

# WHEN SILENCE IS NOT GOLDEN: DISCLOSURE OF PRELIMINARY MERGER NEGOTIATIONS BY CLOSELY-HELD CORPORATIONS

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The small advertising firm's dream was coming true. Three creative artists combining their talents and resources had formed a corporation which had grown and prospered beyond their original intentions. The board of directors had decided that merger with a full marketing services firm would be the next step to maximizing the closely-held corporation's potential. The research and public relations departments of a large marketing firm would promote the advertising firm's creative ideas and sales philosophy.

In January of 1989 the board of directors met with three marketing firms to discuss the possibility of developing a relationship with one of the three firms. By March 1, 1989, discussions with counsel and accountants of one large marketing firm culminated in an agreement to propose merger at the price of \$50 per share for the advertising firm's 100,000 outstanding shares of common stock, contingent upon approval by the marketing firm to proceed with formal merger negotiations regarding other aspects of the merger.

On March 15, 1989, before the buying corporation approved the agreement to proceed, a senior account executive at the advertising firm informed the chairman of the board that he had accepted a position with a competing advertising firm. In his five years with the advertising firm, the senior account executive had acquired 950 shares of the corporation's common stock through an employee stock purchase plan. Pursuant to the terms of the stock purchase agreement, the corporation would be required to purchase

the shareholder-employee's shares back at adjusted book value upon termination of employment for any reason. The adjusted book value of the common stock was \$22.50 on the date of the account executive's resignation.

What should the chairman of the board do? Should he disclose the possibility of merger and the potential increase in value of the employee's shares, even though the employee's loyalties have shifted to a competing firm? What about the large marketing firm's insistence that the merger discussions be kept confidential? Although the merger discussions have set a value on the common stock, there is still no set structure and no formal approval by the merging partner. Would disclosure blow the deal?

On the other hand, would knowing about the potential merger change the shareholder-employee's mind about leaving the corporation? Could the corporation be held liable under the securities anti-fraud rules for failure to disclose the merger negotiations?

This note focuses on the potential liability of a closely-held corporation<sup>1</sup> for failure to disclose material information about preliminary merger negotiations<sup>2</sup> in which it is participating. Failure to disclose occurs when the corporation remains silent when under a duty to speak or when the corporation makes a statement which could be considered misleading without additional disclosure of relevant information. For liability to result in the latter context, the courts would have to conclude that Rule 10b-5 of the Securities Exchange Act of 1934 [hereinafter Rule 10b-5]<sup>3</sup> creates an affirmative duty

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1. Although there is no single, generally accepted definition of a "closely-held corporation," courts generally deem a closely-held corporation to be characterized by: (1) a small number of shareholders; (2) the absence of a ready market for the corporation's stock; and (3) substantial majority shareholder participation in the management, direction, and operations of the corporation. *Donahue v. Rodd Electrotape Co.*, 367 Mass. 578, \_\_\_, 328 N.E.2d 505, 511 (1975).

2. The term "preliminary merger negotiations" generally refers to "all overtures, communications, and discussions between the parties (and/or their agents) [regarding] a proposed corporate merger or other corporate stock acquisition." Gebaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U.L. REV. 1218, 1221 n.11 (1987).

3. 17 C.F.R. § 240.10b-5 (1988). Rule 10b-5 was promulgated by the Securities and Exchange Commission [hereinafter SEC] pursuant to § 10(b) of the Securities Exchange Act of 1934 [hereinafter the 1934 Act], 15 U.S.C. § 78j(b) (1981). Rule 10b-5 provides:

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

(a) To employ any device, scheme, or artifice to defraud,

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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1988).

to disclose material information beyond the traditional "duty not to mislead" and the "duty to refrain from trading."<sup>4</sup>

Closely-held corporations should be aware, particularly when repurchasing their own shares, that courts are currently finding an affirmative duty to disclose material preliminary merger negotiations.<sup>5</sup> This duty is based on the fiduciary relationship between the closely-held corporation and its shareholders.<sup>6</sup> In addition, the "materiality" test recently adopted by the United States Supreme Court in *Basic, Inc. v. Levinson*<sup>7</sup> may trigger a closely-held corporation's duty to disclose long before disclosure was required under the former "agreement-in-principal" standard.<sup>8</sup>

### I. DISCLOSURE OLBIGATIONS UNDER RULE 10b-5

Rule 10b-5 contains a general prohibition against fraud and the misstatement or omission of material facts in connection with the purchase and sale of securities.<sup>9</sup>

Pursuant to section 10(b) of the Securities Exchange Act of 1934,<sup>10</sup> the Securities and Exchange Commission promulgated Rule 10b-5 to promote the fundamental purpose of the 1934 Act: implementation of a "philosophy of full disclosure."<sup>11</sup> Although not expressly provided for in the 1934 Act, "[j]udicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of section 10(b) and Rule 10b-5."<sup>12</sup> The private right of action has become "an essential tool for enforcement of the 1934 Act's requirements."<sup>13</sup>

Notwithstanding the fact that the primary goal of Congress in passing the 1934 Act may have been the regulation of public markets, the language of Rule 10b-5 encompasses any purchase or sale of securities, regardless of

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4. See *infra* notes 20-50 and accompanying text.

5. See, e.g., *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987); *Michaels v. Michaels*, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986); *Piccirillo v. FCB/Leber Katz Partners, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,016 (S.D.N.Y. Sept. 9, 1988).

6. See *infra* notes 23-47 & 111-25 and accompanying text.

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

8. See *Flamm v. Eberstadt*, 814 F.2d 1169, 1174 (7th Cir.), *cert. denied*, 108 S. Ct. 157 (1987) (describing agreement-in-principle as an agreement on price and structure); *Staffin v. Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982) (defining duty to disclose existence of ongoing merger negotiations as triggered when agreement-in-principle is reached).

9. See *supra* note 3.

10. 15 U.S.C. § 78j(b) (1981).

11. See *Basic, Inc. v. Levinson*, 485 U.S. at 230 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977)).

12. *Id.* at 232.

13. *Sulkow v. Crosstown Apparel, Inc.*, 807 F.2d 33, 37 (2d Cir. 1986) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976)). See also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947).

whether the issuer of the securities is publicly- or closely-held.<sup>14</sup> It has been recognized that "neither the small size of the corporation nor the restrictions on transferability remove such a corporation's stock from the reach of Rule 10b-5."<sup>15</sup> In fact, "some of the earliest cases finding a private right of action under Rule 10b-5 involved face-to-face transactions among shareholders in close corporations."<sup>16</sup> In a Rule 10b-5 action, two issues arise:

1. Is there a duty to disclose the fact?
2. Is the fact material?

Case law and commentary suggest that there is no general duty to disclose preliminary merger negotiations.<sup>17</sup> However, there are at least two well-established exceptions to the general right to maintain corporate confidentiality: the duty not to mislead and the duty to disclose or refrain from trading.<sup>18</sup> A third exception, the duty to disclose based on a fiduciary relationship between a closely-held corporation and its shareholders, has recently been recognized as an affirmative disclosure duty under Rule 10b-5.<sup>19</sup>

#### A. Duty to Disclose

The first duty derived directly from the language of Rule 10b-5 is the "duty not to mislead."<sup>20</sup> This duty requires that if disclosure is made, the

14. Rule 10b-5 provides, in relevant part: "It shall be unlawful for any person . . . to engage in any act, practice, or course of business which operates . . . as a fraud . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1988) (emphasis added).

The term "security" has been interpreted to include stock in closely-held corporations: "The fact that Crosstown was a close corporation . . . is insufficient to negate the character of the stock as a security." *Sulkow v. Crosstown Apparel, Inc.*, 807 F.2d at 37.

15. *Sulkow v. Crosstown Apparel, Inc.*, 807 F.2d at 37.

16. *Fishman, Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. CORP. L. 251, 257 (1987) (citing *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956)).

17. The United States Supreme Court held in *Chiarella v. United States*, 445 U.S. 222, 228 (1980), that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." See also *Wander & Pallesen, Timely Disclosure After Basic*, 21 REV. SEC. & COMM. REG. (S & P) 109, 110 n.10 (July 20, 1988) ("Most commentators agree that no court has imposed on issuers an affirmative duty to disclose all material information simply because it exists.").

18. See *infra* notes 20-26 and accompanying text.

19. See *infra* notes 27-50 and accompanying text.

20. In relevant part Rule 10b-5 provides:

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

(b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circum-

disclosure must be accurate and complete in all material respects.<sup>21</sup> Under this duty, issuers are also required to correct prior statements which become inaccurate or materially misleading due to subsequent events.<sup>22</sup>

The second well-established duty of Rule 10b-5 is the "duty to disclose or refrain from trading." Rule 10b-5 precludes anyone, including the issuing company, from purchasing or selling a security while in possession of material, non-public information concerning the security.<sup>23</sup> This duty arises from the "inherent unfairness in allowing an insider<sup>24</sup> to enter the open market and trade for his own account on the basis of material inside information knowing such information is unavailable to those with whom he is dealing, i.e. the investing public."<sup>25</sup> The section 10b duty to disclose or abstain from trading "applies not only to an officer buying for his own account but also to a closely-held corporation . . . dealing in its own securities."<sup>26</sup>

The third disclosure obligation arises where the corporation makes no representations but is under a duty to speak. The "affirmative duty to disclose" obligates the issuer to disclose to the public all available information which is material to investment in the issuer's securities. This affirmative duty may be found only if there is some special relationship between the parties which creates a duty to speak<sup>27</sup> because "silence, absent a duty to disclose, is not misleading under Rule 10b-5."<sup>28</sup>

Courts have found that the fiduciary relationship between a closely-held corporation and its shareholders is a special relationship which triggers an affirmative duty to disclose.<sup>29</sup> The Seventh Circuit Court of Appeals stated in *Jordan v. Duff & Phelps, Inc.*<sup>30</sup> that "[c]lose corporations buying their

stances under which they were made, not misleading . . . .

17 C.F.R. § 240.10b-5 (1988).

21. *Id.* See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

22. See *Fry v. Trump*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,937, at 90,337 (S.D.N.J. Feb. 2, 1988) (citing *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985)).

23. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 848 ("[A]nyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in . . . the securities . . . while such inside information remains undisclosed.").

24. The term insider "generally refers to a corporation's officers, directors, and in some cases, substantial shareholders." *Gebaldon, supra* note 2, at 1223 n.7.

25. *SEC v. Clark*, 699 F. Supp. 839, 844 (W.D. Wash. 1988) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 848).

26. *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir. 1973), cert. denied, 419 U.S. 830 (1974).

27. *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978).

28. *Basic, Inc. v. Levinson*, 485 U.S. at 239 n.17.

29. See, e.g., *Jordan v. Duff & Phelps, Inc.*, 815 F.2d at 435; *Michaels v. Michaels*, 767 F.2d at 1194-97; *Kohler v. Kohler Co.*, 319 F.2d 634, 637-38 (7th Cir. 1963); *Piccirillo v. FCB/Leber Katz Partners, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,753.

30. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).



own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts."<sup>31</sup>

In *Jordan* the chairman of the board of Duff & Phelps, Inc., an investment research and financial consulting firm, had begun "exploring the possibility of selling the firm." Between May and August of 1983, officers of Duff & Phelps negotiated with Security Pacific Corp., a publicly-traded bank holding company.<sup>32</sup> A merger agreement which valued Duff & Phelps at \$50 million was reached, but the agreement was vetoed by a higher official within Security Pacific on August 11, 1983.<sup>33</sup>

At the same time, Jordan, a securities analyst who had been employed at Duff & Phelps for six and a half years, was searching for a new job. After finding a job in another state which paid substantially higher compensation, Jordan tendered his resignation on November 11, 1983.<sup>34</sup> During his employment Jordan had purchased 188 of the 20,100 shares outstanding pursuant to a "stock restriction and purchase agreement."<sup>35</sup> The agreement provided that upon termination of employment for any reason, Duff & Phelps would buy back all shares owned by the employee at adjusted book value.<sup>36</sup>

By mutual agreement with the chairman of the board, Jordan's resignation was made effective as of December 31, 1983, "so that he could receive the book value of the stock as of December 31, 1983—for under the [stock purchase agreement,] departure in November would have meant valuation as of December 31, 1982."<sup>37</sup> In return for delivery of Jordan's stock certificates on December 30, 1983, the firm mailed Jordan a check for \$23,225 (the book value of 188 shares at \$123.54 per share).<sup>38</sup>

Before Jordan cashed the check, a merger between Duff & Phelps and a subsidiary of Security Pacific was announced on January 10, 1984.<sup>39</sup> This merger agreement also valued Duff & Phelps at \$50 million. Thus "[i]f Jordan had been an employee on January 10, had quickly paid for the other 62 shares [for which he had been making installment payments], and the merger had closed that day, he would have received \$452,000 in cash and the opportunity to obtain as much as \$194,000 more in 'earn out.'"<sup>40</sup>

Jordan "refused to cash the check" and filed suit in March of 1984, claiming damages in the amount of "the value his stock would have had" under the terms of the merger agreement (which was ultimately cancelled on

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31. *Id.* at 435.

32. *Id.* at 432.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* at 433.

40. *Id.*

January 9, 1985).<sup>41</sup> The trial court concluded that the agreement in principle approved January 6, 1984, was the first transaction which should have been disclosed, and "[b]ecause Jordan sold his stock no later than December 31, [1983] Duff & Phelps did not violate any duty to disclose."<sup>42</sup>

The Seventh Circuit Court of Appeals reversed. Even though "Duff & Phelps did not lie to Jordan," its silence violated a "fiduciary duty of corporate law."<sup>43</sup> The court's decision was based on the principle that "insiders trading in closely held firms may not buy stock from outsiders in person-to-person transactions without informing them of new events that substantially affect the value of the stock."<sup>44</sup>

Whether such a duty is implicit in the fiduciary relationship between a closely-held corporation and its shareholders was questioned by Judge Posner's powerful dissent in *Jordan*.<sup>45</sup> Judge Posner stated: "[t]he cases do not establish an automatic duty to disclose, even on the part of closely-held corporations . . . ."<sup>46</sup>

Criticizing the majority's conclusion that an affirmative duty of disclosure is implicit in the fiduciary relationship existing between a closely-held corporation and its shareholders, Judge Posner reminded the majority that a publicly-held corporation also has a fiduciary obligation to its shareholders. Under case law at the time, however, Duff & Phelps' publicly-held merging partner would have no duty under the price-and-structure standard to tell the shareholder about the prospect of merger.<sup>47</sup> Thus "the mere existence of a fiduciary relationship between a corporation and its shareholders does not require disclosure of material information to the shareholders."<sup>48</sup>

The central point of Judge Posner's dissent was that, because Jordan was required under his employee stock purchase agreement to sell his shares back to the company at book value upon termination of employment, "the contingent nature of Jordan's status as a shareholder negate[d] the existence of a right to be informed and hence a duty to disclose."<sup>49</sup>

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41. *Id.*

42. *Id.*

43. *Id.* at 435.

44. *Id.*

45. *Id.* at 444-51.

46. *Id.* at 445 (Posner, J., dissenting).

47. *Id.* (Posner, J., dissenting).

48. *Id.* (Posner, J., dissenting).

49. *Id.* at 446 (Posner, J., dissenting). In support of this view, see the discussion of second circuit precedent in *Piccirillo v. FCB/ Leber Katz Partners, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,753:

In *Villada v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 460 F. Supp. 1149 (S.D.N.Y. 1978), the plaintiff voluntarily resigned his employment to accept a position at another brokerage firm . . . . [T]he stock agreement in that case allowed Merrill Lynch to buy back the stock from Villada at any time, for any reason. Villada was under an obligation to sell the stock back to Merrill Lynch with or without the resignation, and with or without knowledge about Merrill Lynch's imminent plans to go

Despite Judge Posner's dissent, the fiduciary relationship between closely-held corporations and their shareholders has been acknowledged by other courts as sufficient basis to trigger the affirmative duty to disclose.<sup>50</sup>

### B. Materiality of Preliminary Merger Negotiations

Even if one of the three duties to disclose applies, Rule 10b-5 requires disclosure of preliminary merger negotiations *only* if the information regarding the negotiations is "material."<sup>51</sup>

Prior to the Supreme Court's ruling in *Basic, Inc. v. Levinson*,<sup>52</sup> the federal appellate courts were divided over the appropriate standard of materiality in the context of preliminary merger negotiations. Some courts held that preliminary merger negotiations were per se immaterial.<sup>53</sup> In 1984 the Third Circuit refined this bright-line rule by holding that merger discussions

public.

In *Keating v. BBDO International, Inc.*, 438 F. Supp. 676 (S.D.N.Y. 1977), the plaintiff was fired for cause. Keating was obligated to sell his shares after being terminated. Any disclosure of information concerning BBDO's plans to go public would have been irrelevant to Keating, and thus immaterial, because of his involuntarily triggered contractual obligation to sell his shares.

*Id.* Distinguishing these cases, however, the court in *Piccirillo* found that the company's right to fire Piccirillo at any time would not alter its duty to disclose information to Piccirillo while he was still employed and thus still a stockholder. *Id.* at 90,753.

50. See, e.g., *Piccirillo v. FCB/Leber Katz Partners, Inc.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,753. The United States District Court for the Southern District of New York held that the fact that Piccirillo was an employee at will did not obviate any fiduciary duty on the corporation's part to disclose information to Piccirillo. See also *Michaels v. Michaels*, 767 F.2d at 1194-97; *Kohler v. Kohler Co.*, 319 F.2d 634, 637-38 (7th Cir. 1963).

51. In relevant part, Rule 10b-5 provides:

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

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

17 C.F.R. § 240.10b-5 (1988) (emphasis added).

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

53. In *Staffin v. Greenberg*, 672 F.2d 1196, 1206 (3d Cir. 1982), the Third Circuit Court of Appeals held that no disclosure of initial merger contacts was necessary because preliminary merger negotiations were "immaterial as a matter of law." The court's rationale was that disclosure of preliminary negotiations "may itself be misleading." *Id.* The court reasoned that "[t]hose persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left 'holding the bag' on a stock whose value was inflated purely by an inchoate hope." *Id.* at 1207. Thus to avoid the risk of creating unrealized shareholder expectations that a merger will occur, the court adopted a per se rule that preliminary merger negotiations are immaterial and need not be disclosed. *Id.*

Relying on *Staffin*, the Second Circuit Court of Appeals in *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983) noted that "[d]isclosure may in fact be more misleading than secrecy so far as investment decisions are concerned."



are immaterial until there is an agreement as to the "price and structure" of the deal.<sup>54</sup> The Seventh Circuit Court of Appeals adopted the price-and-structure standard in *Flamm v. Eberstadt*.<sup>55</sup>

Prior to *Flamm*, however, the Seventh Circuit rejected the price-and-structure standard in the context of closely-held corporations, and held that information concerning preliminary merger negotiations of closely-held corporations may be material.<sup>56</sup> In *Michaels v. Michaels* the court chose not to adopt the price-and-structure standard of materiality because the policies underlying that standard are inapplicable to transactions involving closely-held corporations.<sup>57</sup>

The main concern of the price-and-structure standard is that "disclos[ure] of preliminary merger negotiations would cause speculative investment in the target company's stock, thus raising the price."<sup>58</sup> Moreover, if the merger negotiations were terminated, the stock price would drop. "[I]nvestors who bought shares at inflated, post-disclosure prices suffer a loss and shareholders who would have otherwise sold may find that they can

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54. In *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985), a publicly-traded company voluntarily issued a press release during preliminary merger negotiations. This public disclosure placed the company under an affirmative duty to make accurate statements concerning material information relating to the negotiations. *Id.* at 756. The Third Circuit Court of Appeals concluded that merger discussions are immaterial until there is an agreement on the price and structure of an actual merger. *Id.* at 757. The court stated:

Agreement as to price and structure provides concrete evidence of a mature understanding between the negotiating corporations. They constitute a usable and definite measure for determining when disclosures need be made. Finally, with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity.

*Id.*

55. *Flamm v. Eberstadt*, 814 F.2d 1169, 1178 (7th Cir.), *cert. denied*, 485 U.S. 942 (1987). The court recognized that other courts had held that "efforts by public corporations to arrange mergers are immaterial . . . as a matter of law, until the firms have agreed on the 'price and structure' of the deal." *Id.* at 1174 (citing *Staffin v. Greenberg*, 672 F.2d at 1204-07). The majority identified three possible reasons for this conclusion. First, the court recognized the argument that "disclosure of ongoing negotiations may befuddle the investors, leading them to think that the outcome is more certain than it is." *Id.* at 1175. Second, the court found that premature disclosure could potentially hinder merger negotiations, "destroying the source of the value sought to be disclosed." *Id.* Third, the court identified a "need to create a bright-line rule that would allow firms to plan corporate transactions with the assurance that they will not be condemned no matter which way they proceed on disclosure." *Id.*

Even though the court did not subscribe to the first rationale, the court concluded that the second and third rationales provided strong support for the price-and-structure test and accordingly adopted the test. *Id.* at 1175-78.

56. *Michaels v. Michaels*, 767 F.2d at 1196.

57. *Id.*

58. *Id.* at 1195.

no longer obtain even the pre-disclosure price."<sup>59</sup> Thus the policies underlying the price-and-structure standard are inapplicable when there is no public market for a shareholder's stock.

The court proceeded to adopt the standard of materiality established in the context of proxy solicitations in *TSC Industries, Inc. v. Northway, Inc.*<sup>60</sup> The court stated the standard: "[A]n omission or misstatement is material if there is a 'substantial likelihood that under all the circumstances, the omitted [or misstated] fact would have assumed actual significance in the deliberations of the reasonable shareholder.'"<sup>61</sup>

In the spring of 1988 the United States Supreme Court rejected the price-and-structure standard of materiality for *all* actions under Section 10(b) and Rule 10b-5.<sup>62</sup>

### C. Supreme Court Adoption of the TSC Industries Materiality Test for Rule 10b-5 Actions

After noting the fundamental purpose of section 10(b) and Rule 10b-5, the Supreme Court expressly adopted the *TSC Industries* standard of materiality in *Basic, Inc. v. Levinson*.<sup>63</sup>

The *TSC Industries* standard provides that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."<sup>64</sup> The Court explained that to satisfy the materiality requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."<sup>65</sup>

In *Basic, Inc.*, representatives of Basic, Inc. [hereinafter Basic], a publicly-traded company which manufactures chemical refractories for the steel industry, and Combustion Engineering, Inc., a publicly-traded company which produces mostly alumina-based refractories, discussed merger over a two-year period.<sup>66</sup> During that time Basic made three public statements denying that any merger negotiations were taking place or that it knew of any corporate developments which would account for heavy trading in its

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59. *Id.* at 1196.

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

61. *Michaels v. Michaels*, 767 F.2d at 1194 (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449).

62. See *Basic, Inc. v. Levinson*, 485 U.S. at 236 ("We therefore find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a reasonable investor, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives.").

63. *Id.* at 232.

64. *Id.* (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449).

65. *Id.* (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. at 449).

66. *Id.* at 227.

stock.<sup>67</sup>

After the merger, former Basic shareholders who had sold their stock between Basic's first public denial of merger activity and the suspension of trading in Basic stock just prior to the merger, filed suit. The former shareholders alleged that Basic's public statements had been false or misleading in violation of section 10(b) and Rule 10b-5.<sup>68</sup>

After establishing the appropriate standard of materiality, the Supreme Court remanded the case for reconsideration of the materiality question because the lower courts had applied different standards of materiality.<sup>69</sup>

## II. APPLICATION OF THE *BASIC, INC.* MATERIALITY STANDARD TO PRELIMINARY MERGER NEGOTIATIONS

The Supreme Court noted in *Basic, Inc.* that, because merger negotiations are "contingent or speculative in nature, it is difficult to ascertain whether the 'reasonable investor' would have considered the omitted information significant at the time."<sup>70</sup> The Court recognized that there is an "ever-present possibility that the contemplated transaction will not be effectuated . . . ."<sup>71</sup>

The Court agreed with the analysis in *SEC v. Geon Industries, Inc.*<sup>72</sup> that materiality in the context of preliminary merger negotiations is something to be determined by looking at the probability and magnitude of merger in light of the particular facts of each case:

Since a merger in which [a small corporation] is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.<sup>73</sup>

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67. *Id.* at 227 n.4.

68. *Id.*

69. *Id.* at 241. The district court had granted summary judgment for the defendants, holding that "as a matter of law, any misstatements were immaterial: there were no negotiations ongoing at the time of the first statement, and although negotiations were taking place when the second and third statements were issued, those negotiations were not 'destined, with reasonable certainty, to become a merger agreement in principle.'" *Id.* at 228-29.

The Sixth Circuit Court of Appeals "rejected the argument that preliminary merger discussions are immaterial as a matter of law, and held that 'once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue.'" *Id.* at 229 (citing *Levinson v. Basic, Inc.*, 786 F.2d 741, 749 (1986) *vacated and remanded*, 485 U.S. 224 (1988)).

70. *Id.* at 232.

71. *Id.*

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

73. *Basic, Inc. v. Levinson*, 485 U.S. at 238 (quoting *SEC v. Geon Industries, Inc.*, 531 F.2d at 47-48).

The Court explained the test: "Whether merger discussions in any particular case are material therefore depends on the facts."<sup>74</sup> "Generally, in order to assess the *probability* that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels . . . [such] as board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries. . . ."<sup>75</sup>

"To assess the *magnitude* of the transaction to the issuer . . . a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value."<sup>76</sup> The Court added that "[n]o particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material."<sup>77</sup>

In *Basic, Inc.*, meetings, discussions, and negotiations concerning a future merger were conducted during the relevant two years.<sup>78</sup> Attorneys had prepared analyses and evaluations for use in the merger negotiations and investment bankers had been engaged to facilitate the merger.<sup>79</sup> The Supreme Court refused to apply the new standard to these facts and instead remanded the case for reconsideration of the materiality question.<sup>80</sup>

Subsequently the Fourth Circuit Court of Appeals applied the *Basic, Inc.* standards in *Taylor v. First Union Corp.*<sup>81</sup> In *Taylor*, Bennie Taylor

74. *Id.* at 239.

75. *Id.* (emphasis added).

76. *Id.* (emphasis added).

77. *Id.* The Supreme Court noted in *Basic, Inc.* that the following cases had used a consistent fact-specific inquiry to assess the materiality of merger negotiations:

*SEC v. Shapiro*, 494 F.2d 1301, 1306-07 [(2d Cir. 1974)] (in light of projected very substantial [600 percent] increase in earnings per share, negotiations material, although merger still less than probable); *Holmes v. Bateson*, 583 F.2d 542, 558 [(1st Cir. 1978)] (merger negotiations material although they had not yet reached point of discussing terms); *SEC v. Gaspar*, [[1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,977-90,978 (S.D.N.Y. April 15, 1985)]; *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982)(fact that defendants were seriously exploring the sale of their company [and that sale was likely] was material); *American General Ins. Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-45 (E.D. Va. 1980)(merger negotiations [were serious, substantive, and thus] material four months before agreement-in-principle reached). *Cf. Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1084-85 [(5th Cir. 1970)] (holding immaterial 'unilateral offer to negotiate' [which was] never acknowledged by target and repudiated two days later); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1316-18 (W.D. Mich. 1978)(mere "overtures" immaterial [under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e)]).

*Id.* at 240 n.19.

78. *Id.* at 227.

79. *Levinson v. Basic, Inc.*, 786 F.2d 741, 743-45 (6th Cir. 1986), *vacated and remanded*, 485 U.S. 224 (1988).

80. *Basic, Inc. v. Levinson*, 485 U.S. at 240-41.

81. *Taylor v. First Union Corp.*, 857 F.2d 240 (4th Cir. 1988), *cert. denied*, 56 U.S.L.W. 3620 (1989).

was a member of the board of directors and executive committee of Southern Bancorporation, a South Carolina bank holding company (hereinafter Southern).<sup>82</sup> As chief executive officer of one of its subsidiaries, Bennie Taylor and his wife had acquired 4.9% of the stock in Southern.<sup>83</sup> "On January 11, 1984, representatives of First Union, a North Carolina bank holding company, met with representatives of Southern to discuss the possibility of the two companies developing a 'relationship.'"<sup>84</sup> "On February 6, 1984, a special executive committee of Southern's board [of directors] sought Bennie Taylor's resignation, allegedly because his deteriorating physical and mental condition made him unable to fulfill his responsibilities . . . ."<sup>85</sup> Unable to negotiate a sale of his stock back to Southern, Taylor and his wife sold their shares to First Union at \$18 per share (\$2 above market price) on February 28, 1984.<sup>86</sup>

Southern's president met with representatives of First Union on September 15, 1985 to discuss a proposed merger.<sup>87</sup> An agreement authorizing First Union's purchase of all of Southern's common stock for \$33 per share was accepted by Southern on September 20, 1985.<sup>88</sup> The boards of directors of both companies subsequently approved the deal, and the merger became effective April 1, 1986.<sup>89</sup>

The Taylors filed suit alleging violations of section 10(b) and Rule 10b-5. A jury verdict was returned against the defendants for \$165,975 plus interest and costs.<sup>90</sup> The Fourth Circuit Court of Appeals reversed and ordered judgment in favor of the defendants, holding: "Because their silence was neither material nor misleading, First Union and Southern were under no obligation to disclose to the Taylors their January 11, 1984 discussions of the possibility of a future merger."<sup>91</sup>

The court stated that in contrast to *Basic, Inc.*, the evidence indicated that the discussions in *Taylor* were "preliminary, contingent and speculative. At best, the merger discussions culminated in a vague 'agreement' to establish a relationship."<sup>92</sup> The court considered the following factors: "[t]here was no agreement as to the price or structure of the deal" (recognizing that after *Basic, Inc.* these factors are not dispositive alone, but are nevertheless relevant to the totality of the circumstances);<sup>93</sup> there were no fac-

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82. *Id.* at 242.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.* at 243.

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 244.

93. *Id.*



tual or legal predicates for merger in place (no "board resolutions, actual negotiations, or instructions to investment bankers to facilitate a merger");<sup>94</sup> and last, merger was "contingent upon events beyond the control of the parties" (a Supreme Court ruling on the constitutionality of interstate banking and subsequent enabling legislation in both North Carolina and South Carolina).<sup>95</sup> Noting that "materiality" is "directly related to the likelihood the merger will be accomplished" and that "[i]nformation of speculative and tentative discussions is of dubious and marginal significance" to a shareholder's decision to sell, the court found the discussions immaterial.<sup>96</sup>

#### A. *Differential Treatment for Public and Closely-Held Corporations*

Since the standard of materiality established by *Basic, Inc.* is a question of fact which depends on the significance the "reasonable investor would place on the withheld or misrepresented information,"<sup>97</sup> "materiality" can take on a significantly different meaning to an investor in a small closely-held corporation.

The fact that the corporation is small and closely-held may affect the materiality of an omitted fact in a number of respects. First, it is likely that an event of a given magnitude "has a larger potential impact on the fortunes of a small company than on the fortunes of a large one."<sup>98</sup>

Second, "the principal distinguishing feature of the closely held corporation is [its] small number of shareholders."<sup>99</sup> Generally the same shareholders who own "a substantial portion of the total shares will occupy the top managerial positions or will be involved in a meaningful way in the selection or monitoring of the people who do occupy those positions."<sup>100</sup> Those same few people generally formulate corporate strategies and policies.<sup>101</sup> Thus the impact of leaving a shareholder in the dark about merger negotiations would be much greater in the context of a small, closely-held corporation than in a large, publicly-traded corporation where the shareholders are there simply for investment purposes.

In addition, the free transferability of public shares "enhances the investor's liquidity and gives the investor the ability to exit the corporation at will."<sup>102</sup> This "right of exit" probably makes the shareholders of a public corporation less interested in participating in its affairs than they would be

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94. *Id.*

95. *Id.*

96. *Id.* at 244-45.

97. *Basic, Inc. v. Levinson*, 485 U.S. at 240.

98. *Michaels v. Michaels*, 767 F.2d at 1196; *see also SEC v. Geon Industries, Inc.*, 531 F.2d 39, at 47-48 (1976).

99. W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE* 104 (3d ed. 1968).

100. *Id.*

101. *Id.*

102. *Id.* at 105.

if they were locked into the investment.<sup>103</sup> Where there is no secondary market, as is often the case with a closely-held corporation, the incentive to participate is strong and "shareholder passivity" is not anticipated.<sup>104</sup> Thus a reasonable investor contemplating sale of his shares would probably consider the omitted facts regarding merger "significant" even though the discussions are preliminary.<sup>105</sup>

The different treatment of public and closely-held corporations is exemplified by *Jordan v. Duff & Phelps, Inc.*<sup>106</sup> The Seventh Circuit Court of Appeals stated that the publicly-traded merging partner was entitled to remain silent about its plans and to insist that Duff & Phelps (the closely-held merging partner) also keep matters secret. However, "a whisper in Jordan's ear would not have revealed anything to the public."<sup>107</sup> Accordingly, the public merging partner was entitled to remain silent because no agreement-in-principle as to the price and structure had been reached,<sup>108</sup> but the closely-held merging partner was obligated to disclose the preliminary discussions to a shareholder-employee who was required to sell his shares back to the corporation upon termination of employment.<sup>109</sup>

The court explained that public and private corporations are treated differently because of the potential effects of disclosure. "Often negotiations [by public corporations] must be conducted in secrecy to increase their likelihood of success. The prospect of disclosure to the public, and therefore to potential rival bidders, may reduce the willingness of some firms to enter negotiations and lead others to cut back on the best price they will offer."<sup>110</sup> After all, "putting a mirror behind a poker player can affect the outcome of the game in a very dramatic way."<sup>111</sup> Thus the shareholders in public corporations may benefit more if secrecy is maintained because a better price can be obtained.

On the other hand, the court believed that a closely-held corporation could make a disclosure to one of its investors without alerting the public at large. The court justified the earlier disclosure of negotiations as "a timing rule on which the firm may rely."<sup>112</sup> The court stated that a closely-held

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103. *Id.*

104. *Id.* at n.1.

105. See *supra* notes 63-65 and accompanying text.

106. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

107. *Id.* at 434.

108. At the time the Seventh Circuit Court of Appeals was applying the price-and-structure rule adopted in *Flamm v. Eberstadt*, 814 F.2d 1169, 1174 (7th Cir. 1987) (efforts by public corporations to arrange mergers are immaterial "as a matter of law, until the firms have agreed on the 'price and structure' of the deal").

109. See *supra* notes 30-50 and accompanying text.

110. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d at 431 (citation omitted).

111. Herzel & Shepro, *Setting the Boundaries for Disclosure*, 16 SEC. REG. L.J. 179, 181 (1988).

112. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d at 431.

corporation:

need disclose the existence of the decision to sell (and the status of negotiations) only to the person whose stock is to be acquired. The face-to-face negotiations allow the investor to elicit the information he requires, while permitting the forum to extract promises of confidentiality that safeguard the negotiations.<sup>113</sup>

*B. Materiality Test as Applied to Closely-Held Corporations  
Repurchasing Shares from Shareholder-Employees*

In *Michaels v. Michaels*<sup>114</sup> the Seventh Circuit Court of Appeals applied the *TSC Industries* standard of materiality and held that a closely-held corporation must disclose preliminary sale discussions with an investor from whom it repurchases its stock. The case involved a family squabble between the plaintiff, Joseph Michaels (owner of fourteen percent of the outstanding shares) and two uncles, defendants Ralph Michaels (thirty-six percent owner) and Everett Michaels (fifty percent owner).<sup>115</sup>

After discussions regarding the restructure of ownership among the shareholders, Joseph was told by the controlling shareholders that he was relieved of all his duties as officer and director at Hyman-Michaels: "Joe, you're out . . ."<sup>116</sup> Joseph agreed to sell his shares back to the company on January 27, 1976, for \$300 per share.<sup>117</sup> In July of 1976 the controlling shareholders sold the company's assets for approximately \$13.4 million plus lifetime employment contracts.<sup>118</sup>

After the corporation was sold, Joseph filed suit under Rule 10b-5. Joseph alleged among other claims that Ralph failed to tell him about an agreement with a consultant in London to contact prospective purchasers for the company.<sup>119</sup> The jury found for Joseph on the Rule 10b-5 claim and assessed damages at \$750,000 plus \$200,000 in punitive damages on a common law fraud claim.<sup>120</sup>

The Seventh Circuit Court of Appeals affirmed, stating: "[t]he materiality of the information misstated or withheld is determined in light of what the defendants knew at the time the plaintiff committed himself to sell the stock, in this case by signing the agreement to sell on January 27, 1976."<sup>121</sup> The court concluded that a jury could reasonably find that the agreement with the London consultant to contact prospective buyers on behalf of the

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113. *Id.* (citations omitted).

114. *Michaels v. Michaels*, 767 F.2d at 1194-97.

115. *Id.* at 1191-92.

116. *Id.* at 1193.

117. *Id.* at 1192.

118. *Id.*

119. *Id.* at 1193-94.

120. *Id.* at 1191.

121. *Id.* at 1195.

company was "material."<sup>122</sup>

Looking at the "total mix" of information available to the reasonable shareholder . . ." the court concluded that:

[o]n January 27, 1976, Joseph had only two options—he could sell his stock to the Company for \$300 per share or he could hope that some outside entity would buy [the whole company] at a higher price. If Joseph had decided not to sell and no other company acquired [the company], Joseph would have been the unemployed owner of a minority interest for which there was no market and that paid no dividends.<sup>123</sup>

Therefore knowledge that a consultant had agreed to find a buyer would probably "have assumed actual significance in the deliberations of the reasonable shareholder, and a reasonable jury could find the fact material."<sup>124</sup>

*Jordan v. Duff & Phelps, Inc.* also involved the repurchase of shares from an employee-stockholder. The Seventh Circuit Court of Appeals determined that Duff & Phelps, a closely-held company, had a duty to disclose pending merger negotiations to a departing employee-stockholder from whom the company was buying back stock pursuant to a stockholder agreement, even though no agreement-in-principle had been reached.<sup>125</sup>

In *Jordan* the chairman of the board did not advise Mr. Jordan of acquisition discussions with Security Pacific, a public company, when Jordan resigned on November 16, 1983, and tendered his stock back to the company at book value as required by the stockholder agreement.<sup>126</sup> Citing *Michaels*, the court held that closely-held corporations which purchase their own stock must disclose all material information to the sellers from whom the corporations purchase the stock.<sup>127</sup> The court concluded that "a decision to seek another firm with which to merge may be the sort of material information that must be disclosed to the investor selling his shares . . ."<sup>128</sup>

### III. CONCLUSION

Commentators have suggested that the most troublesome aspect of these decisions is that they take "from the issuer all discretion and business judgment with respect to the timing of disclosure."<sup>129</sup> "[T]he random conduct of a single shareholder [is permitted] to dictate the disclosure obliga-

122. *Id.* at 1197.

123. *Id.* at 1196-97.

124. *Id.* at 1197-98.

125. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d at 434. See *supra* notes 30-50 and accompanying text.

126. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d at 432.

127. *Id.* at 431 (citing *Michaels v. Michaels*, 767 F.2d at 1194-97).

128. *Id.* See also *Piccirillo v. FCB/Leber Katz Partners, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,016 at 90,752 (S.D.N.Y. Sept. 9, 1988) ("Information concerning a merger of a closely held corporation can be material").

129. *Wander & Palleson*, 21 REV. SEC. & COMM. REG. (S & P) 109, 119 (1988).

tions of the issuer."<sup>130</sup> The chairman of the board or the chief executive officer of a closely-held corporation is put in a very difficult position. There are no bright-line rules as to when merger discussions have arrived at the point of "materiality." Applying the holdings of *Basic, Inc., Michaels, Jordan, Piccirillo*, and *Taylor* to the hypothetical question posed at the beginning of this note, it appears that disclosure would be required.

The January meetings with the three marketing firms to discuss the possibility of "developing a relationship" with one of the firms would be immaterial under *Taylor v. First Union Corp.*<sup>131</sup> By March 1, 1989, the hypothetical discussions had progressed to an agreement as to the price, but not necessarily as to the structure. Under the post-*Basic, Inc.* analysis in *Taylor*, price and structure are relevant even though not dispositive.<sup>132</sup> The court would attempt to determine the probability of merger by considering board resolutions, actual negotiations, or instructions to investment bankers to facilitate a merger.<sup>133</sup> In the hypothetical, the advertising firm's board of directors had adopted a resolution to seek a merging partner, but had not approved a definite agreement with any firm. Nevertheless, under the *Michaels* standard (which was followed in *Jordan*) the mere decision to seek a merging partner might be material to an investor selling his shares.<sup>134</sup>

Under the *Piccirillo* analysis the court would also look closely at the terms of the stock purchase agreement to determine the employee's obligation to sell the shares back to the corporation upon termination of employment. In *Piccirillo* the shareholder's obligation to sell his shares was triggered by resignation. Because he asserted in his complaint that had he known about the merger he would not have resigned, "Piccirillo's obligation to sell his shares upon resignation did not obviate the materiality of information concerning a merger" (which was effectuated six weeks after his resignation).<sup>135</sup> Although this analysis may be speculative, we are reminded by the Supreme Court that:

A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any 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 underinclusive.<sup>136</sup>

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130. *Id.*

131. *See supra* notes 81-96 and accompanying text.

132. *Taylor v. First Union Corp.*, 857 F.2d 240, 244 (1988).

133. *Id.* (citing *Basic, Inc. v. Levinson*, 485 U.S. at 236).

134. *See supra* notes 121-24 and accompanying text.

135. *Piccirillo v. FCB/Leber Katz Partners, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,016 at 90,751-53 (S.D.N.Y. Sept. 9, 1988).

136. *Basic, Inc. v. Levinson*, 485 U.S. at 236.



Because the courts are likely to hold closely-held corporations to a strict duty to disclose, extreme caution must be taken when repurchasing shares from employee-shareholders. Although the corporation may not desire disclosure, complete candor toward its shareholders may be wise.

*Barbara J. Lano*

