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TRANSCRIPT OF PROCEEDINGS

IN THE SUPREME COURT OF THE UNITED STATES

BASIC INCORPORATED, ET AL.,	)	
	)	
Petitioners,	)	
	)	
v.	)	No. 86-279
	)	
MAX L. LEVINSON, ET AL.	)	

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Petitioners, :

v. : No. 86-279

MAX L. LEVINSON, ET AL. :

Washington, D.C.

Monday, November 2, 1987

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 1:50 p.m.

APPEARANCES:

JOEL W. STERNMAN, ESQ., New York, New York;

on behalf of the Petitioners.

WAYNE A. CROSS, ESQ., New York, New York;

on behalf of the Respondents.

C O N T E N T S

P R O C E E D I N G S

(1:50 p.m.)

JUSTICE BRENNAN: The next case is Basic, Incorporated versus Levinson.

Mr. Sternman, any time you're ready, sir.

ORAL ARGUMENT OF JOEL W. STERNMAN, ESQ.

ON BEHALF OF PETITIONERS

MR. STERNMAN: Justice Brennan and may it please the Court.

Over the years, private claims for damages under Section 10b have proliferated. At one time or another, countless publicly held companies have been charged with wrong doing. When investors find the market moving against their positions, they often wonder whether the price they paid was higher than it should have been, or the price that they received was lower than it should have been.

Some, such as respondents in this case, elect to sue to see whether any corporate wrong doing contributed to their financial misfortune. This case began in June, 1979. Essentially, respondents contend that three statements issued by Basic were materially false and misleading insofar as they claimed to have denied the existence of merger negotiations when in fact merger negotiations were on going.

The fact is that the statements at issue which are the key to this case, as are the contacts between Basic and

C.E. but the statements did not themselves deny merger negotiations in the sense that respondents claim. The three statements, the first one issued in October, 1977, was issued by the company because a rumor had been present in the marketplace that Basic was having discussions with a company called FlintKote. Basic determined that that rumor had no foundation. Whatever discussions it had were not leading to a merger with FlintKote, and as a result, it properly issued a prompt statement to deny that it was having any discussions with FlintKote.

That statement says, the rumors as to FlintKote are inaccurate and we're having no merger negotiations with anybody.

The second and the third statements don't even refer to merger negotiations. They're issued in September, 1978, and in November, 1978. The earlier statement is to the effect that the company is unaware of any reasons for unusual trading activity in its stock, and there are no corporate developments that would account for it. The November statement is essentially an echo of the September statement and was issued by the company in an effort to insure that its shareholders who might not have seen the September statement which was part of a press release would become aware of the substance of the November statement which was included in a report to shareholders.

No, during this period, beginning even prior to the first statement, Basic had been approached by an executive from Combustion Engineering who had made very clear to Basic that he had an interest in seeing whether a possible acquisition of Basic could be made. Combustion had a line of business that was very similar to the business that Basic was engaged in. That was the refractories business.

So, on four occasions between September, 1976 and the issuance of the first statement in October, 1977, this individual who would go to Cleveland, Ohio, at times to deal with other businesses that Combustion had, would contact representatives of Basic, would have lunch with them, and would say, I'm interested in your company, I would like to see an acquisition made, can we do something, are you interested.

The Basic representatives told him in no uncertain terms that they were not interested, that they desired to remain independent. They were polite. They did have lunch with this individual, but nothing came of it. And at the time the October, 1977 statement was issued concerning the FlintKote rumor, they had had only brief contact with this individual.

Similarly, in the period between October 1977 and September 1978, they had only three more in-person visits by Mr. Kelly who was the combustion engineering representative. Significantly, two of those visits concerned an interest that Basic had developed in acquiring the refractories division of

Combustion Engineering. Basic decided that it might be of interest to it to see whether C.E. would be willing to sell that division. Mr. Kelly agreed to provide certain information. Meetings were held, one in February, 1978; another one in March, 1978. And finally, in June, Basic proposed that it acquire Combustion's refractories division.

Mr. Kelly said no, but what if I were to suggest to C.E. that it make an offer to acquire Basic for $28 a share. The Basic individual said, we wouldn't be interested, but if we were, that would be too low a price. The individuals had occasional telephone contacts during the balance of June and July, 1978, and then Mr. Kelly stopped calling.

No word was heard from him during August or September or October and November, with the exception of one brief telephone call that he made in September when he became aware as did the rest of the public that Basic had issued a statement denying any knowledge of reasons for unusual trading activities in its shares.

So it is an extreme claim to assert that statements such as these issued by Basic in these circumstances were false and misleading.

QUESTION: Doesn't the SG suggest that a simple no-comment would be all right, and that's the way to handle inquiries of this kind?

MR. STERNMAN: Justice O'Connor, they have suggested

that. I think the SEC has suggested it as well.

QUESTION: And what's the matter with that?

MR. STERNMAN: I think that it would do a disservice to the investment community to encourage companies to say, no comment, when in fact in good faith they determine that whatever the market is doing with their stock has nothing to do with anything that's going on with the company.

Judge Friendly in his concurring opinion in Texas Gulf said that there would be a danger of encouraging corporate silence if we with hindsight permitted Section 10(b) claims to be brought against companies who in good faith attempt to provide information to the marketplace.

A no comment response frequently is taken as an indication that something is going on, in any event.

QUESTION: Well, the Court of Appeals found that this last statement at least was false when it was made.

MR. STERNMAN: The Court of Appeals, although on rehearing, I think one of the Judges on that panel indicated that all they did was find that there were issues of fact that precluded its affirming the summary judgment that the District Court had awarded to petitioners, did seem to describe all of the statements as false and misleading. They somehow formed the view that companies can spend 27 months from the first Kelly contact in October 1976, to the actual agreement that was reached at the end of the class period in December, 1978,

pursuing on-going merger negotiations, actively having management, investment bankers and outside counsel of the company engaged for 27 months in negotiations.

The fact is that the outside counsel here never even met during the class period. The investment bankers that the company's retained --

QUESTION: Well, without getting into the facts, we have, the District Court thought they were truthful?

MR. STERNMAN: Yes, that's correct.

QUESTION: And the Court of Appeals thought the opposite?

MR. STERNMAN: That's correct, Justice O'Connor. And I think that one of the implicit issues in this case involves the guidance that this Court should give following Matsushita to Courts of Appeals when they're confronted with a decision such as the one entered by the District Court here, entered on summary judgment. There had been 20 depositions taken in this case. There was an SEC investigation, and there were numerous transcripts that were provided to the respondents.

In their opposing our motion in the District Court, they submitted practically every transcript and inundated the District Judge with all of this material.

QUESTION: Mr. Sternman, are you arguing that we ought to find a different test of when a summary judgment is permissible? A special one here? Standard of review?

MR. STERNMAN: Standard of review, the de novo standard that was applied in this case by the Court of Appeals I think is subject to criticism. They did not make any effort to deal with the District Court's opinion, to explain why he was in error in concluding that there were no issues of fact.

QUESTION: Didn't the District Court go off on the notion that whether these statements were true or false, they weren't material. They said they're not material until there's a deal.

MR. STERNMAN: That's correct.

QUESTION: Well, that doesn't depend on any kind of factual notions about true or false.

MR. STERNMAN: The District Court opinion had three aspects to it. The first part was that --

QUESTION: I know, but that aspect would be dispositive.

MR. STERNMAN: Either one of the three aspects was dispositive, Justice White.

QUESTION: Well, then wholly aside from any issue of fact.

MR. STERNMAN: That's correct. I mean, if the District --

QUESTION: But if the Court of Appeals disagreed with that and said that there can be material facts represented prior to the time there's a deal. That's what the Court of

Appeals said.

MR. STERNMAN: The District Court's standard had been as long as the discussions have not proceeded to the point where it's reasonably certain that there will be an agreement in principle, the facts are not material.

QUESTION: That's right. And none of these statements, all these statements were before that time.

MR. STERNMAN: That's correct.

QUESTION: And so that was the end of the case as far as the District Court was concerned.

MR. STERNMAN: Except the District Court did much more.

QUESTION: It didn't have to.

MR. STERNMAN: I think that's correct.

QUESTION: If it wanted to take the risk that it was right on the law.

MR. STERNMAN: We had presented the issue to it, however, in three steps, as Rule 10(b)(5) permits us to. Our first was that there was no issue of fact as to the accuracy of the statements.

QUESTION: Yes.

MR. STERNMAN: They were not false, they were not misleading.

Our second position was even if in some respect they might have been inaccurate -- and there is an issue of fact as

to that -- they were not materially misleading because the discussions between the companies had not progressed to the point where they should be viewed as material information that rendered the statements materially misleading.

And finally we also argued, and the District Judge agreed, that there was no scienter here. We could win and did win on each of those three points. The Sixth Circuit's decision was to the effect that the District Judge was wrong on all of them, and I think it was critical

QUESTION: But I didn't think that you were, the questions you present here are in your petition was just whether the rule of law they used with respect to when a statement is material and then whether the presumption about reliance.

MR. STERNMAN: Well, on the questions of law that are directly before this Court, the legal principles.

QUESTION: Those are the only things that are before us.

MR. STERNMAN: I was responding to a question that I thought --

QUESTION: I know, but you've been arguing the facts of the case saying that they were true facts.

MR. STERNMAN: Well, I think in order to apply the standards of materiality that have been proposed, some of them require that a few of the facts be developed. The first

standard and the one that we espouse is the agreement in principle test. And you're right there, Justice White, that if the agreement in principle test is adopted, then it matters not what the facts were because there's no question that at the time, any of these statements were issued, there was not an agreement in principle that had been reached between the parties. The respondents did not claim that. The Sixth Circuit did not find that.

So that is a narrow question of law that can be resolved by this Court independently of viewing the record. However, as Justice O'Connor indicated there are other tests that have been suggested. And the most recent version of the Securities and Exchange Commission test is that the discussions have progressed to the point that there is a significantly increased possibility of a value effecting acquisition. I think I've gotten it right.

There it would be necessary to determine whether there was any issue of fact that would preclude summary judgment for the petitioners on the state that those discussions had progressed to. And I think it's important to note various facts. There's no insider trading that was alleged in this case. There were no rumors in the marketplace that Basic was having any discussions with Combustion Engineering. There was no authorization that Mr. Kelly had to make an offer on behalf of Combustion Engineering at any point

during the class period. There were very few contacts between the parties over the class period. Through much of it, Basic was interested in making an acquisition of Combustion, and not the reverse.

Those are undisputed facts in our view, and the Court of Appeals glossed over them and created a scenario that made it appear as if, at the same time Basic was issuing statements in one room, it was sitting in another room with representatives --

QUESTION: Mr. Sternman, can I interrupt you for one minute to see if I can understand your theory?

MR. STERNMAN: Yes, sir.

QUESTION: Drawing a distinction between materiality on the one hand and truth on the other.

MR. STERNMAN: Yes.

QUESTION: Assume for just purposes of discussion that a statement was made that our management has never met, we don't even know anybody at Combustion Engineering, a clearly false statement, but one that was made before any agreement in principle had been reached.

You'd say that was immaterial and not actionable?

MR. STERNMAN: That's correct. You can't have a false statement that is not materially false and would not lead to exposure to this kind of damage.

QUESTION: So in order to judge this case in your

theory, we don't really have to pass on the truth or falsity of the statement, do we?

MR. STERNMAN: If you accept the agreement in principle test.

QUESTION: If we accept your theory and we also agree with you that at the time of these statements, the discussions were sufficiently tentative not to satisfy the test, that's the end of the case.

MR. STERNMAN: That's correct.

QUESTION: So we don't really have to worry about the facts too much.

MR. STERNMAN: That's correct. But if instead of accepting the agreement in principle test, you find more attractive the test that the SEC has offered, its very important to us to persuade you that the decision of the District Court was correct, even under that test, that in effect, the District Court's standard was foreshadowing the SEC's standard that's now advocated.

QUESTION: Well, if you take the SEC standard, that isn't the standard the Court of Appeals used, either. So I would suppose you would state the right rule on remand without dealing with the facts.

MR. STERNMAN: Well, I think, as in Hochfelder where this Court felt it was appropriate not to remand but instead to give judgment to the respondents in that case because the

matter had been litigated long enough.

QUESTION: You mean reinstate the District Court's summary judgment?

MR. STERNMAN: Yes. I would as the Court that when it remands to the Sixth Circuit, it do so with directions that it reinstate that summary judgment order. This case was brought in June, 1979, and these issues have been fleshed out between the parties for a very long time. And we think that certainly under the agreement in principle test, they would have no discretion. But if the Court were to adopt one of the other tests, we think that its review of the record will convince it that the discussions here were never advanced to the point that even under the SEC's test --

QUESTION: If we were to adopt the SEC test, that would require a remand to the Court of Appeals because we'd reject the Court of Appeals test, is that right?

MR. STERNMAN: Yes. But I would hope the --

QUESTION: I know what you would hope, but that's a fact, isn't it?

MR. STERNMAN: Yes, Justice Brennan, that's correct.

QUESTION: Do you think there's really that much difference between the SEC's test and the Court of Appeal's test?

MR. STERNMAN: Yes. The Court of Appeals test which no one has defended simply states that when there is an

inaccuracy in a statement, it renders the undisclosed information material. And as the SEC notes in its amicus brief, that removes the element of materiality completely from the mix. And everything becomes material, even the most trivial statement. I think the Court of Appeals stated if there were but one telephone call from Kelly, that would be sufficient.

It's interesting that it also read the statements as if they were false statements.

QUESTION: That would be sufficient to make it untrue, but do you think that also under their view made it sufficient to be material?

MR. STERNMAN: Yes, that was their view.

Now, the other issue that is before the Court involves the fraud on the market theory that has been used by courts to facilitate class certification in actions under Section 10(b). We have argued that the only case in which this Court has even approached anything that's come lower courts feel relates to that theory is the Affiliated Ute case. And there is nothing in Affiliated Ute which involved a face to face transaction and omissions, rather than misstatements, and a need to shift an evidentiary burden, that provides any justification for fraud on the market theory.

Lower courts, however, have concluded that it is good policy to abandon the traditional reliance requirement under

Section 10(b) and instead to replace it with what they call reliance on the integrity of the market, something that is derived from the efficient market hypothesis, a hypothesis that many people have questioned in light of the events of the last few weeks.

But in a recent Fifth Circuit decision in the Finkel case, they pointed out that even if you accept the fraud on the market theory for some cases, you should not accept it for a case such as ours, which is a 10(b)(5)(b) case, that is, a case that involves misleading statements, rather than omissions.

To the extent this Court continues to believe that Section 10(b) and Rule 10(b)(5) have their origins in a more common law type fraud situation, the element of reliance has to be respected and should be reinstated. It is misleading, I think, for some to argue that reliance is there. It's there in terms of a rebuttable presumption. The presumption of reliance effectively cannot be rebutted. People are confronted with enormous class actions. The class in this case consists of persons who traded two million shares over a fourteen-month period. They claim damages of many tens of millions of dollars. They didn't trade with the petitioners. They sold into the open market.

Any damage that they claim to have suffered did not arise from any benefit that any of the petitioners received. If they feel they were misinformed, which we claim they were

not, other innocent market participants received an offsetting benefit from the lack of information in the marketplace. If a case such as this is proper for certification as a class action, the class should be limited to those who can show that they relied upon the statements in making their investment decisions.

QUESTION: Well, a fraud on the market theory doesn't even require knowledge, does it?

MR. STERNMAN: It doesn't require knowledge of?

QUESTION: That the statements were made at the time?

MR. STERNMAN: That's correct. It permits people who sold because they had to send their children to college and had no idea of any statements.

QUESTION: Nevertheless, just because we bought or sold on the market, we relied.

MR. STERNMAN: That's correct.

QUESTION: And the market reflects accurately what's going on in life.

MR. STERNMAN: Yes. And I think in terms of some of the earlier decisions, that it substitutes loss causation for transaction causation. That it is enough for someone who traded in the impersonal market to recover if he has incurred what he views as a loss, even though his transaction was not influenced in any way by the wrong doing that he claims the defendants are responsible for. This results in the

aggregation of enormous groups of people, enormous classes, and we think violates the Rule's enabling act, as well, because it changes the ball game when you're confronted with a class action. You cannot get a summary judgment on the issue of reliance. It's a non-issue. It's presumed in favor of the respondents. You cannot defeat a class action motion by claiming that the predominance requirement is not met under Rule 23(b)(3). It reads the predominance requirement out of the Rule.

It reflects a policy that class actions are good, that corporations are evil, and that anything that can be done to circumvent -- and this is in the language of the Court of appeals -- to circumvent the predominance requirement of Rule 23(b)(3) and to facilitate class actions, is something that should be done. That, in our view, is unsound policy and unsound law.

We also think in this case that even if the fraud on the market theory were not rejected on its face by this Court, that nevertheless its application in this case should be reversed. This is a seller's class action. Most class actions are purchaser's class actions. This does not involve a company that has made a historical misstatement as to its earnings or some significant event. It involves misleading statements because a company was having preliminary merger contacts.

The case involves a fourteen-month class period. The

claim is that everyone who sold during this period can be represented by the respondents. For all of those, none of the fraud on the market cases has arisen in a situation such as that. Where historical events are misrepresented and there is a market impact, perhaps Courts are attracted by the logic of believing that everyone who purchased a stock that was artificially inflated should be able to join a group and bring a class action.

But these statements logic would dictate in our view had no market impact or a minimal market impact, perhaps a few days. The lower courts believe that it was appropriate not to look at the question of impact. It was alleged, they claimed, therefore it can be assumed. So it thrusts this conditional certification upon the parties at a very early point in the litigation and it hangs over everyone's head until the trial has taken place on the merits, and then after the trial, an opportunity is given to try to rebut that presumption.

Well, in many respects, that opportunity is just not going to be something that litigants are going to wait for. The risk is too great and the imbalance that results in securities litigation from having a fraud on the market theory and class certification that's loosely granted, plus ease in denying summary judgment, plus something that renders material just about anything exposes defendants in the securities marketplace to enormous liability and enormous risks, and we

think ends up in creating a risk of windfall settlements that ultimately hurt American businesses and investors in those businesses.

I'd like to reserve the balance of my time for rebuttal.

JUSTICE BRENNAN: Mr. Cross?

ORAL ARGUMENT OF WAYNE A. CROSS, ESQ.

ON BEHALF OF RESPONDENTS

MR. CROSS: Justice Brennan, and may it please the Court.

On August 10 of this year, Barron's magazine titled its article about this case, "Is It Okay to Lie?" and I hesitate to oversimplify in that kind of journalistic way, but I really think that's what's at issue here. I don't think notwithstanding the extensive discussion of the facts that the petitioners seriously claim that the reasonable investor articulated by this Court in TSC v. Northway, could not have considered the discussions between Basic and Combustion significant to their investment decisions.

They try to minimize the extent of those contacts, but the suggestion that a jury, there's not enough evidence of those contacts that a jury could not conclude that a reasonable investor would find it interesting, significant, alter the mix of information available to them in deciding that a buyer sells securities. That is not a serious suggestion, I submit. I

submit that what is really at issue in this case and at issue in the agreement in principle articulation by the petitioners is a statement that for reasons of corporate efficiency, corporate ease, corporate convenience, companies are free to say virtually anything they want to say about the state of merger negotiations up until the time that there's an agreement in principle, which means an agreement on price and structure.

In the practical world, agreement on price and structure are typically reached the day the merger is announced, perhaps the night before late at night. Typically the investment bankers sit down at the very last minute and discuss price, go to their respective boards of directors with a recommendations frequently in writing saying do it. Up until that point in time, you do not have what they call an agreement in principle. They are suggesting that a rule be adopted by this Court that at any time prior to that no matter how developed the negotiations are, no matter how committed the people are, you can say anything you want to say.

QUESTION: That's the Third Circuit rule, isn't it?

MR. CROSS: That I believe is the Third Circuit rule, Your Honor.

QUESTION: Any others?

MR. CROSS: The only other Circuit that has addressed that issue, and I believe at best you can say it's ambiguous, is the Seventh Circuit in the Flamm case. Talks about the

agreement in principle issue and agrees with it in the context of a non-disclosure context where there's silence. When asked to decide that the Flamm case was really, citing our case, a Levinson misstatement case, and not a silence case, the Seventh Circuit says we don't have to reach that because we don't think there was deception here. The statements made in that case the Seventh Circuit concluded did not --

QUESTION: Well, has any circuit other than the Sixth rejected the fraud on the market theory?

MR. CROSS: The agreement in principle test, I'm not aware that any other circuit has addressed it squarely. The Seventh Circuit did address the issue on reconsideration in the miner case. They had originally made a comment that seemed to follow the decision in the Third Circuit.

QUESTION: So it's really just the Sixth and the Third that have really addressed it?

MR. CROSS: That's correct. And the agreement in principle test is, I submit, asking for a license to distort or freedom to distort. We're not talking here about statements that are ambiguous about the intent.

The first statement issued in this case said no negotiations were underway with any company for a merger. That's as unambiguous as you can say it.

QUESTION: I take it you reject the SEC test then, too?

MR. CROSS: Your Honor, I think the SEC test is very close to the Sixth Circuit test and I think very close to most of the other Circuits. All the SEC was trying to do in its brief, I believe, was articulate some standard of materiality rather than simply saying a jury has to consider what might be important.

QUESTION: Well, the SEC clearly rejects the Sixth Circuit's statement or holding that every false statement is necessarily material. Do you defend that?

MR. CROSS: No. Your Honor, I don't believe that's what the Sixth Circuit said.

QUESTION: Well, it reads like it said.

MR. CROSS: Well, the interpretation the SEC has taken and I understand that. I disagree with it. I think that the Sixth Circuit --

QUESTION: You don't defend that as the standard?

MR. CROSS: I don't say that any, the denial of a merger negotiation makes any contact per se material, no, I don't. I don't think that's what the Sixth Circuit meant to say. There is a reading of some of the language that says that. I think the Sixth Circuit was saying that the TSC standard, that a reasonable investor has to evaluate the information available and I think they were saying in this case, the denial made these statements material. The Sixth Circuit said in their view on the facts of this case, it is inconceivable that

a reasonable investor wouldn't consider these contacts significant.

We're not talking about preliminary premature feelers by brokers or suggestions of interest. We're talking about contacts in which the top executives of both companies met dozens of times, devoted hundreds of hours. Most significantly, they were exchanging their confidential earnings data and projections. Had they not had an interest, a mutual interest, not a unilateral interest in this merger, they would have been breaching their fiduciary obligations to their shareholders. The Basic management was giving away their five-year projections for earnings, their product plans.

QUESTION: The District Court didn't agree with you on that.

MR. CROSS: The District Court, Your Honor, the District Court's opinion is a very curious opinion.

QUESTION: Well, nevertheless, it disagreed with some of the statements you've just made.

MR. CROSS: It disagreed but it didn't disagree that the evidence was there. If you read the District Court opinion, clearly, it is shot full of statements that plaintiff put forward evidence of the following. Defendants put evidence of the following. Balancing those evidence, I find. The District Court treated this motion for summary judgment as if it were a bench trial. The opinion is loaded with, I find. I

conclude. On balance, it's more credible that.

If you read the opinion carefully, there are dozens of findings. This is not a bench trial, this is a summary judgment motion.

QUESTION: You think that the District Court found that any of these statements were false and misleading, or did they think that they weren't?

MR. CROSS: I think the District Court concluded that with respect to the first statement, there are not any negotiations underway for any company for a merger statement, that it concluded that the contacts prior to that statement were not cognizable as "negotiations" and hence the statement was true.

QUESTION: Yes.

MR. CROSS: But that's a characterization of what is a negotiation.

QUESTION: How about the other statements?

MR. CROSS: The other statements, I believe, the District Court conceded there was a possibility that the contacts prior to the September, November statements could be considered preliminary merger negotiations. It concluded once again that because they were preliminary, they were not negotiations and then began to drift over into this agreement in principle test that it articulates, that it was prior to any deal being consummated, and because in his view the deal being

consummated was determinative of materiality, they were not untrue.

QUESTION: Well, how about ordinary corporate projections and forecasts in which the corporation says, well, we think prospects look good or bad or whatever they say? Now, those statements might be of interest to investors, but courts have not found that they are statements on which investors or people who later sell or buy stock can use as the basis for a suit.

Isn't that right? They're deemed constructively immaterial?

MR. CROSS: Justice O'Connor, I think that's not right. I think what those cases is that projections, and particularly earnings projections which are speculative in nature and uncertain, that there is no duty to disclose such projections.

QUESTION: Well, then they are also I think you will find that they are deemed constructively immaterial. Why should a no corporate development statement such as these be treated any differently than forecasts and projections?

MR. CROSS: Well, first of all, the no corporate development statement is not as neutral as it sounds. That statement is taken from the New York Stock Exchange Manual, in a section of the New York Stock Exchange Manual in which it says when there are rumors of the possibility of a merger or

acquisition, it is necessary that corporate management speak out definitively, clearly, and truthfully. If they are not true, a statement that the company is aware of no pending or present corporate development to explain the trading is appropriate. They are code words for saying, no merger. So that it is not simply an analytical equivalent as suggested in the reply brief of a no comment statement. It is the same thing as the first statement here, there are no negotiations for a merger.

QUESTION: You would say that in response to a specific question about negotiations, the corporation could say, no comment, and there would be no liability?

MR. CROSS: That's right. No comment is true. Or silence is true. Or, as is set forth in our brief, the more common practice --

QUESTION: Or none of your business.

MR. CROSS: No. None of your business, I think, is the equivalent of, no comment. But as set forth in our brief, we have dozens of examples, the more common practice in the investment community is to speak the truth. That's the unusual part about this case. There's this conundrum of what's true, what's false. You know, is it material, is it premature. What's wrong with truth?

What most corporate management does, when confronted with a direct question, are you discussing merger or not, if

they're not, they say, no. If they are, they say we have been approached by a company. It has expressed an interest in acquiring us. We have entered into preliminary negotiations and it's too early to tell where we're going. And there are dozens of those statements issued every month. We've got about a dozen in our brief that's in the record in the District Court.

There's nothing wrong with saying that. It has the virtue of telling the truth and informing the investment public of what's going on.

QUESTION: Well, I guess some writers on the subject think that it has the effect of chilling the prospects for mergers which in the long run can greatly harm the existing shareholders. There certainly is some good scholarly writing to that effect.

MR. CROSS: There is some scholarly writing. I'm not aware that there's any judicial writing on that topic, other than the Third Circuit. And it may be that there is a chilling effect, but on the other hand, there is a deceptive effect of denying. We're not talking about a no comment or a silence.

QUESTION: But in the long run, that kind of disclosure can end up in effect causing a greater loss in shareholder share value than otherwise.

MR. CROSS: That may be as a matter of economics true but I submit that if you adopt that as a policy reason for

doing that, it is where I started my argument. It is okay to lie? It is asking for an exception to Rule 10(b)(5) in the merger context that it is possible, indeed appropriate, to lie. To say we are not having a merger discussion, when you are. And that is contrary to everything that both of the Securities Acts have enacted and particularly contrary to 10(b)(5). Rule 10(b)(5) is a judge made rule to take care of that kind of deception.

QUESTION: If you were trying this case, say there hadn't been summary judgment, and you actually got to trial, what would be your definition of materiality?

MR. CROSS: My definition of materiality would be this Court's definition in TSC v. Northway.

QUESTION: Which is?

MR. CROSS: Would the discussions at the time, take for example, the October, 1977 denial, would the discussions that had existed at that time have been considered important to the investment decision of the reasonable investor.

QUESTION: How about reliance?

MR. CROSS: Well, now you're shifting over into the fraud on the market theory. But --

QUESTION: Just forge that.

MR. CROSS: In this particular case, I don't have a problem with reliance because all three of our plaintiffs testified that they'd read the documents and relied on them.

In that particular case, our clients will take the stand and testify that they relied.

QUESTION: But there was a plaintiff class, wasn't there, here that did not apparently have to indicate reliance?

MR. CROSS: Justice O'Connor, that is the ruling of the District Court. We moved for class certification based on reliance, in the alternative fraud on the market. We have three plaintiffs who relied. We believe that their claims are common to other claims and the individual questions of reliance do not predominant.

QUESTION: Well, I'm confused. The Class that was certified here did not require reliance, isn't that right.

MR. CROSS: The District Court, in certifying the class, chose our second alternative articulation of a reason for class certification, and said, in this case, fraud on the market is sufficient to certify a class and certified it that way.

QUESTION: And that stood up in the Court of Appeals.

MR. CROSS: And that stood up in the Court of Appeals.

In this case, I believe, given the certification that was made, we do not have to affirmatively prove reliance. We have to defend the reliance presumption against the claims that the fraud did not have an impact on the market, or its claims that is posited by Mr. Sternman, some of the plaintiffs class

members may have traded notwithstanding any impact on the market, for example, they had to put their kids through school.

QUESTION: Well, I gather from what you say, though, you'd have no objection if we thought reliance had to be established or claimed for the class?

MR. CROSS: The only objection that I would have if you thought that reliance had to be established would be the right to relitigate the class action motion in the District Court. I would not like to be whipsawed between the District Court who took one of two alternative theories and certified, and a Supreme Court that says that theory was wrong, and leave me without a class, which I think is a possibility in this case.

I believe that the District Court could properly and should properly have certified this class on traditional Rule 23 grounds that individual questions did not predominate. That while there may be some individual questions of reliance, they were clearly subordinate to more significant questions of liability, materiality, damages, all of which are common to the class. And that there may come a point in time in the proceeding where the individual class members would have to prove reliance.

I don't think that's necessary. I think the fraud on the market theory is a perfectly viable theory that should not be overruled. If it were overruled and in effect said that

that's the end of fraud on the market, the only thing I would want is the opportunity to relitigate the class motion in the District Court so I don't get whipsawed.

QUESTION: Then get the right class.

MR. CROSS: What?

QUESTION: Then get the right class.

MR. CROSS: Well, I think I have the right class.

QUESTION: Well, in the long run, it would have to be a class of people who relied.

MR. CROSS: It would have to be a class of people who relied, but I think you still even in a class certification context under Rule 23, you still have a presumption of reliance of non-present class members. You get to try the case as a class action.

QUESTION: Yes.

MR. CROSS: It may be on the damage phase, you get some inquiry.

QUESTION: Mr. Cross, having set aside the summary judgment, you're now going back to trial, are you?

MR. CROSS: I hope so.

QUESTION: In the District Court.

And did I understand you to say earlier the standard you'd like to have the District Court apply would be the Northway standard?

MR. CROSS: That's right. Or possibly the Northway

standard as modified by the SEC standard. The SEC standard does not bother me. I don't think it's that different from the Northway standard. I think all the SEC position is is a refinement of the general standard of materiality of Northway in the context of merger negotiations. And I'm perfectly content on the facts of this case with a substantially increased possibility of a value-enhancing acquisition, I'm perfectly content with that on the facts of this case. I've got chief executive officers meeting with each other, talking to their lawyers about antitrust considerations, hiring investment bankers to perform valuations, giving away their most confidential information prior to the time any one of these statements is made. And I'm perfectly content to be able to say that a jury could conclude that those facts indicated the possibility of an acquisition.

QUESTION: Mr. Cross, I was a little puzzled by the Court of Appeals' opinion. I thought they specifically said they wanted trial on the issue of scienter. But I thought the opinion subject to the reading, they decided the falsity and materiality issue. You don't read it that way?

MR. CROSS: Your Honor, I'm intrigued by the opinion, in the sense that --

QUESTION: Yeah, but what are you going to do when you go back to the trial court? Are you going to start from scratch or are you going to argue that two of those issues have

already been decided?

MR. CROSS: I think that on the face of the Court of Appeals decision, what the Court of Appeals said was, in effect, summary judgment on the materiality issue was appropriate for me.

QUESTION: Right.

MR. CROSS: Not as Mr. Sternman has argued that it's articulating a rule of law for all cases. But that simply that in this particular case, the contacts were so substantial that there is not a reasonable investor in the world who wouldn't consider them material.

And the intriguing thing is that the dissenting Judge on rehearing said, no, I didn't mean that, and the other two Judges stood silent. Mr. Sternman placed the question in issue on his Petition for Reconsideration saying basically, you've established summary judgment in favor of the plaintiffs on the materiality issue. Two of the Judges said nothing, and one Judge came back and said, no, I didn't. So I'm intrigued by it.

QUESTION: What is your view? If this case were affirmed, what would your position on the materiality issue be in the District Court?

MR. CROSS: I would argue and I would argue notwithstanding the Sixth Circuit opinion, I would argue that we are entitled to a directed verdict on that issue, and we'd

get all the evidence in. That there is not any question of fact that these contacts are so significant in this case, quite the reverse of there being no evidence.

QUESTION: Well, it's a little different arguing they're so significant you're entitled to it as a matter of law on this record. That's different from saying it's already been decided.

I'm asking you whether you are taking the position the materiality issue has already been decided in your favor?

MR. CROSS: I think as a matter of pure jurisprudence I can't take that position because I didn't make the motion. If I'd made the cross motion for summary judgment on that opinion, I would take that position, but I didn't make it. I may. And I may argue judicial estoppel based on Mr. Sternman's briefs in this Court and in the Court of Appeals, but I don't think I'll take the position that that opinion binds the District Court as a pure matter of jurisprudence.

QUESTION: You're still going to have to put in some evidence.

MR. CROSS: I think I'm going to have to put in some evidence, yes.

QUESTION: That would make these statements material? Evidence that would indicate materiality?

MR. CROSS: Yes. I'm going to put in the record on the contacts between the companies, the intensity of

negotiation, and I believe that that evidence will make the statements material as a matter of law. At a minimum, I'm certainly entitled to a jury verdict on the issue.

I'd like to make one comment about the fraud on the market theory. There's a suggestion that runs through the petitioner's brief and through a number of the amicus briefs that somehow the fraud on the market theory has eliminated the reliance requirement in 10(b)(5) actions. I don't read it that way and I don't think any of the Circuit Courts read it that way.

I think what the fraud on the market theory has done, it has judicially modified that which was a judicially created reliance requirement. This Court indicated in Affiliated Ute that in the context of 10(b)(5), the reliance requirement was not immutable. Now, I'm not arguing that Affiliated Ute governs the fraud on the market cases, but I do think it indicates this Court saying, 10(b)(5) is a judicially created remedy and at least in the context of Affiliated Ute, the reliance requirement can be relaxed.

The Second Circuit ruled in the Penn-Dixie case that in a context where manipulation affected the exchange offer price in a merger agreement, that there was no investment decision necessary because the merged shareholders didn't have a choice. They just got a bad price based on fraud. That in that context, reliance was not necessary.

What I'm suggesting is that the reliance requirement is judicially created, it can be judicially modified, and I think that all the Circuit Courts have done is taken a requirement of direct individual reliance and imposed an indirect reliance requirement. There's no suggestion that you don't have to rely on the fraud. The suggestion in the fraud in the market cases is, a) that the efficient market reflects the fraud -- the market goes up or down based on the fraud; and b) people in making trading decisions rely upon the fact that the price at which they're trading is a fair price.

There's still a connection between the fraud of the defendants and the injury to the plaintiff at the end. It's simply that, as I think the Blackie Court put it, the fraud on the market theory uses the market as the analytical agent for the individual. That instead of sitting down and pouring over the documents themselves and coming to a conclusion as to what is a fair price based on all of the information available, he uses the marketplace as his agent for that.

I think another one of the Circuit Court's called it, the market becomes the transmission belt for conveyance of information from defendants to plaintiffs. I don't think that the fraud in the market theory eliminates reliance. I don't think it does great violence to 10(b)(5). It recognizes the practicalities in 10(b)(5) actions of the difficulty of proof involved with thousands, sometimes millions of shareholders

being required to troop into court, one after another, and say whatever it was they relied upon, and why they made their investment decisions.

That's a practical consideration. That's why presumptions are entered into. It's a rebuttal presumption and I don't think it does any great violence.

Thank you.

JUSTICE BRENNAN: Thank you, Mr. Cross.

Ms. Sternman, you have five minutes.

ORAL ARGUMENT OF JOEL W. STERNMAN, ESQ.

ON BEHALF OF PETITIONERS - REBUTTAL

MR. STERNMAN: Thank you, Justice Brennan.

In many respects, this case represents hindsight run rampant. There was an agreement that was reached between Basic and Combustion in December, 1978. There was disclosure that at the time the agreement documents were publicized that the companies had had discussions for the prior 27-month period.

This lawsuit followed. And the attempt to take the fact that there was an agreement and that there had been contacts during a 27-month period and then to convert that into making three statements misleading does not stand up under the record.

There was a reference by the respondents to there being dozens of contacts before the first statement was issued. In our reply brief, at pages 11 and 12, we identify each and

every meeting that the parties had during the class period. And it comes to four meetings before the first statement, three before the second statement and none before the third. And we describe those meetings. These were not negotiations. It's a distortion of the English language to call an attempt by an executive of a company to see whether another company might be interested negotiations that render statements false and misleading.

Second, we should make it clear that the District Court did not require that there be a deal before the statements would be materially misleading. All that it required was that there be negotiations destined with reasonable certainty to become a merger agreement in principle, or negotiations which might imminently produce an agreement in principle.

It's our argument that at no point during the class period did these contacts between Mr. Kelly and the people at Basic ever approach the level of that definition, or approach the level of the significantly increased possibility formulation that the SEC has used.

Primarily, we advocate adoption by this Court of the agreement in principle test. It has been used over the years by all of the lower courts in dealing with non-disclosure cases. Cases in which no statements are made and persons who trade on the open market claiming that they would not have sold

shares had they known that the company was having discussions. The courts uniformly have held in those cases that that information is not material and did not have to be disclosed.

And all that's happened in the Greenfield case is that that Court has said that that test that courts have been using for years in the non-disclosure area was an appropriate one when a statement such as the statements here have been issued. The agreement in principle test also provides a bright line so that corporations that are the subject of a stock exchange inquiry as to rumors in its stock can know that if they do as Basic did here, seek to disclose accurate information, that they will not be vulnerable to the type of litigation that was brought here because it's going to be claimed that there were issues of fact as to whether there were material negotiations preceding.

There's been reference to the chilling effect. That is another policy benefit that the agreement in principle test provides. It will not require premature disclosure of negotiations which traditionally have caused acquiring corporations to leave, not to want to pursue a possible acquisition because the price of the company stock increases and there's no longer an economic benefit for the acquisition.

Premature disclosure under a test other than the agreement in principle standard also is damaging to executive and employee morale at companies. People who have careers at

corporations do not want to hear that someone has approached that there may be a possible takeover. They're going to start looking for other jobs. And any policy that is going to require very early disclosure of the types of contacts that were had here is going to have a devastating effect on employee and corporate morale.

Premature disclosure also runs the risk of putting a company into play. Basic had absolutely no desire to be acquired. It recognized that it had an obligation to its shareholders to listen to offers. Had it made a statement in October, 1977, that we've been approached by Company X, we're not interested but this representative of Company X said he might recommend an offer, the raiders and the corporate vultures would be out there, and you'd have market disruption in Basic as well as all of the other impacts that I've referred to.

One other point, I think, has to be made very clear. We do not contend that the agreement in principle test should be applied where insider trading is alleged. That is not what's involved in this case. And we feel that the SEC's reluctance to endorse the agreement in principle test reflects a concern on its part that lower courts will blindly apply that test where there's insider trading.

QUESTION: Mr. Sternman, can you answer just one quick question.

You haven't commented at all on the fact that sales data was rather confidential information was given as early as 1976. Would you just respond to that thought?

MR. STERNMAN: The sales data was given -- first of all, in 1978, when there was some sales data given, Basic was interested in acquiring Combustion's refractories division, and it thought that it would pay for that acquisition with Basic stock. So it wanted to give Combustion an opportunity to take a look at what Basic was doing and what that stock might be worth if such an acquisition took place.

But in 1976, the Basic individual, Mr. Muller, did give Mr. Kelly certain confidential information. He trusted him. That information was solely to assist Mr. Kelly to see what he was going to do. But it did not, as the District Court noted when it discussed that, create any negotiations out of what was happening. It may have been ill advised. It may have been indiscrete, but it did not render the discussions that were had material.

QUESTION: Thank you.

JUSTICE BRENNAN: Thank you, Mr. Sternman.

The case is submitted.

(Whereupon, at 2:39 p.m., the case in the above-entitled matter was submitted.)

REPORTER'S CERTIFICATE

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HEARING DATE: November 2, 1987

LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Supreme Court of the United States, and that this is a true and accurate transcript of the case.

Date: November 10, 1987

Margaret Daly

Official Reporter

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