The Over-Used and Under-Defined Notion of "Material" in Securities Law

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Core doctrine in federal securities law 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. “Facts” or “information” must be “material” before a legal obligation to disclose attaches. In other words, the term material has an unrivaled position in the center of all of securities law and agency rules and court decisions applying the term necessarily establish the fundamental scope and bite of securities regulation. A study of close to eight hundred cases in which a federal court’s applies the term to specific facts, however, finds that the case-law is, well, quixotic at best and fickle at worst. An argument on the proper breakdown of the cases is begun here.

The term material and its doctrinal counterpart, “materiality,” connotes, obviously, a level of magnitude, of importance. The Securities and Exchange Commission (SEC) has a strategic approach to the definition. 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. Federal courts, left to define the general term in application in multiple of settings, produce holdings that are maddeningly imprecise and often fickle. The securities markets and their regulators seem strangely

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2 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., In the Matter of Universal Camera Corp., Act Rel. No. 33-3076, 19 S.E.C. 648, 655 (SEC 1945) (early SEC explanation of federal securities regulation).


4 See infra notes 16-24 and accompanying text.


6 See infra note 106 and accompanying text.

7 The term comes, of course, from the common law definition of actionable fraud. Only false “material” facts support a holding of common law fraud. See, e.g., RESTAT. (2ND) OF TORTS §538 (“Reliance upon fraudulent misrepresentation is not justifiable unless the matter misrepresented is material”). The concept is also used widely in contracts (only a “material breach” justifies a refusal to perform, for example see, e.g., RESTAT. (2ND) OF CONTRACTS, §237) and criminal law, see 18 U.S.C. § 1001 (prohibiting false material statements to the federal government); 18 U.S.C. §§ 1341(mail fraud), 1343 (wire fraud), and 1344 (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).

8 See infra notes 20-26 and accompanying text.
content with the imprecision. Academic writers, on the other hand, have long been critical of the vagueness of the standard.9

In this article, I revisit the wandering path of the federal case law on the definition of materiality. There is much to catch ones attention. The Supreme Court’s first comment10 comes a leisurely thirty-seven years after the passage of the first federal securities act and then, due to careless language in the opinion, the Court has to take a second case soon thereafter to fix a tangled thicket of law emerging in the lower court cases.11 The correcting opinion locks-in another mistake, however, crafting an abstract standard 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.12 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.13

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 accumulates14—the concept as defined explicitly by the Supreme Court is wildly 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, common in the stock exchange listings of other countries as well as our own.15

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13 See Sauer, supra note 5, at 321 (“[t]he…standard is general and abstract, establishing a framework for analysis rather than a formula for deciding specific cases”); Heminway, 52 Am. U. L. Rev. at 1135 (noting that the standard gives “no specific disclosure content guidance”).

14 See infra note 106.

15 See infra note 139-43 and accompanying text (discussing stock exchange rules).
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.\(^{16}\) 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.\(^{17}\)

The language of subsections 1 and 3 refer to the common law definition of fraud, which has long included materiality as an element of the offense.\(^{18}\) 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.\(^{19}\)

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, of course, Rule 10b-5, expanding the application of the language in Section 16 to purchases as well as sales of securities.\(^{20}\) 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).\(^{21}\) Congress also recycled the language of subsection 2 in later legislation. 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) are examples.\(^{22}\)

One also finds materiality in the general “catch-all” 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

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\(^{16}\) 15 U.S.C. § 77 et seq. See also §§ 8, 9, 10, 11, 12, 16, 19, 23, 24.

\(^{17}\) Securities Act of 1933, Section 17(a).

\(^{18}\) Id. §§ 17(a)(1) and (3).

\(^{19}\) Id. § 17(a)(2). The language is also in Sections 12 and 24 of the 33 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.

\(^{20}\) SEC Rule 10b-5.

\(^{21}\) SEC Rules 14a-9, 13e-3, Reg M-A.

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.”23 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
catch-all materiality requirement for information additional to the specifics of the
filings.24

Although there are scattered SEC rules that purport to define materiality, the rules
were re-drafted25 well after the 1976 Supreme Court case on the subject and 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 33 Act and 12b-2 under the 34 Act, for
example, define “material” as “those matters to which there is a substantial likelihood
that a reasonable investor would attach importance…” 26

The first major Supreme Court case to define materiality, TSC Industries, Inc v
Northway, Inc.,27 was not sui generis; it followed Mills v Electric Auto-Lite Co.,28 a case
in which the materiality of the omitted information was assumed29 and the issue before
the court was causation. 30 Both cases dealt with proxy solicitations on a merger approval
vote.31 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.32 The Court reversed the Seventh Circuit that had held that plaintiffs did have such
a burden and that, because actual inquiry to the minds of thousands of voters was
impossible, a substitute test—proof of the fairness of the merger itself—would suffice.33
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.34

23 SEC Rule 408(a).
24 SEC Rule 12b-20.
25 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.”
26 SEC Rules 405, 12b-2. The amendment picking up the Supreme Court’s reasonable investor standard
came in 1982.
29 See, e.g., id. at 384. The allegation was that the board of directors had a conflict of interest; all eleven
members of the board were nominees of an over 50 percent shareholder who was also the other party to the
merger. Id. at 378.
30 See 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.
31 Id. at 378; TSC Industries, 426 U.S. at 440-42.
32 Mills, 396 U.S. at 385.
33 Id. at 382, 385.
34 Id. at 385.
Note the three doctrinal maneuvers of the he Mills Court. First, the Court largely eliminated causation and reliance as tests independent of materiality in voting cases. 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. It was something less. This was a major deviation from normal 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.” Why did the 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 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.” 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.”

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 courts and had to be jettisoned by the Supreme Court in its next opinion. What does it mean for a disclosure defect to meet the standard “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 paragraph, Justice Harlan gave an example using the facts of the case. The failure to disclose a serious

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

38 Id.


40 See TSC Industries, 426 U.S. at 449.
conflict of interest on the board of directors was, he wrote, material because “adequate disclosure of this relationship would have warned the shareholders to give more careful scrutiny” to the deal even if it did not change the vote of a reasonable investor.\footnote{Mills, 396 U.S. at 384 n.6.} 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 in 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 one pause on 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….\footnote{Id. at 382 fn. 5.} In view of the many other factors that might lead shareholder 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.”

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.”\footnote{TSC Industries, 426 U.S. at 447.}

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 misstated or omitted will be commonplace.\footnote{Id. at 448.} 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 the favor of those the statute is designed to protect.”

Before considering what Justice Marshall did with a new definition, note what Justice Marshall could have done but did not do. First, Justice Marshall could have used a shifting burden of proof of proof, common in corporate law, 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, to require, for example, that management prove “with clear and convincing evidence” the soundness of the vote.

And 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 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 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. The loss of an individual appraisal remedy may suffice. 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

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). In his article, Booth describes problems with this aspect of the TSC Industries test and argues that a test revolving around whether votes were actually affected—perhaps using statistical means—would be better, the same conclusion reached in this article.


47 See, e.g., 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 to show a certain breaches of fiduciary duty).

48 I am assuming straight voting.

49 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. See, e.g., DEL. GEN. CORP. LAW ch. 1 subch. IX §262.
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:

An omitted fact is material if there is a substantial likelihood that a reasonable investor 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.

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 not trivial. 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.” 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 circumstance, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be [and 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.

For some reason, courts and commentators cite the second, “total mix” test more frequently than the first whenever only one of the tests appears. In a footnote he

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50 Id. at 449. I think the Court should have overruled Mills and started from scratch, using all three of the tests noted in the previous paragraph.
51 Id.
52 See id.
53 Id. at 449 fn.10.
54 Id. at 449 (bracketed numbers added).
admitted that he had deferred largely to the language submitted the Securities and Exchange Commission in its Amicus Curiae brief.\textsuperscript{56}

The standard appears on its face to be very, very inclusive. Most reasonable investors, if asked about what information they want to vote 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, 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 seller.\textsuperscript{57} Second, the proxy statement did not disclose facts needed to evaluate the favorability of terms of the proposed transaction.\textsuperscript{58} The Court of Appeals, sensitive to the conflicted nature of the deal—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.\textsuperscript{59} If the case was a normal summary judgment reversal due to contested facts it would be unremarkable but it was not. The facts were agreed and the Court reversed based on potential contested “inferences” on the facts: “The determination [of materiality] requires delicate assessments of the inferences ‘reasonable shareholders’ 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.”\textsuperscript{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.\textsuperscript{61} The proxy statement did not state that the chairman of the selling firm’s board of directors was the chief executive office of the buyer and that the chairman of the board’s executive committee was the buyer’s executive vice president.\textsuperscript{62} Nor did the proxy statement state that the buyer owned 34 percent of the seller, that no other shareholder owned more than 10 percent, and that five of ten of the board of

\begin{itemize}
\item \textsuperscript{56} Id. at 449 fn. 10. The Court did not follow the SEC position on the facts of the case, however. The SEC brief supported the finding of the Seventh Circuit. Brief for the Securities and Exchange Commission as Amicus Curiae at 25, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (No. 74-1471), 1976 WL 194025 at *25.
\item \textsuperscript{57} TSC Industries, 426 U.S. at 450.
\item \textsuperscript{58} Id. at 450-51.
\item \textsuperscript{59} Id. at 443-44, 464.
\item \textsuperscript{60} Id. at 450.
\item \textsuperscript{61} Id. at 452-53.
\item \textsuperscript{62} Id. at 451.
\item \textsuperscript{63} Id.
\end{itemize}
directors of the seller were buyer nominees and buyer officers. 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.

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 with nominees on the board was buying out all other shareholders. There was no special negotiating committee of independent disinterested directors. The only protection a minority shareholder had in 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. This risk is that controlling shareholder extracts 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 subsidiary or, in a stock for stock exchange as was in issue in TSC, due to undisclosed negative value in the parent.

In this case the proxy statement omitted two facts on valuation. First, the investment-banking firm that supplied a fairness opinion to the selling firm board had sent a second letter to the board lowering its calculation of the percentage of the premium over stock prices that the terms of the deal represented for the selling firm shareholders. The second letter was not disclosed. 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 was set. Since it was a stock for stock deal, 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. The conflicted mutual fund purchases were not disclosed.

64 Id. at 452.
65 Id. at 452-53.
66 See id. at 441.
67 The case was decided before the special negotiating committee became popularized by the Delaware Supreme Court in conflicted deal cases, e.g. Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 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 Industries, 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 27 percent to 19 percent and for common shareholders from 22 percent to 14 percent. Id. at 456, 459.
70 Id.
71 Id. at 460-61.
72 One share of common stock in the seller was exchanged for .5 shares of common stock in the seller and 1 ½ warrants. One share of preferred stock in the seller was exchange for .6 shares of common in the seller and one warrant. Id. at 441 fn. 1.
73 Id. at 461.
74 Id. at 460.
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.\textsuperscript{75} Any follow up communication from an investment banker altering a fairness opinion would surely be of interest to a reasonable investor.\textsuperscript{76} The investment bank was obviously getting cold feet because buyer stock prices\textsuperscript{77} had dropped significantly after the exchange ratio had been set and the investment bank had also realized that it may have under-valued the effect of substantial dilution on the price of the stock warrants used in the exchange.\textsuperscript{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 surely be of substantial interest to a reasonable investor. Even though rumored or alleged and not proven, the 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 all 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 20 percent premium in conflicted, friendly deals. The over 20 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.”\textsuperscript{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 touchtone for causation that indeed, the TSC Industries Court was heavily influenced by its belief, not very well informed, that the buyout in the case was at a fair price.

So we have a case in which the Court, seeking to find a definition of significance that is a surrogate for “decisively affects the vote,” crafts 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 shot through 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 minds could disagree on the inferences from un-contradicted disclosure omissions. The disconnection between the holding on facts of the

\textsuperscript{75} See id. at 461-63.
\textsuperscript{76} The Court noted that shareholder could recalculate the reduced premium themselves and that even a 19 and 14 premium could be called “substantial.” Id. at 459.
\textsuperscript{77} Specifically the value of the stock warrants used in the exchange had dropped from $5.25 to $3.50. Id. at 456.
\textsuperscript{78} The investment bank had valued the stock warrants at $5.25 in the first letter and $3.50 in the second. The investment banks 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.
\textsuperscript{79} Id. at 459.
case and the open-ended language of the materiality test in *TSC Industries* has proven to be a foretelling of 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 language and then, following the example of Justice Marshall, not to apply the breadth of the language to the facts.  

The Supreme Court decided two other cases on materiality. *Basic, Inc. v Levinson*, decided in 1988 and written by Justice Blackmun, which involved acquisition negotiations, and *Virginia Bankshares, Inc. v Sandberg*, 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. 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 … over-or under-inclusive.”

The rationale was ironic given that the materiality test, as was recognized by Justice Marshall, 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 the *Texas Gulf Sulphur* case and held that the probability of an event, sliding backwards in light of its magnitude, would determine when merger discussions were material.

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. 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. The Court rejected the old common law limitation on fraud actions that exempted statements of opinions or beliefs from liability, restraining liability to misleading statements of fact. “We 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 Indus.* test].”

The common law limitation had its roots in three justifications; First, statements of opinion are understood to be just that, normal sales talk; Second, statements of

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80 See infra Part II.
83 *Basic Inc.*, 485 U.S. at 232-33, 236.
84 Id. at 236.
87 *Sandberg*, 501 U.S. at 1088. The proxy statement also included the board’s analysis that the deal was “fair” to the shareholders. Id.
88 Id. at 1088-89.
89 Id. at 1090-91.
90 See id.at 1091-92.
opinion are too indefinite or vague be verified or falsified;\(^{91}\) And third, statements of opinion are too easy to contest and too hard to defend by unadorned claims of undisclosed ulterior motivations.\(^{92}\) The Court rejected the first two each arguments and then, worried about the third, held that statements of opinion are actionable only if the plaintiff can prove that the directors did not in fact hold the opinion and that the opinion was in fact false.\(^{93}\)

Justice Scalia concurred,\(^{94}\) perhaps to clarify Justice Souter’s less than elegant language, and he added yet another wrinkle. He distinguished fact and opinion with a scalpel. A statement that “The board believes the price to be high” is subject to the majority’s test on opinions, Justice Scalia wrote, but a statement that “The board approves the deal because the price is high” is, separate from opinion, a statement of actual fact.\(^{95}\)

So in both cases the Court kept the open-ended, fact dependent language of \(TSC Industries\) intact. The Court in \(Basic\), however, 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. In an early paragraph in the \(Basic\) opinion, Justice Blackmun noted almost in passing that although in \(TSC Industries\) the Court defined materiality by reference to an act of voting,\(^{96}\) the same definition applies to a shareholder deciding whether to buy or sell, trade, a security. As Justice Blackmun put it, “[w]e now expressly adopt the \(TSC Industries\) standard of materiality for the § 10(b) and Rule 10b-5 context.”\(^{97}\) In other words, the justice has instructed us to take the words “how to vote” out of the TSC Industries language and insert “whether to hold, buy or sell.”\(^{98}\) Since there are close to one hundred cases of trading losses bought for every one case of voting fraud, the move applies the \(TSC Industries\) language to a huge new number of cases. Yet the two contexts of voting and trading are significantly different and at issue is whether the difference should be reflected in the materiality standard.

As recognized by Justice Marshall and Justice Souter, voting is a collective act with actual damage dependent on a deceived majority of those entitled to vote.\(^{99}\) An individual who is deceived in the voting may be psychologically wronged\(^{100}\) but is not damaged 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

\(^{91}\) Id. at 1093.
\(^{92}\) Id. at 1095-96.
\(^{93}\) See id. at 1096.
\(^{94}\) Id. at 1108.
\(^{95}\) Id. at 1109 (Scalia, J., concurring).
\(^{96}\) Basic, 485 U.S. at 231-32.
\(^{97}\) Id. at 232.
\(^{98}\) We find in a later case that acts not to buy or not to sell (to hold) were not included. See infra notes 101-02 and accompanying text.
\(^{99}\) It can be a majority of the minority in some cases in which an approval by a disinterested minority is required by contract or by law.
\(^{100}\) This is not to say that the wrong may not be worth a civil fine.
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 plaintiffs’ class, which reduces enforcement costs, but is not definitive on the fact of pecuniary damage. In other words, the reasonable investor test for voters necessarily involves references to collective action, a reasonable majority of voters, and the reasonable investor test for traders implies evidence of individual action, a reasonable trader who trades. One would expect that a materiality test affecting a reasonable majority of voters would be more stringent than the test for traders, not the same. In any event the Court treats the two the same but one does find that cases on voter fraud do seem to have tougher holdings.\textsuperscript{101}

Moreover, and more important perhaps, is the internal collapse of the \textit{TSC Industries} test itself when applied to traders. Recall that Justice Marshall fashioned the test to save 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 similarly must 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.” In other words, liability attaches for traders who lacked full information even if information would not have changed any of the trades actually made so long as the trader would have paused for a moment 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 best illustrated by its application to traders who chose not to trade, 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; they only have to show that the information would have altered the “total mix” of information important to them at the time. This class of traders is, of course, most everyone in trading market. The Court later decided that applying Rule 10b-5 to non-trading individuals was just too ripe for exploitation and artificial;\textsuperscript{102} individuals had to trade, buy or sell, to get the benefit of private relief under Rule 10b-5.\textsuperscript{103} But ironically, 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.”

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, a much more confounding brew. As noted above, in voting cases proving materiality now also, in large part, proves the elements of causation and reliance. The single, very narrow, exception for lack of causation is in cases when the number of deceived voters could not have changed the result and did not otherwise give up valuable individual rights (such as dissenter’s rights).\textsuperscript{104} Materiality in trading cases has a more tenuous relationship to the elements of

\textsuperscript{102} See \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723, 735 (1975).
\textsuperscript{103} See \textit{id}.
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. But note the internal inconsistency with the materiality test itself: In theory, misleading information is material even if not one trader would decide to trade any differently. If so, trades would not affect market price even though the information not disclosed was material. Here one sees the confounding effect of a test formulated in a collective action case applied to a group of individual single actors. Moreover, the Court is no longer willing to imply causation from materiality as Justice Harlan did in the voting cases; if the stock price does not change when the information is accurately disclosed or if the stock price of a company during a time of incomplete disclosure does not deviate from normal industry indexes there is no damage to traders.106

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 in both the voting and trading cases, materiality turned on information’s effect on actual voting or trading, with normal legal allowances for problems in proof in standards of proof or shifting presumptions, we would be free of these doctrinal complexities.

In the Supreme Court’s latest case on materiality, Matrixx Initiatives v. Siracusano, 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 very lenient materiality test and a very active plaintiff’s trial bar, the lower federal courts sought to separate those 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,

105 At common law, the “reasonableness” of the reliance is presumed if the information is “material.” See, e.g., RESTAT. (2ND) OF TORTS §538.
106 See Dura Pharmaceuticals, 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).
108 See infra notes 117-131 and accompanying text.
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”
significance or import of the information that is not properly and accurately disclosed. The lower courts developed through holdings, as one would expect in the normal common law style,\textsuperscript{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.\textsuperscript{111} Other statements are adequately qualified and hedged by other communications, the “bespeaks caution” doctrine.\textsuperscript{112} Statements

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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. 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 had, in fact, been accurately disclosed. It is common to see a court use multiple sub-doctrines in any one case. No doubt other doctrines will develop.

A current topic of controversy on how to measure significance was illustrated by the case of Matrixx Initiatives, Inc. v. Siracusano, recently decided by the Supreme Court after an appeal from the Ninth Circuit. 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. 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. Petitioners in Matrixx further argued that without a quantifiable threshold, manufacturers face a tremendous burden to disclose all adverse reports. The Ninth Circuit rejected the argument; while the First, Second, and Third


114 See, e.g., TSC Industries, 426 U.S. at 452-53. See also Starr ex rel. Estate of Sampson v. Georgeson Shareholder, Inc., 412 F.3d 103 (2d Cir. 2005); McDonald v. Kinder-Morgan, Inc., 287 F.3d 992 (10th Cir. 2002); Benzon v. Morgan Stanley Distributors, Inc., 420 F.3d 598 (6th Cir. 2005); Bond Opportunity Fund v. Unilab Corp., 87 Fed.Appx. 772 (2d Cir. 2004); New England Anti-Vivisection Soc., Inc. v. U.S. Surgical Corp., Inc., 889 F.2d 1198 (1st Cir. 1989); Beck v. Dobrowski, 559 F.3d 680 (7th Cir. 2009). See also 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 (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 puffing, bespeaks caution, truth in the market, and pleading insufficiency all in one case to dismiss complaint). These types of “judicial efficiency” rationales accounted for 88% of the cases in which the plaintiff lost on the materiality issue in the case survey explained supra note 106.

116 For a presumptive “bright-line” test of significance or weight elsewhere in Securities Law, see SEC Rule 14a-8(i) (stating presumptive “bright-line” rules as to what is not proper for shareholder proposals, e.g. “if the proposal relates to operations which account for less than 5 percent of the issuer’s total assets...and for less than 5 percent of its net earnings and gross sales.”). Rule 14a-8’s percentage tests have an important exception for matters “otherwise significantly related to the company’s business. See also AFSCME v. AIG, Inc., 462 F.3d 121 (2d Cir. 2006); Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554 (D.D.C. 1985).

117 See Brief for Professors at Law and Business Schools as Amicus Curiae in Support of Respondents at 11, Matrixx Initiatives, Inc. v. Siracusano (No. 09-1156).

118 See Matrixx Initiatives, Inc. v. Siracusano, 585 F.3d 1167 (9th Cir. 2009).
Circuits had adopted a version of it. In a case similar to that in *Matrixx*, the Third Circuit, for example, rejected as non-material an alleged connection between a weight loss drug and heart valve problems in a few isolated cases in Europe.

A unanimous Supreme Court agreed with the Ninth Circuit, finding that statistical significance was not a prerequisite for materiality. 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.” 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.” Here, because the reports came from medical researchers involving nearly a dozen patients, the Court found that reasonable investors would have considered the reports significant. Sadly, as in earlier materiality cases, the Court provided little guidance to the lower courts on how to satisfy this standard.

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 have been caught. They 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.” In the *Matrixx* case, the test would have excluded considerations of the character of the biological impact found in the adverse reports at issue. 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.

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122 See *In re Carter-Wallace, Inc. Securities Litigation*, 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”); New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC Inc., 537 F.3d 35, 50 (1st Cir. 2008) (incident of five patients using drug developing infections alone not material due to statistical insignificance); Oran v. Stafford, 226 F.3d 275 (3d Cir. 2003).

123 Oran, 226 F.3d at 284. 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.


125 Id. at *10.

126 Id.

127 Id. at *12.

128 See Adam Liptak, *Supreme Court Rules Against Zicam Maker*, THE NEW YORK 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.”).

129 See dispute over definition of tender offer in Rule 14d series.

130 Id. at 10-11 (quoting *Basic*, 485 U.S. at 236).

131 Id. at 12-13.
Other problems in application are specific to the type of disclosure in issue. Two deserve special mention. First, the SEC is struggling to determine whether the agency should adopt a “mosaic theory” of information in insider trading investigations.132 Professional market analysts gather bits of information from numerous sources that individually are not significant but that 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 Dirks133 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 provide 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 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 “include any material information not otherwise specifically identified in the items.” What is the effect of the mind-numbing 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 as not material information he personally viewed to be a significant omission because the SEC had not required specifically such information be disclosed in Rule 10b-10 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.135 Judges’ collective decisions on weight or significance of the information not disclosed are reflected in the sub-doctrines. I expect many sub-doctrines more 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.

133Dirks v. SEC, 463 U.S. 646 (1983). In this case, the Supreme Court established that 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.
134Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000) (deferring to SEC’s decision regarding defendant’s disclosure under 10b-10 and holding 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).
135 See supra note 109 and accompanying text.
Most academics writing on the sub-doctrines are critical, arguing that the doctrines somehow weaken the test so as to disadvantage investors. A different tack was taken in a harsh critique of these sub-doctrines in a 2002 paper co-authored by Professors Bainbridge and Gulati. The authors discuss the cases on “puffery” “bespeaks caution,” “zero price change,” and “triviality.” Lower federal court judges routinely dismiss securities cases on these grounds, they argue, because they are uninterested in them, do not understand securities markets, and off-load the work to equally unimpressed clerks.

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” and, second, judges have no real evidence, other than intuition, on the “behavior of investors or markets.” I tend to agree with Professor 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. It is unfair to criticize one opinion as uninformed when the option 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 hold otherwise conclusively 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 over-broad, 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.

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136 See supra notes 108-11.
138 Bainbridge & Gilati, supra note 125, at 119-25.
139 I fundamentally disagree with the professors’ story. Given forum selection by plaintiffs and judge allocation decisions by chief judges, 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 are too numerous to mention by Judge Friendly in the Second Circuit comes quickly to mind.
140 Bainbridge & Gulati, supra note 125, at 126.
141 Id. at 123.
142 See Langevoort, supra note 125; see also supra note 109.
143 Here I differ with Langevoort’s analysis of bad law driving out good. Langevoort, supra note 125, at 313. The evolution is consistently self-correcting, with, among 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.
Lawyers advising publicly traded corporations, however, should be wary of the Supreme Court’s newest case on materiality, *Matrixx Initiatives.* 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 not disclosed. This practice is now in some 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?

There are other common practices that are questionable as well. When the SEC warned Rajat Gupta that the agency intended to bring a civil action against him for insider trading, he was serving on the boards of directors of three publicly-traded companies. The three companies did not disclose the warning; they waited until the SEC actually filed suit and then disclosed Gupta’s resignation. Lawyers for the companies took the position that the SEC warning was not material. The lawyers did admit that if Gupta was standing for re-election the warning would have been material. Their advice was based, therefore, on the slender reed of whether a proxy statement on re-election had been or was to be filed. Lawyers, pressed by clients who want to disclose only the bare minimum amount of information, seem make such distinctions based on whiffs of precedent and safety in numbers (“street practice”). Courts, case by case, eventually destroy most of the sillier distinctions using the general inclusive language of TSC Industries. The SEC will intervene occasionally if the courts do not. Inevitably, someone calls for more clarity in the test.

Again, I view this as a natural common law evolution of an open-ended test. The specifics of the argument are but a part of the age old debate between those who favor codes and those who favor the common law. At present those who favor codes seem to have the upper hand in the politics of the disagreement.

**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 in issue is, to most 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 back-story: a court is carving an exception to the basic materiality standard, not applying

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144 See *supra* notes 116-127 and accompanying text.
145 See *supra* note 127 and accompanying text.
147 *Id.*
148 *Id.*
149 *Id.*
150 See, e.g., *id.* (quoting Charles Elson of the University of Delaware business school as saying “The disclosure rules scream out for clarification from the regulators”).
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.”

Professors Bainbridge and Gulati see at least one category of these cases as yet another example of judicial inattentiveness and would probably classify them all that way. 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, but the temptation is to be avoided. In Basic, Supreme Court held that “silence, absent a duty to disclose” cannot serve as a basis for liability under Rule 10b-5. 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. Exceptions lie for voluntary statements and for a duty to correct any recently required statement. A real-time system, as is in the United Kingdom, for example, requires disclosure whenever a material event occurs. 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,

151 These cases accounted for 11.9% of cases in which the plaintiff lost in the case survey described supra note 106.
152 Bainbridge & Gulati, supra note 125, at 129 (on internal forecasts). In their discussion they, 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 uses in fact as opposed to one that it has seen.
154 485 U.S. at 239, n.17.
156 See In re Time Warner Inc. Sec. Litig, 9 F.3d 259 (2nd Cir. 1993).
157 The UK has numerous exceptions, however, that we do not and ought to recognize. See UK Financial Services Disclosure Rules, supra note 136. 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. at §§ 6.1.2, 6.1.9-.15.
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 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 a bargain 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,\(^{158}\) the Australian Stock Exchange,\(^{159}\) and the New Zealand Stock Exchange.\(^{160}\) The stock exchange rules are market-tested, since the exchanges compete for company listings in part through their rules.\(^{161}\) Moreover, in the United States, the listing rules on disclosure pre-date the New Deal legislation that created a federal disclosure regime.\(^{162}\) 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

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\(^{158}\) NYSE Rules §472(k)(3) (creating a disclosure exception for “material non-public information regarding specific potential future investment banking services transactions of the subject company”).

\(^{159}\) Australian Stock Exchange 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”).

\(^{160}\) New Zealand Stock Exchange Listing Rules §10.1.1(a) (adopting the same rule as the Australian Stock Exchange *supra* note 140).


\(^{162}\) *Id.* 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). 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.” *Id.* Presumably an audit of the accounts and assets would not include such business sensitive information as merger negotiations and the like.
of Justice Blackmun that the standard of materiality has no room for concerns related to business necessity.\textsuperscript{163}

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 \textit{Radol v. Thomas},\textsuperscript{164} in which the Sixth Circuit held outside appraisal reports to be not material. In a friendly two-stage acquisition,\textsuperscript{165} a tender offer followed by a freeze-out merger, the buyer did not disclose in the tender offer two reports on the net asset value of the target. 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-3, Item 9,\textsuperscript{166} disclosed both studies in the merger proxy statement. In a class action plaintiff shareholders 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.\textsuperscript{167}

The Court cited the \textit{TSC Industries} test, which focuses on what an investor would like to have known, and just blithely concluded that reports were not material. Of course the target shareholders wanted the information on the net asset appraisals used by the bidder to determine the price offered for the target shares.\textsuperscript{168} Any poll of target

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\begin{enumerate}
\item[{163}] Basic, 485 U.S. at 239 n.17. In Note 17, Justice Blackman, after flatly rejecting the concerns of business people over information sensitivity in early merger negotiations, attempts to offer them some instruction. The Justice’s advice is hilarious. When a reporter or NYSE official asks a business executive about 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 if forces an executive to answer “no comment” to everything on anything to do with deal negotiations, whether or not any are underway, to preserve the right to refuse to answer the question when it matters (when a deal is under discussion).
\item[{164}] 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)(failure to disclose the appraisals is not a violation of Rule 10b-5).
\item[{165}] 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 fifty-one percent of the outstanding shares and the freeze-out price for the remaining shares was $76 a share. \textit{Radol}, 772 F.2d at 246.
\item[{166}] Replaced by Schedule TO.
\item[{167}] A fuller analysis of the Court’s reasoning is in \textit{Starkman}, 772 F.2d at 240-41. The Court also held that the lower courts’ 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.
\item[{168}] For a similar holding see Biechele v Cedar Point, Inc., 747 F.2d 209 (6th Cir. 1984)(“selling document” in merger discussions with potential buyers not material for shareholder disclosure). The Third Circuit adopted a factors test but the result was the same—not material. Flynn v Bass Brothers Enterprises, Inc., 744 F.2d 978, 988 (3rd Cir.)(appraisal not established as reliable). There is a humorous moment in the decision 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
\end{enumerate}
\end{footnotesize}
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.\textsuperscript{169} 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 targets 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.\textsuperscript{170}

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*.\textsuperscript{171} In a partial self-tender offer, a firm did not disclose in its Schedule 13e-4 and in a subsequent press release 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.\textsuperscript{172} 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 percent increase in year-over-year sales.\textsuperscript{173} The Fourth Circuit held that the firm had no duty disclose the internal data and projections.\textsuperscript{174} Yet the information not disclosed was of considerable importance.

The Fourth Circuit had four reasons, the first two of which were makeweight. It found that neither the Schedule 13e-4 nor other SEC rules had required the disclosure of “projections.”\textsuperscript{175} Yet the firm had real facts, the weekly sales data as well as projections, and the SEC does use catch-all provisions that require, as noted above, the disclosure of any additional material information not specifically identified.\textsuperscript{176} The second two

\textsuperscript{169} *Radol*, 772 F.2d at 255.
\textsuperscript{170} For similar cases see *Lane v Page*, 649 F. Supp. 2d 1256 (NM. 2009) (internal valuation of target by bidder not material); *Dixon v Ladish Co.*, 597 F. Supp. 20 (E.D. Wis. 1984) (target company’s failure to disclose internal valuation of itself not material).
\textsuperscript{171} 802 F.2d 703(4th Cir. 1986).
\textsuperscript{172} *Id.* at 705.
\textsuperscript{173} *Id.*
\textsuperscript{174} *Id.* at 710.
\textsuperscript{175} *Id.* at 709.
\textsuperscript{176} 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. Item 9, Reg. M-A § 229.1015.
reasons given by the Court are more defensible. The Court found that the projections were too uncertain (they “changed constantly”) and that disclosure was “impractical” (they were too “frequent” and “volatile”). The sales forecasts did bound 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 the forecasts projected huge increases and they were based on real weekly sales data that was in hand. One wonders why the firm should not be obliged to disclose the actual weekly data increases or the general, overwhelming positive trend in the forecasts (as opposed to the exact numbers that were fluctuating). Investors would surely want to know either of both bits of information; the information surely satisfies the “total mix” text.

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 very 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 were deemed immaterial as being too “uncertain and unpredictable.” Yet the sales data feeding these projections was not “uncertain and unpredictable;” it was based on actual sales. Similarly, one could see a distinction being made between the projections and the fact that management relied on them: perhaps the projection itself it 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. 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. 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. 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 portent a change in critical yearly figures.

177 Walker, 802 F.2d at 710.
178 Id. at 705.
179 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.
180 Walker, 802 F.2d at 709 (internal quotation and citation omitted).
181 See id. at 705.
183 See In re Lyondell Petrochemical Co. Securities Litigation, 984 F.2d 1050, 1052 (9th Cir. 1993); Grossman v. Novell, Inc., 120 F.3d 1112, 1125 (10th Cir. 1997); Walter v. Holiday Inns, Inc., 985 F.2d 1232, 1243-44 (3rd Cir. 1993); Starkman v. Marathon Oil, 772 F.2d 231, 239-43 (6th Cir. 1985); Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996).
184 For a similar case see Pavlidis v New England Patriots Football Club, 737 F.2d 1227 (1st Cir. 1984) (revenue projections not material).
2. Ubiquitous Business Conduct

In some cases, the courts appear to 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 did not want to get involved in cases that disputed whether or not the board of directors in a merger actually believed what it said it believed in a disclosure document. The author’s favorite case of those in this category of exceptions is *Lewis v. Chrysler Corporation*.

In *Lewis*, a well-known corporate raider, Kirk Kerkorian, had acquired a nine percent stake in Chrysler Corporation in the late 80s. Chrysler, wanting no part of the raider, adopted a classic takeover defense in response, a shareholder rights plan commonly known as a “poison pill.” Soon thereafter Chrysler amended the plan twice to strengthen it. On the second of the two amendments the firm issued a press release justifying the action. In the press release the company stated ‘the 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.’ Kerkorian sued, arguing, among other things, that the press release was misleading because it did not disclose how the poison pill plan benefitted incumbent managers and it did not disclose the “cost” to the shareholders of the plan. 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 be hostile to current management.”

The Court 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 “in for a peck is in for a bushel” 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,

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185 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.
186 949 F.2d 644 (3rd Cir. 1991).
187 *Id.* at 647.
188 *Id.* at 650.
189 *Id.* at 651.
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 not 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.” 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 amendments190), 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,191 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 defective electromagnetic switches to the United States government and in one case had pled guilty, resulting in a $17.5 million fine.192 The other pending suits alleged damages of close to $400 million dollars.193 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.”194 As such, when information about the alleged illegality was left off of proxy statements for board elections over a period of five years195 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.196 Oddly, the Court noted that it would have heard the case if the plaintiff had alleged personal enrichment.197 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

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190 The Court notes that an “undeveloped future attempt to control Chrysler” could appear. Id. at 653. Fair enough. The future use of the anti-takeover device is uncertain. Chrysler could also use the 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 signal itself can have negative consequences on stock price.


192 Id. at 1371.

193 Id.

194 Id. at 1380.

195 Id. at 1379.

196 Id. at 1381 (noting that the 9th circuit barred these types of claims, “leaving Plaintiffs to state corporate law remedies for claims of mismanagement”).

197 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. (internal citation omitted).
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.  

There are several other examples. One is In re American Express Co Shareholder Litigation, 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. 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 put limits on the amount of liability directors could incur in judgments even when “bad faith” or “dishonesty” were found. 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. 

The District Court rejected this argument, not wanting to “federalize” state corporate law. Quoting the Supreme Court, 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 and securities” and that therefore federal law did “not prohibit ‘instances of corporate mismanagement…in which the essence of the complaint is that the shareholders were treated unfairly by a fiduciary.’” The District Court did note a limited exception for conflict of interest allegations that affect an election of the board of directors. 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. The District Court was unimpressed, replying that “this is the type of ‘garden variety mismanagement’” that cannot sustain a federal conflict of interest claim. 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 its docket.
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. But then one would run up against In re Sears, Roebuck and Co. Securities Litigation, 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. Because the omission “was simply the failure to disclose the existence of state court claims,” the omission was immaterial. The judge declined to find 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. 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.

Indeed, one of the oddest parts of the Supreme Court case that gave up the overboard language that undergirds the modern materiality doctrine, TSC Industries v Northway, was Justice Marshall’s finding on one of the cases’ allegations. 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. The chairman of the board of the buyer was also a director of a large mutual fund and 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. The mutual fund buying stopped once the deal price was announced and signed onto by both boards of directors.

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 Justice Marshall overruled the 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. The lower court had held that the investors had a right to know about the conflict and make their own mind up about the potential for manipulation. There was no dispute over whether the facts were not disclosed; they were not. A potential explanation for the astonishing holding that a clear conflict of interest was not, as a matter of law, material may lie in the Court’s refusal, absent clear direction

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209 See id. at 269 (citing and describing General Elec. Co. v. Cathcart, 980 F.2d 927 (3d Cir. 1992)).
211 See id. at 980-81.
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 The mutual fund ended up with over 8.5% of the buyer’s stock. TSC Industries v. Northway, 426 U.S. 438, 461 (1976).
216 Id.
217 Id.
from the SEC, to federalize pure allegations of conflicts of interest (without more, evidence of improper pecuniary gain by a manager)\textsuperscript{218} 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 \textit{In re Teledyne} has been adopted in a number of circuits, including the Ninth,\textsuperscript{219} Eighth,\textsuperscript{220} and perhaps even the well-respected Second.\textsuperscript{221} 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 \textit{Ernst & Ernst v. Hochfelder}\textsuperscript{222} and \textit{Santa Fe Industries v. Green}.\textsuperscript{223} In \textit{Santa Fe}, the Court explicitly noted that typical breaches of fiduciary duty could not support a 10b-5 claim, absent “manipulation.”\textsuperscript{224} In \textit{Ernst & Ernst}, the Court had determined that “manipulation” was “virtually a term of art” in this context.\textsuperscript{225} The \textit{Santa Fe} Court gave some examples: “wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”\textsuperscript{226} 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.\textsuperscript{227} The Circuit courts that adopt the 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.”\textsuperscript{228} The Second Circuit relied on district court cases both inside and outside its circuit and referenced Delaware state

\textsuperscript{218} See \textit{id.} at 463 (asking the SEC to pass a rule on the issue).
\textsuperscript{219} See \textit{Gaines v. Haughton}, 645 F.2d 761, 776-77 (9th Cir. 1981).
\textsuperscript{220} See \textit{Golub v. PPD Corp.}, 576 F.2d 759, 764 (8th Cir. 1978).
\textsuperscript{221} See \textit{Weiseberg v. Coastal States Gas Corp.}, 609 F.2d 650, 654 (2nd Cir. 1979).
\textsuperscript{222} 425 U.S. 185 (1976).
\textsuperscript{223} 430 U.S. 462 (1977).
\textsuperscript{224} \textit{Id.} at 1300-1.
\textsuperscript{225} \textit{Ernts & Ernst}, 425 U.S. at 199.
\textsuperscript{226} \textit{Santa Fe}, 430 U.S. at 1302.
\textsuperscript{227} The Supreme Court’s decision in \textit{Mills} assumed the lower court’s finding that an omission that one entity had control over both groups in a merger was material. \textit{See Mills}, 396 U.S. at 378. That being said, the issue of whether or not the omission was material was not before the Court in \textit{Mills}, which focused instead on the causation and reliance and other such aspects of materiality. \textit{See supra} Part I. Then in \textit{TSC Industries}, failure to specifically disclose that the merger in question was essentially a self-dealing transaction was found to be immaterial. \textit{See id.} Thus arguably the Supreme Court has at least been somewhat unclear on the matter.
law as well.\textsuperscript{229} 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 releases\textsuperscript{230} and several early cases on materiality.\textsuperscript{231} Some courts created a “substantial certainty” test on projections before the projections become material.\textsuperscript{232} Whether the reasoning will hold up is subject to debate; such a test was rejected in analogous circumstances by the Supreme Court in Basic\textsuperscript{233} 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.\textsuperscript{234} 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 \textit{In re Rockefeller Center Properties, Inc. Securities Litigation}.\textsuperscript{235} In a proxy statement over a proposed merger between the failing corporation that owned Rockefeller Center and a group attempting to acquire the company,\textsuperscript{236} the Rockefeller Center corporation did not acknowledge the value of the air rights over Rockefeller Center.\textsuperscript{237} Plaintiffs argued that the air rights over Rockefeller Center were worth $30 million.\textsuperscript{238} 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.\textsuperscript{239} The Court held that the value of air rights above the Rockefeller Center was not material.


\textsuperscript{231} See, e.g., Gerstle v Gamble-Skogmo, Inc., 478 F.2d 1281,1294 (2nd Cir. 1973)(Friendly, J.,); Sunray v DX Oil Co. v Helmerich & Payne, Inc., 398 447, 450-51 (10th Cir. 1968)(statement on oil reserves could mislead “any investor other than one who is an expert in the industry”).

\textsuperscript{232} Biechele v Cedar Point, 747 F.2d 209 (6th Cir. 1984).

\textsuperscript{233} 485 U.S. 224 (1988).

\textsuperscript{234} \textit{Id}. at 238.

\textsuperscript{235} 184 F.3d 280 (2nd Cir. 1999)

\textsuperscript{236} In other words, this was a work out to avoid bankruptcy. \textit{See id}. at 284.

\textsuperscript{237} \textit{Id}. at 284-85.

\textsuperscript{238} \textit{Id}. at 290.

\textsuperscript{239} \textit{Id}.
The Court found that the rights to too speculative to be valued, “which weighs against a finding of materiality.”\(^{240}\) This was despite the fact that the seller had admitted that the air rights were included in the sale.\(^{241}\) 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 point in the future.”\(^{242}\) Thus the court concluded: “we do not think the disclosure of the air rights would have been important to a reasonable shareholder.”\(^{243}\)

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 a knowledge of the fairly conservative advice given by lawyers on disclosure issues has also 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 \textit{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,\(^{244}\) 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.

\(^{240}\) \textit{Id.} \\
\(^{241}\) \textit{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”). \\
\(^{242}\) \textit{Id.} \\
\(^{243}\) \textit{Id.} \\
\(^{244}\) See supra notes 139-143 and accompanying text about Stock Exchange rules.