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News Release

CARNATION REVISITED:

TOWARD AN OPTIMAL MERGER DISCLOSURE AND

RUMOR RESPONSE POLICY

Address to

The Federal Regulation of Securities Committee,

American Bar Association

The Hyatt Regency Hotel
Baltimore, Maryland

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Commissioner

The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those of the Commission, other Commissioners, or Commission staff.

SUMMARY OF REMARKS

In this address, Commissioner Grundfest surveys the controversy over the Commission's 1985 Carnation release. He reads Carnation narrowly, with careful reference to its specific facts. Accordingly, he views Carnation as a relatively straightforward application of accepted securities law principles. Commissioner Grundfest also explains that the conclusion reached in Carnation is not necessarily at odds with the decision of the Third Circuit in Greenfield v. Heublein. These two cases can be read to minimize tension between them.

The Commissioner explains that Carnation is not the final word on merger disclosure or rumor response policy. He believes that Commission decisions should strive to create an optimal disclosure policy--one that encourages dissemination of accurate information and maintains strong sanctions against false or misleading statements.

In particular, the Commissioner is concerned that imposition of a duty to update statements that are accurate as of the time they are made will chill truthful speech; it may induce corporations to issue "no comment" statements when they might otherwise be willing to inform the public. In response to this problem, Commissioner Grundfest voices his support for a "safe-harbor" that will protect issuers from liability for statements that are accurate as of the time they are made.

Commissioner Grundfest further explains how the rules of inference applied to issuer statements can also chill honest speech. If the law requires that corporate statements be able to support a broad set of inferences, then corporations may decide to remain silent because of concern that someone will draw an incorrect inference from a technically accurate statement. Because truthful information (even if it constitutes less than complete disclosure) is often preferable to silence, investors might be better served by a rule that allows corporations to make statements that are designed to be read narrowly and with careful reference to their precise language. A statement cannot, of course, be condoned if it is part of a larger plan to deceive the market, or if it is calculated to mislead rather than inform.

CARNATION REVISITED:

TOWARD AN OPTIMAL MERGER DISCLOSURE

AND RUMOR RESPONSE POLICY[1]

If you like controversial SEC releases, you're probably a big fan of the Commission's 1985 Carnation release.[2] Well-respected counsel are clearly split about the implications of Carnation, and few Commission pronouncements have generated as much publicly voiced concern.

Some call Carnation a "radical departure from established precedent,"[3] and see it as a clear cause for alarm. To these commentators, Carnation is a "major pronouncement" that is both "troubling and impractical."[4] These observers fear that Carnation "restates the law" not as it is, but as the Commission "would like it to be."[5] Business executives are "scared to death" by the implications of Carnation, according to some of these reports.[6]

To others, the Carnation release is a non-event that "do[es] not reflect any major change of law."[7] According to these observers, Carnation is "far from a momentous event in the field of securities law,"[8] and "basic counselling guidelines have not changed as a

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1/This address was prepared by Commissioner Grundfest with the assistance of his legal counsel, Gerald J. Laporte and Ronald A. Schy.

2/In the Matter of Carnation Co., Sec. Exchange Act Release No. 22214 (July 8, 1985), reprinted in 1984-1985 Fed. Sec. L. Rep. (CCH) ¶ 83,801.

3/Petition for Certiorari at 20, Michaels v. Michaels, No. 85-752 (U.S. filed Nov. 1, 1985), cert. denied, 106 S.Ct. 797 (1986).

4/Hertzberg & Leefeldt, SEC's Merger-Disclosure Ruling May Add to Stock Price Volatility, Wall Street Journal, July 10, 1985, at 27 (quoting Harvey Pitt, SEC General Counsel from 1975 to 1978).

5/SEC Issues Report to Clarify Policy on Disclosure of Merger Negotiations, 17 Sec. Reg. & L. Rep. (BNA) 1229 (July 12, 1985) (quoting Harvey Pitt).

6/Lunzer, No Comment, 136 Forbes 41 (Sept. 16, 1985).

7/Greene, Public Disclosure of Merger Negotiations, N.Y.L.J. Oct. 24, 1985, at 1.

8/Id.

result of the SEC's position in the Carnation matter."[9] The Commission's Division of Enforcement falls squarely in this camp. The Division Director is on record as saying that Carnation "just clarifies the law...[it's not] very different from the advice you would have received from the overwhelming majority of takeover lawyers" prior to the Carnation release.[10]

Clearly, now, we can't have it both ways. Carnation is either a "major pronouncement" or a restatement of accepted legal principles. It can't be both a radical departure and a simple clarification.

The confusion over the meaning of Carnation, combined with the large stakes involved in takeover contests, helps explain why "disclosure of merger discussions is probably one of the most difficult areas of corporate counselling."[11] It also helps explain how the Carnation release quickly gained notoriety as one of the most controversial section 21(a) reports in the Commission's history.

Uncertainty over the meaning of Carnation is unnecessary and costly. This uncertainty exposes bidders and targets to litigation risk, increases the cost of mounting and defending against hostile takeovers, and increases the cost of conducting friendly merger negotiations. In this environment, the legal and business communities understandably seek further guidance from the Commission about the meaning and implications of Carnation. Three members of the Commission have responded to this uncertainty and have publicly commented on the Carnation release, thereby providing a gloss that reaches beyond the four corners of the document. But before joining my fellow Commissioners in the Carnation fray, let me step back and recount the facts of Carnation.

Carnation

The facts of Carnation are straightforward. Early in the summer of 1984, Nestle, S.A., a multinational corporation headquartered in Switzerland, entered into preliminary merger discussions with the Carnation Company. Nestle officials

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9/ SEC Issues Report to Clarify Policy on Disclosure of Merger Negotiations, 17 Sec. Reg. & L. Rep. (BNA) 1229 (July 12, 1985) (quoting Gary Lynch, Director, Division of Enforcement).

10/ Id.

11/ Klein, Disclosure of Merger Negotiations, 19 Rev. Sec. & Commod. Reg. 8, 11 (1986).

expressed concern that increases in Carnation's stock price could adversely affect the merger discussions. Nestle officials informed Carnation that discussions would terminate if there was any public disclosure by Carnation of Nestle's overtures.

Only a small group of senior Carnation executives was informed of the Nestle discussions. By early August, however, numerous press reports had identified Carnation as a potential takeover target. On August 7, Carnation's stock jumped 4 5/8 points and Carnation's treasurer was quoted as saying, "There is no news from the company and no corporate developments that would account for the stock action." The treasurer had no knowledge of the Nestle negotiations. Carnation's management involved in the Nestle negotiations took no steps to correct the treasurer's misleading statement.

By August 21, Carnation's stock hit a 12-month high of 71 1/2. On that day, Carnation's treasurer, who still had no knowledge of the negotiations, was quoted as saying the company knew "of no corporate reason for the recent surge in its stock price," and that, to the best of his knowledge, there was nothing to substantiate rumors regarding potential acquisitions of Carnation. The treasurer went on to say, "We are not negotiating with anyone." Although this statement appears to have been true to the best of the treasurer's knowledge, it was false with respect to the state of affairs as known by senior Carnation management involved in the negotiations.

The substance of the treasurer's remarks was widely reported and the price of Carnation's shares thereafter declined. Shortly after the story appeared, the treasurer was instructed to say that it was company policy not to comment on rumors. The treasurer received no explanation for this new "no comment" instruction.

The Nestle and Carnation boards approved a merger on September 3. A joint public announcement of the transaction was made on September 4, prior to opening of the market.

The Carnation release states that the August 7 "no developments" statement was materially misleading. The August 21 "no negotiation" statement was found to be materially false and misleading.[12] The release concludes that, under section 10(b) of the Exchange Act and Rule 10b-5, issuers are required to speak truthfully and cannot make materially misleading statements. This requirement applies to issuers engaged in preliminary merger negotiations.

12/ Carnation, supra note 2, at 8.

Commissioners' Views

Commissioner Cox has explained that Carnation stands for the proposition that "you don't have to speak during a merger or takeover negotiation if speaking would kill the deal. Rather you can simply say 'no comment.' If you do speak, however, you must be willing to speak the truth."[13] Commissioner Peters has explained that "the Carnation report only says: 'If you speak, you must speak truthfully, and if you speak and you make a misleading statement--even though that misleading statement may be made unintentionally--then you must correct that statement.'"[14] Commissioner Fleischman has recently questioned the effectiveness of the Carnation report and expressed support for the Third Circuit's decision in Greenfield v. Heublein, 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S.Ct. 1189 (1985),[15]--a case which a statement similar to Carnation's August 7 "no corporate developments" statement was found not to be false or misleading, and in which the court held that, as a matter of law, merger negotiations are not material at least until agreement on price and structure is reached.

Carnation was decided before I joined the Commission, and I can therefore shed no light on the reasoning that led the Commission to issue the release in the form and with the language it used. I can, however, share with you my reading of the Carnation release. In particular, I would like to describe the propositions for which I believe Carnation stands, and, perhaps even more importantly, articulate the propositions that I believe Carnation does not support.

In a nutshell, I read Carnation narrowly and with careful reference to its specific facts. Thus, I count myself with the Enforcement Division and others who see Carnation as a relatively straightforward application of established precedent. In Carnation, the issuer voluntarily made statements regarding pending merger discussions. Therefore, Carnation is not a pronouncement about

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13/Cox, New Regulatory Issues in the Takeover Arena, Remarks to the Sixth Annual Northwest Securities Institute, Portland, Oregon, Feb. 22, 1986, at 6.

14/SEC Should Give More Attention to International Issues, Peters Says, 18 Sec. Reg. & L. Rep. (BNA) 357, 358 (March 14, 1986).

15/Stock Exchanges Should Do More to Track Rumors, SEC's Fleischman Says, 18 Sec. Reg. & L. Rep. 441 (March 28, 1986).

the duty to disclose preliminary merger negotiations. In Carnation, the issuer also made no statements that were accurate as of the time made. Carnation therefore says nothing about the duty to update. Instead, I believe Carnation speaks solely to the duty to speak trthfully and to correct false or misleading statements. Beyond that, I believe Carnation says nothing.

Something beyond that can and should, however, be said. Issuers, counsel, and investors deserve reasoned rules that promote optimal disclosure of merger-related events. Optimal disclosure means something between a chorus of "no comments" that does little to inform the market, and a live play-by-play telecast of merger negotiations direct from every bidders' and targets' boardroom. Indeed, as the Second Circuit observed in Reiss v. Pan American World Airways,[16] immediate and honest disclosure can sometimes do more harm to investors than good. The market deserves a rule that steers a responsible course between extremes--a rule that neither forces premature, harmful disclosure, nor sanctions irresponsible concealment. Carnation addresses only a very small part of this fundamental problem, and in my address today, in addition to discussing the limits of Carnation, I would also like to explore--in a tentative and preliminary manner--some potential contours of such an optimal disclosure policy.

The Duty to Disclose

Some commentators claim that, in Carnation, "the SEC has delineated the scope of required disclosure by corporations in the context of preliminary merger negotiations."[17] I don't think Carnation reaches that far at all. In Carnation, the issuer voluntarily undertook to make certain statements regarding market rumors and the pendency of merger negotiations. Nothing in the release suggests that, had the issuer remained silent, it would have violated a duty to disclose.

16/ 711 F.2d 11, 14 (2d Cir. 1983). See also Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982); Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 948-49 (2d Cir. 1969).

17/ Mathews and Citera, Shad-Lynch Enforcement Program: The First Year, Legal Times, March 31, 1986 at 22. See also Brodsky, Disclosure of Merger Negotiations, N.Y.L.J., Nov. 6, 1985, at 1.

The perception that Carnation is a duty to disclose release arises, I think, from Carnation's now famous, or perhaps infamous, statement which, referring to the Third Circuit's Heublein decision, said "The Commission believes that Heublein was wrongly decided." The Third Circuit's 2-1 decision in that case is most widely known for its holding that preliminary merger negotiations are not material as a matter of law, at least until agreement is reached on price and structure. Accordingly, Carnation could understandably be read as criticism of Heublein's per se rule.

That, however, is not my reading of Carnation. No doubt, the Commission is on record as opposing Heublein's per se rule--just read the Commission's amicus briefs before the Sixth Circuit in Levinson v. Basic Incorporated,[18] and before the Seventh Circuit in Michaels v. Michaels[19] and you will find vigorous opposition to the per se rule. In both cases the Commission urged that the courts not adopt the Third Circuit's per se price and structure test for materiality, and in both cases the Commission has been successful in persuading another circuit not to adopt the Third Circuit's rule. But that does not inexorably lead to the conclusion that the result in Carnation is incompatible with the Third Circuit's per se rule.

Recall that in Heublein, the court found that the issuer's statement was neither false nor misleading. In the absence of a false or misleading statement, Heublein was under no duty to disclose its premerger negotiations. However, had Heublein specifically denied the existence of negotiations it could have, in the words of TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), changed the "total mix" of information available to investors. This change in the total mix could impart materiality to negotiations that would otherwise be immaterial because of lack of agreement on price and structure. Therefore, although the issue is rather academic, it is possible that the Heublein court, if confronted with Carnation's false denial of any negotiations, would reach the same conclusion reached by the Commission.

18/Brief for the SEC as Amicus Curiae, Levinson v. Basic Incorporated, No. 84-3730, slip op. (6th Cir. March 27, 1986).

19/Brief for the SEC as Amicus Curiae In Connection With Petition for Rehearing, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985), cert. denied, 54 U.S.L.W. 3460 (U.S. Jan. 13, 1986).

Carnation is, however, clearly at odds with Heublein over the Third Circuit's conclusion that "a statement by an issuer that it was aware of no reason that would explain that day's activity in its stock was not false, inaccurate, or misleading even though company management 'clearly knew of information that might have accounted for the increase in trading, because there was no indication that any of this privileged information had been leaked or that they knew of, or had, information that insiders were engaged in trading.'"[20] The third member of the Heublein panel disagreed sharply with this conclusion. He expressed the view that, although the statement was accurate in a narrow and technical sense, Heublein's statement was effectively misleading.

Apparently, reasonable men can differ over whether Heublein's statement was misleading. The Carnation release places the Commission's support with the dissenter's opinion. But even here, confrontation between Carnation and Heublein could have been avoided had Carnation focused on the August 21 "no negotiations" statement, which was clearly false and not just potentially misleading by omission. Heublein did not deal with such a clearly false statement, and Carnation could have been distinguished on this basis.

Did the Commission "Reverse" the Third Circuit?

I want to make it clear, however, that in discussing a resolution of Carnation that could have avoided a conflict with Heublein, I am not signalling a reticence to challenge judicial decisions with which the Commission disagrees. Some members of the bar have had a field day with the Carnation release. One attorney quipped that, in Carnation, the SEC "issued a writ of certiorari and reversed the Third Circuit."[21] Another attorney observed that "[t]he commission's willingness to thus challenge a final federal appellate court ruling has raised some critical eyebrows. After all," says this commentator, "the commission does not have the power to overrule the courts any more than it can legislate in place of Congress, although at times it seems to assume both powers."[22]

20/Carnation, supra note 2, at 8 n.8 quoting Heublein, 742 F.2d at 759.

21/Materiality of Merger Negotiations, SEC Rules Discussed at ABA Meeting, 17 Sec. Reg. & L. Rep. (BNA) 2076, 2077 (Nov. 29, 1985).

22/Olson, Revealing Merger Talks: When, How Are Critical, Legal Times, Oct. 14, 1985, at 11, 22, citing Olson, Usual SEC Restraint Absent in Takeover Releases, Legal Times, Sept. 2, 1985, at 12.

Now, I understand that Commission bashing can be lots of fun. In fact, I used to enjoy a good Commission bash as much as the next guy. But in all candor, I must admit that, since I became a Commissioner, some of the thrill of a good bash is gone. I've made up for it, however, with a new hobby, critic bashing, and trust that my response to the Carnation critics will be taken in good humor because, as all of us in this room know, all's fair in love and securities law.

The critics who claim there was something improper or unseemly about the Commission expressing disapproval of the majority result in Heublein are just flat wrong. District courts regularly refuse to follow governing precedent from other circuits, and circuit courts find no trouble disagreeing among themselves. I am aware of no rule of law that requires any government agency to accept the result reached by the first Court of Appeals that happens to address a particular issue as the governing principle for all other cases. The Internal Revenue Service often adopts "nonacquiescence" positions with respect to tax court decisions. "Nonacquiescence means the Commissioner's total disagreement with the conclusion reached by the Tax Court and taxpayers are on notice that the Treasury will continue to litigate similar cases."[23] From time to time, the IRS also "issues announcements whether it will or will not follow a decision of another federal court on similar facts."[24] If the IRS can disagree with court decisions when seeking to enforce the tax laws in other jurisdictions, I fail to see the problem in the SEC voicing its disagreement with Heublein.

Indeed, given the Sixth and Seventh Circuits' failure to endorse the Third Circuit's Heublein per se rule, it seems to me that the Commission might have the better side of the argument and criticism of the Commission's Heublein footnote now appears somewhat ironic.

Carnation and the Duty to Update

Moving on from the duty to disclose, it is important also to recognize that Carnation says nothing about a duty to update statements that are accurate as of the time they are made. There were no such statements in Carnation and the release therefore does not state a rule governing such cases.

23/ J. Grauer & M. Rothkopf, Fundamentals of Tax Research 3-28 (AICPA 1977).

24/ Id. at 3-29.

Nonetheless, businessmen have expressed concern that Carnation suggests a duty to update that can chill honest and accurate speech. One senior executive of a major firm that has recently been the subject of takeover rumors explained that counsel advised him against making honest denials of takeover rumors. Counsel reasoned that, in the event of a change in the facts relating to those rumors, the corporation could find itself saddled with an undesirable duty to update if it spoke at all.[25]

Although this advice may be conservative, there apparently is concern that speaking the truth may lead to a duty to update that would otherwise be absent. This impression--whether accurate or not--is harmful because it chills truthful speech, and there is absolutely no reason for the Commission to deter issuers from making statements that are truthful when made.

Thus, if at 5:00 p.m. an issuer truthfully says, "as of 5:00 p.m. we have not been approached with any acquisition proposals," and ten minutes later an unexpected phone call proposes a takeover at a substantial premium, the phone call should not give rise to a duty to disclose preliminary negotiations simply because of the prior 5:00 p.m. statement. Any other rule would unreasonably chill truthful speech and diminish the flow of accurate information to the marketplace.

To the extent that issuers believe comfort in this direction would be helpful, it has already been disclosed that the Commission is exploring a "safe harbor" that would protect companies making statements that are accurate as of the time they are made.[26] The securities laws should not, I think, be read so broadly as to chill accurate speech, and I hope that the Commission will be able to provide strong affirmative guidance in this controversial area.

The "Baby Doc" Rule

Having explained that Carnation says nothing about the duty to disclose preliminary merger negotiations or the duty to update statements that are accurate as of the time made, we're left with natural question, "What then does Carnation stand for?"

25/Statement of William A. Schreyer, Chairman of Merrill Lynch & Co., SEC Roundtable on Market Rumors and Trading Halts at 2 (Feb. 19, 1986).

26/Cox, supra note 13, at 6; Dutt, SEC Does Doubletake on Merger Disclosure, 52 Inv. Dealers' Digest 10 (Feb. 24, 1986).

On this point, I would agree with my fellow Commissioners who see Carnation as a release that deals solely with the duty to speak accurately and the duty promptly to correct any misstatements that might occur. An example may help bring this point home.

Questions about the duty to correct are hardly unique to the business world. They arise even in the highest echelons of government and international diplomacy. As some of you might recall, on January 31 of this year, Larry Speakes announced in midair from Air Force One "that the government of Haiti had collapsed and the leadership, including [Baby Doc] Duvalier, had fled the country."[27] The statement was obviously material and was clearly relied upon as thousands of Haitians in Miami, New York, and Washington spilled into the streets in celebration.

The statement was also false and misleading. Upon investigation, the White House determined that a mistake had been made in the line of communication to the President, and by the end of the day a correction had been issued.

But the damage had been done. Baby Doc was in play. Only a week later a takeover was complete and Baby Doc was safely in France, golden parachute and all.

Now, how well would Mr. Speakes and the White House have fared had they been judged under the Carnation standard? My best guess is that their behavior would have passed muster quite nicely. The available evidence is that the initial false statement was made without scienter and was promptly corrected once accurate information was discovered. Mr. Speakes, the White House, and the State Department thereafter adopted a "no comment" posture. The "no comment" posture was maintained until the price and terms of the subsequent transaction were completed, and former management was safely aboard an Air Force plane on its way to temporary retirement in France.

Thus, had the President been involved in a hostile takeover on Wall Street instead of Caribbean politics, I think he would have had nothing to fear from a Commission enforcement action based on Carnation.

27/Cannon and Omang, Midair Error: Air Force One Reports Coup, Washington Post, Feb. 1, 1986, at 1.

Optimal Disclosure Policy

This reading of Carnation does not, however, address the most fundamental problem in this area of the law: How can the Commission fashion a disclosure policy that promotes the optimal disclosure of information regarding takeovers, rumors, and other significant corporate developments? I do not have a definite answer to that very difficult question, but would like to spend the remainder of this address exploring various approaches to the problem.

Clearly, merger negotiations cannot be conducted in a fishbowl. It would be unreasonable and counterproductive to require play-by-play announcements regarding merger negotiations from the first casual inquiry through the final shareholder vote. In some cases, premature disclosure can kill deals that in the aggregate would be beneficial for stockholders. Moreover, as the Second Circuit observed in Reiss v. Pan American:

> Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned. We [in the merger context] are not confronted here with a failure to disclose hard facts which definitely affect a company's financial prospects. Rather, we deal with complex bargaining between two (and often more) parties which may fail as well as succeed, or may succeed on terms which vary greatly from those under consideration at the suggested time of disclosure. We have no doubt that had Pan Am disclosed the existence of negotiations on August 15 and had those negotiations failed, we would have been asked to decide a section 10b-5 action challenging that disclosure.[28]

Thus, we need to steer a middle course between blind immediacy and undisciplined delay. Here, some observations by the Second Circuit in SEC v. Texas Gulf Sulphur Co. may be instructive:

> We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers interested with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.[29]

28/ 711 F.2d at 14.

29/ 401 F.2d 833, 850 n.12 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

Indeed, under the facts of Texas Gulf Sulphur, the court found that "a valuable corporate purpose was served by delaying the publication of" material information.[30]

It is not difficult to conceive of merger scenarios in which equally plausible arguments can be made that delayed disclosure is in the corporation's best interest and not a violation of the securities laws. Thus, "most courts...have declined to hold that the antifraud provisions impose a general duty of disclosure 'on a corporation which is not trading in its own stock and which has not made a public statement,'"[31] and it might be reasonable to look to the business judgment rule for guidance as to optimal rules of disclosure.

In addition to providing room for the exercise of sound business judgment, an optimal disclosure policy would, I believe, also allow issuers to make statements that are accurate as of the time they are made. These statements should be made without fear that a duty to update will later force issuers to make disclosures that, in their judgment, might not be in the issuers' best interest. Moreover, because a duty to update can inhibit issuers from saying anything at all, a duty to update should clearly not apply to a statement that, by its terms, is intended to speak only as of a particular time. Thus, an appropriate safe harbor for statements that have a defined life in the market could be a useful element of an optimal disclosure policy.

Reliance on business judgment and a safe harbor for statements accurate as of the time made does not imply that issuers should have a blank check in disclosure matters. As a practical matter, issuers clearly are not permitted to make statements that are false or materially misleading as of the time they are made. But even this relatively straightforward rule is frayed about the edges due to controversy over the extent of inference that will be read into a technically accurate statement before deciding that the statement is misleading.

30/ Id.

31/ Block, Barton, & Garfield, Affirmative Duty to Disclose Material Information Concerning Issuer's Financial Condition and Business Plans, 40 Bus. Law. 1243, 1249-50 (1985), quoting Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982).

For example, in Heublein, the corporation's statement that it was aware of "no reason that would explain the activity of its stock"[32] was accurate in a narrow, technical sense. As the majority pointed out, the corporation knew of no leak regarding takeover activity and although it had an awfully good guess as to a reasonable explanation for its stock's behavior, it did not definitely know why its stock was so active.

If the market is put on notice to read such statements very carefully, the market might not be misled at all. The Heublein statement could, in such an environment, be read as a lack of knowledge of any leak or insider trading and nothing more--in effect, an elegant "no comment" on the substance of any rumors.[33]

From a different perspective, as Judge Higginbotham points out in his dissent, the Heublein statement is too cute by half because it feigns ignorance in the face of knowledge of probable cause. Thus, if the market is conditioned to expect an absolutely complete disclosure every time an issuer discusses a rumor, the market may not parse corporate statements as carefully and may instead draw broad implications from corporate pronouncements.

Therefore, it seems that a significant part of the disclosure problem lies not with the precise language that issuers use in responding to rumors, but with the rules we establish in defining how issuers' statements are to be interpreted. We all know that beauty is in the eye of the beholder. I suggest that the extent to which a statement can be misleading depends on the extent to which a reader or listener is led beyond the literal language of that statement. Thus, responsibility for misleading statements may at times reside in the eyes or ears of the readers or listeners who draw inferences, as much as with corporate issuers.

32/ 742 F.2d at 758.

33/ Although the majority in Heublein held that Heublein's statement that it "was aware of no reason that would explain the activity of its stock...was not false, inaccurate or misleading," 742 F.2d at 759, the majority recognized that Heublein "could have made any number of statements saying substantially the same thing." Id. at 759 n.7. The majority reasoned that the presence of alternate (and perhaps less confusing) statements was "of no consequence" to its decision because it was faced with the task of evaluating the accuracy of the statement that actually was made, not the accuracy of a statement that could have been made. Id. However, from the perspective of fashioning an optimal disclosure policy, the presence of these alternative statements is potentially quite instructive.

(Footnote continues on next page.)

I suspect that the markets can function quite reasonably either under the presumption that statements are to be read narrowly and literally, or under the presumption that statements should be able to sustain all reasonable inferences. There is, however, a reason to favor a rule that looks to literal interpretations of corporate statements. Such a rule would allow corporations to speak with greater specificity and could encourage issuers to release at least some accurate information to the market, instead of adopting a broad "no comment" policy because of a fear of misinterpretation.

We should remember that even a little bit of accurate information--as long as it is not part of a plan to deceive or mislead the market--is better than a deafening "no comment." We should remember that the market is not populated by naive or unintelligent traders, and that as long as the rules of the market process are clearly defined, the market will probably be able to adapt quite nicely. The only situation sure to cause confusion, however, is the one we have today where uncertainty over the rules of the road can cause issuers to resort to widespread use of "no comment" statements when truthful information could otherwise be disclosed. It's better to light a candle, even a small one, than to curse the "no comments."

Conclusion

In sum, Carnation is far from the last word on disclosure in the context of rumors or merger negotiations. We have a long road to travel before there is a broad consensus on an optimal disclosure policy, and I look forward to what is certain to be a vigorous, spirited debate.

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In particular, if Heublein management meant to say only that "there was no indication that any...privileged information [relating to merger negotiations] had been leaked, or that they knew of, or had, information that insiders were engaged in trading," id. at 759, then they could have said that far more precisely than they did. To the extent that management intended that its "no corporate developments" statement signal that, in fact, there was nothing going on behind the scenes that could explain the stock price move, and to the extent the market drew such an inference from the statement, the statement caused confusion that could readily have been avoided. Clearly, if we are going to allow corporations to make statements that are to be construed narrowly, according to their terms, corporations will have to act responsibly so that their statements are written narrowly, and do not support inferences beyond the facts that are to be admitted or denied.

The statement in Heublein is hardly a model of such clarity--witness the sharp dispute among the three members of the panel over its accuracy.