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# Southeastern Conference on Corporate and Securities Law

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# SOUTHEASTERN CONFERENCE ON CORPORATE AND SECURITIES LAW

# INTRODUCTION

The pace of change in the world of business is as fast today as at any time in this century. Business leaders must keep abreast of complex developments in relation to virtually the entire spectrum of business concerns. Whether the problems arise from the competitive demands of the international marketplace, fast-paced technological innovation, or the almost revolutionary developments in the mechanisms of capital formation and ownership, the businessperson of today must keep up with and have access to a broad range of information concerning matters that affect business.

If this is the case for business leaders, it is no less true for the lawyers they turn to for legal advice. Today's business lawyer may not take comfort in the immutability of the dog-eared copy of a state's corporations code or in a static regulatory scheme. Rather, in the current environment the corporate practitioner must keep informed through a variety of means—computerized research devices, looseleaf services, or specialized periodicals—of important legal developments in his or her field.

Symposia and conferences, such as the one reported in these pages, provide an important means by which lawyers may keep abreast of matters critical to their concerns. The First Annual Southeastern Conference on Corporate and Securities Law took place at the School of Law of the University of North Carolina at Chapel Hill on June 3 and 4, 1982. The speakers on the first day focused primarily on the Securities and Exchange Commission's involvement in "the corporate boardroom" and on methods by which counsel could assist corporations in dealing with such involvement. On the second day, the emphasis was on the legal definition of the duties of corporate officials toward the shareholders, particularly in the context of changes in shareholder ownership.

The conference commenced with a review by Stanley Sporkin, former Director of the Securities and Exchange Commission's Division of Enforcement, of the development of the Commission's role in defining the legal obligations of members of corporate boards of directors. Theodore A. Levine, an Associate Director in the Commission's Division of Enforcement, and F. Daniel Bell, III, the North Carolina Securities deputy, then described recent developments in their respective agencies in the area of enforcement. The afternoon featured a discussion of methods by which public companies might prevent breakdowns that could lead to unfavorable SEC attention and the means by which companies might defend against SEC enforcement action should breakdowns occur. The presentations of Arthur F. Mathews of the Washington, D.C. firm of Wilmer, Cutler and Pickering and A.A. Sommer, Jr. of the Washington, D.C. firm of Morgan, Lewis and Bockius are featured.

As noted, the second day of the conference focused on the legal obligations of corporations and their board members to their company's present and potential shareholders in selected contexts. Russell M. Robinson, II, of the Charlotte, N.C. firm of Fleming, Robinson, Bradshaw and Hinson discussed

the elimination of minority shareholders; Professor Thomas Lee Hazen of the School of Law at the University of North Carolina at Chapel Hill talked about the relationship of the federal securities laws to breaches in fiduciary duty; Professors James D. Cox of the Duke University School of Law and Donald E. Schwartz of the Georgetown Law Center, and A. Gilchrist Sparks, III of the Wilmington, Delaware firm of Morris, Nichols, Arsht and Tunnel discussed the current law regarding the "business judgment rule." To end the conference, Edward D. Herlihy of the New York firm of Wachtell, Lipton, Rosen and Katz; Roger W. Arrington of E.I. DuPont de Nemours, Wilmington, Delaware; and Hubert Humphrey of Brooks, Pierce, McLendon, Humphrey and Leonard, Greensboro, N.C., dealt with various legal and tactical matters relating to tender offers and takeovers.

In an effort to convey the dynamic quality of the conference, the presentations have been reported as much as possible in the manner in which they were given, rather than being recast into article form. Of course, some editing has been done to clarify and consolidate presentations, but the hope is that the essential character of the conference has been preserved. Footnotes have been added where supplementation of the text seemed appropriate.

The usefulness of the conference as a provider of timely, relevant information for the corporate and securities practitioner should be left to the assessment of the conference participants and to the readers of these pages. The directors of the conference, somewhat biased perhaps, believe that the conference was successful in its objectives, and offered many provocative and useful insights into issues of current concern to the business lawyer.

THOMAS LEE HAZEN
MARIANNE K. SMYTHE

# TABLE OF PANELISTS

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# SEC ENFORCEMENT AND THE CORPORATE BOARD ROOM

STANLEY SPORKIN†

SPORKIN: Of course I realize there was a lot of law on the duties of directors in the SEC before I came to the agency, but I always like to think that one of the turning points in agency policy occurred when the Commission investigated the Penn Central Corporation. One of the things I enjoyed doing in an investigation was finding out what went wrong—almost like a pathologist when a person dies—to discover what caused the "death." As we looked into *Penn Central*[1] we decided not only to investigate the financial debacle, but also to look at the various components to determine what role management had played. We particularly focused on the directors in that case, and in the staff report that we issued, the staff found that the directors were generally accustomed to playing an inactive role in company affairs, permitted management to operate without any effective review or control, and remained uninformed throughout the period of important developments and activities.[2] Although in *Penn Central* the Commission did begin to look at the role of the directors, it did not take action regarding the directors, but merely issued its report.

The Commission then came to a second landmark case, *Stirling Homex*,[3] which concerned a company that was in the modular homebuilding business. The company put the modular units together, sent them to the land site, and erected them on the site. It was a great concept, because by building a home in a factory, Stirling Homex was able to use virtually unskilled labor and, therefore, beat most other prices. Unfortunately, the company started to encounter financial difficulties. While its sales were decreasing, its reports continually tended to show increasing sales and earnings. The company resorted to using the tried and true methods of defrauding through the misrepresentation of fictitious sales, fictitious earnings, and fictitious assets.

A critical obligation of a reporting company under the securities regulations is disclosure. Otherwise, shareholders cannot make informed investment decisions. When we talk about disclosure, we are discussing not only disclosure of good things, but also disclosure of bad things. One cannot have disclo-

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1. *See generally SEC Staff Study of the Financial Collapse of the Penn Central Company*, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,931 (1972) (Report to the Special Subcomm. on Investigations of the House Comm. on Interstate and Foreign Commerce, 92d Cong., 2d Sess.).

2. *Id.* at 82012-82013.

3. *Report of Investigation in the Matter of Stirling Homex Corp. Relating to Activities of the Board of Directors of Stirling Homex Corp.*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80219 (1975).

sure on one side and not the other. So in *Stirling Homex*, the Commission, in addition to bringing action against the various officers, the company itself, the broker, and the accountant, also decided to reexamine the role of the directors.

It is important to realize that when a government agency has limited resources, it is not able to investigate every form of chicanery that comes within its jurisdiction; the agency just does not have the staff to do it. Therefore, when it selects a target, it must spend substantial resources to find out what happened in that particular case. If it investigates and then pursues only the most obvious infractions before moving on to something else, in my view the agency is not spending its resources wisely. The agency ought to hone in, look at all the people who played a role, and look particularly at the professionals who were responsible. The object of the investigation should be to take action of some form against those individuals if, indeed, they were responsible. Why? Because this procedure is a great prophylaxis. Accountants that misplay their role may well take heed and say, "We ought to learn from the *Stirling Homex* that if we do this in another case we are going to be held responsible."

In *Stirling Homex* we looked at the lawyers, the management, and the directors. We at the Commission were having a difficult time dealing with directors, because in *Stirling Homex*, as in the *Penn Central* investigation, we did not find that the directors themselves were part of the fraud. We simply found that the directors were not doing the job that the system required them to do. In our capital-formation system there are various actors who have specific responsibilities: the lawyers have responsibilities, the accountants have responsibilities, and, to be sure, the directors have responsibilities. The problem was that we did not know exactly how to articulate the director's responsibility in a way that fairly reflected SEC policy.

Being a bit conservative, the Commission decided to issue a report on Sterling Homex, and in the report the Commission found that the three outside directors of the company had been deliberately deceived by the company's management.[4] The question then arises, "Why should the SEC be concerned if the directors have been deceived; why should they be liable?" The Commission's response was that it was criticizing the directors because they did not play a significant role in the company's affairs. In effect, they had been willing to sit on the sidelines as spectators. The Commission further noted that there existed no internal system by which the directors were provided with significant corporate information, and it recognized this as a serious deficiency. Nevertheless, it could not be overlooked that the directors blindly accepted management's statements and explanations of what the company was doing and did not subject management to any kind of incisive questioning.

Of course, the business judgment rule provides that directors can rely on their best professional judgment when filling the duties of their office. But what is the key to the business judgment rule? First, the directors must be acting in good faith. But even under the good faith standard, they must make

4. *See id.*

the requisite investigation and inquiry. Otherwise they cannot really be acting in good faith. In effect, the Commission said in *Stirling Homex* that a director cannot passively accept what management is saying; he has a responsibility to take a more active role. The Commission finally concluded that the three outside directors of Stirling Homex did not provide the shareholders with any significant protection. Nor did they go to the board and take action to question the company's operation, action the shareholders might reasonably have expected them to take.

One of the critical concepts that now seems to be appearing in the field of corporate responsibility is the concept of "reasonable expectations" of investors. In essence, the question is this: What does a person reasonably expect in regard to the protection of his rights as an investor? In this respect, the Commission in 1975 began to examine the concept of shareholders' reasonable expectations of directors. In *Stirling Homex* the directors clearly failed to live up to these expectations. I think you can begin to see the thread that seems to run throughout these cases. In short, shareholders would expect their directors to be informed, not to be mere dummy directors; to ask the right questions, not simply to accept answers blindly.

The third and final report that the Commission issued was the case of *National Telephone Company*.[5] National Telephone was in the business of setting up telephone systems on a local basis, and was doing quite well with the technical aspect of its operation. It had a lot of business, but it also had a problem: it simply could not afford its new business, because every time it got a new client, it lost money. In essence, getting new business actually represented a loss to the company.

LEVINE: For those who do not understand why that is so, let me explain. The company had to front money to set up the leasing of telephone systems, and would get it back over the period of a long-term lease. The more orders the company had, the more financing it needed, and the more costly it became. As National Telephone got all this new business, it had to realign its cash flow in order to recoup the money. The company continued to fall into greater debt and had to raise financing either through banks or offerings. As a result, it became more difficult for the company to raise the money to set up the systems.

SPORKIN: Again in this case you find a company engaging in financial debauchery. It is interesting that the three cases that we are discussing (*Penn Central*, *Stirling Homex*, and *National Telephone*) all involved inside financial debaucheries. The companies succumbed, and, of course, we at the SEC were the undertakers. We played the role, and then, of course, we were given the authority to find out what had happened. In *National Telephone*, as in *Stirling Homex*, the SEC went after everybody. We sued the president, we sued the

5. *Report of Investigation in the Matter of National Telephone Co., Inc. Relating to Activities of the Outside Directors of National Telephone Co., Inc.*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,410 [hereinafter cited as *National Telephone*].

inside officials, and we sued the company. The very famous *Carter Johnson*[6] case came out of these proceedings.

At the same time the Commission took this action, it also decided that it would make another release. In this release, the Commission said:

> [t]he outside directors of National were aware during the fall of 1974 and the winter and spring of 1975 of significant facts concerning National's troubled financial condition. Moreover they were aware of the optimistic nature of the company's public disclosures, disclosures which were in direct contrast with the true state of the comapny's affairs. Under these circumstances the company's outside directors had an affirmative duty to see to it that proper disclosures were made.[7]

The Commission was not saying that the directors of a company are responsible for proofreading every line of every press release and periodic filing made by the company. Rather, the Commission was cautioning that at a time of distress in a company's existence, the directors have an affirmative duty to ensure that the marketplace is provided accurate and full disclosures concerning the basic liability of the company and the continuity of its operations. Directors cannot play the role of the ostrich. Directors cannot simply say, "We are not going to do anything." They have a duty and a responsibility. Directors who are smart may try to defend themselves by saying, "We relied on the company's management and counsel to take care of these problems." But the directors in *National Telephone* asserted that they "relied on management to make required disclosures and on company counsel to advise when disclosures were required and that such reliance was well placed."[8] To that assertion the Commission basically replied, "It is out of the question. Reliance is no defense."

The Commission went on to add that the facts developed during this investigation demonstrated the need for adequate, regular procedures in the overall supervision of the board in order to ensure that the proper disclosures were being made. Thus, a director is responsible for ensuring that the company has reliable procedures. Such procedures could include, among other things, a functioning audit committee with authority over disclosure matters, or any other process that involves the board of directors in a meaningful way in disclosure. With such procedure, the corporation's shareholders and the public should be more adequately protected from haphazard or fraudulent disclosure.

You might think the only thing the Commission did during my tenure there was to issue reports. Fortunately, that is not the case. I have been accused of enforcement by press release, but we did bring a few cases over the years—even in the area of directors' responsibilities. One of the critical cases

6. William R. Carter, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (Mar. 7, 1979).

7. *National Telephone*, *supra* note 5, at 88,878.

8. *Id.* at 88,880.

was *SEC v. Star Broadcasting Group, Inc.*,[9] which involved a public company in which the three key controlling persons also conducted a side business. These individuals had some open-air theaters that were not at all profitable. It was determined by these persons that they would save the losing company, which was not a public company, by having their public company bail it out. When the SEC started to investigate the case, it found that the financial condition of these three individuals was so serious that if they did not get a bail-out they would have gone into personal bankruptcy because of the tremendous amount of loans they had taken out.

The Commission decided to sue the directors, including the outside directors, on the grounds that they had tolerated an improper disclosure. The shareholders were not told, for example, that the arrangements constituted a bail-out. They were not told that the terms of the deal were terribly unfair to the company and very favorable to the three individuals. They were not told that the individuals were misusing their inside positions. All of the directors who were sued in *Star Broadcasting* are upstanding citizens of the community. One was president of a very fine southern university. But the Commission decided to sue these persons, and the Commission prevailed.[10]

Consent decrees were entered, and one director was even met with double misfortune. Not only was he sued because he was a director who failed to do his job vis à vis the shareholders, but he was also a director of a bank that had dealings both with Star Broadcasting Company and with the private, failing, company. The Commission charged that when that individual voted in favor of the bail-out of the private company, he in effect was preferring the bank, because the bank's credit to the company would be paid off (which it may not have been had this company failed). In short, defendant, as director of the bank and of Star Broadcasting, by his own vote preferred one of his constituent companies over the public company. Perhaps the moral of the story is that a director may find himself in a Catch-22 situation when he sits as a director for banks and for public companies: should the public company have a problem, the director may have a terrible conflict of interest.

In *Star Broadcasting*, the Commission took rather novel remedial action. In addition to requiring certain disgorgement money to be paid back by the individuals involved, the Commission also got orders that prevented certain of these individuals from serving on a board of directors. For example, one defendant was precluded for a five-year period from serving on a board of directors of a public company. And if you ask me where the SEC got the power to obtain such orders, the answer is through the equitable powers of the court.

MATHEWS: Actually, the SEC really does not have the power to make such an order. It made the order by consent. Although the Commission has the power to bar broker-dealers or investment advisers—people who are affiliated

9. SEC v. Star Broadcasting Group, Inc., No. 79-0357 (D.D.C. Feb. 7, 1979).

10. In *Stirling Homex*, Theodore Kheel, one of the top lawyers in New York City, was a director. In *National Telephone*, one director was "Professor of Finance at a major Graduate Business School," *National Telephone*, *supra* note 5 at 88,878 n.4.

with investment companies—from associating with such firms, there is nothing in the statutes that gives the Commission the authority to bar persons from being directors of a public company. This history has never really been told to a jury.

SPORKIN: That is not entirely true.

MATHEWS: There are one or two district court decisions on that issue. There is *Falstaff Brewing*,[11] in which the court said that under the facts of that case, it was improper for the Commission to restructure the board of directors.

SPORKIN: There is also an Arizona case in which the court issued a disqualification prohibiting an individual from serving on a board of directors.[12] Those sanctions went beyond anything the Commission could compel.

LEVINE: There is a recent case in the SEC Reporter in which an individual was prohibited by the court from serving on the board.[13]

SPORKIN: One of the critical cases in the field of director responsibility is *Lanza v. Drexel & Co.*,[14] which involved a company in the business of operating bowling alleys. Lanza owned a small bowling alley, sold it to a larger company, and got stock of the company in return. He was not told that the company was in very serious financial condition. Lanza later brought suit against all involved, including an outside director who represented the investment banker. The court stated that what it believed was the responsibility under rule 10b-5 of a director who did not participate in the transaction: "We conclude that [the director] in his capacity as a director and as a non-participant in the transaction owed no duty to insure that all material, adverse information was conveyed to prospective purchasers of [the corporation's] stock."[15] A director's liability to prospective purchasers under rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others. Because the outside director in *Lanza* owed no duty to purchasers to convey information not disclosed by the company, and because he was not an aider and abettor, conspirator, or substantial participant in the fraud perpetrated on the plaintiffs, the complaint against him was dismissed.

Finally, I would like to make the point that the Commission did not become inactive after bringing these cases. One of the great strengths of the Commission was its ability to have the Enforcement Division uncover an area of unusually wide-spread problems. Then the Commission would use its rule-making power to promulgate rules to correct the problems unearthed by the Enforcement Division. I always found this procedure to represent a government agency acting in the best tradition: not an agency that merely promul-

11. SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,583, at 94,473-74 (D.D.C. Oct. 28, 1978).

12. SEC v. Techni-Culture, Inc., [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,501, at 95,758 (D. Ariz. Apr. 2, 1974).

13. SEC v. Weil, No. 80-6611, slip op. (S.D. Fla. Apr. 10, 1979).

14. 479 F.2d 1277 (2d Cir. 1973).

15. *Id.* at 1309.

gated rules for rules' sake, but an agency that tried to integrate its enforcement and its regulations, focusing precisely upon the kinds of provisions that were truly necessary.

In 1978, certain amendments were made to the proxy rules.[16] There are a number of rules, but let me mention those I consider to be critical. Item 6(e) of the proxy rules requires that a public corporation identify directors who attend fewer than seventy-five percent of the meetings of the board of directors or committees of the board.[17] Thus, in a proxy for electing these directors, the shareholders will be aware that they may have some "absentee" directors, or they can at least know the voting record of these directors. Item 6(f) now requires a company to disclose the reason for a director's resignation or his declaration not to stand for reelection.[18] When there is a disagreement about the registrant's operations policies or practices, the registrant can request that his reasons be stated in the proxy material, and the company must so state. There must be a direct request by the registrant to trigger the company's duty, however. The rule was a compromise: some of us wanted to require disclosure whether the director wanted it or not. The company may have its say, of course. If it feels that the person has distorted the truth or given only his side, it may also give its own position, so the public can obtain a balanced presentation. There also are new requirements that provide for more detailed information relating to financial and business relationships between the director and the issuer, so that the investor will be able to judge any conflicts between the directors and the company.[19]

I believe the most controversial, but probably the most important, provision that the Commission has adopted is the requirement that a majority of the directors of a company sign the 10-K report that must be filed annually under the Exchange Act of 1934.[20] As you know, there is a lot of debate about what the act of signing the report truly signifies. But at least there is a requirement that a majority of the directors sign the report.[21]

That is where we stand. The Commission has issued many releases and has discussed the relevant history of the cases it has brought. There is one other case that should be mentioned, however. In the nonlitigated case of *SEC v. Bernard W. Shiell*,[22] the Commission charged the directors with falsely representing that they were exercising proper control and authority over management, when in fact they had failed to discharge their duties and had placed unwarranted reliance on the defendant officers. The mere issuance of securities signed by the directors was deemed to constitute an implied representation

16. SEC Exchange Act Release No. 15,384, 43 Fed. Reg. 58530 (Dec. 14, 1978) (codified at 17 C.F.R. §§ 240.14a-8, 240.14a-101, 249.308, 249.308a, 274.106).

17. 17 C.F.R. § 240.14a-101 (1982).

18. *Id.*

19. *Id.*

20. 4 FED. SEC. L. REP. (CCH) ¶ 31,102.

21. *See generally* Sommer, *Signing the Form 10K*, CORPORATE DIRECTOR 26 (Sept.-Oct. 1980) (covering responsibility of signing director).

22. SEC Litigation Release No. 7763 (Jan. 31, 1977).

that the directors were properly carrying out their functions. *Shiell* is thus another case to add into our equation. Combining the three releases that I first mentioned (*Penn Central*, *Stirling Homex*, and *National Telephone*), *Falstaff*, *Star Broadcasting*, and the new proxy rules, you have in a nutshell a guide on how to advise a director.

We have not disscussed the duties and liabilities of a director who finds something occurring of which he is suspicious. Suppose we have a director who is doing his job (the cases mentioned above were cases in which the director was content to do nothing). What happens when a director says, "I want to stop it." What is he supposed to do in this situation? I think in that instance a director can resign, and now under Commission rules he can also require the company to disclose why he resigned.

Can a director who believes that the shareholders are not getting adequate information go to the SEC? This is the whistle-blower concept. Suppose the director is wrong. Is he protected? Must he be right in his accusations? These are questions that obviously have not yet been resolved, but I do believe that a director can take such action if he is acting prudently. Perhaps an attorney can resolve this problem if an individual comes to him and says, "I'm going to be a director, and I want to do my job. Can you help me structure something that permits me to fulfill my duties as a director?" In that case the attorney is in the best position: he can arrange a contract with the company that would give the director certain rights. I would advocate exactly that practice, because I am convinced that a good company would be willing to permit a director to do his job properly.

MATHEWS: Would you let each director hire his own counsel at the corporation's expense?

SPORKIN: No. But I do think that a director ought to be able to direct. A person ought to realize what it is he is undertaking as a director, how he should discharge those responsibilities, and how he can avoid the impediments to discharging his responsibilities. I do think that in advising a director an attorney ought to think ahead. In many instances, the company wants the director pretty badly, and if it wants him badly enough it will give him what he needs to protect himself. In these cases, directors get sued and names get tarnished. It seems to me that a director ought to be able to do what he in his good judgment believes he should do: first, trying to get the company to take proper action; then taking action directly. This type of freedom should be accorded any director.

# RECENT DEVELOPMENTS IN SEC ENFORCEMENT

THEODORE A. LEVINE†

LEVINE: I have been asked to give a current assessment of the Commission's enforcement program. I would like to address the outlook for the Commission, its current programs in the enforcement area, and its emerging strategies and future directions. There has been a lot written in the papers and a lot of controversy about where we are going and what the Commission's enforcement program means today. Contrary to what you may read, enforcement at the Commission is not dead; not at the home office in Washington or at the regional offices around the country. Specifically, in the Atlanta Regional Office we have appointed a new regional administrator within the last several months, Mr. Michael Wolensky, who formerly worked not only in the General Counsel's office in Washington, but also in other regional offices. I worked closely with him on a number of cases, and we are very fortunate to have him in the regional office. So both in the home office and in the regional office in Atlanta, you can look forward to strong and vigorous enforcement.

To understand the Commission today, one must understand the climate in which it is forced to operate. In Washington, and I assume in this area of the country as well, the words "refinement," "simplification," "elimination," "undue burden," and "cost benefit analysis" are the catch phrases of the day. The first thing one must focus on in assessing the Commission's enforcement program is that the regulatory climate is clearly one of reform. The antigovernment mood in the country is intense. While I do sense a slight shifting away from that mood because of the current economic climate, the Commission has responded to the antigovernment mood—and responded from a regulatory point of view—in several fashions.

First, the Commission has made a very intensive reexamination of its own rules and regulations. Despite what one may hear, when the agency reexamines its rule structure, it eliminates a lot of excess provisions. That process makes enforcement much more difficult, because after having an array of rules to enforce, it is very hard to rely exclusively on rule 10b-5 and the other antifraud provisions as the primary enforcement tools. We now have an integration of the 1933 and 1934 Acts, which was intended to reduce unnecessary burdens on the capital-raising process. You are all familiar with the small business initiatives, which the Commission has been considering for several years. We just recently reclassified issuers so an issuer need not comply with the reporting process of the 1934 Act unless three million dollars in assets and

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five hundred shareholders are involved.[1] That single change takes a number of companies—perhaps five hundred companies—out of the coverage of the proxy rules, section 16 (which deals with insider short swing profits), the reporting provisions, the Foreign Corrupt Practices Act, and the tender offer provisions. The change puts a tremendous burden not only on the Commission, but also on the states. As a result of these changes, the focus of enforcement has to shift.

A second change in the regulatory scheme is taking place because of the Supreme Court's disfavor of private actions under the securities laws. Beginning with *J.I. Case v. Borak*[2] and continuing to the *Superintendent of Insurance* case[3] in the early 1970s, the Court implied private actions under the federal securities laws, and there emerged an expansive reading of implied rights. There has now been a tremendous cutback, which also has an impact on enforcement, because in the past the Commission relied in part on private actions to supplement its own enforcement actions.[4]

A third regulatory response to the current antigovernment mood is the recognized inability of the states to cover the ground lost at the national level. The tremendous enforcement programs in the states that police securities transactions simply do not have the capacity or jurisdiction to cover multistate fraud and other schemes that are occurring throughout the country. Thus, tremendous stress is put on the Commission's enforcement program. This means that the Commission stands alone, relying on the antifraud provisions, although such provisions have themselves been cut back by *Aaron*[5] and other cases I will mention later.

Given this environment, where is the SEC going today? I have tried to identify five areas of focus. One is the "failing company syndrome." We have major problems in this country today. I am sure all of you are aware of it, as you look at the newspaper and see major industrial companies failing. Financial institutions are failing, and even those that are not failing have depressed business and earnings. Historically, that environment has spawned many problems in terms of disclosure, financial statement presentations, and even self-dealing. The stress of depressed earnings of failing companies has forced a number of companies to misrepresent their financial condition on their financial statements and through substantive disclosures. That is one crucial problem we are facing at the Commission today.

SPORKIN: How would you deal with that problem? One of the key problems is that if the Commission starts putting pressure on a company, it

1. Securities Exchange Act Release No. 34-18647 (April 15, 1982).

2. 377 U.S. 426 (1964).

3. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

4. The Supreme Court did recently imply a private right of action in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825, 1837-48 (1982). Although the decision interpreted the Commodities Futures Trading Act of 1974, 7 U.S.C. § 2 (Supp. IV 1980), the rules in the securities area are similar. Herman & MacLean v. Huddleston, 51 U.S.L.W. 4099 (U.S. Jan. 24, 1983) (No. 81-680).

5. Aaron v. SEC, 446 U.S. 680 (1980).

brings about the very results that the company struggled to avoid. For example, in the case of Braniff, after the problem was disclosed, what was the effect? If a company is marked too soon for disclosure, the shareholders are protected, but the company then exacerbates the problem. Have I misstated the problem, or is that a fair assessment?

LEVINE: You sound as if you work for one of the bank regulatory agencies. That is precisely the conflict between the depositors and the shareholders of financial institutions. It certainly is a problem. But there are ways to deal with the problem—first, to ensure disclosure, and second, to put the company (if it is a company) back on track. The problem is to balance between that second need and the need to get sufficient information into the marketplace, either to let the public know it cannot rely on past disclosures, or to prohibit trading in a manner that permits some individuals to trade on information that is not publicly available. The SEC will try to take early action and set up an early warning system. We do not want the information after the fact; we want it at a time that allows us to avoid sudden impact. The whole disclosure process dictates and envisions timely disclosure of positive as well as adverse information. The marketplace depends on that information. One has to consider not only how the disclosure is made, but also how the impact of the disclosure is to be absorbed.

SPORKIN: What is the incentive to attorneys who represent a failing public company to do what you are suggesting? Do you have any prod, any threat, such as, "If you don't do it, we are going to investigate"?

LEVINE: There is no prod. I think the Commission in the past, and currently, encourages the volunteer approach. One benefit is that if a company comes forward and discloses the problem, it may obtain the benefit of no-action. On the other hand, when the company has not made disclosure and problems are found later, it will probably feel the bite of an enforcement action. Chairman Shad has advocated a voluntary process, operative even within a company. Although bad publicity is a risk in early disclosure, the great benefit is in avoiding an enforcement action for fraud when accusations of failure to disclose or falsification of information are made. One could probably lessen the harm of disclosure in some respects by making a partial disclosure initially and starting a process whereby the full disclosure will ultimately be made. In the meantime, it is necessary to disclose enough so the marketplace can be alerted to the problem, rather than having the news first come out with the filing of a complaint.

SPORKIN: That is an important point—that you can use the words you want to use in making the disclosure rather than having the SEC enforcement staff do it for you later, in their words.

LEVINE: To return to my previous point, the failing company is probably the biggest problem we face today. The second problem arises from the takeover and merger game, and proxy contests. It is not a new problem, but it is constantly changing its character. Every time we seem to make headway in an enforcement case or in a regulatory scheme, the ingenuity of the bar and in-

dustry develops new sidestepping devices. Key problems include: (1) the "crown jewel" problem—selling off a company's best asset in order to avoid takeovers, (2) the "golden parachute" technique—extraordinary compensation given to executives for the purpose of making it less attractive to take over a company, and (3) the two-tier offer, which injects inherent unfairness in some of the ways deals have been structured in order to engage in a successful hostile bid, or to defend in certain instances. All of these problems have a profound impact, not only from a disclosure perspective, but also from the point of view of the tender offer. We have also been actively involved in many of the proxy contests that have been waged recently.

SPORKIN: When you say you are "active" in proxy contests, what precisely is the Commission's role?

LEVINE: When I say "active," I mean that the SEC conducts a number of investigations involving both sides of the contest. Obviously we are careful. We do not want to be used by one side or the other, because an SEC action has a great impact on the success or failure of a particular contest. But we are involved in analyzing enforcement and the regulatory impact of activity in proxy contests. We have had several cases recently, including *SEC v. Grumman Corporation*,[6] which involved the disclosure of tactics in connection with the defense of a tender offer in which LTV was trying to take over Grumman.

There is also the *Paine Webber* case,[7] a current administrative proceeding, in which we alleged that Paine Webber made a tender offer on behalf of a client. This is really the first litigated test of the definition of a tender offer under the securities laws after the *Becton Dickinson* case.[8]

We just went to court in a 13D[9] case, with the focus of the litigation on the definition of a "group" under the beneficial ownership provision. The case, *SEC v. Severyn Ashkenazy*,[10] involved the acquisition of bank holding company stock by individuals we allege to be a "group." The individuals disclosed neither that they were a group nor the consequences of their trying to take over the target company. This is the direction of our enforcement effort, even though it is not a problem for which we have allocated many of our resources.

The third problem area concerns new products in the securities markets. We are seeing an explosion of new products, and we are trying not only to

6. [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,340 (E.D.N.Y. Nov. 9, 1981).

7. Paine, Webber, Jackson & Curtis, Inc., 15 SEC. REG. & L. REP. (BNA) 131 (Dec. 30, 1982) (purchase by broker-dealer acting as agent of 9.9% of company's outstanding common stock ruled to be unconventional tender offer; no sanctions imposed). On December 30, 1982, Judge Markun issued an initial decision finding that Paine, Webber willfully aided and abetted violations of section 14(d) of the Securities Exchange Act of 1934 by another person in connection with a tender offer for the securities of Diamond International Corporation.

8. Wellman v. Dickinson, 497 F. Supp. 824 (S.D.N.Y. 1980).

9. 15 U.S.C. § 78m(d) (1976 & Supp. IV 1980).

10. C.A. No. 82-1799 (C.D. Cal. Apr. 13, 1982). The case was subsequently settled Aug. 5, 1982.

keep abreast of recent developments, but also to understand where the problems exist in those markets.

The fourth area is the changing ownership of financial intermediaries, including Sears-Dean Witter and Shearson-American Express. The face of the securities industry is changing. One enforcement problem arising from that development is a new focus for us—the problem of banks being in the securities business and brokers being in the banking business. These problems are consuming much of our time. We are currently investigating the *Drysdale*[11] crisis, as well as many other problems that arise from the way the financial institutions run their business. Several financial institutions are no longer merely boutiques—they are now department stores in more ways than one.

SPORKIN: You seem to be saying that the private sector, through its ingenuity and inventiveness, has come like a tidal wave and is engulfing all regulation, and that there is no way the SEC can pause and take inventory. It seems to me that because the financial markets system is changing so dramatically, regulation is truly far behind. There is simply no commensurate regulatory effort to deal with this tidal wave.

LEVINE: I think that is a fair statement of the problem, but the real concern is that politics are dictating the regulatory response. That is an unfortunate result, because what is really needed is a joining of efforts of the best brains, inside and outside of government, to devise a regulatory structure that makes sense in today's environment. That sounds rather reactionary, but it will never occur because the whole system is tied up in politics.

SPORKIN: As things are now, the government may pass a regulation like Regulation Q, which fixed the amount of interest a bank could pay on small investments,[12] but then some inventive people come upon the scene and establish a multibillion dollar industry with money market funds. The money markets attract small investors who cannot get a high interest rate from the bank. Finally, they bring all their money together and purchase big instruments that are not controlled by Regulation Q. Thus, there is created a multibillion dollar industry overnight, and the effect of Regulation Q is avoided. Yet we still have Regulation Q on the books. If Regulation Q really serves no function, then the regulators should have come forth and repealed it.

For instance, I was talking with one of my Canadian friends, a gentleman on the Ontario Securities Commission. I said to him foolishly, "Tell me Commissioner, are you having a big problem with money market funds in Canada?" He said, "What money market funds? We don't have any." I asked, "What do you mean you don't have any money markets? You are behind the

11. *Recent Developments in the U.S. Government Securities Markets Arising From Default of Drysdale Government Securities, Inc., Committee on Banking, Housing and Urban Affairs Subcommittee on Securities*, 97th Cong., 2d Sess. (1982) (statement of Donald N. Malawsky, Regional Administrator, SEC); 17 C.F.R. § 203.2 (1979).

12. Regulation Q, 12 C.F.R. § 217 (1981).

times up there." He replied, "No, we are ahead of the times. We don't have any regulation that limits the interest banks can pay on deposits."

As another example, we have, the Glass-Steagall Act,[13] which seems to say that there is a separation of banking and securities. But look at what the banks are doing today. First, the brokerage industry is setting up its own banks—for example, Merrill Lynch, with its cash management account, sets up its own bank. Then the banks begin to retaliate by buying brokerage firms. Nobody at the SEC seems willing to say that Glass-Steagall is or is not correct. The regulators are simply sitting back; perhaps the regulation is wrong, but at least it should be dealt with directly.

MATHEWS: Let me bring the discussion back to the current state of the financial markets. One of the things to be aware of as you watch the development of the SEC enforcement program in the 1980s is that for the first time in twenty years the SEC has a majority of commissioners that are relatively new and not very experienced with the Commission. Throughout the 1960s there were career staff personnel, such as Chairman of the Commission Manuel F. Cohen and Barney Woodside. Then Irv Pollack was commissioner throughout the 1970s. Phil Loomis, another career staffer, has been on the Commission for eleven years, and is just retiring this month. I believe that one of the problems in trying to anticipate the direction and scope of the SEC enforcement program is that the commissioners are inexperienced. I imagine that this in and of itself is a problem for the enforcement staff, because the staff is forced to spend a lot of its time educating the Commission as to what they are recommending and why they are recommending it.

LEVINE: It is a problem of experience because this is not a subject one can pick up in a three-hour session. It takes a while to master these principles, especially when the problems come in a flood.

I would like to focus on a fifth global enforcement problem—the problem of foreign institutions. We have historically had problems with fraudulent and manipulative activity outside the United States through foreign institutions. There is an inability to identify people who are engaged in these various schemes, because the transactions are hidden through Lichtenstein trusts, Swiss banks, operations in the Cayman Islands or the Bahamas, or by German blocking laws. It is a serious problem today, especially when the Commission attempts to investigate insider trading. But we have made tremendous progress in this area and have, I believe, a possibility of a real break-through, at least with the Swiss. Moreover, at the Inter-American Conference[14] we had a discussion with many foreign countries, and there was a recognition of the internationalization of the securities markets. The economic climate is such that we might make some advances with foreign countries.

These are some of the problems we face currently. I think there is strong motivation at the Commission. The Commission believes that it ought

13. Banking Act of 1933, 12 U.S.C. § 78 (1976).

14. Conference of Inter-American Securities Commissions and Similiar Organizations, Washington, D.C., May 24-28, 1982.

to have an enforcement program; the question then becomes how to implement such a program. I would like to discuss some of the current strategies, many of which date from previous years. We are adjusting some of these strategies to meet the exigencies of today's economic and political climate.

The first goal is to act quickly in the appropriate cases. Speed is important today, not only in cases concerning insider trading and takeovers, but in every enforcement case because of the courts' view of our injunctive authority. The injunctive authority is the primary civil weapon when the SEC brings an action: we bring a civil injunctive action to enjoin the conduct at issue. Changing judicial attitudes about the injunction have forced us to move quickly. We also try to use the preliminary injunction or the temporary restraining order as a device to get relief quickly. We cannot use it in all cases; for instance, it is not available in a complicated fraud or a financial reporting case involving accountants and other professionals. You simply cannot move in all cases rapidly enough for the courts to be receptive to requests for preliminary relief.

On the other hand, such action is very effective from the SEC's point of view in some cases, and we have used it frequently in the last six or eight months. We had used it previously, but we are using it more and more now. It puts a lot of strain on us (we often have had people working throughout the entire weekend in order to prepare the necessary papers to obtain such relief), but it gives us a first shot at the court. If we get our case to court, we may be able to use our investigatory efforts to our advantage because we already will have an investigatory record. Normally this procedure cuts the time it takes for discovery, and we impress upon the court the need for immediate relief. Nevertheless, it must be pointed out that even in the courts in which we normally bring suit—the District of Columbia, the Southern District of New York, or the courts in California—we cannot attempt to get this kind of relief in a very complicated case; the court simply cannot comprehend it. Therefore, when we try to obtain the preliminary injunction or temporary restraining order, we try to simplify the case. Partially for that reason, we are cutting the average length of our investigations. That does not mean that we do not have long investigations when they are appropriate, but we do try to cut the length of time in getting to court.

In addition, we try to use some other tools to expedite investigations and cut back the lawyer's game of delay and frustration. We do this in several ways. If the matter involves a subpoena enforcement action with a bank, one of the tactics is to use the Right to Financial Privacy Act (RFPA).[15] Whenever we can, we have been using section 21(h) of the Securities Exchange Act of 1934, which is an exemption we obtained from the RFPA,[16] and which permits us to go ex parte to a court to get access to bank records without giving the prior notice required by the RFPA. We have used that technique in several cases as a means of avoiding the delay caused by having to give notice and

15. Right to Financial Privacy Act of 1978, 12 U.S.C. §§ 3401-3422 (1979).
16. 15 U.S.C. § 78u(h) (Supp. IV 1980).

waiting fourteen days before obtaining bank records. Of course, a challenge will cause additional delay. In addition, we use subpoena enforcement actions when people refuse to give us documents or delay giving documents. We intend to resist those attorneys who are trying to frustrate us and hope they realize that they will not be able to delay investigation for three years and then obtain another three years via a permanent injunction proceeding. I think the bar has responded to this pressure. Also, we have set limitations on the time during which we permit someone to make a submission, another point of delay. Finally, we are moving the cases quickly. These procedures are not always successful, but I do think we are having some success.

MATHEWS: Still, the SEC usually takes two or three years investigating before it institutes action.

LEVINE: Another current problem is exemplified by the *DeVeau* case.[17] In *DeVeau* we alleged that an individual was misappropriating millions of dollars of a public company. We went to court and got a TRO and a freeze order after working through Memorial Day weekend. I am sure you are also aware of the *Lewellyn* case,[18] in which an Iowa broker-dealer determined that he could buy most of the stock of Safeguard Scientific, and also determined that he did not have to pay for it. We used the TRO/preliminary injunction approach in that case, although ultimately we also obtained a permanent injunction and other relief.

To shift focus a bit, I would like to mention that the area of insider trading is another field in which we are trying to move quickly. I am sure most of you are familiar with the case involving certain unknown purchasers of Santa Fe International options and common stock in connection with an acquisition by the Kuwaiti government.[19] In this case the Commission sued unknown purchasers because it knew that certain people bought through Swiss banks just prior to the public announcement. They bought out-of-the-money options just prior to the expiration date.[20] Using the TRO device, we froze six million dollars and got a preliminary injunction. Now we are attempting to obtain a permanent injunction. In another case, involving an attempt by Seagram to acquire St. Joe Minerals,[21] buying took place, just before the announcement of the tender offer, of out-of-the-money options of St. Joe common stock. Once again, we sought and obtained a TRO against unknown purchasers.

SPORKIN: In those cases, are the unknown purchasers disclosing themselves and fighting for the money, or are they simply walking away and choosing not to defend?

17. SEC v. Deveau, No. SA82 CA 411 (W.D. Tex. May 31, 1982).

18. SEC v. Lewellyn, No. 82-2102 (S.D.N.Y. Apr. 2, 1982); settled April 12, 1982.

19. SEC v. Certain Unknown Purchasers of the Common Stock of, and Call Options for the Common Stock of, Santa Fe International Corp., No. 81-6553 (S.D.N.Y. Oct 26, 1981).

20. A call option is an out-of-the-money option when its striking price is above the market price of the underlying security. A put option is out-of-the-money when its striking price is below the market price of the underlying security.

21. On March 11, 1981, Joseph E. Seagram & Sons, Inc., made a tender offer for all the outstanding shares of St. Joe Minerals Corporation. Wall St. J., Mar. 12, 1981, § 1, at 3, col. 1.

LEVINE: There are a number of people who have approached us anonymously to try to resolve the case.

SPORKIN: Then the banks litigate for them?

LEVINE: No, not if the unknown purchasers approach us and say, "We don't want to tell you who we are; however, we did nothing wrong."

SPORKIN: How will the court let unknown purchasers make any assertions at all if they do not come forward and identify themselves?

LEVINE: They have approached us with several ingenious schemes, none of which we have accepted yet. They have said, for example, "We can demonstrate that we have not done anything wrong. We will submit to an investigation, and if you agree after your investigation that we did not do anything wrong, then you must drop the case. But do not put our names in the public domain. If you think we did do something wrong after the investigation, then you are free to proceed with the litigation." We have not accepted such a proposal yet.

## PANEL DISCUSSION

HAZEN: When shareholders approve directors' actions with approval resolutions after the action has been taken, what effect does the resolution have on shielding directors from liability?

SPORKIN: It seems to me that any court would examine the amount of information available to the shareholders, and if the shareholders were not given enough information to make an informed judgment, then I doubt such a resolution would stand. It is just that simple. Indeed, some courts may take the position that such a vote was an element of fraud. The argument would be that by obtaining this resolution, the directors lulled the shareholders into believing that they had no cause of action, since the directors did not give them any relevant information. Directors simply cannot get a blank check to cleanse fraudulent conduct.

HAZEN: Here is a question for Mr. Levine: What are the criteria by which the Commission determines whether open market purchases constitute a tender offer?

LEVINE: First, one should consider *Wellman v. Dickinson*,[1] in which the Commission identified eight factors, some or all of which are indicative of a tender offer. A second consideration is the Commission's proposed rule defining a tender offer.[2] The rule was first proposed in 1979, and the Commission has not yet adopted it. Not only in the accompanying release, but also in the proposed rule itself, the Commission basically followed a dual approach. One facet concerned the number of shareholders who were solicited. The second facet, which is the approach the Commission used in *Dickinson*, incorporated some unconventional factors, such as the amount of the premium being offered and the presence, or absence, of negotiation. A third consideration can be found in the regulatory scheme proposed to Congress by the Commission in 1980. The proposal was in the form of a letter written by Chairman Williams to Senator Proxmire and former Senator Harrison Williams, and suggested an approach to the definition of tender offer.[3] Finally, there is the issue of the administrative proceeding in *Paine Webber*.[4]

In analyzing the concept of a tender offer, it is best to focus upon the particular conduct involved to determine whether it is a type of transaction for which Congress contemplated that everyone should be treated fairly. The approach then would be one in which the substantive protections of the Williams Act would play a role. I would distinguish an open market purchase, which is

1. 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982).

2. Proposed Amendments to Tender Offer Rules, Securities Act Release No. 6189, Exchange Act Release No. 16,385, Investment Company Act Release No. 10,959 [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374 (Nov. 29, 1979).

3. Letter from SEC Chairman Harold M. Williams to the Honorable William Proxmire (Feb. 15, 1980) (expressing concern with respect to various subjects relating to tender offers, beneficial ownership reporting, and issuer repurchases).

4. Paine, Webber, Jackson & Curtis, Inc., 15 SEC. REG. & L. REP. (BNA) 131 (Dec. 30, 1982).

an ordinary purchase with no premium, no solicitation, and no negotiation of price, from the kind of transaction the Commission found in *Dickinson* or the kind of transaction it alleged in *Paine Webber*. *Paine Webber* involved the solicitation of a number of arbitrageurs and broker-dealers for the sale of up to nine percent of the common stock of a company at a premium. This is the same type of activity that occurred in the *Dickinson* case: no negotiation, and a very quick decision to be made.

Another question I have concerns the criteria the Commission uses to determine the adequacy of statement-of-purpose disclosures in the 13D. For example, does the Commission believe a 13D target is entitled to more than an unqualified representation that target should consider the acquirer more than a passive investor? We have brought a number of cases on this issue over the last seven or eight years. Historically, this has been one of our main problems regarding disclosure. Unfortunately, the bar has become a bit more sophisticated in drafting responses to the "purpose" section. Disclosures used to state that stock was taken "for investment purposes." Such a response meant an easy case, because we at the SEC were usually able to find some evidence contrary to that assertion. Today, one page of boilerplate frequently appears: "We are taking for investment. However, we may seek control or we may not. We may go private. We may take over the whole company." Then the whole range of imaginable possibilities is listed. As a consequence, we at the SEC are still forced to deal with a boilerplate approach that does not disclose the true purpose of the acquisition. We generally focus on the facts, which make or break a case. We probe to find out what happened.

We are still investigating one case in which the 13D simply stated, "We are taking for investment." The SEC discovered there was an executive committee report which stated, in effect, that over the next two years, the buyers would try to get control. The 13D was obviously no disclosure at all in view of that kind of evidence. The committee was clearly intent upon something altogether different. If I were advising the defendant, I would say, "Alert your board in advance not to write those memos and not to make conclusions about future events." But from the point of view of the prosecutor, we look for the type of evidence that suggests the representation in the 13D is not accurate, and on occasion we find such evidence.

HAZEN: Do directors who sign a 10K form have any greater potential liability than directors who do not sign a 10K form?[5]

SPORKIN: I think that is the conclusion of Mr. Sommer's article.[6] Obviously, a director who now signs a signature page without having seen the final filing is taking a risk. If one does not sign the 10K, it seems to me that he should have good reasons and an explanation for what he was doing at the time and place.

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5. 17 C.F.R. § 249.310 (1982).

6. Sommer, *Signing the Form 10-K*, THE CORPORATE DIRECTOR 26 (Sept.-Oct. 1980).

ROEMER: Mr. Sporkin, in the director's contract you envision,[7] would you want a clause to the effect that the director you represent need not be one of the signing directors on the 10K?

SPORKIN: No, I would not. It seems to me that a prosecutor would ask of a director who did not sign the 10K, "What did you know about the business?" I think signing the 10K would create an advantage in the litigation. There is no question about the individual who signed it; you assume that he knows what he signed and you assume that he has done a certain amount of work. But I still think a director has the duty of investigation if he wants to rely on a good faith defense based on his judgment. I do not think he can play the role of the ostrich. Unless for some unforeseen reason he was not present at the time and could not see the paper, I just do not believe a director could avoid responsibility by not signing the 10K.

Pursuing this issue further, suppose someone presents the 10K to a director. He knows something is wrong in the 10K, and he refuses to sign it. Can he just sit idly by and do nothing further?

LEVINE: As a practical matter, normally a plaintiff's lawyer will sue the board of directors, and will not single out those signing and those not signing. I agree that it does not make much sense to sue the entire board when only certain individuals are responsible, but the alternative would require a board on which each director has his own niche of responsibility, and that would defeat the whole concept of corporate governance. I think that in terms of responsibility for affirmative statements and disclosure problems, the courts can assume that a director has an official awareness of what is going on, even if he does not sign. The court will probably impose liability on all directors. Certainly if the director does sign, he is going to have problems ignoring that fact.

Mr. Sporkin, should the outside counsel of a publicly held corporation be ultimately responsible to management or to the directors?

SPORKIN: When you say "outside counsel" I do not know exactly what you mean. It seems to me very clear that, ideally, outside counsel is at the mercy of the corporation. Yes, there ought to be a legal committee of the board of directors; if you do not have a legal committee of the board of directors, then you ought to rely on the audit committee. One of those committees should engage the outside counsel, who then should report to that body. This procedure avoids the multiple defendant problem. In other words, it ought to be clear from the beginning that outside counsel represents only the corporation and not the person in the corporation who hired him as counsel to the company. Ideally, responsibility ought to lie with the legal committee of the board of directors, a legal committee composed of independent directors.

ROEMER: But in the real world, don't you agree that outside counsel is hired by whoever runs the company?

7. *See* Sporkin, *SEC Enforcement and the Corporate Board Room*, 61 N.C.L. REV. 455, 462 (1983).

SPORKIN: In the sense that the inside general counsel should be the party to retain outside general counsel, I think the inside general counsel certainly ought to play a role, but I would still prefer that a legal committee make that determination. Perhaps the inside counsel should be permitted to recommend someone. You have to realize that major corporations use counsel frequently in a host of different situations, and I do not see any difficulty, for example, in allowing inside counsel to select outside counsel when the company needs tax counsel for a tax problem. But when counsel is needed as a general legal advisor for the corporation, I think a legal committee should engage the outside counsel just as the audit committee engages the outside auditor.

ROEMER: I would agree with you in the matter of hiring special outside counsel for a problem such as an investigation, but I think you are presuming that most large corporations still have today only one major primary outside counsel. I do not think that is always the case. I think inside general counsel should hire the outside general counsel with rare exceptions.

SPORKIN: I am not trying to deemphasize the role of inside general counsel. One of the problems involved is that a lawyer must have access to the corporation, so it is important to eliminate the number of impediments to that access. It seems to me that his access must be as deep in the corporation as is possible. I am not talking about the specific tax problem, but, for example, the problem that arises when outside counsel learns that the chairman of the board has done something against the interest of the corporation. In such a situation, I do not think outside counsel will be able to deal effectively with inside counsel. He will be forced to go to the board of directors and explain what the problem is. I think he will have difficulty being protected if he does not do so.

ROEMER: I respectfully disagree. I think he can go to inside counsel, and inside counsel can and should go to the board, particularly if the inside counsel is also a director.

SPORKIN: There is a problem with having counsel as a director of a company. In my view, such a practice should be forbidden, for the very simple reason that the lawyer in effect would be representing himself. There are cases that support me on this point. In other words, there is a real possibility of the company losing its attorney-client privilege when it brings its counsel on the board of directors. It will be very difficult for corporate counsel to say that he learned the information in his role as a lawyer, not in his role as a director. I do think counsel should be present at board meetings and take part, but I do not think he should be a voting member.

A connected problem is how counsel can give effective, independent advice when the board is sued if he is personally involved. He now is a defendant, and it seems to me that a corporation is entitled to have the objective and unbiased view of its counsel, for example, in deciding whether to settle or whether to litigate. For those reasons, I would not have a lawyer as a director.

ROEMER: I have been in the position of a general inside counsel who has been sued, and while it is a very uncomfortable position, it is something that

can be managed. I have also had occasion to step out of the board room to leave the other directors alone with outside counsel who was brought in to represent the company in a case or other directors in other cases.

SPORKIN: What is the advantage of being on the board as opposed to simply being present at board meetings?

ROEMER: I think there is a very large advantage in terms of the extent to which your voice is heard and heeded. If you are just invited to be present occasionally, you can also be asked to be excused. You cannot ask a director to be excused.

AUDIENCE: The original question related to the role of outside general counsel. Mr. Roemer brought in the situation involving an inside general counsel. Most of us in rural North Carolina do deal with some publicly held corporations, but many of them do not have inside general counsel. Ideally, as outside counsel, I would prefer to report to a committee of the board, but the reality is that the president of the corporation hires and fires you.

SPORKIN: What happens if you disagree with the president, or if you believe that the proposed action is inconsistent with corporate responsiblity? It seems to me that the Commission has answered that question in *William R. Carter* when it said that a lawyer has a duty to disclose all material facts to the board of directors since it is the embodiment of the corporation.[8] For instance, counsel must go to the director and tell him that there is a problem and what ought to be done about it. Normally, there is no problem if the chief executive officer wants to comply.

AUDIENCE: Do you then go to the president when the director refuses to follow your advice?

SPORKIN: The point I am making is that if the president refuses to comply, counsel's alternative is to go to the board of directors. I am not sure whether he could simply resign instead of going to the board of directors.

MATHEWS: The crucial fact, however, is that if you go to the board, and if the CEO is a successful leader, you may have won the battle, but you will probably be out of a job as general counsel.

SPORKIN: Let's face the fact that one of the problems in the practice of law is the need for independence. I think that a practicing lawyer must be independent. He must be able to come in every day and know that he is prepared to sacrifice his job for a particular matter. Otherwise, he is not going to be very effective.

8. William R. Carter, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, at 82,181-183 (Mar. 7, 1979).

# RECENT DEVELOPMENTS IN BLUE SKY LAW

F. DANIEL BELL, III†

BELL: When I was originally asked to speak here today, I was told that perhaps the topic of greatest concern would be enforcement on the state level. Although my office does not have a newsletter or a formal facility for communicating with securities lawyers, the brokerage community, and the investing public in the State of North Carolina, I would like to give you an oral newsletter letting you know exactly what we do in Raleigh and in which direction we are heading. I have found that many attorneys in North Carolina are somewhat perplexed and surprised at what we actually accomplish.

In order to provide a picture of the present work load of the Securities Division, I have compiled the following figures. The Division has 375 licensed securities dealers, an increase of 50 over the 325 dealers licensed one year ago,[1] approximately ninety-two percent of which are based outside the state. The Division has also experienced a tremendous growth in licensed securities salesmen. There are presently 7,727 outstanding licenses on securities salesmen as compared with 6,650 at this time last year. This increase of approximately 1000 securities salesmen is further evidence that the Securities Division is in the midst of a boom in securities related filings. We are in the era of multistate dealers and multistate salesmen, and more and more often North Carolina is included in the list of states in which a dealer and its salesmen seek a license.

The Division received a total of 1,528 original and additional[2] securities registrations for the fiscal year 1980-81, which represented 10.3 billion dollars worth of securities available for sale in this state. This was an astronomical increase over the prior fiscal year in which the Division had 1,219 original and additional registrations representing 5.2 billion dollars worth of securities. Thus far in the present fiscal year (the first ten months) there have been 1,272 original and additional registrations totalling 7.7 billion dollars worth of securities. I suspect the Division will at least equal and perhaps surpass last year's level. This dramatic growth has been experienced for over five years. Each of the last five years has evidenced an average increase of twenty-three percent in securities registrations over the immediately preceeding year.

Regarding exemptions from registration of securities, fiscal year 1980-81 provided a forty-one percent increase in notice filings and no-action requests

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1. This figure and subsequent figures contained in this discussion were obtained and compiled from the records and files of the Securities Division of the Department of the Secretary of State of North Carolina.

2. Additional registrations occur when an issuer has sold the amount of securities originally registered and seeks clearance to sell an additional amount. Additional registrations are typical for mutual funds.

for exemptions, primarily private placements. This increase resulted in a total of 772 such requests and notices. This year I expect an additional thirty-five to forty percent increase that will cause the total to exceed one thousand.

Unfortunately, budget appropriations and personnel have not increased proportionately with the rapid increase in work load. Therefore, the backlog of filings is increasing alarmingly. From the instant a registration statement is received, a minimum of four weeks elapses before it is examined, and in some cases five to six weeks elapse. A three-week backlog exists for requests for exemptions, no-action positions, interpretative opinions, or information. Similarly, for dealer and salesmen applications there exists a two to three week processing delay. Because the delay in our response time appears to be increasing, all filings should be submitted as early as possible.

This growth certainly is expected to continue with the advent of Regulation D. The Securities and Exchange Commission, with substantial input from the North American Securities Administrators Association, Inc., promulgated the rules comprising Regulation D, which regulates private placements and limited offerings. The purpose of Regulation D is twofold: First, to shift the regulatory responsibility to the state or local level, and second, to facilitate the capital raising process of small issuers in a depressed marketplace. Industry or practitioners rarely acknowledge the former purpose, but frequently cite the latter. Both are important, and certainly the former will not be overlooked.

Regulation D was adopted on March 3, 1982, and became effective on April 15, 1982. The states, including North Carolina, were afforded very little time to respond. As an emergency measure my office executed an interim order specifically addressing rule 506 of Regulation D.[3] This interim order, which is reproduced in full in the Blue Sky Reporter,[4] will remain in effect until the Division has had an opportunity to address Regulation D fully and promulgate state regulation in response. The purpose of the interim order is to facilitate the filing and processing of rule 506 offerings and to provide a degree of preventive protection for investors.

LEVINE: In terms of Regulation D, are you requiring anything more than the Commission does at this point?

BELL: To some degree, yes. I hesitate to be specific because many issues are presently unresolved and I do not intend to suggest that I am committed to a certain position on these issues. Nevertheless, I will be glad to discuss the interim order.

The order, as a further condition on the availability of the exemption, contains certain disqualifications that may preclude the issuer from claiming the exemption. The disqualifications, frequently termed "state bad boy" provisions, include instances in which the issuer, including executive officers, directors, or general partners of the issuer, is subject in any state to an effective

3. 17 C.F.R. § 230.506 (1982).

4. 18 N.C. ADMIN. CODE 6.1204 (1982), *reprinted in* 2 BLUE SKY L. REP. (CCH) ¶ 43,402.

stop order precluding the offer and sale of its securities, has been convicted of a felony or misdemeanor in connection with the purchase or sale of any security, or is subject to any state administrative order or judgment entered by the state securities administrator including findings of fraud or deceit or a denial or revocation of exemption. A disqualified issuer has available to it registration by qualification, which allows close scrutiny by the Division.

LEVINE: Do you have some vehicle for relief from the disqualification, or is there some time period after which the disqualification expires?

BELL: Yes, typically the time period is five years. Also, upon a showing of justifiable circumstances relating to hardship, for instance, the administrator in his discretion may waive the disqualification.

Another substantive requirement imposed by the interim order on rule 506 offerings involves investor suitability. Regulation D and the interim order impose due diligence requirements upon the issuer in ascertaining the suitability of nonaccredited investors. The interim order, unlike Regulation D, extends these requirements to accredited investors who are accredited by virtue of their net worth, income, or amount of investment. I have not been convinced that these particular individuals, merely by virtue of their having substantial sums of money, are able to reasonably protect themselves in investments. The issuer must represent to the Securities Division in claiming the exemption that the issuer reasonably believes, immediately prior to making any sale to a nonaccredited investor or to an accredited investor who is accredited solely by reason of his net worth, income, or amount of investment, that such investor either alone or with his purchaser-representative has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, and that the investment is suitable for such person based upon the facts disclosed by such person about his other security holdings and about his financial situation and needs.

The filing required to claim affirmatively the exemption provided at G.S. 78A-17(9)(b) for rule 506 offerings must be filed ten business days prior to the first sale or execution of the first subscription agreement and must include an affidavit of the issuer containing certain prescribed information and representations, a consent to service of process naming the Secretary of State as service agent, and a representation that a copy of Form D will be filed concurrently with the filing of that form with the SEC.

LEVINE: What does your focus on rule 506 do to the other aspects of Regulation D? Can you use the old rule 242[5] or rule 240[6]? Do you recognize those on a state level?

BELL: North Carolina has two private placement or limited offering exemptions. In addition to G.S. 78A-17(9)(b), which deals with rule 506, G.S. 78A-17(9)(a) provides an exemption for offers to no more than twenty-five

5. 17 C.F.R. § 230.242 (1981).
6. 17 C.F.R. § 230.240 (1981).

persons, other than institutional investors exempt under G.S. 78A-17(8), during any period of twelve consecutive months so long as the seller reasonably believes all buyers are purchasing for investment and without a view towards resale. Rule 504 and 505 offerings, which supersede offerings under old rules 240 and 242, must rely upon the twenty-five offeree exemption found at G.S. 78A-17(9)(a) and the conditions already in place in the regulations prior to Regulation D. These conditions are presently being studied to identify appropriate revisions.

LEVINE: Does that mean that if an issuer wanted to use rule 505 of Regulation D, the issue must be to under twenty-five offerees for investment purposes? You do not recognize the section 3(b) exemption under current statutes?

BELL: Such an offering would have to rely upon the twenty-five offeree exemption, but this exemption may be coupled with G.S. 78A-17(8), which provides for offers and sales to "institutional" investors. But the institutional investor exemption does not directly parallel the Regulation D concept of accredited investors. In other words, some accredited investors may be included in the twenty-five offeree "head count" whereas others may not.

I would like to shift the focus of our discussion from Regulation D to the subject of enforcement. Although our needs are critical, the recent addition of a full time attorney to handle enforcement matters increased our capacity in the area of enforcement. During the five-month period from January 1, 1982 through May 31, 1982, the Division opened twenty-five investor complaint filesand closed twelve. We also opened forty-two investigations and closed twenty investigation files. An investigation file is distinguishable from a complaint file in that it originates from the discovery by the Securities Division of potential violations, primarily through the examination of filings, newsletters from other states or federal agencies, and newspaper articles and advertisements. I should point out, however, that our active enforcement files total substantially in excess of the thirty-five just mentioned due to a substantial carryover from 1981. There is a great need for additional state enforcement in the North Carolina security markets. The Division is attempting to do the best possible job under the existing constraints.

An overview of our enforcement results along with some examples might be of interest to you. During the past five months there have been several scheduled administrative hearings, but all were cancelled due to settlement by consent order. Through consent orders, or in some instances the failure of the respondent to request a hearing, the Securities Division has suspended four salesmen, revoked the licenses of two salesmen, revoked one dealer license, imposed an administrative injunction, suspended one security registration, denied two exemption requests, and exacted numerous rescission offers.

These figures do not provide a vivid picture without the aid of illustration through actual cases. A representative cross section points out the potential pitfalls of which you should be aware.

On February 18, 1982, my office issued a notice of intention to revoke the

dealer registration of Buchannan and Co., Inc., a dealer based in Jackson, Mississippi. This action was taken as a result of that firm's failure to disclose its enforcement history as required by Form BD, the dealer application. On the basis of a fairly "clean" application filed in early October, 1981, a dealer license was issued. Subsequent to the issuance of the license, it was discovered that Buchannan had been the subject of NASD complaint No. 252 alleging certain violations of section 10(b) of the Securities Exchange Act of 1934 and of rule 10b-5 promulgated thereunder, as well as certain section 17(a) violations of that act. An offer of settlement was accepted without admission of wrongdoing by Buchannan, and this settlement resulted in fines and censure before NASD.

The Division's position was that this information was required by regulation to be disclosed and that such disclosure is material to the licensing decision. Under the consent order, the firm was allowed to withdraw its registration and required to return its license and agree not to reapply prior to January 1, 1983. At that time, upon proper disclosure, my office can make an informed licensing decision.

Another instance involved a couple from eastern North Carolina who had invested $6,000 in two certificates of profit participation in a particular company. The couple alleged that they had not received a penny on these securities and that the company would not answer their inquiries. Upon investigation of this complaint, it was determined that not only were the securities bogus but that no such company even existed. This case has been referred for criminal prosecution and is pending the empanelling of a grand jury.

Another situation involved a mobile home dealer who filed a complaint alleging that an entrepreneur was selling securities in the entrepreneur's newly formed company in order to raise capital to manufacture and distribute a fire escape hatch to be used in mobile homes. Specifically, the complainant alleged that the entrepreneur was selling common stock on the misrepresentation that the complainant mobile home dealer fully endorsed the new design and was excited about the opportunity of using the fire escape in its mobile homes. The complainant clearly asserted to the Securities Division that such was not the case.

Presently our investigation is incomplete. The alleged misrepresentations have not yet been substantiated. We did, however, discover another securities law violation, the offer and sale of unregistered securities. The respondent entrepreneur had been to an attorney in order to incorporate his business. He received his corporate kit and articles of incorporation and proceeded to sell common stock. Apparently he had neither requested nor received from his attorney any securities law advice. Since the articles of incorporation stated that 10,000 shares of common stock were authorized, the entrepreneur believed that he could sell that amount without restriction or limitation. He proceeded to sell stock door-to-door. Since he had sold to twenty-six persons and had made numerous additional offers, he had clearly exceeded the scope of the "twenty-five offeree" exemption. The entrepreneur has defended his activity

on the basis of the "pure heart-empty head" theory. Although the disposition of this case has yet to be determined, this situation greatly concerns me, because I believe that there is substantial abuse of the limited offering exemption.

MATHEWS: You did not mean to imply that the attorney who incorporated him had any obligation or any duty under North Carolina law or otherwise to advise him about securities, did you?

BELL: Certainly not. I do think, however, that the case demonstrates an inherent problem with small issuers. Many small companies are incorporated daily and the proprietors of a substantial number of these small companies apparently have no knowledge of the Securities Act or the limitations imposed by law upon the offer and sale of their securities. It seems to be a communication problem because many of these people, due to their lack of awareness, do not even know to ask for securities law advice.

AUDIENCE: Thinking back to your opening comment that you do not have any communication with the Bar here, is there any particular reason for that?

BELL: The communication problem to which I alluded earlier is not only with the Bar. Perhaps it is more of a general public awareness problem. Many people are unaware of our very existence and those who are aware of our existence seem surprised at what we actually do. The primary form of communication in which my office presently engages is on a one to one basis, except of course, participation in conferences such as this or with Bar committees. This very limited facility for disseminating information is ineffective. I think a newsletter would go a long way toward correcting the problem. Avenues are needed for communicating with the brokerage community, the securities industry, the investing public, and the North Carolina Bar.

# THE ROLE OF OUTSIDE COUNSEL

ARTHUR F. MATHEWS†

MATHEWS: I would like to discuss the strategy, problems, and applicable law with respect to defending SEC investigations and related SEC enforcement actions. Some of the points I plan to cover have a more general application and would apply just as well to investigations by state securities commissions and other government agencies, such as the Commodity Futures Trading Commission, the Federal Trade Commission, the Department of Justice, the United States Attorney's offices, or a grand jury. I will speak, however, primarily to strategy in defending SEC investigations.

Even though I will mention a few "rules of thumb,"[1] I should say at the outset that there is no fixed set of rules relating to enforcement practice, procedure, or strategy that can be used inflexibly in every case. My *first rule* is that an attorney must read precedent cases and relevant literature in order to know what is happening in the courts and agencies before he ever attempts to represent a person in an agency enforcement investigation. Many lawyers tend to forget that most federal agencies and, perhaps, state or local agencies, often have separate bodies of rules that govern the conduct of their investigations. The SEC happens to have a set of rules that is only a page and a half long, which contains eight rules called "SEC Rules Relating to Investigations."[2] It is very important that an attorney read these rules at the start of an SEC investigation, because they do govern, or supposedly govern, what the SEC staff member does or legitimately can do when he conducts the investigation. If he does not know the applicable rules, the lawyer will not be able to ensure that the staff member conducting the investigation stays within the scope of his authority.

There are many articles on the subject, any one of which would be helpful background reading, should an attorney become enmeshed in the defense of a governmental investigation.[3]

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1. Mr. Mathews has articulated a set of "Rules of Thumb in Defending SEC Investigations," which appears in an Appendix to his remarks. *See infra* this issue at 501.

2. *See* 17 C.F.R. § 203.1 to .8 (1981); 5 FED. SEC. L. REP. (CCH) ¶ 66,102 (Jan. 6, 1982).

3. *See generally* 1 A. BROMBERG & L. LOWENFELS, SECURITIES, FRAUD AND COMMODITIES FRAUD § 13.1 to .5 (1982); H. FRIEDMAN, SECURITIES AND COMMODITIES ENFORCEMENT (1981); PRACTICING LAW INSTITUTE, HANDLING AN SEC INVESTIGATION (1980); Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567 (1975) [hereinafter cited as Mathews, *Effective Defense*]; Mathews, *Witnesses in SEC Investigations: A Primer for Witnesses and Their Counsel on the Scope of the SEC's Investigatory Powers*, 3 REV. SEC. REG. 923 (1970); Merrifield, *Investigations By the Securities and Exchange Commission*, 32 BUS. LAW. 1583 (1977); Winter, *Representing Witnesses in SEC Formal Investigations*, 5 LITIGATION, Spring 1979, at 24. For particular references to state agency investigations, see, e.g., DeYonker, *Representing A Client In A State Securities Law Investigation*, 60 MICH. B.J. 16 (1981); Fox, *Securities Investigations Under the*

I should point out at the start, particularly for attorneys who have any degree of criminal practice, that the defense of an SEC investigation (and I presume the defense of investigations by state securities commissions as well) differs in one significant respect from the defense of a federal grand jury proceeding. The crucial difference is that in an SEC case a witness or a target has the right to counsel when he or she is interrogated,[4] whereas at the federal level a witness does not have the right to have counsel present in the grand jury room when questions are asked and answers given.[5] Counsel can be outside the grand jury room door, and the client can from time to time come out of the grand jury room to seek legal advice, but defense counsel plays no significant role in developing the grand jury investigative record. Thus, while most of the law that applies to grand jury investigations is relevant and, indeed, often controlling in SEC and agency investigations,[6] and while much of the strategy is relevant, I think this is one of the most important distinctions between federal grand jury proceedings and SEC investigations. The presence of counsel in the hearing room and his influence over the development of the SEC investigative record mean that counsel has a much greater opportunity to defend the enforcement case very early, perhaps even before charges are brought. Thus, my first rule of thumb is to read the literature and the relevant case law.

My *second rule* is to take control of the investigation to the extent possible. I often upset staff members when I counsel defense lawyers to take control of an investigation, because they think I am counseling obstruction of justice or intentionally impeding the investigation. I do not intend that at all. What I do intend is that counsel should do everything possible from the first day of his retention to influence the development of the investigative record to the client's best advantage. There are all sorts of direct and indirect ways by which an attorney can influence the development of the record or the scope and direction of the investigation. Indeed, part of my second rule is that counsel should offer to investigate, rather than have the government investigate for him.[7] In any case, the primary goal is to get the government agents out as

*Georgia Securities Act*, 17 GA. ST. B.J. 14 (1980). For particular reference to CFTC investigations, see, e.g., Markham, *Investigations Under the Commodity Exchange Act*, 31 AD. L. REV. 285 (1979). For particular reference to grand jury investigations, see, e.g., Sullivan & Spanner, *Representation of Persons in Connection with the Federal Investigation of White Collar Crimes*, in WHITE COLLAR CRIMES 207 (G. Naftalis ed. 1980); Smaltz, *Tactical Considerations for Effective Representation During a Government Investigation*, 16 AM. CRIM. L. REV. 383 (1979); Welch, *Representing a Company and Its Employees in a Criminal Case*, 7 LITIGATION, Winter 1981, at 32; Wilson & Matz, *Obtaining Evidence for Federal Economic Crime Prosecutions: An Overview and Analysis of Investigative Methods*, 14 AM. CRIM. L. REV. 651 (1977); Wing & Wolff, *Defending Criminal Securities Cases in the Grand Jury*, 15 REV. SEC. REG. 947 (1982).

4. Rule 7(b) of SEC Rules Relating to Investigations, 17 C.F.R. § 230.7(b) (1981).

5. *See, e.g., In re* Groban, 352 U.S. 330, 332-33 (1957).

6. *See, e.g*, Woolley v. United States, 97 F.2d 258 (9th Cir. 1938).

7. *See generally* PRACTICING LAW INSTITUTE, THE INTERNAL CORPORATE INVESTIGATION (1980); Fedders, *Corporate Criminal Responsibility—Conducting An Internal Investigation*, in 3 CRIMINAL DEFENSE TECHNIQUES § 62 (M. Eisentein & S. Allen, ed. 1969); Mathews, Klein, Williams & Taylor, *The Functioning of Directors in "Sensitive Payment Inquiries,"* in [Hardcover] 1 NINTH ANNUAL INSTITUTE ON SECURITIES REGULATION 135-260 (1977); Pitt, *Outline on Special Investigative Counsel: The SEC's Independent Police Force or Corporate Representatives*, in 1 A.

quickly as possible, because there are always skeletons in the closet, and whether or not counsel believes the client is in danger, there is always the risk that the agency will stumble over something and catch the client in some type of violation. I have seen few cases in which the client had in every respect perfectly complied with the law. In fact, I do not think I have ever had a client who conducted a business as to which the government could not find some technical violation. Unfortunately, a technical violation in the eyes of the client often is viewed as an egregious fraud by the regulating agency because the violation had not been disclosed publicly as quickly as the SEC would like. So, if possible, get the government out quickly. That approach was very effective in several of the foreign payment cases.[8]

We have heard that the state Commission here in North Carolina has budget problems. Well, the SEC at the federal level has budget problems also. The SEC cannot afford to devote the manpower to investigate one-tenth, or perhaps even one-thirtieth, of the enforcement matters that it would like to investigate. Thus, the corporation can often buy time by saying, "Give us four to six weeks before you start serving subpoenas and taking testimony. Let us, the board of directors (or whoever is involved), bring in an outside counsel, perhaps a special counsel, and have the chance to conduct our own investigation."

SOMMER: Your remarks suggest to me that if you persuade the SEC to let you conduct the investigation, you ought to have a clear understanding with them as to what issues you plan to address. Otherwise, you may find yourself with an obligation to bring out all the skeletons, including those which may be totally unrelated to the activity that originated the SEC investigation.

MATHEWS: That is absolutely correct.

SOMMER: A second question then arises: When you stumble across something that is not in the mandate, what do you do?

MATHEWS: The investigating counsel has to resolve it, and, if necessary, appropriately disclose it. If the corporation is not willing to face up to what it

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MATHEWS, NEGOTIATING SEC CONSENT DECREES: TARGETS & TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS 142 (1979); Block & Barton, *Internal Corporate Investigations: Maintaining the Confidentiality of a Corporate Client's Communications with Investigative Counsel*, 35 BUS. LAW. 5 (1979); Coffee, *Beyond the Shut-Eyed Sentry: Toward A Theoretical View of Corporate Misconduct and An Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Gruenbaum & Oppenheimer, *Special Investigative Counsel: Conflicts and Roles*, 33 RUTGERS L. REV. 865 (1981); Comment, *Corporate Self-Investigations Under the Foreign Corrupt Practices Act*, 47 U. CHI. L. REV. 803 (1980); Note, *Discovery of Internal Corporate Investigations*, 32 STAN. L. REV. 1163 (1980); Note, *Voluntary Disclosure Programs*, 47 FORDHAM L. REV. 1057 (1979).

8. *See, e.g.*, *Report of the SEC on Questionable and Illegal Corporate Payments and Practices Submitted to the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. (1976); Herlihy & Levine, *Corporate Crisis: The Overseas Payment Problem*, 8 LAW & POL'Y IN INT'L BUS. 547 (1976); Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through The Federal Securities Laws*, 43 BROOKLYN L. REV. 681 (1977); *see also* SEC v. Grumman Corp., SEC Litigation Release No. 6359 (D.D.C. Nov. 6, 1981); SEC v. International Tel. & Tel. Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶¶ 96,586 & 96,452 (D.D.C. 1978); SEC v. General Tele. & Elec. Corp., SEC Litigation Release No. 7760 (D.D.C. Jan. 31, 1977); SEC v. Northrop Corp., SEC Litigation Release No. 6842 (D.D.C. April 17, 1975); cases noted in 2 A. MATHEWS, *supra* note 7, at 10-69, 347-581.

has found and correct it as quickly as possible, then it should never have decided to investigate itself. It is wiser to let the government investigate, hold one's breath, and hope it does not uncover anything serious.

In my experience, however, most major public corporations—SEC filing companies, at least—would much rather investigate themselves or have outside counsel investigate them, and at least have a chance to resolve matters internally without having the heavy hand of the government come down upon them. That is so because in many cases, the publicity is much more damaging than any remedy or the substantive effect of any formal charge. It is the cosmetics, particular words and terms of the disclosure, that have a great effect on public reaction. I say this in all seriousness. The SEC may typically charge in an enforcement action: "This is a fraudulent course of conduct that operated as a fraud and deceit because the financial statements were false and misleading." If the corporation is handling the matter, it can take the same facts and make a public disclosure that will probably satisfy all the disclosure statutes. But the corporation can word it a little differently: "This was a course of business that did not adequately comply with the disclosure requirements of the law, because the disclosures previously made were insufficient and inadequate in a certain respect." Both disclosures arise from the same underlying facts, but the cosmetics of the disclosure are very important.

LEVINE: That is the difference between full disclosure and the practice of law.

MATHEWS: Both types of disclosure probably give the corporation sufficient protection in actual litigation concerning the adequacy of the disclosure, but the different perspective is important.

LEVINE: Are you going to mention the problems raised by *In re Sealed Case*?[9]

MATHEWS: I will discuss that when I cover the corporate attorney-client privilege. One important thing to remember when the corporation has the opportunity to investigate itself is that it must be willing to tell the government what it investigated, and it will have to agree in advance to give the government access to the investigative work product to some extent. The SEC, or any other agency, is not going to go away unless the corporation can convince the agency that the methods and procedures employed in the investigation were adequate, that the investigator touched all the bases, and that he did a professional, competent job in dealing with what he uncovered. A corporation should not think that it can investigate itself, never come out with any public disclosure, and never have the SEC look at it, because the agency will be very suspicious about what was done. Nevertheless, self-investigation still is often the best approach for a company.

My *third rule* is, so long as counsel avoids conflicts of interest, when representing the corporate entity, counsel also should represent as many individu-

9. 676 F.2d 793 (D.C. Cir. 1982) (for a discussion of the case see *infra* text accompanying note 34).

als as is tactically and practically possible, and ethically appropriate. The government's consistent approach in conducting enforcement investigations seems to be "divide and conquer." The government likes to suggest that there should be separate counsel for each individual, and that any time a lawyer tries to represent two individuals, he has an actual or potential conflict of interest. The suggestion that when a company obtains outside special counsel, counsel ought to represent only the corporate entity and no individuals, is a somewhat utopian approach. Sometimes counsel may have the luxury—or necessity—of proceeding in that way. But in most cases he will never have the opportunity to do that. Counsel costs money: if fifty attorneys do the job, it will cost fifty times more than having one do it. So there are practical, economic pressures which suggest that the same counsel, absent conflicts of interest, should represent groups of people.[10]

I agree that if the corporate manager has been stealing some of the assets, he or she is going to need separate counsel. In addition to representing the corporate entity, counsel cannot represent principal malefactors whom the corporation may have to fire or sue when the facts are disclosed. But generally speaking, in most cases the law firm that represents the corporation probably can represent a number of the individuals as well.

The important reason for my counseling this practice as a rule of thumb in an SEC investigation is this: if counsel restricts his representation solely to the corporate entity, he will effectively be taking away almost all of his power or opportunity to influence the development of the investigative record. If counsel represents only the entity and no individuals, in most cases he will not be able to appear at any of the investigative testimony of any individuals even though they may be the principal corporate officers, directors, employees, or agents. The SEC may subpoena the chairman of the board, the treasurer, the directors, and the vice-president in charge of sales. If counsel does not represent those persons individually as well as representing the entity, in most cases the SEC will not allow him to be present when they testify. Strict interpretation of SEC rules purports to allow the Commission to exclude the corporate counsel.[11] As a result, corporate counsel is not able to be present when the

10. *See, e.g.*, Borow & Guth, *Outline on Multiple Representation in the Context of an SEC Investigation and Related Criminal Proceedings*, in 1 A. MATHEWS, SEC ENFORCEMENT AND WHITE COLLAR CRIMES—1981, 225, at 229-53 (1981); Miller, *The Problems of Multiple Representation in the Investigation and Prosecution of Corporate Crime*, 29 FED. B. NEWS & J. 217 (1982); Tague, *Multiple Representation of Targets and Witnesses During a Grand Jury Investigation*, 17 AM. CRIM. L. REV. 301 (1980); Tague, *Multiple Representation and Conflicts of Interest in Criminal Cases*, 67 GEO. L.J. 1075 (1979); Note, *Right to Counsel*, 16 AM. CRIM. L. REV. 51 (1978); Note, *Supervising Multiple Representation of Grand Jury Witnesses*, 57 B. U. L. REV. 544 (1977); Note, Developments in the Law—*Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1293-1300 (1979).

11. Rule 7(b) of the SEC Rules Relating to Investigations, 17 C.F.R. § 203.7(b) (1981), called the SEC "sequestration rule," provides, in part, that "all witnesses shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation no witness or the counsel accompanying any such witness shall be permitted to be present during the examination of any other witness called in such proceeding." *But see* SEC v. Csapo, 533 F.2d 7 (D.C. Cir. 1976) ("Before SEC may exclude an attorney from its proceedings, it must come forth with 'concrete evidence' that his presence would obstruct and impede its investigation"); SEC v. Higashi, 359

president gives an answer that is damaging to the corporation. He is not able to pursue the testimony immediately with a follow-up question, to put the answer in its proper context and in the best perspective for the corporation. Counsel simply has to be present in order to help develop and influence lawfully, properly, and professionally the development of the investigative record.

SPORKIN: The thing that troubles me is that when you start, you are advising the corporation. And when you begin to see things unfold which show that three or four of your individual clients are not all completely innocent, how can you honestly, competently, and with integrity give advice to the company when it is in the best interest of the corporation not to serve as counsel for these other people?

MATHEWS: I said that if there are obviously identifiable malefactors, and if the corporation is going to have to fire them, demote them, sue them, or otherwise take a position adverse to them, then counsel is in a conflict of interest position. Judgments must be made day by day. When a lawyer originally accepts the individual representation, he should tell the individual that he is principally the company lawyer and that if the individual desires, the company has offered to make counsel available to him at no cost. The attorney can analyze all the available facts and make a determination that he does not think there is a conflict in such representation. He should ask whether or not the individual knows of anything that might pose an interest adverse to that of the corporation. He should tell the individual that if a conflict arises, at that point he will remain as counsel for the corporation if it is legally permissible under the circumstances, and new counsel acceptable to him will then be brought in to represent him.

AUDIENCE: Are you sure you can do that?

MATHEWS: It depends upon the circumstances, but in many instances you can do it with his consent.[12] It will depend on the particular facts. Depending upon the nature of the conflict and how grievous it is, the attorney may be forced not to represent either party. But some potential—and even actual—conflicts of interest can be waived. To summarize, in most cases a corporation and the individuals involved are usually aided in defending an SEC investigation by having the same lawyer, as long as there are not outright conflicts at the start. Of course, if an unresolvable conflict arises thereafter, that lawyer or law firm may be required to resign completely from any representation whatsoever in the case, and if there is subsequent litigation there will have to be two separate sets of new counsel, one representing the company and one representing the individuals.

In my view, in negotiating a settlement of an enforcement action with the

F.2d 550 (9th Cir. 1966) (sequestration of corporate counsel exceeds the bounds and purposes of sequestration when witness is a director of the corporation).

12. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY D.R. 5-105(c) (1980), which states that "a lawyer may represent multiple clients if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each." *See also* FED. R. CRIM. P. 44(c).

SEC, in most cases counsel will get a better deal for the individuals if he also represents the company vis-à-vis the SEC. This does not always work, but in some cases, when the same counsel represents the company and the individuals in hard, tough negotiating, he can very often leave the individuals unscathed and uncharged in return for the corporation's taking a consent decree. If counsel has a realistic chance of getting the corporation off, then perhaps he has a conflict, and he should not represent both the corporation and the individuals. But in the usual case, when it is almost certain that the SEC is going to sue the corporation, and perhaps sue some of the officers and directors, counsel very often better serves the officers and directors if he is able to offer a settlement on behalf of the corporation and argue that the injunction is broad enough that the SEC does not have to name the individuals as defendants.

LEVINE: I would like to emphasize the other side of this argument. There is a flip side to his argument from a staff point of view. Often the corporate entity is hurt by the community of interest. By keeping everything together rather than forcing the Commission to focus upon the entity, the entity acquires the problems of the individual by virtue of the manner in which the defense is delivered. As long as counsel keeps the representation together, the entity takes on an extra burden, so there is a flip side in terms of how the Commission looks at the case. As Mr. Mathews points out, however, the entity usually has the burden anyway. But sometimes it makes a big difference whether or not you put distance between the individual and the entity, especially in the broker-dealer context. It is not clear in all instances that the community of interest should remain.

MATHEWS: It goes without saying that all of these situations must be resolved on a case by case basis.

SOMMER: Lawyers say that one of the key problems is the information they obtain from the other individuals, and what they should do with it vis-à-vis the corporation. I can give you a case I am aware of. It is not in the securities area, and the matter has been resolved. It is in the antitrust area. In this case, the president of the company retained me to represent him in connection with antitrust matters. In the course of my conversation with him, it came out that there was a clear-cut pattern of conduct involving antitrust violations. The board of directors did not know of the violations, and the president was concerned that if the disclosure were made to the board of directors, he would be fired, and made a scapegoat to the public. At that time I was also representing the corporation. Our conclusion was that we had to terminate representation of both the corporation and the individual. The problem is that you put yourself in a very awkward position when the information obtained from the employee is not known to his superiors or to the board.

SPORKIN: Let me mention to you that although it is great to be a statesman, in my own experience, in too many cases (and I am not talking about one or two, I am talking in the tens and twenties) I saw shareholder rights butchered because of the so-called "Mathews" approach. I honestly saw instances in which companies opened themselves to investigations internally, contrary to

their own best interest. I will admit that sometimes the shareholders do not know enough to bring a malpractice suit. But it bothers me as a lawyer to watch these rights being butchered because the chief executive officer would not cut the corporation loose. The corporation could have had an easy settlement—could have been free in the first two or three days—but it was being held hostage by the chief executive officer who wanted the company to keep paying his legal fees so he could have the benefits of having the company defend with him.

MATHEWS: I disagree with Mr. Sporkin to the extent that he would never condone multiple representation in any cases whatsoever. For example, very often the chief executive officer of the company approaches an attorney and says, "I have a problem. The SEC served a subpoena on one of my vice-presidents. I want you to represent me, and I want you to represent the company." If the lawyer tells him, "No, I'll represent your company, but you've got to hire someone else to represent you personally," he will never be in the case. Lawyers have to make reasonable judgments, and there will never be a case in which anyone can afford to have one counsel per witness or one counsel per individual. It is just too expensive; you simply cannot have it.[13]

AUDIENCE: If counsel begins representation with the presumption that it is in everyone's best interest for him to represent the group as a whole, what sort of agreements should counsel obtain in writing from the individuals, and from the corporate entity, with respect to policy should a conflict develop—either by way of indemnification or otherwise? All things considered, I believe counsel is in a better position by keeping the defendants together and trying to fight collectively rather than individually. But what should an attorney require or request from his prospective clients—the individuals, the inside directors, the outside directors, the officers, or the corporate entity itself—with respect to a written understanding as to where counsel's allegiance will lie in the event conflicts should develop?

MATHEWS: Frankly, I usually do not require a written representation or retainer agreement with clients, but I do cover it orally with each client. I tell the individual client that if a conflict arises, it is my intention to continue to represent the company if I legally and ethically can, and that new counsel will have to be brought in to represent him personally—usually at the expense of the company. I usually tell the individual client that if he disagrees, it may well be that I will be disabled from representing both him and the company and may have to withdraw from both representations. I also advise him to take into consideration, when he determines whether to have me represent him or whether to hire his own counsel, the possible disadvantage of losing his counsel midway through the investigation. He should weigh that risk against the obvious advantages of being personally represented by company counsel.

AUDIENCE: What do you feel compelled to tell this individual regarding

13. *See, e.g.*, SEC v. Higashi, 359 F.2d 550 (9th Cir. 1966).

his rights or courses of action? What are the factors he should consider in making that threshold decision whether to retain his own counsel?

MATHEWS: The first questions are: "Have you been engaged in wrongdoing? Are there skeletons in the closet that the others involved do not know about? You cannot get proper representation unless you are willing to tell your lawyer what you did."

AUDIENCE: When you ask that question, then you are asking whether he has engaged in fraud. When he gives testimony later, you have suggested he speak in terms of simply a "misunderstanding"—that is the problem. Would you advise the individual that the company is going to pay for the counsel if he wants his own separate counsel?

MATHEWS: It varies from company to company. Some companies are generous and some companies are foolishly penurious or stingy.

AUDIENCE: It is not generosity if there is a conflict; it cannot be generosity.

MATHEWS: Some companies are willing to pay for the representation of all their employees in an investigation. Other companies do it subject to a letter saying that the employee or officer will reimburse the company if it is determined that he has violated the law or acted to the disadvantage of the company. Still other companies may say, "No, I'm going to fire that person as soon as this investigation is over, and I'll be darned if I'm going to pay for his or her counsel." It varies from company to company.

AUDIENCE: In many instances the company cannot pay for an employee's counsel unless that employee turns out to be right. That is the state law in North Carolina.[14]

ROEMER: There is another view under Delaware law.[15] Under Delaware law the individual need not undertake to pay for counsel unless the individual is a party to a proceeding that exists or is threatened, and his own personal liability is actively involved. The corporation cannot make an advance of counsel fees unless the individual argees to repay in the event that he is not ultimately determined to be entitled to reimbursement. But in the absence of a proceeding—and an investigation is not necessarily a "proceeding" for purposes of Delaware law—a corporation can provide counsel at company expense for people who are interrogated.

SPORKIN: It troubles me that in the guise of either recognizing what state law may tolerate or controlling the investigation counsel undertakes to represent both individuals and the company. I really question how an attorney, in the best interest of the individual employee, can effectively represent him under those circumstances. It just seems to me that such counsel is not really

14. *See* N.C. GEN. STAT. § 55-20 (1982).

15. Section 145 of the Delaware General Corporation Law, which permits indemnification of officers and employees if they meet certain standards, is not exclusive. DEL. CODE ANN. tit. 8, § 145(f) (1974). Therefore, indemnification pursuant to a corporation's general powers contained in section 121 of the Delaware General Corporation Law is not precluded in those situations that are not addressed by section 145.

being perfectly frank. If counsel is advising someone in the corporation, would he approach the individual in exactly the same way as if the corporation were not a factor? Both counsel and individual client are well aware that the individual's continued employment by that corporation depends in part on how the whole matter is resolved. I believe there is a real problem in defending both the individual and the corporate entity.

MATHEWS: But you are talking about principal culprits, and my general rule takes into account that counsel generally will not be able to represent the principal culprit and the corporate entity. He will have to have separate counsel.

Let us move forward. We could spend the whole conference just on this multiple representation problem—we have not solved it, but at least we have covered some of the issues.

My *fourth rule* is that counsel should give appropriate consideration to existing and potential "parallel proceedings."[16] This is probably one of the most important considerations in any investigation. Any document the company turns over at the start of an investigation and any testimony given on the very first day of an investigation will be in the hands of the government for the purpose of all future enforcement actions. Eventually it will be in the hands of every one of the company's adversaries or counsel's personal client's adversaries for the next five or ten years, whether it be for a criminal case, a class action for damages, or a state, federal or local licensing proceeding. Counsel has to consider not only the present investigation, but also the effects on all the parallel or subsequent proceedings, cases, or situations in which the client may be involved. Recent development of the law is very important. The principal case is *Parklane Hosiery Co. v. Shore*,[17] which holds that if a corporation goes to trial against the Commission, even in an injunctive action without a jury, any findings made will be binding and can be used against the company in a subsequent private damage action. Any admissions and any transcripts of testimony are going to be admissible in any subsequent proceeding. Therefore, be sure not to forget potential parallel proceedings problems.

AUDIENCE: When you have been faced with multiple investigations, plus a grand jury, have you had any success in stopping the criminal proceedings as being unfair?

MATHEWS: No. In fact, I have analyzed the case law in detail at various times. My general analysis (of the last twenty years primarily) of parallel pro-

16. *See generally* N. KAPLAN, P. FRIEDMAN, R. BENNETT & H. TRAINOR, PARALLEL GRAND JURY AND ADMINISTRATIVE INVESTIGATIONS (1981); Mathews, *Outline on Parallel Proceedings Problems In Securities Enforcement Matters* in 1 A. MATHEWS, SEC ENFORCEMENT AND WHITE COLLAR CRIMES 527 (1979); Pickholz, *Parallel Enforcement Proceedings: Guidelines for the Corporate Lawyer*, 7 SEC. REG. L. J. 99 (1979); Wilson & Matz, *supra* note 3, at 701-09; Special Edition, *White Collar Crime: A Survey of Law*, 18 AM. CRIM. L. REV. 165, 184-97 (1980); Note, *supra* note 10, at 1311-40.

17. 439 U.S. 322 (1979); *see also* SEC v. Dresser Indus., Inc., 628 F.2d 1368 (D.C. Cir.) (en banc), *cert. denied*, 449 U.S. 993 (1980); United States v. Fields, 592 F.2d 638 (2d Cir. 1978), *cert. denied*, 442 U.S. 917 (1979); SEC v. OKC Corp., 474 F. Supp. 1031 (N.D. Tex. 1979); *cf.* United States v. La Salle Nat'l Bank, 437 U.S. 298 (1978).

ceedings problems in the securities area[18] covers the first *Parrott* case,[19] the *Kordel* case in the Supreme Court,[20] and probably fifty to seventy other cases, including *Dresser Industries*.[21] As a result of my general analysis, I believe that whether the competing proceedings are IRS, SEC, grand jury, FTC, or private damage actions, the trend of the law seems to be that whenever the government wants to stop one of the parallel proceedings, if it files a motion, the court will accomodate the government. As a result, the private party cannot use, for example, civil discovery in a private action, which would help him in defending the grand jury investigation or subsequent criminal prosecution. On the other hand, whenever a private party tries to stop the government from going forward in the parallel proceeding—usually the IRS or the grand jury—the courts almost invariably refuse to stop the government from pursuing the parallel enforcement case. There are one or two exceptions,[22] but that is the general trend.

Moving on to my *fifth rule*: Avoid subpoenas by voluntarily offering to produce documents whenever you can. Do not force the government to use its formal processes. When mistakes are made by the corporation in forcing the government to use formal processes, the company may be involved in obstruction of justice, perjury, or other serious matters.

One of the advantages of doing things voluntarily is to avoid the typical government subpoena, which is usually as broad as it can be. The company always negotiates to narrow the subpoena, and most government agencies—the SEC in particular—will usually negotiate and reach an agreement to narrow the scope of the subpoena's demand. But if the company simply produces everything covered by the subpoena, subject to withholding certain information on claims of privilege, it may not have pursued the best strategy in defending an investigation. After counsel has reviewed all the documents, determined which ones fall within the scope of the subpoena's demand, and removed all privileged documents, it may be much better strategically to let the government examine the company's files and request copies of selected materials. That procedure will save everyone time and expense. What does that achieve strategically? First, it allows the company to focus its own work only on those documents selected by the government; it need not waste re-

18. *See* Mathews, *supra* note 16.

19. United States v. Parrott, 258 F. Supp. 196 (D.D.C. 1965). *See also* United States v. Rodman, 519 F.2d 1058 (1st Cir. 1975); United States v. Rand, 308 F. Supp. 1231 (N.D. Ohio 1970); United States v. Parrott (*Parrott* II), 315 F. Supp. 1012 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 972 (2d Cir.), *cert. denied*, 400 U.S. 824 (1970); United States v. Thayer, 214 F. Supp. 929 (D. Colo. 1963); Note, *Commingled Civil and Criminal Proceedings: A Peek At Constitutional Limitations and A Poke at the SEC*, 34 GEO. WASH. L. REV. 527 (1966); *cf.* Bennett, *Representing A Defendant in Simultaneous Criminal And Administrative Proceedings: A Practical Approach*, 27 AM. U.L. REV. 381 (1978).

20. United States v. Kordel, 397 U.S. 1 (1970).

21. SEC v. Dresser Indus., Inc., 628 F.2d 1368 (D.C. Cir. 1980) (en banc). For a recent SEC case involving "parallel proceedings" problems, see SEC v. Horowitz & Ullman, P.C., [current] FED. SEC. L. REP. (CCH) ¶ 98,488 (N.D. Ga. 1982).

22. *See, e.g.,* United States v. La Salle Nat'l Bank, 437 U.S. 298 (1978); Perry v. McGuire, 36 F.R.D. 272 (S.D.N.Y. 1964); *cf.* United States v. Simon, 262 F. Supp. 64 (S.D.N.Y. 1966), *rev'd*, 373 F.2d 649 (2d Cir. 1967), *vacated as moot*, 389 U.S. 425 (1967).

sources studying and cataloging voluminous documents that fall within the subpoena's demand, but concerning which the government, in fact, has no interest.

SMYTHE: I would like to mention my own experience in this regard. I have been on both sides of that table, and I know that when I was at the SEC it was great when private counsel would invite me into the file cabinets of his client. Indeed, I would have a wonderful romp through the files of a client that private counsel had not looked at first.

MATHEWS: I agree that it is always necessary for defense counsel initially to review every document before the company provides access to the government. Counsel must first review and collect all the documents subject to the subpoena, put them in a special room, and allow the government agent access to only that room. Counsel should not let the government agent walk through the plant or offices so he can talk informally to secretaries and clerks, or overhear what someone is saying on the telephone.

SMYTHE: I just wanted to make that point. You should not invite them into your company fileroom. Do not let them look at anything counsel has not looked at first.

MATHEWS: And be sure to stay in the room and listen to what the government agents are discussing—but do not eavesdrop surreptitiously. They will find a document that concerns them and ask questions. The business of defending an investigation is really an intelligence gathering. The company is at a disadvantage. The government subpoenas everyone—the company's banker, lawyers, accountants, competitors, and customers—they get it all; the company does not. Counsel must constantly defend the client. He must constantly be groping to discover ethically, professionally, and properly every bit of information the government has, so he can make the right decisions, such as when to fight, when to settle, what to offer, and what not to offer.

LEVINE: Isn't it true that in certain instances counsel should take the opposite strategy, because he wants to control which documents the Commission gets at what time? Sometimes counsel would want to feed documents to the investigators, keep the incriminating ones to the last, and mix them up in such a way that the SEC may overlook the documents that are important.

MATHEWS: I agree with the observation that it may be appropriate to produce documents in separate batches over a period of time. But I would not necessarily leave the incriminating documents until last. I would try to produce them at the same time I produce my best mitigating documents. Let me mention another interesting aspect of what I just said. No rule fits every case. You must ask yourself: is this a good approach in *this* case? Do I trust allowing a government agency in the front door at this point? Another interesting practical observation is that the government agent who leaves Washington, comes out to the company, and starts examining documents, will examine the first thousand or two thousand very conscientiously, but by midafternoon of the first day of the ten days, he is going to be skimming documents. You would be amazed at what the government investigator will miss while he is on

the road—things that he might not have missed if the company had complied formally with the subpoena by boxing up the materials and sending them to Washington.

Let me mention one last thing. The danger in this process is this: counsel may have a duty to come forward if the government misses something really important, something that really hurts the company. In most instances counsel should bring it to the agency's attention, because if a copy exists in the hands of third parties, and the agency gets it, then counsel has lost all credibility and can no longer effectively represent the client.

LEVINE: Is there an ethical obligation here?

MATHEWS: It depends upon the company's arrangement with the SEC. There may well be an ethical obligation, because all the documents counsel lets them examine are under subpoena. I would probably see no obligation if an agreement says, "We will let you inspect, and we want to comply with the subpoena. We will give you copies of those documents that you select and designate." But counsel should realize that if the agency misses a document, it just may cause more problems.

LEVINE: The important information may come up in later testimony. An employee may say, "Sure, there was a memorandum dated so and so, and it hasn't appeared yet." Certainly, if counsel is doing his job, he will want to avoid creating the impression that he has withheld relevant documents.

MATHEWS: My *sixth rule* is to conduct as detailed a preparatory investigation as time and circumstances permit. In this connection, counsel will not always be able to get information from the SEC, but there are other ways. It used to be almost standing policy at the SEC to instruct every witness on the record, "After you testify, do not talk to anyone about this investigation. This is a private investigation, and you are enjoined by the federal government from talking to anyone." Defense counsel would then try to interview the witnesses who had already testified before his own client testified, and each witness would say, "No, I cannot talk to you. The government has instructed me not to."

That is just not the way things are today. Defense counsel is incompetent if he does not try to interview every witness possible before letting the client testify. He is incompetent if he does not try to obtain access to the transcripts of testimony and the exhibits of everyone who is testifying, so long as they have counsel who have agreed to let him have access. Counsel must be very careful that in doing so, he does not put pressure on people to alter their testimony, or advise his client to perjure his or her testimony to conform to what someone else testifies. On the other hand, there is nothing wrong—indeed, I think it is an obligation of defense counsel—with interviewing everyone to learn everything possible about the investigation before the client testifies.[23]

My *seventh rule* is to put as much testimony as possible off the record.

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23. *Cf.* Gregory v. United States, 369 F.2d 185 (D.C. Cir. 1966), *cert. denied*, 396 U.S. 865 (1969); *see also* Mathews, *Effective Defense*, *supra* note 3, at 588.

The record lives forever under oath. If it is newsworthy, that transcript may someday be on the front page of the *New York Times*. Even if not, every one of the client's adversaries is sure to get it. Although counsel can take certain steps to preserve confidentiality, none of them is foolproof; none of them will protect confidentiality forever. So to the extent possible, even if you are in the middle of an interrogation, you should try to go off the record. Tell the examiner, "This is particularly sensitive; it is not directly on point to the investigation. We are not trying to withhold it from you, but we do not want it in the transcript because of the Freedom of Information Act and other reasons." Sometimes it will work; sometimes it will not. But if you do not try it, you will never know.[24]

SPORKIN: Aren't you really flagging a problem when you try to go off the record in a deliberate way? Are you not in fact suggesting that the anticipated testimony is very damaging? When I used to be in that role on the government's side, I could not wait to get that information. I can assure you that none of it was kept off the record if it was required to be on the record.

MATHEWS: On the other hand, I have had one situation in which I represented a registered representative in a case that involved some transactions through Swiss banks and a foreign trust. A question came up about the foreign account of the client's mother-in-law. It had nothing to do with the substance of the investigation; but the SEC was pressing for the identification of the account. There was an independent reason why I did not want the mother-in-law's name in the record. These are all just considerations that vary depending on the case.

My *eighth rule* is to protect the applicable privileges. Any privileges, whether they be common-law privileges or statutory privileges, that generally would apply in a federal civil or criminal case will also apply in an SEC investigation. These privileges include attorney-client, priest-penitent, and work-product doctrines. The doctor-patient privilege is not very broad today, but there is still a bit of it, at least as to confidential communications with a psychiatrist. In some states, there are various types of marital privileges. Do not do something on the record that will be a waiver of an applicable privilege that may later hurt you in some part of the SEC proceeding, or in a parallel or subsequent proceeding. There is a series of fascinating literature on the issues of corporate attorney-client privilege and work-product privilege.[25] Many of

24. *Cf.* United States v. Lieberman, 608 F.2d 889 (1st Cir. 1979), *cert. denied*, 444 U.S. 1019 (1980) (SEC did not violate "due process" when it went "off-the-record" in an investigative hearing. The "Jencks Act," 18 U.S.C. § 3500 (1976), does not require all SEC investigative interviews to be recorded).

25. *See* Borow & Guth, *supra* note 10; Mathews & Borow, *The Corporate Attorney-Client Privilege and Work-Product Doctrine*, in THE CORPORATE COUNSELLOR'S DESK BOOK 207-14 (D. Block, A. Hoddinott & M. Epstein ed. 1982); Sagor, *The Attorney-Client and Work-Product Privileges: Protection and Assertion*, in BUSINESS CRIMES: A GUIDE FOR CORPORATE AND DEFENSE COUNSEL 127 (J. Glekel ed. 1982); Jacobsen, *Attorney-Corporate Client Privilege*, 37 BUS. LAW. 461 (1982); Miller, *The Corporate Attorney-Client Privilege and the Work-Product Doctrine: Protection From Compelled Disclosure in Criminal Investigation of a Corporation*, 12 U.S.F.L. REV. 569 (1978); Welles, *A Survey of Attorney-Client Privilege in Joint Defense*, 35 U. MIAMI L. REV. 321 (1981); *Attorney-Client Privilege Project: White Collar Crime: Second Annual Survey of Law*, 19

the opinions are coming out of the SEC domestic or foreign payment cases and involve circumstances in which either inside or outside counsel did investigations for public companies.

One interesting case was *Garner v. Wolfinberger*,[26] in which the Fifth Circuit held that the corporation may not be able to plead attorney-client privilege against its own shareholders. I will confine the remainder of my discussion, however, to a review of three cases that followed *Upjohn Co. v. United States*[27]: *John Doe Corp. v. United States*,[28] *In re Sealed Case*[29] (it took the *Wall Street Journal* only five days to determine that *In re Sealed Case* was the *Tesoro Petroleum* case), and *United States v. Arthur Young & Co.*[30]

The first case, *John Doe Corp.*, dealt primarily with the attorney-client privilege. The second case, *In re Sealed Case*, touched upon attorney-client privilege but dealt primarily with work-product privilege in the context of a special investigation being conducted on behalf of a corporation. The third case, *Arthur Young*, dealt with a limited accountant/auditor work-product privilege. While there is an accountant-client privilege in several states,[31] there is no accountant-client privilege at the federal level.[32] Since there is not an accountant-client privilege at the federal level, in SEC investigations or any other type of federal investigation, even though the investigation may be of a business and persons located within a state in which a statutory accountant-client privilege exists, the state law privilege will not apply in the federal investigation. Therefore, there is no general accountant-client privilege in any SEC investigation.[33]

Recently in *Arthur Young* the Second Circuit hammered out a very limited auditor's work-product privilege at the federal level. The Second Circuit held that one particular type of auditor's work papers—"tax accrual work papers"—which often could be very damaging to a public company if obtained by the government or by the corporation's nongovernmental adversaries, are subject to an auditor's work-product privilege. In such papers, auditors gener-

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AM. CRIM. L. REV. 251 (1981); Note, *The Corporate Attorney-Client Privilege: Culpable Employees, Attorney Ethics and the Joint Defense Doctrine*, 58 TEX. L. REV. 809 (1980); Block & Fass, *Outline on After 'Upjohn': The Uncertain Confidentiality of Internal Investigative Files in Shareholders' Actions*, in MATERIALS, SIXTH ANNUAL FALL MEETING, SECTION OF LITIGATION, AMERICAN BAR ASSOCIATION (Wash. D.C. 1981); J. Fedders, Speech on Roundtable: Attorney-Client Privilege in SEC Investigations at the 1982 Annual Meeting of the American Bar Association (San Francisco, Cal. 1982).

26. 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971), *on remand*, 56 F.R.D. 499 (S.D. Ala. 1972).

27. 449 U.S. 383 (1981). *See also* Pitt, *The 'Upjohn' Decision: 'To Thine Own Self Be True,'* Legal Times of Washington, Jan. 26, 1981, at 20.

28. 675 F.2d 482 (2d Cir. 1982). Newspapers have since indentified John Doe Corp. as the Southland Corp.

29. 676 F.2d 793 (D.C. Cir. 1982).

30. 677 F.2d 211 (2d Cir. 1982).

31. *See, e.g.*, CAL. CIV. CODE § 43.7 (1982); FLA. STAT. ANN. § 473.316 (Harrison 1981 Cum. Supp.); MICH. STAT. ANN. § 18.32(20) (Callaghan 1980).

32. *See e.g.*, Couch v. United States, 409 U.S. 322 (1973); Sutton v. United States, 658 F.2d 782 (10th Cir. 1981); Falsone v. United States, 205 F.2d 734 (5th Cir. 1953).

33. *See, e.g.*, SEC v. Coopers & Lybrand, [current] FED. SEC. L. REP. (CCH) ¶ 98,700 (S.D. Fla. 1982); *In re* Rashba & Pokart, 271 F. Supp. 946 (S.D.N.Y. 1967).

ally examine the public company's tax treatment of various items on the financial statement. Accountants often take counterpositions in the work papers and refer to facts that might injure the corporation if disclosed publicly.

*John Doe Corp.* involved a payments investigation by inside counsel, with some unknown degree of assistance from outside counsel. Apparently, in the investigation it was determined that an eighty or ninety thousand dollar payment was made to a lawyer. There was an indication that the payment was intended to be passed on to a government official to influence some government agency to take action for the benefit of the corporation. Of course, such a payment would be illegal under state, local, and federal laws. As the corporation went through drafts of the report of investigation that the audit committee was compiling, it edited out all reference to the payment, presumably because the amount of business to which it referred was not deemed material in the SEC disclosure sense. Giving all the lawyers involved the benefit of the doubt, we might assume that they made a legitimate decision that the payment was not material.

The company, which was going public, then showed its underwriter and underwriter's counsel the final report, which made no reference to the payment. The underwriter's counsel approved the registration statement, which made no reference to the suspicious payment, and the underwriter made the public offering. At the same time, the corporation's outside auditors, when auditing the financial statement, refused to sign without qualification unless they were shown the audit committee report. They were shown the final report, and that led to the issuance of a "clean" certificate by the outside auditors.

In the context of a grand jury subpoena for the prior drafts of the report, after all the individuals involved in the corporation pleaded the fifth amendment before the grand jury, the corporation pleaded both the attorney-client and work-product privileges. The Second Circuit held that asserting the privilege to avoid production of the prior drafts was a cover-up. First, the court noted that showing the final report to the auditors and to the underwriter's counsel constituted a waiver of the privileges not only as to the final report but to *all prior drafts*. Second, it held that even if it was not a waiver, the government had established a prima facie case that the corporation and its officers were involved in a continuing cover-up and conspiracy. The court held that under the circumstances, for the purpose of determining a grand jury subpoena enforcement action, no privilege would be recognized. The court thus ordered that all underlying documents relating to the independent investigation, including all prior drafts of the report, be produced. I mention the case because it demonstrates that even if one makes a bona fide judgment in an investigation that a payment was not material and need not be disclosed in a report, a court in hindsight may still find a cover-up conspiracy. Counsel ought to be very careful in deciding what he puts in a report and what he thinks will or will not be privileged information underlying that report.

*In re Sealed Case* was somewhat similar. There had been an investiga-

tion conducted by counsel as part of the SEC "voluntary" program.[34] Several reports and interviews were not described with specificity in the final report. In the grand jury investigation, the government attempted to show that the final report was a sham and a fraud, and actually covered up more than it revealed about the payments made by the company. The District of Columbia Circuit held that the underlying work product of and material gathered by counsel were not privileged. Because the investigation was made as a part of the SEC voluntary program, a number of conditions applied, which forced the company to (1) cease all illegal activity, (2) conduct an independent investigation either through an audit committee or otherwise, (3) publish a report making disclosure either generally or specifically, and (4) give the SEC and its enforcement staff access to its investigation.

The court said that this last aspect of the "voluntary" program in questionable payments cases was in essence a waiver of attorney-client privilege with respect to the documents underlying the investigation, unless a prior specific deal was made with the Commission staff before participating in the voluntary program. Thus, if the company reaches a more narrow agreement in advance with the Commission staff, it can join the voluntary program, investigate, and give access to its privileged material to the Commission under the condition that the waiver will be limited. Confidentiality would be waived only as to the Commission and its staff, and would not be waived for all purposes—the company's adversaries in private litigation would not be able to discover the privileged information.[35] On the other hand, the *Permian* case[36] seems to say that you cannot have a limited waiver of attorney-client privilege. The Supreme Court has not spoken on this subject yet.[37]

SPORKIN: I do not think a limited waiver helps in this case, because even a limited waiver would encompass the federal grand jury.

MATHEWS: I agree. Under a limited waiver probably the SEC, possibly the IRS, and definitely the grand jury will be able to obtain the information.

34. In developing its "questionable foreign payments" enforcement program, the SEC urged corporations to conduct their own internal investigations, identify and halt illegal payments, implement corrective procedures, and "volunteer" to work out appropriate public disclosure with the SEC staff. The SEC offered to consider, but did not absolutely guarantee, foregoing the institution of formal enforcement action against such corporate "volunteers." *See generally Hearings on the Activities of American Multinational Corporations Before the Subcomm. on International Economic Policy of the House Comm. on International Relations*, 94th Cong., 1st Sess. 180-87 (1975) (testimony of SEC Commissioner Phillip Loomis); Henderson & Sommer, *Sensitive Corporate Payments: The SEC's Voluntary Disclosure Program* in EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION 423 (1976); Herlihy & Levine, *supra* note 8; Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Act*, 89 HARV. L. REV. 1848 (1976).

35. *See generally* Block & Barton, *Securities Litigation—Waiver of the Attorney-Client Privilege by Disclosure to the SEC*, 10 SEC. REG. L.J. 170 (1982); Gruenbaum & Oppenheimer, *supra* note 7; Comment, *The Attorney-Client Privilege, the Self-Evaluation Report, and Diversified Industries, Inc. v. Meredith*, 40 OHIO ST. L.J. 699 (1979); Note, *Limited Waiver of the Attorney-Client Privilege Upon Voluntary Disclosure to the SEC*, 50 FORDHAM L. REV. 963 (1982).

36. Permian Corp. v. United States, 665 F.2d 1214 (D.C. Cir. 1981).

37. The Supreme Court bypassed the "limited waiver" issue in Upjohn Co. v. United States, 449 U.S. 383 (1981). The trial court in *Upjohn* had found that voluntary production of privileged material to the SEC and the IRS constituted an across-the-board waiver of attorney-client privilege. *See* 78-1 U.S. Tax Cas. (CCH) ¶ 9277, at 83,605 (W.D. Mich. 1978).

*In re Weiss*[38] is important in this context. In that case an attorney was called as a witness in an SEC investigation. After he testified pursuant to a limited waiver, he was subpoenaed before a grand jury, where he claimed the attorney-client privilege. The Fourth Circuit denied the privilege and found that a limited waiver to the SEC also encompasses the grand jury. Because the attorney in *In re Sealed Case* may also have engaged in obstructionist tactics, I think the real point in question in that case was whether an attorney-client privilege can ever be pleaded successfully in a grand jury investigation when the government contends that the privilege is being asserted solely to conceal an obstruction of justice.

In light of *Permian* and *In re Sealed Case*, it is probably best to focus attention on the work-product doctrine. In that regard, it is important to determine whether the company can come within the Supreme Court's view of that doctrine, which was given a very broad definition in *Upjohn*. It is also important to note that the D.C. Circuit in *In re Sealed Case* did point out rather firmly that there can be an effective "limited waiver" of the work-product privilege.

Let me close by mentioning a few final considerations that I embrace in my *fourteenth rule*. (Rules nine through thirteen appear in the appendix). First, when counsel tries to resolve a case by settlement, if the corporate entity will be named a defendant in any event, he should bargain to have the entity named alone to avoid having individuals named personally as defendants. Second, whenever the company has to pay money, whether in a disgorgement case or a restitution case, always get double credit for the payment. By that I mean make sure that the money is not put in an unmarked fund that may go to charity or to the United States Treasury. Make sure to negotiate a provision that after the company has disgorged the money, it will be held in escrow and can be used to settle all private damage actions that may be filed against the client.

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38. 596 F.2d 1185 (4th Cir. 1979).

# APPENDIX

*AFM Rules of Thumb in Defending SEC Investigations*

1. *Rule One:* Read the appropriate literature and case law precedent to assure proper consideration of all the legal pitfalls as well as available strategic options.
   a. Review the statutes, rules, and particularly the SEC Rules Relating to Investigations. *See also* Rule 2(e) of the SEC Rules of Practice.
   b. The literature and case law precedent relating to administrative disciplinary proceedings, civil injunctive actions, criminal prosecutions, parallel proceedings problems, and perhaps the Foreign Corrupt Practices Act, may be just as important as materials that relate solely to SEC and grand jury investigations. *See* Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567 (1975).
   c. Although SEC investigatory powers resemble the powers of a federal grand jury, the strategy in defending an SEC investigation may be quite different from the strategy in defending a grand jury inquiry embracing the same activities. The fact that defense counsel may not be present in the grand jury room when witnesses testify, but may be present at the SEC interrogation into the same activities, means that defense counsel has a substantially greater opportunity to influence and control the content of the SEC investigative record as opposed to the grand jury record.
2. *Rule Two*: Take control of the investigation—get the SEC out as quickly as possible.
   a. Obviously, neither defense counsel nor his clients should engage in sharp tactics that smack of obstruction of justice, but within acceptable legal and ethical bounds, counsel should influence as much as possible the speed and scope of the investigation.
   b. If necessary, have the client offer to investigate itself, or to have an independent special counsel conduct the investigation. The goal is to have a nonprosecutorial person, rather than a government enforcement agency, conduct whatever investigation is required.
3. *Rule Three*: Consistent with an attorney's duty to avoid conflicts of interests, when representing the corporate entity, also represent as many individuals (officers, directors, and employees) as is tactically and practically possible and ethically appropriate. Otherwise the record may not adequately contain all mitigation evidence on behalf of the entity, or of particular individuals.
   a. Be careful to assure that the representation of any one individual will not raise a future conflict of interest that will require you to withdraw from representing the corporation or other particular individuals in the investigation or in other related litigation.

   b. Explain potential conflicts of interest to each client.
4. *Rule Four*: Give appropriate consideration to existing and potential "parallel proceedings" problems.
5. *Rule Five*: Avoid subpoenas by voluntarily offering to produce documents or witnesses for testimony. Grant access and inspection, rather than originals or copies of documents whenever possible. Ask for return of documents when the government inquiry is completed.
6. *Rule Six*: Conduct as detailed a preparatory investigation as time and circumstances permit, to assure that counsel and investigatees or witnesses will be prepared for all significant issues that might arise.
   a. Study the SEC formal order of investigation in advance.
   b. Review all documents before authorizing inspection or copying by the SEC.
   c. Interview as many persons as possible in advance, and obtain access to, and review, as many transcripts of testimony of other witnesses in the investigation as is allowed by other witnesses and their counsel.
7. *Rule Seven*: Conduct as much testimony as possible off the record.
8. *Rule Eight*: Protect applicable privileges.
   a. When privileges are waived, structure a *Diversified Industries* "limited waiver" so that privileges can still be asserted against third parties in private litigation.
   b. Consider a "self-evaluative" privilege. *See, e.g.*, the discussion of a "self-investigative" or "self-evaluative" privilege in Reed, *Corporate Self-Investigations Under the Foreign Corrupt Practices Act*, 47 U. CHI. L. REV. 803, 820-22 (1980). *See also In re LTV Securities Litigation,* 89 F.R.D. 595 (N.D. Tex. 1981); Murphy, *The Self-Evaluative Privilege*, 7 J. CORP. L. 489 (1982).
9. *Rule Nine:* Protect the record.
   a. Put into the record mitigation evidence (both documentary and by oral testimony) and defenses, subject by subject as the SEC interrogator completes each separate line of inquiry.
   b. If tactically appropriate, do not allow the SEC interrogator to explore on the record areas that are beyond the scope of the formal order of investigation.
   c. Make sure all documents are stamped and numbered both for identification and confidentiality purposes.
   d. Have in the record an itemization (as general as may be appropriate) of all withheld privileged documents.
10. *Rule Ten:* Preserve confidentiality.
   a. AFM *"laundry list":* Set out up front in the record your detailed list of confidentiality and related requests.
   b. FOIA problems.
   c. Privacy Act—object to such "routine uses" as providing investigative information to Congress and to the press.

d. Trade Secrets Act—18 U.S.C. § 1905. There may be entitlement to confidential treatment for most internal business, commercial, and financial information.

e. Right to Financial Privacy Act—12 U.S.C. § 1304. *See., e.g., Hunt v. SEC,* 520 F. Supp. 580 (N.D. Tex. 1981).

f. Possible "self-evaluative" privilege.

11. *Rule Eleven:* Correct and supplement the record. Hold the record open until you can purchase and/or review the transcript of testimony and make whatever additions, corrections, or supplementation (by letter, affidavit, or further sworn testimony) as is required to best protect your client's interest.

12. *Rule Twelve*: Make appropriate strategy decisions designed to keep the prospective criminal defendant or defendants out of jail, and save as much of the defendant's money as possible.

13. *Rule Thirteen*: If making a "*Wells Committee*" Submission, make sure all statements therein are accurate. At the same time, avoid making admissions that will bind the client if and when the Submission is produced in discovery in subsequent litigation. Avoid losing credibility with the Commission and its staff by making unsupported or erroneous statements in a Submission. *See* SEC 1933 Act Release No. 5310 (1972).

14. *Rule Fourteen*: If your client chooses to negotiate a settlement, as opposed to litigating—which is typical when public corporations are the subject of investigation—negotiate a consent that will accomplish, if possible, the following eight objectives (*see* 1 & 2 A. MATHEWS-NEGOTIATING SEC CONSENT DECREES: TARGETS & TACTICS FOR SETTLING CIVIL INJUNCTIVE ACTIONS (1979)):

a. Avoid including in the consent any findings of violations or guilt, thereby avoiding the collateral estoppel effects of the *Parklane Hosiery* case. Also, if findings are necessary (e.g., in an administrative proceeding), agree only to findings of nonfraud violations, or at least limit the findings to those sections of the antifraud provisions that do not require proof of scienter (i.e., those subsections that may be violated by mere proof of negligence. *See* sections 17(a)(2) and 17(a)(3) of the 1933 Act. *Cf.* section 17(a)(1) or Rule 10b-5).

b. Absent conflicts of interest, in cases in which the corporate entity will be named a defendant in any event, let the entity "take the rap" and avoid the circumstance of having individuals personally named as defendants.

c. Get double credit for any money paid in disgorgement. Make sure 100% of any fund can be used to settle parallel private damage actions.

d. Agree to ancillary relief that embraces prophylactic policies, procedures, and practices (e.g., independent audit committee, compliance review) that constitute good business practice the client would con-

sider implementing in any event, even without the existence of an SEC enforcement proceeding.

e. Resolve as many direct or indirect statutory disqualifications as possible as part of the formal settlement. (For a listing of possible disqualifications, *see* Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level (Civil) Injunctive Actions,* 31 BUS. LAW. 1323 (1976); Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 142-46 (1975)).

f. Negotiate the specific language in the charging document (Complaint or Order for Proceeding) as well as the Settlement Order (Injunctive Decree or Order Imposing Remedial Sanctions). The cosmetics of the settlement may be the most important aspect.

g. Have the settlement filed in the jurisdiction of most inoffensive venue.

h. Influence the publicity when the settlement is filed. Try to negotiate a bland SEC press release and have your client issue a press release putting the client in the best fair light. But do not "deny" the allegations when the consent is specifically conditioned on "without admitting or denying" language (avoid a "*Fashion Two-Twenty*" fiasco).

# INTERNAL CONTROLS

A.A. SOMMER, JR.†

SOMMER: I would like to start with some general comments. When an attorney is involved in an internal investigation as outside counsel, inside counsel, or regular outside counsel, there inevitably are going to be antagonisms and tensions. But I do not think they need to escalate to the point to which I have seen them escalate in a number of instances. There will be harshness and bitterness in any event, but I think a tactful and sensible approach on the part of the investigator can avoid a lot of problems and save a lot of money. A company can spend a tremendous amount of money fighting the investigator's report, and I think this can be avoided if there is more sensitivity on the part of the investigators.

My other general observation concerns the development of the internal investigation mechanism. Internal investigations had been performed before the SEC announced its voluntary disclosure policy in the mid-1970s. But as a result of the Commission's voluntary disclosure program, a larger number of important and publicized investigations were undertaken. The result has been the development of a new institution—the internal investigation—which is an extra-legal institution, because there is no statutory basis for it. There is a broad common-law basis for the proposition that if a corporation senses that there has been wrong-doing, management has an obligation to ascertain the extent of it and to pursue a remedy. Nonetheless, there is no statute that directs a corporation to conduct an internal investigation.

Despite the absence of formalized legal support, a set of "laws" has developed around the investigations program initiated by the Commission. A good deal of common practice has developed that can be found in various manuals and articles. Entire congeries of techniques have developed to deal with a problem that requires investigation. It does not necessarily have to be a matter involving securities fraud. Wherever management finds a problem it wants to eradicate effectively and in an objective fashion, it may resort to this new technique of internal investigation. I think this is a very important development in the area of corporate law.

Internal controls have several important attributes from the standpoint of SEC investigations. First, internal controls should reduce the possibility that a corporation will violate the federal securities laws in a manner that would trigger interest on the part of the SEC. There is no guarantee that good internal controls will have this result, but certainly there is every reason to think that violations will be prevented. Second, if the internal controls have been

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effectively monitored and enforced, but the company nonetheless gets into trouble with the SEC, the company has at least a good argument for a mitigation of the severity of the remedy proposed by the Commission. The company can argue that the particular violation at issue was an aberration that simply slipped through the net of an effectively functioning internal control system. The third importance of internal controls is that they are a very important element in negotiating a settlement with the SEC. As a matter of fact, I think it can fairly be said that an attorney who goes into negotiations with the SEC armed with realistic proposals for the development of stronger internal controls places himself in a much better position for negotiating a settlement that in some fashion will be satisfactory to the SEC as well as to his client. I do not want to call this a negotiating ploy because it goes beyond that. It can be an effective way of starting the process of settling these matters in a fashion that avoids at least some of the Draconian remedies the SEC might impose if the negotiator does not take this kind of initiative. Finally, I think the most important thing about effective internal controls is simply that they are good business. They are good economic business because the benefits almost always will exceed the costs. They are also good legal business, not because they provide work for lawyers, but because they demonstrate sound legal judgment.

What do I mean by "internal controls"? I intend the term to have broader significance than the ordinary and most often used definition of internal controls. Most of the literature about internal controls today concerns accounting controls. Of course, part of the reason for this emphasis is the importance placed upon accounting controls as a result of the Foreign Corrupt Practices Act.[1] I am going to suggest that internal controls really consist of two elements: one is accounting control; the other is frequently referred to as administrative or management control. The definition of internal controls in the auditing literature is the plan of organization and all the coordinate methods and measures adopted within the business to safeguard its assets: accounting, checking the accuracy or reliablitiy of accounting data, promoting operational efficiency, and encouraging adherence to a prescribed managerial policy. The last of these measures, with its emphasis on managerial policy, comes close to what I would call administrative control. Thus, internal controls in the broadest sense are concerned with everything that contributes to the existence and continued well-being of the corporation. It includes more than financial accounting matters and addresses issues that are well beyond the scope of financial statements.

Let us first consider accounting internal controls. Prior to December 1977, the matter of internal controls was largely a question of technique. One of the techniques used by the auditing profession in the course of auditing the financial statements of a corporation was to examine the quality and the status of the internal controls of the corporation. If a corporation had reliable internal controls, then the auditor did not have to perform many of the tasks that

1. Foreign Corrupt Practices Act of 1977, §§ 101-104, 91 Stat. 1495, 1495-98 (codified at 15 U.S.C. §§ 78m(b)(2), 78m(b)(3), 78dd-1, 78dd-2 (Supp. V 1981)).

otherwise would have been required to give an opinion on the company's financial statements. The literature has sufficiently elaborated what the standards are in determining what those internal controls should be.

In December of 1977, as a consequence of the Foreign Corrupt Practices Act, practices that had been merely auditing techniques suddenly became legal requirements imposed upon all reporting companies under the 1934 Act. Failure to comply with the standards of internal controls that had been previously embedded in auditing literature became a possible source of an SEC proceeding, and conceivably a criminal proceeding, and could also be the basis for an implied cause of action. The Foreign Corrupt Practice Act was spawned, you might say, by the problem of overseas payments and domestic political contributions. Testifying in 1976, SEC Chairman Hills stated that in virtually every case involving improper payments, the payments had been accompanied by some sort of abusive accounting treatment. In response, Congress adopted the Foreign Corrupt Practices Act, which, in addition to prohibiting certain payments overseas, also provided that every reporting company had to keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect the transactions and the disposition of the assets of the issuer. The Act also stated that each of these companies had an obligation to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were executed in accordance with management's authorizations, that transactions were recorded in a certain fashion, and that access to assets was in accordance with appropriate authorization. In addition, the corporation had to compare the entries of the books with the assets themselves at reasonable intervals.

There was a great deal of discussion of this legislation. In many cases the discussion became very confused because some people, both on the SEC staff and on the outside, believed that the statute dealt with administrative controls as well as accounting controls. But I would emphasize that the thrust of the Act was in the area of accounting controls.

Most of the elements of the accounting internal controls required by the Act were taken from the accounting literature. The words in the statute pertaining to internal controls were drawn verbatim from the accounting literature.[2] Therefore, much of the interpretation of internal controls necessarily is found in the body of accounting literature that preceded the Act. Obviously, whenever lawmakers take a standard that has been developed for a different purpose and bring it into a statutory scheme, they create the possibility of a lot of difficult interpretation problems.

In the course of setting up any system of internal controls, people are the heart of the system. A company must have people who understand what they are supposed to do. Employees must have an appreciation of internal controls, be committed to them, and have an awareness of why they exist and why they are necessary and beneficial to the corporation. Moreover, in setting up

2. *See* CODE OF STATEMENTS OF AUDITING STANDARDS § 320.28 (American Inst. of Certified Pub. Accts. 1976).

internal controls, the company must have a perception of where the risks are likely to be. Some accounting professionals are placing great emphasis upon the assessment of risk areas—areas where it is likely that something will jump out of the basket when least expected.

In assessing risks, the company confronts the problem of determining when a risk is so serious in monetary terms that it should expend whatever amount of money is necessary to control and reduce the risk of a malfunction in the system. "Reasonable assurance" is the statutory expression of the test for determining when a risk should be controlled.[3] The reasonable assurance test is very important when the company is deciding whether a certain control mechanism should be put into place. As an example, if the corporation has an asset worth $1,000, it is not going to employ a security guard at $15,000 a year to guard that asset. In many circumstances, companies will consciously take the risk that there may be an erosion or disappearance of an asset simply because there is no practical economic way to guard against the possibility of the illicit disposal of that asset.

There are inherent limitations in this formulation of the reasonable assurance test. First, it is impossible to create a system that protects entirely against any possibility of diversion of assets or inappropriate or unauthorized transactions. In fact, at the time the Foreign Corrupt Practices Act was being considered in Congress, the American Institute of Certified Public Accountants contended that, rather than mandating certain controls, the legislature should address the problem of individuals who found ways to circumvent controls that on their face seemed adequate. In many instances, there appeared to be merit to that argument.

A second constant danger is circumvention of and collusion to avoid the controls. Rather than employing individuals who are sensitive to the system, know how it is supposed to work, and are committed to it, the company may have people who do not understand how the system should work, do not understand their responsibilities, and are not sympathetic to the reason for the system. A standard system of control with which we are all familiar is the requirement that checks must have two signatures. What happens if the two people who are supposed to cosign the checks happen to be colluding to perpetrate a fraud? Obviously, even though the company has a system of controls in place, the controls will have failed. Does that mean the company ought to require six signatures? This also illustrates the question of how far it is necessary to go and what costs the company should incur to assure the integrity and adequacy of the controls.

The third problem in creating an adequate control system is "control override," which occurs, for example, when someone in authority comes to someone lower on the totem pole and says, "Sign this paper," and the underling says, "I don't want to sign it." The superior replies, "Do you like your job?" and the subordinate remembers that his wife is in the hospital and that

3. 15 U.S.C. § 78m(b)(2)(B) (Supp. V 1981).

he has three kids in college, and suddenly it becomes possible to sign the paper. Control override is always a danger. Therefore, any good control system provides for controls on the chief executive officer as well as on everyone else. In many audits, outside directors review the expense accounts of all officers, including the chief executive officer. They will review any transactions involving the top officers in the corporation. For example, when a company is in the real estate business and the chief executive officer wishes to purchase a piece of property from the company, an independent appraisal should be required. The directors and the audit committee should look at comparable sales in the neighborhood to determine whether the purchase should be authorized.

Finally, changing circumstances may make a control system obsolete. Many companies make the mistake of assuming that once an adequate control system is in place, it is going to be adequate indefinitely. There is a constant necessity for updating controls to assure their validity in the future.

The elements of an internal control accounting system create what is called the control environment. To create the control environment, there first must be an authorization for the controls. A proper system of authorizations must be clearly understood. Requiring two signatures to authorize withdrawal of funds from a bank is illustrative. Another example is the clearly defined authorization structure in a bank. Only certain bank officers can approve loans of certain sizes; some loans have to come to the board if they are of a certain magnitude. Thus, there must be established standards, not only for routine transactions, but for identification of the nonroutine transactions that should be brought to the attention of higher authority.

Second, if the company is going to have control standards, they must be properly communicated to the people who are going to be responsible for their implementation. The standards should be continuously updated, and they should be understood by the people who must implement them. In many instances these standards are communicated through a code of ethics. One of the institutions often recommended as part of this communication effort is a mechanism through which employees who are aware of some sort of an evasion of controls can communicate with someone who can do something about the breakdown. The code of ethics should specifically explain the proper channel of communication; for example, it could indicate that the reporting should be done to the head of the internal control department, at a given address and telephone number.

A third problem is the assurance of properly segregated duties. If a company is going to have an effective accounting control system, the same person should not make the purchase order, sign the invoice or receipt for the goods when received, authorize the payment of the check, and sign the check. In a nonsegregated system, it is very easy for fraud to be committed. Therefore, a segregation of duties in any control system is terribly important.

Additional concerns include the problems of protecting the integrity of an electronic accounting system and implementing safeguards so that unauthorized persons cannot get into the system. Obviously, there is a broad concern

about the use of computer systems: Who should have access? How does a person get access? Who has authority to control access? Again, the company risks the possibility of collusion if two people are necessary to gain access.

The final requirement for an adequate internal control system is to monitor compliance to make sure that the controls are not simply a dead letter. The integrity of both the administrative and the accounting internal control systems require compliance right from the board of directors down through the organization. The directors obviously cannot monitor the controls in detail to determine whether the system is adequate and properly functioning. They often do not even have access to many of the details of the system. But at a minimum they should make an inquiry, usually through the audit committee, into the operation of the accounting control system. They should be sure that a system is in place, and that the employees are sensitive to the importance of adequate internal controls. I am aware of one company in which the chief executive officer was cutting back all overhead across-the-board. All administrative overhead was cut by ten percent, in the course of which ten percent was lopped off the internal auditing staff. The audit committee, made up entirely of outside directors, opposed the cutback because it believed the function of the internal auditing staff was too important. The cutback would lead to a cycle of internal audits that would not be adequate for the corporation. The committee stood its ground, and the internal auditing staff was one department that did not get cut in the course of the general cutback. Thus, there is an increasing sensitivity in corporations to the importance of internal controls as a protective mechanism for the directors as well as for the entire corporation.

Obviously, the responsibility for implementing and monitoring internal controls in the first instance lies with management. In the course of properly carrying out that responsibility management should have an inside auditor who has some channel of communication to the audit committee. If there is no internal audit committee, an increasingly rare occurrence, then the inside auditor should go to the board. In corporations with which I am associated either as counsel or as a member of the board, we meet regularly with the internal auditor, who gives us a monthly report on the internal audits that have been done and the status of controls in each of the divisions of the company. And, of course, the outside auditor is increasingly asked at audit committee meetings whether the company has an effective system of internal controls.

I have been discussing matters that in many respects relate both to administrative and accounting controls; now I would like to focus on the administrative side of controls. Administrative controls are the procedures designed to assure that transactions are authorized at the proper level, that the right people have been involved in the decision making, that the right people have signed off with regard to various actions undertaken, and that the right people have received the information necessary for proper completion of their duties. For example, there is always the difficult question of what matters should be decided by the board of directors. Whereas board matters are sometimes statuto-

rily determined—such as divided payments and merger agreements—it is also customary for other matters to go to the board, such as the designation of proxies and the review of charitable contributions. But one of the problems that every counsel has, particularly inside counsel, is determining what matters are appropriate for board action and when the express or implied authority of some officer permits him to take action without the necessity of board involvement. Conflict of interest problems are a particular difficulty. I was involved in a case in which the corporation purchased one fragment of a piece of property, and the officers and a few other people purchased the remainder of it. Since the officers were indirectly involved in the transaction, the matter had been done without board approval. In retrospect, everyone involved realized that had there been a heightened sensitivity to the probability that there was a germ of conflict of interest in the transaction, the matter should have and would have gone to the board. Had that been done, the transaction probably would have been structured differently and might not have drawn the SEC's attention.

In recent times, increased institutionalization, such as the use of more outside directors and audit committees, has been used to assure compliance with good systems of control. Compensation committees or audit committees as a matter of practice review expense accounts and transactions that involve an officer. The audit committee is a creature of the board, and therefore the board must exercise reasonable care in its appointment and monitoring. I think that any audit committee or executive committee would breach a duty if it did not report to the board of directors something it discovered in the course of its activities that was important for the board to know. If the audit committee knowingly conceals something from the board, and the board has no reason to know of the omission and has performed its monitoring function adequately, the directors not on the audit committee should not be liable, because they had no knowledge or reason to believe there was a breach of duty on the part of the auditor. Members of the audit committee, however, should be liable.

Another internal control problem is determining when counsel should be consulted. Again, the answer involves communication, identification, and updating, because in many instances things will slide through, and nobody will be aware of procedures which dictate that the matter should go to counsel. For instance, in the area of antitrust, counsel should certainly be aware of any meetings between personnel of the corporation and competitors. Counsel should inquire about what topics are going to be discussed, what the agenda is, and whether an attorney is going to be present. This is a difficult area to enforce in a large corporation because there are many people involved who are not all well-educated in the law. This suggests the necessity of a strict, urgent, and comprehensive compliance program so that people have constantly drummed into them what the corporate lawyer is for and when he should be consulted.

A current problem in many corporations is coordinating the activities of

the many lawyers who are involved with corporation affairs. In decentralized companies, law-related activities of one division often do not get communicated to a central source. How does the company make sure that all its attorneys are doing the right job? An illustrative SEC enforcement proceeding involved a law firm, but the same thing could happen to a corporation. The enforcement proceeding arose because the people in the law firm who were handling substantive matters for the corporation were not communicating effectively with the people who were writing the proxy statements or registration statements. As a consequence, some of the transactions were not properly put through the "screening mind," if you will, of people who were specialists in securities law and had an understanding of SEC requirements for proxy and registration statement disclosure of interests in transactions with management. There is a tremendous necessity for administrative control procedures to coordinate the activities of multiple lawyers who are concerned with the affairs of a corporation.

SPORKIN: Couldn't a corporation have a simple list of things that ought to go to the board? A simple checklist could require that when certain kinds of information, such as falsification of records or an overpayment scheme, come to the attention of the accounting department, internal auditor, or general counsel, they should report the information directly to the audit committee.

SOMMER: Checklists are useful devices, but any checklist may have limitations. What is needed more than anything else is intimate involvement of counsel—especially inside counsel—in the ongoing affairs of the corporation, so that he can be sensitive to things that are not on the checklist. There is no question that some kind of litany would be useful, and people should be instructed with regard to it. But people may think that only those things enumerated need to be brought to the board. Yet it is always the unusual kind of transaction that causes a company trouble, and such problems can be remedied only by people who are sensitive to the problem and who are the focal point through which a lot of information flows. The checklist does have a value, but there has to be an elasticity in it; the company must try to overcome the tendency of people to regard the checklist as exclusive.

I would now like to touch briefly upon the recent *Playboy*[4] settlement. This is an instance in which the company had inadequate controls, pure and simple. As part of the settlement, the Commission agreed to accept certain offers made by the company concerning the manner in which these controls could be strengthened. These offers involved not only the strengthening of accounting controls, but administrative controls as well. The settlement required the establishment of a compensation committee, which would have additional duties, such as the review and determination of the fairness of the amount of money Mr. Hefner paid for the use of the mansion and the entertainment of his guests. Another settlement in which internal controls were

4. *In re* Playboy Enterprises, Securities Exchange Act Release No. 17059 (Aug. 13, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,635.

imposed was *Telex*.[5] SEC settlements, as exemplified in the *Telex* and *Playboy* cases, has been a rich source of learning about some of the techniques of control that can shore up and eliminate, or at least reduce significantly, the danger of violations in the future. As a matter of fact, I think one of the credits to the Commission is that in the settlement of this type of case, it has routinely insisted that there be a strengthening of the control systems—both administrative controls and accounting controls—in a fashion that will provide significant guarantees to the shareholders that the abuses of the past, or new abuses, will not emerge in the future.

SPORKIN: I think on that point it is important to avoid misconstruing those cases. The SEC was criticized for imposing these controls by people who thought the SEC was trying to impose them across-the-board for all companies. That was not the case. On the contrary, in *Telex* and *Playboy* the SEC engaged in what is known as regulation by exception: if a particular company has committed violations, then the Commission goes in and pinpoints the problem with that particular company so it can craft the kind of controls necessary to end those particular abuses. But the controls imposed should not be taken as an overall rule.

SOMMER: But I think that is only half the story. Particularly in the overseas payment cases, the Commission saw a means of illustrating the kinds of traps that other companies could fall into. The settlements had a "preaching" effect that was directed at other corporations in addition to the parties to the settlement themselves. Although the settlements were not imposed as a regulation for every corporation, they were seen as a recommendation.

AUDIENCE: In your administrative controls would you include methods of dealing with sensitive information in the company—the insider trading problem?

SOMMER: Yes, I think so. A lot of companies have established procedures to handle the problem of insider trading. Some companies provide extensive memoranda to their officers and directors with regard to both 10b-5 and 16b problems. Some companies have established a practice of preparing Forms 3 and 4 for their directors and have given instructions that officers, directors, and ten percent shareholders inform the company about the transactions they enter into. A number of companies check the holdings indicated by Form 4 against the information directors put down on their questionnaires prepared in conjunction with the proxy statement. I think this procedure is one administrative control that is desirable.

AUDIENCE: Since a lot of directors hold stock in nominees' names, how effective is the monitoring system of Forms 3 and 4?

SOMMER: The basic instruction is that the directors report to the secretary's office any transaction involving any accounts in which they have an interest or a power. Obviously, there may be a breakdown if someone forgets to

5. *In re* Telex Corp., Securities Exchange Act Release 18694 (April 29, 1982), [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,209.

tell the secretary's office. But the next time such a person is given a questionnaire in connection with a proxy statement, if he fills it out accurately and honestly and if there is a good control system, someone in the secretary's office is going to say, "Wait a minute. I don't have a Form 4 on the last 500 shares you bought." I know this can happen because I got caught once. I simply overlooked a hundred shares I had bought for a trust account, and when I put it down on the questionnaire for the proxy statements someone in the secretary's office asked where I got the hundred shares. Suddenly it dawned on me that I had neglected to file a form. In cases such as that, you file a late report. Nothing is going to happen to you, unless it is a very large amount; then you might have some problem.

# ELIMINATION OF MINORITY SHAREHOLDERS

RUSSELL M. ROBINSON, II†

ROBINSON: This subject presents a very good opportunity to examine the basic competing interests in corporate law and the development of corporate law in a changing business climate. The subject illustrates rather dramatically the current state of federal corporation law and the direction in which it may be moving in the future. Because historical development is very important in this context, I will use it extensively in the presentation. Justice Holmes' maxim, "A page of history is worth a volume of logic," is quite pertinent here, whether the listener is a practicing lawyer or has only an academic interest in corporation law.

The beginning point of the historical development is nineteenth century corporation law, which gave minority shareholders the power to disapprove any fundamental change in the corporate structure, such as merger, charter amendment, or dissolution. Because any change of that nature required a unanimous vote of the shareholders, minority shareholders had a veto power over any basic corporate change. As corporation law began to develop, this situation was recognized as impractical and was changed to give minority shareholders who dissented from any fundamental change a right of dissent. Thus, in a merger or consolidation minority shareholders had an election to terminate their interest but could not be forced out. For a number of years that situation was thought to reflect the proper balance between the rights of the majority shareholders and the rights of the minority. The courts were wary of any effort by majority shareholders to force the minority shareholders out and frequently held that minority shareholders had a right not only to the value of their investment but also to the form of their investment.[1] The minority had a right to stay in the corporation if it so desired. Nonetheless, as the complexity of corporate finance has increased, there is often a need to eliminate minority shareholders when differences of purpose between minority and majority shareholders arise out of the complex world of business and law. There has been an increasing desire, or even pressure, on the part of majority shareholders to cash out the minority, and over the years this goal has been accomplished for a number of purposes and by a number of methods.

For corporations other than those that are closely held, it is useful to categorize the types of situations in which minority shareholders have been eliminated. First is the true "going private" situation, which usually occurs when a corporation has been private and then has gone public by public sale. Thereaf-

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1. *See, e.g.*, Starring v. American Hair & Felt Co., 191 A. 887, 890 (Del. Ch. 1937); *see also* Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1069-72 (1931).

ter, the majority, which is represented by the management, may want to reverse the process and remove the minority shareholders to regain private corporation status. This type of elimination of minority shareholders has been most suspiciously regarded by the courts, and some commentators have suggested that it should never be allowed.[2] The second type of situation arises when a corporate enterprise consists of a number of different corporations (for instance, a parent with minority interest in some of the subsidiary corporations), and there is a desire on the part of the majority to eliminate the minority interest in the subsidiary corporation. The third type of situation is the two-step acquisition: instead of making a unitary, single acquisition of the assets of a corporation, the acquiring corporation first makes a tender offer to acquire a majority of the shares of the acquired corporation and then completes the acquisition by eliminating the minority shareholders in a cash out merger.

The methods by which minority shareholders have been eliminated include elimination by dissolution of the corporation. This process involves the sale or transfer of the assets to the majority and cash to the minority. Because the courts simply have not accepted this type of blatant cash out elimination of minority shareholders, such attempted eliminations have seldom been successful.[3] A slightly more sophisticated method that has also generally met with judicial disfavor is a reverse stock split, in which the charter of the corporation is amended to provide that most of the minority shares will be fractionalized and cashed out in the plan of recapitalization.[4] This process has the disadvantage of not giving the minority shareholders a right of dissent, a right emphasized by the courts in validating the elimination of minorities.

A final method of minority elimination is the cash-out or take-out merger, and that is the method I would like to examine more closely in today's presentation. It is crucial to assess the validity of these procedures under both state and federal law. The threshold question under state law is: What is the statutory basis of a cash out merger? The inquiry then must focus upon limitations imposed by state courts. Finally, the matter of federal law must be considered: what federal limitations are to be imposed upon the elimination of minority shareholders by a cash out merger? Key limitations today are rule 10b-5 and the relatively new SEC rule 13e-3.

An example will illustrate the problem: A company is owned by minority shareholders at forty-nine percent and majority shareholders at fifty-one percent. The majority wants to cash out the minority, and chooses to do so by organizing a new shell corporation, to which it transfers all its shares in the company. This transfer terminates the old majority line of ownership and ma-

2. *See* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); Note, *Singer v. Magnavox and Cash Take-Out Mergers*, 64 VA. L. REV. 1101 (1978).

3. *See, e.g.*, Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919); Kellogg v. Georgia-Pacific Paper Corp., 227 F. Supp. 719 (W.D. Ark. 1964); Efron v. Kalmanovitz, 226 Cal. App. 2d 546, 38 Cal. Rptr. 148 (1964).

4. *See, e.g.*, Shivers v. Amerco, 670 F.2d 826 (9th Cir. 1982) (100-for-1 reverse split); Teschner v. Chicago Title & Trust Co., 59 Ill. 2d 452, 322 N.E.2d 54 (1974) (takeout by 600-for-1 reverse split allowed; no claim of unfairness asserted).

jority shareholders now own one hundred percent of the shell corporation, which in turn owns fifty-one percent of the company. The next step consists of merging the company into the shell for cash, creating a "cash merger." The only consideration issued in the merger is cash, which is issued, of course, to the minority shareholders, who are then eliminated. In the simplest terms, this is the cash out merger in instances involving individual majority shareholders.

A variation of this procedure involves a parent corporation that owns a subsidiary at perhaps fifty-one percent, and wishes to cash out a minority shareholder group. This subsidiary then merges into the parent in a cash merger. If the parent owns a sufficiently large percentage of the subsidiary (ninety percent under Delaware law), there can be a short form merger that does not require the approval of any shareholders.[5] More sophisticated versions of the cash out merger include reverse mergers or reverse triangular mergers.[6] Until fairly recently, a cash out merger was not permitted under the law of most states because the only consideration permitted in a merger was securities of a participating or constituent corporation. That began to change, first in the short form merger statutes. New York was the first state to adopt a generally applicable short form merger statute in 1949; that statute permitted the use of cash in a short form parent-subsidiary merger. In the 1960s, most state statutes were amended to permit cash to be used as consideration in mergers.[7] The motivation for these amendments was the liberalization of the federal tax law to permit triangular mergers and other more complex reorganizations to be treated as nontaxable reorganizations.[8] I do not believe that anyone involved in those amendments foresaw what has developed since then. The drafters of the legislation that permitted the use of cash consideration in a merger as a means of providing greater flexibility under the tax law probably did not foresee that it would also be used as a means to eliminate minority shareholders. Nonetheless, it was not long before that potential was recognized.

I think the first case involving cash out of a minority was *Beloff v. Consolidated Edison Co.*,[9] which concerned a short form merger in New York. The court held that the minority shareholders had a protectable right in such a situation only to the value of their shares, not in the form of their investment. The court thus permitted a cash out in a short form merger. As more cases followed, the courts almost without exception held that this type of transaction was permitted by the statutes. The minority shareholders had their right of

5. *See* DEL. CODE ANN. tit. 8, § 253 (1975 & Supp. 1982).

6. In a triangular merger the acquired corporation merges into a wholly owned subsidiary of the acquiring corporation in exchange for shares of the acquiring corporation; in a reverse triangular merger the subsidiary of the acquiring corporation merges into the acquired corporation in exchange for shares of the acquiring corporation. In such cases, the wholly owned subsidiary is usually newly formed for the purpose of the acquisition.

7. The Model Business Corporation Act was thus amended in 1969, as was N.C. GEN. STAT. § 55-106(b)(4). NEW YORK BUS. CORP. LAW § 902 (a)(3) was amended in 1961 and DEL. CODE ANN. tit. 8 § 251(b)(4) was amended in 1967.

8. *See* I.R.C. § 368(a)(2)(D) (1976) (enacted October 22, 1968).

9. 300 N.Y. 11, 87 N.E.2d 561 (1949).

dissent and appraisal, and thus were deemed sufficiently protected. As is often the case, the Delaware cases provided the lead for these holdings and developing attitudes.

For instance, in *Stouffer v. Standard Brands, Inc.*,[10] the Delaware court observed that the real purpose of the short form merger statute was to give the majority shareholder (the parent) a convenient means to cash out the minority shareholder. That principle was extended in *David J. Greene & Co. v. Schenley Industries, Inc.* to long form mergers.[11] The New York Court of Appeals held in *Wilcox v. Stern* that minority shareholders could be cashed out through this type of cash merger.[12] These cases and others developed a body of law that permitted cash out mergers, without any limitations expressed, as a valid minority elimination device. The stage was thus set for the dramatic reversal of the law on this point and the stemming of the tide of federal corporation law that took place in 1977.

Changing attitudes in the business community and various economic developments exposed the inequity of cashing out the minority shareholders in a true going private merger. In the late 1960s going public was the thing to do. Everyone wanted to go public. In the aggressive years, a public offering brought twenty-five or thirty times earnings, and corporations that should have stayed private went public. When recession came in the early 1970s, however, and stocks that sold at thirty dollars per share were trading at one dollar per share, many companies began to consider going private by merging out minority shareholders, thereby avoiding SEC reporting requirements and other corporate burdens. By the fall of 1974, Commissioner Sommer was prompted to observe that it was unconscionable for the law to allow owners of a corporation to invite the public in at a high price, only to eliminate them at a low price when the market fell. He observed that there were two interests to be protected: not only the interest of the minority shareholders, but also the integrity of the marketplace. The developing merger practice was disruptive of confidence in the market place if the corporation could enter the market to seek funds and later eliminate those public shareholders at a tremendous individual loss. In response to this situation, the SEC published a proposed rule, which later became rule 13e-3.[13] Case law in that period was uniform in permitting cash out of minority shareholders. In 1974 the Fifth Circuit, in an opinion by Judge Tuttle, did hold that such transactions were not to be allowed.[14] Nonetheless, that decision stands alone in a judicial environment that readily permitted this kind of cash out merger.

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10. 41 Del. Ch. 7, 187 A.2d 78 (1962).

11. 281 A.2d 30, 35 (Del. Ch. 1971).

12. 18 N.Y.2d 195, 219 N.E.2d 401, 273 N.Y.S.2d 38 (1966).

13. *Going Private Transactions*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366, at 88,735 (Nov. 17, 1977).

14. Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974), *cert. denied*, 419 U.S. 844 (1975).

*Marshel v. A.F.W. Fabric Corporation*[15] offers a particulary good illustration of the problems in allowing a cash out merger in a going private situation. In *Marshel* two families that owned a textile company went public in 1968 and 1969, receiving $7,800,000 from the public. The stock was listed on the American Stock Exchange and traded as high as twenty-five dollars before falling to one dollar. It occurred to the owning families, who still held sixty-eight percent of the stock, that they might eliminate the minority shareholders. The families organized a shell corporation and merged the public company into the shell, thereby cashing out the minority. The shareholders, feeling themselves thwarted by Delaware law and New York law, which apparently allowed this type of transaction without any kind of judicial supervision, took the case to federal court. The district court granted no relief on plaintiffs' rule 10b-5 claims.[16] The Second Circuit, however, had developed a more liberal and expansive view of rule 10b-5 in the "new fraud" rule of *Schoenbaum v. Firstbrook Corporation*,[17] and held that the transaction in *Marshel* constituted a violation of rule 10b-5.[18] In its extensive opinion, the court held the transaction to be both unfair and a breach of fiduciary duty.

*Santa Fe Industries v. Green*[19] is the second key case in this line. Over several decades, Santa Fe Industries had acquired approximately ninety-five percent of the stock in Kirby Lumber Company. There were still substantial minority shareholders in Kirby Lumber, however. Santa Fe decided to eliminate the minority shareholders by merging Kirby Lumber in a short form merger into the parent corporation, thereby cashing out the minority shareholders. The Second Circuit again held that the minority shareholders were entitled to relief.[20]

The Supreme Court, however, reversed the Second Circuit and held that the transaction was not a matter of federal law.[21] Because no deception had occurred, the case did not fall into the prohibitions of rule 10b-5. Stating that the shareholders were not misled in any way, the Court observed:

> [W]e are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities . . . . Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.[22]

15. 533 F.2d 1277 (2d Cir.), *vacated and remanded*, 429 U.S. 881 (1976), *vacated and remanded with instructions*, 552 F.2d 471 (2d Cir.), *dismissed*, 441 F. Supp. 299 (S.D.N.Y. 1977).

16. 398 F. Supp. 734 (S.D.N.Y. 1975).

17. 405 F.2d 215 (2d Cir. 1968) (en banc), *cert denied sub nom.* Manley v. Schoenbaum, 395 U.S. 906 (1969).

18. 533 F.2d at 1281-82.

19. 430 U.S. 462 (1977).

20. Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976), *rev'd and remanded*, 430 U.S. 462, *modified and aff'd*, 562 F.2d 4 (2d Cir. 1977).

21. 430 U.S. 462 (1977).

22. *Id.* at 479 (emphasis in original).

In a rather ominous comment, however, the Court did note that many commentators had put forward the proposition that there should be uniform federal fiduciary standards. The Court recognized that the imposition of federal standards on corporations may be needed, but felt that such a development should come from the legislature. The Court also noted that the minority shareholders had no opportunity for redress under state law. Those observations foreshadowed later developments of rule 10b-5 and issued a warning to the corporate bar and to the courts that this type of elimination of minority shareholders would not be tolerated.

In the meantime, the corporate bar had become generally aware that the pendulum had swung too far in favor of majority shareholders and that minority shareholders would be given some protection, either legislative or judicial. At the time *Santa Fe* was decided, the Delaware Supreme Court was considering two cases that presented the perfect opportunity to address the same concern dealt with by the United States Supreme Court. In *Singer v. Magnavox Co.* [23] and *Tanzer v. International General Industries*[24] the Delaware court overruled the holdings of *Stauffer* and *Schenley*.[25] In *Singer* the court announced certain basic principles and recognized that cash merger statutes did permit a cash merger in some situations, but not all. The court began its analysis with the basic proposition that majority shareholders owe a fiduciary duty to minority shareholders and that a shareholder has a protected interest in the form as well as the value of his investment. Therefore, a court must balance this right of the minority shareholder against the right of the corporation as a whole. Because a cash out merger designed solely for the purpose of eliminating a minority shareholder is a breach of fiduciary duty, a valid merger must have some other purpose than merely to cash out the minority. In addition, the transaction must meet the general standards of fairness previously announced by the Delaware court in *Sterling v. Mayflower Hotel*.[26] The court in *Singer* held that minority shareholders have rights that can be protected, and announced a two prong test for the protection of these rights—a purpose test and a fairness test. A month later the Supreme Court of Delaware handed down the *Tanzer* case, which addressed the issue of what business purposes would justify or validate a cash out merger. The court held that the self-interest of the majority shareholder could be considered a valid business purpose. The parent corporation in *Tanzer* attempted to eliminate minority shareholders in order to facilitate long-term debt financing of the parent,

23. 380 A.2d 969 (Del. 1977).

24. 379 A.2d 1121 (Del. 1977).

25. David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. 1971); Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962). The court in *Stauffer* held that "the very purpose of the [short form merger] statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise" by issuing cash rather than stock to the minority. 41 Del. Ch. at 10-11, 187 A.2d at 80. *Schenley* effectively extended this holding to the long form merger statute. *Singer* and *Tanzer* overruled these cases by holding that a cash out merger instituted for the sole purpose of eliminating the minority shareholder was a breach of the majority shareholder's fiduciary duty to the minority.

26. 33 Del. Ch. 293, 298-302, 93 A.2d 107, 110-12 (1952).

and the court held that such a consideration could constitute a valid business purpose.

SCHWARTZ: After *Tanzer*, is there any significance to the business purpose test?

ROBINSON: It is difficult to say. The conceptual picture is complex, and the cases are not easily reconciled. The court in *Singer* held that a valid business purpose cannot be the elimination of minority shareholders. But in *Tanzer* the court held that the interest of the majority shareholder can be a "valid business purpose." In fact, the elimination of minority shareholders always serves the purpose of the majority shareholders.

SCHWARTZ: Is going private to avoid the expense of complying with SEC regulations a valid business purpose?

ROBINSON: Some courts have held that it is.[27] Some courts have held that any number of purposes are "business purposes." *Tanzer* focused upon a bona fide purpose, not a mere subterfuge. But how does one judge whether the purpose is bona fide or a mere subterfuge? *Young v. Valhi*[28] and *Weinberger v. UOP, Inc.*[29] illustrate the difficulties in this judgment. It is very difficult to distinguish one case from the other on the basis of business purpose. The court in *Young* disallowed a cash out merger because its "basic purpose" was to cash out the minority. A contrary result was reached in *Weinberger*. In essence, it appears that the court found that all the circumstances of the merger were fair in *Weinberger* but were not fair in *Young*.

SPARKS: Mr. Robinson, there is a postscript to the *Young* case. As one of the counsel for defendants in *Young*, I know that the case was settled simply by paying more money to the minority and obtaining court approval. The purpose did not change. If one can buy a purpose by paying more money, what does the purpose requirement really mean?

SCHWARTZ: It does seem that if the majority has a rather specific reason which relates to the promotion of its own economic welfare, and if it clearly articulates that reason, it has satisfied *Tanzer*'s interpretation of the *Singer* test.

SPARKS: There is also a "pattern of conduct" aspect to this analysis. One fact which colored the *Young* decision was that there had been two previous exchange offers made in an attempt to obtain the minority stock. Both offers failed because the exchange was not deemed generous enough by the stockholders. After the attempted merger the court closely scrutinized that long pattern of dealing aimed at eliminating the minority stockholders.

SCHWARTZ: But the key question still remains: is there something inherently unfair about the majority simply deciding that it is time to get rid of minority shareholders? Certainly the underlying philosophy of many of the

27. *See, e.g.*, Tanzer Econ. Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 383 N.Y.S.2d 472 (Sup. Ct. 1976).
28. 382 A.2d 1372 (Del. Ch. 1978).
29. 426 A.2d 1333 (Del. Ch. 1981).

Commission's rulemaking efforts in the going private field is that having sold shares to the public, it is improper for the majority to eliminate minority shareholders when it becomes feasible to do so because the market has fallen.

ROBINSON: I sense that the courts do not adhere to that position. In short, the majority appears to be entitled to rid itself of minority shareholders when it simply would rather have the corporation operate on some other basis. For instance, in *Singer* the Delaware court very carefully avoided saying that the majority had to have compelling reasons in the interest of the enterprise itself before it could eliminate the minority. Courts in other jurisdictions have not said anything to the contrary, so it would seem that the majority is not wedded to the minority. In short, the minority shareholders remain in the corporation at the sufferance of the majority shareholders.

SPARKS: There is a very significant distinction between the *Singer* line of cases and *Bryan v. Brock & Blevins Co.*[30] The *Bryan* case was decided on a fraud theory, not a breach of fiduciary duty theory. It appears to recognize a right to remain in the corporation.

SCHWARTZ: *Bryan* involved a close corporation, however, and that situation is a bit different. In the case of a close corporation, remaining in the corporation may mean one's livelihood. It has far greater significance than merely remaining an owner of a piece of paper in a large, publicly held company.

SPARKS: The Delaware formulation articulated in *Singer* and its progeny is premised solely upon the fiduciary duty owed by a majority stockholder to the minority and is therefore applicable only in the case of a majority stockholder seeking to remove a minority—not in the case of an arms' length cash out.

ROBINSON: We have certainly seen more and more judicial attention to fiduciary duty, by which the court leaves itself much more flexibility: fiduciary duty is just one factor in considering fairness, and a smaller and smaller one as time passes. There is more emphasis on the questions of price and timing, and I imagine that in a few years the business purpose test, as a practical matter, will have little importance. Courts have already rejected the argument that the purpose must be a compelling, involuntary purpose. Thus, the business purpose test is a mechanical test at best, one which I think really does not work as a practical matter. But because the courts still consider it (as does the SEC in rule 13e-3), if one is planning a cash out merger, he will need to contrive, but not appear to contrive, as many business purposes as possible, other than solely eliminating the minority shareholders.

Basically it seems that the success or failure of a cash out merger will depend on the overall fairness of the transaction. *Weinberger* is most instructive in this respect, because it offers a good schematic outline of how to plan and accomplish a cash out merger. In *Weinberger*, the majority followed exactly the proper course: the whole transaction was structured to make it fair to

30. 490 F.2d 563 (5th Cir. 1974), *cert. denied*, 419 U.S. 844 (1975).

minority shareholders. The minority shareholders were, in effect, represented in the negotiations of the price.

Nevertheless, the question still remained whether the entire transaction in *Weinberger* was fair. One interesting aspect of *Weinberger* was that the court dismissed the original complaint because it did not sufficiently demonstrate unfairness. It appeared from the original complaint that the transaction was approved by what the courts term "neutralized voting," which means an approval by a majority of the minority shareholders. The court therefore dismissed the original complaint on the grounds that there was no initial showing of unfairness and that there was not an abuse of majority control. The complaint was then amended, and in the Chancery decision the court stated that although the ultimate burden of proof of fairness is on the defendants (those seeking to sustain the merger), the plaintiff must first come forward with a showing of some basis of unfairness. The defendants must then rebut and carry the ultimate burden of proving the entire fairness of the transaction. One of the principal elements of fairness that the court considers in addition to timing is the fairness of the price.

There has been much discussion in the case law about the question whether "fair value" in this context is something different from fair value in a statutory appraisal. *Weinberger* seems to conclude that it is not. The argument was made in *Weinberger* that in measuring the fair value of the minority's shares, there should should be some premium attached because it is often worth a substantial amount to the majority to eliminate the minority. The court rejected this argument in both *Weinberger* and *Tanzer*. There is, however, one case, *Mills v. Electric Auto-lite Co.*, a Seventh Circuit decision, which seems to indicate that some consideration would be given to that element.[31]

What degree of consideration do the courts give to neutralized voting or approval of majority proposals by the minority? In some instances, for example, in a close corporation, I imagine it would have no significance.

SPARKS: Minority approval seems to be insignificant unless the voting is sterilized. By that I mean the vote of a majority of the minority must be a condition to the merger. Logic dictates that a vote of a majority of the minority which is not sterilized should not make a difference. Many people will not vote if they feel that the result is a foregone conclusion; others will vote with management simply because they know management has over fifty percent of the stock and will win. Thus, it is essential that the vote be structured in such a way that if the minority does not vote for the merger, the merger will not be approved. Otherwise, the majority will not be able to avail itself of the neutralized voting defense. It has been my experience, however, that there are clients who will not adopt that technique because they fear they may not prevail on the vote.

ROBINSON: The neutralized voting defense is a real, substantive advance that has developed in corporation law as a direct result of contemporary

31. 552 F.2d 1239, 1247 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

merger practices. Of course, there are those who will argue that all stockholder votes are meaningless and that stockholders always sign whatever management sends them. But that oversimplifies the matter.

SPARKS: It may be valuable to mention an unreported Delaware case, *Fisher v. United Technologies, Inc.*,[32] which also addresses the subject of neutralized voting. That case perhaps gives the best indication of the future direction of the law. The *Weinberger* court held that obtaining a majority of the minority vote is an element of fairness. *Fisher* takes the analysis a step further and suggests that if a sterilized vote of a majority of the minority is obtained after full disclosure, the burden of proof then is shifted to the plaintiff to prove unfairness. That shift may be of crucial importance, for instance, in a pendant claim in a federal case in which the question is whether or not the issue goes to a jury.

STEWART: Let's shift the focus to the practicalities of structuring cash out mergers, particularly for the types of public corporations that exist in North Carolina. The cash out merger is obviously the most desirable alternative from the insider's standpoint, because if it is successful, it completely eliminates the minority interest. But if the corporation does not have a substantial body of minority stockholders, and if stockholder lists are carefully analyzed, frequently a cash tender offer will also be a successful mechanism. It may not even be necessary to follow through with a second stage cash out merger. One benefit of this procedure is that the response of a large body of minority stockholders, who tender their shares at a price that will be supported by an investment banker's opinion, can then, if necessary, be used as a basis for the fairness of that price in the second stage cash out merger.

ROBINSON: That is a very good point. The cost of offering a price so high that the shareholders cannot turn it down may be substantially less than the cost of litigating.

If a cash out merger is selected as the best way to proceed, there are some alternative proposals for judging the validity of the merger. For instance, there has been some academic comment that some types of merger should always be recognized as valid, others as invalid.[33] In addition, one must be mindful of the requirements that apply to any rule 13e-3 transaction by a registered or reporting company that proposes to acquire its equity securities. A rule 13e-3 transaction is defined by type and effect: the transaction must in some manner involve an acquisition of equity securities by the issuer, and must either have a reasonable likelihood or purpose of going private (i.e., bringing the number of shareholders below the three hundred shareholder threshold). One must file a schedule 13e-3 in such a transaction; information requested by the SEC in that schedule is quite useful as a checklist for elements of the fairness test.

The minority shareholders who resist elimination are faced with a

32. Fisher v. United Technologies, Inc., No. 5847 (Del. Ch., May 12, 1981).

33. *See* Brudney & Chirelstein, *supra* note 2; Note, *supra* note 2.

number of very complex procedural questions as to what type of lawsuits to bring, and when and where to bring them. For example, if the minority attempts to enjoin the merger, can they also dissent? Is the right of dissent and appraisal an exclusive right? It is probably not exclusive in most states, although there is a Pennsylvania case which indicates that under Pennsylvania law the right is exclusive to a point.[34] *Breed v. Barton*, a New York case, indicates that exercising the right of dissent and appraisal does preclude suing as a derivative shareholder and excludes legal action for damages.[35] It does not, however, preclude an action for equitable relief—that is, an injunction against the merger on grounds of fraud. In North Carolina the right of dissent and appraisal is in addition to such other rights in law or equity as the minority shareholders may have.[36] One must also determine whether the exercise of the right of dissent and appraisal is an election of remedies that will bar concurrent pursuit of other remedies.[37]

HAZEN: Can a corporation give dissenters' rights in a reverse stock split?

ROBINSON: The Delaware statute was amended in 1981 to allow such a practice, but I have not seen it done since the amendment.

SPARKS: The existence of appraisal rights is one of the *Tanzer* elements of fairness. Thus, consideration should be given to extending such rights to any reverse stock split. In fact, one of the most objectionable aspects of a reverse stock split has been its lack of appraisal rights.

SCHWARTZ: Another small issue in the reverse stock split is that the split typically will result in some tax liability—dividend income to insiders as well as outsiders. The amount is probably minor, but at that level of income, management will not desire dividend income on a reverse stock split.

ROBINSON: There are two other considerations in reverse stock splits. First, the split, if accomplished by charter amendment, may be thwarted because various preferred stocks may have a right to a class vote. Second, it seems to me that the judiciary looks very closely at the elaborate and complex fractionalization in the reverse stock split. A merger may often be more readily accepted and approved. Perhaps this is improper subjectivity on my part, but I do believe such considerations have lowered the number of successful reverse stock splits.

I would like to conclude by touching upon a subject of special interest to North Carolina lawyers: close corporations and the elimination or departure of minority shareholders. That process involves the disentanglement of what

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34. *In re* Jones & Laughlin Steel Corp., 488 Pa. 524, 412 A.2d 1099 (1980) (statute provided that appraisal is exclusive remedy absent "fraud or fundamental unfairness"; court held that suit for injunction on those grounds must be brought before the merger).

35. 54 N.Y.2d 82, 429 N.E.2d 128, 444 N.Y.S.2d 609 (1981).

36. N.C. GEN. STAT. § 55-113(b) (1975).

37. *See, e.g.*, Twenty-Seven Trust v. Realty Growth Investors, 533 F. Supp. 1028 (D. Md. 1982). Appraisal is not the exclusive remedy in Maryland, but "in the usual case, resort . . . to the appraisal remedy constitutes a statutory election of remedies and bars resort to remedies otherwise available." *Id.* at 1038. But departure from the general rule of election is warranted when plaintiff first sought a preliminary injunction and then asserted his appraisal right only after it was denied, and when there were "serious allegations of breach of fiduciary duty." *Id.* at 1039.

is essentially a personal relationship within close corporations. *Bryan v. Block & Blevins* did involve a closely held corporation, which, of course, underlines the point that rule 10b-5 is applicable not only to publicly held companies, but even to one- and two-man corporations.

One of the most difficult points met frequently by practicing lawyers in North Carolina is how to handle a situation in which there has been an alienation between the minority and majority shareholders. If the majority wants to eliminate the minority, clearly there are various techniques to achieve that result.[38] On the other hand, consider a situation in which minority shareholders want to terminate their interest in the corporation. How may they do so? The question arises frequently, and North Carolina is among the most liberal states in the country with respect to the powers given a court to make an equitable arrangement or dispensation in that situation. In 1955, when the Business Corporation Act was enacted, the court was given authority to order an involuntary dissolution when dissolution was "reasonably necessary for the protection of the rights or interests of the complaining shareholder."[39] The court thus was given wide discretion to dissolve a corporation when the minority, due to change of circumstances or otherwise, and even without fraud, oppression, or deadlock, wanted to terminate its interest. In 1969 that provision was supplemented by another statute, which provided that in case of an action for involuntary dissolution, a court could make any changes among the relationships of the parties that it deemed equitable.[40]

That very broad statutory authority has not yet been fully explored in any reported decision, but I hope it soon will be examined in a way that will give the bar in this state some instruction on how to proceed in handling disagreements in close corporations. A California court in the case of *Stumpf v. Stumpf*[41] has applied a statute on which the North Carolina statute was based to order the dissolution of a small family corporation even though there was no deadlock, oppression, or fraud.

I would not suggest that a minority shareholder should be able to force his way out of a corporation at will. But I do suggest that a court should exercise its equitable powers broadly to extricate a minority shareholder from an inherently oppressive or unfair situation. This is especially advisable when the matter involves, as did *Stumpf*, a family business, as distinguished from a case in which businessmen have consciously elected to invest in a corporation as a consensual arrangement. It seems to me that different rules should apply according to the circumstances, and cases such as *Stumpf* have so held. A court might be less inclined to order dissolution when there has been a consensual arrangement in which businessmen have voluntarily entered the investment relationship. Family members who find their investments locked in corporate form present an altogether different matter.

38. *See generally* F. O'NEAL, CLOSE CORPORATIONS § 8.07 (2d ed. 1971 & Cum. Supp. 1982).
39. N.C. GEN. STAT. § 55-125(a)(4) (1975).
40. *Id.* § 55-125.1.
41. Stumpf v. C.E. Stumpf & Sons, Inc., 47 Cal. App. 3d 230, 120 Cal. Rptr. 671 (1975).

# BREACHES OF FIDUCIARY DUTY AND THE FEDERAL SECURITIES LAWS

THOMAS LEE HAZEN†

HAZEN: SEC rule 10b-5 prohibits material misstatements of fact and omissions of material fact in connection with the purchase or sale of securities.[1] The rule does not apply only to reporting companies; it applies to any security if the jurisdictional means—instrumentalities of interstate commerce—are involved in the transaction. Generally, one thinks of 10b-5 as applying to insider trading, but historically it also has played a role in policing corporate mismanagement. This is especially true in those cases in which the minority shareholder or the corporation itself acquires or disposes of shares in a freeze out transaction as a result of allegedly deceptive or manipulative conduct. Even at a time when the United States Supreme Court is cutting back on private rights of action and has also limited the 10b-5 claim,[2] the Court has recognized a private cause of action by the injured shareholder for a 10b-5 violation.[3]

There are some limiting essential elements in any 10b-5 claim. In the *Blue Chips Stamps* case the Supreme Court held that a plaintiff in a private 10b-5 damage action must be either a purchaser or a seller of the securities touching the fraud in the transaction.[4] In a derivative suit the shareholder can satisfy this purchaser or seller requirement if the corporation was injured as a result of the acquisition or disposition of securities.[5]

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1. 17 C.F.R. § 240.10b-5 (1982).

2. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). For recent cases on implied remedies, *see, e.g.*, California v. Sierra Club, 451 U.S. 287 (1981); Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n, 453 U.S. 1 (1981); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (denying the existence of a remedy under § 17(a) of the Exchange Act, 15 U.S.C. § 78q(a) (1976)); Chrysler Corp. v. Brown, 441 U.S. 281 (1979) (finding no remedy under either the Freedom of Information Act, 5 U.S.C. § 552 (1976), or the Trade Secrets Act, 18 U.S.C. § 1905 (1976)). *But see* Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982) (recognizing implied antifraud remedy under the Commodity Exchange Act, 7 U.S.C. § 1 (1976 & Supp. III 1979)); Davis v. Passman, 442 U.S. 228 (1979) (recognizing an implied private remedy under the United States Constitution); Cannon v. University of Chicago, 441 U.S. 677 (1979) (recognizing an implied remedy under Title IX of The Education Amendments of 1972, 20 U.S.C. § 1681(a) (1976)). *See generally* Hazen, *Implied Private Remedies Under Federal Statutes: Neither a Death Knell nor a Moratorium—Civil Rights, Securities Regulation, and Beyond*, 33 VAND. L. REV. 1333 (1981). There is a recent Supreme Court decision under the Commodities Act recognizing an implied private cause of action, which may trigger a reversal in the pessimistic outlook for other implied remedies. Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 50 U.S.L.W. 4457 (U.S. May 3, 1982).

3. *E.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

4. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754 (1975).

5. *See, e.g.*, Schoenbaum v. Firstbrook, 405 F.2d 215, 221 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

COX: Suppose the corporation is engaged in a reincorporation transaction, moving the state of incorporation from Delaware to Pennsylvania. Would that be a sufficient sale by the corporation or shareholders to qualify under section 10b-5?

HAZEN: The question would be whether there is in essence a change in form with no change in substance or whether the transaction involves a substantive change in the issuer's operation. Certainly, if it is alleged that this transaction is the first step in a freeze out or elimination of minority shareholders, there is arguably a "sale" as the term is defined under the Securities Acts.

COX: SEC rule 145 still uses the "no sale" rationale if the sole purpose is to reincorporate in another state.[6]

HAZEN: Arguably, reincorporating from California to Delaware is not a simple reincorporation in another state if, for example, the reincorporation terminates cumulative voting, which could be required under California law but not under Delaware law.

SCHWARTZ: Nevertheless, faced with that argument, the SEC has said that reincorporation is exempt under the "no-sale" approach embodied in rule 145. On those facts, it is an uphill fight for the plaintiff to show that there is a sale under rule 10b-5.

HAZEN: The second limiting essential element in a 10b-5 claim is the rule enunciated in the *Hochfelder* case, which makes it clear that scienter is necessary for a 10b-5 claim.[7] The defendant must have acted intentionally or recklessly. The subsequent *Aaron*[8] decision makes it clear that this requirement applies in any 10b-5 action, whether it is criminal SEC enforcement, SEC disciplinary, or a private cause of action. Although 10b-5 requires scienter, the Supreme Court in *Aaron* stated that a showing of negligence would suffice under sections 17(a) (2) and (3) of the 1933 Act.[9] The decision further suggests that a showing of negligence would be sufficient in any action brought under the proxy rules. The language of the proxy section[10] and 17(a) is similar. In addition, most courts have begun to recognize a private cause of action under 17(a).[11] The Supreme Court, however, has not taken the chance to overrule these decisions; the current Court may act otherwise. Certainly, the case law under 17(a) as it now stands makes 17(a) the vehicle for a purchaser of securities to bring suit based on negligence. Consequently, the effect of the *Hochfelder* and *Aaron* decisions in terms of implied private remedies is not clear.

6. 17 C.F.R. § 230-145 (1981).
7. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976).
8. Aaron v. SEC, 446 U.S. 680 (1980).
9. *Id.* at 699.
10. 15 U.S.C. § 78n(a) (1976).
11. *See generally* Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978); Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L. J. 163 (1979). *But see* Landry v. All Amer. Assurance Co., 688 F.2d 381 (5th Cir. 1982).

The real question of 10b-5 liability expansion or contraction was raised in a case that will be decided next term, the Fifth Circuit *Huddleston* case,[12] which deals with the overlap of 10b-5 and the express remedies of the Securities Acts.

SCHWARTZ: *Huddleston* is one of three Court of Appeals decisions which have held that rule 10b-5 may be used by anyone who claims to be a defrauded purchaser of securities notwithstanding the fact that there are specific provisions—express civil liability provisions—that apply.[13] In *Huddleston* plaintiff claimed that a false and misleading prospectus deceived him. But for the fact that he was time barred, he could have brought suit under section 11 of the 1933 Act.[14] Section 11 has a very short statute of limitations.[15] Moreover, a plaintiff can sue people under 10b-5 whom he cannot sue under section 11.[16] For example, unless a lawyer happens to be a director, there is no liability for a lawyer as such under section 11. But a lawyer could be named a defendant on an aiding and abetting theory under 10b-5.

HAZEN: As a case in point, *Lanza v. Drexel*[17] involved the overlap of section 11 and rule 10b-5. Plaintiff brought suit under 10b-5 because, although section 11 was theoretically available to that type of transaction, it was not specifically available under the facts of the case. The Second Circuit rejected the argument that because the Act provided a specific remedy, no implied remedy was available under 10b-5. The court said, among other things, that if the plaintiff can show what is necessary to establish liability under 10b-5, then the plaintiff has a remedy under 10b-5 notwithstanding the fact that Congress provided a specific remedy to deal with his situation.[18]

The United States Supreme Court has now granted certiorari in the *Huddleston* case. The pending Supreme Court decision in *Huddleston* may be confined to its specific facts. There are not very many cases under 10b-5 that allege violations in other kinds of documents used by companies, such as annual reports, 14a-9 proxy statements, press releases, or financial statements that become part of a filing on form 10Q or form 10K. If the Court reverses the court of appeals decision in *Huddleston*, the next argument is, if the plaintiff could not sue under 10b-5 because of the availability of section 11, he cannot sue based upon any document that is filed with the SEC because he has a remedy under section 18 of the 1934 Act,[19] a provision of the statute that in

12. Huddleston v. Herman & MacLean, CPAs, 640 F.2d 534 (5th Cir. 1981), *cert. granted*, 102 S. Ct. 1766 (1982).

13. *See infra* note 18.

14. 15 U.S.C. § 77k (1976).

15. *Id.* § 77m (one year after discovery but not more than three years after the public offering).

16. Section 11 defendants are those who participated in the preparation of the prospectus as well as signers of the registration statement, directors, and underwriters. *Id.* § 77k(a). In contrast, 10b-5 liability can extend to anyone participating in the transaction.

17. 479 F.2d 1277 (2d Cir. 1973).

18. *See also* Wachovia Bank & Trust Co. v. National Student Marketing Corp., 650 F.2d 342 (D.C. Cir. 1980); Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

19. 15 U.S.C. § 78r (1976).

the forty-eight year history of the SEC has never been the basis of a successful recovery. The defenses under section 18(a) are significant; there is also a high standard of proof, and section 18 damages are highly uncertain. It would be easy to argue that if section 11 provides the exclusive remedy for prospectus violations, section 18 is the exclusive remedy for violations in all other documents. That may prove to be an irresistible argument if the Fifth Circuit decision in the *Huddleston* case is reversed. It does not necessarily follow, however, that because the specific and directly targeted section 11 would prevent an implied remedy under 10b-5 for a violation covered by section 11, a rather broad liability provision such as section 18 would also preclude an implied remedy under 10b-5. Nevertheless, the argument will be made. The *Huddleston* case, which will probably be decided about one year from today, should indicate where 10b-5 is going. [Subsequent to the conference, the Supreme Court allowed the 10b-5 claim to stand.[20]]

I now want to discuss the circuit courts' interpretation of the Supreme Court's decision in *Santa Fe v. Green*.[21] Basically, the circuit courts, at least the Second, Fifth, Seventh, and Ninth Circuits, have written the *Santa Fe* decision away. In *Santa Fe*, the Court held that there was no 10b-5 claim because the plaintiffs had not been deceived. The defendants had complied with the short form merger statute of the Delaware Act. They had given the notice required by the appraisal statute, and the shareholders were given all the information to which they were entitled under Delaware law. In the famous footnote fourteen the Court pointed out that since there was no state court remedy, there was nothing the five percent minority plaintiffs could have done to stop the merger. Emphasizing that corporate law is a creature of state law, the Court rejected plaintiffs' 10b-5 claim because it was reluctant to create federal corporate law that would impose a higher standard of fiduciary duty than that imposed by the law of the state.

Thereafter, the Second Circuit decided *Goldberg v. Meridor*.[22] *Goldberg* involved a rather complex fact setting, including a series of transactions in which the controlling parent corporation allegedly caused the subsidiary to raise money for the benefit of the parent. There was sufficient involvement of securities transactions in the controlled subsidiary to trigger 10b-5. In all these transactions, there was full disclosure to the board and to all the decisionmakers. The shareholders, however, were left in the dark. The claim of the defense was that under *Santa Fe*, a case in which the defendants had complied with the applicable state law, the plaintiffs had no remedy because there was nothing the plaintiffs could have done even if they had known about the transactions.

In *Goldberg* the Second Circuit pointed out that under the controlling

20. Herman & MacLean v. Huddleston, 51 U.S.L.W. 4099 (U.S. Jan. 24, 1983) (Nos. 81-680 & 81-1076). The Fifth Circuit has held that rule 10b-5 and section 9(e) of the Exchange Act are mutually exclusive and thus no 10b-5 action will lie for a claim based on manipulation. Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149 (5th Cir. 1982).

21. 430 U.S. 462 (1977).

22. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

New York law there are a number of cases recognizing injunctive relief against an unfair merger for which there is no business purpose. The Second Circuit reasoned, therefore, that if the defendant's full disclosure would have given the plaintiffs an opportunity to seek the state court remedy—the state court injunction—defendant's failure to disclose to the shareholders was an actionable 10b-5 nondisclosure. Basically, the court boot-strapped any possible state law remedy into a federal claim. *Goldberg* has been followed in the Seventh, Ninth, Fifth, and Third Circuits.[23]

TAYLOR: It must be remembered that the *Santa Fe* decision occurred before the Delaware Supreme Court had spoken in *Singer v. Magnavox*,[24] which created state law remedies for minority stockholders in a freeze out if the freeze out lacked a proper purpose or did not meet the test of entire fairness.

HAZEN: The Circuit Courts have disagreed on the handling of *Santa Fe* fact situations after *Singer*. The Fifth Circuit in *Alabama Farm Bureau*[25] said that the plaintiff's burden of proof in a 10b-5 case is merely to show that he would have had a prima facie case under state law. On the facts of *Santa Fe*, in which the plaintiffs alleged a grossly unfair price and no valid business purpose other than elimination of the minority, there would seem to be a prima facie case under Delaware law, even though it might very easily be rebutted. Therefore, if you take literally the prima facie case requirement in *Alabama Farm Bureau*, the plaintiff's burden may well have been met, at least to get by the 10b-5 pleading stage. The Second, Seventh, and Ninth Circuits have indicated a more stringent test than establishment of a prima facie case. They look to the probability of success. The plaintiff in the federal case would have to prove that he probably would have succeeded in the state law action had there been full disclosure. In light of what has been happening on remand in the Delaware cases, it would be very hard, if not impossible, to satisfy a probable success test. Some other cases have looked to a possible success test. Query whether that is stronger than a prima facie case test. But I do think the Fifth Circuit, taking the prima facie test literally, would say that *Santa Fe* on its facts would come out differently today.

SCHWARTZ: But doesn't that result in the federal courts doing exactly what the Supreme Court says they should not do—interpreting state law in deciding whether a probable claim is asserted? In situations in which the state court has not yet addressed an issue, the federal courts are operating under the *Erie* principle[26] when they decide a state law question to see whether federal

23. Healy v. Catalyst Recovery of Pa., Inc., 616 F.2d 641 (3d Cir. 1980); Alabama Farm Bureau Mut. Casualty Co., Inc. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979); Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978). *See generally* Hazen, *Corporate Mismanagement and the Federal Securities Act's Antifraud Provisions: A Familiar Path With Some New Detours*, 20 B.C.L. REV. 819 (1979).

24. 380 A.2d 969 (Del. 1977).

25. Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979).

26. Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

law can then be asserted. It is much easier under those circumstances to say, "Look, the Supreme Court really meant what they said in *Santa Fe*." The circuit courts do not like what the Supreme Court said. The Supreme Court in footnote fourteen of *Santa Fe* left this little string the circuit courts could grab to save themselves while they were drowning, and the courts have all latched on to it.

TAYLOR: The plaintiff is still going to have to allege nondisclosure of some factual information and the unfairness of the transaction, which will link up with the state law cause of action.

HAZEN: The Seventh Circuit in *Panter v. Marshall Field*[27] indicated that a bare allegation of nondisclosure will not satisfy the *Goldberg* rationale for the 10b-5 claim. Consequently, I think even though the courts in the Second, Third, Fifth, Seventh, and Ninth Circuits have allowed these *Goldberg* claims to proceed beyond the pleading stage, the picture may still be very dim for plaintiffs once they get beyond the pleading stage to the trial stage. To my knowledge no case has proceeded to the trial stage yet. These are questions of proof.

The Second Circuit in *Goldberg* gave two alternative rationales for its rule.[28] One was the availability of state court relief, which is what subsequent courts have embraced. The other is what you might call the "dirty linen" rationale. The court noted that if defendants had been forced to disclose in advance what they were planning, they would have restructured the transaction and would have given the minority a fairer deal, rather than hanging their dirty linen out in public. In other words, the fact of disclosure would have shamed the defendants into a different transaction. No court has focused on that aspect of the decision.

COX: In your judgment you still have to come up with some colorable claim of nondisclosure, and not just an opinion or an ultimate conclusion of law, to get into federal court.

HAZEN: Yes, that is right.

ROBINSON: The Second Circuit, which is generally the most plaintiff-oriented in this area, has indicated that a plaintiff would have to show the probability of success of the state law claim. The Ninth Circuit imposed an even higher threshhold in the *Meikle*[29] case, in which it said that a plaintiff has to show that he would have prevailed on the state claim.

HAZEN: That requirement represents the actual success test. *Meikle* says that a plaintiff must actually try the state claim. I think this goes against everything the *Santa Fe* court was trying to say in the text of its opinion, even though as was pointed out earlier, the words come from the Supreme Court's footnotes.

27. 646 F.2d 271 (7th Cir. 1981).

28. *See supra* text accompanying notes 22-23.

29. Kidwell v. Meikle, 597 F.2d 1273 (9th Cir. 1979).

*Brown v. Ivie*,[30] another Fifth Circuit decision, points out that rule 10b-5 and the *Goldberg* rationale apply even in the close corporation area. The *Brown v. Ivie* court said that in issuing a buy-out arrangement in closely held corporation, the directors may be liable under rule 10b-5 for not having disclosed their true motive in a situation in which their averred motive was to be able to obtain certain insurance, but their actual motive was to freeze out the plaintiff at book value.

30. 661 F.2d 62 (5th Cir. 1981).

# RECENT DEVELOPMENTS IN SUBSTANTIVE BUSINESS JUDGMENT RULE

A. GILCHRIST SPARKS III†

SPARKS: I have been assigned the topic of recent developments in the business judgment rule. I hope to set out the framework of the business judgment rule because much of the discussion by others will involve various applications of that rule. I am not sure if it is one of the most understood rules, or one of the most misunderstood.

It is important to think about the origins of the business judgment rule and why it exists in the first place. Basically, it developed out of two concepts. The first concept, which arose years ago, was that persons would not serve as directors if they were deemed to be guarantors of the wisdom of their good faith decisionmaking. People would not be willing to be directors if their poor business decisions could be second guessed by a court and by stockholders, subjecting the directors to the threat of personal liability. The second concept underlying the rule is a recognition that courts are ill-equipped to evaluate business judgment decisions. Such decisions are best left to businessmen.

A great deal of the development of the business judgment rule occurred from the turn of the century through the 1940s and 1950s. During the 1960s and the early part of the 1970s, the federal securities laws were at their apogee, and most of the scholarly writing and many of the case decisions focused on the expanding scope of rule 10b-5, which before *Santa Fe Industries, Inc. v. Green*[1] was thought by many to be subsuming much of the state law covering the business judgment rule. Only after the *Santa Fe* decision in 1977, which reemphasized the role of state law, did there appear to be a renewed interest in the business judgment rule.

The *Santa Fe* decision and the reemergence of the business judgment rule coincided with the rising concern about corporate governance. This concern was triggered primarily by the political payment problems of many corporations and the SEC's activities in that area. Many of the problems in the corporate political payment area came to be analyzed under the business judgment rule.

To understand the business judgment rule, its function must be put in perspective. This is most easily done with the following illustration: If a decision by a board of directors is attacked in a derivative suit, initially the burden is on the plaintiff to establish the absence of one of the elements of the business judgment rule. Namely, the plaintiff must prove the absence of reason-

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1. 430 U.S. 462 (1977).

able inquiry into the subject matter of the decision, the absence of good faith, the presence of a disabling conflict of interest, or the absence of a rational basis for the business judgment (and this is only arguably an element). If the plaintiff succeeds in establishing one of these elements, the burden shifts to the defendant to prove the entire fairness of the transaction, and, just as importantly, the court is then permitted to second guess the business judgment decision. In a nutshell, that is what the rule is all about.

One of the advances that has come out of the scholarly writing in the past four or five years is the unanimous conclusion that the business judgment rule is not an absolute shield to liability. The aforementioned elements that are prerequisite to the existence of the business judgment rule are important. There is plenty of room for litigation on whether they are present. Some of the more recent cases I will discuss at the end of my presentation can be criticized, if at all, primarily on the ground that the courts may have occasionally short-circuited proper factual inquiry into the mere presence of such elements as reasonable inquiry or conflict of interest.

For the business judgment rule to apply, the directors must have informed themselves and made reasonable inquiry with respect to the subject matter of the business decision. The rule does not protect uninformed, careless decision making. Of course, this emphasizes for the corporate planner the crucial importance of making records of business deliberations and dealing with important decisions in a studied way so that if they are attacked, the planner can point to the care that was devoted to the board's decision. The standard of care is variously articulated, but the consensus is that one must act as an ordinary, careful, and prudent man would under similar circumstances. What kind of investigations would an ordinarily prudent man make under similar circumstances? The ALI Study devotes pages to what "similar circumstances" means, and to what "ordinarily prudent" means.[2]

The second element of the business judgment rule is good faith, which really translates into a belief that the decision is in the best interest of the corporation. Some would say it needs to be a "reasonable" belief that the decision is in the best interest of the corporation. Clearly illegal acts are per se bad faith, even if they result in a profit to the corporation. Illegal acts are contrary to public policy, and corporations in any rational legal structure should be no more permitted to disobey the law at the direction of their director-agents than should individuals. Examples of situations in which a decision to engage in illegal acts might benefit the corporation, but nonetheless should not be protected by the business judgment rule, would be a deliberate decision by auto makers to continue to make large cars even though Congress had passed a statute requiring that cars be down-sized; a decision to make illegal political contributions thinking that they would result in a benefit to the corporation in the form of favorable legislation; and a decision to engage in price-

2. PRINCIPLES OF CORP. GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01(a) comment (Tent. Draft No. 1, 1982) [hereinafter cited as RESTATEMENT]. *See generally id.* § 4.01 (covering duty of care and business judgment rule).

fixing in deliberate violation of the Robinson-Patman Act. Even though such illegal decisions might benefit the corporation, the directors cannot be allowed to avail themselves of the business judgment rule.

This doctrine, which may surprise some people, has been around at least since *Roth v. Robertson*[3] was decided in 1909. New York, like many eastern states, used to have "blue" laws, which prohibited activities such as playing baseball games and operating amusement parks on Sundays. In *Roth,* a fiduciary opened his amusement park on Sunday, the biggest day for the business of this particular company. The company made a lot of money; it was obviously a good business decision. It was also illegal, and the corporation was blackmailed by persons threatening to report the violation. A shareholder brought a derivative action to recover from the fiduciary the amount of the "hush money" that the corporation paid, and the shareholder recovered. The business judgment rule did not protect the fiduciary.

COX: I just want to drop a footnote there. I am not sure the *Roth* decision would be decided the same way today. Certainly, not in New York and I think not in most other jurisdictions either. The decision in *Borden v. Cohen*[4] indicates that whenever someone alleges a fiduciary's violation of a criminal statute, the shareholder must show in order to establish a breach of duty that the violation was made with knowledge of the statute. There is also a defense on the part of the corporation variously called "the independent damage rule" or "the net loss rule." This rule provides that if the corporation achieved a net gain by violating the statute, then the derivative suit must be dismissed. To determine whether the corporation achieved a net gain, the costs of the violation, such as the fine paid and the cost of litigation, are weighed against the profits made as a result of the violation. The rationale behind the rule is that the derivative suit is supposed to be compensatory, not a deterrent to illegal conduct. This defense, however, is rejected in the comments to the ALI Study.[5] This will have some pernicious effects, which I will talk about later when I discuss special litigation.

SCHWARTZ: It is not clear to me that the net loss rule is the law. There is not only the *Roth* case going back a hundred years; there is also *Abrams v. Allen*.[6]

SPARKS: I agree. I have researched the question. *Borden v. Cohen* does support the "net loss" rule. But I recall another case in Missouri, *Union Electric Company v. Boehm*, which suggests a different result.[7] Frankly, I think the ALI Study is in accord with what a court would do if faced with the question today. Basically, the concept is that cost/benefit analysis is inappropriate when one of the factors is a knowing violation of the law. On the other hand,

3. 64 Misc. 1343, 18 N.Y.S. 351 (Sup. Ct. 1909).
4. 231 N.Y.S.2d 902 (Sup. Ct. 1962).
5. RESTATEMENT, *supra* note 2, § 4.01(c) comment, at 189-90.
6. 247 N.Y. 52, 74 N.E.2d 305 (1947) (moving plant to discourage union activity in contravention of public policy actionable breach of duty by corporate directors).
7. 92 F. Supp. 177 (E.D. Mo. 1950), *appeal dismissed on motion of appellee*, 186 F.2d 715 (8th Cir. 1951).

there are exceptions to the per se bad faith rule that are suggested in the ALI formulation of the rule. One proposed exception to the rule is the test case. The ALI does deal with that exception in the comments and notes that there are instances in which corporations may knowingly choose to violate the law to challenge a particular statute. The suggestion in the ALI Code is that if they do it in very above-board fashion—if they publicize that they are going to violate the air bag law, for example, because they think it is unconstitutional—then it will be treated more like a business decision.[8] Nevertheless, the code suggests the exception would not apply to something like a price-fixing violation, because such a law is not going to be changed, and everybody knows it is not going to be changed.

A second exception to the illegal act/per se bad faith rule occurs in the antitrust context. The courts get a little confused in this area. I think the reason for the courts' confusion is that they are not dealing with a concept of clear illegality. There is a vast difference between being convicted of a criminal violation for price-fixing and being convicted for a Sherman Act violation because the corporation has grown too large or because it has made an acquisition that ultimately gave the corporation too large a market share. In the latter case, especially if the directors were advised by counsel that the action was legal, or was not clearly illegal, the directors should be able to avail themselves of the business judgment rule.

That is enough discussion of exceptions to the good faith requirement of the business judgment rule. Let us move on to the the third requirement of "no disabling conflict of interest," which, stated another way, is the absence of self-dealing.

Self-dealing is a fairly simple concept. Basically, the Delaware courts have defined self-dealing as the receipt by a director or officer of some benefit from the corporation to the exclusion of and in detriment to the other stockholders. Self-dealing is not necessarily present in every transaction in which a director may have a personal interest. For example, the most common type of transaction in which the director has a personal interest is the payment of a dividend to all stockholders, including stockholder-directors. Stockholder-directors who receive dividends in effect are dealing with themselves, but they are treated no differently than the other stockholders. Self-dealing arises only when a director or officer appropriates for himself some corporate benefit that he does not share pro rata with the other stockholders of the corporation for whom he is a fiduciary.

The next element necessary for the business judgment rule to apply is the requirement, which some argue should not be included as part of the business judgment rule formulation, that the directors have a rational basis for the decision. Basically, this requirement is designed to take care of the occasional outrageous corporate decision that somehow meets all the other criteria of the business judgment rule. The decision is made in good faith. There is no con-

8. RESTATEMENT, *supra* note 2, § 4.01(c) comment, at 189-90.

flict of interest. The decision is reached through the exercise of due care. But the bottom line is that nobody in their right mind could have come up with the decision.

I have put together a hypothetical to illustrate this point. Suppose the directors of a corporation decide that the corporation is in desperate need of money. They determine to go to Las Vegas and bring back the best odds maker they can possibly find. They meet for three days with this guy and investigate all the ins and outs of the contemplated transaction. There is absolutely no self-dealing. Everyone is motivated by a common interest; everyone wants to save the corporation. The directors bet all the corporate assets on Linkage in the Preakness.

All the ostensible requirements of the business judgment rule have been met in this hypothetical, but no judge ought to approve of that decision. You might call it "patently unreasonable," or "irrational," which is the ALI term, or you might use my formulation—it is a decision that no person could make. Such a decision should not be made. Nevertheless, there is a very broad range of discretion given to directors. The court ought to interfere only when it is clear that the decision is so far out of line that the court can conclude there must be something wrong. Perhaps, upon further inquiry the courts would find out that what was wrong was that one of the other elements, such as good faith or due care, was missing. But I think it is important to have that safety valve for the unusual case that comes along now and then.

The last area I would like to discuss is the application of the business judgment rule in the context of corporate takeovers. This is the area in which there has been the largest development of substantive law in the last couple of years. Surprisingly, it has taken place almost entirely in the federal courts, which have created some rather strange results. I would like to compare two cases that have interpreted Delaware law in the last year and a half, *Panter v. Marshall Field Co.*[9] and *Johnson v. Trueblood*,[10] with the Delaware law, at least as it is written in the case books. I reserve for the moment what the Delaware law should be or will be. I begin with an established proposition: a corporation's directors are not under an obligation to accept an unsolicited takeover offer even though the proposed price may include a premium over the prevailing market price of the corporation's securities. Indeed, in an unreported decision granting a temporary restraining order that has received about as much attention as any ten-page unreported decision on a preliminary matter, Chancellor Brown stated,

> Not every action taken by the board of directors to thwart a tender offer is to be condemned. The test loosely stated is whether the board is fairly and reasonably exercising its business judgment to protect the corporation and its shareholders against injury likely to befall the corporation should the tender prove successful.[11]

9. 646 F.2d 271 (7th Cir. 1981).
10. 629 F.2d 287 (3d Cir. 1980).
11. *GM Sub. v. Liggett Group, Inc.*, No. 6155, slip op. at — (Del. Ch., April 24, 1980).

This statement demonstrates the trend of the law in recent years to apply the business judgment rule to protect a board's reasonable decision to adopt defensive tactics in response to a takeover attempt, provided that the retention of control by management is not the sole or primary motive for the tactics. Of course, the plaintiff invariably alleges that the defensive tactic was adopted for the sole or primary purpose of keeping management in office. The question is, how do you determine the sole or primary purpose of management? Disposition of this question in federal courts is particularly significant because both *Johnson*, which was not quite a takeover situation but was very analogous, and the *Panter* case, which was a pure takeover defense case, were decided by juries.

The Delaware Court of Chancery, in which Delaware corporate cases are decided, sits without a jury. Unlike the chancery court, the federal courts must deal with the effect on a jury of plaintiff's allegation that the directors resisted the takeover attempt in order to retain their jobs. If a plaintiff introduces evidence that the directors each got $15,000 a year for part-time service as a director, I think a Delaware court would look at that evidence and be sophisticated enough to recognize that while $15,000 may be a lot of money compared to a judge's salary, when compared to the salaries of people who generally sit on the board of directors of major corporations, it is probably not a large amount, certainly not enough to cast the directors in such a light as to destroy the presumption of the business judgment rule. On the other hand, if a plaintiff puts that evidence before a group of jurors, many if not most of whom may not even make $15,000 in a full year, and ask them whether the directors resisted the takeover to keep their jobs, the perceptions might be very different. I think this is the explanation for the federal judges' blocking of certain appropriate inquiries concerning the business judgment rule that perhaps Delaware state court judges would not block if the same case were brought to them.

*Johnson* was a case involving the refusal of a controlling board of directors to sell stock to the minority. The issue was what instruction should be given to the jury on the business judgment question. Chief Judge Seitz, a former Delaware chancellor, and now Chief Judge of the Third Circuit, held for the majority that a plaintiff must prove that maintaining oneself in office was the primary or sole motive for a decision having control implications before the burden of proof shifts to the defendant to establish that the transaction had a valid purpose. He based that interpretation of Delaware law on his recognition that directors always have a conflict of interest, in that even when a director handles the day-to-day business of the corporation, he is hoping that his success will be recognized and that he will be rehired the following year. Directors always want to keep their jobs; therefore, to apply a more rigid test would emasculate the business judgment rule in almost every case in which control is at stake. Judge Rosenn, in a very cogent dissent, would have found Delaware law to be otherwise. According to the dissent, once the plaintiff has shown that the desire to maintain control was a motive, the burden then shifts

to the defendant to justify the transaction as being in the best interest of the corporation.

In *Panter* the same issue arose in the context of a directed verdict for defendants after plaintiff's case had been presented in the jury trial. In that case, the Seventh Circuit affirmed the trial court's directed verdict for defendants. The directed verdict removed from the jury the questions whether there was a disabling conflict, whether good faith was present, and whether due care had been exercised. *Panter* is a questionable decision procedurally, according to the very persuasive dissent by Judge Cudahy, because there certainly were some factial issues that the jury could have addressed.

The substantive interest in *Panter*, however, stems from Judge Cudahy's articulation of a different formulation of the business judgment rule that would apply in extraordinary transactions such as mergers. He would have shifted the burden to defendants to prove the fairness of the transaction and would have let the question go to the jury. Compare that formulation of the business judgment rule with the current state of Delaware law, as it was last announced by the Delaware Supreme Court in *Bennett v. Propp*[12] and *Cheff v. Mathes*.[13] In *Cheff*, a repurchase of stock was used to fend off a corporate raider. Of course, there may be a different rule for repurchasing stock than there is for buying or selling subsidiaries to fend off a raider. Nevertheless, under *Cheff*, the burden is on the defendants to show good faith and reasonable investigation. If the defendants succeed in showing good faith and reasonable investigation, then the business judgment rule applies, and the court will not look behind the decision once the directors have proved that their motive was proper.

Whether *Cheff* would come out the same today is an open question. *Panter* and *Johnson*, in my judgment, involve a strained reading of the Delaware cases designed to reach results that judges wanted to reach, although the outcome of both cases was probably correct. I believe Delaware courts today would follow the modern trend of these cases by making clear that control transactions are subject to protection by the business judgment rule, and would articulate a different burden of proof rule that would be more favorable to defendants than that in *Cheff*. But, at the present time, the law on burden of proof remains unclear.

12. 41 Del. Ch. 14, 187 A.2d 405 (1962).
13. 41 Del. Ch. 494, 199 A.2d 548 (1964).

# THE BUSINESS JUDGMENT RULE IN THE CONTEXT OF TERMINATION OF DERIVATIVE SUITS BY INDEPENDENT COMMITTEES

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COX: The issue presented by the recent success of the special litigation committee in causing the dismissal of derivative suits raises a concern for the role of the courts in responding to a committee's recommendation that is analogous to a problem recently addressed by Judge Seitz in *Lewis v. Curtis*.[1] The defendants in the derivative suit sought a ruling that would require the plaintiff to make a demand upon the board as a condition to continuing the derivative suit. Judge Seitz reasoned that the answer to the question whether a demand should be required depends on whether the court believes the directors have sufficient detachment to render an impartial response.[2] It is a determination the court should make based on all the facts raised by the individual case and should not be rigidly determined by the nature of the allegations in the complaint.[3]

The impartiality of the special litigation committee is another issue that requires consideration of a range of factors before a court should accept the committee's recommendation to dismiss a derivative suit. *Auerbach v. Bennett*,[4] the leading case in this area, holds that a committee's recommendation is to be examined under conventional applications of the business judgment rule; the recommendation is presumed valid and dismissal of the derivative suit should occur unless the plaintiff can establish that the committee was not independent or acted in bad faith.[5] Two important aspects of *Auerbach* are the court's determination that the burden of proof is on the plaintiff and the court's loose definition of independence and good faith.

Independence has generally been satisfied when the special litigation committee members are not defendants in the suit.[6] The Ninth Circuit, how-

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1. 671 F.2d 779 (3rd Cir. 1982).
2. *See id.* at 786.
3. *See id.* at 786-87.
4. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (Ct. App. N.Y. 1979).
5. *Id.* at 630-31, 393 N.E.2d at 100-01, 419 N.Y.S.2d at 926-27.
6. *See, e.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir.), *cert. denied*, 102 S. Ct. 1006 (1981); Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980); Cramer v. G.T.E., 582 F.2d 259 (3rd Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

ever, in *Lewis v. Anderson*,[7] used an even less demanding interpretation of independence. The court held that even though one of the three committee members was named in the suit, the director would nevertheless be considered independent if he was not directly involved in the alleged wrongdoing that was the gravamen of the complaint.[8] With one exception, lack of independence has not caused any recommendation of a special litigation committee to be rejected.

The one exception is the North Carolina case of *Swenson v. Thibaut*,[9] in which the issue of independence was raised by the court on its own. The basis for finding that the committee lacked sufficient independence was that at the board of directors meeting in which the second item on the agenda was the creation of a special litigation committee, the first item was a vote on whether the suit had merit. All the directors, including those later appointed to the committee, voted against the suit. The court held that the committee members, because they had already indicated prejudgment of the matter, lacked sufficient independence.[10] The recommendation of the special litigation committee was therefore ignored.

Independence, I submit, has generally been a very empty standard. I also submit that regardless of who has the burden of proof, the standard is one that favors the defendants, and leads to dismissal of the action, unless other standards lead to a more searching inquiry.

The second requirement for the business judgment rule to apply is that the committee must have acted in good faith. Good faith appears to require that the committee was guided by the hand of able counsel.[11] Every committee that has ever been formulated has hired counsel to guide it in its investigation and to prepare the tentative conclusions for the committee. A second aspect of good faith pertains to the committee's diligence in reviewing the evidence.[12] Was it familiar with the investigative report prepared by counsel or others? Has it asked searching and probing questions? Did the committee prepare a report articulating its conclusions?

The problem presented by the special litigation committee is unique because it presents a concern of "structural bias" on the part of the committee members.[13] The presence of this bias is unlikely to be detected solely by an inquiry into the committee's relationship to the defendant and the lawsuit or by its relative diligence in reviewing the case. Structural bias refers to a predisposition toward the defendant because the members who serve on the spe-

7. 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

8. *See id.* at 780.

9. 39 N.C. App. 77, 250 S.E.2d 279 (1978).

10. *Id.* at 106-08, 250 S.E.2d at 297-98.

11. *See, e.g.*, Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980).

12. *See, e.g.*, Rosengarten v. I.T.T. Corp., 466 F. Supp. 817 (S.D.N.Y. 1979).

13. *See generally* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980); Comment, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CAL. L. REV. 885 (1981); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600 (1980).

cial litigation committee have a common cultural bond with the defendants on whom they are passing judgment. They all serve as directors of a publicly held corporation. The Delaware Supreme Court recently summarized the committee members' feelings: "There but for the Grace of God go I."[14] There is also a feeling of collegiality among the directors, so that passing judgment on one's colleague is at best distasteful. An adverse judgment is unlikely, except under the most exceptional circumstances. There is also the problem of the defendants having the ability to select their own jury. With only one exception,[15] special litigation committees have been created after commencement of the derivative suit. There is a serious question of shopping for one's own jury.

A departure from *Auerbach*'s uncritical review of a committee's recommendation was made in *Zapata Corp. v. Maldonado*,[16] decided by the Delaware Supreme Court. *Zapata* offers two levels of analysis. The first level is mandatory; the second discretionary. Under the first level of analysis, a hearing analogous to a motion for summary judgment is held.[17] The focus of this hearing is to review the record, findings, and recommendations of the committee.[18] *Zapata* responds to structural bias by placing the burden of proving the elements of the business judgment rule (i.e., independence, good faith, and reasonable basis) on the recommendation's proponents.[19] The independence factor is not altered by *Zapata*, which appears not to offer any different meaning for its definition. Independence is likely to continue to be judged by objective evidence regarding the committee members' relationship to the defendants and the misconduct underlying the suit.

Good faith is an easy standard to meet. To satisfy the good faith requirement one should be sure that the committee is guided by the hands of experts, legal or accounting depending on the nature of the case; that the committee keeps minutes; that the committee is systematic in its investigation; and that its record is cohesive and coherent.

The reasonable basis requirement was not clearly defined by the court. Some obvious confusion appears in an important message in *Zapata*:

> First, the Court should inquire into the independence and good faith of the committee and the *bases* supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a *reasonable investigation*, rather than presuming independence, good faith and *reasonableness*. If the Court determines either that the committee is not independent or has not shown *reasonable bases* for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good

14. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).
15. Falkenberg v. Baldwin, N.Y.L.J. Mar. 3 1980 at 12, col. 6.
16. 430 A.2d 779 (Del. 1981).
17. *Id.* at 788.
18. *Id.*
19. *Id.*

> faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.[20]

From the above quotation, a good deal of imprecision is found in the court's holding. Does the court require only the reasonable basis standard of the business judgment rule, under which directors are free to choose from conflicting alternatives?[21] Or does the reference to reasonable bases merely require that the grounds advanced for the committee's recommendation are of a type that serves the corporate interest?[22] The court may envision that a reasonable investigation is synonymous with a committee having a reasonable basis for its recommendation. It is important to resolve the meaning of reasonable basis, because the level of scrutiny given to a committee's recommendation is directly dependent upon the reasonable basis criteria.

Crucial to conducting an adversarial hearing to review a committee's recommendation is the level of discovery a plaintiff is permitted before challenging a committee's recommendation. *Zapata* states that the reviewing court may extend discovery rights to the plaintiff.[23] In a footnote the court cited four cases.[24] All four of those, however, were decided under the *Auerbach* type standard. Three[25] of the four denied the plaintiff an opportunity to conduct discovery on matters germane to the suit's merits. Discovery was permitted only against the committee members to explore their good faith and independence. The fourth case[26] merely suggests the possibility of broader discovery by recognizing that the plaintiff had failed to seek *any* discovery. The only illumination to date on the discovery rights under *Zapata* is *Watts v. Des Moines Register and Tribune*.[27] In *Watts* the court held that the plaintiff shall have a right to discover the facts that were considered by the committee. The plaintiff, however, is expressly prohibited from discovering from the committee members the reasons for their consideration of those facts, their decision not to consider other facts, or their decision not to pursue other avenues of inquiry.[28] Of course, an important consideration here is the amount of time that has elapsed since the suit's initiation and the committee's recommendation. If the special litigation committee is created several years after the initia-

20. *Id.* at 788-89 (emphasis added).

21. For instances in which courts have deferred to the choice of the directors, even though an equally supported alternative was considered, *see, e.g.*, Elfenbein v. American Fin. Corp., 487 F. Supp. 619 (S.D.N.Y. 1980), *aff'd*, 652 F.2d 53 (1981); Muschel v. Western Union Corp., 310 A.2d 904, 908-09 (Del. Ch. 1973).

22. In *Zapata* the court states that the basis for a committee's request "is the best interests of the corporation." 430 A.2d at 788.

23. *Id.* at 788.

24. *Id.* at 788 n.16.

25. Galef v. Alexander, 615 F.2d 51, 56 (2d Cir. 1980); *Rosengarten*, 466 F. Supp. at 823; Gall v. Exxon Corp., 418 F. Supp 508, 520 (S.D.N.Y. 1976).

26. Maldonado v. Flynn, 485 F. Supp. 274, 285-86 (S.D.N.Y. 1980).

27. 525 F. Supp. 1311 (S.D. Iowa 1981).

28. *Id.* at 1329-30.

tion of the derivative suit, as in *Zapata*, there is reason to believe that the plaintiff has been accorded sufficient discovery against the defendants to launch a vigorous attack on the committee's recommendation. But if the special litigation committee's recommendation is offered soon after the filing of derivative suit, the plaintiff may encounter serious difficulties in probing the committee's report if some discovery on the suit's merits is unauthorized.

A further point in *Watts* is the court's response to a disagreement between the committee and its counsel. Counsel reasoned that one of the asserted causes of action should be allowed to go forward because there was reason to expect that the claim served the corporation's interest. The committee's report viewed all the causes of action to be without merit and urged dismissal. Because the committee did not explain or otherwise support its decision to ignore its counsel, the court retained the case for further consideration. The court held that there must be a further hearing on the committee's justification for ignoring the advice of counsel,[29] even though the court was satisfed that the committee had established its good faith and independence.

The second level of analysis set forth in *Zapata* is discretionary and is to be applied only in nonfrivolous actions.[30] The court is to exercise its own independent judgment: the court is to "give special consideration to matters of law and public policy in addition to the corporation's best interests."[31]

To suggest, as *Zapata* does, that the committee's recommendation should be subordinated to established public policy raises an important question concerning the purpose of the derivative suit. For example, assume a special litigation committee reports as follows: "We recognize the suit has merit and the recovery can be expected in the amount of $300,000; however, the total cost of prosecuting the action is expected to exceed $500,000 when considering the loss of employee time, morale problems, and the cost of litigation." *Zapata* contemplates that a court, even though satisfied that the committee is independent, acting solely in the corporation's interest, and is correct in its estimates of costs and benefits, could ignore the committee's recommendation if it believes public policy would be advanced by the action's continuance. In my opinion this conscripts the corporation to vindicate the public interest, even though it results in a net loss to the corporation.[32] It must not be overlooked that it is the shareholders of the corporation who will bear the loss.

Proponents of this result may argue that it was first offered by the United States Supreme Court in *Burks v. Lasker*.[33] The Supreme Court held that whenever there is litigation under a federal statute, the first issue is whether

29. *Id.* at 1328-29.

30. 430 A.2d at 789.

31. *Id.*

32. In other areas, the courts have conditioned corporate actions upon there being a compensatory purpose served by the suit; mere deterrence of wrongdoing is insufficient. *See, e.g.*, Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R., 417 U.S. 703, 717 (1974); Home Fire Ins. Co. v. Barber, 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903); Borden v. Cohen, 231 N.Y.S.2d 902, 903 (1962).

33. 441 U.S. 471 (1979).

the committee's recommendation would have caused dismissal under state law; the second issue is whether dismissal offends public policy.[34] But the situation in *Burks v. Lasker* was vastly different from that contemplated in *Zapata*. *Burks* appears to apply a public policy test only when suit is under a federal statute for which Congress has carefully tailored derivative suit procedures. Cases suggested by the Court were actions under section 16(b) of the Securities Exchange Act and 36(b) of the Investment Company Act. In those situations the Court held that the directors should not have a right to terminate a derivative suit because Congress had clearly expressed a policy that the directors' refusal to sue should not be an automatic ban to the suit.[35] That analysis is vastly different from the reasoning that the obvious public interest in clean air, clean water, and no bribery of public officials compels the corporation to extend its resources to punish the defendants, even though the net result is a loss to the corporation.

ROBINSON: Let me comment on the *Swenson v. Thibaut*[36] case. I think that it is a very important case for North Carolina lawyers, not because of what the court decided, but for what the court said by way of dictum. Although the court decided that good faith and independence did not exist, it nonetheless expounded on the role, function, and authority of a special litigation committee. Citing *Auerbach v. Bennett* (this was before *Zapata*), the court said that it should undertake only the first level of analysis.[37] The court should inquire only whether there is an independent litigation committee and whether it acted in good faith; it should make no inquiry into public policy. It is a very restrictive opinion that is bound to have some influence, at least on the lower courts, and my guess is that the North Carolina Supreme Court would probably follow this line of reasoning. Thus, the law in North Carolina is the more restrictive view of *Auerbach v. Bennett*.

COX: One case I did want to mention was *Stein v. Bailey*,[38] a case in which demand was not excused and which therefore involved a different fact pattern than *Zapata*. The *Stein* court departed from precedent and required the directors to establish their independence.[39] Rejection of the demand was made by a minority of the entire board. Because the court feared such a small number was not a critical mass to assure independence, the court placed the burden of proving independence on the committee. The plaintiff still had the burden of establishing either bad faith or lack of reasonable basis.

Finally, let me remark that I agree with the American Law Institute project in its view that one should not distinguish between cases in which demand is excused and those in which demand is made. The problems of collegiality, cultural bias, and jury shopping transcend both situations. The answer is for the courts to get more involved in a review of the directors' reasoning in sup-

34. *Id.* at 480.
35. *Id.* at 483-86.
36. 39 N.C. App. 77, 250 S.E.2d 279 (1978).
37. *Id.* at 105-08, 250 S.E.2d at 297-98.
38. 531 F. Supp. 684 (S.D.N.Y. 1982).
39. *Id.* at 693.

port of their recommendation for dismissal or rejection of a demand that the corporation file suit. I believe that is the thrust of the ALI project.

SCHWARTZ: The concern about the future of the derivative suit really began with *Lewis v. Anderson*.[40] In that case the plaintiff challenged the propriety of stock options that had been awarded. A committee was appointed, which even included one of the defendants. Based upon its interpretation of California law, the court found that the committee was independent and could dismiss the derivative suit. The court cited such cases as *Burks* never pausing to note that this case, unlike the others, involved an allegation of breach of fiduciary duty through self-dealing. Because *Lewis* involved self-dealing, it was an impermissible extension of the business judgment rule to dismiss a derivative suit; it was beyond the scope set forth in *Burks* and *Gall*.

I think you can array derivative suits on a spectrum. One end of the spectrum would be claims against third parties on any number of things—for example, the corporation has a claim against some supplier of the company who either delivered the wrong kind of merchandise or overcharged the company, and the company decides for a whole host of reasons that it does not want to bring suit, but a shareholder brings a derivative suit. That is one extreme, when no insider of the corporation is involved, and when there is no self-inflicted wound on the corporation by its officers or directors. On the other end of the spectrum is the self-dealing transaction by the controlling person of the company. In between would be lesser charges against controlling persons who did not line their own pocket (for example, negligence actions) and breach of fiduciary duty by noncontrolling persons (for example, outside directors who may have seized a corporate opportunity). Those categories fall in between the extremes of self-dealing by the controlling person and claims against third parties. The early cases in which the committee device was used, *Gall* through *Abbey*, including *Auerbach* and even *Burks*, did not involve the most extreme cases on either side. They did not involve actions against third parties or breaches of fiduciary duty by controlling persons. Indeed, in most of those cases there was not even any alleged harm to the corporation.

The ALI project on Corporate Governance, Tentative Draft No. 1, which was presented to the Institute's meeting in May of this year, leaned toward the *Zapata* approach that the business judgment rule is not the appropriate way to analyze a decision to terminate derivative litigations, other than third party litigations. Claims against third parties, states the ALI project, ought to be judged in the courts in accordance with the business judgment rule, and I think there is no quarrel on that issue. But the ALI takes the position, which the courts have not accepted, that suits against controlling persons (a defined term in the ALI project) alleging self-dealing may not be terminated by any action of the corporation itself. Of course, the suit is subject to dismissal on grounds that the claim does not state a cause of action, but it cannot be dis-

40. 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980).

missed simply because the corporation determines that it is not a good idea to go ahead with the lawsuit. All other types of suits may be dismissed if certain procedures are followed and if the court makes certain findings. The findings must conclude that there was a business justification warranting dismissal.

To dismiss a derivative suit under the ALI rules, there must be an independent committee; that is, there must be three directors who are independent and who then appoint special counsel, who is also independent. The committee must conduct an investigation, come up with a written report, and have the authority to act. The committee must have been chosen by the independent members of the board and not by persons who are not independent. Independence is not precluded simply because a person is named as a defendant in the lawsuit for the sole purpose of making him nonindependent. In other words, a bootstrap action to render the board incapable of having an independent committee will not work. But even if the board cannot have an independent committee—if the conduct alleged legitimately challenges everybody on the board—the company is not without recourse to this dismissal route. The board can go to court and ask the court to name a special panel of three persons, which can do the same thing the independent committee would have done. If a special panel includes lawyers, it may not even need to retain independent special counsel because the panel itself has the ability to deal with the legal issues.

There are several very important aspects of the ALI proposal. First, it rejects the business judgment analysis because the burden is on the moving party to show that the suit ought to be dismissed. Second, it does not require demand on the board to press the derivative suit. *Zapata* held that if demand were required, the decision to dismiss would be assessed in accordance with the business judgment rule and the burden would be on the plaintiff to show that dismissal of the lawsuit was wrongful, which is a difficult thing to show. The ALI procedures are applicable regardless of whether demand was required, but if demand was made or was required under traditional rules, it is a factor that weighs in favor of the committee's determination not to proceed with the lawsuit. Third, there is some limited discovery that the court may allow the plaintiff. The proceedings are like a mini-trial—if the board wants to fight it out at this stage and advance reasons why the suit should not go ahead, then the plaintiff is entitled, within the discretion of the court, to take some discovery. Finally, the special counsel appointed by the committee enjoys a privileged relationship with respect to the committee so that communications between counsel and the committee are privileged. This is a limited reversal of *Garner v. Wolfenbarger*[41] in the context of the derivative suit. There was very little discussion and very little criticism of this part of the ALI project dealing with derivative suits.

I think the courts are going to have occasion to look at the ALI proposal and draw upon whatever wisdom they see in it. The proposal may creep into

41. 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

the law even though it is not official at this point and may never become anything official. But it is a document that has been written by serious people and looked over by serious people. Whatever you may say of the ALI project, it is an exercise not of advocacy but of scholarship.

HAZEN: I think it is clear in light of the obvious confusion of the courts that the proposal is a document that cannot be ignored. It is something the courts are going to have to grapple with, at least until it is finally adopted or rejected.

# RECENT DEVELOPMENTS IN DEFENSIVE TACTICS

ROGER W. ARRINGTON†

ARRINGTON: I would like to make a few comments about the defensive tactics used in the acquisition of Conoco. To summarize the events of last year, Dome Petroleum Company was interested in buying Conoco's fifty-three percent interest in the Hudson Bay Oil and Gas Company. Negotiations between the parties broke down, and to "get some leverage" Dome made a tender offer for twenty percent of Conoco's common stock. Conoco's shareholders responded by tendering over forty percent of their shares to Dome. Because of this tremendous response to the Dome offer, Conoco became a marked acquisition candidate. The Seagram Company became involved at this point in discussing with Conoco the purchase of a block of Conoco stock. When negotiations broke down, Cities Services popped into the picture briefly, and Seagram followed with a hostile cash tender offer. E. I. du Pont de Nemours entered as a white knight, and Mobil attempted to acquire Conoco as well. When it was all over, Conoco was a wholly owned subsidiary of du Pont, and Seagram owned twenty percent of du Pont. During the acquisition of Conoco four defensive tactics were used, which chronologically occurred as follows: a restrictive bylaw provision, executive employment agreements, an option to purchase shares, and a standstill agreement.

The first tactic was a bylaw amendment adopted by the Conoco board providing for an alien ownership restriction that prevented any "alien company" from acquiring more than twenty percent of Conoco's stock. This amendment was adopted after the Dome tender offer was consummated, but before Seagram's involvement in the takeover. From the date the Conoco board adopted this bylaw provision, every stock certificate issued by Conoco on the transfer of shares was stamped with a legend stating that any holder of a stamped certificate would be bound by the alien ownership restriction. After announcing its tender offer for Conoco stock, Seagram challenged this bylaw provision in the Federal District Court for the District of Delaware.[1]

The statute in dispute, section 202 of the Delaware General Corporation Law, provides that a written restriction on the transfer of securities must be conspicuously noted on the security and that no such restriction shall be binding with respect to securities issued prior to the adoption of the restriction, unless the holder of the security is a party to an agreement or voted in favor of the restriction.[2] Conoco's position was that the word "securities" as used in

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1. Joseph E. Seagram & Sons, Inc. v. Conoco Inc., 519 F. Supp. 506 (D. Del. 1981).
2. DEL. CODE ANN. tit. 8, § 202 (1975).

section 202 of the statute means "stock certificates," and therefore the restriction could apply to any stock certificate issued by its transfer agent after the adoption of the bylaw provision. In rejecting this argument, Judge Latchum held that the restriction could not be imposed on shares of Conoco stock issued and outstanding before the adoption of the bylaw, unless the holder of the shares was a party to an agreement or voted in favor of the restriction.[3]

One result of this decision is that du Pont's standstill agreement with the Seagram Company expressly provides that du Pont will not take or recommend to its shareholders any action during the term of the agreement that would impose limitations on company shareholders based upon the nationality of security holders.

The second defensive tactic employed by Conoco in its acquisition defense was to enter into employment agreements with certain of its executives. Although much criticism has been made of these kinds of agreements, to the best of my knowledge there is no decision on the validity of "golden parachute contracts."[4] In defense of these agreements, it is argued that they serve a valid business purpose: to allow management to focus on the running of the business during this period of uncertainty. It must be remembered that these are generally people who have been employed with their company for a number of years and who in a month or two may be out of a job. There is great uncertainty during the takeover experience, and it may be beneficial to the corporation and its stockholders to give the top management a certain amount of security during such times.

HUMPHREY: I agree with you; it can be in the corporation's best interest to enter such an agreement. Have any executives who received the agreements since left the company?

ARRINGTON: No, none have left. I do believe, however, that the use of "golden parachute" agreements can be abused. The validity of these kind of agreements will depend, in my opinion, on the surrounding circumstances leading up to the agreement, the duration of the agreement, the method of computing compensation, and the conditions of performance required for the executive to keep the agreement alive. I believe that if the agreement has a limited term and the compensation is based on current salary rates and current employee benefits, and there are provisions that require the executive to perform for the company during the period of agreement, the agreement should be defensible. The agreement should specify what events permit termination by the company "for cause" and what is considered to be "good reason" for the executive to resign voluntarily. In the agreements with Conoco, good reasons for the executive's resignation include assignment of duties inconsistent with those described in the agreement, reduction in salary, failure to maintain the executive's participation in company benefits plans, relocation without executive consent, failure to provide a reasonable number of vacation days, and

3. 519 F. Supp. at 514.

4. "Golden parachute contracts" generally refers to executive employment agreements that become operative when employment is terminated by reason of, or coincidental to, a takeover.

failure of the company to obtain an assumption of the agreement. In addition to the above provisions, the chairman of the board of Conoco may voluntarily terminate his employment at any time he shall determine in good faith that due to the change in control he is not able effectively to discharge his duties.

A third defense used by Conoco was the granting to du Pont of an option to acquire a large block of Conoco's common stock. The acquisition agreement between du Pont and Conoco granted du Pont an option to purchase 15.9 million shares at $87.50 per share. The option was exercised by du Pont at the same time it purchased the Conoco shares that had been tendered to du Pont for cash in the offer; the net result was to give du Pont ownership of over fifty percent of Conoco's outstanding stock. Mobil attempted to enjoin the exercise of the option by du Pont in the Southern District of New York. Judge Pierce, in refusing to enjoin the exercise, emphasized that adequate disclosure had been made through the discussion of the option in du Pont's prospectus.[5] In addition, du Pont's tender offer material disclosed that the acquisition of Conoco shares pursuant to the offer or the option would increase the likelihood that the merger would be effected. It further disclosed that the purchaser would vote all its Conoco shares in favor of the merger. Judge Pierce concluded that this level of disclosure satisfied the requirements of section 14 of the Securities Exchange Act of 1934 and further held that the grant of the option was presumed to be proper under the business judgment rule.[6]

The last defensive tactic I want to mention is the standstill agreement between du Pont and Seagram, which was consummated after completion of the acquisition of Conoco. The agreement provides that Seagram will not acquire more than twenty-five percent of du Pont shares outstanding for a period of ten to fifteen years. Paragraph 7(a) of the agreement provides:

> Seagram, on the one hand, and the Company, on the other acknowledge and agree that irreparable damage would occur in the event any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. It is accordingly agreed that the parties shall be entitled to an injunction or injunctions to prevent breaches of the provisions of this Agreement and to enforce specifically the terms and provisions hereof . . . .[7]

I do not know if anyone has had any experience enforcing a clause such as this in court. In any event, I do not look upon a standstill agreement as a fail-safe defensive technique.

In summary, the bylaw provision that Conoco attempted to use did not work as a defensive tactic. The employment agreements may have continued management's participation in the business, but they did not prevent acquisi-

5. Conoco, Inc. v. Mobil Oil Corp., No. 81-4787 (S.D.N.Y. Aug. 4, 1981) (order denying injunction), *appeal denied*, Conoco, Inc. v. Mobil Oil Corp., No. 81-7552 (2d Cir. Aug. 4, 1981).

6. Since this decision, additional opinions have addressed the validity of options granted during takeover attempts. *See, e.g.*, Marshall Field & Co. v. Icahn, No. 82-0755 (S.D.N.Y. Mar. 26, 1982); Mobil Corp. v. Marathon Oil Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) 398, 399 (6th Cir. 1981).

7. Exhibit C of Amendment no. 3 to the JES Holdings, Inc. Schedule 13D filed Oct. 7, 1981.

tion. The use of the option did give du Pont an advantage over the unfriendly raiders. Finally, the standstill agreement will have to pass the test of time.

# STATE TENDER OFFER STATUTES

HUBERT HUMPHREY †

HUMPHREY: Beginning with Virginia in 1968, the states began adopting antitakeover statutes. There are now thirty-seven such statutes. These statutes essentially have been defensive measures adopted at the urging of local management in order, among other reasons, to protect local business interests. The statutes vary from state to state, but there are certain common characteristics that can be identified. The most extreme version of the antitakeover statutes is sometimes called the "benevolent bureaucrat" statute. I think the *MITE Corporation v. Dixon*[1] case was the first to use that phrase. Under this type of statute, a state securities administrator actually decides whether a tender offer is fair to the shareholders.

Another version permits the administrator to convene a hearing to determine whether the disclosures made under the statute are accurate. All state statutes require certain disclosures. The administrator in certain states, but not in North Carolina, is permitted to investigate issues of fairness and disclosure and to conduct a hearing. If the administrator in states that have a fairness requirement decides that the takeover is not fair to the target or its shareholders, or if the administrator decides that the offeror's disclosures are inaccurate, he is permitted, in some states, to issue a cease and desist order himself; he may, in others, ask a court to issue such an order. In still another version of the antitakeover statutes, the administrator can rely upon the fiduciary duty of the board of the target company, and if the board has taken the position that the takeover is a good thing for the shareholders, the administrator may waive some or all of the statutory requirements. North Carolina has no provision in its statute giving the administrator the right to hold a hearing.[2] In North Carolina the administrator is given the right to go into court to get an injunction against violators of the statute, including those failing to comply with the disclosure requirements. The North Carolina statute requires the acquiring corporation to disclose certain information such as the purpose of the acquisition and the methods of financing.

All state antitakeover statutes require a waiting period between the announcement of an intention to make a tender offer and the making of the offer. In North Carolina the acquiring corporation must wait thirty days after announcing the tender offer before proceeding. All state statutes have a pro rata acceptance requirement: for a certain period of time after extending the tender offer, the acquiring corporation must accept all shares tendered on a

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1. 633 F.2d 486, 494 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE Corp., 102 S. Ct. 2629 (1982).

2. N.C. GEN. STAT. § 78B-4(b) (1981).

pro rata basis, as opposed to a first-come-first-served basis, if more shares are tendered than the corporation has offered to buy.

Cases under antitakeover statutes generally come into court when an administrator alleges a violation. Often, he will be encouraged by the target company to bring such an action. Because outside tender offerors generally fare better in federal court than in a local state court, they frequently will try to preempt a state court action by getting into federal court first on an action to enjoin the state administrator or the target company from using the state act. The basis for seeking an injunction is usually either that the state act does not apply or that it is unconstitutional. Under the applicability issue, the question is whether the target company is subject to the state act. Some acts, including North Carolina's, require that the company be incorporated in that state and have substantial assets in that state before the statute will apply. Other state statutes provide that mere incorporation of the target in that state is sufficient for the statute to apply. Still other state acts say that it is sufficient for the target to have a substantial number of assets in the state even though the principal place of business is outside the state. Finally, other state statutes merely provide that if a certain percentage of the corporation's shareholders reside in that state, then the statute applies.

Another applicability question is whether the tender offer is of a kind that is covered by the statutes. For example, in *Sheffield v. Consolidated Foods Corporation*[3] the North Carolina Supreme Court held that "creeping tender offers" (open-market purchase programs) do not come within the scope of the North Carolina statute. A few other states have held differently; still others have amended their statutes specifically to cover creeping tender offers, providing that if a shareholder owns five percent of the target's stock and then goes over that amount, its open market purchases are deemed to be a tender offer and, therefore, are subject to the act. A few courts have upheld these statutes, while other courts have found them to be unenforceable on constitutional grounds.

If a statute is held to be applicable, the next question is whether it is constitutional. The constitutionality of a state act is subject to attack on two grounds. The first ground is that the state statute conflicts with the Williams Act and is thus preempted under the supremacy clause of the Constitution. The second ground is that the state act impermissibly burdens interstate commerce and thus violates the commerce clause of the Constitution. Generally, both of these grounds are argued and both are frequently addressed by the courts.

In the first important case, *Great Western United Corporation v. Kidwell*,[4] the Fifth Circuit held the Idaho statute unconstitutional on both grounds. The Supreme Court reversed the circuit court decision, but on technical grounds not relevant to the constitutionality issues. The case was brought in Texas,

3. 302 N.C. 403, 276 S.E.2d 422 (1981).

4. 577 F.2d 1256 (5th Cir. 1978), *rev'd on venue grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979).

and the Supreme Court held that the Texas federal district court did not have venue to pass on an Idaho statute. The Court is apparently going to consider the constitutional questions in *MITE Corporation v. Dixon*[5] very soon. In *MITE* the Seventh Circuit held the Illinois statute unconstitutional. That statute had a benevolent bureaucrat approach and a twenty-day waiting period. The *MITE* case was argued before the Supreme Court in November, 1981.[6]

The Fourth Circuit has addressed the constitutionality questions, although not clearly, in *Telvest v. Bradshaw*.[7] Judge Merrige, in a Virginia federal district court, held the Virginia antitakeover statute unconstitutional. Upon review, the Fourth Circuit concluded that Judge Merrige had been a bit hasty; *Telvest* was just in the preliminary injunction hearing stage and the record was not complete. Although the Fourth Circuit concluded the district judge had jumped the gun on his conclusion, it did say that it questioned whether the Virginia statute was unconstitutional.

Before the 1980 changes in SEC tender offer rules, the courts were fairly evenly split on the constitutionality questions. For example, in *Dart Industries, Inc. v. Conrad*,[8] Indiana federal district court held the Delaware tender offer act unconstitutional. In *Wylain, Inc. v. TRE Corporation*,[9] however, a Delaware state court held that the Delaware tender offer act was constitutional. In hopes of ending the confusion, on January 7, 1980, the SEC amended its tender offer rules in several respects. Rule 14d-2(b)[10] was altered to require that tender offers be disseminated and all required SEC filing be made within five days after the tender offer's "commencement," which is described as being the announcement of certain key terms, such as the price and volume. In adopting these rule changes the SEC, in much quoted language, said:

> Thus the conflict between Rule 14d-2(b) and such state statutes is so direct and substantial as to make it impossible to comply with both sets of requirements as they presently exist. While recognizing its long and beneficial partnership with states in the regulation of securities, the Commission nevertheless believes that the state takeover statutes—all of them presently in effect—frustrate the operation and purpose of the Williams Act.[11]

A majority of the state and federal cases decided since January of 1980 have agreed with the Commission's view. In *Kennecott Corporation v. Smith*[12]

5. 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE Corp., 102 S. Ct. 2629 (1982). The Supreme Court's decision on June 23, 1982, shortly after the Conference, held the Illinois statute to be unconstitutional on commerce clause grounds.

6. *See id.*

7. 618 F.2d 1029 (4th Cir. 1980), *vacating* [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,154 (E.D. Va. Sept. 3, 1979). On January 6, 1983, after the Conference, the Fourth Circuit once again ruled on the *Telvest* case and held the Virginia statute to be unconstitutional on commerce clause grounds. 51 U.S.L.W. 2427 (4th Cir. Jan. 6, 1983).

8. 462 F. Supp. 1 (S.D. Ind. 1978).

9. 412 A.2d 338 (Del. Ch. 1980).

10. 17 C.F.R. § 240.14d-2(b) (1982).

11. Tender Offers, 44 Fed. Reg. 70326 (Dec. 6, 1979), *reprinted in* [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,373, at 82,584.

12. 637 F.2d 181 (3rd Cir. 1980).

the Third Circuit ruled that the New Jersey statute conflicted with the Williams Act, but narrowed its decision to the immediate conflict between the delay period in that act and the five day period of the SEC rules. The federal rule now says the offeror must go forward within five days, but many state acts are saying the offeror cannot go forward for twenty or thirty days. So it is fairly clear at this point that this area is in virtually irreconcilable conflict.

The North Carolina Act was held to be unconstitutional by Superior Court Judge Braswell in *Eure v. Grand Metropolitan, Ltd.*,[13] a case in which I participated. Grand Metropolitan made a tender offer for the Liggett Group two months after the federal rule change. Considering a challenge under the North Carolina Act, Judge Braswell held that North Carolina's thirty-day waiting period violated the SEC's five-day rule. In other litigation involving that takeover, the Delaware chancery court held the Delaware act unconstitutional on these same grounds.

The current status of the constitutionality question is to await the *MITE* decision.[14] Meanwhile, the state administrators have adopted a Uniform Take-over Act.[15] The Uniform Act was adopted only eight months ago and has not yet been adopted in North Carolina, but it represents the culmination of the thinking—pre-*MITE* thinking—of the state administrators. It provides for an administrative hearing, but the administrative hearing is only to determine whether full disclosure was made. Thus, the Uniform Act does not take the benevolent bureaucrat approach, but simply provides for a determination of whether the act has been complied with; it does not provide for a hearing to determine on behalf of the stockholders whether the offer itself is fair. The Uniform Act also attempts to regulate creeping tender offers. Anytime a shareholder attempts to acquire more than five percent of a subject corporation's stock, the attempt is considered a tender offer, and the shareholder must comply with the Uniform Act. I mention the Uniform Act because it may become the prototype of state statutes in the wake of *MITE*.

The legislative history of, and the case law addressing, the Williams Act focus upon a basic regulatory concept. It is the "market approach": do not take sides; let the investor decide in the free market what is the best way; do not protect incumbent management; do not help out the tender offeror; leave the market alone so that it may operate as designed. I think there is a fundamental question whether these state acts violate the market approach, and I suppose a lot of people hope the Court does not decide to deal with that basic issue. It is conceivable that the Supreme Court could strike down all state tender offer statutes. It is more probable that the Court will render a narrow decision.

One of the real problems in this area is that, as a practical matter, state

13. [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,694 (N.C. Super. Ct. Apr. 18, 1980).

14. *See supra* note 5.

15. UNIFORM TAKE-OVER ACT (North Am. Sec. Adm'rs Ass'n, Inc. 1981), *reprinted in* 1 BLUE SKY L. REP. (CCH) ¶ 5,295.

statutes have a tremendous impact on multistate transactions. I remember in the Grand Met takeover of the Liggett Group that the South Carolina administrator at one point held up the whole transaction for about a ten-day period because Liggett had acquired a few Pepsi-Cola plants in South Carolina. The South Carolina administrator delayed the entire acquisition, which was primarily taking place elsewhere, because Liggett had some minor assets in South Carolina. Tender offers often cross state lines, so one state administrator frequently can stop a multistate tender offer to protect solely local interests, yet his actions materially affect stockholders everywhere. This is a problem the Supreme Court may or may not address.

CORNE: I would like to point out what a purchaser of a company might expect from the North Carolina Act. When I was the Securities Deputy, after the *Grand Metropolitan*[16] decision we took the position that we would not enforce the Act in court and would accept filings if they were filed contemporaneously with or as soon as possible after filing with the SEC. I believe that is a reasonable policy in light of *MITE* and some of the other cases in the area.[17] I would support repealing North Carolina's present statute in favor of a statute that serves the purpose of protecting North Carolina companies and shareholders, rather than also protecting companies with an incidental connection to the state, as the present statute does.

FARNAM: At the risk of being the only one to defend these statutes, I will tell of a recent situation illustrating their worth. In the acquisition of Hickory Furniture by Telvest,[18] Telvest filed twenty-three amended 13D forms[19] on Hickory Furniture. In each 13D Telvest disclaimed any intent to acquire control. It nibbled and nibbled and filed one 13D after another. The ultimate takeover of Hickory Furniture in a period of about two years is a prime example of what happens as the result of a creeping tender offer if the state statute contains no restriction on open market purchases. What happened, and what could happen to any client, is that without notifying the shareholders about

16. Eure v. Grand Metropolitan Ltd., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,694 (N.C. Super. Ct. Apr. 18, 1980). In awarding summary judgment to the defendants, the superior court held

> as a matter of law that the 30-day waiting period of time for the commencement of a tender offer prescribed in NCGS 78B-4(a) is in direct conflict with the Federal Rule of five days promulgated by the Securities and Exchange Commission . . . . The Federal Rule is overriding and pre-emptive. The 30-day provision of NCGS 78B-4 is not enforceable.

*Id.*

17. *See* Sheffield v. Consolidated Foods Corp., 302 N.C. 403, 276 S.E.2d 422 (1981); Eure v. NVF Co., No. 79-CVS-4093, slip op. (N.C. Super. Ct., May 15, 1980).

18. Telvest, Inc. v. Bradshaw, 618 F.2d 1029 (4th Cir. 1980), *vacating* [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,154 (E.D. Va. Sept. 3, 1979).

19. Any person acquiring more than five percent of any equity security registered pursuant to the Securities and Exchange Act of 1934, § 12, 15 U.S.C. § 781 (1976), must file a Schedule 13D or equivalent information with the SEC. 15 U.S.C. § 78m(d) (Supp. IV 1980); 17 C.F.R. § 240.13d-1 (1982). Schedule 13D is a statement containing various information about the acquirer, including a statement of the purpose or purposes of the purchase. 17 C.F.R. § 240.13d-101 (1982). Anyone required to file a schedule must file amendments in the event of any material change in the information in the first schedule, including changes in the number of shares that have been purchased. *Id.* § 240.13d-2.

the shift in control occurring slowly but surely, and all the while disclaiming any intent to gain control, Telvest acquired forty-nine percent of Hickory Furniture's shares. It bought this forty-nine percent at $5.00 to $6.00 a share, then made a tender offer at $20.00. By that time the ball game was over and the poor guy who sold at $6.00, not knowing that the $20.00 offer was in the works, took a bath.

GRESSMAN: It is somewhat hazardous to try to predict what the Court is going to hold in the *MITE* case, particularly in this day of what I call neo-federalism, when the Court is running like a runaway truck down the federal mountain. As you know, the Court is giving more and more deference to states' rights, and perhaps this will spill over to the preemption field. With respect to the constitutional arguments I have heard in the *MITE* case and others like it, I am least impressed by any allegation that the state statute violates the commerce clause. It is very difficult for me to imagine the Supreme Court holding that state tender offer statutes impermissibly burden interstate commerce. But I may be totally wrong about that. It is too hazardous to predict how the Court will rule on any given issue.

The argument that the Williams Act preempts the state statutes, however, has more merit. In constitutional terms preemption is really a psuedo-constitutional issue. There are no standards concerning preemption written into the Constitution. The Court has said many times that the basic question in a preemption case is not an interpretation of the Constitution—it is a comparison of two statutes. If the state statute is found to conflict with or be preempted by the federal statute, then the state law falls by virtue of the supremacy clause. But that results from the Court's reading the two statutes side by side and comparing the purposes and the provisions of the federal and state statutes. Beyond that, preemption is simply not favored, and the Court has said so as recently as last year.[20] The presumption is that a state law is not preempted unless one of two very persuasive reasons is present. The first reason, of course, is that Congress has unmistakably provided or ordained in the federal statute that state law inconsistent therewith shall not be effectuated. I am not aware that Congress has so provided in the Williams Act. But I am intrigued by something that appears to be a preemptive intent in new SEC rule 14d-2(b).[21] As the SEC says, the adoption of that rule is plainly in conflict with state takeover statutes and therefore preempts them. This is an intriguing argument. Can an administrative agency by adoption of a rule provide this unmistakable intention of Congress to preempt? While the agency may be given the power to issue rules and regulations that have the effect of law, I am not sure that, constitutionally speaking, an administrative agency can create the preemption that Congress has not ordained or approved in some unmistakable fashion.

The other ground on which the preemption doctrine can be invoked, of course, is when the nature of the regulated subject matter permits no other

20. Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 522 (1981); Chicago & N.W. Transp. Co. v. Kalo Brick Co., 450 U.S. 311, 317 (1981).

21. 17 C.F.R. § 240.14d-2(b) (1982). *See supra* note 12 and accompanying text.

conclusion. This is where you get into the ultimate "constitutional" question. Does the state statute affect the regulated subject matter of the Williams Act in such a fashion that the purposes and provisions of the Williams Act cannot be carried out? If it is literally impossible to effectuate the purpose and language of Congress in the Williams Act when there is a particular kind of state tender offer statute being executed at the same time, then the preemption doctrine would invalidate the state tender offer statute. I do not know enough about the particulars of the Illinois state tender offer statute to determine whether it has made it impossible to effectuate the Williams Act. It may be that it is possible to comply with the five day requirement of the Williams Act and at the same time comply with the twenty or thirty day additional limit of the state statute. We have had a number of cases in the Supreme Court which have said that it is possible to comply with both the federal and state statutes at the same time, even though the state statute may have higher standards, as long as the company complies with the minimum federal requirements.[22] I suppose that will be one of the critical determinations the Court may make in the *MITE* decision. Otherwise, I do not think you can say that tender offers are a subject matter which is so federalized in nature that no state statute can come into effect in this area.

There are some situations—such as the control of subversive activities, the regulation of rates of interstate motor carriers and railroads, and the regulation of safety features of airports and air carriers—that are so pervasively federal in nature that no state statute may impose any additional or different requirements in those areas.[23] I would question whether tender offers have that basic federal ingredient which makes it impossible for states to have legislation in addition to what Congress has provided. A leading case in this area is *Florida Lime & Avocado Growers, Inc. v. Paul*,[24] in which the Court said that avocados are not imbued with an overriding federal interest. I would guess offhand that tender offers are more like avocados than railroad rates.

HUMPHREY: When Florida enacts legislation governing the growing of avocados in Florida, it does not affect the growing of avocados in North Carolina. The problem is that a South Carolina administrator may stop thousands of stockholders in North Carolina and elsewhere from selling their Liggett Group stock for $6.00 a share, and that is the problem with tender offers for a large company. This point was made clear in the case of the du Pont-Conoco takeover. Suppose the majority of the shareholders are in another state, yet some administrator in Idaho is stopping them from having the right to sell their stock. I think that is the problem the Supreme Court ought to face.

GRESSMAN: It is important to recall that the federal securities acts were

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22. *See, e.g.,* Florida Lime & Avocodo Growers, Inc. v. Paul, 373 U.S. 132 (1963).

23. *See* City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624 (1973); Perez v. Campbell, 402 U.S. 637 (1971); Pennsylvania v. Nelson, 350 U.S. 497 (1956); Hines v. Davidowitz, 312 U.S. 52 (1941); Texas & Pacific Ry. v. Abilene Cotton Oil Co., 204 U.S. 426 (1907).

24. 373 U.S. 132 (1963).

imposed upon a long history of state securities statutes that were in existence before the 1933 or 1934 acts were even contemplated. For that reason, I think the whole problem of securities regulation is not inherently federal.