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SECURITIES LAW

McCORMICK v. FUND AMERICAN COMPANIES: ALTERING THE TOTAL MIX OF INFORMATION MADE AVAILABLE DURING DISCLOSURE IN CORPORATE REPURCHASES OF STOCK

I. INTRODUCTION

In *McCormick v. Fund American Companies*,¹ the Ninth Circuit granted summary judgment to defendant corporation over plaintiff shareholder's claim that defendant had violated the Securities Exchange Act² by misrepresenting or omitting material information during negotiations to repurchase stock from plaintiff.³ The court found that in light of plaintiff's status as a "sophisticated business executive,"⁴ defendant's alleged misrepresentations and omissions did not "significantly alter the total mix of information made available"⁵ concerning the contemplated sale of a subsidiary company of defendant

1. *McCormick v. Fund Am. Cos.*, 26 F.3d 869 (9th Cir. 1994) (per Fletcher, J.; the other panel members were Kozinski, J., and Trott, J.).

2. Securities Exchange Act of 1934, § 10(b) states in pertinent part:

It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance 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.

15 U.S.C. § 78j(b) (1988).

3. *McCormick*, 26 F.3d at 884.

4. *Id.* at 879.

5. *Id.* at 884.

corporation.⁶

II. FACTS AND PROCEDURAL HISTORY

The plaintiff, William M. McCormick, was a stockholder in defendant Fund American Companies (FAC),⁷ the parent company of Fireman's Fund Insurance Company (FFIC).⁸

In May 1990, FAC repurchased from McCormick his outstanding shares of FAC stock.⁹ Three months later, FAC sold its full interest in FFIC to Allianz, a large German insurance company.¹⁰ As a result of the sale, the price of FAC stock rose dramatically, and McCormick consequently requested a price adjustment on the repurchased stock to reflect the increased price of FAC shares.¹¹

6. *Id.*

7. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 872 (9th Cir. 1994). McCormick was CEO of Fireman's Fund Insurance Company from 1983 until his resignation in 1989. At the time of his resignation, McCormick owned approximately 500,000 performance shares and option shares of FAC stock, the vesting period of which ran through 1991. *Id.*

8. *Id.* FFIC was wholly-owned by FAC. *Id.*

9. *Id.* at 874. The negotiations for repurchase of McCormick's FFIC stock began on April 27, 1990. On May 14, 1990, FAC told McCormick that \$38 per share was the last offer FAC would make to McCormick that year and on May 15, McCormick signed the buyout agreement. At the time of the signing, FAC had disclosed nothing to McCormick concerning its intention to sell some or all of its interest in FFIC. *Id.* Upon counsel's advice, the chief financial officer of FAC met with McCormick on May 16, 1990 to disclose nonpublic information regarding the sale of FFIC. *Id.* at 874-75. Specifically included in this disclosure was mention that the success of the sale would likely cause a considerable increase in the price of FAC stock. Upon conclusion of the meeting, FAC issued and McCormick signed an acknowledgment form summarizing the information disclosed. *Id.* at 874. Although the disclosure meeting took place the day after consummation of the repurchase, McCormick's counsel conceded at oral argument that the parties' understanding at the time would have allowed McCormick to back out of the bargain after the disclosure. *Id.* at 875 n.2.

10. *Id.* at 873-75. Some debate exists as to when negotiations for the sale of FFIC actually began with Allianz, for the transaction was conducted through the efforts of an investment banker from Lehman Brothers, and it is unclear when FAC authorized his representation. *Id.* at 878-79. Despite McCormick's claims and a dated retainer agreement to the contrary, the Ninth Circuit ultimately held that the banker's initial contacts with Allianz were not in representation of FAC. *Id.*

11. *Id.* at 875. Due to the sale of FFIC, FAC stock rose from approximately \$31 per share to approximately \$50 per share. *Id.* McCormick's 500,000 shares thus would have been worth an additional five million dollars had he retained them. *Id.* at 874-75.

Upon FAC's refusal, McCormick instituted proceedings against FAC, claiming that FAC had omitted and misrepresented material information regarding the likelihood of the sale of FFIC in violation of section 10(b) of the Securities Exchange Act of 1934,¹² and Code of Federal Regulations Rule 10b-5.¹³

The district court granted summary judgment to FAC and McCormick appealed to the Ninth Circuit.¹⁴

III. BACKGROUND

The Securities Act of 1933 proscribes, with exceptions, the use of any means of interstate commerce or the mails to offer to sell or buy a security unless the security is registered with the Securities Exchange Commission.¹⁵ Once registered, the corporation issuing the security is subject to various disclosure and reporting requirements, including section 10(b) of the Securities Exchange Act of 1934.¹⁶ Under this section and its expansion by Code of Federal Regulations Rule 10b-5, a person can be liable for materially misleading representations or omissions made in connection with the purchase or sale of securities.¹⁷

12. *McCormick*, 26 F.3d at 872-73. For pertinent provision of Securities Exchange Act § 10(b), see *supra* note 2. 15 U.S.C. § 78j(b) (1988) is the statutory codification of Securities Exchange Act § 10(b).

13. 17 C.F.R. § 240.10b-5 (1994). Rule 10b-5 extends the "employment of manipulative and deceptive devices" to include oral misrepresentations or omissions and states in part that "[i]t shall be unlawful for any person . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ." *Id.*

McCormick also brought claims for violation of state securities laws, breach of fiduciary duty, fraud, and deceit. The court held that federal standards of materiality applied to these state claims, and dismissed them as well. *McCormick*, 26 F.3d at 884.

14. *McCormick*, 26 F.3d at 872.

15. 28 U.S.C. § 77(e) (1988) (Securities Act of 1933, § 5). For exceptions see 28 U.S.C. § 77(c), (d).

16. See *supra* note 2 for the pertinent text of § 10(b).

17. See *supra* notes 12-13. See also *Jensen v. Kimble*, 1 F.3d 1073, 1077 (10th Cir. 1993) (omissions not materially misleading in light of circumstances).

In *Basic Inc. v. Levinson*,¹⁸ the United States Supreme Court considered various tests for determining materiality in the section 10(b) context.¹⁹ *Basic Inc.* stemmed from a petition by the class of former Basic shareholders claiming that Basic had released false or misleading statements concerning a forthcoming merger.²⁰ The Court ultimately adopted for section 10(b) cases the test detailed in *TSC Industries, Inc. v. Northway, Inc.*,²¹ which makes a fact material if there is "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."²² The Court further noted that in cases where the event in question is speculative, this determination includes a bal-

18. 485 U.S. 224 (1987).

19. *Id.* at 231-38. The Court considered three tests: (1) the *TSC Industries* test, described *infra* note 21 and accompanying text; (2) the "agreement-in-principle" test, under which preliminary merger discussions do not become material until the would-be merger partners have reached agreement as to the price and structure of the transaction; and (3) the test used by the court of appeals in that case, in which information concerning otherwise insignificant developments becomes material solely because of an affirmative denial of the developments' existence. The Court expressly rejected the latter two tests. *Id.* at 237-38.

20. *Id.* at 226-30. *Basic Inc. and Combustion Engineering, Inc.* conducted extensive negotiations to merge for approximately two years. During that time, Basic made three public statements denying that any merger negotiations were taking place or that it knew of any facts that would account for heavy trading activity in its stock. Each member of the class of plaintiffs sold their stock between the first statement denying a merger and the suspension of trading activity just prior to the merger announcement. They filed suit based on section 10(b) violations. *Id.*

21. 426 U.S. 438 (1976). *TSC Industries* considered the materiality of information presented in a joint proxy statement issued to shareholders of defendant corporations National Industries and TSC Industries. National bought a 34% voting interest of TSC from TSC's founder and principal shareholder. The founder promptly resigned from the board of directors of TSC and five National nominees were subsequently elected. The board thereafter approved a proposal to liquidate and sell TSC's assets to National. TSC and National issued a joint proxy statement to their shareholders recommending approval of the proposal, which was ultimately obtained, and the liquidation and sale were effected. Plaintiff was a TSC shareholder who filed suit against TSC claiming that the joint proxy statement was incomplete and materially misleading in violation of Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1988). Plaintiff asserted that the statement omitted material facts relating to the degree of National's control over TSC and to the favorability of the terms of the proposal. *Id.* at 440-43.

22. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The Court in *TSC Indus.* stated that to alter the total mix of information, there must be a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. *TSC Indus.*, 426 U.S. at 449.

ancing of the magnitude of the corporate event and the likelihood that the event will occur.²³ The Court concluded by noting that materiality is fact-specific and must therefore be determined on a case-by-case basis.²⁴

*Kohler v. Kohler Co.*²⁵ also addressed section 10(b) disclosure requirements. In *Kohler*, the Seventh Circuit was confronted with the question of whether section 10(b) applied to entities other than persons with material, nonpublic information.²⁶ The court held that while the text of section 10(b) speaks only to "person[s],"²⁷ the provision's requirements "apply not only to majority stockholders of corporations and corporate insiders, but equally to corporations themselves."²⁸

Despite this clear progression of section 10(b) analysis, precedent could not provide a summary answer for the question *McCormick* presented to the Ninth Circuit.²⁹ The facts indicated, and McCormick did not contest, that the *possibility* of the sale of FFIC was disclosed to him.³⁰ McCormick's contention was that FAC had omitted and misrepresented material information concerning the *likelihood* of the sale of FFIC which, if properly disclosed, would have altered the total mix of information.³¹

23. *Basic Inc.*, 485 U.S. at 238 (citing *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

24. *Id.* at 238-41.

25. 319 F.2d 634 (7th Cir. 1963). In *Kohler*, defendant Kohler Co., a corporation, repurchased plaintiff shareholder's stock. Plaintiff claimed a violation of section 10(b) asserting that the book value of the stock differed according to the accounting method utilized in determining the price; that defendant utilized a method that caused the lower price to be reflected; and that defendant knew this to be true but failed to inform plaintiff before repurchasing plaintiff's securities. *Id.* at 635-37.

26. *Id.* at 637-38.

27. 15 U.S.C. § 78 j(b) (1988) (Securities Exchange Act of 1934, § 10(b)).

28. *Kohler*, 319 F.2d at 638. The court emphasized that in such cases the duty to disclose is necessarily limited to an exercise of fair and honest business practices under all the circumstances existing at the time of the transaction. *Id.* at 641.

29. *McCormick*, 26 F.3d at 877.

30. *Id.*; see *supra* note 9.

31. *McCormick*, 26 F.3d at 877.

IV. THE COURT'S ANALYSIS

In examining plaintiff's claim, the Ninth Circuit first considered whether FAC had a duty to disclose material information to McCormick, and then appraised the materiality of FAC's alleged misrepresentations and omissions.³²

A. FAC OWED A DUTY OF DISCLOSURE TO MCCORMICK

The Ninth Circuit applied the well-established principle that a corporate issuer has a duty to either disclose nonpublic, material information to its stockholders or refrain from repurchasing its securities.³³ However, the court's inquiry into this aspect of McCormick's claim was only cursory, for the duty element of section 10(b) was not strenuously contested by FAC.³⁴ Accordingly, the court held that FAC owed a duty to McCormick, but emphasized that the crux of the case revolved around the materiality of the information at issue.³⁵

B. ADDITIONAL INFORMATION CONCERNING THE LIKELIHOOD OF SALE OF FFIC WOULD NOT HAVE SIGNIFICANTLY ALTERED THE TOTAL MIX OF INFORMATION MADE AVAILABLE TO MCCORMICK

The Ninth Circuit reiterated that the *Basic Inc. v. Levinson* test for materiality in the section 10(b) context³⁶ makes a fact material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by

32. *Id.* at 875.

33. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994); *see, e.g.*, *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567, 1572-75 (11th Cir. 1990); *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963); *Green v. Hamilton Int'l Corp.*, 437 F. Supp. 723, 728 (S.D.N.Y. 1977).

34. *McCormick*, 26 F.3d at 875. The court notes that FAC's conduct of having the disclosure meeting with McCormick indicated that it recognized a duty to disclose, but that FAC "distanced" itself from that position during oral arguments and in the course of litigation. The court summarily held that the original position was the correct one. *Id.* at 875-76.

35. *Id.* at 876.

36. *Basic v. Levinson*, 485 U.S. 224, 230-32 (1988) (adopting holdings from *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) and *SEC v. Texas Gulf Sulfur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).

the reasonable investor as having significantly altered the 'total mix' of information made available.³⁷ The court also acknowledged *Basic Inc.*'s balancing test.³⁸ The Ninth Circuit then examined the eight alleged omissions and seven alleged misrepresentations to determine whether they singly or as a whole were both material and misleading.³⁹

Throughout its analysis, the court explicitly and implicitly stressed the importance of the plaintiff as a "sophisticated business executive."⁴⁰ The court noted that "McCormick was a sophisticated businessman, and he was the former CEO of FFIC and a director of FAC at the time of the events in question. His reading of the Acknowledgement must be seen against that background."⁴¹ Consequently, the court considered McCormick's sophistication as it determined the materiality of each alleged omission and misrepresentation.⁴²

37. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994); see *supra* note 21 and accompanying text.

38. *Id.* The test weighs the magnitude of the corporate event in question against the likelihood that the event will occur. *Id.*

39. *Id.* at 878-83. The eight alleged omissions were: (1) FAC retained Lehman Brothers, as of January 15, to sell FFIC; (2) in February, FAC committed in writing to entertain the sale of FFIC; (3) FAC pursued Allianz and conducted face-to-face negotiations in Germany; (4) nonpublic information had already been furnished to Allianz; (5) after review of nonpublic information, Allianz asked for further discussions; (6) FAC had agreed to buy back FFIC portfolio assets; (7) FAC had agreed to reinsure up to 50% of FFIC's reserves; and (8) FAC and Lusardi [investment banker from Lehman Brothers] had planned meetings with a tax expert to discuss post-sale holding company issues. *Id.*

The seven statements that McCormick alleged were misrepresentations were: (1) a confidentiality letter was sent to Allianz; (2) preliminary discussions were about to start; (3) the buyer's due diligence had not yet begun; (4) Byrne [CEO and chairman of the board of FAC] did not know about the Allianz developments when he proposed the buyout on April 27; (5) Byrne did not want to sell FFIC, (6) the potential buyer could not meet Byrne's price; and (7) the Allianz development was a sudden one, and was unlikely to materialize. *Id.*

40. *Id.* at 879-84. The court borrowed this terminology from *Jensen v. Kimble*, 1 F.3d 1073, 1078 n.9 (10th Cir. 1993), in which the Tenth Circuit held that no liability existed because the defendant there had "specifically advised" the plaintiff of the points which would not be disclosed.

41. *Id.* at 884.

42. *Id.* at 878-83. The Ninth Circuit placed explicit emphasis on McCormick's sophistication in its analysis of the third and fifth alleged omissions. *Id.* at 879-80. The court also placed implied emphasis on McCormick's sophistication in its analysis of the fourth, sixth, seventh, and eighth alleged omissions and the first and fifth alleged misrepresentations. In each of these latter instances, the court stated that McCormick should have or could have inferred the information claimed unavailable from the information already known to him. *Id.* at 880-82. For further

In each instance, the court's determinations fell into one of three categories: (1) the alleged omissions or misrepresentations were not, in light of the circumstances, actually omissions or misrepresentations;⁴³ (2) the alleged omissions or misrepresentations were not material;⁴⁴ or (3) the alleged omissions or misrepresentations were material, but in light of the circumstances, not misleading.⁴⁵ Since the court therefore determined that the alleged misrepresentations and omissions, both individually and as a whole, did not significantly alter the total mix of information made available, the court concluded that FAC did not violate section 10(b).⁴⁶

V. CRITIQUE

Despite the case-by-case analysis of Securities Exchange Act section 10(b) claims,⁴⁷ some practical problems cannot be avoided. One such problem is that the courts have the luxury of analyzing a situation retrospectively. What may seem immaterial in light of the circumstances after the fact may have been highly probative during the transaction. *McCormick* illustrates this predicament, as the issue here was the materiality of information allegedly omitted or misrepresented concerning the likelihood of the sale of FFIC.⁴⁸ As noted, the likelihood of the event in question is one prong of determining whether undisclosed or misrepresented information is material.⁴⁹ If

discussion of the role of the "sophisticated business executive" in determining materiality, *see infra* notes 51-53 and accompanying text.

43. *McCormick*, 26 F.3d at 878-83. The court held that the information of the second alleged omission was not true, and thus FAC could not be faulted for omitting it. *Id.* at 879. The court further held that the statements complained of in the second, third, and sixth alleged misrepresentations did not amount to legal misrepresentations. *Id.* at 881-83.

44. *Id.* at 878-83. For the first, fourth, fifth, sixth, seventh, and eighth alleged omissions, and the fourth, fifth, and seventh alleged misrepresentations, the court held that the statements would not have significantly altered the total mix of information, and thus were immaterial as a matter of law. *Id.*

45. *Id.* at 880-81. The court held that in light of the information which was provided to McCormick, the third alleged omission and the first alleged misrepresentation were not misleading. *Id.*

46. *Id.* at 883-84.

47. *Basic Inc. v. Levinson*, 485 U.S. 224, 238-41 (1988); *see supra* note 24 and accompanying text.

48. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 877 (9th Cir. 1994).

49. *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (citing *SEC v. Texas Gulf*

information concerning the likelihood itself is at issue, application of a test based upon that likelihood becomes questionable.⁵⁰

Other facets of the *McCormick* analysis are also noteworthy. At various points in the court's discussion, the Ninth Circuit holds the information immaterial based on the plaintiff's status as a "sophisticated business executive."⁵¹ This condition is important, as each case is decided in light of the surrounding circumstances,⁵² but the court's virtually conclusive reliance suggests a two-tiered system of analysis for materiality: one test for the reasonable investor and another less demanding one for the "executive."⁵³

Finally, the Ninth Circuit gives only cursory notice to the fact that the disclosure took place after the sale of the stock.⁵⁴ The circumstances suggest, however, that the court should have assigned greater weight to this detail. Because he had

Sulfur Co., 401 F.2d 833, 849 (2nd Cir. 1968)).

50. The difficulties inherent in a retrospective attempt to discern the "likelihood" of a speculative event are evident in the court's analysis. In addressing the sixth and seventh alleged omissions and the seventh alleged misrepresentation, the court reasons that because negotiations "nearly broke down in the middle of July," statements discounting the likelihood of the sale of FFIC made in May, the time of repurchase, would not be materially misleading. *McCormick*, 26 F.3d at 880-81, 883. The court thus used information not yet available in May to assess the likelihood of the sale of FFIC at that time. *Id.*

51. *McCormick*, 26 F.3d at 878-84; see *supra* notes 40-42 and accompanying text for the court's explicit and implicit reliance on this characteristic. The court's analysis here is somewhat confusing. The conclusions seem to indicate that materiality is inversely proportional to the sophistication of the stockholder. However, unless this case is merely the exception to the rule, the facts here do not support such a scheme. As a "sophisticated business executive," in light of the information disclosed, *McCormick* still thought the sale so unlikely that he forewent the opportunity to earn an additional five million dollars. *McCormick*, 26 F.3d at 874-75.

52. *Kohler v. Kohler Co.*, 319 F.2d 634, 641 (7th Cir. 1963); see *supra* note 28.

53. This is exemplified in the third alleged omission, in which the court held that FAC's "quasi-disclosure" was sufficient in light of plaintiff's background. *Id.* at 879. Other courts have rejected that different standards might apply depending on the level of sophistication of the parties to the transaction. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988) (finding "no authority in the statute, the legislative history, or our previous decisions, for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited").

54. *McCormick*, 26 F.3d at 874-75. *McCormick* and FAC consummated the sale of the stock on May 15, 1990. *Id.* at 874. The disclosure meeting took place on May 16, 1990. *Id.* at 874-75.

already signed one agreement to sell, McCormick had indicated to FAC his commitment to sell the stock.⁵⁵ FAC thus enjoyed a superior bargaining position over McCormick during the disclosure meeting. In light of this indicated commitment and superior bargaining position, it was FAC's interest to keep disclosure to a minimum, for the transaction represented roughly five million dollars profit.⁵⁶ Since McCormick could have avoided the agreement,⁵⁷ FAC clearly wanted to offer him no reason to do so.

VI. CONCLUSION

The Ninth Circuit held that FAC had not violated the provisions of the Securities Exchange Act.⁵⁸ The court concluded that as a matter of law any additional information disclosed to McCormick concerning the likelihood of the sale of FFIC would not have significantly altered the total mix of available information, and the information that was disclosed was not materially misleading, particularly in light of McCormick's business sophistication.⁵⁹ Consequently, the court affirmed the grant of summary judgment to FAC.⁶⁰

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55. *Id.*

56. *Id.*

57. *Id.* at 875 n.2.

58. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 884 (1994).

59. *Id.* at 883-84.

60. *Id.* at 885.

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