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Business and Corporations Law Section, Los Angeles County Bar Association

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RECENT DEVELOPMENTS IN CORPORATE AND SECURITIES LAWS

The Business and Corporations Law Section of the Los Angeles County Bar Association gathered on March 11, 1980, for a symposium on recent developments in corporate and securities laws. Many distinguished Los Angeles attorneys shared their views on important changes in the following areas of the law:

PARTICIPANTS

Myrl Scott—Moderator

Simon M. Lorne—Attorney-Client Privilege

Samuel H. Gruenbaum—Disciplinary Proceedings Against Attorneys

Joseph F. Troy—Liabilities of Corporate Officers and Directors

Donald G. Davis—Definition of a Security

Theodore G. Johnsen—Registration and Reporting Requirements

George W. Bermant—Private Rights of Action

Grover T. Wickersham—Small Issue Financing; Regulation A and Form S-18

Neal H. Brockmeyer—Small Issue Financing; Rule 242

Peter R. Pancione—Developments in California Securities Law

MR. MYRL SCOTT: Our first speaker, Mr. Simon Lorne,¹ will address the problem of preserving the attorney-client privilege in the corporate context.

MR. SIMON LORNE: It is necessary to address an issue that is becoming increasingly important, but has not been given the attention it needs, particularly by those who advise corporations. That issue is the erosion of the attorney-client privilege in the corporate context, and the limitations of the privilege. The following hypothetical will aid in the discussion of the limitations of the privilege. Suppose someone is representing a corporation and a corporate officer comes to him or her and

1. Member, California Bar; Acting Director, University of Pennsylvania Center for Study of Financial Institutions, 1977-78; Member, Executive Committee, Business and Corporations Law Section, Los Angeles County Bar Association, 1974.

discusses activities of the corporation that constitute a criminal violation of the antitrust laws. If the illegality implicates the officer personally, then to what extent is that conversation privileged in a criminal action against the officer as an individual? Unfortunately, the answer to that important question is neither simple nor certain.

A few preliminary observations are in order. First, the scope of the attorney-client privilege determines the extent to which communications between an attorney and client are protected from disclosure without the consent of the client. That is to be distinguished from the lawyer's ethical obligation to maintain confidentiality. The latter is far broader than the privilege, and includes any information that might be embarrassing to the client.

Second, what are the general limitations of the privilege in the context of the corporate client? Ignoring for the moment the problem of the individual corporate officer, what material is privileged as to a corporation? The prevailing view adopts the "control group" test which provides that information regarding a particular matter is privileged if it is communicated by a person who has control over the matter. Assume, for example, that the corporation is considering issuing a press release. Discussions regarding that release between counsel and the vice-president in charge of public relations would be privileged, assuming that the client is seeking legal advice, because the vice-president is responsible for preparing the release. However, if the lawyer goes to the plant to get more information, and talks to the research biologist who has come up with a new invention, and that research biologist does not have a role in the decision-making process regarding press releases, then the research biologist will probably be outside of the control group and there may be no privilege attaching to those communications.

There is another line of cases that has broadened the privilege considerably, moving toward allowing the corporation to assert the privilege with respect to discussions involving virtually any corporate employee. I believe that those who act as corporate advisors would be wise to proceed as though the privilege will not attach where there is any basis for claiming that it does not exist, rather than to assume the contrary. Consequently, it is sensible to conduct conversations on the assumption that the control group test is applicable. *Diversified Industries v. Meredith*² has a very good discussion of the differing theories and the current thought. The *Diversified Industries* decision also has

2. 572 F.2d 596 (8th Cir. 1978).

useful analysis of what is meant by the attorney-client privilege and what conditions may be imposed on its assertion.

In *United States v. United Shoe Machinery Corp.*,³ Judge Wyzanski asserted that:

The privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion of law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.⁴

It should be added that when litigation exists or is anticipated, many discussions outside the scope of the privilege may be protected under the work-product rule. In the context of Judge Wyzanski's summary, one can imagine the difficulties surrounding the privilege in the corporate context. Is the lawyer acting as a lawyer with respect to the corporation? Is the corporation seeking legal advice when discussing a press release? Many discussions are unquestionably privileged, but there are many uncertainties regarding the scope of the attorney-client privilege in the corporate context.

Finally, assume hypothetically that the conditions for the privilege are met, but the legal advice sought has to do with the fairness of a new stock option for the control person. If the question involves a potential conflict of interest between the insider and the corporation that the attorney represents, then does the privilege still attach?

Another problem with the attorney-client privilege in the corporate area is determining who the client is. *SEC v. National Student Marketing Corp.*⁵ involved a proxy solicitation and challenge to counsel representing the defendant for not either requiring a re-solicitation of proxies, or communicating directly with the SEC when it learned that the corporation's proxy materials were materially misleading. The SEC's major argument in the case was that the lawyer represented the shareholders, who owned the corporation. The court reasoned that the

3. 89 F. Supp. 357 (D. Mass. 1950).

4. *Id.* at 358-59.

5. 457 F. Supp. 682 (D.D.C. 1978).

lawyer should have insured that his clients, the shareholders, were properly advised. The theory that the corporate attorney's client is the shareholders is not found in any authoritative source. The Code of Professional Responsibility, for example, asserts that the client in the corporate context is the corporate entity.⁶ There is a great deal of discussion in *National Student Marketing* and other cases asserting that the shareholders are the client. If the shareholders are the client, there cannot be any meaningful confidentiality in the context of the publicly-held corporation. Proposals suggesting a greater responsibility to the shareholder by corporate counsel are found in the "Georgetown Petition" to the SEC for rulemaking in this area,⁷ as well as in the current proposals before the American Bar Association from the Kutak Commission's draft for a revised code of professional responsibility.⁸ Defining the client as the shareholder would substantially inhibit the exercise of the attorney-client privilege.

There have been at least two decisions, one of which is *Garner v. Wolfenbarger*,⁹ which held that, at least under certain limited circumstances, the attorney-client privilege did not apply in the context of a shareholder's derivative action. A more complicated and troublesome case concerning this issue is *Cohen v. Uniroyal, Inc.*¹⁰ In *Uniroyal*, the court adopted the approach of the *Garner v. Wolfenbarger* court and applied it to a class action suit reasoning that it was extremely hard for the plaintiffs to get the information any other way. This is a rather questionable result. However, it suggests the sort of attack that is generally being made. Some very well respected practitioners have expressed the view that sooner or later the courts will no longer recognize the attorney-client privilege in the corporate context.

Another related area of interest is the position of the corporate executive. In recent years, there has been more of a tendency to punish the corporate executive, largely in an attempt to reform corporate behavior by making the corporate executives individually responsible. This has occurred frequently in the antitrust area, where jail terms and other disciplinary actions have been imposed on corporate executives.

In at least two recent decisions, *In re Grand Jury Proceedings*¹¹ and

6. ABA CODE OF PROFESSIONAL RESPONSIBILITY EC 5-18 (1980).

7. Institute for Public Representation, Georgetown University Law Center, 44 Fed. Reg. 44,881 (1979).

8. ABA COMMISSION ON EVALUATION OF PROFESSIONAL STANDARDS, MODEL RULES OF PROFESSIONAL CONDUCT, Discussion Draft (1980).

9. 430 F.2d 1093 (5th Cir. 1950).

10. 80 F.R.D. 480 (E.D. Pa. 1978).

11. 434 F. Supp. 648 (E.D. Mich. 1977), *aff'd per curiam*, 570 F.2d 562 (6th Cir. 1978).

United States v. De Lillo,¹² the courts have determined that the attorney-client privilege belongs to the corporation and not the individual corporate officers. An individual may be part of a control group and therefore have his or her communications privileged. However, if the corporation chooses to waive the privilege, the executive cannot claim it.

In re *Grand Jury Proceedings* involved precisely that situation. An executive had had discussions with counsel in preparing for proceedings against the corporation. Subsequently, the government brought proceedings against the individual executive. He sought to protect some of his discussions with counsel from discovery by claiming the attorney-client privilege. The corporation elected to waive the privilege. The court held that the executive could not, therefore, assert the privilege. The facts in *De Lillo* are slightly different. However, the court reached the same conclusion with respect to a union pension fund trustee who had ceased to be a trustee. The pension fund board of trustees waived the privilege, and the court decided that Mr. De Lillo could not then claim the privilege. Given the dramatic increase in activities against corporate executives, it is extremely important that corporate lawyers keep in mind the direction of the law in this area.

What can an attorney do to protect corporate executives? The first important issue is whether counsel is a member of the bar. Usually such membership does not make any difference. Periodically, however, there are discussions with corporate inside counsel about whether it makes any difference if they are members of the state bar. I believe that this is one area in which bar membership may make a difference. An executive may be able to claim an attorney-client privilege for communications with inside general counsel more successfully if the counsel is a member of the bar of the state.

Second, it is useful to encourage the client, when there are discussions that may possibly involve personal criminal liability—under the antitrust laws, the securities laws, the Foreign Corrupt Practices Act, and many other laws—to move away from direct facts and to engage in hypothetical discussions, at least until a framework has been established by which to evaluate the situation and give it more precise attention. I think it is important very early in the discussion that the executive say to counsel, “Look, I want you to know that I am asking for your advice for me personally, as well as for advice on behalf of the corporation, and I want to know how to proceed so that I can best

12. 448 F. Supp. 840 (E.D.N.Y. 1978).

protect myself legally." It should be made clear that the executive is seeking personal legal representation. However, this may involve a conflict of interests on the part of the lawyer. It is possible that the corporate interests may not be identical with the executive's interests. However, it seems that the conflict does not necessarily destroy the confidentiality of the communications, particularly if neither party is raising the conflict. The lawyer must, however, be wary of conflicts, and be sensitive to them. However, in the situation just described, I think an attorney could probably go ahead and discuss the matter provided he or she establishes the ground rules.

Does that confidentiality apply regarding disclosures to other officers or board members of the company so that, for example, if another director or board member of the company asked the attorney to disclose that confidential communication of the officer, may the attorney do so? Absent a waiver from the executive, I think he cannot disclose the confidential communication. The attorney may well be in a position where, in order to represent the corporation, he has to put the corporation on notice. He may be obligated to say, "Now look, I have represented X in a personal capacity as well and have some confidential information that I cannot divulge to you without his permission and you should be aware of that. You should not be expecting me to tell you everything he or she told me in my office." But, it does not appear that counsel can divulge that information to the corporation if the executive has sought personal advice.

There is another means for protecting the executive that a few larger corporations have been exploring. It is, however, feasible only for the larger corporations. Under this new alternative, separate counsel is retained for executives to discuss these questions with them. This program is made available just as are medical plans. It is a useful development for the executives and is the safest way to fully protect the executive, although there is concern as to the impact of that procedure on internal communications. A chief executive may not want all the vice-presidents talking to outside counsel before they will discuss anything with inside general counsel. That is a question with which corporate executives will have to wrestle.

It is possible for management to be able to have privileged communication with its own corporate counsel vis-a-vis a minority or dissident director. Some of the language in the *Wolfenbarger* case supports that view, but there are no clear answers.¹³

13. See Note, *The Attorney-Client Privilege and the Corporation in Shareholder Litiga-*

MR. SCOTT: The next speaker is Mr. Samuel H. Gruenbaum,¹⁴ who will address the subject of disciplinary proceedings against attorneys who practice in the corporate and securities area of the law.

MR. SAMUEL GRUENBAUM: The subject that I am going to speak about is one that affects every attorney directly: the risks that attend our daily practice. As I go over what has happened in this area in the recent past, I will not simply outline for you recent developments; rather, I will, in some instances, discuss the origin of issues and their development over the years.

I would like to proceed with the subject of disciplinary proceedings against attorneys. I might also mention that I had hoped to talk about proceedings by the SEC and the state of California. However, I have decided not to talk about proceedings in California. This was a fairly simple decision—there is almost nothing to report to you. There have been several disciplinary proceedings in the state, but they have not involved conduct in the corporate-business-securities context. Rather, they have involved such things as co-mingling of funds, and personal difficulties of lawyers, which resulted in the lawyers not devoting the necessary attention to their clients.

In the area of rule 2(e) and the SEC, however, there is a dramatically different situation. The Commission has been very active in this area over the years, and 1979 was no exception.¹⁵

Under rule 2(e), the Commission may discipline an attorney, after a hearing, if it finds that: (1) the attorney does not possess the requisite qualifications to represent others; (2) the attorney is lacking in character or integrity; (3) the attorney has engaged in unethical or improper professional conduct; or (4) the attorney has willfully violated or willfully aided and abetted violations of the federal securities laws.¹⁶ The

tion, 50 S. CAL. L. REV. 303 (1977); Lorne, *You and the Company Lawyer*, THE WHARTON MAGAZINE 40 (Fall 1979).

14. Member, California and District of Columbia Bars; Attorney, Division of Enforcement, Securities and Exchange Commission, 1977-79; Adjunct Professor, Loyola Law School.

15. See, e.g., Securities Exchange Act Release No. 16046 (July 26, 1979) (permanent suspension); Securities Exchange Act Release Nos. 16229 (Sept. 26, 1979) & 16448 (Dec. 26, 1979) (suspension); Securities Exchange Act Release No. 15982 (July 2, 1979) (ancillary relief obtained); *In re Carter*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (1979) (temporary suspension). See also Securities Act Release No. 6105 (Aug. 15, 1979) (order reinstating attorneys to appear and practice before the Commission). Cf. *In re Nielsen*, Securities Exchange Act Release No. 16479 (Jan. 10, 1980), [Current] FED. SEC. L. REP. (CCH) ¶ 82,446 (rule 2(e) proceeding against accountant; note Commissioner Karmel's dissenting opinion).

16. 17 C.F.R. § 201.2(e) (1980).

rule covers just about everything, and it provides the basis under which the Commission may suspend a lawyer temporarily or permanently from practicing or appearing before it.

The term "practicing or appearing" has been defined in both rule 2(g)¹⁷ and in at least one federal district court case.¹⁸ The term encompasses things that go far beyond physically appearing at the Commission in matters such as representing someone in a staff investigation or in an administrative proceeding. As a matter of fact, it covers situations where the lawyer does not even write a letter to or telephone the SEC. There may be no contact with the Commission, yet the rule comes into play. It covers such things as participating in the preparation of filings with the Commission, or giving advice with respect to filings made with the Commission.

The rule was initially promulgated in 1935. As promulgated, it was a rule of admission. In other words, an SEC Bar was established. In 1938, the rule was amended and the admission requirement was removed.¹⁹ Of course, under the Administrative Practices Act of 1965, with few exceptions, attorneys were given the right to appear before federal bodies when representing others.

The Commission's authority to proceed against professionals, including lawyers, has been a matter of considerable judicial discussion over the years. However, it was not until 1979 that a court squarely held that the Commission had the authority to promulgate rule 2(e) and that, under the rule, the Commission has the authority to proceed against professionals. That case was *Touche Ross & Co. v. SEC*,²⁰ decided by a panel consisting of Chief Judge Kaufman and Circuit Judges Timbers and Gerfein on the Second Circuit Court of Appeals. The opinion was written by Judge Timbers, who was formerly SEC General Counsel.

The primary holding of the *Touche Ross* case was not that the Commission had the authority to promulgate 2(e) and discipline professionals under it, but that *Touche Ross & Co.* did not exhaust its administrative remedies in the proceeding before the Commission before looking to the courts for help. Therefore, the District Court for

17. 17 C.F.R. § 201.2(g) (1980).

18. *SEC v. Ezrine*, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,594 (S.D.N.Y. Aug. 2, 1972).

19. Securities Act Release No. 1761 (June 27, 1938).

20. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. 1979). The *Touche Ross* case at the administrative proceeding level appears to have been the first public 2(e) proceeding. See *In re Touche Ross & Co.*, [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,270 (1976).

the Southern District of New York and the Second Circuit Court of Appeals both sent the case back to the Commission. Touche Ross ultimately settled its case with the SEC,²¹ so I do not believe any more will be said on Touche Ross' challenges to the Commission's authority.

Aside from holding that Touche Ross did not exhaust its administrative remedies, Judge Timbers examined the question of whether the Commission had the authority to promulgate the rule and discipline professionals under it. He held, quite clearly, that the Commission did have the authority. This holding was in the context of accountants, but the court did not try to distinguish accountants from lawyers. On the contrary, when the court spoke about accountants, it usually spoke also about lawyers. Touche Ross not only challenged the Commission's authority to promulgate the rule, but it also attacked the constitutionality of the rule. It argued that the rule was too vague, and asserted the impropriety of having the SEC hear cases such as that involving the charges against Touche Ross.

One might be inclined to say that the *Touche Ross* decision was a limited one in that it decided only two issues, namely, (1) that the administrative remedies were not exhausted, and (2) that the Commission does have the authority to promulgate the rule. Upon analysis, it is a completely different matter. As I have often heard Harvey Pitt, former SEC General Counsel, say when speaking about many of the recent Burger Court's restrictive decisions relative to federal securities laws, "You can look at the words or you can listen to the music. And in the Burger Court's decisions, the music is very clear." The same idea applies in the *Touche Ross* case, except unlike the Burger Court's decisions, the Second Circuit wrote what I think is a very happy song for the SEC.

When the court discussed the type of conduct that the Commission could proceed against under the rule, it took a very broad view. For example, the Commission may proceed against a professional under the rule as a method of assuring the fitness of those who represent others before the Commission. The Commission may also proceed against professionals under the rule to make sure that the professionals who appear or practice before the Commission perform their tasks diligently and with a reasonable degree of competence. Then Judge Kaufman, in a concurring opinion that praised Judge Timber's opinion, added that rule 2(e) is necessary to insure that professionals who prac-

21. 401 SEC. REG. & L. REP. (BNA) A-1 (May 4, 1977).

tice before the Commission meet the highest ethical standards and do their job adequately.

The only suggestion in the *Touche Ross* decision expressing some hope for respondents in administrative proceedings is a note that Judge Timbers added at the very end of the decision, and that Judge Kaufman picked up on and amplified significantly in his concurring opinion. Both judges questioned the propriety of sanctioning an entire firm, such as Touche Ross, that at the time had 525 partners, for the erstwhile conduct of three members of the firm.²² In this regard, Judge Kaufman cautioned that panels of Article III judges sit ready, willing, and able to undo administrative excesses that may occur.

The Commission has not been insensitive to the question of the appropriateness of sanctioning an entire law firm for the conduct of a few individuals. This brings me to the first major 2(e) proceeding during last year, which was *In re Keating, Muething & Klekamp*.²³ This was a case that involved a Cincinnati, Ohio, law firm that at the time consisted of about twenty lawyers. I might mention, as an aside, that that was the last case I investigated and brought to the Commission before I left the staff, so I have a special interest in it.

In any event, *Keating, Muething & Klekamp* is one of the very few 2(e) proceedings, I believe only one of two, that the Commission has ever brought against an entire law firm as opposed to individual members of a firm.²⁴ Its articulated basis for doing that was that almost everyone in the firm had done some sort of work for this one reporting company-client. As a result, there was a wealth of information scattered throughout the firm about the client; the firm also prepared the client's filings with the Commission, or prepared and/or reviewed them; and when it came time to make the filings, several reportable

22. *Cf. In re Ernst & Ernst*, Accounting Series Release No. 248 (1978), 6 FED. SEC. L. REP. (CCH) ¶ 72,270, at 62,733 & nn.67 & 68, where the Commission said: "[W]e have consistently held that where . . . a firm of public accountants permits a report or certificate to be executed in its name, it will be held responsible therefor."

The courts have been questioning the propriety of holding a firm responsible for the conduct of a few individuals. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170-77 & nn.48 & 49 (D.C. Cir. 1978); *Rolf v. Blyth, Eastman, Dillon & Co., Inc.*, 570 F.2d 38, 48 & nn.17 & 18 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 701 n.42 (D.D.C. 1978).

In one case against a national accounting firm, the SEC imposed sanctions which ran to only one of the firm's offices. *In re Haskins & Sells*, 6 FED. SEC. L. REP. (CCH) ¶ 72,263, at 62,695-97 (1978).

23. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (July 2, 1979).

24. *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (1979); *In re Plotkin, Yolles, Siegel & Turner*, Securities Act Release No. 5841 (July 5, 1977).

transactions were omitted from the disclosures made. The Commission, therefore, felt that the firm as a whole, collectively, had knowledge of the omissions, and on that basis brought disciplinary proceedings against the entire firm. The Commission was careful to point out, however, that this "was not a case where a law firm [was] being held accountable for knowledge or conduct of a few of its members."²⁵

In terms of the daily practice of law, the *Keating, Muething & Klekamp* proceeding has a couple of very important messages. The first message is that members of a firm must communicate with one another when preparing a client's filings with the Commission. The reason for this is that while the person preparing the filings may not know of a material reportable transaction that the client has engaged in, someone else in the firm may. On the basis of such information, the entire firm may be held responsible for knowing the information, and accordingly, it should be communicated to the person preparing the filings.

The second lesson to be learned from the *Keating, Muething & Klekamp* case is that a law firm should have (the Commission did not say *must* have) some sort of internal procedural mechanism for funneling information that is scattered throughout the firm to the people preparing the filings. The reason for this is obvious—it is to insure that information gets to the person preparing the filings.

One question that remains open in the *Keating* case is whether a lawyer has an affirmative duty to disclose information about his client. The answer is not clear from the Commission's opinion, but the inference may be there. One statement in particular raises the issue of the obligation of a lawyer to blow the whistle on his client, which was the subject of the *National Student Marketing*²⁶ controversy. In its four to one opinion, the Commission stated that "[a] law firm has a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client."²⁷ The Commission stated that the law firm has the obligation to make sure that the information is contained in the filings. I suggest to you that this implies that an attorney does have the obligation to blow the whistle on his client, because the only way a lawyer can insure that information is being disclosed is to advise the client to make the disclosure, or to make the

25. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,988.

26. *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

27. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,989.

disclosure if the client refuses to do so. How else can an attorney make sure that the information is disclosed except by disclosing it himself?

One view is that the opinion does not address the obligation of a lawyer or a law firm faced with a client who refuses to disclose information that the lawyer believes should be disclosed. In other words, it does not address the situation where the lawyer or law firm withdraws from the representation. Is there a duty to blow the whistle in that situation? Victor Kramer, who was a director of the public interest group that submitted the Georgetown rulemaking petition has suggested that the ABA should adopt a rule that makes withdrawal mandatory in that situation.²⁸ In an article²⁹ I wrote in response to Professor Kramer, I suggested that the Code at least arguably already requires that, and after reviewing several recent 2(e) proceedings and several decisions in civil and criminal cases against attorneys, I concluded that there may be an obligation to do more than simply withdraw. Certainly that is the implication that one gets from reading the district court decision in the *National Student Marketing* case, which was settled only a few weeks ago, thereby precluding the Court of Appeals from addressing that issue.³⁰

This very question was addressed, and, to the satisfaction of the administrative law judge, resolved in *In re Carter & Johnson*.³¹ Before discussing that case, I would be remiss if I did not mention that in *Keating, Muething & Klekamp*, Commissioner Karmel, who recently tendered her resignation from the Commission, wrote a blistering broadside attack on rule 2(e), challenging the Commission's authority to promulgate the rule. She argued that the type of conduct that the Commission is proceeding on is not conduct that comes within its jurisdictional mandate under the rule, and that the rule denies due process of law, in addition to a host of other attacks on the rule. She was, however, a lone dissenter. Faced with the *Touche Ross* decision that came out only two months earlier upholding the Commission's author-

28. Kramer, *Clients' Frauds and Their Lawyers' Obligations: A Study in Professional Irresponsibility*, 67 GEO. L.J. 991 (1979).

29. Gruenbaum, *Clients' Fraud and Their Lawyers' Obligations: A Response to Professor Kramer*, 68 GEO. L.J. 191 (1979).

30. The Commission has previously argued that a lawyer has a duty to blow the whistle on his client. See paragraph 48(i) of the SEC's complaint in *SEC v. National Student Marketing Corp.*, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,360, at 91,313 (D.D.C. 1972). However, the court did not decide the issue. *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978); see Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibilities, and Liability to Investors*, and *National Student Marketing Corp.*, 54 Notre Dame Law. 795 (1979).

31. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, at 82,165 (1979).

ity under the rule, Commissioner Karmel acknowledged the decision, but said that until Congress or the Supreme Court tells her that the Commission has the authority under the rule, she does not think that it does and will continue to argue that it does not. Commissioner Karmel brought up several important questions about the rule, most of which will probably receive judicial attention sometime in the not too distant future, possibly in the *Carter & Johnson* decision.

Carter & Johnson was decided in April of 1979 by an administrative law judge (ALJ) and is presently on appeal to the Commission. Many of us expected the Commission's decision to come in the latter part of last year, but for whatever reason, it still has not. Unlike *Keating, Muething & Klekamp*, the *Carter & Johnson* case involved a situation where lawyers were being charged with material omissions in a press release by their client, in a letter to shareholders by their client, and in a form 8-K and in a form 10-K. The lawyers were being charged in two respects. They were being charged (1) for having committed and having aided and abetted violations of the federal securities laws, and (2) for having violated their professional obligations under that portion of rule 2(e) that permits the Commission to proceed against attorneys who act improperly or unprofessionally.

In the *Carter & Johnson* case, the lawyers repeatedly urged their clients orally and in writing, to disclose the omitted facts. That did not deter the ALJ in reaching the conclusion that they had violated the law and their professional obligations. The judge concluded that, as a matter of law, not as a matter of professional responsibility, at some point both lawyers knew that management was ignoring their advice to make the disclosure, and at that time they had some sort of duty to do something to stop the continued violations. He did not say what that something was as a matter of law. Having done nothing once they knew their advice was being ignored, the ALJ found the lawyers to be primary violators and aiders and abettors with respect to violations of the reporting and anti-fraud provisions of the Exchange Act.

To find the attorneys to have been primary violators in that situation suggests that they had a primary duty of disclosure themselves, which I think is incorrect. It is the client, the reporting company, that has the duty. So at worst, they should have been aiders and abettors. But the judge did not address that question.

As a matter of professional responsibility, the ALJ concluded that the lawyers did not fulfill their professional obligations. The lawyers argued that charges against them, acting unprofessionally and unethically, were unconstitutionally vague. The ALJ had two responses to

that. The first was that, as commonly understood, those terms are not vague. Secondly, the SEC has previously taken the position that the ABA Code of Professional Responsibility applies in its administrative proceedings and therefore that attorneys have guidance from the code in how to act. The ALJ went on to analyze the code and the proper conduct of the attorneys in that situation and concluded that they had violated the code. In so concluding, he said that the lawyers not only had a duty to go above management's head when they realized that management was ignoring their advice, but they also had a duty to go to the board of directors. But he did not stop there. He stated that the lawyers "failed to carry out their professional responsibilities with respect to appropriate disclosure to all concerned, including stockholders, directors and the investing public."³² I think there is no question that the ALJ in this case clearly believed that lawyers have an obligation to blow the whistle on their clients.

As extreme as this may sound, two recent federal district court decisions squarely hold that a lawyer has an obligation to blow the whistle on his client.³³ I caution you, however, to be circumspect in relying on these cases because they involved egregious factual situations and there was little, if any, analysis by the judges in assessing the proper course of conduct by the lawyers under the circumstances. However, several other cases appear to strongly suggest that at least in some circumstances a lawyer may be required to blow the whistle on his client.³⁴

I would like to end my discussion on the issue of whether "scienter" as defined in *Ernst & Ernst v. Hochfelder*³⁵ is necessary in 2(e) proceedings. The judge in *Carter & Johnson* was of the view that *Hochfelder* did not apply in rule 2(e) proceedings. He cited several Commission releases since *Hochfelder*, as well as a Second Circuit decision following *Hochfelder*. From these, he determined that the Commission has taken the position and the courts have agreed that *Hochfelder* does not apply. Instead, he decided that the standard adopted in *Tager v. SEC*³⁶ was applicable. In that decision, the Second

32. *Id.* at 82,183.

33. *Felts v. National Account Sys. Assocs.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,840 (N.D. Miss. 1978), *appeal docketed*, No. 79-1639 (5th Cir. March 15, 1979); *SEC v. Century Mortgage Co.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,777 (C.D. Utah 1979).

34. See Gruenbaum, *Clients' Frauds and Their Lawyers' Obligations: A Response To Professor Kramer*, 68 GEO. L.J. 191 (1979).

35. 425 U.S. 185 (1976).

36. 344 F.2d 5 (2d Cir. 1965).

Circuit Court of Appeals defined "willfully" for purposes of administrative proceedings against broker-dealers as intentionally committing the act which constituted the violation. The actor need not be aware that he is violating any of the provisions of the Securities Acts.

The ALJ in *Carter & Johnson* relied on *Arthur Lipper Corp. v. SEC*³⁷ to support his position that *Hochfelder* is not applicable in rule 2(e) proceedings. I believe that the judge's reliance on *Arthur Lipper* was misplaced, because in that case Judge Friendly assumed, without holding, that *Hochfelder* does apply in administrative proceedings. However, Judge Friendly said that the definition of scienter under *Hochfelder* does not mean that the violator must know that he is violating the law. The ALJ, I think, incorrectly concluded from this that *Hochfelder* does not apply in 2(e) proceedings. Alternatively, however, the judge held that even if *Hochfelder* does apply, the requisite culpability was shown in *Carter & Johnson* because there were knowing omissions. He was attempting to save the case, but even with that standard, I think he failed, because under *Hochfelder*, mere knowledge of the omissions does not appear to be sufficient. Several circuit court decisions in 1979 indicate that there must be some sort of intent to deceive or defraud someone, rather than mere knowledge of the omission. The Ninth Circuit might agree with that position considering some of the decisions that it has handed down in the last two years.³⁸ However, I would point out that the Ninth Circuit's view is presently the subject of a petition for certiorari to the Supreme Court in *Spectrum Financial Cos. v. Marconsult*,³⁹ and the Ninth Circuit's view, I personally believe, is not the appropriate view in light of *Hochfelder*.

MR. MYRL SCOTT: The next speaker is Mr. Joseph Troy.⁴⁰ Joe is well known within the securities bar, as an author, lecturer, professor, and expert in the field of officer and director liabilities.

MR. JOSEPH TROY: Thank you. There is an English philosopher who divided other philosophers into hedgehogs and foxes. The foxes, he said, were those who had lots of little ideas, and the hedgehogs were those who had one big idea in their careers. I am going to be a

37. 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978).

38. *E.g.*, *Spectrum Financial Cos. v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979); *Kidwell v. Meikle*, 597 F.2d 1273, 1294 (9th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1336-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

39. 608 F.2d 377 (9th Cir. 1979), *pet. for cert. docketed*, No. 79-1251 (1980).

40. Member, California and District of Columbia Bars; Chairman, Business and Corporations Law Section, 1977-78; Member, Executive Committee, Business and Corporations Law Section, Los Angeles County Bar Association, 1971.

hedghegog this afternoon and cover one big idea, a new phenomenon that I think will have a great deal of impact on all of our practices.

It is derived, essentially, from *Burks v. Lasker*,⁴¹ a 1979 Supreme Court case. *Burks* and its progeny are part of a line of cases⁴² dealing with the board of directors as a tribunal for resolving intra-corporate disputes outside of the court system.

First, it is important to summarize the factual setting in which these cases have arisen. Essentially, they involve derivative actions in which a minority shareholder brings a suit against a director or group of directors, usually alleging some breach of fiduciary duty or negligence on the part of the directors, or violations of the federal securities laws for which the directors are liable as controlling persons.⁴³ Traditionally, in a state court action, the corporation would move the court for security on the grounds that there is no reasonable probability that prosecution of the cause of action alleged in the complaint will benefit the corporation or its shareholders.⁴⁴

But in the *Burks v. Lasker* line of cases something else happens—the board of directors of the corporation appoints a committee, usually called a “special litigation committee.” The special litigation committee consists of nondefendant “independent directors.” They are given authority to review and investigate the litigation and to determine whether the corporation should join in or resist the litigation. Then the committee retains independent counsel and observes certain procedures calculated to achieve due process. Ultimately, the committee usually concludes that the litigation is not in the best interests of the corporation. The committee then directs counsel for the corporation to file a motion with the court to dismiss the action on a motion for summary judgment, a motion for dismissal, or at least a motion for partial summary judgment.⁴⁵

41. 441 U.S. 471 (1979) (interpreting Investment Co. Act and Investment Advisers Act of 1940; remanding for a determination of Delaware law).

42. See *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (applying California law and §§ 10(b) & 14(a) of the 1934 Act; involved stock options issued to defendant directors by Walt Disney Productions); *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), cert. denied, 100 S. Ct. 670 (1980) (applying Delaware law and §§ 13(a) & 14(a) of the 1934 Act).

43. Minority shareholders sue certain (or all) directors derivatively, alleging (i) breach of their fiduciary duty or standard of care (e.g., for waste, improper use or negligent loss of corporate funds in making or failing to stop illegal payments), and (ii) federal securities law violations (e.g., inadequate disclosure of the improper payments in violation of §§ 10(b), 13(a), and 14(a) of the Securities Exchange Act of 1934).

44. The plaintiffs usually allege futility of demand upon board to sue, under FED. R. CIV. P. 23.1 or applicable state statute, e.g., CAL. CORP. CODE § 800(c)(1) (West 1977).

45. E.g., *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (held that California law per-

In the past, all that usually happened was that the corporation would come into court asking for costs or security. In the *Burks v. Lasker* line of cases, however, the corporation is asking to dismiss the action on the grounds that a disinterested committee of the board has heard the case and determined that it is not in the best interests of the corporation to continue further with it. Because a derivative action is for the benefit of the corporation and because the decision to pursue a cause of action for the benefit of the corporation is a management decision, the corporation, through the committee, argues that the board of directors (or its independent committee) should have basic managerial power to control the action. After the committee completes its work, it intervenes on behalf of the corporation, arguing that it has examined the matter thoroughly, carefully, and impartially, and believes that there is no good reason to bring the action (or that the disadvantages outweigh any possible gain to the corporation), and that the action should therefore be dismissed.

The remarkable thing is that the courts have suddenly accepted this theory. It is remarkable because it seemed revolutionary to many plaintiffs' lawyers. There was a debate between plaintiffs' and defendants' lawyers in New York City a few years ago when these cases started. The plaintiffs' bar was in absolute horror at this development, saying that it would be a mortal blow to minority shareholder rights and that it would eliminate derivative actions. On the other hand, many astute corporate counsel believed that this was a very welcome development, because it would lessen the burden of litigation, would create a new kind of forum, and would give the board new powers.

mitted such a dismissal); *Abbey v. Control Data*, 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 100 S. Ct. 670 (1980) (held that Delaware law permitted such a dismissal). *Contra*, *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. Ct. 1980) (reached a contrary conclusion, but the Delaware Supreme Court has agreed to hear an appeal of that decision). See note 61 *infra* and accompanying text regarding a case involving essentially the same parties and facts in the federal courts. As of September 9, 1980, the state and district court decisions in *Maldonado* were on appeal. However, the Second Circuit has stayed its hearing in the district court awaiting a definitive ruling by the Delaware Supreme Court on state law. The Delaware Supreme Court is scheduled to hear the case in fall, 1980, despite a ruling by the Chancery Court on May 29, 1980, contingently granting the defendants' motion for dismissal on the grounds of *res judicata*. Such dismissal was made contingent on affirmance of the federal district court decision by the Second Circuit, which, as stated above, has stayed its hearing pending a definitive statement of Delaware law by the Delaware Supreme Court.

If the Delaware Supreme Court reverses, following the *Burks* line of cases, the Second Circuit is likely to affirm and thereby trigger the contingent dismissal entered by the Delaware Chancery Court. If the Delaware Supreme Court affirms the Chancery Court and holds that Delaware law does not allow dismissal by a special litigation committee under the circumstances presented, the Second Circuit is likely to reverse, thereby leaving the case to be decided in the Delaware Chancery Court and/or the federal district court.

The moving factor in all this has been the decision of the Supreme Court in *Burks v. Lasker*, which will be discussed shortly. It presents many questions, and the preliminary ones will be discussed briefly.

First, the Court considered whether the business judgment rule⁴⁶ was applicable in this situation. Litigation committees generally proceed under the theory that their determinations are a proper exercise of business judgment and therefore are not subject to being second guessed by the courts. What is the business judgment rule? The business judgment rule essentially holds that courts will not second guess a diligent board's good faith decision, even if in hindsight it proves to be wrong.⁴⁷ In other words, directors are not liable for honest mistakes in business judgment, and their honest business judgments generally will not be scrutinized by courts. An example of the business judgment rule is that boards of directors are entitled, by a long line of cases, to decide using their best business judgment, which litigation to bring on behalf of the corporation.⁴⁸ Obviously, the corporation is not required to pursue all causes of action that it has. For example, it may decide that a particular cause of action is not worth bringing because it is not significant enough or the costs would be too great.

According to virtually all the cases for many years, it is clearly within the business judgment of the board of directors to determine not to bring litigation against third parties. But, *query*: can the board of directors decide not to bring litigation against all or some of its own members? In other words, can the board of directors make a decision that is going to be binding on both the courts and the minority shareholders, that the corporation should not and will not bring an action against management? This question was addressed a few years ago in *Gall v. Exxon*,⁴⁹ a district court case, and then in *Burks v. Lasker*.⁵⁰

Burks v. Lasker involved a registered investment company. Some may say the decision does not apply to most corporations because it involved a different body of law. However, arguably it applies to other kinds of actions and corporations as well, and certainly other courts have read it to that effect. In *Burks v. Lasker*, an investment company had purchased \$20,000,000 worth of Penn Central commercial paper. The minority shareholders of the investment company sued the com-

46. See, e.g., *Kamin v. American Express Co.*, 86 Misc. 2d 809, 383 N.Y.S.2d 807, *aff'd*, 387 N.Y.S.2d 993 (1976).

47. ABA Section on Corporate Laws, *Report*, 29 BUS. LAW. 947, 951 (1974) ("a director should not be liable for an honest mistake of business judgment").

48. See *Abbey v. Control Data*, 615 F.2d at 727, 729.

49. 418 F. Supp. 508 (S.D.N.Y. 1976).

50. 441 U.S. 471 (1979).

pany's registered adviser and its directors who were affiliated with the adviser, claiming that they had been negligent in making this purchase without independent investigation. To summarize a rather lengthy proceeding, the board of directors then appointed a special committee, which consisted of those of its directors who were essentially "independent" (neither affiliated with the investment adviser nor defendants in the action), and they in turn retained special counsel who had previously been a judge. He advised them that the complaint failed to state a cause of action. They moved to dismiss at the district court level, and, after presenting evidence on their independence, were granted a dismissal.

The Second Circuit reversed on the grounds that there were no cases to the effect that a board of directors can dismiss a non-frivolous action under the Investment Company Act⁵¹ and that a committee of directors is never truly independent when dealing with a case against fellow directors.⁵²

Ultimately, the Supreme Court decided that the decision to dismiss was correct. They reversed the Second Circuit and derived a two-prong test. The first prong is whether the state law business judgment rule permits such a dismissal. The Supreme Court said in dictum that there "may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue—as, for example, where the costs of litigation to the corporation outweigh any potential recovery."⁵³ The second prong of their two part test was whether dismissal would be inconsistent with the federal remedy. In *Burks*, the court found that dismissal would be consistent with the Investment Company Act because the Act created a concept of independent directors for the very purpose of policing the internal management of investment companies.⁵⁴

In *Auerbach v. Bennett*,⁵⁵ a New York state case based on state law, the court also upheld the decision of the litigation committee to move to dismiss the action based on the Committee's business judgment. In *Abbey v. Control Data Corp.*,⁵⁶ decided by the Eighth Circuit under Delaware law and the federal securities laws, the court again decided that the business judgment and the dismissal should be upheld

51. *Lasker v. Burks*, 567 F.2d 1208, 1210 (2d Cir. 1978).

52. *Id.* at 1212.

53. *Burks v. Lasker*, 441 U.S. at 485.

54. *Id.*

55. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (applying New York law; involved questionable payments by GTE, Corp.).

56. 603 F.2d 724 (8th Cir. 1979), *cert. denied*, 100 S. Ct. 670 (1980).

and that such disposition was not inconsistent with section 13(a) (on reporting) and section 14(a) (on proxy statements) of the Securities Exchange Act of 1934.

In *Lewis v. Anderson*,⁵⁷ a recent case in the Ninth Circuit applying California law, the court found no state court cases directly on point, but held that if a state court were to address the issue, it would follow the "trend" of *Auerbach* and *Abbey*. In *Lewis*, the court was applying section 10(b) of the Securities Exchange Act of 1934, as well as section 14(a) of the 1934 Act, and found that it would not be inconsistent with either section 10(b) and rule 10b-5 or section 14(a) and rule 14a-9 to dismiss. The dismissal was upheld, because both prongs of the *Burks* test were met: state law authorized the exercise of business judgment by the litigation committee in recommending a motion to dismiss, and such dismissal was found to be consistent with federal law.⁵⁸

Even if the business judgment rule does apply, the second question is whether it is ever proper for the committee to move for dismissal when the action is or appears to be meritorious, or at least non-frivolous. The Supreme Court ruled directly in *Burks* that, even if the action is non-frivolous, it is appropriate to move to dismiss. In virtually all of the cases that I have read in this area, the committees have determined that the claims were not meritorious. However, the courts in both *Lewis v. Anderson*⁵⁹ and *Rosengarten v. International Telephone and Telegraph Co.*⁶⁰ allowed dismissal of arguably meritorious actions. Additionally, in the federal court action of *Maldonado v. Flynn*, the court held that "the essence of the business judgment rule in this context is that directors may freely find that certain *meritorious* actions are not in the corporation's best interests to pursue."⁶¹ The rationale seems to be a cost-benefit analysis. If, for example, a meritorious action against a director would cost \$500,000 to pursue and the director is judgment proof, why bother to bring the suit? The applicability of cost-benefit analysis will come up time and time again.

The next question is, to what extent is the committee decision sub-

57. 615 F.2d 778 (9th Cir. 1979).

58. *Contra*, *Maldonado v. Flynn*, No. 4800, slip op. (Del. Ch. Ct. Jan. 11, 1980).

59. 615 F.2d 724 (9th Cir. 1979).

60. 466 F. Supp. 817 (S.D.N.Y. 1979).

61. 485 F. Supp. 274, 285 (S.D.N.Y. 1980). Note that the *Maldonado* litigation is being conducted in both a Delaware state court, cited hereinafter as "*Maldonado* (Del. Ch.)," and in the Federal District Court for the Southern District of New York, cited hereinafter as "*Maldonado* (S.D.N.Y.)."

The federal court decided that the Delaware law allowed dismissal on the basis of the business judgment of the litigation committee. The Delaware Chancery Court, however, reached a contrary conclusion. Both decisions are now on appeal. See note 45 *supra*.

ject to review by the courts? This is a very critical question. All the cases say that the independence and good faith of the litigation committee is subject to court review. Furthermore, the *Auerbach* case expressly states that the due process of the committee is subject to court review. The judge in *Auerbach* said, "[a]s to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. In fact they are better qualified in this regard than are corporate directors in general."⁶²

Another point to consider is the thoroughness and diligence of the investigation. The business judgment rule basically protects only a diligent board. There is some contrary dicta, but essentially the courts hold that the business judgment rule will not protect decisions when the board of directors has not been diligent in the exercise of their business judgment. In addition, the scope of the committee's work will probably be held to be subject to review by the court.

The final question as to what the courts can review, which was briefly debated in the course of the oral arguments to the Supreme Court in *Burks*, is the reasonableness of the committee's decision. Is it subject to review by the courts? The cases have come down almost uniformly since *Burks* to the effect that the reasonableness of the committee's decision is not subject to court review.⁶³ The Supreme Court has not addressed this point directly, but it seems to have given latitude to the lower courts to decide that the substantive reasonableness of the committee's decision is not subject to court review. In *Auerbach*, the court noted that "[t]o permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee. Its substantive valuation of the problems posed and its judgment in their resolution are beyond our reach."⁶⁴

What are the appropriate qualifications for membership on the committee? In *Maldonado* (S.D.N.Y.), the court stated that committee members must be genuinely independent of the disqualified directors and disinterested in the action. Does the appointment of the committee by the full board, which includes the defendant directors, compromise the independence of and thereby disqualify the committee? In *Maldo-*

62. *Auerbach v. Bennet*, 47 N.Y.2d at 626, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929.

63. *E.g.*, *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *Contra*, *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. Ct. 1980).

64. *Auerbach v. Bennett*, 47 N.Y.2d at 634, 393 N.E.2d at 1002, 419 N.Y.S.2d at 929.

nado (Del. Ch.), for example, the plaintiffs argued that, if the business judgment rule applied, it would enable wrongdoers to obtain exoneration of their own acts, and therefore a committee appointed by the directors was not and could not possibly be independent. The courts in both *Maldonado* (S.D.N.Y.) and in *Burks* rejected this argument.

Is it permissible to appoint new directors solely for the purpose of serving on the committee, for example, if it turns out that all current directors are defendants? The answer appears to be yes. In *Maldonado* (S.D.N.Y.), for example, the court stated that new directors can be appointed for this purpose.

What procedure should the committee follow? It is helpful to briefly outline the procedures followed in the cases which have been cited. In *Auerbach*, the litigation committee (i) promptly retained independent counsel to investigate the facts and to advise it regarding the law; (ii) interviewed witnesses and directors who participated in any way; (iii) interviewed the audit committee and auditors; (iv) reviewed transcripts of testimony; (v) studied documents and work papers of special counsel; (vi) sent questionnaires to non-management directors; (vii) interviewed the representatives of counsel (a very big law firm that had about twenty or thirty lawyers working on this matter; they even interviewed associates in that law firm); and (viii) obtained pertinent legal advice.⁶⁵ In *Burks*, the pertinent legal advice was in the form of a written opinion by a former judge.

But note that in *Rosengarten v. International Telephone and Telegraph Co.*⁶⁶—although that is a case that was decided before *Burks* and one must be wary of relying on such cases—the court held that the committee may not delegate its responsibilities to counsel. It must undertake these responsibilities itself. Another issue in that case was the discoverability of the committee's work product. It was held discoverable and depositions were taken of all of the committee members. This is an important point to remember when an attorney represents one of these committees.

What are the appropriate grounds or factors for the committee to consider in deciding to seek dismissal? The most important ones mentioned in the cases are that: (i) the claims are not meritorious (usually the counsel or the committee determines that the claims are not meritorious or that the complaint fails to state a cause of action, or, that it suffers from substantial weaknesses; but the claims probably do not

65. *Id.* at 634, 393 N.E.2d at 1002-03, 419 N.Y.S.2d at 929.

66. 466 F. Supp. 817 (S.D.N.Y. 1979).

have to be nonmeritorious so long as they suffer from substantial weakness); (ii) the defendants made no personal profit, they lacked any direct involvement, and/or they are being sued merely on the basis of secondary liability for negligence in having failed to do something about the primary malfeasance; (iii) the litigation will waste management's time and impair the board's ability to manage; (iv) the litigation will cause adverse publicity; (v) there is an obligation by the corporation to indemnify, so that there would not be anything for the corporation to gain, or the indemnification would, in any event, cover all the lawyers' fees, which might be much greater than anything that would be gained for the corporation; (vi) there is no material injury to the corporation; (vii) there is only a slight possibility of any recurrence of the violations; and (viii) the litigation will have adverse effects on the company's relations with employees, suppliers, and customers.

What occurs as a result of a criminal conviction? May the board or the committee seek to dismiss a civil suit brought as a result of a criminal conviction of the defendants? In *Abbey*, the criminal suit was against the corporation. The corporation had paid \$1,381,000 in civil and criminal penalties; yet the court expressly held that the committee could move to dismiss the civil suit.

Can a committee dismiss actions under the federal securities laws? In *Burks*, the Supreme Court answered this question in the affirmative with respect to an action under the Investment Company Act. Also, in *Lewis v. Anderson*, the Ninth Circuit allowed such action with respect to 10b-5 claims, and, in *Abbey*, the court permitted the dismissal with respect to claims involving sections 13(a) and 18(a) of the Securities Exchange Act of 1934.

In *Lewis*, *Abbey*, and *Maldonado* (S.D.N.Y.), claims relating to proxy statements under section 14(a) were also discussed. There is some contrary dictum, at least in *Galef v. Alexander*,⁶⁷ that well-pleaded 14(a) claims are not subject to business judgment dismissal. This question is suitable for the Supreme Court to decide, because there is conflict among the circuits.

May the committee appoint as its independent counsel a law firm of which a committee member is a partner? In *Maldonado* (S.D.N.Y.), the court held that such an appointment was proper.

What if the committee makes its decision to dismiss in good faith but makes it negligently? In *Lewis*, the Ninth Circuit commented that

67. 615 F.2d 51, 63-64 (2d Cir. 1980) (applying Ohio law and § 14(a) of the 1934 Act; involved stock options of TRW, Inc.).

such a decision would be upheld. However, the statement was dictum and I doubt its credibility. An action constituting negligence in procedure might be one in which the committee failed to consider some material point.

In conclusion, it is significant to note that this line of cases is going to be a powerful new impediment to derivative actions. It provides an important new power for boards of directors, and it should create a strong impetus for adding independent directors to boards.

MR. MYRL SCOTT: Thank you, Mr. Troy. Our next speaker is Mr. Don Davis,⁶⁸ who will discuss developments in the area of pension plans and the definition of a "security".

MR. DON DAVIS: Thank you, Myrl. I am going to comment briefly on a few cases in the area of pension plans. I will speak primarily about *International Brotherhood of Teamsters v. Daniel*⁶⁹ and the aftermath of that decision in early 1979. The major issue in *Daniel* was whether or not an employee benefit plan was a security. If it was a security, then was it necessary to register the plan under the Securities Act of 1933 and was it subject to the fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934? The Supreme Court unanimously concluded that in an involuntary plan, where an employee was automatically covered and made no monetary contributions, the employee benefit plan ought not to be covered by the securities laws. The Court essentially decided that because the employees did not participate in the plan with the expectation of profit, such a plan involved no significant investment.

Subsequently, the circuit and district courts have applied the standards established in *Daniel* to different facts. In *Black v. Payne*,⁷⁰ the Ninth Circuit concluded that in the context of a state's voluntary, non-contributory plan, *Daniel* applied and hence, the plan was not a security. Shortly after this decision, the Securities and Exchange Commission published a comprehensive release dealing with employee benefit plans.⁷¹ The release does not discuss medical contribution plans. It only discusses plans that will return cash to employees upon termination. Basically, the release sorts the plans into four categories deter-

68. Member, California Bar; Associate Professor, Federal and State Securities Law, Southwestern University School of Law; Member, International Association of Financial Planners; Member, Executive Committee, Business and Corporations Law Section, Los Angeles County Bar Association.

69. 439 U.S. 551 (1979).

70. 591 F.2d 83 (9th Cir. 1979).

71. Securities Act Release No. 6188 (Feb. 1, 1980), 1 FED. SEC. L. REP. (CCH) ¶ 1051.

mined by whether they are voluntary or non-voluntary and contributory or non-contributory. In the context of a non-voluntary, non-contributory plan, the release states that it is not a security and therefore should not be covered by the securities laws. This conclusion is of course consistent with the Supreme Court's pronouncement in *Daniel*. The staff of the Securities and Exchange Commission concluded that a non-contributory but voluntary plan is also not covered by the securities laws. In its judgment, such plans do not trigger registration requirements, and 10b-5 concerns are inapplicable. However, in a voluntary, contributory plan where the employee chooses whether or not to contribute to the plan, the staff took the position that such a plan is indeed a security subject to the registration requirements of the 1933 Act, and to 10b-5 and section 17. However, various exemptions are available for this type of plan. The release extensively discusses many of the possible exemptions: Keogh plans, plan dealings between plans, and entities that pool money from various plans. I am not sure that the staff's position in this release is correct in all respects, but it is something that certainly provides a roadmap for the development of the law in this area.

In addition to the discussion of whether or not the pension is a security, there have been a couple of other cases that seek to define a "security." These cases do not always seem to be consistent. In *Cameron v. Outdoor Resorts of America*,⁷² the Fifth Circuit concluded that the sale of condominium campsites involved an investment contract. The campsites were being marketed primarily to individual users, and in that context, I think we all probably would agree that no security was involved. However, the salesman spoke to some people who came to look at the campsites and sought to sell them twenty or twenty-five block sites, and assured them through written materials and oral representations that they could make five dollars per day per site, and that the campsites would be occupied eighty percent of the time. The court concluded that the sales pitch given to these potential buyers was really in an investment context, because the buyers were not going to use the campsites themselves and their profits were dependent on the overall management of the campground. Therefore, the campsites were indeed a security and the securities laws were applicable.

The flip side of this case is presented in *Deluz Ranchos Investment, Ltd. v. Coldwell Banker*.⁷³ This case involved the sale of property to an investor who relied upon a developer's representation that he would

72. 608 F.2d 187 (5th Cir. 1979), *modified*, 611 F.2d 105 (1980).

73. 608 F.2d 1297 (9th Cir. 1979).

put in common facilities and would develop the surrounding area. The developer indicated that the entire area would appreciate rapidly and sold the land at three times its market value in a double escrow transaction. The court concluded that no security was created by the land sale contract because only the land was being sold. The written agreements signed by the parties made this fact very clear, despite oral representations to the contrary. We are likely to continue to see cases in which courts make fine distinctions when determining whether or not a particular transaction involved a security.

MR. MYRL SCOTT: Our next speaker, Mr. Theodore G. Johnsen,⁷⁴ is going to bring us up to date on certain developments under the 1933 and 1934 federal securities acts. Mr. Johnsen is in private practice in Los Angeles.

MR. TED JOHNSEN: I am going to discuss some of the recent developments in the registration and reporting requirements under the federal securities acts. Because there are so many developments to address, I will try not to concentrate on the detail of the new requirements, such as numerical tests and the like. I will cover the safe harbor rule on projections, the new rules on going private, and the recent releases concerning the new integrated disclosure system.

Safe Harbor Rules on Projections

As many are aware, we have come nearly full circle on projections.⁷⁵ Over ten years ago, projections were either prohibited or, at least, greatly discouraged by the regulators. Now, the SEC is encouraging issuers to make projections if they do so within the guidelines established by the SEC.

The SEC has adopted guides pertaining to projections under both the 1933 Act (guide 62) and the 1934 Act (guide 5). Under the guides,

74. Member, California Bar; Member, Section on Corporation, Banking and Business Law, American Bar Association.

75. See generally *Guides for Disclosure of Projections of Future Economic Performance*, Securities Act Release No. 5992 (Nov. 7, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,756; *Guides for Preparation and Filing of Registration Statements: Guide 62: Disclosure of Projections of Future Economic Performance*, 1 FED. SEC. L. REP. (CCH) ¶ 3822 (1978); *Guides for the Preparation and Filing of Reports and Proxy and Registration Statements Under the Securities Exchange Act of 1934: Guide 5: Disclosure of Projections of Future Economic Performance*, 2 FED. SEC. L. REP. (CCH) ¶ 23,060D (1978); *Safe Harbor Rule for Projections*, Securities Act Release No. 6084 (June 25, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,117; *Liability for Forward-Looking Statements by Issuers*, 17 C.F.R. § 230.175 (1980); and, *Projections of Future Economic Performance by Issuers*, 17 C.F.R. § 240.3b-6 (1980).

two of the most important requirements regarding projections are that the issuer have a reasonable basis for making the projection and that the projection be made in an appropriate format. In determining what is a reasonable basis for the projections, the guides mention that a history of making projections is helpful but not necessary. Another consideration is whether an independent review of the issuer's projections has been conducted. If there has been such a review, there must also be disclosure regarding the qualifications of the reviewer, the extent of his review, his relationship with the issuer, and similar matters. The reviewer will be considered an expert for these purposes.

When addressing the format of projections, the guides suggest that the issuer consider: (i) the financial items to be projected, (ii) the period to be covered, and (iii) the manner of presentation. The guides further suggest that usually the financial items to be projected would be the standard ones of revenues, net income, and earnings per share. Of course, there is no prohibition upon projecting other items, but the SEC has said that to project revenues without a corresponding disclosure of earnings might be misleading.

The guides provide some advice concerning the period to be covered by the projections, but in my opinion they are not extremely helpful. They simply state that, depending on the kind of company that is issuing the projections, the range may vary from as little as a six month projection or end of fiscal year projection, up to as much as a two or three year projection. The guides strongly suggest that issuers disclose the assumptions made in preparing the projection. They also suggest the possibility of making projections within a specified range, or making several projections based upon varying assumptions.

Finally, the guides state that issuers should caution investors against attributing undue certainty to projections and should disclose the accuracy of previous projections. This raises the difficult question of whether an issuer has an obligation to retract a projection that no longer has a reasonable basis, and under what circumstances such an obligation exists. The guides are not helpful on this question, stating only that an issuer "may" be obligated to retract a previous projection that no longer has a reasonable basis.

In addition to the guides, the SEC adopted, in July of 1979, a safe harbor rule pertaining to projections.⁷⁶ As might be expected, the safe

76. *Safe Harbor Rules for Projections*, Securities Act Release No. 6084 (June 25, 1980), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,117; *Liability for Forward-Looking Statements by Issuers*, 17 C.F.R. § 230.175 (1980); *Projections of Future Economic Performance by Issuers*, 17 C.F.R. § 240.3b-6 (1980).

harbor rule is similar to the guides in many respects. It encourages projections and provides freedom from liability for issuers making projections unless the projections were prepared without a reasonable basis or disclosed other than in good faith. Accordingly, under the safe harbor rules, the burden of proof on the question of whether the projections were reasonable and made in good faith is on the plaintiff, not the issuer.

The safe harbor rule, like the guides, covers projections of revenues, net income, and earnings, as well as capital expenditures and other financial items. Disclosure of assumptions is strongly encouraged but not required. In my opinion, issuers making projections should carefully think out and document their bases for making the projections in advance of disclosing them, even if the bases and assumptions are not disclosed. If the assumptions are necessary to an understanding of the projections, disclosure of those assumptions should also be carefully considered.

The safe harbor rules are applicable only in certain circumstances. For example, they apply to reporting companies and to non-reporting companies in connection with documents filed under the Securities Act (such as registration statements on form S-1 or form S-18). With regard to 1934 Act reporting companies, the rules apply only to registration statements, 1934 Act reports, annual reports to shareholders, and other documents filed with the SEC.

The safe harbor rules provide that if a projection is given in connection with a specific transaction or event, then the issuer has an obligation to retract that projection if it becomes no longer valid or if it becomes apparent that the projection was false or misleading from the outset. However, the rules are imprecise on the question of whether the issuer would have a duty to retract the projection in other contexts, stating only that it depends upon the particular circumstances.

There may be some guidance on this retraction question in the proposed new going private rule, which also deals with projections. Under that rule (to be discussed more fully later), if an issuer has made a projection in the past eighteen months and delivered it to certain specified kinds of entities, including lenders, then the issuer would have to give that projection in connection with a going private transaction under the proposed rule. Further, in its release on the going private rule, the SEC has asked whether the provision on projections ought to be extended back five years and apply whether or not the issuer has voluntarily made a projection or simply generated projections for internal use. If adopted, such a provision would dramatically increase the

issuer's potential exposure to liability. The SEC argues that if the issuer is required to go back only eighteen months and deal only with projections that have already been generated, then it may not be enough when the issuer is attempting to go private. Of course, this overlooks the burden of potential liability if the projections are incorrect.

In my view, the guides and safe harbor rules are not likely to result in a great increase in the making of projections for several reasons. First, the protection of the safe harbor rule is available only after meeting its requirements, and some of them are quite subjective in nature. Accordingly, it is not easy to be sure that you have reached that safe harbor. Second, in my opinion, there is little to be gained in making projections and much to be lost in terms of potential liability.

MR. GEORGE BERMANT: Let me interject a question here, Ted. Are you in favor of mandatory projections? If all issuers were forced to make projections, would that change your view?

MR. TED JOHNSEN: It is my understanding that the SEC has regularly stated that projections may be made only if there is a reasonable basis for them, which certainly seems to be an appropriate approach. There are many companies whose history and financial circumstances would dictate that they have no reasonable basis for making projections. That fact seems to preclude adopting a mandatory rule.

MR. GEORGE BERMANT: I would assume that if the projections an issuer would be required to utilize in a going private transaction were negative, *i.e.*, that the company is not going to do as well next year or after the next five years, then either the company would choose not to go private or the SEC would not let the company put the projections in its disclosure documents.

MR. TED JOHNSEN: I agree. Remember also, however, that the SEC has asked whether the requirement to give projections in going private transactions should be broadened to include internally generated projections and projections made as long ago as five years before the going private transaction. Of course, there may be some justification for requiring projections in going private situations. However, as a practical matter, careful issuers are going to disclose the most positive information, including projections, when repurchasing their stock, just as they disclose the most negative information when selling it. Therefore, requiring disclosure of projections may not be necessary to the extent that

they are at all reasonable, and requiring them when they have become outdated or are not reasonable is, in my view, not justified.

MR. GEORGE BERMANT: But isn't it true that one consistent criticism of the entire regulatory scheme of the securities acts has been that it focuses on information in the past, while what the investor is most interested in is information about the future, to the extent that it can be provided with some reasonable basis. If that is right, then the question becomes: how do you encourage companies to make reasonable projections? If you choose not to encourage projections, then do you jeopardize the capital allocation purposes that supposedly are behind the 1933 Act?

MR. TED JOHNSEN: I agree with encouraging projections for exactly those reasons. However, I wonder whether the subjective standards in the safe harbor rules will really encourage the making of projections. Also, it has always struck me that if it is used properly, the section on management's discussion and analysis of the statement of income should be a place where management should be encouraged, and I think is being encouraged, to point out those factors in the historical financial statements which either are getting worse or better so that the informed reader can evaluate the extent to which past action is reliable to predict the future. There is also some language about that in the releases in January 1980, pertaining to the integrated disclosure system. To look ahead to that for a moment and to follow up on the point raised, there is a proposal that the management's discussion section include an analysis of five year trends and a broader range of topics than simply the summary of operations.

*Going Private Transactions*⁷⁷

Now that we have raised the question of the going private transactions, perhaps I should explain the recent developments in that area. Again, the SEC has been active in this area for several years and in August 1979, the SEC adopted rule 13e-3.

First, let us discuss certain technical aspects of the new rules. The first is the nature of the transactions that are governed. The rules cover transactions which have a "reasonable likelihood" or a "purpose" of achieving one of two events, either (i) the termination of reporting re-

77. See generally *Going Private Transactions by Public Companies or Their Affiliates*, Securities Act Release No. 6100 (Aug. 2, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,166; *Going Private Transactions by Certain Issuers or Their Affiliates*, 17 C.F.R. § 240.13e-3 (1980).

quirements under the 1934 Act, or (ii) the delisting of securities on an exchange or the termination of the quotation of the securities on NASDAQ. The rules discuss various kinds of transactions, and except certain kinds of transactions involving the purchase of minority interests, which might normally be thought of as going private transactions. However, that aspect of the rule is a bit technical and I will not dwell on it.

In connection with the going private transaction, it is necessary for the issuer to file a schedule 13e-3 and to comply with numerous disclosure and dissemination requirements. But compliance with 13e-3 does not excuse the issuer from compliance with other requirements of the federal securities laws. By its terms, the new going private rule is not exclusive, so if the proxy rules or some other provision of the federal securities laws would otherwise be applicable, it remains applicable. However, there are provisions within rule 13e-3 for coordination of the various filings. For example, an issuer may be able simply to file a 13e-3 cover page over its proxy statement, add a signature page, and comply with 13e-3. There are also provisions coordinating the timing of the various filings.

One of the more interesting developments in this area is that, under more than a little bit of pressure, the SEC has dropped its requirement that the going private transaction must be fair to the minority shareholders and has replaced that provision with a requirement for rather extensive disclosure of management's opinion of the fairness of the transaction. The SEC is undoubtedly attempting through this requirement to establish a basis for liability under the securities acts for misleading statements.

Integrated Disclosure System

Very little of my allotted time remains, and this topic is a long and very detailed one.⁷⁸ Accordingly, rather than attempting to go through

78. See generally *Proposed Amendments to Annual Report Form; Integration of Securities Act Disclosure System*, Securities Act Release No. 6176 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,422; *Business Combination Transactions—Proposed Short Form for Registration and Proposed Amendments of Related Rules*, Securities Act Release No. 6177 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,423; *General Revision of Regulation S-X*, Securities Act Release No. 6178 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,424; *Uniform Instructions as to Financial Statements—Regulation S-X*, Securities Act Release No. 6179 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,425; *Proposed Amendments Regarding Exhibit Requirements*, Securities Act Release No. 6149 (Nov. 16, 1979), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,355; *Amendments to Regulation Statement Form S-8 and Related New and Amended Rules Under the Securities Act of 1933*, Securities

the detailed provisions of the new disclosure rules, this discussion will focus simply on the general thrust of the proposed integrated disclosure system.

For years now, the SEC has pleaded for reports and registration statements filed with it to be more "readable." The proposed new rules are a continuation of its attempt both to make those documents more readable and more uniform. It is asking for an elimination of "boiler-plate disclosures and disclaimers," and attempting to encourage the readability, quality, and "communicative style" of most annual reports to shareholders. The SEC's method, as reflected in these proposed rules, is to use the annual report to shareholders as the basic disclosure document for reporting companies and to supplement it with traditional 1934 Act reporting documents. This may be somewhat of an exaggeration, but it seems to me the SEC has given up on its form of documents and now is going to try to use ours.

The question in my mind is: will it work? That is, will attorneys "destroy" the annual report to shareholders by injecting in it the "boiler-plate and disclaimers" that the SEC abhors but that the attorneys seem to feel are necessary for legal protection? It may be that a combination of the annual report to shareholders and of the 10-K report (or prospectus) as joint reporting documents may inhibit the attorneys' apparent tendency to put protective language in disclosure documents, in this case the annual report to shareholders. It may be that by combining the disclosure of the two documents, the boiler-plate and disclaimers will find their way into the 10-K, leaving the annual report "readable."

My concern, however, is that the SEC's characterization of the annual report to shareholders as the "critical integrating document" may be a clarion call which lawyers cannot resist. It seems to me that inevitably lawyers will become more involved than ever before in the preparation of the annual report to shareholders. Because lawyers, perhaps unlike the SEC, have long viewed disclosure documents as insurance policies against liability (and therefore have believed that the docu-

Act Release No. 6190 (Feb. 22, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,457; Effective Date of Post-Effective Amendments on form S-8, 17 C.F.R. § 230.464 (1980); Delaying Amendments, 17 C.F.R. § 230.473 (1980); Pre-Effective Amendments on Form S-8 Deemed Filed with Consent of Commission, 17 C.F.R. § 230.475a (1980); Withdrawal of Registration Statement or Amendment, 17 C.F.R. § 230.477 (1980); Contracts in General, 17 C.F.R. § 230.485 (1980); Form S-8, 45 Fed. Reg. 23656 (1980) (to be codified in 17 C.F.R. § 239.16b); *Short Form for the Registration of Securities; Final Rules*, Securities Act Release No. 6020 (Feb. 1, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,934; and, Form S-16, 17 C.F.R. § 239.27 (1980).

ments should contain as much protective language as possible) those same attorneys may address the preparation of the annual report with the same outlook.⁷⁹

MR. MYRL SCOTT: The next speaker is Mr. George Bermant,⁸⁰ who will discuss life after *Hochfelder* and implied private rights of action.

MR. GEORGE BERMANT: A question was raised earlier in the discussion which relates directly to this topic. That is, to the extent the annual report is filed with the SEC, is there liability on the annual report under the federal securities law, and, if so, where does that liability arise? Thus far, the SEC has not required the annual report to be filed unless it is specifically incorporated by reference in some other document. If it is filed, there is liability under section 18 of the 1934 Act which provides for express liability for documents filed with the SEC. If it is not filed, there has to be some other basis for liability. Such liability probably arises under section 10(b) and rule 10b-5.

During the last five years, the Supreme Court has been doing that which many had hoped would be done in the lower courts: rather rigorously defining the scope of rule 10b-5. Beginning with *Blue Chip Stamps v. Manor Drug Stores*,⁸¹ the Court held that only buyers or sellers of securities can sue under rule 10b-5. A general "Gee whiz, I didn't buy" or "I would have bought" or "I would have sold" will not suffice. There must have been an actual purchase or sale by the plaintiff. The Court has followed *Blue Chip* in a series of cases under 10b-5, culminating with two recent significant cases.

The first is *Ernst & Ernst v. Hochfelder*,⁸² in which the Court said that in order for a private right of action for damages to exist, there has to be a knowing intent to commit a fraud, scienter, as defined by the

79. On September 10, 1980, subsequent to the presentation of this program, the SEC adopted final rules on the integrated disclosure program. See *Amendments to Annual Report Form, Related Forms, Rules, Regulations and Guides; Integration of Securities Act Disclosure Systems*, Securities Act Release No. 6231 (Sept. 2, 1980), 6 FED. SEC. L. REP. (CCH) ¶ 72,301 (1980); *Business Combination Transactions—New Short Form for Registration and Related Rule Amendments*, Securities Act Release No. 6232 (Sept. 2, 1980), [Current] FED. SEC. L. REP. (CCH) ¶ 82,648; *General Revision of Regulation S-X*, Securities Act Release No. 6233 (Sept. 2, 1980), 6 FED. SEC. L. REP. (CCH) ¶ 72,302 (1980); *Uniform Instructions as to Financial Statements—Regulation S-X*, Securities Act Release No. 6234 (Sept. 2, 1980), 6 FED. SEC. L. REP. (CCH) ¶ 72,303 (1980); *Proposed Comprehensive Revision to System for Registration of Securities Offerings*, Securities Act Release No. 6235 (Sept. 2, 1980), [Current] FED. SEC. L. REP. (CCH) ¶ 82,649; *Proposed Revision of Form 10-Q, Quarterly Report*, Securities Act Release No. 6236 (Sept. 2, 1980), [Current] FED. SEC. L. REP. (CCH) ¶ 82,650.

80. Member, California Bar.

81. 421 U.S. 723 (1975).

82. 425 U.S. 185 (1976).

Supreme Court in a footnote to the decision.⁸³ Whether recklessness is scienter was not settled. Recklessness is a wanton disregard of the legality of an action. The Court saved the decision as to whether or not recklessness constitutes scienter for a later case, because recklessness had not been plead in *Hochfelder*. The district and circuit courts are now addressing this issue.

Most of these cases have been resolved at the pleading level. The plaintiff now has to plead knowing fraud. Rule 9 of the Federal Rules of Civil Procedure states that fraud must be plead with particularity.⁸⁴ It is not enough for plaintiff to say that another defrauded him; plaintiff must allege the specific circumstances of the fraud. This particularity makes the pleading more difficult. It does not make it impossible to get beyond the pleading stage, but it requires that the plaintiff be able to allege fraud when he drafts the complaint. He cannot rely on discovery to establish the fraud. That seems to me to be the principal requirement added by *Hochfelder*.

The second case, and I believe the more important, is *Santa Fe Industries, Inc. v. Green*,⁸⁵ which was decided the following year. In *Santa Fe*, the Court stated that 10b-5 is not a substantive remedy. Rule 10b-5 does not create a federal common law of fairness. There must be some misstatement, or some failure to disclose. It is not determinative that the price of going private was not fair. If the price can be established, and if the truth about the company was told, then 10b-5 does not provide a remedy. From that ruling has developed the "sue facts" of the SEC's going private rule. All of the factors which determine the price must be disclosed so that a state court can determine whether the going private transaction meets the requirements of state law.

An interesting development along the line of the going private cases is the substantially uniform decisions of the Second Circuit in the 1977 case of *Goldberg v. Meridor*,⁸⁶ the Seventh Circuit in the 1977 case of *Wright v. Heizer Corp.*,⁸⁷ the Third Circuit in the 1980 decision of *Healey v. Catalyst Recovery of Pa. Inc.*,⁸⁸ and the Ninth Circuit in its 1979 decision of *Kidwell v. Meikle*,⁸⁹ holding that there was a 10b-5 cause of action despite *Santa Fe* and *Green*, if one fails to disclose "sue facts." These decisions assumed that the plaintiff could establish either

83. *Id.* at 193-94 n.12.

84. FED. R. CIV. P. 9.

85. 430 U.S. 462 (1977).

86. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

87. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

88. 616 F.2d 641 (3d Cir. 1980).

89. 597 F.2d 1273 (9th Cir. 1979).

that he might have won, or would have won, or that there existed a reasonable probability that he would have won in the state court. These three standards were applied in these circuits, each circuit using one or another or a combination of the standards. In the Ninth Circuit, if the plaintiff had known the facts and could establish his reasonable probability of winning, then there is a 10b-5 violation not to disclose the facts that would have given the plaintiff a valid state action. In a rather hardheaded dissent in the Third Circuit, one judge pointed out that this creates an anomaly under *Santa Fe* which stated that there were state court remedies. The only way to get a 10b-5 action under these circumstances is if one has an adequate state court remedy. If the state court remedy is inadequate, then there is no 10b-5 remedy available. This means that you have double enforcement of half the cases and zero enforcement of the other half, assuming the state court will decide in favor of the plaintiff in half the cases.

In 1946, the Eastern District Court of Pennsylvania stated that rule 10b-5 creates a private cause of action. Then, in *J.I. Case Co. v. Borak*,⁹⁰ *Superintendent of Insurance v. Bankers Life*,⁹¹ and *Affiliated Ute Citizens v. United States*,⁹² the Supreme Court acceded to the proposition that 10b-5 created a private right of action. The right was simply assumed. Sir Edward Coke's commentary on the Magna Carta stated that every act of Parliament made against any injury or grievance either expressly or impliedly gives a remedy to the party wronged.

Recently, there has been a rather significant Supreme Court restriction on the concept that if a law declares conduct illegal, the injured party can sue privately for damages when the law is violated. Two 1979 cases dealing with the private right of action are *Touche Ross v. Redington*⁹³ and *Transamerica Mortgage Advisors, Inc. v. Lewis*.⁹⁴ The first, *Touche Ross*, involved a claim that Touche Ross should be liable because section 17(a) of the 1934 Act provides that every broker-dealer shall have honest books, and Touche Ross had audited books that were not honest. The circuit court held that there was a private right of action under section 17(a) because of the line of cases following *Cort v. Ash*.⁹⁵ The Supreme Court in *Touche Ross* stated that there is no private right of action under section 17(a). Neither the express lan-

90. 377 U.S. 426 (1964).

91. 404 U.S. 6 (1971).

92. 406 U.S. 128 (1972).

93. 442 U.S. 560 (1979).

94. 444 U.S. 11 (1979).

95. 422 U.S. 66 (1975).

guage of the statute nor its congressional history state that there is a private right of action. The Court in *Touche Ross* stated that if Congress intends to provide a private right of action, it knows how to do so, and will indicate such intention in very clear terms. The Court referred to section 18 of the 1934 Act and to sections 11 and 12 of the 1933 Act to prove that Congress expresses its intent clearly when it intends to create a private right of action. *Touche Ross* is very clear presage to the fact that there is a mood developing within the Supreme Court favoring a restriction of private rights of action.

During the same year the Court decided *Transamerica*, a case which arose under the Investment Advisers Act. The Act provides that it is illegal for an investment adviser to defraud a client. The 1940 Advisers Act also provides that every contract made in violation of the Act is void. However, the Supreme Court held that "void" means that the holder of the void contract can sue for rescission, because he should not have been in the contract in the first place; but he cannot recover damages. No damages can be recovered under section 206 because it is a rule 10b-5 type statute that merely makes an act illegal, but does not necessarily create a private right of action.

To determine whether the Act creates a private right of action, it is necessary to determine congressional intent. To imply a private right of action from the legislative history of a statute, the requirements set out in *Cort v. Ash* must be satisfied. *Transamerica* did not reject outright, but came very close to rejecting, the four-prong test of *Cort v. Ash*. The four-prong test of *Cort* states that a cause of action *will be implied* if (1) the plaintiff was a member of the class for whose special benefit the statute was intended; (2) the legislative history supported such a remedy; (3) a private right of action would not frustrate the underlying purpose of the legislation; and (4) the cause of action was one not traditionally relegated to state law.

The Court decided *Cannon v. University of Chicago*⁹⁶ the same year that it decided *Transamerica* and *Touche Ross*. The Court in *Cannon* found an implied private right of action under Title IX of the Education Amendments of 1972. When the sex discrimination law was passed in 1972, the Court was very liberal in implying private rights of action. Therefore, it should be assumed that Congress took that into consideration when it passed the sex discrimination statute. The Court applied the *Cort v. Ash* tests and found that an implied right of action would not "frustrate" the purpose of the Act, and that women consti-

96. 441 U.S. 677 (1979).

tuted the special class for whose benefit the statute was intended. Justice Powell, in a rather vitriolic dissent, pointed out that the holding in *Cort v. Ash* is a poor test for determining implied rights of action. Powell further stated that the Court intended to limit creation of new implied rights of action. However, since *Cannon* was decided last year, there have been twenty-four reported cases in the lower courts in which private rights of action have been found to exist. It was to prevent just such a proliferation of implied rights of action that Justice Powell argued that the Court should write a new test. Of course, Justice Powell was in the majority in both *Transamerica* and *Touche Ross*.

Private rights of action are disfavored in both the Supreme Court and some lower courts. Under the Commodity Exchange Act, the district court in New York, in *National Superspuds, Inc. v. New York Mercantile Exchange*,⁹⁷ found no private right of action under one of the sections of the Commodity Exchange Act. The *Cort v. Ash* tests are being downplayed. The new approach seems to be to question whether there is an express remedy provided in the law. If there is, the likelihood is that the Supreme Court is not going to imply an additional remedy. District courts and circuit courts have not yet fully heard the message. They are still implying private rights of action, although the trend is slowing.

Although I believe that this trend is proper, I do not favor unlimited damage claims. Many courts, including the Ninth Circuit, have held that there are private rights of action under rule 10b-5 or section 11 in order to join additional defendants or because the statute of limitations under the federal law has expired. What is the purpose of Congress adopting a law that establishes a three year statute of limitations for filing a false registration statement, when, if a court implies a private right of action, the same plaintiff will be given five years to file a lawsuit? In such instances, the court's conduct amounts to judicial legislation. I am not prepared to argue that private rights of action under rule 10b-5 ought to be eliminated completely, but I think that the courts have gone further than necessary in implying private rights of action.

MR. MYRL SCOTT: Let us move on to the new developments in small issue financing. We are very pleased to have with us Mr. Grover Wickershaw.⁹⁸ He is a branch chief at the SEC's Los Angeles Regional Of-

97. 425 F. Supp. 665 (S.D.N.Y. 1977), *appeal dismissed*, 591 F.2d 174 (2d Cir. 1979).

98. Branch Chief, Los Angeles Regional Office, Securities and Exchange Commission.

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office and formerly a staff attorney in the SEC's Division of Corporate Finance in Washington, D.C.

MR. GROVER WICKERSHAM: I am going to discuss form S-18 and regulation A. Later, Mr. Neal Brockmeyer will discuss rule 242. According to the current thinking both on the Commission and in Congress, "small business" includes very substantial enterprises, with hundreds of employees, up to the \$25,000,000 in annual revenues, and a very substantial asset base. For example, in a bill introduced by the administration, there is a definition of "small business" that would apply to as many as half of the companies currently reporting under the Securities Exchange Act. Obviously, "small business" is somewhat of a misnomer.

The recent rule and statutory changes may be helpful to many clients that are not normally thought of as being small businesses. During April and May of 1978, the Commission held a series of hearings on the problems that small businesses have in raising financing. In order to encourage as much input as possible, the hearings were held in cities around the country, including Los Angeles. As a result of the hearings, the Commission adopted form S-18, proposed rule 242, and changed regulation A to increase its usefulness.

Form S-18 is a somewhat simplified registration statement which can be used for sales of up to \$5,000,000 in securities by certain qualified corporate issuers. Excluded from use of the form are partnerships, investment companies, mining companies, reporting companies under the 1934 Act, or companies with significant oil and gas operations. The reason for the large number of exclusions is that the Commission perceives form S-18 as an experimental form which should be "phased in" during an initial period in which its use is carefully monitored. The form will be reviewed on a continuing basis to determine whether or not some of the exclusions should be removed.

One and one-half million of the \$5,000,000 in securities that can be registered on form S-18 may be registered for resale by affiliates of the issuer, the rationale being that small business financing often originates from venture capital companies. Typically, venture capitalists prefer "recycling" their investments. If and when one of its client companies reaches a stage where it is desirable for it to go public, S-18's secondary resale provision provides the means for the venture capital firm to easily liquidate part of its investment, as part of the public offering.

The principal disclosure differences between form S-18 and form

of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

S-1 relate to the financial statement requirements. The financial statements for form S-18 need not comply with regulation S-X which is the Commission's comprehensive accounting regulation, but need only comply with generally accepted accounting practices. The smaller accounting firms tend to view this as a distinct advantage. Form S-18 requires income statements for only two years, while form S-1 requires three years. Certain schedules required by form S-1 and regulation S-X also need not be provided.

Form S-18 requires textual disclosure which is less detailed and lengthy than what is required by form S-1. Even so, I should point out that the textual disclosure appearing in the forms S-18, that have been filed to date in the Los Angeles Office, resemble in detail what I have seen in the S-1 forms. The somewhat complicated remuneration disclosure requirements found in form S-1 are not required by form S-18, however, and I think that is a clear advantage.

Another advantage of S-18 is that when the issuer on a form S-18 prepares its first 10-K filing, it is required only to provide the information required by form S-18, whereas form 10-K and regulation S-X would otherwise require more expansive disclosure. The public commentators were enthusiastic about having the option of filing in the SEC regional office for the state in which the issuer's business is located. In fact, almost all form S-18's have been filed regionally instead of in Washington.

I want to briefly review certain regional office procedures. The pre-filing conference procedure, which has been a Commission procedure for a long time and which is discussed in guide 1 of Release 33-4936, also applies to the SEC's regional offices. Counsel and the issuer may come into the regional office prior to filing to discuss major disclosure questions with the staff. This permits the issuer to address important areas of staff concern by providing supplemental information. In my experience, the total processing time for filing is decreased by this early exchange of information.

The SEC operates under informal guidelines from the regional administrator, which encourages the staff to furnish initial comments on S-18 and regulation A filings within two weeks of the filing date. However, in some instances, it takes as long as three weeks or a month to furnish initial letters of comment.

Recent changes in regulation A included an increase in the maximum amount of money which can be raised from \$500,000 to \$1,500,000. Given the substantial fixed costs of underwriting, few underwriters found it possible to participate in regulation A offerings at

\$500,000. Since the ceiling was increased in the fall of 1978 to \$1,500,000, we have experienced a significant increase in the number of regulation A filings. In 1977, we received approximately 24 filings. We have received around 35 filings to date in 1979. Moreover, the companies utilizing regulation A appear to be more sophisticated. More than twenty-five percent of the filings received are reporting pursuant to section 12(g) of the 1934 Act. Most of the filings are underwritten and some have obtained "firm commitments" from their underwriters, which is particularly significant. It is probable that the Commission will further increase the regulation A ceiling to as much as \$3,000,000, further enhancing its usefulness.

Another recent change in regulation A was the amendment of rule 256 to permit use of preliminary offering circulars, "red herrings," in underwritten offerings under regulation A. The increased involvement of underwriters is partially due to the ability to use red herrings. However, California state regulations discourage use of red herrings in regulation A offerings.

There are three advantages to using regulation A as compared to registration on form S-18 or form S-1. First, an issuer using regulation A does not automatically become a reporting company pursuant to section 15(d) of the 1934 Act. This is important, especially where the offering is a limited one in connection with an employee benefit plan and the company is not ready to assume the costs and obligations of making form 10-K and other such periodic filings with the Commission. Second, the financial statements used in regulation A may be unaudited. Upon application, California has permitted the use of unaudited financial statements for limited offerings, for example, in connection with some employee benefit plans. This can provide great savings in cost. Third, under regulation A, officers, directors, and named experts are not subject to the standards of strict liability imposed by section 11 of the 1933 Act.

I reviewed my office's statistical records to determine the recent trends. Though the Los Angeles Regional Office's territory includes California, Hawaii, Nevada, and Arizona, ninety percent of the issuers were located in California with the other ten percent spread over the other three states in the region. Approximately eighty percent of the offerings other than stock option plans or other employee benefit plans were underwritten offerings. Usually the underwriter sold the offering on a "best efforts" basis.

Approximately twenty percent of the issuers on regulation A are already reporting companies under the 1934 Act. As an aside, it is

worthwhile to mention that where an issuer is a reporting company, the preparation of the regulation A filing is, in most instances, very simple, because counsel has available a form 10-K and proxy materials. In many instances, the requirements of form 10-K and the proxy rules are more extensive than the requirements of regulation A. I suspect that the time and cost of preparing a regulation A filing is substantially lessened where the issuer is a reporting company under section 12(g). The staff is considering allowing reporting companies to merely "wrap" a brief description of the specific securities around the company's 10-K and proxy statement, not unlike what is done by larger companies on form S-16.

Only two of the underwritten regulation A filings were sold in California. The others were sold in Colorado, New York, Oregon, and Arizona, in that order of importance. A fairly large number of filings, approximately thirty percent, were limited offerings. In one case, there was a spin-off.

There were three offerings which involved a very limited number of investors who made substantial investments of around \$20,000 to \$25,000 per investor. Counsel determined either that the private placement exemption was not available or did not want to take a risk, and, therefore filed a regulation A. Approximately twenty percent of the filings reviewed had unaudited financial statements. Of this twenty percent, one-half were limited offerings such as employee benefit plans, and the others were offerings made in Oregon or Nevada, which do not require audited financial statements.

Seventy-five percent of the issuers in my sampling were corporations, primarily engaged in highly technological manufacturing: gold mines, one consulting firm, and a smattering of different types of consumer goods companies. Approximately twenty-five percent of the issuers were limited partnerships, or other non-corporate issuers such as realty trusts.

It appears that the S-18 program and the regulation A program are gaining momentum. Accordingly, the Los Angeles Regional Office has added additional staff to its full disclosure group, so that we can try to keep our processing time to the minimum.

MR. SCOTT: Our next speaker, Mr. Neal Brockmeyer,⁹⁹ will continue the discussion of developments in small business financing.

99. Member, California Bar; Member, Executive Committee, Business and Corporations Law Section, Los Angeles County Bar Association; Chairman, Committee on Corporations, State Bar of California, 1978-79.

MR. NEAL BROCKMEYER: There have been several developments in rule 144, which is used for resale of securities acquired in private placements and for sale of securities by "affiliates".¹⁰⁰ With respect to rule 146,¹⁰¹ a report of offering is now required to be filed with the regional office. These reports do not just go into a file in Washington; they are analyzed and reviewed. One of Mr. Wickersham's colleagues once commented that the SEC has observed that a number of offeree representatives are reappearing on these reports with some frequency, which raises a question as to their licensing. The SEC also, on occasion, will check names and request offering materials from various issuers. There

100. 17 C.F.R. § 230.144(1) (1980). Rule 144 permits, subject to compliance with prescribed standards, holders of restricted securities and affiliates of issuers to sell their securities without registration under the Securities Act of 1933. The SEC has amended rule 144 in several significant respects.

The SEC has limited the amount of securities that can be sold under the rule as of September 25, 1978. Securities Act Release No. 5979 (Sept. 19, 1978). The SEC reduced the six-month period for measuring sales under the rule to three months. In addition, the rule permits, for both listed and unlisted securities, the sale of the *greater* (rather than the lesser) of one percent of the outstanding securities of the class or the average weekly trading volume during the four calendar weeks preceding the sale.

The SEC also adopted amendments to rule 144 to permit nonaffiliates in certain circumstances to disregard the volume limitations after a holding period of either three or four years. Securities Act Release No. 6032 (March 5, 1979). The three year period applies if the securities are listed on a national securities exchange or quoted on NASDAQ. Otherwise, the four year period applies if the issuer files periodic reports under the Securities Exchange Act of 1934 (the "1934 Act"). Those who have been affiliates must wait three months after their affiliate status has ended to utilize the new provision.

The SEC also amended the portion of the rule that requires sales to be effected in "brokers' transactions." Securities Act Release No. 5979 (September 19, 1978). It was felt that the brokers' transaction requirement imposed unnecessary expense by requiring the interpositioning of a broker in those situations where the seller could trade directly with a market maker. Accordingly, as an alternative to selling brokers' transactions, it is now permissible to sell directly to a market maker. Another amendment exempts estates and beneficiaries who are not affiliates of the issuer from the brokers' transaction requirement. A new paragraph has also been added to rule 144 to clearly state that the rule is nonexclusive in nature. Securities Act Release No. 6032 (March 5, 1979).

101. 17 C.F.R. § 230.146 (1980). Rule 146(e) has been amended to provide that in an offering of \$1.5 million or less the offeree must have access to or be furnished with the information required by schedule I of regulation A, rather than the information required for registration statements under the 1933 Act. Securities Act Release No. 5975 (September 8, 1978).

Issuers are now required to file with the SEC a report on form 146 containing information about offerings made in reliance upon rule 146, except for offerings aggregating less than \$50,000 cumulatively during a twelve-month period. Securities Act Release No. 5912 (March 3, 1978).

Rule 146(b) has been amended to make it clear that transactions not satisfying all the conditions of the rule shall not raise any presumption that the exemption provided by section 4(2) of the 1933 Act is not available. Securities Act Release No. 5975 (September 8, 1978).

is a letter that is sometimes sent by the SEC indicating deficiencies in the report and asking that it be amended.

Mr. Wickersham stated that there have been 980 filings under rule 146 in the Los Angeles Regional Office. The rule appears to be used rather extensively, most often in real estate and oil and gas syndications. Another interesting statistic is that the filings in the Los Angeles Regional Office have amounted to about \$4,000,000,000. The next largest regional office has reported \$1,500,000,000 in filings. To some extent, this can be explained by several very large rule 146 offerings in this region.

Rule 146 was adopted by the SEC in 1974. Another rule, rule 240, was adopted in 1975, and is available for rather limited offerings involving up to \$100,000. The most significant recent development in this area is rule 242.¹⁰² Rule 242 was proposed last year and was

102. 17 C.F.R. § 230.242 (1980).

The SEC adopted rule 242 under section 3(b) of the 1933 Act effective February 25, 1980. Securities Act Release No. 6180 (January 17, 1980). This rule will allow certain corporate issuers to offer and sell up to \$2 million of securities to an *unlimited* number of their executive officers and directors, institutional-type purchasers, purchasers of at least \$100,000 of securities, and 35 other purchasers. This rule was proposed last fall in an effort to address the problems posed by the subjective determinations and mandatory disclosure requirements of rule 146 and the limited utility of rule 240. Securities Act Release No. 6121 (September 11, 1979).

Sales of securities by a "qualified issuer" in compliance with *all* the conditions of the rule are exempt from registration under section 5 of the 1933 Act pursuant to section 3(b) of that Act. A "qualified issuer" is generally a domestic or Canadian corporation which is not an investment company, a corporation engaging in or intending to engage in oil and gas related operations, or in significant mining operations or disqualified from using the regulation A exemption. Although traditional integration factors will apply, the rule contains a qualified safe harbor for sales more than six months before and offers and sales after six months following a rule 242 offer or sale.

The aggregate offering price may not exceed the amount allowed under section 3(b) of the 1933 Act (currently \$2 million), less the aggregate gross proceeds from all securities sold pursuant to any section 3(b) exemption (other than certain regulation A offerings made in connection with specified employee plans) six months prior to the commencement and during the offering of securities pursuant to rule 242. This would include offerings by predecessors and certain affiliates.

The issuer must have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than 35 purchasers. In computing the number of purchasers, all "accredited persons" are excluded, as are certain relatives and related trusts, estates, corporations, and other organizations. "Accredited persons" are defined to include certain institutional-type investors, any person who purchases \$100,000 or more of securities in any combination of cash, a full recourse obligation payable within 60 days or cancellation of indebtedness, and any director or executive officer of the issuer.

If sales are made only to accredited persons, the rule does not specify what information must be furnished. In any offering involving only nonaccredited persons, or both accredited and nonaccredited persons, the issuer must provide the same kind of information as that specified in part I of form S-18, to the extent material, and such further material information

adopted recently. It became effective on February 25, 1980. Let us compare the new rule with rule 146 and disregard rule 240, the intra-state exemption and rule 147.

Rule 242 has been adopted under section 3(b) of the Securities Act of 1933, and not section 4(2). The reason is that there is a good deal of case law under section 4(2) that deals with the sophistication, knowledge, and ability of an investor to fend for himself. In order to eliminate these factors, the SEC believed that it could adopt rule 242 only under section 3(b).

Rule 242 is only available to the same types of issuers that generally can use form S-18. For example, limited partnerships cannot avail themselves of this rule. Also, issuers that are disqualified from the use of regulation A are similarly disqualified from the use of this rule.

In comparing this new rule with rule 146, one can see that there is no dollar limitation in rule 146, but because section 3(b) is limited to \$2,000,000, rule 242 has to be similarly limited. The rule does not specify \$2,000,000, but it references section 3(b). Thus, if Congress were to increase that \$2,000,000 limit, the rule's limitation would automatically increase.

One of the significant innovations in rule 242 deals with purchasers. The SEC has done away with the offeree representative concept, sophistication, and the ability to bear the economic risk. Under the rule, sales can be made to any number of "accredited persons," being generally institutions and certain persons who purchase \$100,000 or

as may be necessary. The rule provides, however, that only the financial statements for the most recent fiscal year must be certified. If the issuer is subject to the reporting requirements of the 1934 Act, this requirement may be satisfied by furnishing purchasers with certain publicly available information, together with information in response to certain of the items of form S-18. The offerees must also be afforded the opportunity to ask questions, receive answers, and obtain additional information to verify the accuracy of the other disclosures. Each purchaser must receive a description of written information obtained from the issuer by any accredited persons.

Securities issued in reliance on the rule are deemed to have the same status as if they had been acquired in a transaction pursuant to section 4(2) of the 1933 Act. The definition of "restricted securities" in rule 144 has been amended to include securities issued in reliance on rule 242. Issuers are obligated to exercise reasonable care to assure that purchasers are not statutory underwriters, which includes reasonable inquiry to determine whether they are acquiring securities for their own account, informing them of restrictions on resale and placing legends on certificates or other documents evidencing the securities.

Within ten days after the first sale, ten days after the completion date of the offering and every six months after the first sale, the issuer must file with the SEC five copies of a notice on form 242. Depending upon the timing of completion of the offering, one or both of these latter filings can be avoided. In lieu of requiring the filing of offering materials as originally proposed, the notice contains an undertaking by the issuer to furnish such materials to the SEC on request.

more of securities in any combination of cash, cancellation of indebtedness, or full recourse notes payable within sixty days. It is important to note that the sixty day requirement is different than the similar provision in rule 146. Also, rule 242 as finally adopted, includes directors and executive officers among the accredited persons. Note, however, that not every officer is an *executive* officer as defined in the new rule.

In addition to accredited persons, an issuer can sell its securities to thirty-five nonaccredited persons. They can be any type of investor. They do not have to meet any particular standards, and do not have to purchase more than \$100,000 in securities. Furthermore, there is no limitation with respect to offers like that found in rule 146, where in making an offer the offeree must meet certain tests. Commissions are also permitted under rule 242, as in the case of rule 146. Under rule 240, no commissions are permitted.

The information that is to be supplied to investors under this new rule is quite different than under rule 146. Rule 146 requires an issuer, except for companies subject to the periodic reporting requirements, to furnish the information that would be contained in a registration statement. In an offering of \$1,500,000 or less, the information required is that which would be supplied under regulation A. In making an offering under rule 242 only to accredited persons, there is no information that is required to be furnished to them. If, however, nonaccredited persons are included, the issuer must provide the information for an S-18 filing, but only to the extent that it is material. If there are disclosures in an S-18 filing that are deemed not to be material, they can be excluded. One other significant variation is that certified financial statements are required only for the last fiscal year, not for two years as in form S-18.

A notice is required to be filed in Washington for rule 242 offerings. Filing in certain instances can be accomplished by deposit in the mails. This is the kind of enlightened change that ought to be encouraged, particularly for California issuers, so that they can mail the notice and not bear the cost of air freight to Washington. There are several key dates to keep in mind. First, a notice must be filed within ten days after the first sale; then, within ten days after completion of the offering, and every six months after the first sale if the offering continues. The notice contains an undertaking whereby the issuer undertakes to supply offering materials to the SEC at its request.

It is important to know the extent to which the SEC will ask for the offering materials. One of the criticisms of form 146 has been that it is viewed as an enforcement tool. There are few, if any, cases being

brought in the Los Angeles Regional Office based on form 146. But this criticism has extended over to consideration of rule 242. The requirement that offering materials be supplied to the SEC in certain instances is only for purposes of monitoring the rule and not for commenting on the offering materials or any other similar purpose. The rule 242 filings selected for requests for offering materials will be on a random basis by computer. The sampling will probably be rather small, but there is always a possibility with any document filed with the SEC that there might be an enforcement action, but the chances are relatively remote. The form itself is rather extensive. It includes a great deal of information concerning numbers of employees and similar matters that does not appear pertinent to the offering. The announced purpose is to accumulate data for computer analysis.

I think these exemptive rules are useful tools in corporate acquisitions, in addition to their application to small business financing involving cash offerings. Rule 146 has been a rather useful tool. Rule 242 is not limited to cash offerings. It also can be used in acquisitions, although unlike rule 146, it does not contain specific provisions that apply to acquisitions. This is something to keep in mind with respect to acquisitions involving less than \$2,000,000.

It was mentioned earlier that there is a new form, form S-15, that has been proposed as a short form registration statement for use in lieu of form S-14 in certain acquisitions. This form will be very useful where a larger publicly held corporation acquires a small company. All of these developments are very favorable towards small businesses.

MR. MYRL SCOTT: The final speaker today is Mr. Peter Pancione,¹⁰³ who will discuss recent developments in California securities laws.

MR. PETER PANCIONE: This has been a relatively quiet year for the Department of Corporations and for the corporate securities law. Most of the action that has taken place in California with respect to securities was to decrease regulation. There was a broad based regulatory retreat, which was highlighted by specific action taken to ease the regulatory burden in certain areas. It is probable that this trend will continue in California.

In this discussion, I will highlight the changes and their possible effects on practicing in the securities area. California had a commodity law that was repealed effective January 1, 1980. The law was enacted

103. Member, California and New York Bars; Acting Commissioner of Corporations, State of California, 1979; Member, Business and Corporate Law Section, Los Angeles County Bar Association.

in 1972, and was initially successful in combating the commodity option scams that were prevalent at the time. In 1974, Congress passed the Commodity Futures Trading Act, which substantially preempted California law. The residual jurisdiction maintained by California resulted in some activity for the California Corporations Department, primarily in the enforcement area. The law was repealed because the cost incurred in enforcing the commodity law was no longer justifiable.

Another significant change, which became effective January 1, 1980, was the method for licensing securities broker-dealers and agents. Prior to the change in the existing law, California engaged in a comprehensive review of form BD, the application form to become licensed as a security broker-dealer. This form is filed with the California Department of Corporations, the Securities and Exchange Commission, the National Association of Securities Dealers, and other self-regulatory bodies, primarily the stock exchanges.

California substantially simplified the procedure. At present, a broker-dealer that is licensed by the SEC or a member of the New York Stock Exchange, the American Stock Exchange, the Pacific Stock Exchange, or the National Association of Securities Dealers, can be licensed by filing a relatively simple notification form with the department. Licensing is automatic three days after the notification form is filed. The form requires only basic information, in contrast to the information required by form BD. The department does not make any finding with respect to the notification form. Accordingly, the regulatory burden is eased. When this statute was going through the legislative process last year, a study was made that determined that approximately fifty to fifty-five out of the nine hundred broker-dealers licensed in California would not come under the new notification procedure.

Similarly, agents are no longer licensed as securities agents by the Department of Corporations. For an agent to be eligible to sell securities in California, it is necessary for the broker-dealer employing the agent to supply to the Department of Corporations a list of all agents employed by him. This list is updated monthly by indicating which agents started and which were terminated during that month. Again, this significantly eased the regulatory burden. The broker-dealer, however, must retain in his records all the qualification requirements for that agent, such as the questionnaires and the agents' passing of the required examinations. Basically, the new law shifted the paperwork incidence from the Department of Corporations to the broker-dealer.

The new licensing procedure will not have any effect on the de-

partment's regulatory program or on its enforcement program. All the tools that were available prior to the change in licensing are still available. The department can still revoke or suspend that broker-dealer's license. Similarly, the department can still terminate an agent's employment.

The next area I want to cover concerns escrows and shares that are subject to the Commissioner's Legend Condition. The Legend Condition states that it is unlawful to consummate a sale, transfer a security, or any interest therein, or receive any consideration therefor, without the Commissioner's prior written consent. The problem that has arisen for the department is that, typically, business brokers operate in selling a business by automatically opening an escrow, and if a security is involved, the security is placed in the escrow along with any consideration from the buyer of the security. Sooner or later, the sale will close. The Department of Corporations historically took the position that this was a transfer for consideration and the mere placing of the security, with the consideration for the security, in escrow was a violation of the Commissioner's consent requirements.

In October 1979, the department issued an interpretive release to solve this problem. The release stated that if an escrow is opened and the escrow holder is an independent third party (excluding accountants or attorneys or other representatives of one of the parties to the transaction), and the escrow instructions provide that the securities will not be released nor consideration paid for them until the Commissioner's consent is obtained, then the transaction will not violate the Commissioner's Legend Condition.

The interpretive release, however, contained some confusing language. The release provided that, notwithstanding the opening of an escrow, placing the securities and consideration therefore in the escrow, obtaining the Commissioner's consent, and then closing the sale, that there was still a question as to whether a qualification for the sale of the security was required. The release defined a "sale" and an "offer" by using the words of the statute. The release then stated that, in the Commissioner's opinion, the placing of securities and/or consideration in escrow or the execution of escrow instructions comes within the definition of sale. Therefore, it seems that the mere placing of the securities and the consideration therefor in the escrow effects a sale. If this analysis is correct, then the release contains an inconsistency.

I believe that an attorney involved in such a transaction is best advised to follow the release. From an enforcement standpoint, it is doubtful that anyone will encounter difficulties by following the release

in regard to the opening of an escrow and obtaining the Commissioner's consent prior to closing. However, given certain facts and the arguments that the release itself makes, it may be possible to argue that a sale occurred when the escrow was opened.

Next, I would like to discuss the use of red herring offerings with respect to regulation A offerings. In 1979, the United States Secretary of Corporations adopted a rule allowing the use of red herring offering circulars with respect to regulation A offerings. There was no similar exemption under the California Corporate Securities Law. The department was besieged with requests to adopt a rule providing for such an exemption. The department was concerned because most of the regulation A offerings that were submitted for qualification to the department had difficulty meeting the fair, just, and equitable standards. Particularly, there was excessive promoter compensation. Typically, the promoters had a plan of business that was incomplete. Though the idea was good, there was no way to know whether it would ever be profitable. In common with these two problems was the problem that the offering price bore no relation to the assets or future profitability of the company. Because these issues were raised, often at the first review level, the department reasoned that it would be inappropriate to allow a red herring offering circular to be distributed when, in order to be qualified, significant changes would have to be made. Nevertheless, in January 1980, the department did adopt a rule that allows the use of red herring offering circulars for regulation A offerings, subject to certain requirements. There may not be stop orders against the offer and sale of the security. In addition, if material changes are made in the offering circular between the time of initial distribution and the time of final offering, then a legend indicating the material changes must be placed on the offering circular. Also, the purchaser is afforded a right to rescind the sale for three days from the time he received the final offering circular. This places a tremendous burden on the issuer and also on any broker-dealer involved in the sale. Therefore, very accurate records as to when the purchaser received the final offering circular, when the purchaser's money may be spent, and when the purchaser's right of rescission expired will have to be kept.

