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Materiality Under the Anti-Fraud Provisions of the Federal Securities Acts: How Much Disclosure?

Kim Gregory Mayhall

choice and the historical purpose of the grand jury as a shield and not an unlimited prosecutorial tool should be weighed before disqualification is ordered. A witness's apparent waiver of his right to a conflict-free attorney, however, should be carefully scrutinized as the potential conflicts in multiple representation in the context of criminal prosecutions are numerous and sometimes subtle, making a knowing and intelligent waiver difficult.

Robert Bruce Macmurdo

MATERIALITY UNDER THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES ACTS: HOW MUCH DISCLOSURE?

A minority shareholder in an acquired corporation sought damages, restitution, and other equitable relief under the Securities Exchange Act of 1934, and rules promulgated thereunder, alleging that the joint proxy statement issued by the boards of directors of both corporations soliciting approval of the acquisition was incomplete and misleading in that it omitted certain material facts.[1] The trial court denied plaintiff's motion for partial summary judgment on the liability question.[2] The Court of Appeals reversed in part, granting plaintiff's motion for summary judgment under Section 14(a) of the Securities Exchange Act of 1934,[3] and rule 14a-9,[4] finding that certain facts omitted from the proxy statement were material as a matter of law.[5] The Supreme Court granted writs[6] to review the

1. The plaintiff claimed violations of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78N(a) (1934) and rules 14a-3 and 14a-9, promulgated thereunder, 17 C.F.R. §§ 240.14a-3, 240.14a-9 (1975). The basis of the rule 14a-3 claim was the averment that the statement did not disclose that the transfer of certain stock to National (the acquiring corporation) had given National control of *TSC* (the acquired corporation). The rule 14a-9 complaint alleged omission by TSC and National of certain material facts relating to the degree of National's control over TSC and the favorability of the terms of the proposal to the TSC shareholders. 96 S. Ct. 2126, 2129-30 (1976). The petition also claimed violation of rule 10b-5, 17 C.F.R. § 240.10b-5 (1976). This claim was not before the Court.

2. 361 F. Supp. 108 (N.D. Ill. 1973).

3. 15 U.S.C. § 78n(a) (1934).

4. 17 C.F.R. § 240.14a-9 (1976).

5. Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324 (7th Cir. 1975). The court also affirmed the denial by the lower court of the plaintiff's motion for summary judgment on the rule 14a-3 question and the defendant Schmidt's cross-motion for summary judgment on the 10b-5 question. No appeal was taken on these questions.

6. 423 U.S. 820 (1975).

definition of materiality applied by the appellate court. In reversing the summary judgment, the Supreme Court *held* "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries, Inc. v. Northway, Inc.*, 96 S.Ct. 2126 (1976).

The Securities Act of 1933 regulates new issues of certain securities by requiring, through various devices, comprehensive and detailed disclosure of prescribed information to the Securities and Exchange Commission and prospective investors.[7] The Securities Exchange Act of 1934 was designed to supplement and continue the policies of the 1933 Act by providing for disclosure in other areas of securities dealing.[8] The objective of the Acts is to insure informed investor and shareholder decisionmaking in securities transactions by substituting a policy of full disclosure for the philosophy of caveat emptor.[9] Section 14(a)[10] of the 1934 Act delegates authority to the Securities and Exchange Commission to enact rules to protect investors and shareholders in situations involving proxy solicitations.[11] Rule 14a-9, adopted to that end, prohibits making a statement in a proxy solicitation which is "false or misleading with respect to any material fact or which omits to state any material fact necessary in order to

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7. *See* H. SOWARDS, 11 BUSINESS ORGANIZATIONS— SECURITIES REGULATION, THE FEDERAL SECURITIES ACT § 1.02.

8. *See* E. GADSBY,11 A BUSINESS ORGANIZATIONS—SECURITIES REGULATION, FEDERAL SECURITIES EXCHANGE ACT § 1.01. [hereinafter cited as GADSBY].

9. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973); GADSBY, *supra* note 8, at § 6.01; Comment, *Reliance Under Rule 10B-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562 (1972).

10. Section 14(a) provides that: "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 78l of this title." 15 U.S.C. § 78 n(a) (1934).

11. "One of the conclusions reached by Congress as the result of the stock market investigations of 1933-34 was that the machinery of proxy solicitation required extensive regulation to compel disclosure to stockholders of the matters as to which their powers of attorney are being sought." GADSBY, *supra* note 8, at § 7.01[1]. *See also* J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 14 (1934)(also cited in part in Mills v. Electric Auto Lite, 396 U.S. 375 (1970)); S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934).

make the statements therein not false or misleading. . . ."[12] Thus, the definition of materiality determines the scope of the rule's coverage.

The concept of materiality was used at early common law in actions for fraud and misrepresentation[13] to determine if the wronged party was justified in acting on the misrepresentation.[14] It was felt that use of this element maintained commercial stability in preventing parties from withdrawing from a transaction by claiming some insignificant or irrelevant misrepresentation.[15] The question of materiality must be an objective one.[16] The Restatement of Torts, Second, defines a material fact as one to whose existence or non-existence a reasonable man would attach importance in determining his choice of action in the transaction in question.[17] However, courts generally have recognized that in the interpretation of the antifraud provisions of the federal securities acts, they are not bound by the elements essential to common law fraud.[18]

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12. 17 C.F.R. § 240.14a-9 (1934) (adopted September 21, 1935. Securities Exchange Act, Rel. No. 378(A)). The source for the provision was Section 17a of the 1933 Act.

13. "The hornbook elements of deceit . . . are six in number. There must be:
(1) a false misrepresentation of
(2) a material
(3) fact;
(4) the defendant must know of the falsity (*scienter*) but make the statement nevertheless for the purpose of inducing the plaintiff to rely upon it; and
(5) the plaintiff must justifiably rely on it and
(6) suffer damages as a consequence."

3 L.LOSS, SECURITIES REGULATION 1431 (2d ed. 1961) [hereinafter cited as LOSS].

14. *See generally* F. BURDICK, LAW OF TORTS 430-31 (3d ed. 1913) [hereinafter cited as BURDICK]; 2 T. COOLEY, COOLEY ON TORTS 947 (3d ed. 1909); W. HALE, HALE ON TORTS 344-45 (1896); F. HARPER, HARPER ON TORTS 224-25 (1933); W. PROSSER, LAW OF TORTS 718 (4th ed. 1971) [hereinafter cited as PROSSER].

15. *See* BURDICK, *supra* note 14, at 430-31; PROSSER, *supra* note 14, at 719.

16. *See* Tucker v. Arthur Anderson & Co., 67 F.R.D. 468 (D.C. N.Y. 1975); PROSSER, *supra* note 14, at 719.

17. RESTATEMENT (SECOND) OF TORTS § 538 (Tent. Draft No. 10, 1964) (not adopted); ALI FEDERAL SECURITIES CODE § 256(a) (Tent. Draft No. 2, 1973) (not adopted).

18. *See* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); Blackett v. Clinton E. Frank, Inc., 379 F. Supp. 941 (N.D. Ill. 1974); Lerman v. Tenney, 295 F. Supp. 780 (S.D. N.Y. 1969); 3 LOSS, *supra* note 13, at 1435; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 585 (1975) [hereinafter cited as *Reliance Requirement*]. Some elements have been discarded and others altered in order to satisfy particular policy considerations of different sections of the Acts. The varying degrees of culpability is an excellent example. Compare Section 11 of the 1933 Act with rule 10b-5 under the 1934 Act as recently interpreted by *Ernst & Ernst v. Hochfelder*, 96 S.Ct. 1375 (1976). For an examination of the *Hochfelder* decision see Note, 37 LA. L. REV. 255 (1976).

Early cases offer little discussion of the definition of materiality.[19] As litigation increased under the antifraud provisions,[20] three separate tests, which corresponded with particular courts' perceptions of the scope of liability under the act, began to evolve. The leading case, *List v. Fashion Park, Inc.*,[21] is commonly cited for the proposition that the basic test of materiality is whether a reasonable man *would* attach importance to the fact misrepresented in determining his course of action in the questioned transaction.[22] This test finds ample authority in the common law.[23] Some courts, however, perceived that the policies underlying the securities acts called for a much more liberal interpretation and held material any fact which *might* have been considered important by the reasonable shareholder deciding how to vote.[24] This interpretation gained increased acceptance when the Supreme Court referred to it approvingly in *Mills v. Electric Auto Lite Co.*[25] and *Affiliated Ute Citizens v. United States*.[26]

19. *See, e.g.*, Otis & Co. v. SEC, 106 F.2d 579 (6th Cir. 1939); SEC v. Macon, 28 F. Supp. 127 (D. Colo. 1939).

20. The increase was to a large degree due to the allowance of private causes of action under various antifraud provisions, such as Section 10b and rule 10b-5 (Karden v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947)) and Section 14a and rule 14a-9 (J.I. Case Co. v. Borak, 377 U.S. 426 (1964)).

21. 340 F.2d 457 (2d Cir. 1965), *cert. denied sub nom.* List v. Lerner, 382 U.S. 811 (1965).

22. *Id.* at 462. Probably the most persuasive discussion of this test was in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) (Friendly, J.). However, while *List* has been cited by many cases as announcing the "would" test, it appears that it could also be authority for either the "might" or *General Time, Inc. v. Tally Assoc.* tests discussed hereinafter. Other cases adopting the "would" test are: Chelsea Assocs. v. Raponos, 527 F.2d 1266 (6th Cir. 1975); Robinson v. Cupples Container Co., 513 F.2d 1274 (9th Cir. 1975); Smallword v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973); Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966). The test was not easy for some courts to isolate prior to *Gerstle*, upon which many later courts relied. For some cases which offer contradictory tests or cite contradicting authority for their holding see, for example, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); List v. Fashion Park, 340 F.2d 457 (2d Cir. 1965).

23. *See* PROSSER, *supra* note 14, at 714-20.

24. *E.g.*, Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

25 396 U.S. 375 (1970).

26. 406 U.S. 128 (1972) (see note 34, *infra*). Subsequent appellate court decisions supporting the "*would*" test point out, as did the Supreme Court in the instant

Finally, there is a small line of cases holding that a fact is material only if the plaintiff would have taken a contrary course had he known the truth of the misrepresented fact or the existence of the omitted fact.[27] This subjective approach defines materiality in terms of reliance.[28] The importance of the definition of materiality was greatly enhanced by *Mills v. Electric Auto Lite Co.*[29] where the Supreme Court found that proper enforcement of rule 14a-9 was frustrated by the difficulty of proving reliance where an omission of material fact was alleged.[30] *Mills*, therefore, eliminated reliance[31] as an element in cases of non-disclosure[32] under rule 14a-9.[33]

case, that the language relevant to materiality was merely preliminary to other findings. *See, e.g.*, Smallwood v. Pearl Brewing Corp., 489 F.2d 579 (5th Cir. 1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973). However, as the court of appeals in *TSC* pointed out, it does appear unlikely that the Court would use the same test in both cases without any appreciation of its possible impact.

27. Vohs v. Dicksen, 495 F.2d 607 (5th Cir. 1975); Ronsen Corp. v. Liquifin Aktiengesellschaft, 483 F.2d 846 (3d Cir. 1973); Electronic Speciality Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969); General Time v. Tally Indus., Inc., 403 F.2d 159 (2d Cir. 1968). This test also has been cited with approval where another test was adopted. *See, e.g.*, Gould v. American Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976). The test is apparently the product of confusion between reliance and materiality.

28. That the fact was so important that the plaintiff would have taken a contrary course had he known the truth embodies proof that he relied upon what was represented.

29. 396 U.S. 375 (1970).

30. *Id.* at 381-85. Without the burden of showing reliance, the liability issue would consist of materiality and the requisite degree of culpability. Hence the broader the definition of materiality, the more likely a plaintiff would be able to show an actionable misrepresentation or omission, and the wider the potential scope of liability.

31. *Id.* at 384. Note, however, that the plaintiff does have to prove that the proxy solicitation was "an essential link in the accomplishment of the transaction," *id.* at 385, but this burden is substantially lighter than proving the defect itself was relied upon.

32. There is authority that *Mills* is limited to its facts, *i.e.*, instances of partial non-disclosure. *See* Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271 (2d Cir. 1975); *Reliance Requirement, supra* note 18, at 584. It has been suggested that the same proof problems do not exist in the case of affirmative misrepresentations as with omissions. The problem in the case of an omission is that the plaintiff first must show that he had the existence of the particular fact in mind and then that he relied upon the negative of it. In the case of an affirmative misrepresentation it is said to be easier for the plaintiff to show that he had the fact in mind since it was positively asserted. Therefore, all he must show is reliance. While the proposition is sound, there were other factors weighed in *Mills*. The Court noted that (1) many factors affect an investor's decision, (2) the requirement created difficult problems of determining how many votes were affected, and (3) doubts should be resolved in favor of those whom the statute is designed to protect. 396 U.S. at 385 (1970).

33. Subsequent decisions have applied *Mills* to other analogous provisions of

In the instant case the appellate court was strongly influenced by certain language in *Mills* and *Affiliated Ute*.[34] In adopting the "might" test, that court was moved by both the prophylactic function of the section and the fear that injection of "probability" into the test of materiality would signal the return to pre-*Mills* reliance.[35] Noting that after *Mills* the definition of materiality had assumed heightened importance,[36] the Supreme Court rejected the lower court's interpretation of the standard gleaned from *Mills* and *Affiliated Ute*.[37] The Court balanced the policy directives of the Act—full disclosure to facilitate informed shareholder or investor decisionmaking and greater stability in securities transactions—against the proxy solicitor's ability reasonably to conform to the disclosure requirements in a manner which would be meaningful to the shareholders.[38] The Court concluded that the "might" test created a substantial risk

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the Act condemning non-disclosure of material facts. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (rule 10b-5, clause 2); SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973) (Section 17(a) of the 1933 Act); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973) (Section 14(e) of the 1934 Act); Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970) (Section 12(2) of the 1933 Act).

The court apparently felt that the more liberal the test, the more likely parties would disclose all information relevant to the transaction, rather than withhold some and gamble on the possibility of its not being found material if discovered. The test would not include facts which were "trivial" and "unrelated," because of the reasonable man standard. 396 U.S. at 381.

34. In pertinent part the language provided: "Where the misstatement or omission in a proxy statement has been shown to be 'material', as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable investor who was in the process of deciding how to vote." Mills v. Electric Auto Lite Co., 396 U.S. 375, 384 (1970) (cited with approval in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972)).

35. Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324, 331 (7th Cir. 1975). The court seemed to assume two basic facts: (1) that the object of *Mills* was to expand the scope of liability of rule 14a-9 by eliminating the plaintiff's burden of reliance; and (2) that proving what a reasonable man would do is as difficult as proving what a particular person actually did in the same instance.

36. 96 S. Ct. 2126, 2130-31 (1976).

37. "The references to materiality were simply preliminary to our consideration of the sole question in the case— whether proof of the materiality of an omission from a proxy statement must be supplemented by a showing that the defect actually caused the outcome of the vote. It is clear, then, that *Mills* did not intend to foreclose further inquiry into the meaning of materiality under Rule 14a-9." *Id.* at 2132. Referring to *Ute*, the Court noted that the issue in that case was whether reliance was necessary under 10b-5 in case of alleged non-disclosures. *Id.* at n.9.

38. "[T]he disclosure policy embodied in the proxy regulation is not without

of exposing management to excessive liability by imposing an unduly heavy burden and of frustrating full disclosure by over-disclosure to the extent of the shareholder being buried in a deluge of information, relevant and irrelevant, supplied by solicitors to prevent any claims of non-disclosure.[39] In light of this balancing, the Court affirmatively adopted the "would" test: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote.[40]

In an attempt to clarify the standard, the Court pointed out that it is not necessary to show substantial likelihood that knowledge of the omitted fact would have caused the reasonable investor to change his vote. This negative qualification emphatically precludes assertion of the test recognized in *General Time v. Talley Industries, Inc.*,[41] and its progeny. All that is required is that the plaintiff show that "the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[42] In other words, "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."[43]

Though fully informed decisionmaking in securities dealings is a worthy goal, its accomplishment via the requirement of absolute disclosure would exact a heavy price. Equally undesirable, however, is a standard of materiality so restrictive as to require little, if any, disclosure. The Court chose a realistic test balancing the shareholders' need to know against the implications of establishing too broad a standard for disclosure.[44] The Court was also at pains to isolate a standard of conduct

limit. . . . Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." *Id.* at 2132.

39. "The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information—a result that is hardly conducive to informed decision making. Precisely these dangers are presented . . . by the definition adopted by the Court of Appeals in this case. . . ."*Id.* at 2132-33.

40. *Id.* at 2133.

41. 403 F.2d 159 (2d Cir. 1968). See the discussion in the text beginning at note 26, *supra*.

42. 96 S.Ct. at 2133.

43. *Id.* The Court desired to clarify its intent by defining materiality in several different ways.

44. *See* Comment, *Reliance Under Rule 10b-5: Is the "Reasonable Investor"*

which would be reasonably discernible to those in the securities field in order to provide stability in transactions where disclosure is required. The "would" test incorporates the elements of relevancy and probability of reliance to determine whether a fact is material.[45] This standard is more restrictive than the "might" test offered by the appellate court[46] which was based primarily on relevancy. At the same time, the requirement that the plaintiff need only show that there is a substantial likelihood that the undisclosed fact would, in the eyes of the reasonable shareholder, alter the *total mix* of facts is considerably broader than the test in *General Time*.[47]

The standard chosen by the Court is consistent with *Mills v. Electric Auto Lite Co*. The major objective in that case was to ease the plaintiff's burden of proof rather than to expand the scope of liability or coverage of the Act.[48] Prior to *Mills* the plaintiff had to prove both reliance and materiality. The present approach incorporates constructive reliance into the definition of materiality. Instead of having to show that he actually relied upon the undisclosed fact, the plaintiff need only show the fact to be of such significance that there is a substantial likelihood that a reasonable investor would have considered it important in his decision. That is, the fact is so important, a reasonable investor with knowledge is presumed to have relied upon it, hence proof of materiality raises a presumption of reliance in favor of the plaintiff.[49] Showing how a reasonable investor

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Reasonable?, 72 COLUM. L. REV. 562 (1972). With too broad a scope of liability, management finds itself in the position of not only being unable to comply with the regulations, but not knowing how to comply. The result of non-compliance is suits for rescission or damages by dissatisfied parties. The insecurity of transactions thus created leads to general instability and unpredictability in the field. While one goal of the Act may be fairness, the goal of stability seems equally important.

45. To succeed on his claim of materiality, the plaintiff must show that: (1) the fact is relevant, and (2) it is probable, or there is a substantial likelihood, that the fact would have achieved significance in the decision making process.

46. 512 F.2d 324, 331 (7th Cir. 1975).

47. See the text at note 26, *supra*.

48. It is arguable that whenever the burden of proof is eased, the scope of liability is thereby expanded. It is submitted, however, that what appeared to be expansion of the scope of liability in *Mills* was actually only the imposition of liability to its existing limits, which had been frustrated by difficulty of proof.

49. The adoption of the presumption of reliance approach raises the question whether the defendant may introduce evidence of non-reliance by the plaintiff. The authorities appear mixed on this question. *Compare* Chelsea Assocs. v. Rapanos, 527 F.2d 1266 (6th Cir. 1975) *with* Kohn v. American Metal Climax Inc., 458 F.2d 255 (3d Cir. 1972). It would seem that the better view is that the defendant should be able to rebut the presumption by showing that the plaintiff did not rely on the omitted fact. Materiality asks the objective question: Would a *reasonable investor* have considered the fact in determining his course of action? Reliance asks the

would regard a known fact, in situations where many elements could influence a decision, is considerably less burdensome than showing that the plaintiff actually relied on the negative of an omitted fact.

Since the standard for disclosure is determined by the definition of materiality, the required degree of disclosure is the same for both affirmative misrepresentations and omissions of fact. However, if the plaintiff must prove reliance in the case of an affirmative misrepresentation or untrue statement then a solicitor would be in a better position affirmatively misrepresenting a fact than not disclosing it at all. Under the "would" test, the distinction between omission and affirmative misrepresentation becomes less important because the burden of proof becomes more nearly equal. The Court should apply *Mills* to cases of affirmative misrepresentation because (1) the conservative "would" test of *TSC* incorporates constructive reliance, (2) the policy issues involved are similar to those considered by *Mills* in the case of omissions,[50] (3) the change would not result in a significant expansion of liability, and (4) the equalization of the burden of proof in cases of misrepresentations and omissions would promote proper enforcement of the Act.[51]

In spite of the relative clarity of the test established in *TSC*, the Supreme Court, in applying that test, appears to have created some analytical difficulties.[52] At common law it was generally agreed that fraud required some form of misrepresentation or misleading conduct. As a

parallel subjective question: Did *this* investor actually consider the fact important in deciding his course of action? (*Cf.* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965)). Therefore, a showing by the defendant that the fact was not actually the sole cause or determining factor in the decision would be insufficient to prove non-reliance. The defendant would have to show that the plaintiff did not consider the fact important in determining his course of action. In the ordinary case, this showing will be at least as difficult as the pre-*Mills* burden which forced the plaintiff to show actual reliance. However, the rebuttable presumption theory will aid the defendant in cases where investors with actual knowledge of the existence of an omitted fact seek to use the act as an insurance policy. Thus, where the defendant can show that the plaintiff had such knowledge, the Court should find that, not having relied on the statements of the defendant, the plaintiff is not entitled to recover. For an enlightening examination of the problem where the presumption view is adopted, see *Reliance Requirement*, *supra* note 18.

50. The policy factors are discussed in note 32, *supra*.

51. The equalization of both the standard of disclosure and the burden of proof in cases of omissions and misrepresentations would remove the emphasis from that distinction and place it more properly upon the lack of full disclosure, regardless of the form.

52 The Court examined the questions in light of whether they warranted summary judgment. Therefore, some of the results may change on remand. However, the analysis should be the same; only the sufficiency of the proof is varied.

result, in cases of non-disclosure legal fictions such as implied misrepresentation developed.[53] The question of the misleading quality of a statement where an omission is alleged is a vestige of those concepts.

In examining the plaintiff's allegation that a statement adverting to the favorability of the acquisition to TSC shareholders[54] was misleading because it omitted a material fact,[55] the Court asked two questions: Was the statement misleading? Was the fact material?[56] The statement was found not to be "materially misleading" as a matter of law; however, the Court never examined the materiality of the fact omitted in light of the new test.[57] It would appear from the Court's approach that the misleading quality of the statement is an element in the analysis to determine whether a fact is material, or at least that the finding is preliminary to examination of the materiality question.[58]

53. *See* Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEXAS L. REV. 1 (1936).

54. The proxy statement contained a reference to a favorable opinion of the transaction issued by an investment banking firm to the effect that one factor considered was "the substantial premium over current market values represented by the securities being offered to TSC stockholders." 96 S. Ct. at 2135-36.

55. Actually there were two issues: (1) Was the fact that the "substantial premium" was calculated on the basis of national stock warrants valued at $3.50, and not the market price listed in the proxy statement, material? and (2) Did the statement create the impression that the shareholder should calculate his premium on the basis of the quotations given in the statement? The Court used the same approach in analyzing both questions. *Id.* at 2136-38.

56. The approach is not novel. *See generally* GADSBY, *supra* note 8, at § 7.04[2]. There seems to be no uniform manner in which the test is applied. *Compare* TSC Indus., Inc. v. Northway, Inc., 96 S.Ct. 2126 (1976) *with* Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970). It has been noted by one respected authority that the questions tend to merge in securities cases. 2 LOSS, *supra* note 13, at 916.

57. The Court said that it was unable to find the statement materially misleading as a matter of law, indicative of the merger of concepts noted above. However, at one point the Court recognized the legitimate issue: "The real question. . . [is whether the fact] had to be disclosed in order to clarify the import of the proxy statement's reference to the 'substantial premium over current market values represented by the securities being offered to TSC stockholders'." 96 S. Ct. at 2137. If the duty of disclosure is determined by materiality, then the fact should have been examined in light of the new test.

58. The question may appear to be one of semantics only. Closer examination reveals that how the question is approached can determine the finding, as clearly shown in the instant case. It is not inconceivable that had the Court weighed the fact, in light of the entire circumstances, it could have found it material. By asking whether the statement was misleading, the Court denied the shareholder the opportunity to make his own decision based upon all the facts. *Cf.* Mills v. Electric Auto Lite Co., 396 U.S. 375 (1970).

Apparently the Court found the language of the statute ambiguous and thus viewed the section in light of the traditional common law approach requiring some form of misrepresentation. It is submitted that the Court has injected a rather confusing step into the analysis which serves no function in the context of the securities laws.[59] The so-called fraud provisions of the securities acts are not confined to the common law concepts of fraud. Since the 1933 and 1934 Acts are generally disclosure acts, prophylactic in nature and not merely remedial, it follows that liability for non-disclosure may be assessed even absent misrepresentation.[60] Also the fact that there appears to be no uniform manner in which the courts have applied "misleading" causes a blurred analytical approach which defies continuity from case to case.

It is submitted that the policy directives of rule 14a-9 and similar provisions are achieved by assessing liability for non-disclosure,[61] requiring the facts omitted to be of substantial importance (such that their inclusion would alter the total mix), and incorporating constructive reliance into the definition of materiality (substantial likelihood that a reasonable shareholder would consider the fact important).[62] Resort to "mis-

59. Since false statements or misrepresentations are always misleading, the question is not important in those cases. However, the reverse is true where an omission is alleged. The issue is particularly important in cases of total non-disclosure as distinguished from partial non-disclosure. Two problems immediately arise: (1) In the case of partial non-disclosure, how misleading must the statement be? and (2) Where total non-disclosure is alleged how will the plaintiff be able to show that the statement is misleading at all? Some writers believe the section in question is not applicable in cases of total non-disclosure. *See* I A.BROMBERG, SECURITIES LAW: FRAUD, § 2.6(2) at 51-52 (1970). The cases indicate the opposite. *See, e.g.*, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973); Speed v. Transamerica, 99 F. Supp. 808, 829 (D.C. Del. 1951), *aff'd*, 235 F.2d 369 (2d Cir. 1956). Either result is undesirable. If the former view prevails, the plaintiff will be forced to an action under rule 10b-5, clause 1 or 3 to which *Mills* has not been held applicable. If the latter view is adopted, under the present Supreme Court analytical approach, the plaintiff would never reach the materiality question due to inability to establish that the omission relates to a statement which is misleading.

60. It would be a non sequitur to require that the questioned statement be misleading and at the same time not require the plaintiff to show he relied upon it. The emphasis is on the fact omitted.

61. A more helpful analysis would proceed as follows: (1) Isolation of misrepresentation or omission of fact. (2) Analysis of the relative importance of the fact in context of the case and application of the materiality test. If fact material then (3) Determination whether the fact asserted to be omitted cannot be gleaned or deducted by the reasonable investor from the material given.

62. Informed investor decisionmaking and stability in securities transactions is achieved through (1) prophylactic control, (2) a discernible standard of conduct, (3)

leading" adds nothing to that achievement; instead, it frustrates it by creating confusing analytical problems. The relative importance of the culpable act is better assessed by examination of the fact omitted than of the misleading quality of the statement made. The term is more appropriate when used in a conclusory fashion[63] to describe a statement which has omitted a material fact.[64]

The language of rule 14a-9 referring to both untrue statements and omissions of material fact is contained in other antifraud provisions of both the 1933 and 1934 Acts. These provisions deal with the duty to disclose in such situations as registration statements,[65] purchase and sale of securities[66] and tender offers.[67] While the elements of culpability and reliance may vary from section to section according to differing policy factors, it seems that materiality, the standard for disclosure, should be uniform and that the test of *TSC* should be extended to those provisions.[68]

The lower courts must now endeavor to apply the Court's new test and its operative terms—"substantial likelihood," "significantly altered" and "total mix." It has been said that language is an imperfect form of communication, but the new language, if applied within the general context in which it was given, should be a genuine aid in future analysis.

Kim Gregory Mayhall

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a standard which is analytically workable, and (4) diminution of difficult proof problems of actual reliance.

63. The statute is so written that even a strict reading would render the above analysis acceptable.

64. This analysis does not purport to answer the problem where all facts are disclosed but arranged in a fashion which creates a misleading impression. It would seem that this problem is better left to rule 10b-5, clause 1 or 3.

65. Section 11(a) and 12(2) of the 1933 Act.

66. Clause 2 of rule 10b-5.

67. Section 14(e) of the 1934 Act.

68. *See* Wheat v. Hall, 535 F.2d 874 (5th Cir. 1976) (applying *TSC* to a 10b-5 action). Had the Court opted for a more liberal definition, this probably would not be true. The difficult problems of distinguishing for the purposes of defining varying standards of disclosure between face to face transactions and form disclosure for personal and market transactions are solved by the more conservative standard. The same conclusion applies to insiders. The test is susceptible to compliance in all of the above transactions. It is noteworthy that the materiality issue does not apply in cases where there is a strict statutory requirement of disclosure of certain designated facts (*e.g.*, Section 14 of the 1934 Act prescribes those things required to be included in the proxy statement). Liability is assessed in those situations for the non-disclosure alone regardless of the materiality of the facts.