC Industries* language and then, following the example of Justice Marshall, not to apply the breadth of the language to the facts.⁸¹

The Supreme Court decided two other cases on materiality. *Basic, Inc. v. Levinson*,⁸² decided in 1988 and written by Justice Blackmun, which involved acquisition negotiations, and *Virginia Bankshares, Inc. v. Sandberg*,⁸³ decided in 1991 and written by Justice Souter, which dealt with opinion. In both cases, the Court rejected potential decisional rules that would tighten the materiality test. In *Basic*, the Court rejected the Third Circuit's *agreement-in-principle* test for when negotiations become material in preliminary acquisition discussions.⁸⁴ Noting that a "bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in light of all the circumstances," the Court nevertheless rejected the test as "necessarily . . . overinclusive or underinclusive."⁸⁵ The rationale was ironic given that the materiality test, as Justice Marshall recognized, is itself a second-best test compared to the optimal test of accurate evidence on the effect of the defect on a vote. The Court reached back to Judge Friendly's language in *SEC v. Texas Gulf Sulfur Co.*,⁸⁶ and held that the probability of an event, sliding backwards in light of its magnitude, would determine when merger discussions were material.⁸⁷

In *Sandberg*, the firm's proxy statement included an exhortation from the board of directors to the shareholders asking them to vote for a merger due to the *high* value offered in the deal.⁸⁸ The plaintiffs claimed that the board members did not, in fact, believe that the price was "high," but were motivated by other factors to support the deal.⁸⁹ The Court rejected the old common law limitation on fraud actions that exempted statements of opinions or beliefs from liability, and thereby constrained liability to

81. *See infra* Part II.

82. 485 U.S. 224 (1988).

83. 501 U.S. 1083 (1991).

84. *Basic, Inc.*, 485 U.S. at 232–33, 236.

85. *Id.* at 236.

86. 401 F.2d 833, 849 (2d Cir. 1968).

87. *Basic, Inc.*, 485 U.S. at 238–39.

88. *Sandberg*, 501 U.S. at 1088. In *Sandberg*, the firm's directors solicited a proposal's adoption by stating to minority stockholders that they had the opportunity to achieve a *high* value for their stock, which they elsewhere described as a *fair* price. *Id.*

89. *Id.* at 1088–89.

misleading statements of fact. It said that “[w]e think there is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, [can meet the *TSC Industries* test].”⁹⁰

The common law limitation had its roots in three justifications: first, statements of opinion are understood to be just that, normal sales talk;⁹¹ second, statements of opinion are too indefinite or vague to be verified or falsified;⁹² and third, statements of opinion are too easy to contest and too hard to defend by unadorned claims of undisclosed, ulterior motivations.⁹³ The Court rejected the first two arguments and then, worried about the third, ultimately held that statements of opinion are actionable only if the plaintiff can prove they are knowingly false or misleadingly incomplete.⁹⁴

Justice Scalia concurred,⁹⁵ perhaps to clarify Justice Souter’s less than elegant language, and added yet another wrinkle. Scalia’s concurrence further distinguished fact and opinion. “A statement that [t]he board *believes* the price to be high is subject to the majority’s test on opinions,” Justice Scalia wrote, but a statement that “[t]he board approves the deal because the price is high is, separate from opinion, a statement of actual fact.”⁹⁶

In both cases, the Court kept the open-ended, fact-dependent language of *TSC Industries* intact. In *Basic*, however, the Court made a second doctrinal move that was buried in the text, without explicit justification. We have since accepted the step in application to be unremarkable and inevitable. Dissected, however, the move reveals itself to be quite a leap. Early in the *Basic* opinion, Justice Blackmun noted that although in *TSC Industries* the Court defined materiality by reference to an act of voting,⁹⁷ the same definition applies to a shareholder deciding whether to buy or sell a security. Per Justice Blackmun, “[w]e now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.”⁹⁸ In other words, the Justice has instructed us to take the words “how to vote” out of the language from *TSC Industries* and insert “whether to hold, buy or sell.”⁹⁹ Since there are nearly 100 cases of trading losses brought

90. *Id.* at 1090–91.

91. *Id.* at 1091–92.

92. *Id.* at 1093.

93. *Id.* at 1095–96.

94. *See id.* at 1096 (holding that absent proof of false or misleading statements, disbelief or undisclosed motivation is not sufficient to meet evidentiary burden).

95. *Id.* at 1108.

96. *Id.* at 1109 (Scalia, J., concurring).

97. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

98. *Id.* at 232.

99. Acts not to buy or not to sell (to hold) were not included. *See infra* notes 103–04 and accompanying text.

for every one case of voting fraud, the move applies the *TSC Industries* language to a huge number of new cases. Yet the two contexts of voting and trading are significantly different, and the real issue is whether the difference should be reflected in the materiality standard.

As Justice Marshall and Justice Souter recognized, voting is a collective act with actual damage dependent on a deceived majority of those entitled to vote.¹⁰⁰ An individual who is deceived in the voting process may be psychologically wronged¹⁰¹ but is not damaged from a legal standpoint if a majority is not deceived. Any pecuniary damage comes from the collective action of a misled majority. A shareholder who is deceived into trading a security has individual damage, augmented or reduced by what other shareholders do at the same time. The collective action of other shareholders is important in establishing a plaintiff class, which reduces enforcement costs, but is not definitive on the issue of pecuniary damage. In other words, the reasonable investor test for voters necessarily involves references to the collective action of a reasonable majority of voters and the reasonable investor test for traders implies evidence of individual action, i.e. a reasonable trader who trades. While one would expect that the materiality test affecting a reasonable majority of voters would be more stringent than such a test for traders, the Court generally treats them the same. However, one does find that cases on voter fraud do seem to have tougher holdings.¹⁰²

Additionally, and perhaps more important, the *TSC Industries* test collapses when applied to traders. Justice Marshall's test saved Justice Harlan's view that liability did not depend on a finding that the deceived shareholders would have voted differently had they known the truth. A perfectly parallel test for traders would similarly not depend on a finding that the deceived trader would have traded differently had she known the truth, only that the trader would have considered the information significant in the *total mix*. Liability attaches where traders who lacked full information—even if such information would not have changed any of the trades actually made—would have paused to reflect on the information before making the trades. This puts a substantial emphasis on personalized valuations by *objective* or *reasonable* traders.

The reach of the test is illustrated by its application to traders who held or refused to buy. In theory, these traders do not have to prove that they would have traded had they known the truth, only that the information

100. In some cases, in which an approval by a disinterested minority is required by contract or by law, it can be a majority of the minority.

101. This is not to say that the wrong may not be worth a civil fine.

102. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 461–63 (1976) (refusing to impose civil liability based on theory that undisclosed information may indicate market manipulation).

would have altered the total mix of information important to them at the time. This class of traders is inclusive of most everyone in the trading market. The Court later decided that applying Rule 10b-5 to non-trading individuals was too ripe for exploitation regarding estimates of economic damages;¹⁰³ individuals had to trade, by purchase or sale, to get the benefit of private relief under Rule 10b-5.¹⁰⁴ However, if a trader buys or sells, she does not have to prove that she would not have made the same trade on accurate information. She would only have to show that the information altered the *total mix* of information important to them at the time.

The real effect of the Court’s application of the diluted materiality test to traders is to take a test harmlessly intertwined with the tests of causation and reliance for voters and intertwine those same tests with materiality for traders, resulting in a much more confounding brew. As noted above, voting cases proving the materiality element also tend to prove the elements of causation and reliance. The single exception for lack of causation is cases where the number of deceived voters could not have changed the result and did not otherwise give up valuable individual rights (such as dissenters’ rights).¹⁰⁵ Materiality in trading cases has a more tenuous relationship to the elements of causation and reliance. The Court struggled with the relationship in *Basic*, holding that proof of materiality implied a market price effect in a liquid market and that a presumed reliance on market price by traders substitutes for proof of actual reliance by traders on the misleading information.¹⁰⁶ Still, here this is internal inconsistency with the materiality test itself: in theory, misleading information can be material even if not one trader would decide to trade differently. If no individual traded differently, trades would not affect the market price even though the information not disclosed was material. Here the effect of a test formulated in a collective action case applied to a group of individual single actors appears. Moreover, the Court is no longer willing to imply causation from materiality as Justice Harlan did in the voting cases. If the company’s stock price does not change when the information is accurately disclosed, or if the stock price does not deviate from normal industry indexes during a time of incomplete disclosure, there is no damage to traders.¹⁰⁷

103. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735 (1975).

104. *Id.*

105. *See Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1105–06 (1991) (discussing the policy rationale for causation element in cases where shareholders could not change the outcome of the particular vote).

106. At common law, the *reasonableness* of the reliance is presumed if the information is *material*. *See, e.g.*, RESTATEMENT (SECOND) TORTS § 538 (1977).

107. *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344–46 (2005) (holding that causation cannot be shown unless the eventual disclosure leads to a decrease in the stock price).

None of the problems noted would have occurred had Justice Marshall not tried to save Justice Harlan's effort to separate the materiality standard from the actual decision on how to vote. If materiality in both the voting and trading cases turned on the information's effect on actual voting or trading—with normal legal allowances for problems in standards of proof or shifting presumptions—we would be free of these doctrinal complexities.

The Supreme Court's latest case on materiality, *Matrixx Initiatives v. Siracusano*,¹⁰⁸ a 9-0 opinion written by Justice Sotomayor, the Court applied by rote the language in *TSC Industries* and *Basic*. There was no effort to reevaluate the problems now inherent in the materiality test itself. The materiality test's language in the Court's touchstone cases is, for the foreseeable future, written in stone. Tellingly, the Court, without comment, slid back and forth from materiality to causation as if the two were one and the same. The Court also signaled comfortableness with the open-ended structure of the materiality test and its very inclusive language: ruling against a motion to dismiss, the Court held that evidence of negative patient side-effects with use of a drug, even if not statistically significant in a statistician's analysis, could be material.

II. THE MATERIALITY TEST APPLIED

A. *The Many Faces of Weight, Significance or Import*

Faced with a lenient materiality test and a active plaintiff's trial bar, the lower federal courts sought to separate Rule 10b-5 cases that ought to be brought from those that ought not.¹⁰⁹ Many of the cases are true to an investigation of the weight, significance or import of the information that is not properly and accurately disclosed. The lower courts developed, as one

108. 131 S. Ct. 1309 (2011).

109. In a survey of 726 reported cases from federal courts since 1965 (based on Westlaw Headnotes in the Securities Section, particularly "Materiality" (349Bk60.28(11)); "Materiality of Violation" (349Bk60.46) "False or Misleading Statements; Misrepresentation" (349Bk649.21); and "Materiality of Omissions" (349Bk49.22(2)) the plaintiff won on materiality 51.5% of the time. This was especially true when the SEC or the U.S. government was claiming the omissions or statements were material: the government won on materiality in nearly eighty-eight percent of cases in which it was a party. See, e.g., *SEC v. Wills*, 472 F. Supp. 1250 (D.D.C. 1978) (finding liability outside of rule 10b and 10b-5 for material misrepresentations); *SEC v. Parklane Hosiery Co.*, 558 F.2d 1083 (2d Cir. 1977) (finding that omissions concerning an appraisal in a premerger proxy statement were material); *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975) (finding defendant guilty of making materially false statements in proxy statement filed with the SEC); *SEC v. Gen. Refractories Co.*, 400 F. Supp. 1248 (D.D.C. 1975) (finding that proxy materials filed with the SEC were false and misleading).

would expect in the common law style,¹¹⁰ groups of cases categorized by sub-doctrines that variegated the definition of unimportant dependent on context. Some statements are *puffery*, general statements of optimism regarding the firm.¹¹¹ Other statements are adequately qualified and hedged by other communications, the “bespeaks caution” doctrine.¹¹² Statements

110. See KARL N. LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 108–117 (1960) (describing how common law doctrines evolve in a process of “change, rehammering, reshaping”); EDWARD H. LEVI, *AN INTRODUCTION TO LEGAL REASONING* 3–4 (1949) (describing how and why common law rules evolve); OLIVER WENDELL HOLMES JR., *THE COMMON LAW* 1–5 (1909) (same, using the evolution of liability as an example); Jack M. Balkin, *The Crystalline Structure of Legal Thought*, 39 RUTGERS L. REV. 1, 44, 109 (1986) (discussing “the normal common law development of doctrine”).

111. See, e.g., *City of Monroe Emp. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 670–71 (6th Cir. 2005) (holding that statements of self-praise and confidence amount to immaterial opinions that are not actionable), *cert. denied*, 546 U.S. 936 (2005); *Howard v. Haddad*, 962 F.2d 328, 331 (4th Cir. 1992) (holding that statements amounting to *puffery* lack the materiality essential to a securities fraud action); *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (holding that a characterization of bonds as *marvelous* amounts to puffery and is not actionable); *Newman v. Rothschild*, 651 F. Supp. 160, 163 (S.D.N.Y. 1986) (defining categories of puffery that do not qualify as material misstatements); *Darvin v. Bache Halsey Stuart Shields, Inc.*, 479 F. Supp. 460, 462–64 (S.D.N.Y. 1979) (holding that securities laws are not meant to provide relief for all stock market losses resulting, in part, from opinions regarding when to buy and sell); see also Owen Weaver, *Everything You Will Ever Want to Know About Puffery and How the Second Circuit Wrongly Applied it in Time Warner Cable, Inc. v. DirectTV, Inc.*, 43 NEW ENG. L. REV. 357 (2009) (discussing an erroneous application of the doctrine by the Second Circuit and how the English common law understanding of puffery is significantly different from its modern application); David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395 (2006) (describing the application of the doctrine in a variety of fields, including securities law, and how consumers have reacted to the doctrine); Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998) (arguing that puffery should not be applied in securities cases and that courts are using the doctrine to avoid engaging in a true materiality analysis); R. Gregory Roussel, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049 (1998) (noting that this doctrine is less understood and less familiar to courts in comparison to the bespeaks caution doctrine, thus leading to the adoption of different puffery standards by different courts).

112. See, e.g., *Saltzberg v. TM Sterling/Austin Assocs. Ltd.*, 45 F.3d 399, 400 (11th Cir. 1995) (holding that material misstatements or omissions may be non-actionable if accompanied by statements of caution and warnings of risk); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414–15 (9th Cir. 1994) (applying the doctrine narrowly by holding that cautionary statements are a sufficient defense only when attached to forecasts, estimates and predictions), *cert. denied*, 516 U.S. 868, 909 (1995); *In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig.*, 7 F.3d 357, 373 (3d Cir. 1993) (holding that cautionary statements must negate any potentially misleading effect a statement has), *cert. denied*, 510 U.S. 1178 (1994); *Moorhead v. Merrill Lynch*, 949 F.2d 243, 245–46 (8th Cir. 1991) (affirming lower court decision that potentially misleading statements were accompanied by sufficient cautionary statements); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991) (finding that projections or estimates are not actionable if accompanied by cautionary statements); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991) (finding that statements contained within the prospectus clearly bespeak caution);

that are misleading are not actionable if made in a market in which the participants already know the truth, the *truth-in-the-market* exception.¹¹³ Finally, courts have fashioned a *close enough* exception for cases in which the information disclosed is not in the express language demanded by the plaintiffs, but the essence of the information demanded has been accurately disclosed.¹¹⁴

see also Jonathan L. Booze, *A Comparative Analysis of the Application of the Bespeaks Caution Doctrine to Forward-Looking Statements*, 47 U. KAN. L. REV. 495 (1999) (arguing that courts have adopted the doctrine as a way to encourage more disclosure); Erin M. Hardtke, *What's Wrong With the Safe Harbor for Forward-Looking Statements? A Call to the Securities and Exchange Commission to Reconsider Codification of the Bespeaks Caution Doctrine*, 81 MARQ. L. REV. 133 (1997) (arguing that codification of the doctrine may cause confusion and even more litigation); Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619 (1997) (describing the traditional bespeaks caution doctrine and how it required good faith, in contrast to a safe harbor in the Private Securities Litigation Reform Act modeled after the common law doctrine); Jonathan B. Lurvey, *Who is Bespeaking to Whom? Plaintiff Sophistication, Market Information and Forward-Looking Statements*, 45 DUKE L.J. 579 (1995) (arguing that application of the doctrine may be problematic in cases where the cautionary terms are not sufficient to warn a less sophisticated investor); Christopher M. Marks, *Securities Law: When Does a Securities Disclosure Truly "Bespeak" Caution?*, 20 U. DAYTON L. REV. 467 (1994) (discussing the application of the doctrine, using a Third Circuit case as an example).

113. *See, e.g.*, *Davis v. SPSS, Inc.*, 431 F. Supp. 2d 823 (N.D. Ill. 2006) (holding that optimistic statements of future success were not actionable); *In re Corning, Inc. Sec. Litig.*, 349 F. Supp. 2d 698, 720–22 (S.D.N.Y. 2004) (holding that potentially negative news of study conducted by Corning had already reached the investment market); *see also* Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know*, 62 BUS. LAW. 1281, 1390–91 (2007) (giving an overview of the doctrine); Robert Norman Sobol, *The Benefit of the Internet: The World Wide Web and the Securities Law Doctrine of Truth-on-the-Market*, 25 J. CORP. L. 85 (1999) (describing how the Internet has made the doctrine more relevant than ever); Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843, 849 (1994) (discussing the rationale and origins of the doctrine).

114. *See, e.g.*, *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 452–53 (1976) (holding that omission of material facts, when considered against disclosures contained in a proxy statement, is not actionable); *Beck v. Dobrowski*, 559 F.3d 680 (7th Cir. 2009) (holding that there is no actionable claim where a proxy solicitation provides all required details regarding the company's best acquisition offer); *Starr ex rel. Estate of Sampson v. Georgeson S'holder, Inc.*, 412 F.3d 103 (2d Cir. 2005) (holding that statement of notices regarding their fees rendered claim of inadequate disclosure to be meritless); *Benzon v. Morgan Stanley Distribs., Inc.*, 420 F.3d 598 (6th Cir. 2005) (holding that prospectus provided sufficient information to compare relative value of different share classes); *Bond Opportunity Fund v. Unilab Corp.*, 87 F. App'x 772 (2d Cir. 2004) (denying recovery where potentially misleading information was accurately and fully disclosed in Proxy statement); *McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992 (10th Cir. 2002) (holding that accurate past financial information filed did not give rise to inadequate disclosure claim regarding additional risks to performance going forward); *New England Anti-Vivisection Soc., Inc. v. U.S. Surgical Corp.*, 889 F.2d 1198 (1st Cir. 1989) (holding that proxy materials fully and adequately described company proposal in a way necessary for shareholders to draw their own conclusions); *see also* Stefan J. Padfield, *Who Should do the Math? Materiality Issues*

It is common to see a court use multiple sub-doctrines in any one case.¹¹⁵ No doubt other doctrines will develop.¹¹⁶

A current topic of controversy on how to measure significance was illustrated by *Matrixx Initiatives, Inc. v. Siracusano*, recently decided by the Supreme Court after an appeal from the Ninth Circuit.¹¹⁷ Business people, yearning for more certainty in the *materiality test*, periodically ask for more quantitative measures of significance, a presumptive (or even absolute) *bright-line* test akin to those found in other areas of securities law.¹¹⁸ In *Matrixx*, which involved the materiality of reports on the alleged adverse effects of homeopathic cold remedies, the petitioners argued that “statistical significance” should be a threshold test for determining materiality—i.e., that if reports of problems with a product are not statistically significant, the reasonable investor would not consider them to be material.¹¹⁹ Petitioners in *Matrixx* further argued that without a quantifiable threshold, manufacturers face a tremendous burden to disclose all adverse reports.¹²⁰ The Ninth Circuit rejected the argument;¹²¹ while the

in Disclosures That Require Investors to Calculate the Bottom Line, 34 PEPP. L. REV. 927 (2007) (arguing that courts should not be so quick to dismiss claims where the bottom line was not disclosed).

115. *See, e.g.*, *Grossman v. Novell, Inc.*, 120 F.3d 1112 (1997) (using the doctrines of puffing, bespeaks caution, fraud on the market, and pleading insufficiency all in one case to determine if the case should be dismissed).

116. *See, e.g.*, *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (demonstrating a type of case in which *judicial efficiency* rationales are used by courts; these types of cases account for eighty-eight percent of the cases in which the plaintiff lost on the materiality issue in the case survey explained).

117. *Id.*

118. *See, e.g.*, 17 C.F.R. § 240.14-8(i)(5)(2008) (stating a presumptive *bright-line* Securities and Exchange Commission rule as to what is not proper for shareholder proposals. Rule 14a-8’s percentage tests have an important exception for matters “otherwise significantly related to the company’s business.” The rule states that “[i]f the proposal relates to operations which account for less than five percent of the company’s total assets . . . and for less than five percent of its net earnings and gross sales,” then the proposal is improper under state law); *see also* *Am. Fed’n of State, County & Mun. Emp. v. Am. Int’l Grp., Inc.*, 462 F.3d 121 (2d Cir. 2006) (interpreting SEC Rule § 240.14a-8(i) to mean that the court did not have to give normal deference to the SEC’s interpretation of its own regulations); *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985) (holding that the meaning of SEC Rule § 240.14a-8 covers proposals that are significantly related to the corporation’s business, which included the plaintiff’s proposed additions to proxy materials in anticipation of a shareholder meeting).

119. *See* Brief for Professors at Law and Business Schools as Amicus Curiae in Support of Respondents at 11, *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (No. 09-1156) (arguing for a *bright-line* test to determine the materiality of the rate of reported adverse incidents among product users).

120. *Id.* at 24–26. The respondents believe that a threshold requiring facts about adverse event reporting would not result in excessive and unfiltered information and reporting and would not impose an undue burden on the manufacturer. *Id.*

121. *Matrixx Initiatives, Inc. v. Siracusano*, 585 F.3d 1167 (9th Cir. 2009) (holding that

First, Second, and Third Circuits adopted a version of it.¹²² In a case similar to *Matrixx*, the Third Circuit, for example, rejected as non-material an alleged connection between a weight loss drug and heart valve problems in isolated cases in Europe.¹²³

A unanimous Supreme Court agreed with the Ninth Circuit, finding that statistical significance was not a prerequisite for materiality.¹²⁴ Writing for the unanimous court, Justice Sonia Sotomayor explained the rationale behind this decision as follows: “Given that medical professionals and regulators act on the basis of evidence . . . that is not statistically significant, it stands to reason that in certain cases reasonable investors would as well.”¹²⁵ While such evidence might not always be enough, the Court found in this case it was, based on “the source, context and context of the reports.”¹²⁶ In *Matrixx*, because the reports came from medical researchers involving nearly a dozen patients, the Court found that reasonable investors would have considered the reports significant.¹²⁷ Unfortunately, as in earlier materiality cases, the Court provided little guidance to the lower courts on how to satisfy this standard.¹²⁸

The dispute in *Matrixx* is ageless and ubiquitous: business advocates want clarity and certainty in the legal standards; enforcement-oriented advocates resist, afraid that they may have missed something that ought to

Matrixx Initiative’s withholding of Zicam adverse effect reports and pending lawsuits of Zicam users inferred that they had intent or knowledge of wrongdoing).

122. *N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc.*, 537 F.3d 35, 50 (1st Cir. 2008) (holding that incidents of five patients using drug developing infections alone was not material due to statistical insignificance); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000) (holding that the defendant corporation did not make material misrepresentations or omissions because the regulation did not create a duty to disclose trend data); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 155–57 (2d Cir. 1998) (finding no duty to disclose that company’s drug may have caused ten deaths because that was not enough to show that death “may be cause[d] by—rather than randomly associated with—use of the drugs”).

123. *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000) (holding that the few reports of adverse effects of the weight loss drug in Europe could not be conclusively related to the heart valve problems of the drugs users because there was not enough data or reports to support such an inference). Then-Circuit Judge Samuel Alito delivered the Third Circuit’s opinion in that case, yet appeared to repudiate this position in *Matrixx* as a member of the U.S. Supreme Court.

124. *Matrixx*, 131 S. Ct. at 1313–14. The Court based its holding not on the significance of statistical data but on the evidence that *Matrixx* withheld information to protect its profits. *Id.*

125. *Id.* at 1321.

126. *Id.*

127. *Id.* The Court noted that the likelihood that investors may find information about adverse effect reports related to Zicam was important because it may inform how they act.

128. See Adam Liptak, *Supreme Court Rules Against Zicam Maker*, N.Y. TIMES, Mar. 23, 2011, at B5 (quoting Northwestern law professor Ronald J. Allen as explaining how the Court “provided only limited guidance to companies and lower courts”).

have been caught.¹²⁹ Enforcement-oriented advocates are particularly afraid of the next clever avoidance trick that finds the edges of whatever test may have been clearly identified. The respondents’ rebuttal in *Matrixx*, for example, was traditional: an amicus brief filed by a cohort of law and business school professors on behalf of the respondents noted *Basic*’s admonition that “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or under-inclusive.”¹³⁰ In the *Matrixx* case, the test would have excluded considerations of the character of the biological impact found in the adverse reports at issue.¹³¹ In other words, the government needs to sport an open-ended test on materiality so as not to miss forms of significant information that cannot be encased in quantified standards.

Other problems in application are specific to the type of disclosure at issue. Two deserve special mention. First, the SEC is struggling to determine whether the agency should adopt a *mosaic theory* of information for insider trading investigations.¹³² Professional market analysts gather bits of information from numerous sources that individually are not significant, but when woven together provide material information on which to trade. If the bits of information come from numerous sources, each (or a majority of which) are under a duty of confidentiality to an issuer and are receiving some form of personal benefit from disclosure (satisfying the *Dirks*¹³³ standard), is the gatherer an illegal tippee if she trades? Does the scuttlebutt become material insider information under Rule 10b-5? The inquiry will be more theoretical than real if the SEC must prove that a *Dirks*-qualifying tipper provided every part of the mosaic. If the courts accept proof that a *Dirks*-qualifying tipper provided only a substantial portion of the mosaic, then the theory will have real bite.

The second application, which has always troubled the author but few others until very recently, is the relationship between the open-ended materiality test and the many specific disclosure schedules, with *items* of

129. See Securities and Exchange Act of 1934, 17 C.F.R. § 240.14d-1(a) (2008) (noting the dispute over definition of tender offer in Rule 14d series).

130. *Matrixx*, 131 S. Ct. at 1318 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 (1988)).

131. *Id.* at 1320. The Court noted that experts as well as the FDA use data beyond statistics to determine if adverse effects are linked the health problems, including biological impact and plausibility. *Id.*

132. See Andrew Ross Sorkin, *Collecting Tidbits, And Trouble*, N.Y. TIMES, Nov. 30, 2010, at B1 (explaining how investors and analysts search various sources to gain bits of nonpublic information to give themselves an edge over their competitors).

133. *Dirks v. SEC*, 463 U.S. 646 (1983) Tippees who receive non-public information from an insider do not have to abstain from trading unless the insider breached a duty to the company in revealing the information. *Id.*

demands, authored by the SEC. The items are inherently, at some level, over-inclusive and demand too much trivial information. A failure to comply is, of course, a violation of the rules that require a filing of the schedules. The schedules also include catchall provisions: some version of phrases like *include any material information not otherwise specifically identified in the items*. What is the effect of the meticulous detail in the numerous items on the general definition of materiality? How do the items in the forms shape the definition of materiality in non-formal information disclosures? In a recent case, a judge held information he personally viewed to be a significant omission as not a material omission because the SEC had not specifically required such information be disclosed in Rule 10b-10 regarding broker-dealer disclosures.¹³⁴ One has to have some sympathy for the view that given the reams of SEC directions in specific items, some of which are admittedly over-inclusive, it seems odd to expose persons to crushing civil and even criminal liability on the non-disclosure of information not required by any schedule items.

In any event, these sub-doctrines of materiality are a normal evolution of an open-ended standard. Judges' collective decisions on weight or significance of the information not disclosed are reflected in the sub-doctrines. I expect many more sub-doctrines will develop as the case law matures. For example, I would expect that sub-doctrines based on context, press releases as opposed to formal disclosure schedules, are not far off in the future.

Most academic writings on the sub-doctrines are critical, arguing that the doctrines somehow weaken the test so as to disadvantage investors.¹³⁵ A different tack was taken in a harsh critique of these sub-doctrines in a 2002 paper co-authored by Professors Stephen M. Bainbridge and G. Mitu Gulati.¹³⁶ The authors discuss the cases on *puffery*, *bespeaks caution*, *zero price change*, and *trivial matters* doctrines.¹³⁷ They say that lower federal court judges routinely dismiss securities cases on these grounds, they argue, because they are uninterested in them, do not understand securities

134. *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 132 (2d Cir. 2000). The court deferred to the SEC's decision regarding defendant's disclosure under 10b-10 and held that because the defendant had satisfied 10b-10 disclosure, they satisfied 10b-5 disclosure even though in other circumstances the omission would have been material. *Id.*

135. *See, e.g., supra* notes 110–13.

136. Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does-Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83 (2002). *Cf.* Donald C. Langevoort, *Are Judges Motivated to Create "Good" Securities Fraud Doctrine?*, 51 EMORY L.J. 309 (2002) (reviewing Bainbridge & Gulati's article, agreeing with the authors' points of view, but claiming their conclusion may be oversimplified).

137. Bainbridge & Gulati, *supra* note 136, at 119–25.

markets, and off-load the work to equally unimpressed clerks.¹³⁸

The authors’ main reason in support is a version of the same two arguments: In many of the cases, first, it is “implausible that all reasonable investors ignore information about small aspects of the business”¹³⁹ and, second, judges have no real evidence, other than intuition, on the “behavior of investors or markets.”¹⁴⁰ I tend to agree with Professor Donald C. Langevoort’s rebuttal that the lower courts are not slothful, but are creating, quite normally, a common law sub-division of doctrine underneath a very general test.¹⁴¹ It is unfair to criticize one opinion as uninformed when it builds on others; a better question is whether the entire line of cases is uninformed.

More important for this paper is the link between Professors Bainbridge and Gulati’s argument to the basic error in *TSC Industries*. These doctrines appear much more sensible if one does not buy into the thesis that materiality can exist without any effect on shareholder choice. The criticism that some trader or voter would want to know information X and no judge could conclusively hold otherwise without strong evidence to the contrary is, frankly, low hanging fruit. If the criticism is based on whether the information would change the outcome, lower court judges come off looking much, much better. Consistent with argument that the *TSC Industries* language is overbroad, one would expect lower court judges to retreat from the lower edge of hypothetical reasonable investor *total mix* test with applications and sub-doctrines on weight or significance that are a bit tougher. The evolution of doctrine on significance is best seen as a collective development of judicial learning and evaluation on information disclosure in the markets.¹⁴²

Lawyers advising publicly traded corporations, however, should be wary of the Supreme Court’s newest case on materiality, *Matrixx*

138. I fundamentally disagree with the professors’ claims. Given forum selection by plaintiffs and decisions by chief judges regarding judge allocations, many federal judges develop and relish a special expertise in securities cases and those judges do get significant reputation benefits from a well-earned reputation in the area. Examples by Judge Friendly in the Second Circuit, too numerous to mention, come to mind.

139. Bainbridge & Gulati, *supra* note 136, at 126.

140. *Id.* at 123.

141. *See* Langevoort, *supra* note 136 (noting that judges try to make right decisions but sometimes they do not have the time, knowledge or resources to conduct careful inquiry and end up relying on their intuition).

142. Here I differ with Langevoort’s analysis of bad law driving out good. The evolution is consistently self-correcting, with, among other things, judges using or not using the sub-doctrines (after all, many of the decisions are unexplained and simply declared) as understanding and criticism mount. *Cf.* Langevoort, *supra* note 136, at 313 (explaining that a bad precedent or slothful disposition can overshadow good and diligent decisions, and can turn into judicial bias, an assertion that I disagree with).

Initiatives.¹⁴³ The case's tenor and tone could put in doubt established views on what a publicly traded company need not disclose. For example, lawyers commonly assume that the contractual details of private debt placements are not material to the company's public investors. Thus the practice of putting the debt obligations on a cover page that is disclosed and the covenants on a second page that is not disclosed. This practice is now in question. Who can say with confidence that the covenants of large private debt placements are not of interest to a reasonable investor under the *total mix* language?

B. *Judicial Sleights of Hand: When is Significant Information Not Material?*

In the lower federal courts, small but steadily growing categories of cases have found statements to be immaterial even though the information at issue is—to most, if not all, objective and neutral observers—serious, weighty, and important. Most traders (or voters) would love to have it and the courts deny them access. None of the aforementioned sub-categories of *non-important* types of information apply. Each of these cases has a backstory: a court is carving an exception to the basic materiality standard, without applying the standard's articulated test. The exceptions usually are just declared and only opaquely and briefly explained, for the ultimate rationale of the exception cannot be written because the notion of an exception itself is not yet legitimate. These cases are, in essence, defining exceptions that are not exceptions.¹⁴⁴

Professors Bainbridge and Gulati see at least one category of these cases as yet another example of judicial inattention and would probably classify them all that way.¹⁴⁵ I disagree and believe the lower court cases are a conscious and measured reaction to a materiality standard that is over-inclusive. I would add, however, that more judicial candor on the non-exception exceptions would be welcome and refreshing.

One may be tempted to explain the cases under a *duty to speak* deficiency,¹⁴⁶ but the temptation is to be avoided. In *Basic*, Supreme Court

143. See *supra* notes 116–27 and accompanying text (explaining the details of *Matrixx*).

144. These cases accounted for 11.9% of cases in which the plaintiff lost in the case survey described. See, e.g., *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (demonstrating judges deciding that information on adverse reports was not material, even though the defendant was ultimately found liable, not for failing to disclose material data, but for scienter).

145. Bainbridge & Gulati, *supra* note 136, at 129 (on internal forecasts). In their discussion the authors, like the judges in the cases discussed below, overlook the difference between a forecast and the data that goes into the forecast and between a forecast that management actually uses as opposed to one that it has seen.

146. See, e.g., 15 U.S.C. § 78j (2006) (explaining that the duty to speak arises from

held that “silence, absent a duty to disclose” cannot serve as a basis for liability under Rule 10b-5.¹⁴⁷ Our required disclosure system is periodic and episodic rather than real-time, meaning that disclosure obligations attach every financial quarter and for specified major events.¹⁴⁸ Exceptions lie for voluntary statements and for a duty to correct any recently required statement.¹⁴⁹ A real-time system, as is in the United Kingdom, for example, requires disclosure whenever a material event occurs.¹⁵⁰ But the cases noted below do not fail the *duty to speak* problem. The issuer held the information not disclosed at the time of a required or voluntary statement.

So far, four types of cases contain this *exception, but not an exception* application of the materiality test. First are cases in which the court is concerned about business value sensitivity to the confidentiality of the information. Second are cases in which the court chooses to not, on the grounds of judicial economy, police a form of ubiquitous conduct. Third are cases in which the court is exercising deference and choosing not to preempt doctrines developing in other courts (usually state courts). And fourth are cases in which the courts are uncomfortable with a type of information that, even if accurately and fully disclosed, issuers can use, by disclosure timing alone, to influence and mislead traders. Each category is best understood by example.

1. Business Sensitive Information

All business people know well that there are categories of business information that are valuable because they are held in confidence. Once published, such information not only loses its value but the publication may

trading on insider or confidential information); *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that there is no duty to speak solely based on possession of nonpublic information).

147. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

148. *See, e.g.*, Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under 10b-5*, 57 VAND. L. REV. 1639 (2004) (describing the SEC disclosure requirements). Compare the U.S. system with UK Financial Services Agency Disclosure and Transparency Rules § 6: Continuing Obligations and Access to Information, *available at* <http://fsahandbook.info/FSA/html/handbook/DTR/6> [hereinafter UK Financial Services Agency Disclosure Rules].

149. *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) (“a duty to update opinions and projections may arise if the original opinions or projections have become misleading as the result of intervening events”).

150. The UK has numerous exceptions, however, that we do not and ought to recognize. *See* UK Financial Services Agency Disclosure Rules, *supra* note 148. The continuing disclosure requirements only apply to amendments to the company’s constitution or information about changes in shareholder contract rights, shareholder meetings, issuance of new shares, payment of dividends and payment of interest; *see id.* §§ 6.1.2, 6.1.9–15 (noting disclosure and transparency rules for issuers of securities).

injure the company as well. Most examples come from business negotiations in large-scale arrangements with customers, suppliers, investors, or acquisition partners. In their early stages, the negotiations themselves are sensitive to disclosure; early disclosure can destroy the possibility of a closed deal.

Moreover, in all these negotiations, the firm holds information in reserve that the executives use to fashion a bottom-line, *walk away* negotiating position. The firm's goal, to maximize gains in excess of their walk-away position, is compromised completely if opponents can accurately construct the firm's bottom-line calculation. As such, the need to keep these kinds of figures and calculations confidential is reflected in the rules of stock exchanges around the world, including the New York Stock Exchange,¹⁵¹ the Australian Stock Exchange,¹⁵² and the New Zealand Stock Exchange.¹⁵³ The stock exchange rules are market-tested, since the exchanges compete for company listings in part through their rules.¹⁵⁴ Moreover, in the United States, the listing rules on disclosure pre-date the New Deal legislation that created a federal disclosure regime.¹⁵⁵ It is no surprise then that some federal courts have felt similar pressures in determining what is *material*.

The information of the early negotiations and information that becomes the basis of a bottom-line calculation is hardly insignificant; it is hugely significant. Yet lower courts can label it *immaterial*. This is in the face of the express and blunt admonition of Justice Blackmun that the standard of materiality has no room for concerns related to business necessity.¹⁵⁶

151. NYSE Rule 472(k)(3), 2006 WL 5017351 (creating a disclosure exception for "material non-public information regarding specific potential future investment banking services transactions of the subject company").

152. ASX Listing Rules § 3.1A (allowing companies to avoid disclosure if the information is confidential, if the "information concerns an incomplete proposal or negotiation," or if it "is generated for the internal management purposes of the entity").

153. NZSX Listing Rules § 10.1.1(a) (adopting the same rule as the Australian Stock Exchange, *supra* note 152).

154. See, e.g., Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1435–38 (2008) (claiming a dynamic market for securities laws).

155. *Id.* at 1435. These pre-Securities Act rules required companies listed on the NYSE to submit audited reports on their financial condition to an NYSE committee at least twice a year. See CHARLES H. MEYER, *THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES*, 858–59 (1931) (explaining that the report needed to be a "complete audit of their accounts and assets . . . in accordance with such regulations as shall be prescribed by the [relevant NYSE] Committee"). Presumably, an audit of the accounts and assets would not include such business sensitive information as merger negotiations and the like.

156. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) (Justice Blackmun, after flatly rejecting the concerns of business people over information sensitivity in early merger

Justice Blackmun rejected the lower courts’ application of a business sensitivity test in the disclosure of early stage negotiations, but the Supreme Court has not yet dealt with the reservation of materials used to fashion bottom line negotiating positions. Lower courts have, in the asset appraisal cases. Yet trial judges were heavily influenced by both concerns. In the end, the lower courts simply bent the test. Courts just found *not material* information that looked to be of interest to traders or voters. A few examples easily demonstrate the point.

One of the leading cases on the issue is *Radol v. Thomas*,¹⁵⁷ in which the Sixth Circuit held outside appraisal reports to be not material. In a friendly two-stage acquisition,¹⁵⁸ a tender offer followed by a freeze-out merger, the buyer did not disclose in the tender offer two reports on the target’s net asset value. The seller internally prepared one, and a well-known investment bank prepared the other. In the second stage of the acquisition the buyer, to comply with Schedule 13E-4, Item 9,¹⁵⁹ disclosed both studies in the merger proxy statement. Plaintiff shareholders in a class action argued that the reports should have been disclosed in the first-stage tender offer. The Court held that the reports’ conclusions were not “substantially certain to hold” and rejected the claim.¹⁶⁰

The Court cited the *TSC Industries* test, which focuses on what an investor would like to have known, and blithely concluding that reports were not material.¹⁶¹ Of course the target shareholders wanted the information on the net asset appraisals used by the bidder to determine the

negotiations, attempts to offer them some instruction). Justice Blackmun’s advice in *Basic* is nonsensical. Assume a reporter or NYSE official asks a business executive whether stock price gyrations are a sign of yet undisclosed merger negotiations, and the executive knows that they probably are. The executive should say “no comment” unless the executive knows that the public will interpret the “no comment” as a “yes” because all previous answers have been “no” when the executive was not in any deal discussion. This asks an executive to violate the firm’s listing requirement with the NYSE that requires a truthful answer, and it forces an executive to answer “no comment” to any question dealing with negotiations, whether or not any are underway, to preserve the right to refuse to answer the question when a deal is actually under discussion.

157. 772 F.2d 244 (6th Cir. 1985). See also *Starkman v. Marathon Oil Co.*, 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986) (noting failure to disclose appraisals are not violations of Rule 10b-5).

158. The target favored the buyer over a hostile bidder and even agreed to a coercive structure to the offer. The tender offer price was \$125 a share for 51% of the outstanding shares and the freeze-out price for the remaining shares was \$76 a share. *Radol*, 772 F.2d at 246.

159. Replaced by Schedule TO, 17 C.F.R. § 240.14d-100 (2007).

160. *Radol*, 772 F.2d at 253. A fuller analysis of the Court’s reasoning is in *Starkman*, 772 F.2d at 240–41. The Court also held that the lower court’s decision to send the matter to a jury was error. Materiality decisions are matters of law for judges to decide. The jury had found for the defendants on the merits.

161. *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976).

price offered for the target shares.¹⁶² Any poll of target shareholders would have returned overwhelming numbers in favor of disclosure. The Court also had to reject arguments relating to the SEC rules on the second half of the transaction that declared the reports (or at least the investment bank report) to be presumptively material: It held that transaction should not be collapsed into one deal; the materiality definition of the merger did not apply to the tender offer, and so on.¹⁶³ It is an astonishing holding, to say the least. A better explanation of the holding would seem to be that the Court was comfortable supporting the target's efforts to sell the company to a white knight rather than a hostile raider/bidder and did not want the hostile bidder to have the critical valuation information until after control of the target had been locked up.¹⁶⁴

Another form of business sensitive information is the information necessarily generated in routine, internal management reports. Managers need real-time information on firm operations to best direct the affairs of their companies. If the internal reports show a real change in the fortunes of a business, must the managers reveal something about the changes to the public in required or voluntary disclosures? The trial courts have held no.

The best-known case on internal data is *Walker v. Action Industries*.¹⁶⁵ In a partial self-tender offer, a firm issued a Schedule 13e-4 and a subsequent press release but did not disclose that the buyer's internal financial reports were reflecting substantial increases in actual weekly sales (*flash sales reports*) over the prior year, which sales were also reflected in routinely generated, projected quarterly and yearly sales forecasts (*gross sale forecasts*) that exceed prior year sales.¹⁶⁶ The plaintiff sold his shares after the press release and watched in dismay as the stock tripled in price on the later disclosure of interim financials that detailed a seventy-five

162. For a similar holding, see *Biechele v. Cedar Point, Inc.*, 747 F.2d 209 (6th Cir. 1984) (holding that selling documents in merger discussions with potential buyers is not material for shareholder disclosure). The Third Circuit adopted a factors test, but the result was the same—not material. See *Flynn v. Bass Bros. Enters., Inc.*, 744 F.2d 978, 988 (3d Cir. 1984) (holding that appraisal was not established as reliable). A humorous moment in the decision occurs when the Circuit Court must confront the plaintiff's argument that the bidder paid \$130,000 for the report in 1976 so the bidder, at least, thought the report was reliable. The Circuit Court said, "even if there had been some reliance on the reports [by the bidder], that alone would be insufficient to mandate disclosure in this case." *Id.* at 989. What shareholder would not want to know what valuation data the bidder was using to set the acquisition price?

163. *Radol*, 772 F.2d at 255.

164. For similar cases, see *Lane v. Page*, 649 F.Supp. 2d 1256 (D.N.M. 2009) (holding internal valuation of target by bidder was not material) and *Dixon v. Ladish Co.*, 597 F. Supp. 20 (E.D. Wis. 1984) (holding that target company's failure to disclose internal valuation of itself not material).

165. 802 F.2d 703 (4th Cir. 1986).

166. *Id.* at 705.

percent increase in year-over-year sales.¹⁶⁷ The Fourth Circuit held that the firm had no duty to disclose the internal data and projections,¹⁶⁸ yet the information not disclosed was of considerable importance.

The Fourth Circuit had four reasons, the first two being makeweight. It found that neither the Schedule 13e-4 nor other SEC rules had required the disclosure of “projections.”¹⁶⁹ Yet the firm had real facts, the weekly sales data as well as projections; and the SEC does use catchall provisions that require, as noted above, the disclosure of any additional material information not specifically identified.¹⁷⁰ The second two reasons given by the court are more defensible. The court found that the projections were too “uncertain[]” (they “chang[ed] constantly”) and that disclosure was “impractical” (they were too “frequen[t]” and “volatil[e]”).¹⁷¹ The sales forecasts did bounce around somewhat in their detail, and some of the forecasts projected increases in excess of the actual seventy-five percent increase that eventually manifested. But all of the forecasts projected huge increases, and they were based on real weekly sales data that was in hand.¹⁷² One wonders why the firm should not be obliged to disclose the actual weekly data increases or the general, overwhelmingly positive trend in the forecasts (as opposed to the exact numbers that were fluctuating).¹⁷³ Investors would surely want to know either or both bits of information; the information surely satisfies the *total mix* test.

The reasoning of the federal courts surrounding the materiality of projections has been sloppy, perhaps by design. The courts, once a projection is on the table, fail to separate the projection itself from, first, the facts that are the basis of the projection and, second, the important fact that a company’s managers are relying on the projections. *Walker* is a clear example of this failure to parse the facts: the forecast and the sales data that went into these projections were deemed immaterial as being too “uncertain and unpredictable.”¹⁷⁴ Yet the sales data feeding these projections were not uncertain and unpredictable; they were based on actual sales.¹⁷⁵ Similarly, one could see a distinction being made between

167. *Id.*

168. *Id.* at 710.

169. *Id.* at 709.

170. In Schedule TO for issuer re-purchasers, an issuer must disclose any report, opinion, or appraisal from an *outside party* that is *materially related* to the transaction. So a gross sales forecast made by an outside consultant may have to be disclosed. SEC Schedule TO, Item 9, 17 C.F.R. § 240.14d-100 (referring issuer to Reg. M-A § 229.1015).

171. *Walker*, 802 F.2d at 709–10.

172. *Id.* at 705.

173. A disclosure of trends would negate the Court’s argument that if the firm had disclosed the actual numbers in sales forecasts the plaintiff could have sued based on the “misleading” nature of the specific projections. *Id.* at 710.

174. *Id.* at 708 (internal quotation and citation omitted).

175. *Id.* at 705.

the projections and the fact that management relied on them: perhaps the projection itself is too speculative to be material, but the fact that management relied heavily on such a projection might well be a material fact. A few courts do draw the distinction.¹⁷⁶ Most often, however, courts anxious to declare projections to be not material throw out every fact associated with the projection as well as the projection itself.¹⁷⁷ One could write this off as carelessness or, on the other hand, as carefully intended judicial convenience and efficiency.

A better explanation of the holding is perhaps that the Court has a soft spot in its heart for routine internal business reports.¹⁷⁸ All businesses use them, and the Court does not want to review them every time a shareholder complains about a stock-price drop. Imagine the dialogue between firm executives and firm lawyers whenever internal reports show some changes in operation that could portend a change in critical, yearly figures.

The ambivalence of the federal courts is mirrored by both the SEC itself and by state courts. The SEC, for example, does not specifically require the disclosure of expert reports, opinions or appraisals that detail bottom line negotiating positions unless (1) the report is mentioned voluntarily in a disclosure document,¹⁷⁹ or (2) the deal is a going private transaction.¹⁸⁰ It goes without saying that it is odd that the SEC, with its specific rules on the required disclosure of expert reports, throws the matter into the courts with a general materiality catchall provision, recognizing the liberalness of the *TSC Industries* test. The Delaware courts, adopting the *TSC Industries* standard for their case law on disclosure obligations under state law doctrines of fiduciary duty, have also struggled with whether to require the disclosure of internal valuation reports relevant to acquisition

176. See, e.g., *Fisher v. Plessy Co.*, 559 F. Supp. 442, 450 (S.D.N.Y. 1983) (“defendants must disclose material facts on which projections can be made”).

177. See, e.g., *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1125 (10th Cir. 1997) (holding cautionary statements to be projections, but those projections were not material enough to give rise to a duty to disclose); *Glassman v. Computervision Corp.*, 90 F.3d 617, 631 (1st Cir. 1996) (holding that there was not a duty to disclose because the projections were not material); *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1052 (9th Cir. 1993) (holding that the plaintiff failed to state claim based on the company’s duty to disclose because the company’s internal financial projections were not material); *Walter v. Holiday Inns, Inc.*, 985 F.2d 1232, 1243–44 (3d Cir. 1993) (holding non-disclosures during a conduct of partnership buy-out transaction not to be material); *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 239–43 (6th Cir. 1985) (holding that the projections were not material, which meant that the company did not have a duty to disclose under Rule 10b-5).

178. For a similar case, see *Pavlidis v. New England Patriots Football Club*, 737 F.2d 1227 (1st Cir. 1984) (holding revenue projections were not material).

179. See, e.g., SEC Registration Statement (Form S-4, Item 4(b)), cross-referencing to Item 1015(b) of Reg. M-A, Reports, Opinions, Appraisals and Negotiations, 17 C.F.R. 229.1015(b) (2011).

180. Item 9, Schedule TO, cross-referencing to Item 1015(b), *supra* notes 170, 179.

pricing.¹⁸¹

2. Ubiquitous Business Conduct¹⁸²

In some cases, the courts appear to be using the materiality doctrine to stay out of disputes that otherwise would be ubiquitous and time-consuming. We have seen a variation of this theme in the Supreme Court case discussed above, *Virginia Bankshares*. The Supreme Court has been reluctant to get involved in cases that dispute whether or not the board of directors in a merger actually believes what it says it believes in a disclosure document. The author’s favorite case of those in this category of exceptions is *Lewis v. Chrysler Corporation*.¹⁸³

In *Lewis*, a well-known corporate raider, Kirk Kerkorian, had acquired a nine percent stake in Chrysler Corporation in the late 1980s.¹⁸⁴ Chrysler, wanting no part of the raider, adopted a classic takeover defense in response, a shareholder rights plan commonly known as a *poison pill*.¹⁸⁵ Soon thereafter, Chrysler amended the plan twice to strengthen it.¹⁸⁶ On the second of the two amendments, the firm issued a press release justifying the action. In the press release, the company stated “[t]he amendments adopted today are intended to enhance the ability of Chrysler’s Board to act in the best interest of all the Company’s shareholders if someone should seek to obtain a position of control or substantial influence over Chrysler.”¹⁸⁷ Kerkorian sued, arguing, among other things, that the press release was misleading because it did not disclose that the poison pill plan benefitted incumbent managers, and it further did not disclose the “cost” to the shareholders of the plan.¹⁸⁸ In support, he noted an interview of a Chrysler board member in the *Wall Street Journal*, in which the board member said that the poison pill was “prudent” because he was “not sure that Kerkorian’s intentions would not

181. Compare *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (disclosure of international report required) with *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985) (disclosure of internal report not required). See also *In re Pure Resources Inc., S’holder Litig.*, 808 A.2d 421 (Del. Ch. 2002) (requiring disclosure of work papers behind an investment banker fairness opinion).

182. This title is not entirely accurate, but it comes close to capturing the basic idea. This exception is really based on context. For example, courts do not want to find themselves in the business of litigating press releases in the overwhelming majority of cases. If they did, they would be flooded by litigation, as the use of press releases is ubiquitous in the business community.

183. 949 F.2d 644 (3d Cir. 1991).

184. *Id.* at 647.

185. *Id.* at 646.

186. *Id.* at 646–47.

187. *Id.* at 647.

188. *Id.* at 650.

be hostile to current management.”¹⁸⁹

The Third Circuit punted and dismissed the complaint. The court did not want to get involved in the propriety of firm anti-takeover devices under the rubric of the federal securities laws. Part of the opinion justified its holding on an aversion to *bootstrapping* into federal courts claims under state law on fiduciary duty claims that swirl around hostile acquisition attempts. One also suspects that the court knew that the saying *in for a peck is in for a bushel* applies in these cases. Once a plaintiff could argue improper board motive and propriety and/or shareholder losses in disclosure cases based on press releases on acquisitions, all acquisitions would inevitably end up in federal court.

So how does the court stay out? It declares board motive and shareholder losses to be not material. In other words, the court finds that a board’s motive to entrench itself at the expense of its shareholders is not material to those same shareholders. Moreover, the shareholders’ loss of stock value due to the defeat of a hostile bidder, the current value of a lost potential takeover premium, is also declared not to be material. Neither Court holding on materiality is based on the significance of the information, the supposed test. The first holding is based on an *anti-bootstrapping* rationale, and the second holding is based on a declaration that the cost is “wholly speculative . . . and unreliable.”¹⁹⁰ While the exact cost may be somewhat speculative (one presumes it could be approximated by the difference between the market value of the shares before and after the announcement of the plan amendments),¹⁹¹ some cost to defeating a hostile takeover attempt is undeniable.

3. Deference to State Courts

The argument in *Lewis* against bootstrapping is an argument for deference to the state courts. One sees the argument used to justify some startling results. One example is *In re Teledyne Defense Contracting Derivative Litigation*,¹⁹² where the court held that the firm’s and the directors’ complicity in criminal activities was not material and did not have to be disclosed in a proxy statement covering board elections. The company was subject to a number of criminal and civil suits after its sale of

189. *Id.* at 651.

190. *Id.* at 653.

191. The Court notes that an “undeveloped future attempt to acquire control of Chrysler” could appear. *Id.* at 653. Fair enough. The future use of the anti-takeover device is uncertain. Chrysler could also use the poison pill plan to negotiate a higher offer from Kerkorian or to negotiate a severance package for the incumbent managers. But the plan amendments themselves signal the stock market of the board’s intentions, and that type of signal itself can have negative consequences on stock price.

192. 849 F. Supp. 1369 (C.D. Cal. 1993).

defective electromagnetic switches to the United States government and in one case had pled guilty, resulting in a \$17.5 million fine.¹⁹³ The other pending suits alleged damages of close to \$400 million dollars.¹⁹⁴ Clearly these allegations and the pending litigation would be material to a reasonable investor. Indeed, the district court noted that “[f]rom a common sense standpoint, Plaintiffs are surely correct: had the Director Defendants confessed the wrongdoing . . . it is not difficult to imagine that the shareholders might have [voted] differently.”¹⁹⁵ As such, when information about the alleged illegality was left off of proxy statements for board elections over a period of five years¹⁹⁶ a number of shareholders sued.

Yet the district court found that the omissions were not actionable. The judge held that the proper forum for the allegation was in state court under a claim of a breach of fiduciary duty.¹⁹⁷ Oddly, the court noted that it would have heard the case if the plaintiff had alleged personal enrichment.¹⁹⁸ An allegation of personal enrichment is also a breach of fiduciary duty under state law, violating a duty of loyalty and a duty to act in good faith in the best interests of the firm. Thus, one type of state action for breach of fiduciary duty may be heard in California federal court while another may not. The plaintiff’s efforts to show personal enrichment based on an allegation that the board members were seeking to keep their positions was not enough to meet that personal enrichment threshold, however.¹⁹⁹

There are several other examples. One is *In re American Express Co. Shareholder Litigation*,²⁰⁰ where the district court held that a failure to disclose that the gross negligence of the board had exposed the firm and the board to numerous and expensive lawsuits was not material in a proxy statement. Specifically, the company was alleged to have plotted the defamation of a potential competitor.²⁰¹ In preparing to execute this scheme, the company asked shareholders to ratify new amendments to the by-laws and charter to indemnify the directors against judgments where there was no “bad faith, deliberate dishonesty, or personal benefit” and also

193. *Id.* at 1371.

194. *Id.*

195. *Id.* at 1380.

196. *Id.* at 1379.

197. *Id.* at 1381 (noting that the Ninth Circuit barred these types of claims, “leaving Plaintiffs to state corporate law remedies for claims of mismanagement”).

198. *Id.* The court stated that “in this circuit, ‘credible allegations of self-dealing . . . or dishonesty or deceit which inures to the direct, personal benefit of the directors’ are absolute prerequisites” to a federal omission claim. *Id.*

199. *Id.* The court noted that the plaintiff’s argument “blurs the critical distinction drawn” by the Ninth Circuit “between simple corporate mismanagement . . . and self-dealing”). *Id.*

200. 840 F. Supp. 260 (S.D.N.Y. 1993).

201. *Id.* at 262.

put limits on the amount of liability directors could incur in judgments even when “bad faith” or “dishonesty” were found.²⁰² The plaintiffs alleged that the failure to include information about the alleged defamation plot on the proxy statements seeking enactment of those amendments was a material omission.²⁰³

The district court rejected this argument, not wanting to *federalize* state corporate law. Quoting the Supreme Court,²⁰⁴ the district court stated that to allow these suits would be to “federalize the substantial portion of the law of corporations that deals with transactions in securities” and that therefore federal law did “not prohibit ‘instances of corporate mismanagement . . . in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.’”²⁰⁵ The district court did note a limited exception for conflict of interest allegations that affect an election of the board of directors.²⁰⁶ The plaintiffs attempted to make that argument in this case by noting that there was such a conflict here: the directors were omitting information to push through protection for the acts that were omitted in the proxy statement.²⁰⁷ The district court was unimpressed, replying that “this is the type of . . . ‘garden variety mismanagement’” that cannot sustain a federal conflict of interest claim.²⁰⁸ Thus some conflict of interest claims are not material and others are, not based on some measure of significance but instead based on courts’ efforts to control their dockets.

One could argue, perhaps weakly, that in such cases the significance of state fiduciary breach claims is too speculative unless the claims have actually been filed in state court.²⁰⁹ But then one would run up against *In re Sears, Roebuck & Co. Securities Litigation*,²¹⁰ a case in which the company had been actually sued in state court and did not disclose the suit in a proxy statement. The case adopted the same *federalization* rationale used in *In re American Express*, citing many of the same cases.²¹¹ Because

202. *Id.*

203. *Id.* at 267.

204. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977).

205. *In re American Express Co. S’holder Litig.*, 840 F. Supp. 260, 268 (S.D.N.Y. 1993) (internal citation omitted).

206. *Id.* (noting that “this does not mean that facts can never be both a basis for state law fiduciary duty claims and also subject to disclosure under” federal law in situations as when the directors violated both a duty and federal law “by failing to disclose certain information regarding their ownership of options on the [target] corporation’s stock” in a merger or acquisition).

207. *Id.*

208. *Id.*

209. *See id.* at 269 (citing and describing *Gen. Elec. Co. v. Cathcart*, 980 F.2d 927 (3d Cir. 1992)).

210. 792 F. Supp. 977 (E.D. Pa. 1992).

211. *See id.* at 980–81 (citing the *Santa Fe* and *Lewis* cases).

the omission “was simply the failure to disclose the existence of state law claims,” the omission was immaterial.²¹² The judge declined to find that the fact that a state action had been pending during the release of the proxy statements distinguished it from the earlier precedent, despite the fact that those cases involved only *potential* state claims.²¹³ The Court fashioned a different exception than the *self-enrichment* exception found in *In re American Express*, however. It held that the suit was not material unless the allegation was for some form of common law fraud.²¹⁴

Indeed, one of the oddest parts of the Supreme Court case that gave up the over-board language that undergirds the modern materiality doctrine, *TSC Industries v. Northway*, was Justice Marshall’s finding on one of the case’s allegations.²¹⁵ The plaintiff shareholders had alleged, with some basis in fact, that the buyer in a stock swap merger and manipulated its stock price before the deal price was negotiated so as to buy the target company on the cheap.²¹⁶ The chairman of the board of the buyer was also a director of a large mutual fund. The fund, prior to the deal negotiations, had entered the market and bought over time what turned out to be an unusually large position in the buyer’s stock.²¹⁷ The mutual fund buying stopped once the deal price was announced and signed onto by both boards of directors.²¹⁸

Justice Marshall found that the mutual fund buying and the conflicted position of the buyer’s chairman were not material. The Court of Appeals had held that the information had to be disclosed, granting summary judgment for the plaintiffs, and the Supreme Court, through Justice Marshall’s majority opinion, overruled that holding. Justice Marshall used an argument based on the procedural posture of the case, reasoning that there were facts in dispute as to whether there was actual, intended manipulation.²¹⁹ The lower court had held that the investors had a right to know about the conflict and make their own minds up about the potential for manipulation.²²⁰ There was no dispute over whether the facts were not disclosed; they were not.²²¹ A potential explanation for the astonishing holding that a clear conflict of interest was not material as a matter of law,

212. *Id.* at 981.

213. *See id.* (“under [those earlier cases], defendant’s omission of a description of the [state] action in the proxy statement is not a material omission”).

214. *See id.* (noting that the omission would be material if the pending state claim involved “fraud, deception or manipulation”).

215. *TSC Indus., Inc. v. Northway*, 426 U.S. 438 (1976).

216. *Id.* at 461–62.

217. *Id.* at 461. The mutual fund ended up with over 8.5% of the buyer’s stock. *Id.*

218. *Id.*

219. *Id.* at 461–62.

220. *Id.* at 443.

221. *Id.* at 458.

may lie in the Court's refusal, absent clear direction from the SEC, to federalize pure allegations of conflicts of interest (without more evidence of improper pecuniary gain by a manager)²²² as breaches of fiduciary duty, which are matters of state law concern.

This seemingly odd distinction between cases in which a manager inappropriately takes cash, *self-enrichment* is material, and *garden variety mismanagement* (not material) noted in cases like *In re Teledyne* has been adopted in a number of circuits, including the Ninth,²²³ Eighth,²²⁴ and perhaps even the well-respected Second.²²⁵ The origin of this exception to the implicit exception may have its origins in U.S. Supreme Court in cases that seek to limit the scope of Rule 10b-5 claims in deference to state court prerogative, like *Ernst & Ernst v. Hochfelder*²²⁶ and *Santa Fe Industries v. Green*.²²⁷ In *Santa Fe*, the Court explicitly noted that typical breaches of fiduciary duty could not support a 10b-5 claim, absent "manipulation."²²⁸ In *Ernst & Ernst*, the Court had determined that "manipulat[ion]" was "virtually a term of art" in this context.²²⁹ The *Santa Fe* Court gave some examples: "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."²³⁰ The Court's effort to stake out an exclusive area for state court adjudication is evident in the reasoning. The federal courts will hear cases of traditional securities violations but leave general mismanagement cases to the state courts.

But a *self-enrichment* exception to the *not material* exception does not make similar sense. Self-dealing has long been a breach of fiduciary duty litigated primarily in state courts; the class of cases included in the category is not limited to traditional securities trading activity. The Supreme Court itself is conflicted on the issue.²³¹ The Circuit courts that adopt the

222. *See id.* at 463 (asking the SEC to pass a rule on the issue).

223. *Gaines v. Haughton*, 645 F.2d 761, 776–77 (9th Cir. 1981) (holding allegations of director misconduct involving breach of trust or self-dealing presumptively material and allegations of director misconduct involving simple breach of fiduciary duties and wasting corporate assets immaterial).

224. *Golub v. PPD Corp.*, 576 F.2d 759, 764 (8th Cir. 1978) (holding that a proxy statement, which was issued relative to proposed sale of a corporation's assets and which stated that approval of the sale was a foregone conclusion, still met the requirements of the Securities Exchange Act).

225. *Weiseberg v. Coastal States Gas Corp.*, 609 F.2d 650, 654 (2d Cir. 1979) (ruling that a shareholder, who sought to have election of officers set aside due to misconduct, was entitled to discovery to demonstrate that alleged omissions were material).

226. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

227. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

228. *Id.* at 472–75.

229. *Ernst & Ernst*, 425 U.S. at 199.

230. *Santa Fe*, 430 U.S. at 476.

231. The Supreme Court's decision in *Mills* assumed the lower court's finding that an omission that one entity had control over both groups in a merger was material. *See Mills v.*

exception do not cite the Supreme Court on the matter and some of the decisions demonstrate a fairly long reach in an effort to find precedent. The 9th Circuit, for example, relied solely on district court cases from outside its circuit for the proposition that self-dealing “is presumptively material.”²³² The Second Circuit relied on district court cases both inside and outside its circuit and referenced Delaware state law as well.²³³ Once again we will have to wait for the Supreme Court to clear up the doctrine on the exception to the exception.

4. The Misuse of Sensitive Information

Some of the older cases holding information to be not material relied on an argument that the information was important, but would be misunderstood by the public.

Courts, and the SEC, knew that investors want so-called *soft information*: asset appraisals, sales and profit projections, and other forms of firm valuations, particularly when firm decision-makers were using the information in significant firm decisions. One sees the argument in earlier SEC releases²³⁴ and several early cases on materiality.²³⁵ Some courts

Elec. Auto-Lite Co., 396 U.S. 375, 378 (1970) (ruling that a claimed defect in the proxy statement was a material omission). That being said, the issue of whether or not the omission was material was not before the Court in *Mills*, which focused instead on the causation and reliance and other such aspects of materiality. See *supra* Part I (discussing how materiality became evidence of causation and reliance). Then in *TSC Industries*, failure to specifically disclose that the merger in question was essentially a self-dealing transaction was found to be immaterial. *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 463 (1976). Thus, arguably the Supreme Court has at least been somewhat unclear on the matter.

232. *Gaines v. Haughton*, 645 F.2d 761, 776–77 (9th Cir. 1981). Notably, these district court cases either do not cite a case for this proposition or cite *Maldonado*, *infra* note 233. See *Bertoglio v. Texas Int’l Co.*, 488 F. Supp. 630, 650 (D.Del. 1980) (citing *Maldonado*); *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*, 475 F. Supp. 328, 330–32 (S.D.N.Y. 1979) (citing *Maldonado*); *Lewis v. Valley*, 476 F. Supp. 62, 65–66 (S.D.N.Y. 1979) (citing *Maldonado*).

233. *Maldonado v. Flynn*, 597 F.2d 789, 796–97 (2d Cir. 1979). As with *Gaines*, the district court opinions cited in *Maldonado* themselves rely on other district court opinions, although one attempted to cite through the imprimatur of the Supreme Court by using a “*cf.*” cite to *J.I. Case v. Borak*, 377 U.S. 426 and *Mills*. See *SEC v. Kalvex, Inc.* 425 F. Supp. 310, 315 (S.D.N.Y. 1975) (citing to both Supreme Court cases using “*cf.*”).

234. See Adoption of Amendment to Rule 14a-9 and Withdrawal of Other Proposals, Securities Act Release No. 5699, 1976 WL 160385 (Apr. 23, 1976) (informing of the withdrawal of various rule and form proposals relating to projections of future economic performance and to changes in control).

235. See, e.g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1294 (2d Cir. 1973) (noting the industrious research done by the Commission’s able staff and their specialization in SEC matters); *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447, 450–51 (10th Cir. 1968) (providing that a statement on oil reserves could mislead “any investor other than one who is an expert in the industry”).

created a *substantial certainty* test on projections before the projections become material.²³⁶ Whether the reasoning will hold up is subject to debate; such a test was rejected in analogous circumstances by the Supreme Court in *Basic*²³⁷ when the Court used a sliding scale for the disclosure of preliminary merger discussions based on the importance of the discussions and the probability of the deal.²³⁸ In these cases the courts were convinced that firms could disclose (or even manufacture the data to disclose) the sensitive data, even though accurate, so as to mislead or stampede otherwise ignorant investors. It is not that the data was not significant; it was. It is that the data was too complex to be understood properly by the investing public.

An extreme example of the genre is perhaps the case of *In re Rockefeller Center Properties, Inc. Securities Litigation*.²³⁹ In a proxy statement over a proposed merger between the failing corporation that owned Rockefeller Center and a group attempting to acquire the company,²⁴⁰ the Rockefeller Center Corporation did not acknowledge the value of the air rights over Rockefeller Center.²⁴¹ Plaintiffs argued that the air rights over Rockefeller Center were worth \$30 million.²⁴² As such, the plaintiffs contended that the reasonable shareholder would want to know of this value and the fact that the acquiring company was potentially underpaying to obtain Rockefeller Center by not ascribing value to those air rights.²⁴³ The Court held that the value of air rights above the Rockefeller Center was not material.

The Court found that the air rights were too speculative to be valued, “which weighs against a finding of materiality.”²⁴⁴ This was despite the fact that the seller had admitted that the air rights were included in the sale.²⁴⁵ The Court found, however, that the buyer had not indicated it would sell the rights and there was no record of any other buyers expressing an interest in buying the rights: “[the] plaintiffs have provided no evidence the air rights would be sold, that [the acquirer] planned to sell them or that [anyone] had expressed any interest in acquiring them at any

236. *Biechele v. Cedar Point*, 747 F.2d 209 (6th Cir. 1984).

237. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

238. *Id.* at 238.

239. *In re Rockefeller Ctr. Props., Inc. Sec. Litig.*, 184 F.3d 280 (2d Cir. 1999).

240. In other words, this was a work out to avoid bankruptcy. *See id.* at 284 (stating that the board believed the company might not remain solvent if the merger failed).

241. *Id.* at 284–85.

242. *Id.* at 290.

243. *Id.*

244. *Id.*

245. *Id.* (the company “disclosed that Rockefeller Center had air rights and the Proxy Statement disclosed that Whitehall Group would acquire Rockefeller Center through the acquisition”).

point in the future.”²⁴⁶ Thus the court concluded: “we do not think [the] disclosure of the air rights would have been important to a reasonable shareholder’s voting decision.”²⁴⁷

The argument that investors will misunderstand sensitive valuation data has lost much of its support, however. Courts and the SEC, a bit humbled by recent attacks by sophisticated market participants, are adopting a less presumptive view of market investors as unable to protect their own interests when given accurate, even complex information. Moreover, the success of suits against managers, and knowledge of the fairly conservative advice given by lawyers on disclosure issues, has led courts and the SEC to be less worried about managers successfully using information disclosure timing strategies of otherwise accurate information to mislead market traders.

III. CONCLUSION

Much of the development of an open-ended doctrine of materiality can be written up as a normal legal phenomenon, a case-by-case development of an abstract standard in a variegated and evolving context—modern securities regulation. Yet there are two parts of the case law that deserve a re-consideration. First, the error made by Justice Harlan very early on, now cemented in the jurisprudence, that materiality does not necessarily refer to any actual action or decision made by a group of targeted shareholders as voters or investors. The standard in *TSC Industries* is literally over-broad. And second, that the doctrine has two explicit exceptions from its standard of significance or weight of the information in issue. The policies around the exceptions that appear haphazardly and episodically in cases need to be isolated, identified, debated, and included in SEC rules of conduct. Taking an education from well-considered stock exchange listing rules,²⁴⁸ the SEC ought to consider explicit exceptions from disclosure that begin with categories for, among other things, preliminary negotiations with financing advisors, incomplete proposals or negotiations, and routine documents prepared for internal firm operational management.

246. *Id.*

247. *Id.*

248. *See supra* notes 151–53 and accompanying text about stock exchange rules (carving out specific items that can be excluded from listing and filing documents).