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10th Biennial Midwest/Midsouth Securities Law Conference

Office of Continuing Legal Education at the University of Kentucky College of Law

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SECURITIES LAW CONFERENCE

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Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
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THE BUSINESS JUDGMENT RULE, DUTIES OF CONTROLLING STOCKHOLDERS, AND REGULATION M-A

IN THE CONTEXT OF MERGERS, ACQUISITIONS AND TENDER OFFERS

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SECTION A

THE BUSINESS JUDGMENT RULE, DUTIES OF CONTROLLING SHAREHOLDERS AND REGULATION M-A IN THE CONTEXT OF MERGERS, ACQUISITIONS AND TENDER OFFERS

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I. DUTIES OF DIRECTORS

A. The Business Judgment Rule.

1. Most state corporation laws contain language to the effect that the "business and affairs of every corporation shall be managed by or under the direction of a board of directors." *See* Del. § 141 and N.Y. § 701. Courts have developed a firmly established policy of judicial deference to corporate decision-making that is commonly referred to as the "business judgment rule." In general, assuming directors of a corporation act with due care and have no self-interest, this rule establishes a presumption that in making a business decision the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company and its stockholders. The burden is on the party challenging the decision to establish facts rebutting the presumption by a showing of fraud, bad faith, self-interest or lack of care on the part of the directors. In cases where the business judgment rule is applied, the courts will not "second guess" the judgment of the directors if the directors' actions can be "attributed to any rational business purpose." *Unitrin.* v. *American General Corp.*, 651 A.2d 1361, 1373 (Del. 1995); *Sinclair Oil Corp.* v. *Levien*, 280 A.2d 717 (Del. 1971).

2. In a decision by the Delaware Supreme Court, *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984), a case involving the need for a demand to be made on a company's board of directors in order to bring a derivative suit, the Supreme Court restated and reaffirmed the protections afforded directors by the business judgment rule:

   > "The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."

3. In order to overcome the presumption, a plaintiff must show that the board acted with "gross negligence." *Smith* v. *Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Gross negligence is generally found only in egregious cases, where there is no rational basis for the board's actions or the board failed to obtain and consider information reasonably available before acting. "For example, where their methodologies and procedures are so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham, then inquiry into their acts is not shielded by the business judgment rule." *Hanson Trust PLC* v. *SCM Corporation*, 781 F.2d 264 (2nd Cir. 1986) (applying New York law).

   In *Van Gorkom*, the Supreme Court of Delaware held the directors of a corporation liable to the corporation's stockholders for failing to adequately evaluate a merger proposal before adopting it and failing to provide to stock-holders all information which the stockholders would consider important in deciding whether to vote for the merger. The court concluded that the directors were *grossly negligent* in approving the merger because, among other things, they were uninformed as to the intrinsic value of the company (there was no independent investment banking advice), they approved the transaction upon two hours' consideration without prior notice and they relied on an oral description of the merger agreement by an officer who had never read the agreement. As a result of the *Van Gorkom* decision, many states passed laws enabling the corporation, with shareholder approval, to eliminate monetary liability for directors for breach of a duty of care, with certain exceptions.

B. Revlon Duties.

1. Director's Actions to Sell Company - "*Revlon* duties." A board of directors is under no duty to sell the company, but once the board decides to sell the company or deems that a break-up is inevitable, the board assumes a duty to negotiate the best price for the shareholders. *Revlon, Inc.* v. *MacAndres & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Often referred to as a board's "*Revlon*" duties, the Delaware Supreme Court's decision and its progeny in some cases require the conduct of a formal auction of the corporation, or other alternatives. The court observed that in this context the board's responsibilities are altered significantly:

> [The corporation] no longer faces[s] threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures [becomes] moot. The directors' role [is] changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

Revlon at 182. The *Revlon* duty is to try in good faith to get the best available transaction. The Board is entitled to take a lower offer with higher certainty over a higher offer which may not close. *Revlon* does not require that every change in control be preceded by an auction. *Revlon* duties arise when it is inevitable that the company will be sold and stockholders' interests terminated.

In *Revlon,* the Delaware Supreme Court affirmed the Chancery Court's injunction against the use of a "crown jewel" lock-up device in the midst of a bidding contest for a corporation. The court found that when the board of directors ceased protecting the interests of the corporation as a going concern and decided to break-up the Company by selling to an LBO group, the board assumed a duty to negotiate the best price for the shareholders and that the board could not, by granting the lock-up, stop an active bidding contest between two essentially equivalent bidders, particularly where such lock-up was in part granted in exchange for relieving the directors of potential liability. *See also Mills Acquisition Co.* v. *Macmillan Inc.*, 559 A.2d 1261 (Del. 1989) (in an auction, the proper objective "was to obtain the highest price reasonably attainable for the company, provided it was offered by a reputable and responsible bidder. . . ."), and *In re Wheelabrator Technologies Inc. Shareholders Litigation*, C.A. No. 11495 (Del. Ch. Sept. 1, 1992) (market check not required where there was no bidding contest and no allegation that directors were uninformed about company's value), and *Giammargo* v. *Snapple Beverage Corp.*, C.A. No. 13845 (Del. Ch. November 15, 1994) (court refused to grant a preliminary injunction to enjoin a merger on the grounds that the price was "too low" and that the target directors received approximately $2 million in "side payments" for option terminations, etc.; the court reasoned that the target directors, who were also 68% stockholders, had a strong economic self-interest to obtain a fair price for the stock and were not influenced by the relatively small side payments in the context of a $1.4 billion deal). *See Herd* v. *Major Realty*, Fed. Sec. L. Rep. (CCH) P95,772 (Del. Ch. Dec. 21, 1990) (*Revlon* duties not applicable in transaction where stockholders may elect cash or to keep their stock.); *Wells Fargo* & Co. v. *First Interstate Bancorp*, 1996 WL 32169 (Del. Ch. Jan. 19, 1996) (dismissing *Revlon* claims on the grounds that, as a matter of law, no *Revlon* duties had been breached because proposed merger was a stock-for-stock deal where control stayed in a large shareholder group).

2. *Revlon* duties do not apply in the context of a parent-subsidiary merger. *Bershad* v. *Curtis-Wright Corp.*, 535 A.2d 840 (Del. 1987). *See also Kleinhandler* v. *Borgia* (1989 WL 76299, Del. Ch.) (*Revlon* duties inapplicable to freeze-out of 40% owned subsidiary).

3. Lock-up agreements. Under *Revlon*, once the target board has made a decision to sell the corporation, a lock-up agreement (an agreement conferring an advantage on a favored bidder in order to evade a raider) may only be used to protect and benefit shareholders. *Revlon* and its progeny did not invalidate all lock-up agreements, only those that foreclose competition in the sale of the company. *See also Samjens Partners I* v. *Burlington Industries, Inc.*, 663 F. Supp. 614 (S.D.N.Y. 1987) (Applying Delaware law, board may use lock-ups if it enhances the bidding process, such as when used to convince a white knight to enter the bidding, compensating the white knight for the risk it undertakes).

   a. When management has seats on the board, lock-up options may be subject to higher scrutiny. "When the intended effect [of a lock-up agreement] is to end an active auction, at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession." *Mills Acquisition Co. v. MacMillan*, Inc. 559 A.2d 1261 (Del. 1989).

   b. Duty to seek the best value for shareholders, but no duty to conduct an auction. *QVC Network v. Paramount Communications, Inc.* 635 A.2d 1245 (Del. Ch. 1993). The court found that a lock-up option given by Paramount to Viacom did not satisfy the *Revlon* test. The lock-up option at issue gave Viacom the right to purchase almost 20 percent of Paramount stock for approximately $1.6 billion, which Viacom could opt to pay with a subordinated note instead of cash. Additionally, the lock-up option contained a put provision that permitted Viacom to require Paramount to pay Viacom the difference between the share option price and the market price of Paramount's stock at the time the option was triggered, with no cap limiting the maximum dollar value of the put. The court enjoined the lock-up on the grounds that the note and put provisions were "potentially 'draconian'" to Paramount and "unusually and highly beneficial" to Viacom.

The Delaware Supreme Court affirmed the Chancery Court's opinion, and explained further what actions will satisfy the duty to obtain "the best value reasonably available to the stockholders." In defining the Paramount board's duties, the Court stopped short of stating that Paramount's board had to auction the company, instead defining the board's duties as follows: (i) to be diligent and vigilant in examining critically the offer and all other offers; (ii) to act in good faith; (iii) to summon, and act with due care on, all material information reasonably available, including information to compare competing offers to determine which provides the *best value* available to the stockholders; and (iv) to negotiate actively and in good faith with all bidders. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

c. Certain termination fee provisions have been validated by a different standard than *Revlon.* In *Brazen* v. *Bell Atlantic Corp.*, 695 A.2d 43 (Del. 1997), the Delaware Supreme Court upheld a merger agreement between Bell Atlantic Corp. and NYNEX Corp., which contained a reciprocal, two-tiered $550 million termination fee. The express language of the agreement unambiguously stated that the termination fee constituted liquidated damages and not a penalty. The Supreme Court held that "we find no compelling justification for treating the termination fee in this agreement as anything but a liquidated damages provision, in light of the express intent of the parties to have it so treated."

C. <u>Enhanced Scrutiny (Unocal and Blasius).</u>

1. <u>Applying the Business Judgment Rule in the Acquisition Context.</u>

a. <u>Directors' Actions Subject to Enhanced Scrutiny</u>. As described above, under the business judgment rule, directors' actions carry a presumption of regularity. That is, directors are presumed to have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. However, in the context of defensive measures implemented in anticipation of or in response to an unsolicited takeover threat, courts generally follow Delaware law which reviews board actions with *enhanced scrutiny* as described below. If this burden of enhanced scrutiny is met, the traditional Business Judgment Rule applies, with the plaintiff bearing the burden of demonstrating a breach of the directors' fiduciary duties.

For a discussion of the desirability of broadened, enhanced judicial scrutiny, *see* Martin Lipton and Theodore N. Mirvis, Enhanced Scrutiny and Corporate Performance: The New Frontier for Corporate Directors, 20 Del. J. Corp. L. 123 (1995).

b. Court Review of Defensive Measures - Delaware's <u>Unocal</u> Approach: The Delaware Supreme Court's landmark decision in *Unocal Corp* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), established the standard by which the Delaware courts review defensive measures in response to a threat to corporate control. In *Unocal*, the court upheld the board's decision to make an issuer tender offer in which a hostile tender offeror was not allowed to participate. The court found that, faced with a grossly inadequate two-tiered coercive tender offer coupled with the threat of greenmail, the board had a clear duty to protect the corporate enterprise and the selective repurchase plan chosen *was reasonable in relation to the threat posed.* The Unocal court adopted this standard upon observing that, in taking steps to deter an unsolicited offer, there exists the "omnipresent specter that the board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."

c. Two-Prong Unocal Test. The initial burden of proof in cases involving defensive measures lies with the directors, who must show: (1) that directors had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (2) that the defensive measure decided upon was "reasonable in relation to the threat posed." *Unocal*, 493 A.2d at 955.

i. To satisfy the first prong, directors have a duty to investigate carefully a responsible offer and to respond to that offer in good faith and on a reasonable basis. *See Paramount Communications Inc.* v. *QVC Network Inc.*, 637 A.2d 34 (Del. 1994) (Paramount Board was obligated to investigate competing and "unfriendly" QVC offer). While the *Unocal* court did not define what constitutes good faith and reasonable investigation, in *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989), the Delaware Supreme Court stated that in conducting such an investigation, the board's analysis should consider, among various proper factors:

(a) the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests;

(b) the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interest. *MacMillan* at 1282 n.29.

ii. The proof presented by the board in support of its burden is "materially enhanced" where a majority of the board consists of "outside independent directors." *See Unitrin* v. *American General*, 651 A.2d 1361, 1375 (Del. 1995); *Paramount*

Communications, Inc. v. *Time,* 571 A.2d 1140, 1154 (Del. 1990).

iii. There is no *per se* duty to negotiate in response to an offer. *See Pogostin* v. *Rice*, 480 A.2d 619, 627 (Del. 1984); *Desert Partners* v. *USG Corp.*, 686 F. Supp. 1289, 1300 (N.D. Ill. 1988). The duty is to respond to the offer as presented. In fact, in *Turner Broadcasting System, Inc.* v. *CBS, Inc.*, 627 F. Supp. 901 (N.D. Ga. 1985), the court held that "[i]n considering tender offers management has the responsibility to oppose offers which in its best business judgment are detrimental to the company or its stockholders," and that if directors "determine in good faith that the threatened action is adverse to the shareholders' and corporation's interests, they have a duty to resist the takeover through all legal means at their disposal." *See generally* DiBlasi & Feit, *Where Must a Target's Board Negotiate With a Potential Acquiror*, The National Law Journal (Sept. 25, 1989);

d. Board's Actions Must be "Defensive" to be Subject to the *Unocal* Standard. All defensive measures adopted by Delaware corporations are subject to enhanced scrutiny if the directors adopted the measure "in reaction to a perceived 'threat to corporate policy and effectiveness which touches upon issues of control," *Unitrin.* v. *American General Corp.,* 651 A.2d 1361, 1372 n. 9 (Del. 1995); *Stroud v. Grace*, 606 A.2d 75, 82 (Del. 1992) (quoting *Gilbert v. El Paso Co.*, 575 A.2d at 1131, 1144 (Del. 1990)).

i. *Paramount Communications v. Time Inc.*, 571 A.2d 1140 (Del. 1990) - The Delaware Supreme Court viewed Time's pending merger with Warner as a long-planned business combination, not as a defensive measure in response to Paramount's bid to acquire Time, and affirmed the Chancery Court's application of traditional business judgment concepts because the combination with Warner was part of Time's strategic business plan. Accordingly, the transaction was not subject to *Unocal's* enhanced judicial scrutiny until the form of the transaction changed in response to Paramount's bid. *Gilbert v. El Paso*, 575 A.2d 1131, 1143 (Del. 1990) (describing the court's reasoning in *Paramount v. Time*). In addition, the court observed that directors "are not obliged to abandon a deliberately conceived corporate plan for a *short-term* shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Time,* 567 A.2d at 1154.

ii. Similarly, in *Williams* v. *Geier*, 671 A.2d 1368 (Del. 1996), the Delaware Supreme Court determined that neither the *Unocal* or *Blasius* standards applied (*see* discussion of *Blasius* infra) where the board acted in the absence of a threat or act of disenfranchisement. The Court affirmed a Chancery Court summary judgment upholding as valid an amendment to Cincinnati Milacron's charter that provided for "tenure voting" --

each existing share would receive ten votes, but upon sale or other transfer, would revert to one-vote-per share status until held by its owner for three years. Milacron was controlled by the Geier family, which owned a little over 50% of its stock. Thus, the stockholder approval of the charter amendment was virtually assured. Moreover, the Geier family peculiarly benefited from the amendment because it permitted them to sell some of their shares without relinquishing control of the company.

The majority determined that, because the plan did "not involve either unilateral director action in the face of a claimed threat or an act of disenfranchisement . . . neither *Blasius* nor *Unocal* applie[d]." Rather, the majority concluded that the decision of the board to recommend the amendment was subject to business judgment rule review and that the plaintiff failed to rebut the presumption of the rule because at summary judgment he failed to demonstrate that the board's purpose in proposing the amendment was anything other than promoting the long-term stability of the company. The majority also rejected various arguments that the stockholder vote in favor of the plan was ineffective.

e. Directors' Actions must be "reasonable in response to threat posed."

In *Ivanhoe Partners* v. *Newmont Mining Corp.*, 535 A.2d 1334 (Del. Sup., 1987), the Delaware Supreme Court held that the Newmont board, faced with an inadequate two-tier, coercive tender offer, (i) had no duty to conduct an auction for the company unless and until it decided to sell the company, (ii) reasonably responded to the threat posed by the Ivanhoe offer by declaring a $33 cash dividend which enabled Newmont's largest shareholder to increase its position from 26% to 49.7% through open market purchases, subject to a ten-year standstill agreement that assured Newmont's continued independence.

In *Bass Group, Inc.* v. *Evans, et al.*, 552 A.2d 1227 (Del. Ch. 1988) the Delaware Chancery Court enjoined a recapitalization proposal to be undertaken by Macmillan, Inc. in response to a series of offers from the Bass Group to acquire the company. The restructuring involved a complicated split-up/spin-off of Macmillan and would have resulted in management increasing its ownership interest (through "equitable adjustments" to outstanding options and restricted stock awards) from 4.5% to approximately 39% in one of the spun-off businesses.

Having found that the recapitalization was tantamount to a "sale of control" and that the offer eventually made by the Bass Group was (i) for all shares and (ii) within Macmillan's "fairness" range, the Court held that the recapitalization was an unreasonable response to the "minimal" threat posed by the Bass Group.

"The circumstances of each individual case determine the reasonableness of an anti-takeover defense. That determination, of course, will depend upon the nature of the threat posed. Here, the threat was that the Bass $73 per share proposal, while fair, was not the highest price that might be available if the company were being sold.... Thus, given the nature of the threat, a reasonable response would, at a minimum, offer stockholders higher value than the Bass Group offer or, at the very least, offer stockholders a choice between equivalent values in different forms. The management restructuring offers neither. Not only does it offer inferior value to the shareholders, it also forces them to accept it. No shareholder vote is afforded; no choice is given. The restructuring is crafted to take the form of a dividend, requiring only director approval. On that basis alone, as more fully discussed below, I find preliminarily that the restructuring is a coercive, and economically inferior, response to the Bass Group 'threat.'"

f. Judicial Deference to Board Actions. Despite the hurdle imposed by *Unocal*, its progeny have demonstrated that boards retain substantial discretion to enact defensive measures to combat hostile takeover attempts.

i. *Unitrin v. American General Corp.*, 651 A 2.d 1361 (Del. 1995) In the *Unitrin* decision, the Delaware Supreme Court reversed a Chancery Court decision preliminarily enjoining a stock repurchase program announced by Unitrin in the face of a hostile tender offer by American General.

Applying *Unocal*, the Court affirmed the Chancery Court's holding that the American General proposal constituted a "threat" because the board of directors believed in good faith that the price was inadequate. The Court disagreed, however, with the Chancery Court's analysis of the second prong of *Unocal*, which considered whether the repurchase program was "necessary" in light of Unitrin's poison pill. The Court held that the "necessary" analysis was incorrect and instead the Chancery Court should have determined whether (1) the defensive measure was "draconian" (which the court defined as coercive or preclusive) and (2) if it determined that the defensive measure was not draconian, whether it was within a "range of reasonableness". In remanding the case to the Chancery Court, the Supreme Court noted that Delaware courts had frequently found defensive repurchases of stock to be "reasonable."

The Supreme Court specifically found two holdings of the Chancery Court to be erroneous: first, the Chancery Court, without any record support, had assumed that the directors would be motivated to entrench themselves; the Supreme Court found this an unreasonable conclusion considering the fact that the board owned $450 million worth of Unitrin stock. Second, the Chancery Court had held that the repurchase program would permit Unitrin's board to take undue advantage of a super-majority voting provision in the Unitrin charter that required a vote of a majority of directors or 75% of the shareholders for a merger to be approved. The repurchase program would have increased the directors' ownership interest from 23% to 28% and, thereby, according to the Chancery Court, allow the directors to control any super-majority vote. The Supreme Court noted that the Chancery Court had apparently overlooked the fact that American General could replace the Unitrin board in a proxy contest, which would only require a 50% vote (for this reason, the Supreme Court also strongly hinted that it would not find the program "preclusive"). In making this determination, the Court noted that a high percentage of Unitrin's stock was held by institutions, which, according to the Court, do not routinely favor management.

ii. There are other considerations besides *Unocal*, however, which might serve to invalidate defensive measures. In *Quickturn Design Systems, Inc.* v. *Mentor Graphics Corp.*, No. 511 (Del. December 31, 1998), the Delaware Supreme Court invalidated a "no hand" feature of Quickturn's shareholder rights plan. The effect of the "no hand" provision would have been to delay the ability of a newly-elected board to redeem the poison pill for six months in any transaction with an "Interested Person" as defined in the provision. The Supreme Court held that the provision was invalid under 8 Del. C. Section 141(a), "which confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation." "[The 'no hand' p]rovision, however, would prevent a newly elected board of directors from *completely* discharging its fundamental management duties [in the area of corporate control] to the corporation and its shareholders for six months."

"No hand" provisions are not dead in every jurisdiction. *See Invacare Corp.* v. *Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997) (provision requiring one continuing director to approve pill's redemption valid under the Georgia Corporation statute); *AMP, Inc.* v. *Allied Signal, Inc.*, 1998 WL 778348 (E.D. Pa.) (court applied business judgment rule under Pennsylvania law to finite "no hand" provision in favor of target board of directors).

g. Actions that Interfere with Stockholder Vote. Courts will accord even closer scrutiny, beyond the *Unocal* Reasonable Response test, when an exercise of legal authority is designed for the primary purpose of interfering with the effectiveness of a stockholder vote. *Blasius Industries, Inc.* v. *Atlas Corp.*, 564 A.2d 651, 659 (1988). Although an action diminishing a shareholder's vote is not invalid, per se, the right of an individual stockholder to exercise the voting rights of its shares is a fundamental corporate right. The right of franchise must not be diluted except where reasonably necessary to accomplish an appropriate corporate business policy. *Id.*

The *Blasius* case challenged the validity of a board action that added two new members to Atlas' seven member board. That action was taken as an immediate response to the delivery to Atlas by Blasius the previous day of a form of stockholder consent that, if joined in by holders of a majority of Atlas' stock, would have increased the board of Atlas from seven to fifteen members and would have elected eight new members nominated by Blasius.

In increasing the size of Atlas' board by two and filling the newly created positions, the members of the board realized that they were thereby precluding the holders of a majority of the Company's shares from placing a majority of new directors on the board through Blasius' consent solicitation, should they want to do so. Chancellor Allen found that when a board acts for the primary purpose of preventing or impeding an unaffiliated majority of shareholders from expanding the board and electing a new majority, even though in good faith and with appropriate care, the action offends the traditional relationship between corporate directors and shareholders. As a result the court concluded that the board action was invalid and must be voided.

One court has held that board interference with the right of franchise is governed by the *Blasius* standard even where outright control of the board cannot be achieved by the stockholders. In *IBS Fin. Corp.* v. *Seidman and Assocs.*, 1998 WL 52292 (3rd. Cir. (N.J.)), the Third Circuit Court invalidated a decision of the board of directors of a N.J. corporation to reduce its size from seven to six directors prior to an annual meeting where a shareholder committee planned to seek representation on the board. The court rejected the argument that a contest must be for outright control of the board in order to trigger *Blasius*, reasoning that the anticipated election "represented a step towards control of the board by the Committee."

h. Entire Fairness. Successful resistance to a takeover attempt will most likely have the collateral effect of perpetuating the incumbent directors' control so that the directors' self-interest in maintaining control may appear to have been one of the purposes of resistance. In a transaction approved by the board of directors, once the presumption of the business judgment rule has been rebutted, the board of directors' actions are examined under the entire fairness standard, which is discussed under II.A.1., below.

Fairness has two basic aspects: fair dealing and fair price (discussed below). The board bears the burden of demonstrating entire fairness by presenting evidence that it discharged all of its fiduciary duties. In order to meet such burden the directors are not, however, required to prove that they discharged all of their fiduciary duties: "[a] finding of perfection is not a *sine qua non* in an entire fairness analysis. That is because the entire fairness standard is not applied unless the presumption of the business judgment rule has been rebutted by evidence that the directors . . . breached any *one* of the *triads* of their fiduciary duty -- good faith, loyalty or due care. Thus, perfection is not possible, or expected as a condition precedent to a judicial determination of entire fairness." *Cinerama, Inc.* v. *Technicolor, Inc.*, 663 A.2d 1156 (1995) (citations omitted). If fully informed shareholders approve the transaction, claims alleging breaches of the duty of care are extinguished, but duty of loyalty claims remain subject to entire fairness or business judgment review, depending on whether the other party to the transaction is a controlling shareholder. *In re Wheelabrator Technologies, Inc.*, Shareholders Litigation, 1995 WL 301416 (Del. Ch.).

i. In a decision by the Delaware Supreme Court in *Cinerama* v. *Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), the Court indicated *in dicta* that it agreed with the Chancery Court which stated that it had "grave doubts" about the Technicolor Board's exercise of due care because, among other things, (i) the merger agreement was not preceded by a prudent search for alternatives, (ii) seven of the nine Technicolor directors knew virtually nothing about the proposed merger until they approved it and (iii) the stock purchase agreement and stock option agreement with McAndrews & Forbes Group, Inc. ("MAF") (the party seeking to acquire Technicolor), which gave MAF over 34% of Technicolor's stock and Technicolor's repeal of its supermajority provision in its charter, which required a 95% stockholder vote to approve a merger, effectively locked up the transaction early on. In *Technicolor*, the Court went on to reject the Chancery Court's position that a plaintiff must show proof of injury to overcome the presumption of the business judgment rule.

   On remand in *Cinerama*, Chancellor Allen examined the merger under the entire fairness standard. He found the price to be fair because the merger price was a 100% premium over the unaffected market price and had been bargained for at arms-length. As to "process," Chancellor Allen found the process to be fair even though the board did not conduct any market check because there was no evidence that the board had not bargained in good faith in the best interests of the shareholders (the board had negotiated the merger price up to $23.00 from $15.00). The Court went on to discuss whether rescissory damages would have been an appropriate remedy if the merger had not satisfied the entire fairness test. The Court held that rescissory damages will generally be unavailable to remedy a breach of care unaccompanied by a material conflict of interest.

ii. Presumption of Independence. To rebut the presumption of a Board's independence there must be evidence that the material self-interest of one or more directors infected or affected the deliberation process of the board (after evaluating the directors' self interests on a director by director basis). *Cinerama, Inc.* v. *Technicolor Inc.*, 663 A.2d 1156 (Del. 1995).

iii. Section 144(a) of the Delaware General Corporation Law. Section 144(a) which protects corporate action from invalidation on grounds of director self-interest if such self-interest is (i) disclosed to and approved by a majority of disinterested directors; or (ii) disclosed to and approved by the stockholders; or (iii) the transaction is found to be fair.

iv. Disinterested Directors. While not an absolute safeguard, courts are more likely to apply the protection afforded by the business judgment rule to director action where proof is made that at least a majority of the directors voting to approve an action were "disinterested" outside directors possessing business and financial sophistication.

(a) *See Unitrin* v. *American Gen. Corp.*, 651 A.2d 1361, 1375 (Del. 1995): "[T]he presence of a majority of outside independent directors will materially enhance such evidence [that the board made a good faith, reasonable investigation]." For the definition of an "independent" director, *see Williams* v. *Geier,* 671 A.2d 1368, 1377 n. 19 (Del. 1996).

(b) In the *Norlin* case discussed below, however, the Second Circuit said it was not persuaded that a different test applies to "independent" as opposed to "inside" directors under the business judgment rule, and that a showing of a "collective" conflict of interest underlying the directors' actions would shift the burden of proof to the directors.

v. Shareholder Votes: In *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, 663 A.2d 1194, reversing his decision in an earlier phase of this litigation, Chancellor Jacobs held, based on recent Delaware Supreme Court cases including *Kahn v. Lynch* and *Stroud* v. *Grace*, that a fully-informed shareholder vote on a transaction does not extinguish a claim that the board breached its duty of loyalty. Instead, the board's action is evaluated under the business judgment rule (not the entire fairness standard), with the party challenging the board's action having the burden of proof.

For the purposes of the entire fairness test, however, tender of shares for merger by a majority of a corporation's shareholders constitutes substantial evidence of fair dealing. *Cinerama, Inc.* v. *Technicolor, Inc.*, 663 A.2d 1156, 1176 (Del. 1995).

2. The Unocal test has not been followed in all states, notably New York where the traditional business judgment rule applies in takeover situations.

For example. in *Norfolk Southern Corp.* v. *Conrail Inc.*, Civ.A.No. 96-7350, slip op. at 635 (E.D. Pa. Nov. 19, 1996), which applied Pennsylvania law, the Court applied the business judgment rule to efforts by Conrail Inc.'s ("Conrail") directors to protect against an unwanted tender offer from Norfolk Southern Corp. ("Norfolk"). Norfolk instituted an all-cash for all-shares tender offer for Conrail's outstanding stock that was clearly superior to a previously announced merger agreement between CSX Corporation ("CSX") and Conrail. In response to the Norfolk bid, Conrail and CSX amended their merger agreement so as to change the structure of the tender offer and increase the cash portion of the merger consideration.

Norfolk sued contending that the CSX transaction was a front-end loaded, two-tiered acquisition that was coercive to Conrail's shareholders. In determining whether the Conrail board had gone too far in its protection of the CSX deal, the Court primarily relied on § 1715 of the PBCL, which provides that a director's fiduciary duties are owed to the corporation as a whole as opposed to the shareholders. The PBCL also rejects the application of heightened levels of scrutiny for board conduct in the takeover area and states that any act of a Pennsylvania board, including actions taken relating to an attempted change of control, shall be presumed to be in the best interest of the corporation. Because Conrail argued that it had considered both merger partners and concluded the CSX provided better long-term prospects, the Court declined to second guess this decision. The Court also disagreed with Norfolk's contention that the CSX deal was "coercive" because the Conrail shareholders could reject the transaction either by not tendering into the first step of the tender offer or voting against Conrail's opting out of the fair price provision (which was part of the restructured merger plan).

The Court also criticized the *Unocal* and *Revlon* decisions. The Court stated:

> There are practical problems with the *Unocal* and *Revlon* line of cases as I see it, aside from their myopic view that because stockholders are at least in theory the owners of the corporation . . . only their interests should be considered or at a minimum given the highest priority and importance. The primary problem is that it replaces the discretion of a corporate board of directors who hopefully are sophisticated practical business managers, and eventually under *Unocal* and those decisions places it in the hands of judges whose business judgment, however altruistic, is certainly apt to be less reliable than that of business managers.

See also AMP, Inc. v. *Allied Signal, Inc.*, 1998 WL 778348 (E.D. Pa.) (applying business judgment rule to finite "no hand" provision in favor of target board of directors). *But see* Union Pacific/So. Pacific (Del. Supr. 1995). Shareholder vote doesn't extinguish *Revlon* claims.

D. Additional Cases Related to the Duties of Directors and the Business Judgment Standard in the Context of Acquisitions.

1. *Wittman* v. *Crooke*, No. 769 (Md. Ct. Spec. App. March 27, 1998).

Appellant, a shareholder in Baltimore Gas and Electric Co. (BGE), filed a claim against BGE's board of directors alleging that in BGE's merger with the Potomac Electric Power Co. (PEPCO), each director stood a chance of being named a director in the new company, and as such, the directors should be prohibited from deciding whether to recommend the merger. Appellant also alleged that Goldman, Sachs & Co. was "interested" because Goldman stood to gain $8.5 million more by recommending the merger than by advising against it.

The court held in favor of the directors regarding the breach of duty of loyalty claim. Regarding the Goldman claim, the court noted that Goldman examined several utilities in the Northeast before determining that PEPCO was the most suitable candidate with whom BGE could merge. The court concluded that "to say that [Goldman] just [approved the merger] because they want to make $8 million . . . there has to be more than that." Moreover, the stockholders vote ratifying the transaction extinguished any duty of care claim.

2. *Safety-Kleen Corp.* v. *Laidlaw Envtl. Servs.*, 97 C 8003 (N.D. Ill. Feb. 4, 1998). The district court, applying Wisconsin law, refused to force Safety-Kleen to redeem a poison pill in the face of a hostile bid by Laidlaw Environmental Services for stock and cash worth approximately $30 per share, even though Safety-Kleen had signed up a friendly, all cash deal with Phillip Services Corp. for $27 per share.

   The court acknowledged that Wisconsin law permits the board of directors to look at factors other than simply enhancing shareholder value, but proceeded to apply the Delaware law of enhanced scrutiny under *Revlon* and *Paramount* v. *QVC*. The court noted that the board was largely independent and that the directors' financial interests were aligned with those of the shareholders. The court concluded that the directors did not breach their fiduciary duty, as evidenced by a long and scrupulously deliberate auction process, the reasonable judgment that a $27 all cash bid was too good to lose and the fact that an exclusivity condition was necessary to make the deal happen.

3. *AMP, Inc.* v. *Allied Signal, Inc.*, 1998 WL 778348 (E.D. Pa.). Allied Signal announced an unsolicited cash tender offer for all AMP shares and a consent solicitation seeking AMP shareholder approval to expand AMP's board in order to redeem AMP's shareholder rights plan. AMP's board proceeded to add "no hand" provisions to its Rights Plan. Allied Signal, in turn, amended its consent solicitation, seeking AMP shareholder approval to remove from AMP's board all power, rights, and duties concerning the Rights Plan and to give that authority to a designated three-person committee. The companies then sued each other: AMP sought partial summary judgment on its request for declaratory relief that the court enjoin Allied Signal from proceeding with its consent solicitation; Allied Signal sought summary judgment on its claims that the amendments to the Rights Plan were illegal and void under Pennsylvania law.

   Regarding the consent solicitation proposal to delegate to a three-person committee control over AMP's Rights Plan, the court held that the proposal violated Pennsylvania law (PBCL § 2513) because Pennsylvania corporations have broad power to adopt shareholder rights plans on such terms as are fixed by the board and that AMP shareholders have no power to take away the board's authority.

Regarding the "no hand" provisions, the court stated that because the Rights Plan was finite in time, the "no hand" provisions must be viewed in light of the ordinary business judgment rule and presumed to be in the best interests of AMP.

The court refused to preclude Allied Signal's consent solicitation to expand the board, but enjoined the consent solicitation until its nominees stated unequivocally to the shareholders that they have a fiduciary duty solely to AMP.

4. *Kahn* v. *MSB Bancorp, Inc.*, 1998 WL 409335 (Del. Ch.). MSB Bancorp, Inc. rejected a merger offer from HUBCO, a bank holding company in New Jersey. Shareholders of MSB brought claims for damages against individual directors alleging breach of their fiduciary duties. The court refused to apply the *Unocal* rule, holding instead that "*Unocal* applies when a board takes defensive action in response to a threat to its control. Here, there was no defensive action. The board merely voted not to negotiate the merger offer." Under the business judgment rule, the court noted that the presence of 90% outside directors strengthens the presumption of good faith. The court rejected the notion that the fact that directors receive fees for their services is enough to establish an entrenchment motive.

5. *Rand* v. *Western Air Lines, Inc., et al.*, 1994 Del. Ch. LEXIS 26 (February 25, 1994), *aff'd*, 1995 Del. LEXIS 6 (January 6, 1995). Plaintiffs, the former stockholders of Western Air Lines ("Western"), filed suit challenging the 1986 merger between Delta Airlines and Western. Vice Chancellor Berger rejected plaintiffs' argument that the negotiating directors were biased because of "golden parachute" arrangements, stating that there was no evidence that the directors did not negotiate in good faith, and held that Delaware law did not require that the directors delegate negotiating responsibility to a special committee. The court further found that because alleged "valuations" done for Western by Dillon Read were aimed at inducing Delta to make an attractive offer and not at estimating the true value of the company, they need not have been considered by the directors or disclosed to shareholders. Finally, the court held that the directors had not breached their fiduciary duties by entering into a "no-shop" provision and "lock-up" agreement with Delta because (i) Delta made an important concession in exchange for these agreements and (ii) Western had canvassed the marketplace and found Delta to be the only viable merger prospect before entering into these agreements.

6. *Moore Corporation* v. *Wallace Computer Services Inc.*, (No. 95-472) the District Court for the District of Delaware, interpreting Delaware law, refused to order the redemption of the rights issued pursuant to Wallace Computer Services, Inc.'s stockholder rights plan. The *Moore Corporation* court analyzed the Wallace board's defensive measures under the standards established by the Delaware Supreme Court in *Unocal* and *Unitrin*. The court read *Unocal* and *Unitrin* to provide that a board's defensive response to a hostile offer will be evaluated under the business judgment rule if the board shows (a) that it had reasonable grounds to believe that the hostile offer posed a danger to the target's

"corporate policy and effectiveness" and (b) that the defensive measure was "reasonable in relation to the threat posed" by the offer, meaning (i) that the defensive measure was not "coercive" to the target's shareholders or "preclusive" to the hostile bidder and (ii) that the defensive measure fell within a "range of reasonableness". The court first determined that Wallace's retention of the pill in response to Moore's all cash offer was reasonable based on Moore's recent sales and profit results noting that Wallace's shareholders, who had tendered more than 70% of the shares in Moore's offer, might tender without appreciating the fact that Wallace's business strategy was beginning to pay off. In addition, the court determined that retention of the pill was neither coercive or preclusive as the board's action would neither have a discriminating effect on shareholders nor have an effect on a proxy contest by Moore. The court then examined whether the retention of the pill was within "range of reasonableness" and determined that it was because of the board's good faith belief that Moore's offer was inadequate.

7. In *Kidsco Inc.* v. *Dinsmore*, 674 A.2d 483 (Del. Ch. 1995), the Delaware Supreme Court upheld a board's decision to amend a by-law in order to delay a special stockholder meeting demanded by a bidder. After The Learning Company ("TLC") announced a merger agreement with Broderbund, Softkey announced a tender offer for TLC and called a special meeting to remove TLC's board. TLC subsequently negotiated an increase in the Broderbund deal and then amended its special meeting by-law in such a way as to insure that the vote on the proposed Broderbund merger occurred prior to the occurrence of the special meeting. The Chancery Court approved the by-law amendment under a "*Unocal/Unitrin* analysis," reasoning that the board acted appropriately in responding to the last minute Softkey offer by seeking to protect the ability of the stockholders to vote on the pre-existing Broderbund merger and, thereby, exercised its fiduciary duties with respect to the Softkey proposal. The Delaware Supreme Court affirmed the Chancery Court without opinion.

8. In *H. F. Ahmanson & Co.* v. *Great Western* (Letter Opinion dated April 25, 1997), the Delaware Chancery Court (a) granted a motion by Great Western to dismiss Ahmanson's claim that the Great Western board's fiduciary duties required them to hold its annual meeting sooner than June 13, 1997, but (b) denied the motion with respect to a claim that the board had ignored a by-law requiring it to hold a special meeting for the election of directors as soon as practicable after the date when the annual meeting was originally to be held.

On February 24, 1997, six days after Ahmanson had announced an unsolicited proposal for the company, Great Western adjourned indefinitely a previously scheduled April 22, 1997 annual meeting. On April 10, Great Western rescheduled the annual meeting for June 13, 1997. Ahmanson argued that no good reason existed for the June 13 date other than entrenchment and therefore the board's behavior was in breach of its fiduciary duties. The Court dismissed this claim on the grounds that a mere delay in the annual meeting did not sufficiently establish irreparable injury to support an injunction moving the date forward. The Court held that, in order to establish irreparable injury, the "delay must adversely threaten the exercise of the shareholders' right to vote in some tangible way." Mere delay "without more" is legally deficient.

The Court also held, however, that the by-law count stood on a different footing because the violation of a by-law encompasses harm not only to the corporation's electoral process but also to the corporation's governance process. The Court stated "[w]here the shareholders or the directors, by adopting a by-law, command a performance of a certain act, to hold that coercive relief cannot be had to enforce that command would violate basic concepts of corporate governance."

9. In *Hilton Hotels Corp.* v. *ITT Corp.*, 962 F. Supp. 1309 (D. Nev. 1997), the U.S. District Court in Nevada enjoined ITT's attempt to proceed with a corporate plan, adopted in the face of Hilton's hostile tender offer, which would split ITT into three new entities. The plan was to be implemented before the 1997 annual shareholders meeting. Under the plan, one of the new entities, ITT Destinations, would be comprised of ITT's current board but that board would be classified. Citing the lack of Nevada statutory or case law on point, the Court applied Delaware law, specifically the *Unocal* analysis, and found that the plan was preclusive because the classified board provision for ITT Destinations would force ITT's stockholders to accept the plan as well as a majority of ITT's incumbent directors for at least one year. [The Court acknowledged that ITT's board could normally adopt a classified board to create ITT Destinations. However, the Court applied the reasoning of *Blasius* to hold that these actions could not be undertaken if the board's primary purpose was to disenfranchise ITT stockholders in light of Hilton's tender offer and proxy contest.

10. *Arnold* v. *Society for Savings Bancorp*, 650 A.2d 1270 (Del. 1994). *Arnold* arose out of a merger between the Bank of Boston Corporation ("BOB") and Society for Savings Bancorp ("Society"), pursuant to which Society shareholders received 0.8 shares in BOB for each Society share held. Plaintiff argued that the Society board's approval of the merger should have been subjected to "enhanced scrutiny" as opposed to the business judgment rule because the merger constituted a "sale of control" under *Paramount*. The Supreme Court disagreed, holding that no "sale of control" had occurred because control of the combining companies remained in a "large, fluid, changeable and changing market". The Court also rejected plaintiff's argument that a sale of control took place because Society's former shareholders were relegated to minority status in BOB. The Court held that because Society's former shareholders continued as BOB shareholders, their opportunity to realize a control premium had not been foreclosed. Often cited for the proposition that a nondilutive stock-for-stock merger does not involve a sale of control.

11. Numerous cases in addition to those cited above have applied the business judgment rules to director actions in response to hostile efforts to take control of a company. *Buffalo Forge Co.* v. *Ogden Corp.*, 717 F.2d 757 (2d Cir.), *cert. denied*, 104 S.Ct. 550 (1983) (no fiduciary breach in sale to "white knight" of treasury stock along with grant of a "lock-up" 18 1/2% option to purchase additional treasury stock); *Gearhart Industries, Inc.* v. *Smith International, Inc.*, 741 F.2d 707 (5th Cir. 1984) (court affirms trial court decision not to enjoin sale of debentures with "poison pill" warrants attached which were issued in response to anticipated hostile tender offer); *Martin Marietta Corp.* v. *Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982) *aff'd* Nos. 82-1307, (7th Cir. March 5, 1982) (no fiduciary breach in "PAC-MAN" counter-tender offer by target for

shares of bidder); *Whittaker Corp.* v. *Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982) (no fiduciary breach in sale of "crown jewel" subsidiary to a third party in the face of a hostile tender offer); *Thompson* v. *Enstar Corp.*, Civ. A. Nos. 7641, 7643 (Slip Op. Del. Ch. June 20, 1984, revised August 16, 1984) (applying the business judgment rule to a board's decision, in the face of a proxy contest, to enter into a "lock-up" agreement which conveyed to a potential "white knight" a valuable corporate asset solely to induce it to make a bid); *Carter Hawley Hale Stores, Inc.* v. *The Limited, Inc.*, C.A. No. 84-2200-AWT (Slip Op. C.D. Cal. April 17, 1984) (no fiduciary breach where target company bought in more than half its outstanding common stock, while issuing a new preferred, with the result of frustrating a tender offer and giving the directors practical voting control of the company); *Pogo Producing Co.* v. *Northwest Industries, Inc.*, No. H-83-2667 (Slip Op. S.D. Tex. May 24, 1983) (no fiduciary breach in competing issuer tender offer by target); *GAF Corporation* v. *Union Carbide Corporation*, Civ. A. No. 85-9588 (S.D.N.Y., December 30, 1985) (no fiduciary breach by commencing issuer exchange offer using securities with restrictive covenants which would make hostile offer difficult to complete). *Samjens Partners I* v. *Burlington Industries, Inc.*, 663 F. Supp. 614 (SDNY 1987) (break-up fees equal to 2% of aggregate deal upheld). *Tomczak* v. *Morton Thiokol, Inc.* C.A. No. 7861 (Del. Ch. April 5, 1990) (swap of a company division for 8.23% of its stock acquired in a creeping acquisition held a reasonable response to a perceived threat); *Newell Co.* v. *Vermont American Corporation*, No. 89 C 5202 (N.D. Ill. October 13, 1989) (upholding share repurchase, issuance of 7% of stock in friendly acquisition and lower threshold on poison pill); *Day* v. *Quotron Systems, Inc.*, C.A. No. 8502 (Del. Ch. Nov. 20, 1989) (no breach of fiduciary to take no position on, and no defensive actions with respect to, a tender offer at a price within range of fairness even if not as high as board believes might be attainable; *Union Pacific Corporation* v. *Santa Fe Pacific Corporation* (letter opinion) (Del. Ch. January 30, 1995) (based on the hostile bidder's delay in filing its motion, refusing the hostile bidder's request for an expedited preliminary injunction hearing on its claim seeking a court order that the target redeem or exempt the hostile offer from its poison pill)).

E. Constituency Statutes.

1. Constituencies the Board of Directors May Consider.

    a. Stockholders (must consider).

    b. A growing number of states have specific statutory provisions addressing constituencies, other than stockholders, the Board may address:

        i. Employees

        - *See* N.Y. § 717(b), § 1716 of Pennsylvania Business Corporation Law.

ii. Creditors

- When a corporation is insolvent, a fiduciary duty is owed to the creditors. *Geyer* v. *Ingersoll Publications*, 621 A.2d 784 (Del. Ch. 1992).

iii. Community interests

- *See* N.Y. § 717(b), § 1716 of Pennsylvania Business Corporation Law.

iv. Depositors (for banks) and any others to whom the corporation or the board acts in a fiduciary position.

v. New York cases have explicitly recognized that directors may consider constituencies other than stockholders. *GAF Corporation* v. *Union Carbide*, Civ. A. No. 85-9588 (S.D.N.Y., December 30, 1985). ("The protection of loyal employees, including managers, of the organization is not anathema in the Courthouse.") But *see Revlon*, where Delaware Supreme Court held that directors may have regard for various constituencies, *provided that there are rationally related benefits accruing to the stockholders*. The court also stated that concern for non-stockholder interests is inappropriate when an auction is in progress and the object is no longer to protect the corporate enterprise. Indiana statute (§ 23-1-35-1) specifically states that "Certain judicial decisions in Delaware . . . are inconsistent with the proper application of the business judgment rule under this article."

Similarly, in *Norfolk Southern Corp.* v. *Conrail Inc.*, Civ.A.No. 96-7350, slip op. at 635 (E.D. Pa. Nov. 19, 1996), the Court noted that § 1715 of the Pennsylvania Business Corporate Law expressly states that the board should consider all affected entities including the corporation's employees, suppliers, customers, creditors and communities in which the corporation is located, as well as shareholders, with no group taking any particular precedence over any other.

vi. Bondholders. *See* Wyoming § 17-18-201.

vii. Long term vs. short term interests:

- New York (§ 717(b))

- New Jersey (§ 14A:6-1; 14A:6-14)

- Pennsylvania (§ 1715)

II. DUTIES OF MAJORITY OR CONTROLLING STOCKHOLDERS TO MINORITY.

A. Delaware Cases.

1. *Weinberger* v. *UOP, Inc.*, 457 A.2d 701 (Del. 1983) (cash merger with majority stockholder to eliminate 49.5% minority, conditioned on approval by a majority of the minority voting on the merger).

   a. Delaware Supreme Court explicitly overruled "business purpose" requirement for cash-out mergers of earlier line of cases following *Singer* v. *Magnovox*.

   b. In Delaware, the interested party seeking the merger generally has the ultimate burden of proving the "entire fairness" of the transaction, *Sealy Mattress Co. of N. J.* v. *Sealy Inc.*, 532 A.2d 1324 (Del. Ch. 1987), although the plaintiff still has an initial threshold burden to demonstrate some basis for the claim that the terms of the transaction are unfair to the minority, *Weinberger* v. *UOP Inc.*, 426 A.2d 1333, 1345 (Del. Ch. 1981), *rev'd on other grounds*, 457 A.2d 701 (Del. 1983).

   c. In Delaware, the transaction itself is generally judged under the "entire fairness" standard. The "entire fairness" test is defined to be both procedural ("fair dealing") and substantive ("fair price"). In the case of a tender or exchange, however, a claim based on unfair price alone generally is not sufficient to support a preliminary injunction. *See Solomon* v. *Pathe Communications Corp.*, 672 A.2d 35, 39-40 (Del. 1996) (as a general principle, Delaware law holds that "the determinative factor as to voluntariness is whether coercion is present, or whether there is materially false or misleading disclosures made to shareholders in connection with the offer. . . . Moreover, in the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue.").

   d. *See Kumar* v. *Racing Corp. of America*, C.A. No. 12039 (Del. Ch. Apr. 26, 1991), in which the Court of Chancery enjoined a proposed freeze-out merger on the grounds that the majority shareholder had breached its duties of entire fairness and due care in structuring and causing the approval of the merger (because representatives of the majority shareholder stood on both sides of the transaction, fixed its terms and caused it to be effectuated, the transaction was to be judged under the "entire fairness" standard).

   e. "Fair dealing" involves timing of transaction, how the process was initiated, structure, how it was negotiated, disclosure and how approvals of directors and stockholders were obtained.

   f. Approval of merger by an *informed* majority of the minority, where such is a condition to the merger, or by a committee of independent directors acting autonomously and aggressively shifts burden of proof to plaintiffs to show unfairness. *See generally*, Warden & Feit, *Reviewing the Work of Special Committees in Freeze-Out Transactions: Should the Business Judgment Rule Govern?*, M&A and Corporate Governance Law Reporter (Feb. 1991); *Cinerama, Inc.* v. *Technicolor, Inc.*, C.A. No. 7129, slip op. at 48 (Del Ch. Oct. 19, 1990); *Citron* v. *E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990); *Kahn* v. *Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994) *Arnold* v. *Society for Sav. Bancorp, Inc.*; *Kahn* v. *Tremont Corp.*, 694 A.2d 422 (Del. 1997) (burden did not shift, even though committee of supposedly independent directors advised buyer's board regarding fairness; two members of the committee failed to attend all the informational meetings and the third member had a long history of providing legal and advisory services to the controlling shareholder).

g. "Fair price." *See Solomon* v. *Pathe Communications Corp.*, 672 A.2d 35 (Del. 1995), in which the Delaware Supreme Court affirmed a Chancery Court opinion holding that, in the absence of coercion or disclosure violations, a controlling shareholder has no duty to offer a fair price in a voluntary tender offer. This is the first explicit holding by the Delaware Supreme Court to this affect. However, this ruling may be of only marginal significance to controlling shareholders who plan to follow their tender offer with a cash-out merger at the same price as the tender offer.

Court held that in non-fraudulent transaction, appraisal proceedings under § 262 of DGCL is exclusive remedy. However, it deemed the traditional Delaware valuation method (the combined weighted average of asset value, market price of stock and earnings) as "out-moded" and significantly broadened the factors Delaware courts may now consider in arriving at "fair value".

See Nebel v. *Southwest Bancorp, Inc.*, 1995 WL 405750 (Del. Ch.); *Cavalier Oil* v. *Harnett supra*; *In re: Appraisal of Shell Oil Co.*, C.A. 8080 (Del. Ch. December 11, 1990). Shareholders are entitled to their proportionate interest in a "going concern". Minority discount at shareholder level is contrary to requirement that company be viewed as going concern, however a minority discount at company level may be permissible in weighting of different valuation methodologies. *Appraisal of Shell Oil Co. See also Cinerama, Inc.* v. *Technicolor, Inc.* C.A. No. 7129 (Del. Ch. October 19, 1990).

For a recent case analyzing different valuation methodologies, *see LeBeau* v. *M.G. Bancorporation, Inc.*, 1998 WL 44993 (Del. Ch.).

h. *Bershad* v. *Curtis-Wright Corp.*, 535 A.2d 840 (Del. 1987). Court ruled that *Revlon* duties do not apply in the context of a parent-subsidiary merger. *See also Kleinhandler* v. *Borgia* (Del. Ch.) (*Revlon* duties inapplicable to freeze-out of 40% owned subsidiary).

Similarly, in *Williams* v. *Geier*, 671 A.2d 1368 (Del. 1996), the Delaware Supreme Court determined that neither the *Unocal* or *Blasius* standards applied where the board acted in the absence of a threat or act of disenfranchisement. The Court affirmed a Chancery Court summary judgment upholding as valid an amendment to Cincinnati Milacron's charter that provided for "tenure voting" -- each existing share would receive ten votes, but upon sale or other transfer, would revert to one-vote-per share status until held by its owner for three years. Milacron was controlled by the Geier family, which owned a little over 50% of its stock. Thus, the stockholder approval of the charter amendment was virtually assured. Moreover, the Geier family peculiarly benefited from the amendment because it permitted them to sell some of their shares without relinquishing control of the company.

The majority determined that, because the plan did "not involve <u>either</u> unilateral director action in the face of a claimed threat <u>or</u> an act of disenfranchisement . . . neither *Blasius* nor *Unocal* applie[d]." Rather, the majority concluded that the decision of the board to recommend the amendment was subject to business judgment rule review and that the plaintiff failed to rebut the presumption of the rule because at summary judgment he failed to demonstrate that the board's purpose in proposing the amendment was anything other than promoting the long-term stability of the company. The majority also rejected various arguments that the stockholder vote in favor of the plan was ineffective.

The dissent rejected the significance of an essentially meaningless shareholder vote that was arguably coercive -- the proxy statement disclosed that, because of the Geier control bloc, the amendment was virtually assured of passing but that, if it was not approved by two-thirds of the shares, the company's stock would be delisted by the NYSE. The dissent argued that a trial was necessary to determine if the board's purpose in recommending "tenure voting" was to either reduce the minority's voting powers (*Blasius*) or entrench the controlling shareholders (*Unocal*).

i. *Kahn* v. *Lynch*, 638 A.2d 1110 (Del. 1994). In *Kahn*, the Delaware Supreme Court reversed a Chancery Court decision holding that Alcatel U.S.A. Corp. ("Alcatel"), a 43.3% shareholder in Lynch Communication Systems, Inc. ("Lynch"), had not breached its fiduciary duties by instigating a cash-out merger of Lynch's minority shareholders. Although the Supreme Court agreed that Alcatel incurred fiduciary duties through the exercise of "actual control" over Lynch and, accordingly, bore the initial burden of demonstrating the entire fairness of the merger, the court rejected Alcatel's argument (and the Chancery Court's determination) that the approval of an independent committee of Lynch directors shifted the burden of proof to the shareholder-plaintiff to demonstrate that the merger was unfair. In doing so, the court held that for such burden-shifting to occur, (a) the controlling shareholder must not dictate the terms of the merger and (b) the special committee must have real bargaining power it can exercise on an arms-length basis. Applying that standard, the Court concluded that the shareholder committee appointed to negotiate the merger did not have sufficient bargaining power to warrant burden-shifting where, *inter alia*, Alcatel had demonstrated its willingness to block alternative transactions and threatened to commence a tender offer at a lower price if its final merger proposal was not accepted.

On remand, the Chancery Court held (1) that the Supreme Court's finding that the independent committee had been coerced into accepting the transaction did not preclude a determination that the transaction met the "entire fairness" test, and (2) that despite the absence of certain elements of fair dealing and Alcatel's failure to disclose that the independent committee had been coerced into accepting Alcatel's transaction, Alcatel satisfied its disclosure obligations and met both the "fair dealing" and the "fair price" elements of the "entire fairness" standard. *Kahn* v. *Lynch*, 1995 WL 301403 (Del. Ch. April 17, 1995), *aff'd* C.A. No. 8748 (Del. November 22, 1995). The Supreme Court also held that coercive conduct towards selling shareholders does not create liability *per se*; to be actionable the coercion must be a material influence on the decision to sell, as in the case of a squeezeout merger or a two-tiered tender offer.

j. *Mendel* v. *Carroll*, 651 A.2d 297 (Del. Ch. 1994). In *Mendel*, Chancellor Allen of the Delaware Chancery Court held that a board of directors was not required to issue a block of stock to dilute a shareholder's controlling interest in the corporation. The case arose after the Carroll family, controlling shareholder of Katy Industries, made a proposal to purchase the remaining Katy shares at $25.75, which was accepted by the Katy board. The Carroll family later withdrew its proposal after Pensler Capital Partners made a merger proposal for Katy at a price of $27.80 per share. The Pensler Capital proposal was conditioned on the board issuing sufficient stock to dilute the Carroll family's controlling interest. The board declined to issue the stock, thereby derailing the Pensler Capital bid because the Carroll family refused to sell its stock.

Plaintiffs argued that once the Katy board had agreed to the Carroll proposal, "*Revlon* Duties" were visited upon the board, which required to board to do all it could to secure the Pensler transaction, including diluting the Carroll family's controlling interest. The Court rejected this argument, holding that even though the Carroll proposal was for less value than the Pensler proposal, it still may have been "fair" because, unlike the Pensler proposal, it did not involve a purchase of control. The Court held that under these circumstances, the Katy board's fiduciary obligations did not require it "to deploy corporate power *against* the majority stockholders in the absence of a threatened serious breach of fiduciary duty by the controlling stock". The Court left open the possibility that circumstances could exist that would justify the extraordinary remedy of ordering a board to issue a dilutive block of stock, stating ". . . I continue to hold open the possibility that a situation might arise in which a board could, consistently with its fiduciary duties, issue a dilutive option in order to protect the corporation or its minority shareholders from exploitation by a controlling shareholder who was in the process or threatening to violate his fiduciary duties to the corporation . . . .".

k. *Kahn* v. *Tremont Corp.*, 694 A.2d 422 (Del. 1997). The board of Tremont, advised by an independent committee, approved the purchase of shares of NL held by Valhi, Inc. Valhi owned the majority of NL stock and controlled Tremont through its ownership of 44% of the shares. The Delaware Supreme Court held that the fact that two of the three members of the independent committee advising Tremont as to fairness did not regularly attend informational meetings and the third member had a long history of providing legal and advisory services to the controlling shareholder of Valhi, NL and Tremont meant that the burden of proving entire fairness remained with the buyer.

The Supreme Court held that Valhi was not required to disclose to Tremont that two other companies had rejected the offer to buy the shares, because such information was immaterial. The Supreme Court also held that Valhi had no duty to disclose that an investment advisory firm had issued an informal opinion that a 20% liquidity discount from market would be required in order to conclude the sale, "because the normal standards of arms-length bargaining do not mandate a disclosure of weaknesses".

2. Appraisal is *not* the exclusive remedy for challenge to a merger on grounds of "entire fairness" or "unfair dealing." See *Stauffer* v. *Standard Brands, Inc.*, 187 A.2d 78 (Del. 1962); *David J. Greene & Co.* v. *Schenley Industries*, 281 A.2d 30 (Del. Ch. 1971); *CEDE & Co.* v. *Technicolor, Inc.*, No. 18 (Del. June 10, 1988) (appraisal and fraud actions may be prosecuted simultaneously). *In re: Radiology Associates, Inc.*, C.A. No. 9001 (Del. Ch. May 16, 1990); *Nebel* v. *Southwest Bancorp, Inc.*, 1995 WL 405750 (Del. Ch.).

3. *Lynch* v. *Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977), on remand 402 A.2d 5 (Del. Ch. 1979) (majority stockholder making tender offer has duty to make "full and frank disclosure"; finding of fair price on remand). *See also Zirn* v. *VLI Corp.*, Fed. Sec. L. Rep. (CCH) P95,862 (Del. Ch. 1991) (a tender offeror that became a majority stockholder of the target company upon completion of the offer thereby acquired a fiduciary duty to non-tendering stockholders. No fiduciary duty prior to that time).

4. In *Joseph* v. *Shell Oil Co.*, 482 A.2d 335 (Del. Ch. 1984), the Chancery Court enjoined a tender offer for Shell Oil Co. by its majority shareholder, the Royal Dutch Shell Group; the court rejected the contention that a majority shareholder has a duty to offer a fair price in a tender offer, since all shareholders are free to accept or reject the offer. Since the burden of "complete candor" requires disclosure of all germane facts with respect to the tender offer and the offeror's subsequent plans, and since the court found that the majority shareholder had failed to disclose certain critical information necessary to make an informed investment decision, shareholders were thereafter provided with a limited right of rescission. *See also Solomon* v. *Pathe Communications Corp.*, 1995 WL 250374 (Del. Ch. April 21, 1995) (majority shareholder has no obligation to

make a tender offer at a "fair price" so long as a free choice to accept or reject the tender offer is present).

5. Control (and fiduciary obligations) can be found in a less than 50% stockholder. In re: Tri Star Pictures, Inc. Litigation, 634 A.2d 319 (Del. 1993) (Coca Cola, 36% stockholder, loses motion to dismiss breach of fiduciary duty claims based on possible influence over directors).

B. New York Cases.

1. *Willcox* v. *Stern*, 18 N.Y.2d 195, 273 N.Y.S.2d 38 (1966) (cash merger to eliminate 3% minority; finding of fairness by Superintendent of Insurance; held, minority has no right to continue as stockholders).

2. *People* v. *Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (N.Y. Cty. 1975), *aff'd* (4-1), 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (lst Dept. 1975) (following public offering at $25 per share in 1968, the stock fell and in 1975 the majority (68%) stockholders proposed to eliminate the minority for $3 per share; in suit by Attorney General to enjoin "fraudulent practices", injunction was granted where no "real corporate purpose" was demonstrated).

3. *Tanzer Economic Associates, Inc. Profit Sharing Plan* v. *Universal Food Specialties, Inc.*, 87 Misc. 2d 167, 383 N.Y.S.2d 472 (N.Y. Cty. 1976) (short-form merger after tender offer providing for same price; court refused to issue injunction where no showing of fraud, illegality, concealment or nondisclosure of material facts, etc.).

4. *Bosee* v. *Babcock International Inc.*, No. 17370/77 (N.Y. Sup. Ct. 1978), *aff'd*, 410 N.Y.S.2d 1008 (App. Div. 1978) (holds that, under New York law, "appraisal is the only remedy afforded dissenting stockholders in a [short-form] merger, absent extraordinary circumstances").

5. *Alpert* v. *28 Williams St. Corporation*, 63 N.Y.2d 557; 473 N.E.2d 19; 483 N.Y.S.2d 667 (1984) - A unanimous Court of Appeals held, in the context of a two-step cash-out merger, that the transaction viewed as a whole must be fair, and that variant treatment of the minority shareholders will be sustained only if related to the advancement of an independent corporate purpose.

C. "Going Private" under Federal Laws.

1. *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) (holds that no cause of action exists under Rule l0b-5 where a Delaware short-form merger is effected without any business purpose, since Rule l0b-5 requires only full and fair disclosure and not fairness of the transaction).

2. Rule l3e-3; applies where issuer or an affiliate undertakes a merger, purchase of stock, reverse stock split or other transaction that results in delisting from a national exchange, removal from NASDAQ or non-reporting status -- *i.e.*, the corporation "goes private"; detailed, burdensome and extensive disclosure

requirements, including statement of opinion whether transaction is fair, together with reasons, and disclosure of any valuation opinions received. Broadly speaking, there are two general exceptions to the application of Rule 13e-3:

a. "unitary" transactions -- second-stage transactions occurring within one year of the termination of a tender offer in which "affiliate" status was established where the consideration offered is at least equal to the highest consideration offered in the tender offer, provided this was disclosed in the initial tender offer. Rule 13e-3(g)(1);

b. similar equity security -- securityholders receive only an equity security having substantially the same rights as the equity security removed, and the issuer files reports under the 1934 Act. Rule 13e-3(g)(2);

c. SEC Release No. 34-17719 provides guidance on how to structure certain multi-step acquisitions to avoid Rule 13e-3 application. *See* (c) below.

3. The Commission proposed in 1981 to broaden the "unitary" transaction exception to conform to "no-action" positions taken by the staff with respect to transactions involving the purchase, other than by means of a tender offer, of a controlling interest in a class of equity securities of an issuer prior to the acquisition of the remaining outstanding shares. The exception requires that certain conditions be met which relate to the timing of the steps, the consideration offered and the lack of affiliation between the issuer and the acquiring entity prior to entry into a binding agreement or agreements to acquire all of the outstanding stock. Although the proposed broadened exception of Rule 13e-3(g)(1) was never adopted, it is still possible to get "no-action" relief with respect to such transactions.

4. The Commission is taking an increasingly expansive view of the reach of 13e-3 -- *e.g.*, the merger of The Continental Group was held to be a going-private transaction merely because two representatives of the acquiror went on Continental's Board of Directors after the execution of the merger agreement. In situations where a party's status as an "affiliate" is not clear, the Commission has taken the position that affiliation cannot be eliminated by attempting to conduct arms' length negotiations. Recently, the Commission has taken the position that an acquiror which is a large stockholder with board representation and significant business relationships with the target has a sufficient enough ability to influence the management and policies of the target to constitute control for purposes of the definition of affiliate.

5. The Commission is also taking an increasingly stringent view of the disclosure required by 13e-3 -- *e.g.*, great detail must be given with respect to the investment bankers' presentations and all materials prepared by them and given to the Board must be filed as exhibits; the Commission is also requiring such disclosure and filing of exhibits with respect to presentations and reports given to the acquiror.

6. The Sixth Circuit has held that there is a rebuttable presumption that any information required to be disclosed by Schedule 13E-3 is material in a

Section 14(a) damages action. *Howing Co.* v. *Nationwide Corp.*, No. 89-4084 (6th Cir. Mar. 6, 1991) (Item 8 of Schedule 13E-3 creates a presumption that a discussion of book, going concern and liquidation value would be material to a reasonable shareholder).

7. The SEC has recently adopted extensive disclosure requirements for "roll-up" transactions involving the combination or reorganization of limited partners' interests for securities of or interests in successor entities, and the President signed into law in December 1993 a Roll-Up Statute passed by Congress.

D. Other Cases.

1. *Zahn* v. *Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947) (redemption of class A common stock at $80.80 per share followed by liquidation in which the class A stockholders, had they converted into class B, would have received $240 gave rise to cause of action by class A stockholder for breach of board's fiduciary duty; controlling shareholder may not use that control to avoid equitable distribution of corporate assets).

2. *Sterling* v. *Mayflower Hotel Corp.*, 93 A.2d 107 (Del. 1952) (merger of 83% owned subsidiary into parent; Court found that parent met the burden of establishing the transaction's "entire fairness").

3. *Jones* v. *H.F. Ahmanson & Co.*, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (Justice Traynor articulates an expansive fiduciary duty of majority to minority; such a duty also exists when no sale or transfer is directly involved, such as here, where majority used its power to exclude the minority from a trading market. Here, majority holders of U.S. Savings & Loan Ass'n created a Delaware holding company -- United Financial -- and then went public; so anyone interested in Ass'n stock bought stock of United Financial, thereby ending trading market in Ass'n stock. United Financial then offered to buy out the Ass'n holders at a very low price; the offer was refused and Ass'n holders sued and the court held that majority's actions breached their fiduciary duty).

4. *Sinclair Oil Corp.* v. *Levien*, 280 A.2d 717 (Del. 1971) (97% owned subsidiary had a contract with 100% owned subsidiary; breach of contract action was judged by "intrinsic fairness standard"; parent failed to meet burden of proof that decision not to enforce contract was intrinsically fair to minority shareholders).

E. Leveraged Buyouts.

1. Normally a transaction in which management and principal shareholders (who may be one and the same) combine with outside investors to buy out the remaining shareholders, using a significant amount of secured and unsecured debt and/or preferred stock to fund the acquisition. Since January 1991, credit conditions have made these transactions very difficult to arrange.

2. Usually takes the form of a merger where newly formed company owned by "insiders" is merged with existing company and remaining shareholders are cashed out.

3. Because most LBOs involve affiliates of "acquired" company, the same Federal and state law questions of disclosure and "fairness" are usually present.

4. To enhance proof of "fairness", transactions are now generally structured so that a special committee of "independent" directors is created, with its own legal and financial advisors, to negotiate on behalf of the "public" shareholders.

5. A former SEC Commissioner, Bevis Longstreth, has criticized the failure of the current Federal and state laws (including the *Weinberger* decision) to assure that public shareholders get fair market value for their shares in leveraged buyouts.

   a. As a result of recent developments, it is clear that a management LBO cannot be entered into unless an auction has been conducted first or LBO bid is structured to allow for a subsequent "market test" (*In re Fort Howard Corporation Shareholders Litigation*, Civ. A. No. 9991 (Del. Ch. Aug. 8, 1988) (LEXIS, Del. Library, Del Ch. File) *appeal denied*, 547 A.2d 633 (Del. 1988); *In re KDI*; *In re Formica*.

   b. Should "acquired" company be able to agree with buyout group that it will not solicit other buyers? *Edelman* v. *Fruehauf Corporation*, 798 F.2d 882 (6th Cir. 1986), invalidated, among other things, an absolute "no-shop" agreement by the company. *Samjens Partners* v. *Burlington Industries*, 663 F. Supp. 614 (S.D.N.Y., 1987) allowed "window shop" agreement, foreclosing *solicitation* of bids but not responses to unsolicited offers. Consider Del. Supreme Court views in *Paramount*.

   c. Should issuer be able to grant an option on unissued stock, or other forms of financial assistance, to the buyout group essentially "locking-up" the company? In *Fort Howard*, court allowed $1.00 per share break-up fee in return for LBO management group agreeing to "market test" (*i.e.*, LBO group had to keep tender offer open for 30 business days, during which time Board was allowed to consider and provide information to any third parties interested in competing). After *Paramount*, lock-ups are certain to come under "enhanced" judicial scrutiny. In *Burlington*, the court allowed a breakup fee equal to 2% of the value of the transactions.

   d. Should the Company be able to grant "crown jewel" lock-ups to buyout group? *See Revlon* and *SCM. Macmillan* allows such a grant during an auction only if the Board properly perceives that such favoritism will enhance shareholder interests and the action is reasonable in relation to the goal sought to be achieved (*i.e.*, obtaining the highest price for the Company).

   e. Should investment bankers be able to give "fairness" opinions where they have not "shopped" the company? Is disclosure of this fact enough?

f. Is the use of "outside directors" to negotiate on behalf of the public shareholders adequate protection? *Fruehauf*; *Fort Howard*; *Macmillan* suggest that direct negotiation by outside directors, independently advised, is essential. *See generally*, Warden & Feit, *Macmillan: Outside Directors and Other Observations*, Mergers and Acquisitions Law Reporter (June 1989).

g. "Fairness" of auction process. Courts have allowed some disparity of treatment. In *Burlington*, court did not require the company to provide confidential data to Edelman since he refused to sign the same confidentiality agreement (with a standstill) that all other bidders signed.

F. Sale of Control -- Sale of a Controlling Interest at a Premium.

1. If other stockholders are not given the opportunity to participate, do they have a remedy? Absent "special circumstances", probably not. *See Zetlin* v. *Hanson Holdings, Inc.*, 48 N.Y.2d 684 (1979); O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. Pgh. L. Rev. (1976). *Citron* v. *Steego*, C.A. No. 10171 (Del. Ch. Sept. 9, 1988) (large stockholder could obtain control premium).

2. Cases involving looting; *e.g.*, *Insuranshares Corp.* v. *Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *Gerdes* v. *Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941) (investment companies); *Harris* v. *Carter*, C.A. No. 8768 (Del. Ch. May 4, 1990) (controlling shareholder can be liable for negligently selling shares to a purchaser who then loots the company).

3. *Perlman* v. *Feldman*, 219 F.2d 173 (2d Cir. 1955) ("We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do this with impunity when the buyer is an interested customer, actual or potential, for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate goodwill and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains.") *See also Jones* v. *H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (". . . majority shareholders . . . have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority"); Berle theory that "control" is a "corporate asset", *see* Berle & Means, *The Modern Corporation and Private Property* (1932), has not generally been followed in the courts, *see, e.g., Honigman* v. *Green Giant Co.*, 208 F. Supp. 754 (D. Minn. 1961), *aff'd* 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963). *See* also Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965), for another theory that has not attained widespread acceptance. ("A controlling stockholder should not be free to sell, at least to an outsider, except pursuant to a purchase offer made equally to other stockholders; or, put in the affirmative, that one of the rights of minority stockholders is to have an equal opportunity, with all other stockholders to participate ratably in any sale of shares pursuant to a favorable

offer for the purchase of controlling shares in their corporation.") *See, e.g.* *Clagett* v. *Hutchison*, 583 F.2d 1259 (4th Cir. 1978); *Zetlin* v. *Hanson Holdings, Inc.*, 421 N.Y.S. 2d 877, 397 N.E.2d 387 (1979), rejecting Andrews proposition.

4. *Thorpe* v. *CERBCO, Inc.*, where the Delaware Chancery Court denied defendants' motion for summary judgment where plaintiffs alleged that two controlling stockholders of CERBCO, who were also officers and directors, had attempted to usurp a corporate opportunity by precluding a sale of CERBCO's holdings to a third party in order to pursue a sale of their own stock. The court held that if the sale of defendants' shares constituted a sale of substantially all CERBCO's assets, thus triggering a shareholder vote under Del. § 271, defendants were free to act in their capacity as shareholders to pursue a transaction in their own best interest even where alternatives would have better served the interests of minority shareholders. If a shareholder vote was not required, however, the court held that defendants could be liable as officers and directors for breaching their duty of loyalty by attempting to divert a corporate transaction to their personal benefit.

5. Narrow applicability of Rule l0b-5; *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952); theory that Rule 10b-5 applies only to an injury suffered in connection with the purchase or sale of securities (*i.e.*, non-purchaser and non-seller have no cause of action under Rule 10b-5) affirmed in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). However, 1934 Act § 13(d) provides for disclosure of identity of 5% beneficial owners and plans and intentions.

6. "Sale of Corporate Office" -- changes in the Board of Directors incident to sale of control are generally upheld where shares are sold. (Question often arises in connection with investment companies.) *See SEC* v. *Insurance Securities*, 254 F.2d 642 (9th Cir. 1958); compare *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971), *cert. denied* 409 U.S. 802 (1972). *But see* 1934 Act § 14(f).

SULLIVAN & CROMWELL

November 4, 1999

MEMORANDUM

Three Recent Delaware Rulings Address "No-Talk" Provisions in Stock-for-Stock Mergers

Three recent Delaware Court of Chancery rulings on motions for injunctive relief highlight the Court's sensitivity to the fiduciary duty implications of "no-talk" provisions in stock-for-stock merger agreements. No-talk provisions can either strictly prohibit a party from engaging in discussions with third parties concerning alternative business combination transactions, or merely limit the circumstances under which such discussions can take place. The rulings indicate that a court applying Delaware law is likely to scrutinize carefully a board of directors' decision to enter into a strict no-talk provision (*i.e.*, one which does not contain any type of "fiduciary out"), even if the transaction can be deemed a "strategic merger."

In a bench ruling on plaintiff's motion for a preliminary injunction in *Phelps Dodge Corporation* v. *Cyprus Amax Minerals Company* (Civ. Act. No. 17398),* the Court stated that the decision by the boards of directors of defendants Cyprus Amax and Asarco to enter into a strict no-talk provision likely constituted a breach of the boards' duty of care, notwithstanding the fact that Delaware courts have long held that absent special circumstances a stock-for-stock merger does not constitute a sale of control and therefore does not trigger a board's so-called *Revlon* duties.** (Under the *Revlon* doctrine, in the context of a transaction that constitutes a sale of control of the corporation, the board's duty is to negotiate the best price reasonably available for the stockholders and the board may not, by adopting "deal protection" mechanisms or otherwise, take action that would thwart its ability to satisfy that duty.) Although the Court confirmed that the Cyprus Amax and Asarco boards did not have a duty to negotiate with a third party, the Court stated that the boards' decision not to negotiate must be an informed one. According to the Court, by agreeing in the merger agreement not to engage in discussions with any third parties, the Cyprus Amax

* *Cyprus Amax* was the subject of our Memorandum dated September 29, 1999.

** *See Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *Arnold* v. *Society for Savings Bancorp, Inc.*, 678 A.2d 533 (Del. 1996).

and Asarco boards had completely foreclosed the opportunity to engage in non-public discussions with Phelps Dodge and had essentially bargained away their right even to become informed about whether or not to negotiate. The Court stated that this was the "legal equivalent of willful blindness, a blindness that may constitute a breach of a board's duty of care." Despite this reasoning, the Court held that an injunction was unavailable because the probability of irreparable injury had not been shown. The bench ruling did not discuss the negotiating process that culminated in the no-talk provision or address the applicability of the business judgment rule.

In *ACE Limited* v. *Capital Re Corporation* (Civ. Act. No. 17488), the Court was faced with a target company that had received a superior proposal and two competing readings of a no-talk provision in the merger agreement that contained a fiduciary out. Capital Re, the target company, asserted that the no-talk provision left it to the board to decide whether its fiduciary duties required it to enter into discussions with third parties, based on advice it received from legal and financial advisors. ACE asserted that the provision allowed the Capital Re board to engage in discussions only if it received written legal advice opining that its fiduciary duties "required" such discussions.* Finding Capital Re's reading persuasive, the Court held that ACE would be unlikely to prevail on the merits and denied ACE's request for a temporary restraining order against Capital Re's termination of the agreement.**

The Court, however, went on to analyze the no-talk provision under the assumption that ACE's reading of the fiduciary out was correct, and expressed its view that in that case the no-talk provision would likely be found invalid. Such a provision, the Court reasoned, "comes close to self-disablement by the board" and "involves an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company in which the board's own judgment is most important." In forming its view, the *Capital Re* Court was apparently influenced by the fact that approximately 46% of the outstanding shares of Capital Re's common stock were either held by ACE, or were

* The Court noted that ACE had not brought a suit against XL Capital (the competing bidder) alleging tortious interference by XL Capital with the merger agreement. In strongly worded *dicta*, the Court stated that in the context of a merger agreement with a fiduciary out such a claim would be "farfetched, if not outrageous."

** The Court stated that "although [the no-talk provision is] perhaps not so clear as to preclude another interpretation, [it] is on its face better read as leaving the ultimate 'good faith' judgment about whether the board's fiduciary duties required it to enter into discussions with XL Capital to the board itself. Though the board must 'base' its judgment on the 'written advice' of outside counsel, the language of the contract does not preclude the board from concluding, even if its outside counsel equivocates (as lawyers sometimes tend to do) that such negotiations are fiduciarily mandated."

"locked up" by voting arrangements that could not be terminated -- and would effectively ensure consummation of the merger notwithstanding the existence of a superior proposal -- unless the Capital Re board could terminate the merger agreement.

Vice Chancellor Steele's opinion in *In re IXC Communications, Inc. Shareholders Litigation* (Consolid. Civ. Act. Nos. 17324 and 17334) was issued only two days after Vice Chancellor Strine's *Capital Re* opinion. The no-talk provision at issue in *IXC* was amended in light of *Cyprus Amax* to add a fiduciary out that permitted either party to "participate in discussions" regarding any superior proposal for the purpose of deciding whether to change its recommendation to stockholders. Unlike *Capital Re*, a superior proposal never emerged, so the meaning and enforceability of the fiduciary out in *IXC* was not at issue. In moving to preliminarily enjoin the stockholder vote on the merger agreement, the *IXC* plaintiffs alleged (among other things) that the pre-amendment version of the no-talk provision somehow evidenced a pattern of "willful blindness" on the part of the IXC board of directors. Stating that no-talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty," the Court was "comfortable concluding that the IXC board met its duty of care" in view of the facts that the board had conducted an auction process for nearly six months and that the fiduciary out allowed the IXC board to participate in discussions concerning superior proposals. The Court went on to find that the IXC's board's decision to approve a termination fee, stock option agreements and certain voting and stock purchase arrangements which "locked up" approximately 40% of IXC's outstanding common stock was entitled to deference under the business judgment rule, and injunctive relief was denied.

The decisions in the *Cyprus Amax*, *Capital Re* and *IXC* cases appear to be influenced substantially by the cases' respective factual records. Certain aspects of the decisions in *Capital Re* and *IXC* are particularly difficult to reconcile, however, and the clarification of certain issues will be possible only as a result of further developments in these cases or as the result of decisions in other cases. Nevertheless, it is possible to identify certain factors of significance in the Court of Chancery's evaluation of no-talk provisions in stock-for-stock merger agreements.

First, although it is not clear that *Cyprus Amax* should be interpreted as an absolute ban on no-talk provisions that do not contain fiduciary outs, both *Capital Re* and *IXC* make clear that provisions which include fiduciary outs are significantly more likely to withstand the scrutiny of courts applying Delaware law. Second, a board that decides to enter into a strict no-talk provision should be prepared to convince the court that it has satisfied its duty of care by conducting a thorough "market check" before entering into such a provision and that other provisions do not preclude an informed stockholder vote. The Court in *IXC* based its finding that the board discharged its duty of care not only on the fact that the no-talk provision, as later amended, contained a fiduciary out, but also on the fact that IXC had negotiated with various purchasers. Indeed, according to the Court in *Capital Re*, "one legitimate circumstance" in which a board could prudently place itself in the position of not being able to entertain and consider a superior proposal "may be where a board has actively

canvassed the market, negotiated with various bidders in a competitive environment and believes that the necessity to close a transaction requires the sales contest end."

The relative importance of other "deal protection" provisions to the analysis of no-talk clauses in stock-for-stock merger transactions is not completely clear. Although the Court in *Capital Re* was apparently troubled by the fact that approximately 46% of Capital Re's stock was "locked up," therefore making the fiduciary out the only practical escape clause under the contract, the fact that approximately 40% of IXC's stock was similarly "locked up," even when combined with a termination fee and stock option agreements, did not produce a holding that the IXC board had failed to discharge its duty of care. In any event, the Court in each of *Capital Re* and *IXC* followed earlier Delaware cases in examining the provisions in question and the other deal protection provisions as a totality, suggesting that the interrelation among all of the deal protection features of a given merger transaction must be given careful consideration.

Finally, the appropriate legal framework under which no-talk provisions should be evaluated in the context of stock-for-stock mergers is not clear. The *Capital Re* decision does not even allude to the business judgment rule, and contains *dicta* to the effect that a no-escape no-talk provision might constitute an unreasonable preclusive and defensive obstacle within the meaning of *Unocal*,* implying that an enhanced level of scrutiny and a more rigorous standard of review are appropriate. In *IXC*, however, the Court addressed not just the no-talk provision, but also the termination fee and the stock option agreements, and stated that as none of these mechanisms was instituted to respond to a perceived threat from a potential acquiror, "enhanced judicial scrutiny does not apply and entire fairness is not the standard of review." According to the *IXC* Court, in the absence of a showing of disloyalty or lack of care, these provisions "are reviewable as business judgments and are, thus, granted deference." Further development of the caselaw will be necessary to reconcile *Capital Re* with *ICX*.

Clients with questions concerning issues raised by the Court of Chancery rulings are encouraged to contact any of James C. Morphy, John L. Hardiman, Joseph B. Frumkin, Mitchell S. Eitel or Matthew G. Hurd, all of our New York office, at (212) 558-4000.

SULLIVAN & CROMWELL

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* *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

SULLIVAN & CROMWELL

November 9, 1999

MEMORANDUM

Re: SEC Adopts Final Exemptive Rules for Cross-Border Tender Offers, Business Combinations, and Rights Offerings

On October 22, 1999, the Securities and Exchange Commission (the "SEC")* adopted a number of exemptive rules that would facilitate participation by U.S. holders of the securities of non-U.S. companies in cross-border tender offers, business combinations, and rights offerings. The adoption of these rules culminates the SEC's efforts in this area which began in 1990.

The rules as adopted reflect certain modifications suggested by commenters on the proposed rules** and become effective on January 24, 2000.

SUMMARY

The rules, which are discussed in more detail below, provide that:

- Tender offers for the securities of non-U.S. issuers generally could be made on the basis of the applicable regulations of the target issuer's home jurisdiction when U.S. holders (as defined below) hold ten percent or less of the class of securities sought (the "Tier I" exemption).

* Release Nos. 33-7759, 34-42054, 39-2378, International Series Release No. 1208; File No. S7-29-98; __ Fed. Reg. _____ (October 22, 1999) (the "Adopting Release").

** The proposed rules were made in Release Nos. 33-7611, 34-40678, International Series Release No. 1171; File No. S7-29-98; 63 Fed. Reg. 69136 (November 13, 1998) (the "1998 Release"). See also our Memorandum dated December 7, 1998 discussing the 1998 Release.

- Limited exemptions from the U.S. tender offer requirements would be available to allow tender offers for securities of non-U.S. issuers when U.S. holders hold forty percent or less of the class of securities sought, without the need to obtain case-by-case relief to harmonize conflicting rules (the "Tier II" exemption).

- Rights offerings by non-U.S. issuers generally could be made on the basis of applicable regulations of the target issuer's home jurisdiction when U.S. holders hold ten percent* or less of the class of securities sought (the "Rule 801" exemption).

- Exchange offers for the securities of non-U.S. issuers generally could be made on the basis of applicable regulations of the target issuer's home jurisdiction when U.S. holders hold ten percent or less of the class of securities sought (the "Rule 802" exemption).

- Under certain circumstances, tender offers for the securities of non-U.S. issuers would be exempt from new Rule 14e-5 (formerly Rule 10b-13)** to allow purchases outside the tender offer when U.S. holders hold ten percent or less of the class of securities sought.

Qualifying for the new exemptions will in certain cases require the offeror to make filings with or furnish information to the SEC and to observe certain U.S. procedural requirements. These procedural requirements, however, are significantly less extensive than the SEC requirements currently applicable to these transactions.

* The percentage threshold proposed in the 1998 Release for the Rule 801 exemption and the Rule 802 exemption was five percent. In raising this percentage, the Adopting Release notes that when U.S. security holders own ten percent or less of the issuer, the participation of U.S. holders is generally not necessary for the offer to be successful. As a result, the SEC found that U.S. security holders are commonly excluded when the U.S. ownership is below the ten percent level.

** New Rule 14e-5 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), was adopted in a separate release that updates and simplifies the rules and regulations applicable to takeover transactions. See Regulation of Takeovers and Security Holder Communications, Release Nos. 33-7760, 34-42055, IC-24107; File No. S7-29-98; __ Fed. Reg. _____ (October 22, 1999) (the "Regulation M-A Release"). We are distributing a separate Memorandum discussing the Regulation M-A Release.

The general antifraud and civil liability provisions of the U.S. federal securities laws, which relate principally to material misstatements and omissions, will continue to apply to any tender or exchange offer or rights offering made to U.S. security holders. In view of the requirement that written information be disseminated to U.S. security holders or published in the United States if it is used in the home jurisdiction, tender offer materials and offering documents in transactions which are exempt under the new rules will need to be prepared with the potential for liability under U.S. law in mind.

I. BACKGROUND

The Adopting Release notes that U.S. security holders are commonly excluded from tender and exchange offers, business combinations and rights offerings involving non-U.S. issuers. In order to avoid the application of the U.S. securities laws, bidders and issuers will exclude U.S. security holders from these transactions. This, the Adopting Release notes, is particularly true when U.S. security holders own a small percentage of the outstanding shares of the non-U.S. foreign private issuer. The SEC is concerned that by excluding U.S. security holders from tender or exchange offers, U.S. security holders are denied the opportunity to receive a premium for their securities. In the case of rights offerings, U.S. security holders that are excluded from such offerings lose the opportunity to purchase shares at a possible discount from the market price.

In order to facilitate the inclusion of U.S. holders in such transactions, the Adopting Release sets forth an approach that will permit qualifying offers to be extended to U.S. holders on the basis of home country requirements in cases where U.S. investors own a small percentage of the securities sought, subject to compliance with the general antifraud provisions of the U.S. federal securities laws. Given this relief, non-U.S. offerors and issuers would presumably be encouraged to extend more offers to U.S. holders in these circumstances. To implement this approach, the SEC has issued the rules described in the Adopting Release.

II. TENDER AND EXCHANGE OFFERS; RIGHTS OFFERINGS

A. Tender Offers

1. Tier I Exemption

The Adopting Release exempts from the procedural and disclosure requirements of the Williams Act* any issuer or third-party tender offer for a class of securities of a foreign private issuer**, regardless of the nationality of the bidder***, if all of the following conditions are satisfied:

- U.S. holders hold ten percent or less of the subject class.
- In the case of a class of securities subject to Rule 13e-4 or Regulation 14D under the Exchange Act, bidders submit (but not "file"****) an English language translation of the offering materials to the SEC under cover of Form CB and file a consent to service on Form F-X.*****
- U.S. holders (including holders of American Depositary Receipts ("ADRs")) are permitted to participate in the offer on terms at least as

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* Primarily Sections 14(d), 14(e) and 14(f) of the Exchange Act, which principally relate to tender offers.

** The term "foreign private issuer" is defined to mean any foreign (i.e., non-U.S.) issuer other than a foreign government and other than an issuer with more than fifty percent of its outstanding voting securities held of record by U.S. residents that also has: (i) U.S. citizens or residents making up a majority of its executive officers or directors; (ii) more than fifty percent of its assets located in the United States; or (iii) its business administered principally in the United States.

*** U.S. offerors would be eligible for this relief on the same basis as non-U.S. offerors.

**** Liability under Section 18 of the Exchange Act for making false and misleading statements with respect to material facts in documents "filed" with the SEC under the Exchange Act would not apply. However, the antifraud provisions of the federal securities laws other than Section 18 would still apply.

***** The Form CB must be received by the SEC no later than the next business day after the tender offer has commenced. If the bidder is a non-U.S. company it must also file a Form F-X to appoint an agent for service of process in the United States.

favorable as those offered to any other holder of the subject class, subject to permitted exceptions as discussed below.

- Dissemination of the tender offer circular or disclosure document, to the extent required by the target's home jurisdiction, is made to U.S. security holders on a comparable basis as provided to security holders in the target's home jurisdiction, except that any offering circular or disclosure document disseminated in the United States must be in English and, where dissemination is made by publication, the offeror must simultaneously publish the offering materials in the United States.

Satisfaction of the above conditions would exempt the tender offer from the disclosure, filing, dissemination and minimum offering period requirements, proration and withdrawal rights, and other requirements of the Williams Act and the tender offer rules, except that the general antifraud provisions would still apply.

An exception to the equal treatment rule discussed above would permit the bidder to offer U.S. holders only cash if the bidder has a reasonable basis to believe that the cash consideration is substantially equivalent to the value of the securities offered to non-U.S. holders. If the offered security is not a "margin security" within the meaning of Regulation T,* the offeror must provide, upon the request of the SEC or a U.S. security holder, an opinion from an independent expert stating that the cash-only consideration is substantially equivalent to the securities and any cash offered outside the United States. If the offered security is a "margin security" within the meaning of Regulation T, such an opinion is not required.** Under this exception, the substantially equivalent value

* The term "margin security" includes: (1) any security registered or having unlisted trading privileges on a national securities exchange; (2) after January 1, 1999, any security listed on the Nasdaq Stock Market; (3) any non-equity security; (4) any security issued by either an open-end investment company or unit investment trust which is registered under Section 8 of the Investment Company Act of 1940 (the "Investment Company Act"); (5) any foreign margin stock; or (6) any debt security convertible into a margin security.

** In this case, the offeror must undertake to provide any U.S. holder or the SEC staff, upon request, information on recent trading prices of the offeror's securities.

determination is to be made at the commencement of the offer and the amount of cash consideration must be adjusted during the term of the offer if the bidder no longer has a reasonable basis to believe the cash is substantially equivalent to the value of other consideration offered to non-U.S. holders.

2. Tier II Exemption

Under the Tier II exemption, eligible tender offers would be entitled to limited exemptive relief from the U.S. tender offer rules to minimize conflicts with non-U.S. regulatory schemes. To be eligible for the Tier II exemption, the tender offer must be for the securities of a foreign private issuer and U.S. security holders of record must hold forty percent or less of the class of securities sought in the tender offer*. The exemptive relief provided under the Tier II exemption consist of the following:

- <u>All Holders/Best Price Rule</u>: A bidder may divide its offer into two separate offers if the offer to U.S. holders is made on terms at least as favorable as those offered to any other holder of the subject class.** In this instance, the U.S. offer would comply with the U.S. regulatory scheme and would be limited to U.S. security holders and the non-U.S. offer would comply with the home jurisdiction rules and would exclude U.S. security holders.

- <u>Notice of Extensions</u>: A bidder may announce extensions of the offer in accordance with the practices of its home jurisdiction, rather than before the commencement of trading on the next business day as is required by the U.S. rules. However, the rules do not provide relief from the

* When U.S. ownership exceeds forty percent, the SEC will consider relief on a case-by-case basis when there is a direct conflict between the U.S. laws and practice and those of the home jurisdiction. In such an instance, the bidder (as in the past) must submit a written application requesting relief, along with a discussion of the basis for the request. Any relief granted by the SEC would be limited to what is necessary to accommodate conflicts between the regulatory schemes and practices.

** A bidder may offer loan notes only to non-U.S. holders. However, the "cash only" exception to the equal treatment condition of the Tier I exemption is not applicable to Tier II offers.

requirement that all tender offers must provide mandatory extensions for certain changes in the terms of the offer.*

- Prompt Payment for or Return of Tendered Securities: A bidder will meet the requirements for prompt payment for, or return of, tendered securities if it complies with the home jurisdiction requirements and practice.

- Reduction of Minimum Condition: A bidder may reduce or waive the minimum acceptance condition without extending withdrawal rights during the remainder of the offer (unless an extension is required by Rule 14e-1), if, among other things, the bidder announces through a press release or otherwise, that it may reduce the minimum condition five business days prior to the time it reduces such condition.**

Thus, although a bidder must still comply with the U.S. tender offer rules, the Tier II exemption would provide the bidder with the exemptive relief outlined above without requiring the bidder to submit a written application to the SEC.

The 1998 Release had also proposed exemptive relief relating to the commencement of the offer and withdrawal rights. In the Regulation M-A Release, the requirement that a cash tender offer commence or be withdrawn within five business days of announcement has been rescinded. An offer will now be deemed to commence once a bidder disseminates transmittal forms or discloses instructions on how to tender into an offer. In addition, the Regulation M-A Release adopted a proposal with respect to withdrawal rights that would permit a third-party bidder in both domestic and foreign transactions to provide at its election for a "subsequent offering period" without withdrawal rights.

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* In the 1998 Release, the SEC indicated that it was not aware of any jurisdiction where the U.S. duration and extension periods conflicted with those of the home jurisdiction. Even though some jurisdictions permit a shorter time period, the SEC noted in the 1998 Release that those home jurisdiction rules do not prohibit the bidder from keeping the offer open or extending the offer for a longer period of time.

** The SEC stated that a statement at the commencement of the offer that the bidder may reduce the minimum condition would not be sufficient.

B. Exchange Offers, Business Combinations and Rights Offerings

The Adopting Release provides exemptions from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), for securities issued to U.S. security holders of a foreign private issuer in exchange offers, business combinations*, and rights offerings. The target company (or the issuer in an issuer tender offer or rights offering) must be a foreign private issuer.

- Rule 801 provides an exemption from Securities Act registration for rights offerings that are made on the basis of applicable regulations of the issuer's home jurisdiction when U.S. holders hold ten percent or less of the class of securities sought.

- Rule 802 provides an exemption from Securities Act registration for exchange offers for the securities of non-U.S. issuers that are made on the basis of applicable regulations of the target issuer's home jurisdiction when U.S. holders hold ten percent or less of the class of securities sought.

If the conditions to one of these alternatives can not be satisfied, the offeror would be required to register the securities offered in the United States or to qualify for another exemption. An issuer making an offering in reliance on either Rule 801 or Rule 802 may claim any other available exemption under the Securities Act.

Rules 801 and 802 impose certain restrictions on the transferability of the securities that an offeror may issue in exchange offers or business combinations or the equity securities that may be purchased pursuant to Rule 801 upon the exercise of the rights. To the extent that the subject securities are "restricted securities"** prior to the

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* "Business combination" is defined as a statutory amalgamation, merger, arrangement or other reorganization requiring the vote of shareholders of one or more of the participating companies. It also includes a statutory short-form merger that does not require a shareholder vote.

** Restricted securities are generally securities acquired from the issuer in transactions not involving a public offering, resales of which may require registration under the Securities Act or the availability of an exemption such as (continued...)

Rule 801 or Rule 802 transaction, securities acquired by the U.S. investor in such transaction will be "restricted securities." On the other hand, if the subject securities are unrestricted, then the securities acquired in the transaction will also be unrestricted.* For purposes of rights offerings, the proportion of restricted to unrestricted securities is determined as of the record date that determines the allocation of rights among security holders. In the case of an exchange offer or business combination, the proportion is based upon the securities tendered or exchanged by the holders.

Rules 801 and 802 do not require that specific information be disclosed or sent to U.S. security holders. The rules do, however, require that when any document, notice or other information is provided to offerees outside the United States, copies that are translated into English must be provided to U.S. security holders. To encourage non-U.S. issuers to include U.S. security holders in rights offerings and exchange offers, the rules provide that the offeror must circulate any informational documents to U.S. holders, in English, on at least a comparable basis to that provided to security holders in the offeror's home jurisdiction. If the offeror publishes information regarding the offering in its home jurisdiction, the offeror must publish the information in the United States in a manner reasonably designed to inform U.S. holders of the offer. In any event, the offeror may mail the relevant documents to U.S. security holders. Under both rules, the offeror must provide the notice or offering document to U.S. security holders in English at the same time it provides the information to offerees outside the United States.

Under both Rules 801 and 802, the offeror must submit a notification to the SEC on new Form CB. A copy of any document, notice or other information mailed

**(...continued)
Rule 144 under the Securities Act.

* The Adopting Release observes that because no more than ten percent of the subject company's securities may be held in the United States the potential that Rule 801 and Rule 802 will be misused as a means to conduct illegal distributions in the United States should be minimal.

to U.S. offerees would be included as an attachment to Form CB. A non-U.S. company must also file a Form F-X when it submits the Form CB.

1. Rule 801

Rule 801 is available only for rights offerings of equity securities made on a pro rata basis to existing security holders of the same class, including holders of ADRs evidencing those securities. The SEC limited Rule 801 in this regard since the offerees have already made their investment decision with respect to that class of securities. In addition, this rule would require that the rights granted to U.S. security holders not be transferable except in accordance with Regulation S.

2. Rule 802

Rule 802 does not have any limitations based on the domicile or reporting status of the offeror. An offeror need not be a reporting company and may be either a U.S. company or a foreign private issuer.* The target company, on the other hand, must be a foreign private issuer.

Rule 802 does not contain any restrictions on the type of securities that an issuer could offer in reliance on the rule. As a result, offerors may offer debt securities in an exchange offer or business combination for the subject company's equity or debt securities. Generally, unless otherwise exempted, the issuance of debt securities requires qualification of an indenture under the Trust Indenture Act of 1939 (the "Trust Indenture Act"). Absent relief from this requirement, the usefulness of the other relief afforded by Rule 802 would be undermined in the case of debt securities. In view of the SEC's belief that the benefits to be obtained by U.S. investors justified not providing U.S. investors with the protections of the Trust Indenture Act, a new rule was adopted that exempts any

* The SEC recognized that a U.S. bidder would be at a competitive disadvantage if this exemption were available only to foreign private issuers since a U.S. bidder for the securities of a non-U.S. target would then be required to register the U.S. portion of its exchange offer while a non-U.S. bidder would not be so required.

debt security issued pursuant to Rule 802 from having to comply with the provisions of the Trust Indenture Act.

C. General

Certain aspects of the rules adopted in the Adopting Release common to the transactions discussed above are discussed in this part C.

U.S. ownership ceilings. The Adopting Release defines "U.S. holder" to include those persons resident in the United States. Record ownership is determined in accordance with Rule 12g3-2(a) under the Exchange Act, except that the offeror is required to "look through" record ownership of brokers, dealers, banks and other nominees located (i) in the United States, (ii) in the subject company's jurisdiction of incorporation or that of each participant in a business combination, and (iii) in the jurisdiction that is the primary trading market for the subject securities, if different from the subject company's jurisdiction of incorporation.* Offerors must also count securities as owned by U.S. holders when publicly filed reports or information that is otherwise provided to an offeror indicates that the securities are held by U.S. residents. If, after reasonable inquiry, an offeror is not able to obtain information about the amount of securities represented by the nominee's customer accounts, the offeror may assume that such customers are residents of the jurisdiction in which the nominee has its principal place of business.

In determining U.S. ownership for purposes of the U.S. ownership ceilings, shares held by holders of more than ten percent of the subject class, and shares held by the offeror in an exchange offer or business combination, would be excluded. In addition, other types of securities that are convertible into or exchangeable for the subject securities (e.g., warrants, options, and convertible securities) are not taken into account in

* The SEC noted that these jurisdictions should cover most of the trading volume of the subject securities and is likely to yield the greatest number of U.S. beneficial owners.

calculating U.S. ownership. On the other hand, the outstanding class of securities subject to the tender or exchange offer would include securities represented by ADRs, as well as the amount of the subject class of securities held by U.S. holders.

To accommodate the planning process of an offeror or an issuer, the new rules include a 30-day "look back" period. As adopted, the offeror would make the calculation of U.S. ownership 30 days before the commencement of the tender offer, exchange offer or rights offering. In the case of a business combination such as a merger where the securities are issued by the acquiring company, the calculation will be based on U.S. ownership of the target company 30 days before the commencement of the solicitation for the merger. In business combinations such as an amalgamation, where a successor company issues securities to all participating companies, the calculation would be based on U.S. holder information available 30 days before commencement, but applied on a pro forma basis as if measured immediately after completion of the business combination.

The Adopting Release recognizes that it would be difficult for third-party bidders to ascertain whether any exemption is available without information on the subject company's U.S. ownership. Accordingly, under the rules a third-party bidder in a hostile tender offer* would be entitled to a presumption that the percentage threshold requirements of the Tier I, Tier II or Rule 802 exemptions are not exceeded unless one of the following conditions is met:

- the aggregate trading volume in the United States of the subject class of securities exceeds ten percent in the case of Tier I offers and Rule 802, or forty percent in the case of Tier II offers, of the worldwide aggregate trading volume over the 12-calendar-month period ending 30 days prior to commencement of the offer;

- the most recent annual report or other informational form filed or submitted by the issuer to securities regulators in its home jurisdiction or

* This presumption would not be available in negotiated transactions since the bidder would be able to get this information from the target company.

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with the SEC indicates that U.S. holdings exceed ten percent in the case of Tier I offers and Rule 802, or forty percent in the case of Tier II offers; or

- the bidder knows or has reason to know from other sources that the level of U.S. ownership of the subject class of security exceeds the thresholds.

Even if this presumption is not available, the bidder may nevertheless rely on the applicable exemption if it can demonstrate that U.S. ownership is less than the relevant threshold.

Equal treatment. As a general condition to the availability of the relief granted in the rules, U.S. security holders must be allowed to participate in the offer on terms at least as favorable as those offered to any other security holders of the subject securities. As such, U.S. security holders must be offered the same amount and form of payment, including securities if offered elsewhere. Moreover, the procedural terms of the offer (i.e., duration and withdrawal rights) must be the same for all security holders.

One exception to this condition would arise when (i) despite a good faith effort to register or qualify an exchange offer, the sale of the offered securities is prohibited in a particular U.S. state under its securities (so-called "blue sky") laws, or (ii) the exchange offer in the United States is exempt from Securities Act registration under Rule 802 but a state's blue sky laws do not provide a corresponding exemption. In either event, instead of excluding such security holders, the offeror must offer them cash consideration if it has offered cash consideration to security holders in another state or in a jurisdiction outside the United States. In this instance, the offeror must offer the cash consideration only if it is offering a cash-only alternative consideration (e.g., not if it is only offering a part cash/part stock form of consideration).

Another exception to the general condition would permit U.S. holders to be precluded from electing to receive "loan note" securities. The Adopting Release points out that it is common in the United Kingdom for a bidder in a cash tender offer to offer a loan note alternative that allows target security holders to receive a short-term note in lieu of an immediate cash payment and thereby, under U.K. tax law, generally defer the

recognition of capital gain until the redemption of the note. The Adopting Release notes that such tax treatment is not available under U.S. law, which would require gain recognition at the time of the exchange for the notes.

Competing offers. In order to provide a level playing field in the case of competing offers, a subsequent competing bidder would not be subject to the applicable U.S. ownership limitation conditions if the initial bidder relied on the Tier I or Tier II exemption or the exemption in Rule 802. Accordingly, the competing bidder will be eligible to use such relief as long as all of the other conditions to the relevant exemption are satisfied.

Investment Company Act. The Tier I and Tier II exemptions are available if the subject company is a closed-end investment company that is registered under the Investment Company Act. Similarly, the registration exemptions for rights offerings, business combinations and exchange offers provided by Rules 801 and 802 are also available for securities issued by closed-end investment companies that are registered under the Investment Company Act. In adopting the rules, the SEC stated that it believed extending the relief to closed-end investment companies was consistent with the SEC's previous decision to permit closed-end investment companies to rely on the Regulation S safe harbor to issue unregistered securities abroad.* However, these rules are not available to any other type of investment company, whether foreign or domestic, that is registered or required to be registered under the Investment Company Act.

Informational legends. Although the disclosure to be provided to U.S. holders generally would be governed by the requirements of the target's home country, an offering circular or other published notice disseminated to U.S. holders would be required to bear specified informational legends regarding the foreign nature of the transaction and that the offer is subject to the disclosure requirements of a foreign country that are

* See Offshore Offers and Sales, Securities Act Release No. 6863 (April 24, 1990), 55 Fed. Reg. 18306.

different from those of the United States. In addition, the legend must state that investors may have difficulty in enforcing rights against the issuer and its officers and directors. This legend does not have to be placed on the cover page; instead, it may be placed in another prominent location in the document.

Limits of granted relief. The civil liability and general antifraud provisions of the U.S. federal securities laws would remain applicable to these transactions to the extent extended to security holders in the United States.* Furthermore, the Adopting Release does not grant any relief from the share ownership disclosure requirements of Sections 13(d), 13(f) and 13(g) of the Exchange Act and the rules thereunder.**

III. RULE 14e-5 (FORMERLY RULE 10b-13)

As the Adopting Release notes, many non-U.S. jurisdictions permit participants in tender and exchange offers to engage in activities that would be prohibited in the United States by Rule 14e-5 under the Exchange Act.*** Indeed, certain non-U.S. jurisdictions may have regulations that effectively require market-making affiliates of the offeror or its financial advisers to engage in activities that would be prohibited by Rule 14e-5.

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* Civil liability and antifraud provisions that may be applicable, depending upon the circumstances, include Sections 11, 12(2) and 17(a) of the Securities Act, Sections 10(b), 14(e) and 18 of the Exchange Act, and Exchange Act Rules 10b-5, 13e-4(b)(1) and 14e-3.

** Any person acquiring beneficial ownership of more than five percent of any class of securities registered under Section 12 of the Exchange Act generally is required to file a statement on Schedule 13D or Schedule 13G, as appropriate, disclosing such ownership and certain other information, and to promptly amend such statement to disclose material changes.

*** Rule 10b-13 was revised and redesignated as new Rule 14e-5 in the Regulation M-A Release. Rule 14e-5 generally prohibits a person making a tender offer from directly or indirectly purchasing the subject security otherwise than pursuant to such offer, from the time of its public announcement until its expiration.

The Adopting Release provides for an exception to Rule 14e-5 for Tier I tender or exchange offers (i.e., when U.S. persons held of record ten percent or less of the class of subject securities), if all of the following conditions are satisfied:

- The bidder prominently discloses in the U.S. offering documents the possibility of any purchases, or arrangements to purchase, or the intent to make such purchases otherwise than pursuant to the terms of the tender or exchange offer.
- The bidder discloses information in the United States regarding purchases or arrangements made in the United States in a manner comparable to the disclosure made in its home jurisdiction.
- The bidder discloses in the U.S. offering documents the manner in which any information about such purchases or arrangements will be disclosed.
- The purchases comply with the applicable tender offer laws and regulations of the home jurisdiction.*

This exception for Tier I tender offers basically represents a codification of the conditions contained in exemptions previously granted by the SEC. As noted in the Adopting Release, no exception to Rule 14e-5 is granted for Tier II offers in light of the greater U.S. interest in such offers. The SEC will continue, however, to review requests for relief from Rule 14e-5 for offers other than Tier I eligible offers on a case-by-case basis.

In the context of cross-border offers that are subject to the requirements of the U.K. City Code on Takeovers and Mergers (the "City Code"), the SEC has in the past granted relief to permit market makers and principal traders that are affiliated with the bidder's advisors ("Eligible Traders") to continue their U.K. market making activities during such an offer. Without relief from Rule 14e-5, Eligible Traders would be forced to withdraw from trading in U.K. target securities, with possible adverse consequences for the liquidity of those securities. The SEC has codified in the Adopting Release this class exemption which is not limited to Tier I offers. The rules provide relief to bidders or

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* The SEC did not adopt a requirement that purchases must be made outside the United States.

anyone acting on behalf of bidders (such as advisors and other nominees or brokers). The rules for Eligible Traders are available if all of the following conditions are satisfied:

- The issuer of the target security is a foreign private issuer.
- The tender offer is subject to the City Code.
- The Eligible Trader is a "connected exempt market maker" or "connected exempt principal trader," as those terms are defined in the City Code.
- The Eligible Trader complies with the applicable provisions of the City Code.
- The offering documents disclose the identity of the Eligible Trader and describe how U.S. security holders can obtain information regarding an Eligible Trader's market making or principal purchases to the extent such information is required to be made public under the City Code.

IV. SEC'S VIEWS ON INTERNET DISCLOSURE

In response to commenters, the SEC provided guidance in the Adopting Release regarding when bidders can provide information on the Internet about offshore tender and exchange offers without triggering U.S. tender offer and securities registration requirements. This guidance is designed to provide certain clarification regarding the SEC's views published in March 1998 regarding when the posting of materials on Internet web sites would not be considered an offer or soliciting activity in the United States for purposes of the registration requirements of the federal securities laws (the "1998 Internet Release").* In the 1998 Internet Release, the SEC indicated that offering materials posted on a web site would not be deemed an offer, general solicitation or directed selling efforts in the United States, as long as the offeror implemented precautionary measures reasonably designed to ensure that the Internet offer is not targeted to persons in the United States or to U.S. persons.

* Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Securities Act Release No. 7516 (March 23, 1998), 63 Fed. Reg. 14806. The SEC's interpretation is discussed in our Memorandum dated April 3, 1998.

As noted in the Adopting Release, posting materials relating to tender and exchange offers and rights offerings on a web site raises issues not present in the context of public underwritten offerings. Accordingly, the SEC indicated that offerors using a web site to publicize their offer should take special care to ensure that it is not used to induce indirect participation by U.S. holders of those securities. One safeguard suggested by the SEC is for an offeror to obtain adequate information to determine whether the holder is a person in the United States or a U.S. person in responding to inquiries and processing letters of transmittal. Another example that an offeror could employ is to obtain representations by the investor that the investor is not a person in the United States or a U.S. person. Special care should also be taken to avoid mailing the cash or securities consideration into the United States. Despite the use of precautionary measures, a web site could be viewed as an offer in the United States if the content is clearly designed to induce U.S. investors to find an indirect means to participate in the offer through offshore nominees or other means.

* * *

The Adopting Release will be published in the Federal Register and reproduced in various securities law reporting services, and is available on the SEC's web site (www.sec.gov). Copies of the Adopting Release are also available from Ivy Moreno (212-558-3448) in our New York office.

Clients having questions regarding the above rules are invited to call one of the lawyers on the attached list.

SULLIVAN & CROMWELL

SULLIVAN & CROMWELL

November 10, 1999

MEMORANDUM

Re: SEC Adopts Amendments to the Rules Regulating Takeovers and Securityholder Communications

SUMMARY

On October 19, 1999, the SEC adopted far-reaching amendments to the rules regulating takeovers and securityholder communications in business combination transactions and proxy solicitations. These amendments, which become effective January 24, 2000, represent a significant modernization of the SEC's regulatory scheme. The amendments primarily (i) liberalize the current restrictions on publicity and other communications in connection with business combination transactions and proxy solicitations to allow for significantly greater disclosure and communications with securityholders before the filing of any registration, proxy or tender offer statement that may eventually be required, and (ii) eliminate certain existing disparities between exchange offers and cash tender offers.

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I. EXPANSION OF PERMITTED COMMUNICATIONS WITH SECURITYHOLDERS

General

Acknowledging the need of market participants for more rapid dissemination of information regarding business combination transactions,* the SEC has adopted what amounts to a free market approach to the use of such information. Under the new rules, participants in a business combination transaction or proxy solicitation are generally free to communicate with securityholders, employees, customers and others without the constraint of first having to prepare and file a registration, proxy or tender offer statement. Instead, the SEC has imposed only three fundamental rules:

- Participants must file all written communications with the SEC on the day of first use, so that the information in the communication is "disseminated" broadly and promptly.
- Participants must include in their written communications a legend noting, among other things, that a full disclosure document is forthcoming.
- Parties to a merger who elect to take advantage of the liberalized communications rules cannot file their proxy statements confidentially with the SEC. As a practical matter, this requirement is likely to make the confidential review process far less common than it is today.* The SEC has reiterated that its accounting staff is available to discuss particular accounting issues in advance of filing.

Significantly, the SEC has not required that copies of filed communications be sent to securityholders – only the basic registration, proxy and/or tender offer statements and amendments and supplements thereto must be mailed to securityholders.

The SEC also has relaxed the timing requirements for filing certain registration, proxy and tender offer statements. Thus, the SEC has repealed the so-called "five business day" filing rule applicable to third-party cash tender offers, the "prompt" filing requirement applicable to exchange offers and the "as promptly as practicable"

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* In this memorandum, the term "business combination" refers to all tender offers and mergers, whether for cash or securities and whether initiated by the issuer or a third party. The term "mergers" includes asset transfers, consolidations and (continued...)

*(...continued) reclassifications where the vote of securityholders is sought.

* To preserve the right to file proxies confidentially, parties to a merger will be limited to making public statements that contain no more than the information permitted by current Rule 145(b), and therefore will not be able to publicize the transaction in any meaningful way.

filing requirement under the proxy rules.* In recognition of the unique nature of tender offers as a tool for fraudulent market manipulation and of the fact that the five business day rule has acted as a deterrent for such behavior, the SEC also has adopted an antifraud rule specifically targeted at persons who announce tender offers fraudulently or without intending or being reasonably capable of commencing the offer. This relaxation of timing, combined with the increased latitude permitted in communications, will permit a target company to respond to a tender offer that has not been formally "commenced" in the manner it deems best before filing a complete Schedule 14D-9, no longer constrained to the subject matter limits imposed by the current "stop-look-and-listen" rule.

The amendments do not, however, represent a fundamental change in the federal liability regime for communications relating to business combination transactions** or the basic requirement that securityholders receive an SEC-mandated registration, proxy or tender offer statement before being asked to vote or make an investment decision. There also continues to exist a distinction between "oral" and "written" communications.***

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* Current Rule 14d-2(b), Rule 14d-2(e) and Rule 14a-12(a)(4), respectively.

** Thus, (i) oral and written communications in connection with a registered offering of securities but not contained in the registration statement would be subject to liability under Section 12(a)(2) of the Securities Act of 1933, (ii) oral and written communications in connection with solicitation of a securityholder vote would be subject to Rule 14a-9, (iii) oral and written communications in connection with a tender offer would be subject to liability under Section 14(e) of the Securities Exchange Act of 1934 and new Rule 14e-8, and (iv) all communications could be subject to liability under Section 10(b) of the Securities Exchange Act of 1934 and other applicable antifraud rules.

*** The SEC stated in the release that "written" communications would generally include, for example, "scripts used by parties to the transaction to communicate information to the public and other written material (e.g., slides) relating to the transaction that is shown to investors." We do not believe this is a change from the SEC's current position on these materials.

Scope

The amendments are extremely broad in scope:

- The rules allow generally unrestricted freedom in communications relating to business combination transactions and other actions requiring a securityholder vote, subject only to the antifraud rules, a legending requirement and a same-day filing requirement for written communications.*

- The exemptions are available to all issuers, regardless of size or seasoned status, and to all participants and persons authorized to act on behalf of participants in a business combination transaction.

- The proxy rules exemption applies to all proxy solicitations, not just those relating to a business combination transaction. Thus, subject to the filing requirement, management and securityholders are free to discuss proxy issues and proposals before the filing of a preliminary proxy statement, provided no proxies are sought until a definitive proxy statement is filed.**

The Securities Act exemptions, however, apply only to business combination transactions – therefore, communications with the primary purpose or effect of conditioning the market for capital raising or resale transactions, for example, would not be protected by the new safe harbor.

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* The legending and filings requirements are embodied in: Rules 165(c)(1) and 425(a), respectively (for stock mergers and exchange offers), Rules 13e-4(c) and 13e-4(c)(1), respectively (for issuer cash tender offers), Rules 14a-12(a)(1)(ii) and 14a-12(b), respectively (for cash mergers), Rule 14d-2(b)(2) (for cash tender offers) and Rule 14d-9(a)(2) (for target company responses to cash tender offers). Consistent with the relaxation of content restrictions on communications made in advance of the registration, proxy or tender offer statement, the content restrictions formerly imposed upon summary advertisements used to commence tender offers (current Rule 14d-6(a)(2)) have been removed.

** Although the SEC solicited comment on a broader "test the waters" proposal, pursuant to which management could communicate proposals to securityholders without being required to file written communications related thereto, the final rules did not contain such a rule.

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II. LEVELING OF THE PLAYING FIELD FOR ACQUIRORS USING STOCK

Noting the "distinct timing advantage" for cash tender offers over exchange offers under the current rules, the SEC adopted largely as proposed rules permitting (but not mandating) the commencement of exchange offers, including the solicitation of tenders, upon the filing of a registration statement (rather than upon effectiveness of the registration statement). This relaxation does not apply to going-private transactions or roll-up transactions, but is applicable to other issuer exchange offers. In order to commence an exchange offer before a registration statement becomes effective, the offeror must

- file a complete registration statement relating to the securities offered,
- disseminate a complete preliminary prospectus to all securityholders,
- file a tender offer statement with the SEC, and
- not purchase shares until after the registration statement is effective.

Many commenters on the proposed rules, including Sullivan & Cromwell, pointed out that delays associated with the SEC review process of registered exchange offers could affect the stated goal of leveling the playing field for cash and stock offers. While the final release expresses the SEC's "commitment" to expedited staff review of exchange offers, there remains a risk that the SEC staff will not review an exchange offer registration statement in time to permit the timing of the exchange offer to compete effectively with the timing of a cash tender offer. Even if the staff does act promptly to review an exchange offer, the risk that staff comments will necessitate material changes in the offering documents and an extension of the exchange offer period likely remains greater in exchange offers than in tender offers.*

* The rules specify minimum time periods necessary for the dissemination of changes to preliminary prospectuses that are used to commence an exchange offer early: (i) five business days for most material changes, (ii) ten business days for changes in price, number of shares sought or similarly significant changes and (iii) twenty business days for materially deficient preliminary prospectuses. The SEC (continued...)

III. UPDATING AND HARMONIZING OF THE TENDER OFFER AND PROXY RULES

Other notable rule revisions contained in the release include:

- The release promulgates new Regulation M-A, which consolidates and in many cases simplifies the disclosure requirements for issuer tender offers, third-party tender offers and going-private transactions (including the related tender offer statements) into a single disclosure regulation. Former Schedules 13E-4 and 14D-1 are combined into a single new Schedule TO, and each tender offer schedule now refers to Regulation M-A for all substantive disclosure requirements. Regulation M-A does not contain significant new disclosure requirements.
- A "plain English" summary term sheet of the proposed transaction is now required for issuer and third-party tender offer statements, cash merger proxy statements* and going-private disclosure documents.
- The new rules streamline certain financial statement requirements for business combinations by
  - eliminating the requirement to file financial statements for target companies in cash mergers where the acquiror's shareholders are not voting on the transaction,
  - clarifying that acquirors are not required to file financial statements in cash mergers and cash tender offers if the financial statements are not material to the securityholders' voting or investment decision and, where the financial statements are required, reducing the requirement from three years to two, and

*(...continued)
expressed in the release its view that "these time periods represent general guidelines that should be applied uniformly to all tender offers," including cash tender offers. Material changes can be disclosed in a prospectus supplement rather than a redelivered complete final prospectus.

* Mergers and tender offers involving the registration of securities are already subject to the SEC's "plain English" rules.

- easing the requirements for three years of audited financial statements for non-reporting target companies in stock mergers and stock tender offers (no financial statements required if a non-reporting target is not significant to the acquiror above the 20% level described in Rule 3-05 of Regulation S-X, and the target's securityholders are not voting on the transaction; if the non-reporting target's securityholders are voting on the transaction, at least one year's financial statements prepared in accordance with GAAP are required).

- The rules add a requirement for pro forma and related financial information in cash tender offers where the offeror intends to engage in a back-end stock merger with a significant (greater than the 20% level described in Rule 3-05) target.

- Rule 13e-1, which prohibits an issuer whose securities are the subject of a third party tender offer from repurchasing any of its equity securities until information about the intended acquisition is filed and disseminated to securityholders, has been amended to (i) delete the requirement for sending such information to securityholders, (ii) exclude from the rule's application periodic repurchases made in the ordinary course of business and not in response to the tender offer and (iii) require such information to be provided after the tender offer is made (rather than up to six months before, as under the current rules).

- The SEC has conformed the stockholder list requirements under the tender offer rules to those under the proxy rules. Accordingly, companies electing to provide a stockholder list to a requesting party in lieu of mailing the requesting party's materials would be required to disclose the most recent list of names, addresses and security positions of non-objecting beneficial owners (as well as record owners) it has in its possession, or subsequently obtains.

- The new rules clarify and codify certain staff interpretations of Rule 10b-13 (which prohibits an offeror from making purchases of subject securities outside of its tender offer), adopt four new exemptions and two exemptions originally proposed in the release on cross-border tender offers and redesignate the rule as Rule 14e-5. As adopted, Rule 14e-5 has ten exceptions, the most significant of which for domestic business combinations is that the person making the tender may exercise options acquired before announcement of the tender offer.

IV. SUBSEQUENT OFFERING PERIOD

The new rules also permit (but do not require) securities to be tendered without withdrawal rights during a 3- to 20-day subsequent offering period after the close of an acquiror's initial offer period if the offeror commits to purchase all outstanding securities of the class sought and discloses its intent to do so in advance of the expiration of the initial offering period. In response to strong criticism from commenters that the advance notice requirement may create a "hold-out" problem with securityholders, the SEC did not include the advance notice requirement in the rule, stating instead that they would rely on staff interpretation to guide the advance notice requirement's future development.* The same consideration would have to be paid in both the initial and subsequent offering period.

V. EFFECTIVE DATE

The new rules become effective January 24, 2000, and would generally be applicable on that date to all business combination transactions, whether or not then underway. Persons with confidential preliminary proxy statements on file as of that date must choose whether to limit written communication regarding their transaction or forgo confidential treatment by making a public filing. Exchange offers for which a registration statement has been filed but is not yet effective may be commenced on or after January 24, 2000 by complying with the applicable provisions. The new disclosure requirements will apply only to registration statements, tender offer statements and proxy statements and information statements initially filed on or after January 24, 2000, however.

VI. ACTIONS NOT TAKEN

Although the release significantly rationalizes the differing SEC regulatory requirements for business combination transactions utilizing cash and securities, some

* In the release the Commission states, "After the Division of Corporation Finance gains practical experience with the operation of the subsequent offering period, the Division may decide, through staff interpretation, to shorten or possibly eliminate the requirement for advance notice."

distinctions remain. In three significant areas, however, the release is particularly significant for actions not taken.

- First, the SEC has positioned itself to move quickly and without additional rulemaking to abandon the requirement that advance notice of a subsequent offering period is required. In our view, this would make the subsequent offering period more appealing to offerors.

- Second, the SEC has not extended the safe harbor for forward-looking statements authorized in the Private Securities Litigation Reform Act of 1995 to statements made in connection with tender offers. The SEC stated in the release that "given the relative infancy of the body of law interpreting the PSLRA generally and the safe harbor in particular, we do not believe that extending the reach of the safe harbor would be prudent."

- Finally, while acknowledging that "some selective disclosure may continue to occur" despite the new rules because a distinction between oral and written communications remains, the SEC clearly has made an attempt to reduce the potential for selective disclosure by clarifying what it considers "written" and by imposing the filing requirement for all written communications in a business combination transaction. In the release, the SEC states that "[a]lthough this release does not impose new requirements on oral communications, we remain extremely troubled by the selective disclosure of material information." Whether this is a portent of future rulemaking or merely a warning to market participants to conduct themselves in an appropriate manner to prevent the SEC from doing so remains to be seen.

The SEC also chose not to adopt final rules in other less significant areas, such as the broader "test the waters" proposal described above and the direct delivery of proxy statements and other soliciting material to non-objecting beneficial owners to facilitate more timely and informed voting decisions. In each of these areas, the SEC has indicated that it may revisit these topics in the future.

* * *

The release, which was first published October 22, 1999, will be published in the Federal Register and reproduced in various securities law reporting services, and is

available on the SEC's web site (www.sec.gov). Copies of the release are also available from Ivy Moreno (212-558-3448) in our New York office.

If you have any questions regarding the rule amendments, please call James C. Morphy (212-558-3988), Joseph B. Frumkin (212-558-4101), John K. Robinson (212-558-3154) or any of the other lawyers on the attached list.

SULLIVAN & CROMWELL

DEALING WITH NEWS

- THE BAD, THE GOOD AND THE UGLY -

Stockholders, Boards of Directors, Analysts and the Media

David C. Fannin
Office Depot, Inc.
Delray Beach, Florida

SECTION B

David C. Fannin is Senior Vice President, General Counsel and Corporate Secretary for Office Depot, Inc., Delray Beach, Florida. The views expressed herein are solely those of the author and do not reflect the views of Office Depot or of the University of Kentucky.

DEALING WITH NEWS—
THE BAD, THE GOOD AND THE UGLY

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DEALING WITH NEWS – THE BAD, THE GOOD AND THE UGLY

By David C. Fannin

1. What is Bad News?

This paper focuses on the required and discretionary delivery of news – both negative and positive news – on behalf of a public company. As many well-publicized cases have illustrated recently, the release of negative information - "bad news" - can have a profound effect on a public company. In many cases, the immediate result can be a quick devaluation of the company in the form of a lowered stock price. In some cases, a single company's release of negative information can impact an entire segment of the market or industry group.[1]

There has been much public focus recently on one particular type of negative information about public companies, viz. adverse financial information. Company's frequently issue "pre-releases" warning the investment community that they will not meet earnings expectations for the current fiscal period or for a year. In addition – and more drastically – numerous companies have been required to restate previously issued (and filed with the SEC) financial information. In some respects, this is the ultimate "bad news" scenario and inevitably leads to stockholder litigation, possible SEC investigation and even sanctions of the entity or individuals. Other than restatements on technical grounds, such a move says to the investment community that "our prior representations to you were inaccurate and you can't trust our numbers."

Another category of bad news involves disclosure that the company has engaged in improper or even illegal conduct. This sometimes goes hand-in-hand with an announcement of earnings restatement. Among several recent examples is the situation at Cendant Corporation, which within the past two years was obliged to disclose intentional wrongdoing, to restate its financial

[1] For a recent example, see the News Article "Dell's Warning Spurs Hardware Sell-off" in the Appendix.

results for several years and settle a class action lawsuit for multi-billions of dollars.[2]

Once a company discovers that its officers or employees have engaged in wrongful conduct – regardless of the nature of the conduct – it must weigh carefully whether it has an obligation to make a disclosure. Similarly, if a company becomes the subject of an informal inquiry or formal investigation by a governmental agency, particularly if the investigation is criminal in nature, it must decide whether and to what extent to make that fact public.

Many public companies have received informal inquiry letters from the SEC, the FTC and other governmental agencies, ranging from routine questions to questions regarding more serious concerns, even leading to potential criminal action or other enforcement action by the agency. Knowing when it is required that disclosure be made is of critical importance to counsel advising public companies.

This topic is not just about "bad news" in the strict sense. Consideration needs to be given to all areas of news and information which may have a less direct but equally significant impact on the valuation of the enterprise and the verdict of the marketplace – a depressed stock price. Sometimes news that is not "bad" in the classic sense can have a negative impact. For example, a company may exceed the consensus of financial analysts who follow the company but not beat the so-called "whisper number" on the street.[3] That is to say that if the news is not "good enough," the effect may be the same as really bad news – or perhaps it merely expands the definition of "bad news."

The capital marketplace today is driven as much by "expectation" as by any other factor, and a company's stock price may decline and its profile among the plaintiff's bar may increase in direct proportion to the extent to which the company falls short of, or exceeds, expectations of the investment community.

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[2] See the Form 8-K filed by Cendant Corporation on December 7, 1999, in the Appendix.

[3] This issue is quite common in the so-called high tech industry, where merely being good is often not enough.

So-called "whisper numbers," rising stock prices in "anticipation" of a company's earnings press releases and other similar situations suggest strongly that a company has been less than diligent in avoiding selective disclosure to financial analysts and others, a topic covered in greater detail below. The existence of these expectations also evidences the power of the analyst community to ferret out information and to create expectations among investors.

Given the potential for drastic effects on its stock price, a company must carefully consider every press release, every statement to an analyst, every presentation to an investor conference, indeed every statement outside the confines of the company itself. Ours is an age on information overload. Consider the many cable television channels that exist to provide 24-hour coverage of business topics. These media outlets will seize upon and analyze – if not overanalyze – every bit of information about a public company that they can gather by proper means or otherwise. In an area which places a premium on being able to distinguish the "material" from the "immaterial," even seemingly trivial matters can be elevated to the material.

Bad news certainly is not limited to purely financial information, such as missed earnings, restated financials and the like. Other examples of news with the potential to affect materially a company's stock price include: poor sales or the clear failure of a new product line or marketing scheme, business cycles that impact a company's products (e.g. a drought that impacts a seller of agricultural machinery), product defects and recalls, adverse verdicts in litigation, the filing of a class action (securities or otherwise and meritorious or frivolous), informal or formal SEC inquiries, management changes, health concerns of key senior managers, to cite but a few examples. Even rumors – which are often adamantly denied by a company – can have a serious impact on the company's stock price. Consider, for example, the situation surrounding one-time high flier, Tyco International, Ltd.:

"...mere <u>questions</u> about the accounting methods of Tyco International, Inc. have sent the formerly highflying stock down more than 25% this fall."[4]

In considering the example of Tyco, rumor became reality. In this case, the SEC launched its own investigation into Tyco's accounting practices relative to acquisitions, presumably because SEC staffers can read the newspapers and visit Websites as well as anyone else.[5]

Companies and their managers have to deal every day with information that has the potential to constitute "bad news" in the sense that it has the power to affect the assessment of the company in the investment community. Analysts and investors are all too ready to read into virtually any development the potential of negative impact on the business. Therefore every disclosure made by a public company needs to be measured against the potential for a negative impact on the company's stock, and its perceived value in the investment community. Let's look at some examples of particular types of "bad news" releases of information.

Earnings Pre-Releases

Perhaps the most common type of release of "bad news" in today's financial marketplace is the so-called earnings pre-release. Dissemination of this sort of information is usually issued in the form of a press release, which is then frequently filed with the SEC under Form 8-K[6]. Such a pre-release is required

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[4] "Why Investors and Companies Should Fear a Year-End Audit" by Herb Greenberg, <u>Fortune</u>, December 6, 1999, Vol. 140, No. 11, page 374. Of interest is the fact that the first information regarding Tyco came from a prominent "short seller" who operates a fund specializing in short selling and similar techniques, (continued) known as the Prudent Bear Fund. Regardless of whether the information is accurate, it would appear newsworthy that the source of the news has a clearly vested interest in seeing the prices of stocks he has sold short decline in price, as that is how he makes a living, covering his short positions with cheaply purchased stocks. Several Tyco International Forms 8-K are included in the Appendix.

[5] See the Tyco International Form 8-K on this topic in the Appendix.

[6] Note that the filing is not required by the SEC. See the discussion below regarding mandatory and discretionary use of Form 8-K.

under the following scenario. Public companies usually are followed by a number of industry analysts, employees (usually) of large investment banking institutions. Through a variety of means (including frequent badgering of company representatives, requesting the company to review their assumptions in creating financial "models" of the company, etc.), these person periodically publish reports on the company, including their "estimates" of the company's likely financial results for upcoming quarters and usually for the next full year as a whole. Their analysis of the reasons for their estimates forms the backbone of the "research" arm of most investment banking firms.

While there is technically no requirement that a public company get involved with analysts at all, much less assist them in writing their reports, it is common practice to cooperate with the analyst community. Various bodies from the SEC to the New York Stock Exchange to the United States Supreme Court have recognized that analysts perform a valuable service and are a vital part of the total mix of information available to investors.

Another concept important to this subject and necessary to understanding the necessity for earnings "warnings" – as they also are called – is the "consensus" of analysts following the company. Various services (the most prominent is First Call®) compile the recommendations, earnings estimates and "ratings" of various analysts who follow a particular company and publish those ratings on a regular basis. While certain estimates included in FirstCall® may be "thrown out" or disregarded as being too far off the mark, in general the **average** of the analysts' estimates regarding earnings of a company becomes commonly viewed as the "consensus" of those analysts. You will see press releases in which companies refer to being "on target" or "comfortable" with the consensus of the "street" which refers to the consensus of the analysts following that particular company.

The issue of "pre-releasing" is one which arises when a company, for any number of reasons recognizes that its actual operating results will differ in a material way from the so-called street consensus. When this occurs, the company must face the issue of whether to issue a press release with the news (which may be either bad or good, although the vast majority of pre-releases deal with disappointing news) that the company's actual results are expected to differ from the estimates of the analysts.[7] Why is such a statement a "pre-release" in the usual parlance of the investment community and why is it necessary at all?

Because of the close involvement of public companies with the analyst community, it is very difficult for a public company today to fully disassociate itself from the reports of the various analysts who follow the company. For reasons discussed in more detail later, companies frequently see analyst reports before they are published, and in very many cases, they comment on the reports prior to publication – presumably just to correct factual errors, but in far too many cases also to provide insights that may constitute the sharing of material nonpublic information.

The earnings warning is a "pre-release" because it comes at a time other than (and prior to) the date when the company releases its actual results of its operations. Whereas the company usually will release its earnings and other operating information at a predictable time following each fiscal quarter or fiscal year – and this is referred to as the company's earnings "release" date, the realization that the company's actual results will differ can be material nonpublic information and almost certainly is so when the company has cooperated with the analyst community to the extent that is common today.

So why does the company not simply wait for its regular press release as to earnings and simply "disappoint" or pleasantly surprise the investment community at that time? In fact, some companies do so, although today most public companies recognize that the level of their cooperation with the analysts following the company is so pervasive that if there is a significant market movement in the stock following a good or bad "surprise" in announced earnings

[7] See Forms 8-K and Press Releases of Office Depot, Inc., dated August 30, 1999 and The Coca-Cola Company, dated January 26, 2000, in the Appendix.

results, there is a distinct possibility of litigation asserting that the company was **responsible** for the consensus of the analysts and therefore had a duty to "correct" the misinformation available to the public.

Some companies attempt to avoid having to pre-release disappointing news by a process known as "talking down the street" or "lowering analyst expectations" in the hope that the analysts will public updating reports that gradually lower the consensus. This practice refers to the company's using the informal contacts it has with financial analysts to stress "risks" in the company's meeting its objectives or to drop hints that the company is looking at a "tough" quarter or year.

This is a highly dangerous practice for a number of reasons. For one thing, the company - whether it wishes to admit it or not – is using the process to make selective disclosures to analysts in the expectation that they will use this information for a desired result. Further, there can be no guarantee that the analysts will take the hint if the company is too subtle, for example, in leaking or indirectly alluding to bad or good news to come. Moreover, this process causes the company to become even more entangled that it already is in the analysts' reports on the company.[8]

The practical advice in this area is to follow what is probably the prevailing practice among public companies. That is (1) to recognize that the company is sufficiently entangled with the analyst community to be held responsible for the reports of analysts that are published, (2) to be constantly aware of the consensus of the analysts following the company and (3) to be prepared to bite the bullet and issue a release whenever the company has sufficient information to know that it will miss the consensus.

An additional complicating factor is knowing what to say in such a pre-release. One truism that is actually true is that Wall Street hates missing information. If the laws of physics dictate that nature abhors a vacuum, then

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[8] See the Article, "Compromised Analysts? The SEC is Shocked," The Wall Street Journal, December 29, 1999, in the Appendix.

Wall Street equally abhors a vacuum of information. Without guidance from either the company or analysts, investors would – God forbid! – have to make their own decisions on which securities to buy or sell. In the absence of information – a vacuum of knowledge – the street likely will sell the stock, period! For this reason, it is difficult to imagine a company issuing a pre-release without establishing in the release at least a range of potential outcomes for the period in question. That is, it is almost never sufficient to state simply that the company will "miss" its own forecasts or the estimates of the analyst community. It must advise investors as to the amount by which it will miss its numbers, the reasons why it will miss those numbers and, ideally, a good explanation as to what management proposes to do to ensure that such a thing doesn't happen again. To do otherwise – to state simply that the company will not meet street estimates —without stating what the company **will** do suggests either that the company doesn't have a clue as to its own operations, that its financial forecasting function is broken, that management is incompetent or all of the foregoing.

The earnings pre-release is among the most common forms of "bad news" (and occasionally good news) release from a public company. Before it happens to you, you are well advised to collect several examples of how other companies have dealt with similar information, particularly companies in your business segment. Some recent examples are included in the Appendix.

Other Financial News

Numerous other kinds of financial developments will warrant a press release and possibly the filing of a Form 8-K as well. For example, changes in a company's credit rating are often quite material.[9] Material defaults under bank credit agreements, agreements with bank lending groups to extend dates for covenant compliance, defaults under, or other changes in material agreements could also require disclosure. Consider for example the situation in which a

[9] See Form 8-K in the Appendix, filed by The Coca-Cola Company to advise investors of the lowering of its credit rating by Standard & Poors.

company's lending arrangements, if defaulted, could cause the company to cease operations or even file for bankruptcy.

Management Changes

Another kind of "bad news" – or sometimes "good news" – release deals with management changes. Investors invest in many things – good ideas or products, a track record of consistent results – but among the things that inspire the most confidence in investors are good managers. One need only look at the impact of Steve Jobs on Apple Computer in recent times to appreciate the significance of a an effective CEO. If Bill Gates founded a new company tomorrow, that company would automatically have credibility in the marketplace, and its stock would move upward in price. So the hiring of a "star" manager may be material news – usually good news.

Conversely the termination, health concerns or death of a key manager is another area in which a company may find itself having to issue bad news – or at least news, as this information is almost always material. Generally speaking, any news about the company's chief executive officer is material if it may affect his or her ability to function or continue to function in the future. While the mere naming of a new chief executive – particularly one with a stellar track record or other attributes – has the power to "move" a stock price upward, the termination, resignation, poor health or death of a well recognized CEO can move a company's stock in the opposite direction.

So, any change in the top position in a company warrants a press release as soon as practicable after the event occurs. Typically, the exchange on which the company's stock is traded will treat such news of sufficient significance to "halt trading" in the company's stock. This sort of management news is the kind that can add or take away millions of dollars in "stockholder value."[10]

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[10] See, for example, the account of the impact of the hiring of one-time celebrity CEO, Al Dunlap on the stock of Sunbeam Corporation in Chainsaw: The Notorious Career of Al Dunlap in the Era of Profit-at-any-Price, by John A. Byrne, pages 10-12. See also, the Form 8-K filed by the Coca-Cola Company on December 6, 1999, advising that the Board of Directors accepted the resignation of the company's CEO.

As to other executive level positions, the issue of whether to make a special release of information and, if so, when to make it is largely a test of materiality. The New York Stock Exchange requires member companies to notify the Exchange "...of any changes in directors or officers of the company."[11] Since the NYSE requires this information, which is usually provided by way of letter or memorandum to the Exchange, one is left to wonder why the public should not also be informed by means of a press release at the same time. Accordingly, if any executive officer of the company arrives or departs, a press release appears warranted. The news may be good or bad, but it is material news.

Other management changes include the resignation of directors, which may be a required disclosure under the instructions to Form 8-K but almost always at least merits some form of press release. The resignation of certain key officers in the compliance area, such as the Chief Financial Officer, Controller or General Counsel also would suggest that a release is appropriate, particularly to reassure the investment community that there is nothing wrong – if that is the case.

Health Concerns

The question of when or whether to inform the public of the health concerns of an executive officer is less clear. Most companies readily inform the public of major - and noncontroversial - concerns, such as a heart attack suffered by the CEO of the company. Less clear is how many companies would choose to inform the public that the CEO is undergoing alcohol or drug treatment at a clinic, or is undergoing treatment for depression. Of course, there may be no choice if she or he must cancel numerous speaking engagements or other opportunities to be seen by the public. Most public company CEO's are prominent people in the communities in which they live and as a result cannot

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[11] NYSE Listed Company Manual, Rule 204.14. Other examples of NYSE required disclosures include resignation of directors (Rule 204.14); changes in auditors (Rule 204.04), among others. All press releases by an Exchange listed company are required to be filed in duplicate with the NYSE (Rule 204.26).

simply disappear from view for long without provoking questions. Many CEO's have become highly visible personalities in their own right – Bill Gates, Lee Iacoca, Dave Thomas, Al Dunlap and others come readily to mind.

Clearly the CEO has some right to privacy, but the test appears to be one of materiality once again – whether the news is of such nature that it is likely to be important to investors in the overall mix of information available. If the CEO dies, that is material.[12] By contrast, if he or she is undergoing treatment for depression on an outpatient basis or through regular visits to the psychiatrist or psychologist, that news is probably private and immaterial, if for no other reason than it is unlikely to affect performance – and even less so than the alternative of not getting treatment.

But what if the CEO were diagnosed with a sexually transmitted disease, with AIDS or with some other problem that, in and of itself, is likely to make at least some investors uncomfortable? What would be the company's position on disclosure? When does the information move from the purely personal to requiring public comment? The test: Is the situation one that is likely to materially affect the executive's performance of his or her position and duties? If you can honestly say that the situation is unlikely to affect job performance, then the right of privacy likely will prevail over the investing public's right to be made aware of material information affecting the company.

SEC Inquiries; Criminal Inquiries

Another question involves whether and, if so, when to make a disclosure of an SEC inquiry or other governmental inquiry. Some such inquiries are routine, not much more material than a routine audit by the IRS, clearly not worthy of public disclosure unless adversely determined, and the result of the determination is material. On the other hand, an SEC **formal** investigation is another type of "animal" altogether. Unlike an informal inquiry letter, such a

[12] For example, the tragic and untimely death of Coca-Cola CEO Roberto Goizuetta within the past two years.

proceeding has at least some of the trappings of a criminal investigation, and disclosure is almost certainly mandated. Given the potential impact of such an announcement – would you buy the stock of a company that announced the SEC was launching a formal investigation into its accounting practices, at least *until* you knew the outcome – considerable care must go into crafting this sort of statement.[13] Generally speaking, it probably is not news that requires **immediate** disclosure, meaning immediately after being notified by the agency that an investigation is being launched. A thoughtful disclosure is mandated, and legal counsel MUST be closely involved in the drafting of this sort of disclosure.

Some companies will use the announcement as an opportunity to proclaim their "confidence" in the individuals or practices called into question. This can be a high-risk proposition, however, For the very release that protests the innocence of the company or its executives may become a subsequent count in a shareholder lawsuit if the persons or practices defended are subsequently found to be a problem. The company's "reassurance" or "defense" of its own conduct or that of its executives can be construed as an independent act of issuing a materially misleading statement by the company.

How to deal with this situation? State the facts and any "explanation" in as neutral terms as possible. It is certainly okay to express a "belief" that the company has not done anything wrong, without strident denials that may come back to haunt the company. But don't do so if you don't really believe what you are saying! An example of a rather "neutral" type of statement is the following:

> *XYZ Corporation announced today that it has received notice from the Enforcement Division of the United Stated Securities and Exchange Commission that the company is the subject of a formal investigation into*

[13] See the example of a Form 8-K and Press Release in the Appendix from Tyco International Ltd., disclosing that the SEC had launched an informal inquiry of the company. In this case the company chose to make a public disclosure of an informal inquiry presumably because of rampant rumors swirling about the company. See discussion below on the topic of dealing with rumors.

its accounting for acquisitions over the past several years. While the company believes that its accounting for acquisitions has been in accordance with generally accepted accounting principles, and that its previously released financial statements, filed with the SEC, have been correct and complete in all material respects, the company is cooperating fully with the SEC in this matter. The company does not intend to make further comment on this matter while the investigation is pending.

In the case of other types of inquiries or investigations, including those that may have criminal penalties attached (e.g. antitrust investigations), a disclosure is undoubtedly appropriate or even required, particularly if a large fine or prohibition from conducting business in a particular manner is at issue. Again, this is an area in which the prudent exercise of judgment is paramount. This topic is discussed in more detail below.

Product Recalls, Problems, Etc.

Another subspecies of "material" information involves a company's having to decide from time to time whether and in what manner to deal with product problems, recalls, etc. Generally speaking, true product recalls will take care of themselves, as by their very nature public notification is required. For example in the case of most consumer products, the U.S. Consumer Products Safety Commission requires that a joint press release be issued whenever a consumer product is recalled under the auspices of that agency.[14]

However, such a CPSC news release may not be universally and uniformly disseminated to the financial community. The CPSC has its own list of media to which it wants releases sent, and a company may wish to make its own release supplemental to the CPSC release in order to inform (and possibly

[14] For the perils of not cooperating with the CPSC, note the administrative law case of CPSC v. Black & Decker, in which administrative proceedings were brought against a consumer products manufacturer for issuing its own release unilaterally, which the agency deemed "inadequate." See www.CPSC.gov @ topic "New/Recalls" and a copy of the joint press release in the Appendix.

reassure) the investment community. If so, the company would be well advised to inform the agency of its intention to do so, and to get clearance on the form and content of the release. Dealings with other governmental agencies are similarly best handled with a "full disclosure" approach to the agency.

Allegations of Harassment, Employee Litigation, Other Litigation

Among other types of allegations, charges and suits pertaining to harassment, discrimination and other types of employee litigation must be considered. Here once again, the primary determinant of whether to disclose is materiality. Truly individual claims, regardless of the facts, are unlikely to merit disclosure because the potential for financial impact on the company is immaterial. Even if the conduct complained about is distasteful, disclosure and the measure of materiality are financial impact on the company, not the prurient interest of the public.

If the accused executive is the CEO, and if the allegations appear to have at least some semblance of merit, then the pendulum begins to swing in the direction of disclosure, although the news still may be immaterial. If the CEO is accused of harassment by his secretary, that is not necessarily news. If the CEO is accused of routinely and systematically harassing employees, it may be difficult to avoid making some type of disclosure.

Class actions alleging widespread problems with discrimination, harassment and the like are likely to require disclosure because of the greater potential for financial impact on the company. Generally speaking, however, prior to class certification, there would appear little need to make a disclosure as putative class actions are as easy and inexpensive to file as any other type of litigation. Once again, however, the intervention of the traditional media may require that a company make a statement. Suits are generally public information, and the likelihood of a news account of the filing of an alleged class action is great.[15]

In most other types of litigation, legal counsel will be called upon to make an early determination as to the likelihood of an adverse result and to assess the potential for damages – and to provide input as to whether a disclosure is required. Just because a civil suit alleges "millions of dollars" in damages does not make it worthy of disclosure. As our litigation colleagues will tell us, it costs less than $100 in most locales to file any sort of complaint one wants, alleging whatever one wishes. Fortunately in most cases, the decision is an easy one – disclosure is required in only the most extreme cases until there has been an adverse determination, and then you can always say that you plan to appeal!

If responding to media accounts of litigation, it may be advisable to defer to the company's legal counsel. The best approach is probably to respond as "clinically" as possible and that usually means that legal counsel (including the General Counsel of the company) is a better spokesperson than the company's media relations person.

When to Release – During the Trading Day or Otherwise

One of the key decisions to be made once a decision is reached that some sort of disclosure is required is **when** to make the announcement. Traditionally, material announcements are made either prior to the opening of the markets or after they close. However, there is a potential for liability, if the necessity of issuing material news is sufficiently clear, in holding it until after the markets close. Moreover, there is so much trading in the after hours market today that the "neat and tidy" practice of releasing either before or after the markets appears less neat and tidy all the time. If the news is material and sudden and therefore does not lend itself to choosing the timing (such as would

[15] For an example of a company release disclosing the filing of class action lawsuits against it see in the Appendix, the release of Tyco International, Ltd.

be the case in announcing the arrival or departure of an executive officer), then the better practice may well be to release it during the trading day.

The New York Stock Exchange requires that it be given advance notice of such releases, that a copy be furnished in advance of the release going over the financial wires and that it have the opportunity to decide whether to halt trading "pending news."[16] In many cases of releases during the trading, the Exchange will notify the trading floor that trading in the company's stock is to be halted. Trading will resume only when there is assurance (1) that the news has been adequately disseminated to the investment community and (2) there is sufficient balance in buy and sell orders with the company's specialist on the floor of the Exchange to ensure an orderly market in the stock of the company.

2. Mandatory Disclosures

While certain disclosures by public companies are discretionary and require an exercise of judgment as to timing and content, there are also many mandated disclosures in the form of Registration Statements, Forms 10-K , 10-Q and 8-K and Proxy Statements. The Management Discussion & Analysis ("MD&A") sections of required filings which are subject to Regulation S-K provide one area of "discretion" in terms of content, and SEC enforcement actions have indicated that candor and disclosure are expected, rather than mere "boilerplate," in the preparation of such management discussions of the company. MD&A is intended to provide management insights "behind the numbers." Regulation S-K requires, among other things, disclosure of "known trends, commitments, events or uncertainties"[17] involving a company's business.

One fairly recent case, *In the Matter of Caterpillar*, [18] provides significant insight into the Commission's views on content of MD&A – and the consequences of failing to fully disclose material uncertainties known to

[16] NYSE Listed Company Manual, Rule 204.26.
[17] Regulation S-K, Item 303.

[18] Exchange Act Release No. 34-30532, 51 S.E.C. Docket 147 (March 31, 1992).

management but not generally known to investors. In *Caterpillar*, the Commission issued a cease-and-desist order against The Caterpillar Company for failing to disclose major uncertainties relating to its Brazilian subsidiary. The subsidiary was a material one, accounting for almost a quarter of Caterpillar's net profits in 1989 (the enforcement action pertains to inadequate disclosures in the 1989 10-K and 1990 first quarter 10-Q).

Asserting that operating income of the subsidiary was inflated due to a number of non-operating factors, including gains on currency translation, export subsidies and tax loss carry-forward, among other matters, and noting also that Caterpillar's management was well aware of turmoil in the Brazilian economy and political scene, the SEC sanctioned Caterpillar for failing to disclose to investors the potential materiality of these circumstances and uncertainties, the materiality of the Brazilian subsidiary to overall company results and the possibility of materially lower operating results in the future as a result. The Commission stated further that not only was disclosure of these facts required, Caterpillar also should have made an effort to quantify the impact of these facts on its then-current (in a positive sense) and likely future (in a negative sense) financial results.

While the *Caterpillar* order came as something of a shock to reporting companies at the time in 1992, it really should not have, any more than a motorist who regularly exceeds the speed limit – but is moving with the flow of traffic – has a right to be shocked when he is pulled over and given a ticket. Regulation S-K is replete with requirements, for example, that a reporting company disclose "any risks attendant to [its] foreign operations and any dependence of one or more of the registrant's industry segments upon such foreign operations."[19]

MD&A is required, among other things, to "identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way; "[20] "describe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations...;"[21] and to "describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[22]

If the "black letter" of the rule were not clear enough, the instructions to Item 303(a) of Regulation S-K surely leave no doubt as to the nature and extent of required disclosures:

> 2. *The purpose of the discussion and analysis shall be to provide to investors and other users information relevant to an assessment of the financial condition and results of operations by evaluating the amounts and* ***certainty*** *of cash flows from operations and from outside sources...*
>
> 3. *The discussion and analysis shall* ***focus*** *specifically on material events and* ***uncertainties known to management*** *that would cause reported financial information not to be* ***necessarily*** *indicative of future operating results or of future financial condition.*[23]

Other examples of reporting companies sanctioned for inadequate MD&A include In the matter of Bank of Boston Corp,[24] in which the failure to disclose a deteriorating real estate loan portfolio was cited; In the Matter of Gibson Greetings, Inc.[25], in which the company was sanctioned for inadequate

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[19] S-K, Item 101(d)
[20] S-K, Item 303(a)(1)
[21] S-K, Item 303(a)(3)(i)
[22] S-K, Item 303(a)(3)(ii)
[23] S-K, Instructions to Para. 303(a), emphasis added.
[24] Release No. 81, 60 S.E.C. Docket (December 33, 1995).
[25] Exchange Act Release No. 34-36357, 60 S.E.C. Docket 1154 (October 11, 1995).

disclosure of derivatives transactions; _In the Matter of Larry L. Skaff and John F. Liechty_,[26] in which the CFO's of **two** merging companies, Fruehauf Trailer Corporation and Terex Corporation, were sanctioned for failing in the MD&A of their respective companies to disclose the impact of purchase accounting treatment relating to the merger transaction; _In the Matter of Cypress Bioscience Inc._,[27] in which a company was cited for failing to comment on its increased sales for a quarter by disclosing that a substantial portion (nearly half) of the revenue was due to unusual "bill and hold" transactions as part of a special promotion, and that the company had changed its accounting policies to recognize the revenue earlier than it otherwise would have, which also jeopardized future results.

An interesting recent case is _In the Matter of W.R. Grace & Co._ [28] In this case, Grace and two partners from Grace's accounting firm, Price Waterhouse (now PriceWaterhouseCoopers) were sanctioned for understating revenues and earnings in the 1991-1995 period. The accountants were sanctioned for failing to detect the earnings manipulation in connection with their audits of Grace for the relevant periods. In an era when the headlines primarily concern companies which "pad" their earnings through accounting devices or outright fraud[29], why would a company **understate** revenues and earnings, and why would the SEC be concerned about it?

A Grace subsidiary, National Medical Care ("NMC") had enjoyed substantial and unexpected revenue boosts in the early 1990's due to changes in Medicare reimbursement rules. Grace decided, in effect, to "manage earnings" by reporting only so much of the revenues and earnings of NMC as it needed to "meet street expectations." The rest was tucked away in a reserve for the future, thereby creating a "cookie jar" reserve for future reporting periods. In

[26] Exchange Act Release No. 41313 (April 20, 1999).
[27] Securities Act Release No. 7333; Exchange Act Release No. 817 (September 19, 1996).
[28] Exchange Act Release No. 41578 (June 30, 1999); In the Matter of Eugene F. Gaughan, C.P.A., Exchange Act Release No. 41580; In the Matter of Thomas J. Scanlon, C.P.A..
[29] See, for example, the Form 8-K filed by Cendant Corporation in the Appendix.

1995, Grace sold NMC and reversed the excess reserves remaining, describing the change in its MD&A as "change in accounting estimate."

The SEC has made the issue of so-called "managed earnings" a matter of the highest priority. The issue is quite simple to articulate and yet quite complex in application. A company may "manage" its earnings in many ways. Indeed, it may be argued that most public companies engage to some degree in earnings management on a regular basis. One need only look at the "remarkable ability" of Wall Street analysts so often to predict quarterly earnings of companies "on the nose" to realize that companies will make various judgment calls to ensure that they neither disappoint the analysts nor overshoot the mark by too much.

In pronouncements, including public speeches, and enforcement actions, the SEC has made clear its distaste for earnings "management" which it is safe to say they view as simply a polite word for earnings "manipulation." In the preparation of MD&A, one cannot stress too forcefully the necessity of full, accurate and truthful disclosure that recognizes the obligation to provide the company's own "analysis" of its numbers and what current and anticipated future trends may do to those results in the future.

3. Discretionary Disclosures

Press Releases; Use of Form 8-K

In addition to the required filings of public companies, many situations arise from time to time which cannot wait for the next quarterly or annual filing. Such situations frequently call for the issuance of a company press release in order to disseminate the news between filing intervals. These sorts of press releases are, of course, distinguished in the first instance from the routine and often "feel good" sorts of press releases that companies issue on a regular basis to announce the launch of new products or advertising programs, the opening of new retail outlets, etc. Financial press releases, as distinguished from "PR" press releases provide one of the most common ways for public companies to communicate with the investing public. When is such a press release required to be issued, and what should it say?

The timing and content of press releases have perhaps had more impact on companies in terms of securities litigation than almost any other area. As discussed earlier, earnings warnings – press releases that "warn" analysts and investors that a company is unlikely to meet the then-current "expectations" of Wall Street – often result in dramatic declines in stock price, with the consequent increased exposure to shareholder litigation.

Frequently, however, information **develops** into "material" information over a period of time. As an advisor to a public company, you may have to make a decision as to when the information is sufficiently material to warrant a press release. Then you will need to ensure that the press release does not do more harm than good. By this I do not mean that one should buffer bad news with some good news. One unfortunate tendency of company managements is the overwhelming urge to include some "good news" in a release that is being made because of a <u>requirement</u> to disseminate negative information. How that good news is handled, and whether it essentially undercuts the message of the negative announcement may mean the difference between a suit against the company or not.

Why and when do companies issue such press releases? Where does one discover the "duty" to do so? Effectively there probably is no **requirement** that a public company ever issue a press release. But there are so many circumstances that may necessitate such a release that the exceptions outweigh the general rule.

One of the most common reasons for issuing a press release is compliance with the basic legal requirement that the company must correct previous disclosures that the company determines were incorrect when made or which have become inaccurate due to intervening circumstances.[30] Perhaps the most common single form of "bad news" press release is one correcting either prior announcements by the company or correcting "street" expectations regarding a company's earnings – the so-called "earnings warning." In addition to entanglement with analysts, discussed earlier[31], most public companies have issued press releases and most CEO's and other senior executives have made statements at investor conferences and in other forums that describe anticipated future financial results. While never a good idea it does and will happen. Despite the adoption of the Private Securities Litigation Reform Act of 1995, supposedly protecting most forward-looking statements if the company has in advance warned of risks inherent in its business, such statements sometimes still require the issuance of a press release to correct prior statements that were too optimistic regarding future financial performance.

With regard to corrective and "early warnings," the New York Stock Exchange is explicit in its Listed Company Manual [32] that:

> *A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.*[33]

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[30] Although the Private Securities Litigation Reform Act of 1995, as amended, provides certain safe harbors for "forward looking information," companies still face peril if they fail to advise the public of changes that make previously "correct" statements no longer correct.
[31] See also the discussion below under the topic, Selective Disclosure.
[32] NYSE's Listed Company Manual is available online for any user at www.nyse.com or in hard copy from the Exchange for listed companies.
[33] New York Stock Exchange Listed Company Manual, Sec. 202.05

In these two short sentences are encompassed several important concepts, which are important to public companies whether they are listed on the NYSE or not. The first is that news which is required to be issued should be released "quickly." Another is that a key determinant of whether to issue news is whether that information "...might reasonably be expected to materially affect..." the market price of securities. This standard suggests that even in the absence of certainty, the possibility of a material effect – if that possibility moves towards a reasonable likelihood – then disclosure may well be required.

Disclosure of Pending Legal Proceedings and Investigations[34]

One of the stickier issues facing public companies is whether and when to make disclosure of improper conduct and pending or threatened governmental regulatory or even criminal action. You will recall that Item 103 of Regulation S-K requires disclosure of pending civil legal proceedings which are material to the company's business or financial condition. In at least one area, however, environmental disclosure, a reporting company is required to make a specific and detailed disclosure when it is subject to "proceedings involv[ing] a governmental authority and there is a potential monetary sanction (translation: fine or penalty) of more than $100,000."[35] At least in the environmental area there is a requirement to disclose governmental proceedings where the company faces a fine or other monetary sanction which to many companies would otherwise be an "immaterial" amount and therefore not disclosable if it were exposure in a civil case.

Item 401(f) of Regulation S-K requires disclosure of any criminal conviction of a director or officer of the company during the past five years or any pending criminal proceedings against that person (excluding traffic offenses or other minor offenses).[36] What is not so clear is whether there is any obligation to

[34] See examples in the Appendix of disclosures of the pendency of SEC investigation and also of securities class action filings, both by Tyco International Ltd.
[35] Regulation S-K, Item 103, Instructions, 17 C.F.R. § 229.103.
[36] Regulation S-K, Item 401(f), 17 C.F.R. § 229.401(f).

disclose other sorts of potentially criminal conduct if the company or individual has not yet been charged. The Second Circuit has provided some guidance on the subject, however, in United States v. Matthews, 787 F. 2d 38 (2d Cir. 1986), in which the court overturned a criminal conviction of a company director for failing to disclose in a proxy statement "that he had engaged in a conspiracy to bribe public officials and to defraud the United States" – crimes with which he had not been charged![37] The Second Circuit found that "... at least as long as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution."[38]

However, other courts, in cases following Matthews have been careful to distinguish that case where information withheld from investors – while potentially criminal but not involving formal charges – nevertheless was deemed material to investors and potential investors. For example, see Roeder v. Alpha Industries, Inc., 814 F. 2d 22 (1st Cir. 1987); In re Par Pharmaceutical, Inc. Securities Litigation, 733 F. Supp. 668 (S.D.N.Y. 1990); and Ballan v. Wilfred American Educational Corporation, 720 F. Supp. 241 (E.D.N.Y. 1989). For cases following the holding in Matthews, see, e.g. United States v. Crop Growers Corporation, 954 F. Supp. 335 (D.D.C. Jan. 3, 1997); United States v. Cisneros, 26 F. Supp.2d 24 (D.D.C. 1998); and In re Teledyne Defense Contracting Derivative Litigation, 849 F. Supp. 1369 (C.D. Cal. 1993).

Dealing with Rumors and Information Leaks

Rumors! Another reason to issue a press release may be the existence in the marketplace of rumors or unusual market activity, frequently coupled together. While many public companies try to take a consistent position of not commenting on rumors and issue releases to the effect that "the company's policy is not to comment on rumors about the company," there are times when

[37] United States v. Matthews, 787 F. 2d 38, at 49 (2d. Cir. 1986).

that approach simply will not work. The New York Stock Exchange, once again, takes a position with regard to companies listed on the Exchange:

> *If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required.*
> *A listed company should act promptly to dispel unfounded rumors which result in unusual market activity or price variations.*[39]

All too often, what are characterized as "rumors" are in fact "leaks" from within the parties to a transaction or their advisors. Applying the rule that it is often permissible to say nothing but it is never permissible to mislead or issue false information, a public company must be extremely careful in issuing a release to the effect that "the company knows of no reason for the unusual activity in its stock" or that "the company denies rumors to the effect ..." as these statements may simply be untrue. If there is truth to the rumor, and you are not prepared to give a "no comment" response, then extreme care is warranted to ensure that the company does not mislead investors by denying something which is knows to be true.

For example, if a company is engaged in substantive discussions regarding a possible transaction, such as an acquisition, divestiture, sale or merger, and if the information somehow "leaks out" and affects the stock price, there are a number of alternatives available:

1. The company may issue a statement to the effect that "it never comments on rumors in the marketplace." However such a statement (a) should be true (i.e. has the company taken a consistent position on rumors in the past)

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[38] Id.
[39] NYSE Listed Company Manual, Sections 202.03 and 202.05.

and (b) risks running afoul of the requirement – at least for NYSE listed companies – that "a frank and explicit announcement is clearly required."[40]

2. The company should consider the status of whatever transaction is under way – if the rumor or leak involves a transaction – and determine whether it is in a position to make the "frank and explicit announcement" referred to in the NYSE Listed Company Manual. For example, the company may choose to "acknowledge that it is in discussions regarding the strategic direction of the company and will make an announcement when and if something concrete develops."[41] This may be coupled with a statement to the effect that "...the company does not intend to make any further announcement regarding this matter until it has reached a definitive agreement." Depending upon the circumstances, however, such an announcement might be deemed to be less than "frank and explicit" and the effort to "disclaim" any obligation to update may not be sufficient to avoid in fact having to provide updated information – especially if there is further unusual activity in the stock.

3. The company may decide that due to the "leak" it has no other choice than to make a truly "frank and explicit" announcement by disclosing such of the details as are concrete at that time. Before making a unilateral decision to do so, however, the company has to consider several important matters: (a) it may have signed a non-disclosure agreement with the other party, (b) it has to consider the impact on the other party, especially if it also is a public company, regardless of whether a non-disclosure agreement was signed and (c) it has to consider the impact of the "frank and explicit" announcement on the future course of events. For example, in deciding to issue such a release, there arises a fairly clear duty to continue to update a specific statement regarding the matter, if for no other reason than the risk of selective disclosure of further information to analysts and other third parties.

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[40] Id.

Form 8-K – When to Use It; Mandatory Use Discussed

From discussions with other house counsel and outside counsel as well, there appears to be considerable uncertainty as to when to use Form 8-K, as some companies seem to file a great number of 8-K's whereas others seldom file such a form. There is a misconception among some that Form 8-K is always a discretionary filing, which is not the case. Certain filings on Form 8-K are mandatory in nature. The instructions to Form 8-K provide that a current report on Form 8-K is "...**required** to be filed by every reporting company upon the occurrence of any one or more of the events specified in Items 1-4, 6 and 8 of [Form 8-K]."[42]

Required reports are the following, all due within 15 calendar days following the occurrence of the event unless otherwise noted:

- A change in control of the registrant
- Acquisition or disposition of a "significant amount of assets, otherwise than in the ordinary course of business..."[43] by the registrant or by any majority-owned subsidiary
- Bankruptcy or receivership of the registered company
- Change's in the registrant's certifying accountant – due within five days of the occurrence of the event[44]
- Resignation of a director, or a director's declining to stand for re-election, "...because of a disagreement with the registrant on any matter relating to the registrant's operations, policies or practices..." – due within five days after the event[45]

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[41] Note that such an announcement almost certainly mandates a subsequent announcement when either a transaction can be disclosed or when discussions are terminated.
[42] General Instructions to Form 8-K, at para. B, emphasis added.
[43] "An acquisition or disposition shall be deemed to involve a significant amount of assets (I) if the registrant's [and subsidiary's] equity in the net book value of such assets or the amount paid or received...exceeded 10 percent of the total assets of the registrant and its consolidated subsidiaries, or if it involved a business...which is significant..." General Instructions to Form 8-K, Item 2.
[44] The resignation or dismissal of an independent accountant and the appointment of a new accountant are separate events, which in some cases will require two separate 8-K filings. General Instructions, Item 4.
[45] Under this provision, disclosure is required only if the resigning director furnishes the registrant a letter describing the disagreement and requesting disclosure. "If the registrant believes that the description

- A change in the registrant's fiscal year from the fiscal year used in the most recent filing with the SEC.

If any of these events occurs, an 8-K filing is required, and is **not discretionary**. In most cases, the company also will issue a press release, and one effective use of 8-K is to file a copy of the press release, with nothing more than an introductory paragraph.

Voluntary use of Form 8-K

In addition to the mandatory filing requirements, the instructions to Form 8-K provide for a registrant "...at its option, [to] report under this item any events, with respect to which information is not otherwise called for by this form, that the registrant deems of importance to security holders."[46] Consistent with the voluntary nature of this sort of filing, no time frame is mandated. The SEC **encourages** registrants to make such filings, and to make them "promptly" after the event.[47]

It is this "voluntary" use of Form 8-K which gives rise to more questions than the instances of required use of the form. When should this form be used, and when is it not advisable? If the SEC encourages the use of Form 8-K, why not just file the form whenever possible? Clearly some companies have elected to utilize Form 8-K as almost a routine method of providing information, utilizing such a filing with even routine press releases. Other companies utilize a voluntary 8-K filing only with respect to "significant" press releases, attaching the press release as an exhibit to the 8-K. For example, a number of companies have decided to file their quarterly and annual releases detailing earnings and other financial information for the quarter as an exhibit to Form 8-K.

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provided by the director is incorrect or incomplete, it may include a brief statement presenting its views of the disagreement."

[46] Form 8-K, General Instructions, Item 5, Other Events.

[47] See Discussion, CCH Federal Securities Law Reports, ¶23, 591.020, at p. 17,291-3.

Given that the use of Form 8-K is voluntary under Item 5, there is no hard and fast rule as to whether or when to file. However it would appear obvious that "overuse" of this form of Report **could** be unwise. Consider whether the information contained in a Form 8-K (such as the filing of a press release as an exhibit to an 8-K) more clearly requires "updating" than information disseminated in other ways. Having decided to use an 8-K filing for a particular matter, does a subsequent occurrence of a similar matter, which is not filed with an 8-K give rise to a question as to why no filing was made? There are no clear-cut answers to these questions, but each public company and its advisers must face the questions.

Some interesting examples of the use of Form 8-K are contained in the Appendix. These include 8-Ks filed on December 6, 1999 and on January 12, 2000 by The Kroger Co. The January 12 Form 8-K serves to update the 8-K filed in December of last year and to disclose that the company held a meeting with analysts on January 12, including a very detailed description of estimates and assumptions furnished to the analysts in completing their "models" for the current year. Kroger's December 6, 1999 8-K includes a copy of the company's third quarter earnings press release. While a number of companies make a similar filing, i.e. a filing attaching their earnings press release, note that the 8-K <u>also</u> includes the text of prepared remarks made at the beginning of the investor/analyst conference call made on December 6. This is a rather unusual level of detail at present, but as discussed below, with the potential advent of Regulation FD, more if not most companies will find themselves making similar filings.

While on the one hand, it certainly appears that the management of The Kroger Co. has taken to heart the SEC's recent admonitions regarding selective disclosure[48], it also is arguable that these disclosures border on "information overload." How many investors are really concerned with this level of detail? And aren't the professionals who are interested generally attuned to the analysts' reports as soon as they are issued? Without filings such as those made by The Kroger Co., few companies would deem themselves obligated to update comments made in a conference call, unless extremely material and not covered in an earnings press release. By filing the information, however, it may increase the extent to which updating is required. Does the filing of the information in and of itself suggest a level of importance that mandates updating if the information changes?

Once a company adopts a practice of filing to this level of detail, where does the practice end? Since most companies made presentations to numerous analysts and investor conferences throughout the year, since most CEO's make many speeches to various groups, and since investor relations officers speak almost daily to sell side and buy side analysts[49], when is a disclosure to be made? Must a company file with Form 8-K a copy of each speech its CEO makes? Must the IR officer consider whether he or she has told one analyst some new fact requiring disclosure, measuring carefully the materiality of every telephone conversation?[50] Unfortunately - or fortunately, depending upon one's point of view – newly promulgated Regulation FD from the SEC may make such filings rather routine in the very near future. Forms 8-K of the sort filed by Kroger and included in the Appendix may become routine, and, as usual, the risk that the presence of "too much" information may serve to obscure truly material information.

The SEC's view of integrated disclosure indicates that proper use of Form 8-K plays an important and even critical role in providing investors with a "continuous stream of corporate information."[51] Coupled with recent SEC emphasis on avoiding selective disclosure, it appears likely that we will see more

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[48] See discussion infra, in detail, of recently promulgated preliminary SEC rules on selective disclosure.
[49] "Sell side" analysts generally work for the major investment banking firms and follow a particular segment of the marketplace, making buy or sell recommendations to their firm's investors and publishing their recommendations for a variety of investors. "Buy side" analysts generally work for major institutional investors, such as large mutual funds, and analyze companies for the purpose of investment decisions made by their companies.
[50] See Discussion infra at topic Selective Disclosure and discussion of proposed SEC Regulation FD.
[51] CCH Federal Securities Law Reports, ¶ 23,591.055, citing to SEC Release No. 33-6383.

rather than less utilization of Form 8-K filings, accompanied by all sorts of information, ranging from the text of press releases to copies of prepared comments made in a variety of forums.

In this environment, what approach should the company take? My own view is that use of Form 8-K is still best reserved for more material information, rather than routine filings of all sorts of information. It is all too easy to imagine a plaintiffs' suit against a company that routinely uses 8-K filings and yet fails to do so in that one critical instance in which equally material information is not so filed, because the company simply decides not to file, or overlooks the matter and its past practice of filing in similar circumstances. Where the use of such filings is reserved for really material news, there appears less likelihood of a "slip-up" resulting in a suit that otherwise might have been avoided. Moreover, there are other ways of dealing with concerns about selective disclosure, including making conference calls more inclusive of the investing public and not just analysts, utilizing Websites to post conference call information and similar devices.

Selective Disclosures

We have already discussed the topic of selective disclosure in the context of several other areas of interest. But what **is** "selective disclosure" exactly, and what are the consequences of engaging in it? "Selective Disclosure" refers to the disclosure to one or more persons, but not to others, information that is "material" to the company. The topic of selective disclosure, whether of bad news or good news, cannot be understood in the absence of a clear understanding of "materiality" since it is only material information that is of concern in dealing with selective disclosure.

The issue of materiality of information can be determinative of (1) whether a company has a disclosure obligation; (2) whether insiders may have individual liability when trading in the securities of a company while in possession of information and (3) whether discussion of the information with analysts and other third parties constitutes "selective disclosure" of that information. To understand whether you must make a disclosure, when you must make it, whether you are free to trade in a company's securities or whether your communications with third parties may be coming close to the line of selective disclosure, you must know what information is material.

Guidance from the Supreme Court is that information is material if there exists "...a substantial likelihood that the...[information] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[52] Another source of guidance is the Financial Accounting Standards Board ("FASB"), which states that a statement in a financial report is material:

> *...if, in the light of surrounding circumstances, the magnitude of the item is such that it is probably that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.*[53]

The SEC also has provided recent guidance as what is "material" in the context of financial statements. In Staff Accounting Bulletin No. 99 (August 12, 1999), the SEC staff deals with materiality by way of rejecting a purely quantitative analysis of whether information is material or not. In so doing, it offers some guidance to considerations you might make in evaluating "materiality" in other contexts.[54]

- Does a particular item of information "mask a change in earnings or other trends"?

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[52] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976), citing Basic v. Levinson, 485 U.S. 224, 231 (1988).
[53] FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, at 132 (1980).
[54] SAB No. 99, available at www.SEC.gov.

- Does the information reflect a failure to meet estimates of financial analysts who follow the company?
- Does the information change a loss into income or vice versa?
- Does the information concern a change or particularly favorable or unfavorable trend with respect to a particular segment of the business that is key to its success, even though not yet reflected in a major change in results of the enterprise as a whole?
- Does the information pertain to non-compliance with a regulatory matter, including environmental, FTC, FDA and similar considerations?
- Does the information disclose a failure to satisfy covenants in loan agreements or other mandatory requirements binding the company?
- Does the information reveal an unlawful transaction or practice?
- Is the information likely to cause a significant movement in the price of the company's securities?[55]

While SAB No. 99 deals with financial statement reporting and not the determination of whether other types of information require public disclosure, it certainly offers a sense of the SEC accounting staff and presumably all the staff, including enforcement, on the topic of what is material. When evaluating whether to make a public release of information, the checklist of items material in the financial statement context is not a bad guide.

With this "guidance" what can we say about "materiality" and "material information"? It seems clear that determining whether information is material cannot be a purely quantitative analysis but requires a qualitative evaluation as well. It takes us back to the Supreme Court test: Would the information be important to, or make a difference to an average investor in deciding whether to buy, sell or hold a particular security? In some contexts, even seemingly insignificant bits of information may reflect issues that have far-reaching importance. All of this suggests that dealing with analysts and investors,

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[55] SEC Staff Accounting Bulletin: No. 99, Materiality, August 12, 1999, See Appendix at page 4

especially institutional investors, is a process of constantly evaluating on a qualitative basis the information sought by those with whom the company comes into contact, determining whether that information has been made public and the likely consequences of disclosing it in the context of an interview, conference call or investor conference appearance.

In addition to the regulations promulgated by the SEC (including proposed Regulation FD, discussed below), there are many other indications of the concerns of the Commission with selective disclosure of material information. When Chairman Levitt stated in a 1998 speech that "it is very clear to me – and the SEC's Enforcement Division – that issuers should not selectively disclose information to certain influential analysts in order to curry favor with them and reap a tangible benefit, such as a positive press spin," [56] companies and their counsel need to sit up and take notice.

There are many insidious problems in dealing with analysts, as discussed elsewhere in this paper. Despite the supposed "wall of silence" between the analyst side of the house and the brokerage side of the house at major investment banking institutions, there have been far too many instances of analysts providing early warnings to their brokerage colleagues, or to their own "clients" based upon information gathered in the process of due diligence in anticipation of issuing a report on a company.

Dealing with analysts has been compared to "fencing on a tightrope, "[57] an image that you need to pause over for a moment to fully appreciate the nuances of that metaphor. It is at once exhilarating and dangerous. It requires enormous skill, training and preparation, but no matter how skilled you may be, there remains an element of luck in staying on the wire. If you are an in house counsel or attorney who regularly counsels managers who deal with analysts, the media and investors, you must insist that those managers take the time to learn the basic rules of doing so. Make certain that **you** know the basic case law and the

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[56] Levitt, A Question of Integrity, Speech delivered February 27, 1998, available at WWW.SEC.gov.
[57] Dirks v. SEC, 445 U.S. 222 (1980).

rules embodied in that caselaw -- and then be very careful. As if such care were not already obvious enough, the publication of proposed Regulation FD has underscored the dangers of selective disclosure in new and interesting ways.

Proposed New SEC Rule on Selective Disclosure – Regulation FD

The SEC has recently promulgated new rules, summarized by the Commission as addressing three issues:

> *[1]The selective disclosure by issuers of material nonpublic information; [2] whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information; and [3] when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading. The proposals are designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading.*[58]

Three proposed new SEC rules are available for public comment through March 29, 2000. Of the three proposed rules (Regulation FD (Fair Disclosure), Rule 10b5-1 and Rule 10b5-2), we will focus on proposed Regulation FD.

Succinctly put in the Commission's executive summary, "Regulation FD...deals with the problem of issuers making selective disclosure of material nonpublic information to analysts, institutional investors or others, but not to the public at large."[59] As the summary continues, "Although analysts play an important role in gathering and analyzing information, and disseminating their analysis to investors, we do not believe that allowing issuers to disclose material

[58] Proposed rule: Selective Disclosure and Insider Trading; Release Nos. 3307787, 34-42259, File No. S7-31-99. A copy is contained in the Appendix to this paper.
[59] Id., at p. 2.

information selectively to analysts is in the best interests of investors or the securities markets generally."[60]

In a lengthy "background" section explaining the need for Regulation FD, the Commission discusses the caselaw, including the Supreme Court's decisions in Chiarella v. United States[61] and Dirks v. SEC[62] and notes that "promoting investor confidence in the fairness of our securities markets..." requires "...protecting investors from the prospect that others in the market possess 'unerodable informational advantages' obtained through superior access to corporate insiders."[63] Noting that "issuers are continuing to engage in selective disclosures of material nonpublic information, perhaps due in part to the uncertainty in current law about when selective disclosures are prohibited...,"[64] the SEC's proposed Regulation FD uses the Commission's regulatory authority over public companies "...to require "full and fair disclosure [from issuers] of material information..." [65]

The basic outline of Regulation FD is contained in Rule 100:

§243.100 General rule regarding selective disclosure.

(a) Except as provided in paragraph (b) of this section, whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person or persons outside the issuer, the issuer shall:

(1)In the case of an intentional disclosure, make public disclosure of that information simultaneously; and

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[60] Id. It should be noted that the New York Stock Exchange has had a similar rule for many years, embodied in Rule 202.02. Among other things, this rule provides that "...if during the course of a discussion with analysts substantive material not previously published is disclosed, that material should be simultaneously released to the public. While "on the books" it seems that this rule may have been honored more in the breach than the observance. See Appendix for copy of NYSE Rule 202 on Material Information.

[61] 445 U.S.222 (1980)

[62] 463 U.S. 646 (1983)

[63] Id., at p.3.

[64] Id., at p.2.

[65] Id., at p.5.

(2) In the case of non-intentional disclosure, make public disclosure of that information promptly.

(b) Paragraph (a) of this section shall not apply when a disclosure is made to a person who owes a duty of trust or confidence to the issuer (including, for example, an outside consultant such as an attorney, investment banker, or accountant) or to a person who has expressly agreed to maintain such information in confidence.[66]

The definitions in §243.101 provide further guidance. A disclosure is "intentional" when the issuer or person making the disclosure "...either knew prior to the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic."[67] A "person acting on behalf of an issuer" includes "any officer, director, employee, ***or agent*** of an issuer, who discloses material nonpublic information while acting ***within the scope of his or her authority***..."[68] An interesting exception states that "an officer, director, employee, or agent of an issuer who discloses material nonpublic information ***in breach of a duty of trust or confidence*** to the issuer shall not be considered to be acting on behalf of the issuer."[69]

A "public disclosure" of the information is made in one of three ways: filing an 8-K; issuance of a press release containing the information through a widely circulated news or wire service; or dissemination of "...the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access, such as announcement at a press conference to which the public is granted access...by personal attendance or by telephonic or other electronic transmission."[70]

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[66] Proposed Regulation FD, §243.100, at page 35 of SEC Release contained in the Appendix to this paper.
[67] §243.101(a)
[68] §243.101(c), emphasis added
[69] Id., emphasis added
[70] §243.101(e).

As with many rules having profound impact (e.g. Rule 10b-5), proposed Regulation FD says quite a lot in relatively few words. Assuming its final adoption in current form (and there is really no reason to suspect otherwise), it has the potential to make significant changes in the manner in which public companies relate to the investment community. Relationships with analysts and institutional investors are likely to be changed in ways as yet unclear. CEO's and CFO's who routinely meet in "one on ones" with analysts and major institutional investors conceivably may be limited to carefully scripted statements or may have to consider whether to maintain a verbatim record of the interview or meeting in order (1) to remember precisely what they said, whether any of it constituted "material nonpublic information" thereby requiring "prompt" [71] disclosure to the public and (2) as a defense to Commission enforcement action or possible third party lawsuits. And this is only to safeguard against "**non-intentional**" disclosures of material nonpublic information.

Analysts and institutional investors periodically travel hundreds and thousands of miles to visit the companies they follow or in which they may have millions of dollars invested. They are paid handsomely to provide accurate investment analysis or to make "smart" investments that give their institutions an edge over the competition. They are smart and inquisitive. Does anyone really think that they will continue to go to all that trouble for "nonmaterial" information or only for material information that is already public anyway?

The fact is that analysts on both the sell and buy sides will continue to probe and ask tough questions of managements. They will pry and prod, seeking to gain an advantage in terms of having a more insightful report or a better return for investors than the competition. In some respects, these people **exist** precisely for the purpose of seeking to get behind the information that is publicly available. They will continue to sponsor conferences in exotic locations – Hawaii and Vail in the Winter, beach resorts and England in the Summer – for

[71] Disclosure is to be made promptly, meaning "as soon as reasonably practicable (but in no event more than 24 hours) after a senior official of the issuer…knows, or is reckless in not knowing, of the non-

the primary purpose, I would argue, of trying to gain access to material nonpublic information.

And why should they not continue to do so? The burden of proposed Regulation FD rests squarely on issuers, their officers, directors, employees and agents. Nothing in the proposed regulation says that an analyst or financial reporter cannot ask questions that call for disclosures of material nonpublic information. They can ask, but the issuer must carefully evaluate before it answers, and particularly so if Regulation FD becomes final in its present form. As we all know, it is not always easy to decide what information is "material" particularly when dealing with a skilled analyst who may string together a series of disclosures that could seem "immaterial" standing alone, but which become "material" when combined with other disclosures and the analysis of the analyst.

Certainly in some contexts, the easiest course of action for an issuer may be to issue a printed copy of the CEO's prepared remarks to an investor conference. Why run the risk that he or she will inadvertently make a selective disclosure of material information? But such forums always include question and answer sessions. And since they are in exotic locales, most attendees will come early and stay late, for the skiing or the watersports, talking to other attendees over dinner or on the golf course – not to mention at cocktails, where inhibitions may be reduced. How will issuers deal with those situations?

For Immediate Release

> *New York, NY – While playing golf today with a group of analysts, our Chairman and CEO, Larry Loudmouth, predicted record sales for the second half of the year, noting for the first time that production at our facilities in Louisiana is expected to resume well ahead of schedule. We determined that this information may be material and therefore require disclosure under Regulation FD. For further information, contact our investor relations officer, Sally Silly, but don't expect her to answer questions beyond the scope of this press release.*

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intentional disclosure.

Of course it sounds rather silly today, but is it so far from reality if Regulation FD becomes final and is conservatively interpreted? In the context of proposed Regulation FD, such disclosures do not sound as much like a case of "over-disclosure".

In the area of precautionary activity, the commentary provided by the SEC in its Release on Regulation FD suggests some steps that companies may take to avoid non-compliance with the proposed rules. First, they recommend limiting the number of persons who are authorized to make disclosures and answer questions from analysts, investors or the media.[72] Most public companies today have a designated "investor relations" and/or "media relations" person to handle day to day inquiries that come in to the company. Attendance at investor and analyst conferences is largely limited to CEO's and CFO's, but many of them – particularly CEO's – are not among the most "trainable" members of any executive team, so considerable emphasis needs to be placed on training and instructing senior managers as the rules.

A second recommendation contained in the Release is that issuers "...make sure that some record is kept of the substance of private communications with analysts or private investors – for example, by having more than one person present during these contacts or by recording conversations."[73] The third suggestion is that "...issuer personnel can decline to answer questions that raise issues of materiality until they have had an opportunity to consult with others."[74]

The commentary to proposed Regulation FD also suggests that issuers "...secure the agreement of analysts not to make use of certain information for a limited time until they have had the opportunity to review ...notes of the

[72] SEC Release on Regulation FD, at p. 7.
[73] Id.
[74] Id.

conversations and engage in whatever consultation they deem necessary to reach a conclusion as to materiality."[75]

For anyone experienced in dealing with analysts and investors, the specter of entering a brave new world is clearly present. Attorneys may cheer the SEC's advice that "when particularly difficult issues arise, responsible officials should seek the advice of counsel."[76] While commenting that "...though it is likely that this Regulation will require corporate officials to consider more thoughtfully precisely what to disclose, it is unlikely, given the robust, active capital market, that the flow of information to the market will be significantly chilled."[77] But two sentences later, the writers of the SEC commentary state that "we request comment on whether the use of the procedures discussed above or similar procedures can significantly reduce the risk of "chilling" the flow of corporate information to the marketplace."[78] It will prove interesting to see what effect, if any, comments from corporate America and the corporate bar will have on the proposed rule.

Since it is reasonable to assume that Regulation FD will become final in something like its proposed form, some views on ***reasonable*** efforts to comply with it are in order. First, issuers, their senior officers and spokespersons will simply have to become more knowledgeable in the area of what is "material" and what information is likely to lead to material conclusions by analysts and investors. Secondly, the open and friendly relationships with analysts will necessarily have to be "chilled" somewhat. When companies begin to tape record conversations with analysts and/or insist that someone be in the room during the conversation – for example inhouse counsel – the relationship cannot remain as open as it is today.

Because analysts, investors and the media are essentially unaffected by Regulation FD, the burden will be on the issuer to "reign in" these persons by

[75] Id.
[76] Id.
[77] Id.
[78] Id, at p.8

imposing on them a responsibility that could give rise to liability for trading on inside information, or becoming a "tipper". This will most likely be accomplished by requiring that such persons sign a confidentiality agreement, a form of which is contained in the Appendix. Such an agreement will state that during the course of the conversation, there may be a "disclosure of material nonpublic information" and requiring that **all** information be embargoed for a given period of time (say, 24 hours) during which the issuer will evaluate the interview and advise the analyst if any portion of the interview must **remain** subject to the confidentiality agreement. The burden will undoubtedly be on the issuer to make a quick evaluation and communication to the analyst, or otherwise he or she will be free to use the information.

The adoption of such a policy would afford the issuer the protection of proposed Rule 243.100(b), which states in material part that public disclosure of material information is not required "...when a disclosure is made to a person who owes a duty of trust or confidence to the issuer...**or to a person who has expressly agreed to maintain such information in confidence**."[79] The analyst who signs a confidentiality agreement would become such a "person" and would thereby both free the issuer from having to make any disclosure and also would become potentially liable under Rule 10b for violating that confidentiality agreement.[80]

As the use of the Internet and Websites grows, one question may be the extent to which a company's Website may serve to satisfy the public disclosure requirements of Regulation FD. While encouraging the use of Websites, the SEC commentary in its Release makes clear that it "...would not consider a Website posing by itself to be a sufficient means of public disclosure." A footnote explains that "despite the rapid expansion of Internet access, a significant

[79] Proposed Rule 243.100(b)

[80] Not to mention, of course, potential liability for breach of contract with the issue, which could be imposed on the analyst's employer, for example.

number of households do not have access. Moreover, simply putting information on a Website does not alert investors that it is available."[81]

Another topic of concern – although perhaps it becomes a foregone conclusion under the proposed Regulation – is access to quarterly and other conference call with analysts. Many companies have made it a practice to limit access to such calls in the past. The phone number is not publicly disseminated, and analysts are in essence "invited" to phone in, hear a presentation and ask questions. Given the nature of such calls, which aim to provide information "behind" the text of earnings and other press releases, it would seem virtually impossible to deny access on the call to anyone who chooses to call in if Regulation FD is adopted in its present form. An "open" call would appear much preferable to another alternative, which would be to "embargo" the information on the call pending a company determination as to whether it must make a full public disclosure by means of press release or similar disclosure. As a practical matter, such an embargo would be virtually impossible.

In conclusion on this topic, here are some suggestions for consideration in the likely event that Regulation FD becomes final:

- Designate a limited number of persons who are authorized to speak on behalf of the issuer, and see that those persons are educated as to the requirements of the Regulation and the meaning of "materiality"
- On quarterly earnings release and other conference calls with multiple analysts, the call should be open to the "public" including of course media and even the competition.
- In "one on one" meetings with analysts and investors, insist on having signed some form of confidentiality agreement that will embargo the information disclosed in the meeting until a thoughtful analysis can be made and any material information kept confidential unless the issuer is prepared to make full public disclosure of it.

[81] SEC Release, at p. 11.

- Whenever possible, disclosures should be carefully scripted and even rehearsed. An investor relations executive who answers her own phone is asking for problems. It is almost always better to ***return*** calls than to ***take*** them. This affords an opportunity to consider the identity of the caller, the likely areas of inquiry, the best ways to phrase the responses, etc. It also increases the likelihood that consistent information will be provided from person to person.
- Issuers should routinely release the text of prepared remarks made by company spokespersons at analyst and investor conferences, and conference organizers should consider a "blanket rule" that answers to Q&A be embargoed for some period of time to allow speakers at the conference to declare information "confidential". Release of the text of prepared remarks should be made "simultaneously" with the actual presentation by means of a press release. The text also may be posted on the issuer's Website, but this is not adequate disclosure under the rule.
- When providing information for analysts "models" or reviewing their reports for "factual errors," be especially careful.[82] It is all too easy to become "entangled" in the reports of analysts. Your job in reviewing the draft report is to look for factual errors, or assumptions that are wildly off the mark. Don't correct the analyst's "conclusions," but it is okay to point out erroneous assumptions or math errors. Above all, don't write the report for any analyst. If you check , you will find that most of these people are making a lot more money than you are, so why should you do their work for them? There is no guarantee that following these steps will avoid the problem of "entanglement" but if you write the report, you may as well publish it as well, because it is yours.

[82] See Elkind v. Liggett & Myers, 635 F.2d 156, at 162-164 (2nd Cir. 1980) for a good discussion of the consequences of becoming "entangled" in analysts' reports.

- When in doubt, stick to the truth. Sounds too easy, but it is a rule that will avoid much grief later. If the truth is too painful to disclose, then make it clear that you cannot deal with that particular topic. Never try to "fake it" and never resort to information that is what you wish things were, rather than the way they really are.
- Have counsel – whether inhouse or outside – become more involved in all presentations to analysts and investors and in evaluating whether and when to make full public disclosures.

The Internet and Chatrooms

One of the particular phenomenons of the Internet Age is the proliferation of chatrooms and other forums for the exchange of ideas. The SEC has recently begun to look closely at the potential for such forums to move a stock price, and therefore the potential for manipulation of a stock price. In fact, the entire subject of the Internet has been made a separate page on the SEC's Website (***www.SEC.gov***) under the Enforcement Division section of the site under "Internet Related Announcements." Violations range from chatroom manipulations to the offering for sale of unregistered over auction sites such as eBay![83]

In one particularly well-publicized enforcement action, the SEC recently (January 5, 2000) filed suit against an Internet "personality popular with day traders, nicknamed "Tokyo Joe" and his company, which dispensed investment advice over the Internet. The defendants, whose real names are Yun Soo Oh Park (a/k/a Tokyo Joe) and Tokyo Joe's Societe Anonyme Corporation, have

been charged with engaging in schemes to defraud members of the Tokyo Joe stock recommendation service. Among other things, "Joe" is charged by the SEC with having posted false performance results, failing to disclose that he received compensation from companies whose stock he recommended over the

Internet and failing to disclose that he was selling stocks he recommended that others purchase.

Members of the day trading community paid $100 to $200 per month for Joe's advice, including stock picks. In addition, Joe's company operated a chat room to discuss Joe's picks and other investment matters. He also sent e-mails recommending stock picks to members of his service. According to the complaint, Joe bought stocks, recommended them to his members (who regularly traded up the price of the stock) by means of his chatroom and then selling the stock himself at a handsome profit. The SEC complaint seeks a permanent injunction against Tokyo Joe and his company and disgorgement of ill-gotten gains as well as civil monetary penalties.

Without of course prejudging the outcome of the case, if the allegations are established by the Commission's enforcement division, it serves to prove perhaps one thing. The Internet is no different than any other channel of communication in terms of the potential for spreading false and misleading information and plain old-fashioned fraud. Yet there remain many who somehow believe that the Internet is used only by well-intentioned and honest individuals desiring to share information with their fellow day traders.

What should you do if your company becomes (and it almost certainly will) the subject of chatroom conversation? Even if your company is not the subject of a "fraudulent" chatroom, the fact is that many investor chatrooms are little more than "rumor mills". Yet more than a few companies have been placed into difficulty for years by rumors spread in ways other than over the Internet. In this sense there is little to distinguish chatrooms from other kinds of rumors. The principal difference is that chatrooms offer the potential for rumors to spread much more quickly and widely than at any other time in the history of financial markets.

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[83] For example, see the cases in the Appendix, In the Matter of Richard L. Davis, In the Matter of J.R. Hoff and In the Matter of Louis B. Sitaras, all issued on October 20, 1999.

The basic principles remain the same as with dealing with any other rumors. The wrong response is to get the company or its representatives involved in the world of chatrooms themselves. Avoid the temptation to have a company representative go "into" the chatroom to set the record straight. Doing so only adds credibility to the chatroom process and validates the information contained in the chatroom. If it were meaningless, or the chatroom itself not credible, why would the company go on line to refute it? Even worse is to have a company representative go into the chatroom *anonymously* to try to correct misinformation. The risks are many. If discovered (and that is a real possibility), there is an impression that the company did something wrong in concealing that it was behind a chatroom participant. You don't want to be compared with our friend, Tokyo Joe. Another real concern is that by participating in a chatroom "discussion" the Company or its representative could engage in what amounts to selective disclosure. Company communications should come in very limited ways as discussed above. Only official company spokespersons, using customary means of communications – press releases, filings of Forms 10-K, 10-Q and 8-K – should speak on behalf of the company.

Conclusion

We have looked at a number of issues relating to the release of bad news – or simply news – by or on behalf of public companies. What conclusions can we draw from this review? First of all, that every public company, its management and advisers, including it inhouse and outside attorneys, must ensure that they understand thoroughly the mandatory disclosures required by SEC rules and releases. In areas such as MD&A, there remain far too many instances of companies not taking seriously the requirements inherent in this required disclosures, relying too heavily on boilerplate language and merely updating "last year's filings."

Additionally we can safely conclude that areas such as selective disclosure are at the highest levels of attention and concern at the SEC. With the likely advent of Regulation FD, and reviewing the commentary that accompanies the rule during the period in which persons may comment on the Regulation, it is obvious to anyone who follows these sorts of developments that the Commission is going to be looking very closely at instances of perceived selective disclosure and likely will seek early enforcement of alleged violations of Regulation FD in order to make a point about these matters.

In the midst of the longest running bull market in the history of American securities, with companies trading at multiples of *sales* that used to be reserved for multiples of *earnings*, the potential risks to public companies have never been greater. One way of controlling those risks is to adhere rigorously to the standards of disclosure that mandate revealing that information which a reasonable investor would find material in making a decision to buy or sell the securities of the company at the earliest time at which the company can make a reasonably definitive determination as to the existence of the information and its materiality. In the Internet age, coupled with Moneyline, CNN's Business Hour, CNBC's 24-hour ticker and the venerable Wall Street Week with Louis Rukeyser, there remains no excuse for sharing material information only with a select group of analysts and large investors.

To test your own knowledge of the rules and principles applicable to dissemination of news and selective disclosure, I have provided some hypothetical examples of fact situations which serve to provoke your own thinking in the context of real world situations. Those are contained in the following pages, after which there is an Appendix with several items relevant to this discussion.

Hypothetical Case Studies

In each of the following hypotheticals, consider whether a disclosure is required, how and when any required disclosure should be made and the consequence of not making disclosure.

1. Company XYZ.com, Inc. has developed a technology that greatly expedites ordering of products by repeat customers, allowing them to place orders by "one click" of a computer mouse. XYZ has secured a patent on the technology. A competitor, Q&R.com, Inc., obtains advice of counsel that the patent should not have issued and therefore is invalid as the technology is merely a non-unique compilation of various elements of prior art. Q&R launches its own slightly modified "one click" system and is promptly sued by XYZ. A district judge enjoins Q&R from using the system while the case proceeds to trial on the merits. Assuming that the convenience of one click ordering is a material advantage to XYZ, what disclosure is Q&R required to make? Naturally, XYZ will probably issue its own "good news" press release discussing its "triumph" over Q&R, but is this sufficient to discharge any duty of disclosure by Q&R?

2. Texas Pete's, a Mexican fast food chain, has enjoyed rapid growth in a relatively short period of time. The brainchild of Pete Schmedlap, the IPO was a huge success, and the stock has quadrupled in only two years, with rapid growth, fueled in part by a series of television ads featuring the CEO in various amusing skits. The last of 10 children, Pete is now a multi-millionaire, at least on paper, since all of his wealth is tied up in Texas Pete stock. At a Board meeting, Pete announces:

   A. That he is an alcoholic and needs to take several months off to take the "cure" for his condition. This is personally embarrassing to Pete, and he wants to avoid disclosing the situation. Several ads are "in the can" and the CFO can handle investors for a while.

   B. That he has inoperable cancer and has been given only a year to live. He can function for about six months, during which time he will continue to lead the company while a successor is selected. He will also continue his personal TV ads. For the sake of his family, however, he would like an opportunity to liquidate a portion of his substantial holdings in Texas Pete's and therefore would like to delay any announcement until he is too ill to function or a successor is named.

   The Board asks your advice on what disclosure, if any, is required in these situations.

3. Big Corp. has received a letter from the SEC advising that the Commission is informally investigating trading activity in Big Corp's stock in the period surrounding the announcement of its acquisition of its largest rival. The SEC provides a list of individual names and asks Big Corp if it can identify any of the persons named on the list. The General Counsel circulates the list to the executive management team, but no one recognizes any of the names. Does Big Corp have an obligation to make a disclosure?

   What if Big Corp's CEO recognizes the names of his brother-in-law and several other members of his wife's family?

   What if the list contains the names of several high-ranking employees of the company's largest division?

   What if the list contains the names of several administrative level employees (i.e. secretaries)? What if they are in the executive suite or the finance department?

4. Sam, the secretary, accuses CEO Martha of sexual harassment. Martha founded the company, took it public and is the personification of wholesomeness in the media and on her popular TV appearances.

   a. An internal investigation is inconclusive, but the consensus is to settle the claim for big bucks, with a confidentiality covenant.
   b. Alternatively, the investigation discloses that the actions occurred, and Martha is remorseful, stating that nothing like this has ever happened to her before and it won't happen again.
   c. Alternatively the investigation uncovers not only credible evidence of the harassment, but also a pattern of such activity by Martha over the years. Nevertheless, given the importance of Martha to the company, a settlement is negotiated with Sam.

   What disclosures are required or should be made in these situations?

5. Large Corp.'s CEO is attending an investor conference and ski-weekend at a Colorado resort. The meeting is sponsored by Big Fees, Inc., an investment banking firm. In attendance at the conference are a number of companies in Large's industry group, as well as dozens of analysts and investment bankers from Big Fees. At a cocktail party, the CEO is surrounded by a group of analysts who engage in Q&A about new product ideas, what is on the drawing boards. Also in the discussion are CEO's from Ultra, Inc. and Big-Is-Us Corporation, both arch-competitors of Large. The next morning on the ski slopes, Large's CEO wonders if she talked too much at the cocktail reception, especially about several new products that are still in testing. She calls the company's general counsel and asks you for advice as to what to

do, and please have the answers by the time she skis to the bottom of the black diamond course!
What advice do you give? What disclosure obligations do you see for Large? Are there any disclosure obligations for the other two CEO's? What impact would new Regulation FD have on your advice?

6. Your company's stock has been moving steadily downward for the past several weeks. You have no material unpublished information, and the business appears to be doing well, or at least as well as you have told the street. There have been "rumblings" of a slowdown in the second half of the fiscal year, but those have not yet risen to the level of mandatory disclosure, as there has been no determination that earnings will not meet expectations. You learn that a popular trading chatroom has been discussing your stock and that the discussions have included "rumors" of a slowdown in the second half of the year. You are furious that these rumors, which have at least some basis in fact, have managed to leak outside the company, but you are uncertain as to what action to take. What can you do? What should you do?

SEC RELEASE ON PROPOSED REGULATION FD

Proposed Rule:
Selective Disclosure and Insider Trading

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 240, 243, and 249

Release Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99

RIN 3235-AH82

Selective Disclosure and Insider Trading

Agency: Securities and Exchange Commission

Action: Proposed rule

Summary: The Securities and Exchange Commission is proposing new rules to address three issues: the selective disclosure by issuers of material nonpublic information; whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information; and when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading. The proposals are designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading.

Dates: Public comments are due on or before March 29, 3000.

Addresses: Please send three copies of your comment letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549-0609. Comments can also be sent electronically to the following e-mail address: rule-comments@sec.gov. Your comment letter should refer to File No. S7-31-99. If e-mail is used, include this file number on the subject line. Anyone can inspect and copy the comment letters in the Commission's Public Reference Room at 450 5th St., N.W., Washington, D.C. 20549. Electronically submitted comments will be posted on the Commission's Internet web site (http://www.sec.gov).

For Further Information Contact: Richard A. Levine, Assistant General Counsel, Sharon Zamore, Senior Counsel, or Elizabeth Nowicki, Attorney, Office of the General Counsel, at (202) 942-0890.

Supplementary Information: The Securities and Exchange Commission (Commission) today is proposing for comment new rules: Regulation FD,[1] Rule 181 under the Securities Act,[2] Rule 10b5-1,[3] Rule 10b5-2,[4] and amendments to Forms 8-K[5] and 6-K.[6]

I. Executive Summary

Information is the lifeblood of our securities markets. Congress enacted the federal securities laws to promote fair and honest securities markets, and a critical purpose of these laws is to promote full and fair disclosure of important information by issuers of securities to the investing public. The Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), as implemented by Commission rules and regulations, provide for systems of mandatory disclosure of certain material information in securities offerings and in periodic reports.

The antifraud provisions of the federal securities laws also play a very important role in furthering full and fair disclosure. Among other things, the antifraud provisions prohibit insider trading, or the fraudulent misuse of material nonpublic information. Unlike the law underlying the issuer disclosure requirements, which generally has been developed through statutes and rules, the law of insider trading has largely been developed through a series of Commission and judicial decisions in civil and criminal enforcement cases involving fraud charges. As a result, a few areas of insider trading law have been marked by disagreement among the courts.

Today's proposals address several issues related to full and fair disclosure of information, and insider trading law. The proposed rules are the following:

- **Regulation FD** (Fair Disclosure), a new issuer disclosure rule, deals with the problem of issuers making selective disclosure of material nonpublic information to analysts, institutional investors, or others, but not to the public at large. Although analysts play an important role in gathering and analyzing information, and disseminating their analysis to investors, we do not believe that allowing issuers to disclose material information selectively to analysts is in the best interests of investors or the securities markets generally. Instead, to the maximum extent practicable, we believe that all investors should have access to an issuer's material disclosures at the same time. Regulation FD, therefore, would require that: (1) when an issuer intentionally discloses material information, it do so through public disclosure, not through selective disclosure; and (2) whenever an issuer learns that it has made a non-intentional material selective disclosure, the issuer make prompt public disclosure of that information.

- **Rule 10b5-1** addresses an important unsettled issue in insider trading law: whether the Commission must show in its insider trading cases that the defendant "used" the inside information in trading, or merely that the defendant traded while in "knowing possession" of the information. The Rule would state the general principle that insider trading liability arises when a person trades while "aware" of material nonpublic information, but also provides four exceptions to liability. In these four situations, where a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith, it will be clear that the trader did not use the information he or she was aware of.

- **Rule 10b5-2** addresses another unsettled issue in current insider trading law: what types of family or other non-business relationships can give rise to liability under the misappropriation theory of insider trading. The Rule would set forth three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving information: (1) when the person agreed to keep information confidential; (2) when the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and (3) when the person who provided the

the securities markets. As a recent academic study indicated, selective disclosure has the immediate effect of enabling those privy to the information to make a quick profit (or quickly minimize losses) by trading before the information is disseminated to the public.[15] Indeed, while issuer selective disclosure is not a new practice,[16] the impact of such selective disclosure appears to be much greater in today's more volatile, earnings-sensitive markets. Accordingly, we think that a continued practice of selective disclosure by issuers inevitably will lead to a loss of public confidence in the fairness of the markets.

Even apart from the issue of fundamental fairness to all investors, selective disclosure poses other real threats to the health and integrity of our securities markets. Corporate managers should be encouraged to make broad public disclosure of important information promptly. If, however, they are permitted to treat material information as a commodity that can be parceled out selectively, they may delay general public disclosure so that they can selectively disclose the information to curry favor or bolster credibility with particular analysts or institutional investors.[17]

Moreover, if selective disclosure were to go unchecked, opportunities for analyst conflicts of interests would flourish. We are greatly concerned by reports indicating a trend toward less independent research and analysis as a basis for analysts' advice, and a correspondingly greater dependence by analysts on access to corporate insiders to provide guidance and "comfort" for their earnings forecasts.[18] In this environment, analysts are likely to feel pressured to report favorably about particular issuers to avoid being "cut . . . off from access to the flow of non-public information through future analyst conference phone calls" or other means of selective disclosure.[19] This raises troubling questions about the degree to which analysts may be pressured to shade their analysis in order to maintain their access to corporate management. We believe that these pressures would be reduced if issuers were clearly prohibited from selectively disclosing material information to favored analysts.

These concerns about selective disclosure are widely shared, as reflected both in stock exchange listing standards and in "best practices" guidelines of investor relations and analyst groups. The New York Stock Exchange Listed Company Manual and the NASD Rules both require listed issuers to disclose promptly "to the public" information about material developments.[20] The National Investor Relations Institute (NIRI) guidance in this area also states that an issuer "should not disclose in selective situations – such as conference calls and analyst meetings – information that it is unwilling to make available for general public use."[21] Similarly, the Association of Investment Management and Research Standards of Practice Handbook states that if an analyst selectively receives disclosure of information that he deems material, "the member must encourage the public dissemination of that information and abstain from making investment decisions on the basis of that information unless and until it is broadly disseminated to the marketplace."[22]

Finally, revolutions in communications and information technologies have made it much easier for issuers today to disseminate important information broadly and swiftly. A generation ago, issuers may have relied on conferences attended by a handful of interested parties, or news releases that led to delayed, indirect retransmission of information to the public. Lacking effective means to communicate directly to large numbers of investors, issuers may have relied on analysts to serve as information intermediaries. In the last few years, however, new, effective methods for mass communications have become widely available. Today, issuers can – and many do – use a variety of these new methods to communicate with the market, including: live transmissions of annual meetings and news conferences on the Internet or closed circuit television; listen-only telephone transmission of meetings and analyst conferences; and company websites.[23] With the availability of these new

information was a spouse, parent, child, or sibling of the person who received the information, unless it were shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

II. Selective Disclosure: Regulation FD

A. Background

Full and fair disclosure of information by issuers of securities to the investing public is a cornerstone of the federal securities laws. In enacting the mandatory disclosure system of the Exchange Act, Congress sought to promote disclosure of "honest, complete, and correct information"[7] to facilitate the operation of fair and efficient markets.[8]

Despite this well-recognized principle, the federal securities laws do not generally require an issuer to make public disclosure of all important corporate developments when they occur. Periodic reports (*e.g.*, Forms 10-K and 10-Q) call for disclosure of specified information on a regular basis, and domestic issuers are additionally required to report some types of events on a Form 8-K soon after they occur. However, in the absence of a specific duty to disclose, the federal securities laws do not require an issuer to publicly disclose all material events as soon as they occur. While we encourage prompt disclosure of material information as the best disclosure practice,[9] and self-regulatory organization (SRO) rules often require this,[10] issuers retain some control over the precise timing of many important corporate disclosures.

In practice, issuers also retain control over the audience and forum for some important disclosures. If a disclosure is made at a time when no Commission filing is immediately required, the issuer determines how and to whom to make its initial disclosure. As a result, issuers sometimes choose to disclose information selectively – *i.e.*, to a small group of analysts or institutional investors – before making broad public disclosure by a press release or Commission filing.

Many recent cases of selective disclosure have been reported in the media.[11] In some cases, selective disclosures have been made in conference calls or meetings that are open only to analysts and/or institutional investors, and exclude other investors, members of the public, and the media. In other cases, company officials have made selective disclosures directly to individual analysts. Commonly, these situations involve advance notice of the issuer's upcoming quarterly earnings or sales figures – figures which, when announced, have a predictable and significant impact on the market price of the issuer's securities.

We are troubled by the many recent reports of selective disclosure and the potential impact of this practice on market integrity. As the Supreme Court has recently emphasized, promoting investor confidence in the fairness of our securities markets is an "animating purpose" of the Exchange Act.[12] Clearly, one critical component of that mission is protecting investors from the prospect that others in the market possess "unerodable informational advantages"[13] obtained through superior access to corporate insiders.

In our view, the current practice of selective disclosure poses a serious threat to investor confidence in the fairness and integrity of the securities markets. We have recognized that benefits may flow to the markets from the legitimate efforts of securities analysts to "ferret out and analyze information"[14] based on their superior diligence and acumen. But we do not believe that selective disclosure of material nonpublic information to analysts – or to others, such as selected investors – is beneficial to technologies, issuers can much more easily reach a wide investor audience with their disclosures, and do not need to rely on analysts as heavily as in the past to serve as information intermediaries.[24]

Nevertheless, issuers are continuing to engage in selective disclosures of material nonpublic information, perhaps due in part to the uncertainty in current law about when selective disclosures are prohibited. For at least the past 30 years, the issue of potential liability for selective disclosure has been addressed under the principles of fraud law, particularly the law of insider trading. Under early insider trading case law, which appeared to require that traders have equal access to corporate information,[25] selective disclosure of material information to securities analysts could lead to liability.[26]

This changed with the Supreme Court's decisions in *Chiarella v. United States*[27] and *Dirks v. SEC*.[28] In *Chiarella*, the Court rejected the "parity of information" approach, which considered trading to be fraudulent whenever the trader possessed material information not generally available. The Court instead held that there must be a breach of a fiduciary or other relationship of trust and confidence before the law imposes a duty to disclose information or refrain from trading.

In *Dirks*, the Supreme Court addressed the disclosure, or "tipping," of material nonpublic information by an insider to an analyst.[29] The Court rejected the idea that a person is prohibited from trading whenever he knowingly receives material nonpublic information from an insider. Instead, it stated that a recipient of inside information is prohibited from trading only when the information has been made available to him "*improperly*" – that is, in breach of the insider's fiduciary duty to shareholders. To determine whether a breach of duty occurred, "courts [must] focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings."[30]

After *Dirks*, there have been very few insider trading cases based on disclosure to, or trading by, securities analysts. In some situations, an insider's selective disclosure can be viewed as improper, because the disclosure was motivated by a desire for some type of personal benefit.[31] In other cases, however, the evidence to support the "personal benefit" argument under *Dirks* is less clear. As a result, many have viewed *Dirks* as affording considerable protection to insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information.[32]

Although the antifraud provisions of the securities laws do not require that all traders possess equal information when they trade, we believe that our disclosure rules should promote fair treatment of large and small investors by, among other things, giving all investors timely access to the material information an issuer chooses to disclose. Therefore, we are today proposing new rules, which use a different legal approach, to address selective disclosure.

The approach we propose does not treat selective disclosure as a type of fraudulent conduct or revisit the insider trading issues addressed in *Dirks*. Rather, we propose to use our authority to require full and fair disclosure from issuers, primarily under Section 13(a) of the Exchange Act, as a basis for proposed Regulation FD. This Regulation is designed as an issuer disclosure rule, similar to existing Commission rules under Exchange Act Sections 13(a) and 15(d).[33] We believe this approach would further the full and fair public disclosure of material information, and thereby promote fair dealing in the securities of covered issuers.

B. Description of Proposed Regulation FD

Rule 101 of Regulation FD sets forth the basic rule regarding "selective disclosure." Under this Rule, whenever:

(1) an issuer, or any person acting on its behalf,

(2) discloses material nonpublic information

(3) to any other person outside the issuer,

(4) the issuer must

(a) simultaneously (for intentional disclosures), or

(b) "promptly" (for non-intentional disclosures)

(5) make public disclosure of that same information.

Several definitional and other provisions in the Regulation establish the scope and effect of the general rule. As a whole, the Regulation would require that whenever an issuer makes an **intentional** disclosure of material nonpublic information, it must do so in a manner that provides general public disclosure, rather than through a selective disclosure. In the case of an **unintentional** selective disclosure, the issuer must make full public disclosure promptly after it learns of the selective disclosure. Regulation FD does not mandate that issuers make public disclosure of all material developments when they occur. What it does require, however, is that when an issuer chooses to disclose material nonpublic information, it must do so broadly to the investing public, not selectively to a favored few.

The key provisions of the Regulation are discussed in greater detail below.

1. Disclosures by "An Issuer or Person Acting on its Behalf"

Regulation FD applies to all issuers with securities registered pursuant to Section 12 of the Exchange Act, and those issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies but not including other investment companies.[34] It would apply not only to a selective disclosure formally made in the name of the issuer, but also to a selective disclosure made by a "person acting on behalf of an issuer." This term is defined by Rule 101(c) as any officer, director, employee, or agent of the issuer who discloses material nonpublic information while acting within the scope of his or her authority.

The definition of "person acting on behalf of an issuer" distinguishes between cases where a properly authorized employee or agent of the issuer makes a selective disclosure, and cases where an employee or agent discloses material nonpublic information for his or her own benefit – *i.e.*, provides a "tip" that would violate Rule 10b-5 if securities trading ensued. This distinction means that the issuer would not automatically be liable under Regulation FD (or be responsible for making simultaneous or prompt public disclosure) whenever one of its employees or agents improperly trades or tips.[35] The Rule also would not apply if an official disclosed information to another person who owed him or her a duty of trust or confidence – such as a medical professional. By focusing on employees and agents acting within the scope of their authority, the Rule would make an issuer responsible only for the disclosures of company officials, employees, or agents who are properly authorized or designated to speak to the media, the analyst community, and/or investors.

We request comment on this approach. Is the definition of "person acting on behalf of an issuer" appropriate? Should it be narrower – for example, limited to executive officers and directors, and persons acting on their behalf? Or should it be broader, to prevent evasion – for example, covering any person authorized to act on behalf of the issuer?

2. Disclosure of Material Nonpublic Information

Regulation FD addresses the selective disclosure of "material nonpublic information." The Regulation does not define the term "material, " but instead relies on the same definition as is generally applicable under the federal securities laws: information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if it would have "significantly altered the 'total mix' of information made available."[36]

We recognize that materiality judgments can be difficult. Corporate officials may therefore become more cautious in communicating with analysts or selected investors, or may feel compelled to consult with counsel more frequently about their ability to respond to questions from analysts and investors. We understand that these communications take many forms, including unrehearsed question-and-answer sessions, and responses to unsolicited inquiries. We are mindful of the potential burdens of requiring instant materiality judgments to be made by those put in the position of responding immediately to questions.

We believe that these concerns are significant but can be mitigated in several ways, many of which involve practices already in place at many issuers.[37] First, issuers can designate a limited number of persons who are authorized to make disclosures or field inquiries from analysts, investors, or the media. Second, issuers can make sure that some record is kept of the substance of private communications with analysts or selected investors – for example, by having more than one person present during these contacts or by recording conversations. Third, issuer personnel can decline to answer questions that raise issues of materiality until they have had an opportunity to consult with others. Fourth, issuer personnel can secure the agreement of analysts not to make use of certain information for a limited time until they have had the opportunity to review their notes of the conversation and engage in whatever consultation they deem necessary to reach a conclusion as to materiality;[38] then, if the issuer determines that public disclosure of the information is necessary, it can do so. Finally, and most importantly, as described in greater detail below, the Regulation recognizes that issuers may sometimes unintentionally make a selective disclosure of material nonpublic information, and it treats such unintentional disclosures differently from cases in which the issuer makes a planned selective disclosure.

We also believe that a heightened awareness of materiality issues may well have overall benefits to the disclosure process. Senior corporate officials who are responsible for dealing with analysts, investor relations, and disclosure issues already should be sensitive to materiality questions. When particularly difficult issues arise, responsible officials should seek the advice of counsel. Though it is likely that this Regulation will require corporate officials to consider more thoughtfully precisely what to disclose, it is unlikely, given the robust, active capital market, that the flow of information to the market will be significantly chilled.

Although materiality issues do not lend themselves to a bright-line test, we believe that the majority of cases are reasonably clear. At one end of the spectrum, we believe issuers should avoid giving guidance or express warnings to analysts or selected investors about important upcoming earnings or sales figures; such earnings or sales figures will frequently have a significant impact on the issuer's stock price. At the other end of the spectrum, more generalized background information is less likely to be material. We request comment on whether use of the procedures discussed above or similar procedures can significantly reduce the risk of "chilling" the flow of corporate information to the marketplace.

The Regulation also does not specifically define the term "nonpublic." It is well established that information is nonpublic if it has not been disseminated in a manner making it available to investors generally.[39] In order to make information public, "it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."[40] The Regulation does specify means by which "public disclosure" is to be made.[41] We request comment on whether to rely on existing standards for the term "nonpublic." Should we provide further guidance, or is the specific definition of "public disclosure" provided in Rule 101(e) sufficient?

3. Selective Disclosure "To Any Other Person Outside the Issuer"

Rule 100(a) covers selective disclosures made to "any person or persons outside the issuer." Therefore, the Rule would not apply to communications of confidential information by officials and employees of issuers to each other. Only selective disclosures to outsiders, such as analysts or selected investors, are covered by the Regulation.

To make clear the scope of the Regulation, paragraph (b) of Rule 100 expressly states that the Rule does not apply to disclosures of material information to persons who are bound by duties of trust or confidence not to disclose or use the information for trading. Paragraph (b) expressly refers to several types of persons whose misuse of the information would subject them to insider trading liability under Rule 10b-5: (1) "temporary" insiders of an issuer – *e.g.*, outside consultants, such as its attorneys, investment bankers, or accountants;[42] and (2) any other person who has expressly agreed to maintain the information in confidence, and whose misuse of the information for trading would thus be covered either under the "temporary insider" or "misappropriation" theory.[43]

This approach recognizes that issuers and their officials may properly share material nonpublic information with outsiders when those outsiders agree to keep the information confidential. This would permit issuers to discuss confidential strategies or plans with outsiders, as necessary for business purposes, without need to make public disclosure under this Rule. For example, issuers could share material nonpublic information with other parties to a business combination transaction or with a purchaser in a private placement without having to make public disclosure if the party receiving the information agrees to hold the information in confidence. Similarly, if it served an issuer's corporate interests to make disclosure of material information to selected analysts – for example, to give the analysts sufficient time to analyze complex information before its public release, or to solicit analysts' views on a business strategy under consideration – it could do so, provided that the recipients of the information expressly agreed not to use the information and to keep it confidential prior to public disclosure. Such a confidentiality agreement would also include an agreement not to trade on the nonpublic information.

We request comment on whether the proposed Regulation covers the appropriate categories of persons. Should other types of persons be enumerated in Rule 100(b) as proper recipients of material nonpublic information? By permitting disclosures to outsiders who agree to confidentiality requirements, does the Regulation adequately permit issuers to engage in legitimate business communications with customers or suppliers, potential co-venturers, and others? Would purchasers in private offering who receive material nonpublic information be willing to sign confidentiality agreements? How would this affect the resale market for private offerings and the flow of information in these transaction? Would the proposals reduce liquidity in the 144A market? How should the Regulation account for practices in this market? Should we require that confidentiality agreements take any specific form – *i.e.*, be written – or include certain required provisions?

4. Timing of Public Disclosure Required by Regulation FD

An important provision of Regulation FD is that the timing of required public disclosure differs depending on whether the issuer has made an "intentional" or a "non-intentional" selective disclosure.

When an issuer makes an "intentional" disclosure of material nonpublic information, Rule 100(a)(1) requires the issuer to publicly disclose the same information **simultaneously**. In effect, this requirement for simultaneous disclosure means that issuers cannot engage in an intentional selective disclosure consistent with the terms of Regulation FD.

Under the definition provided in Rule 101(a), a selective disclosure is "intentional" when the individual making the disclosure either knew prior to making the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic. This definition would cover, for example, situations where an issuer official determined to hold a conference call or meeting that excluded the public, or selectively contacted a particular analyst or investor, to disclose material nonpublic information. The individual making the disclosure must know (or be reckless in not knowing) that the information he or she is going to disclose is both material and nonpublic. Thus, for example, a communication would not be "intentional" under this Rule if it was disclosed inadvertently through an honest slip of the tongue, or because the individual mistakenly (but not in reckless disregard of the truth) believed that the information had already been made public.

Under Rule 100(a)(2), when this type of "non-intentional" disclosure of material nonpublic information occurs, the issuer is required to make public disclosure promptly. In this situation, because the disclosure was unplanned, the Rule does not require simultaneous public disclosure. Instead, the Rule requires "prompt" public disclosure, with "promptly" defined to mean "as soon as reasonably practicable" (but no later than 24 hours) after a senior official of the issuer knows (or is reckless in not knowing) of the non-intentional disclosure.[44] "Senior official" is defined as any executive officer of the issuer, any director of the issuer, any investor relations officer or public relations officer, or any employee possessing equivalent functions.[45]

By creating a separate requirement for "prompt" public disclosure in the case of a non-intentional selective disclosure, the Rule recognizes that corporate officers may sometimes make mistakes without the intent to selectively disclose material nonpublic information. When mistakes are made, absent intent or recklessness, we do not believe that the issuer should be held in violation of Regulation FD for not having made simultaneous public disclosure.[46]

If, however, an inadvertent selective disclosure of material information occurs, the issuer must take prompt "corrective" action when it knows (or is reckless in not knowing) that the disclosure of material information has occurred. The requirement to take corrective action arises when a senior official of the issuer (as defined above) becomes aware of the selective disclosure.[47] When that occurs, the issuer is required to act "as soon as reasonably practicable" to make full public disclosure of the information that has been selectively disclosed.[48]

We request comment on the distinction between "intentional" and "non-intentional" disclosures for purposes of the timing of public disclosure. Does the proposed definition of "intentional" disclosure draw the appropriate distinction? Does the definition of "promptly" provide an appropriate time period for the required public disclosure? Should the time period be shorter (*e.g.*, same trading day); or longer (*e.g.*, next business/trading day or 48 hours later)? Is the definition of senior official appropriate, or should it be narrower (*e.g.*, executive officers only) or broader (*e.g.*, all employees)?

5. Definition of "Public Disclosure"

Rule 101(e) defines the type of "public disclosure" that will satisfy the requirements of the Regulation. This definition provides issuers with considerable flexibility in determining how to make the required public disclosure.

In general, the Rule states that issuers can comply with the "public disclosure" requirement by filing a Form 8-K with the Commission containing the information (or, in the case of foreign private issuers, by filing a Form 6-K).[49] We are proposing to add a new Item 10 to Form 8-K for disclosures made under Regulation FD. Should we permit issuers to make Regulation FD disclosures on existing Item 5 of Form 8-K as an alternative to proposed new Item 10? Item 5 is not confined to material disclosures; accordingly, if a registrant used Item 5 it would not acknowledge that the information disclosed was necessarily material. Is this a preferable approach?

As alternatives to making a Commission filing, the Rule permits an issuer to choose other methods of public disclosure. Under Rule 101(e)(2), an issuer will be exempt from the filing requirement if it uses one of the following alternative methods of public disclosure:

- First, an issuer could make public disclosure by disseminating a press release containing the information through a widely circulated news or wire service. Under current practice and SRO rules, corporate issuers typically provide press releases to services such as Dow Jones, Bloomberg, Business Wire, PR Newswire, or Reuters. Any of these services would continue to be a satisfactory means of making public disclosure.
- Second, an issuer could make public disclosure by disseminating information through any other method of disclosure that is reasonably designed to provide broad public access, and does not exclude access to members of the public – such as announcement at a press conference to which the public is granted access (for example, by personal attendance or by telephonic or electronic transmission). In order to afford broad public access, an issuer must provide notice of the disclosure in a form that is reasonably available to investors.

As noted above, current technology provides various means that issuers can use to transmit announcements and press conferences to the public. The Rule would not require use of any particular technological means, but would give issuers their choice of any method that did not limit public access to announcements and conferences.

An additional method for issuer dissemination of material information is posting the information on the issuer's website.50 We encourage issuers who maintain websites to post information on their websites whenever they make public disclosure through one of the means described above. However, the proposed Rule would not consider a website posting by itself to be a sufficient means of public disclosure.51 Will this limitation make issuers less willing to post information on their websites?

We request comment on the proposal's approach for making public disclosure. We acknowledge that filings on EDGAR may only be made during specified hours, and only on business days of the Commission. In the case of filings permitted to be made in paper (as in the case of foreign private issuers), there are similar constraints because of our filing desk hours. Therefore, when an issuer is required to make public disclosure within 24 hours, the timing of a weekend or holiday may mean that EDGAR filing is not an available method of public disclosure. Issuers would therefore have to use one of the other methods. We solicit comment on whether this approach is workable, or whether we should alter the timing requirements of the Rule so that filing is always an available method. How else can we promote issuer flexibility and investor access?

We are also considering whether to require a delayed filing of a Form 8-K (within two business days) when an issuer chooses one of the other methods of making public disclosure. This would ensure that the information is part of the Commission's public files. Should we adopt this alternative approach? If so, is two business days the appropriate time period, or should it be shorter (*e.g.*, one business day) or longer (*e.g.*, five business days)?

Are the current technologies that we discuss available to all issuers? Are they prohibitively costly? Would they provide all investors with sufficient access? Are there other methods of public disclosure that might be as effective as a press release or an open press conference? Should these methods be specified in the Rule? Would an open press conference alone provide adequate dissemination of information in all circumstances (*e.g.*, for smaller companies with less media or analyst coverage)? Should we require that information be posted on an issuer's website, if it has one, in addition to the other methods of publicizing the information?

6. Issuers Covered by the Regulation

Regulation FD would apply to all issuers with securities registered under Section 12 of the Exchange Act, and all issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies but not including other investment companies. Are there any categories of issuers that should not be included? Should we have different and/or modified rules for small business issuers? If so, what modifications are warranted?

We are proposing to apply Regulation FD to foreign private issuers that are subject to the reporting requirements of the Exchange Act, although these foreign issuers would be permitted to make filings under the Regulation on Form 6-K rather than Form 8-K.52 The vast majority of these issuers have subjected themselves to such reporting requirements by their election to access U.S. markets. Most of the issuers have a class of securities listed on the New York or American Stock Exchanges, or are admitted to trading on the Nasdaq Stock Market. The listing standards of these markets make no distinction between domestic and foreign issuers in requiring timely disclosure of material information.53

The content and timing of submissions on Form 6-K currently are based on a foreign private issuer's disclosure obligations and practices in its home jurisdiction and in any other jurisdiction where its securities are listed. We recognize that this Rule proposes for the first time to add a substantive disclosure requirement to Form 6-K, thereby changing the fundamental character of the form. We understand that some foreign issuers may view Regulation FD as requiring a change in what they consider to be normal communications with major shareholders, analysts, the press, labor unions, and other constituencies. In many cases, the disclosure requirements of Regulation FD also will impose a translation requirement on the information disclosed to the public and/or filed on Form 6-K. On the other hand, the benefits of the proposal to shareholders in all markets, not just the U.S. capital markets, may warrant the additional steps required of foreign issuers.

Regulation FD permits issuers to use other means for publicly disseminating non-intentional selective disclosures as alternatives to Forms 8-K or 6-K. Under current Form 6-K requirements, however, foreign private issuers are required to submit a Form 6-K containing any material information that is disseminated publicly, promptly after the dissemination. As proposed, foreign private issuers would not have to file a Form 6-K if they use one of the alternative means of disclosure permitted by Regulation FD.

We note that Forms 6-K are not currently required to be filed on EDGAR, which may impede investor access to information. Does this limitation make the requirement to file on Form 6-K less useful? If so, how should we address this issue?

We request comment on the proposed coverage of Regulation FD. Would it be appropriate to exempt all foreign private issuers from compliance with Regulation FD? If so, what would be the basis for this exemption and how would we address the impact on U.S. investors of having different requirements for selective disclosures by U.S. issuers and foreign private issuers? Would it be more appropriate to limit the application of Regulation FD to only certain foreign private issuers, such as those issuers with equity securities listed on a registered national securities exchange or the Nasdaq Stock Market National Market System, or foreign private issuers whose number of U.S. shareholders or volume of trading in our capital markets exceeds certain levels? If so, what levels should trigger the application of Regulation FD? Are there other ways the proposal could be modified to reduce the burden on foreign private issuers? Should foreign and domestic issuers be treated similarly with respect to the application of Section 18 to Regulation FD disclosure?

We are proposing to apply Regulation FD to closed-end investment companies, but not other types of investment companies. Investment companies that are continually offering their securities to the public already are required to update their prospectuses to disclose material changes subsequent to the effective date of the registration statement or any post-effective amendment, and are not permitted to sell, redeem, or repurchase their securities except at a price based on their securities' net asset value. While we believe that Regulation FD would offer little additional protection to investors in these types of investment companies and therefore they should be excluded from its coverage, these considerations do not apply in the case of closed-end investment companies. We are thus proposing to include closed-end investment companies within the requirements of Regulation FD.

At present, no form used by registered closed-end investment companies is equivalent to Form 8-K. In order to provide closed-end investment companies with the same disclosure options under Regulation FD available to operating companies, we propose to permit registered closed-end investment companies to file on Form 8-K for the sole purpose of making the public disclosure required by Regulation FD. The Commission does not intend by this rule proposal to otherwise require registered investment companies to file on Form 8-K.54

We request comment on whether any investment companies should be covered by Regulation FD, and if so, which types of investment companies should be covered. Commenters should address whether there are specific types of information relating to investment companies that could be the subject of problematic selective disclosure (*e.g.*, the impending departure of a portfolio manager who is primarily responsible for day-to-day management of the fund, or information relating to the fund's portfolio investments). We also request comment on whether it is appropriate for closed-end investment companies to file on Form 8-K for purposes of making disclosure under Regulation FD, and whether there should be a separate Item 11 for closed-end investment companies making disclosure on Form 8-K, so that members of the public can easily distinguish filings by closed-end investment companies from those of operating companies. Commenters that oppose the use of Form 8-K by closed-end investment companies should discuss other methods for obtaining equivalent disclosure from those companies.

7. Liability Issues and Securities Act Implications

Regulation FD is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act. It is not an antifraud rule, and unlike other Section 13(a) and 15(d) reporting requirements, it is not intended to create duties under Section 10(b) of the Exchange Act or any other provision of the federal securities laws. As a result, no private liability will arise from an issuer's failure to file or make public disclosure.[55]

If an issuer fails to comply with Regulation FD, however, it will be subject to an SEC enforcement action.[56] We could bring an administrative action seeking a cease and desist order, or a civil action seeking an injunction and/or civil money penalties.[57] In appropriate cases, we could also bring an enforcement action against the individual(s) at the issuer responsible for the violation, either as "a cause of" the violation in a cease and desist proceeding,[58] or as an aider and abetter of the violation in an injunctive action.[59]

In addition, Regulation FD does not affect or undermine any existing bases of liability under Rule 10b-5. Thus, for example, liability for "tipping" under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the *Dirks* "personal benefit" test.[60] In addition, an issuer's failure to make a public disclosure still may give rise to liability under a "duty to correct" or "duty to update" theory in certain circumstances.[61] And in other cases, an issuer's contacts with analysts may lead to liability under the "entanglement" or "adoption" theories.[62]

Moreover, if an issuer's filing or public disclosure made under Regulation FD contained false or misleading information, or omitted material information, the issuer could incur liability for those misstatements or omissions. Rule 10b-5 would apply to any materially false or misleading statements made to the public, and if an issuer had filed a Form 8-K containing false or misleading information, Section 18 of the Exchange Act[63] would apply as well. If a Form 8-K filed under Regulation FD was required to be incorporated into an issuer's registration statement, it would be subject to liability under Section 11 of the Securities Act.[64] If the public disclosure is not filed on a Form 8-K, it may nevertheless be subject to Section 11 liability if the information is otherwise required to be included in a registration statement subject to Section 11.

As noted above, Regulation FD applies only to issuers that have securities registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of that Act. Accordingly, the Regulation would not apply during an issuer's initial public offering (IPO) of its securities prior to effectiveness of the registration statement.[65]

The proposed Regulation would, however, apply to disclosures made by reporting issuers while they have pending registration statements for securities offerings. For example, the Regulation would apply to statements made in a "roadshow" for a reporting issuer's offering. In that situation, if an issuer made oral selective disclosure of material information, Regulation FD would require the issuer also to make public disclosure of the same information. This would be a departure from current distinctions in the Securities Act between oral and written communications around the time of an offering.[66]

The required public disclosure could also be considered an "offer" of the securities for purposes of Section 5 of that Act,[67] and when made by writing or broadcast could be considered a "prospectus" for purposes of Section 2(a)(10) of the Act.[68] This creates the possibility that an issuer may violate Sections 5(c) or 5(b)(1) of the Securities Act by making the public disclosures required by Regulation FD.

To permit an issuer that has already filed a registration statement to make the required public disclosure without violating Section 5(b)(1) of the Securities Act, we are proposing new Rule 181 under the Securities Act. Under this Rule, any public disclosure required by Rule 100(a) of Regulation FD would not be required to satisfy the requirements of Section 10 of the Securities Act[69] for a prospectus, as long as the disclosure was made in compliance with Regulation FD. We request comment on whether this Rule should apply only to non-intentional disclosures. Should we place other conditions on the use of this Rule – for example, requiring the material information to be included in the registration statement at the time it is declared effective?

A more difficult situation arises when a reporting company is planning an offering, but has not yet filed a registration statement. A company may find itself in the position of being required by Regulation FD to disclose to the public information which could constitute an "offer" of its securities prior to the filing of a registration statement, contrary to Section 5(c). While companies are not supposed to make offers to anyone prior to filing a registration statement, an inadvertent disclosure of material nonpublic information to one person could result in an obligation to disclose information to the public, thus resulting in offers being made to many persons. If the company complies with the Regulation FD requirement in that situation, its disclosure would violate Section 5(c), and subject it to liability under Section 12(a)(1) if it proceeds with its offering. The public disclosure also could constitute a general solicitation and therefore preclude the company from undertaking a private exempt offering.

If the Commission were to adopt an exemption from Section 5(c) for Regulation FD-required disclosure, however, companies could abuse that exemption to make public communications that hype an offering before filing a registration statement with the Commission. In that event, the balanced full disclosure, against which to test the hyping information, would not be available. The protections of Section 5 could thus be eroded. While we have published proposals that, if adopted, would allow offers to be made prior to the filing of a registration statement in some offerings, those proposals did not extend to offerings by unseasoned companies to less sophisticated investors.[70] We proposed to retain the pre-filing prohibition on offers in those cases because of the continued need for this aspect of investor protection.

We request comment on whether we should also adopt an exemption from liability under Section 5(c) of the Securities Act for communications made before the filing of a registration statement. If we do so, should the exemption apply only to non-intentional disclosures? Do the same reasons for providing a Section 5(b)(1) exemption also apply to Section 5(c), either for all issuers, or for offerings made by very large issuers or to more sophisticated investors? Or could a Section 5(c) exemption provide issuers with such freedom to make public disclosures prior to filing a registration statement that issuers could engage in the hyping of an offering that Section 5(c) is designed to prevent?

With respect to the interplay between Regulation FD and the Securities Act, we request comment on the proposed approach described above. Should the Regulation also apply to issuers engaged in IPOs? Alternatively, given the liability questions under the Securities Act for these disclosures and the pending proposals in the Securities Act Reform release, should the Regulation not cover communications made as part of securities offerings under the Securities Act?

In our recent release on business combinations,71 we adopted non-exclusive exemptions under the Securities Act, proxy rules, and tender offer rules that permit communications with respect to business combinations72 for an unrestricted length of time without a cooling-off period between the end of communications and the filing of definitive disclosure documents. Those communication exemptions apply regardless of materiality, so long as the conditions to the exemption are satisfied. All written communications must be filed on the date of first use. Those communications must contain a prominent legend advising investors to read the registration, proxy, or tender offer statement, as applicable, when it becomes available. Under those rules, oral statements are not required to be reduced to writing and filed.

Proposed Regulation FD would impose requirements on material communications, written and oral, that are in addition to the filing and legend requirements of the new business combination rules. Any material information disclosed to the public, whether oral or written, would be required to be publicly disseminated by filing, press conference, news release, or otherwise.73 Issuers may use confidentiality agreements to protect communications in the context of business combinations or other transactions which the issuers expressly mean to reserve from public disclosure. Early discussions among parties negotiating a transaction that are subject to confidentiality agreements among the parties and are kept confidential generally would not be subject to disclosure requirements of Regulation FD or the communications exemptions. Similarly, discussions between a party to a transaction and a security holder regarding a possible "lock-up" or other agreement generally would not be subject to these requirements so long as a confidentiality agreement is in effect.

Under current practice, parties negotiating a transaction do not always enter a confidentiality agreement, so Regulation FD may effect a change to current practice. Does this provide a practicable solution for parties seeking to negotiate transactions or to discuss "lock-ups"?

III. Insider Trading Issues

The prohibitions against insider trading in our securities laws play an essential role in maintaining the fairness, health, and integrity of our markets. We have long recognized that the fundamental unfairness of insider trading harms not only individual investors, but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets. Congress, by enacting two separate laws providing enhanced penalties for insider trading,74 has expressed its strong support for our insider trading enforcement program. And the Supreme Court in *United States v. O'Hagan* has recently endorsed a key component of insider trading law, the "misappropriation" theory, as consistent with "an animating purpose" of the federal securities laws: "to insure honest securities markets and thereby promote investor confidence."75

Neither we nor Congress have expressly defined insider trading in a statute or rule. Instead, insider trading law has developed on a case-by-case basis under the antifraud provisions of the federal securities laws, primarily Section 10(b) of the Exchange Act and Rule 10b-5. As a result, from time to time there have been issues on which various courts have disagreed. With the Supreme Court's *O'Hagan* decision, the fundamental issues in insider trading law are now settled. Today's proposals address two issues on which disagreement remains.

A. Rule 10b5-1: Trading "On the Basis of" Material Nonpublic Information

1. Background

One unsettled issue in insider trading has been what, if any, causal connection must be shown between the trader's possession of inside information and his or her trading. In enforcement cases, we have argued that a trader may be liable for trading while in "knowing possession" of the information. The contrary view is that a trader will not be liable unless it is shown that he or she "used" the information for trading.

Until recent years, there has been little case law discussing this issue. Although the Supreme Court has variously described an insider's violations as involving trading "on"76 or "on the basis of"77 material nonpublic information, it has not addressed the use/possession issue. Three recent court of appeals cases address the issue, but have reached different results.

The three court of appeals cases recognize the practical difficulty of divorcing a trader's knowing possession, or awareness, of inside information from its "use" in a trade. In *United States v. Teicher*,78 the Second Circuit suggested that "knowing possession" is sufficient to trigger insider trading liability, for precisely this reason.79 In *SEC v. Adler*, the Eleventh Circuit held that "use" was the ultimate issue, but that proof of "possession" provides a "strong inference" of "use" that suffices to make out a *prima facie* case.80 In *United States v. Smith*, the Ninth Circuit required that "use" be proven in a criminal case.81

The *Adler* court suggested that we could adopt a new rule or amend existing Rule 10b-5 to adopt a presumption approach or to provide for liability for trading while in "knowing possession" of material nonpublic information.82 In view of the differing opinions expressed in the three cases discussed above, we agree that it would be useful to define the scope of Rule 10b-5, as it applies to the use/possession issue.

In our view, the goals of insider trading prohibitions – protecting investors and the integrity of securities markets – are best accomplished by a standard closer to the "knowing possession" standard. Whenever a person purchases or sells a security while aware of material nonpublic information that has been improperly obtained, that person has the type of unfair informational advantage over other participants in the market that insider trading law is designed to prevent.83 As a practical matter, in most situations it is highly doubtful that a person who knows inside information relevant to the value of a security can completely disregard that knowledge when making the decision to purchase or sell that security. In the words of the Second Circuit, "material information can not lay idle in the human brain."84 Indeed, even if the trader could put forth purported reasons for trading other than awareness of the inside information, other traders in the market place would clearly perceive him or her to possess an unfair advantage.

On the other hand, we recognize that an absolute standard based on knowing possession, or awareness, could be overbroad in some respects. Sometimes a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place. A rigid "knowing possession" standard would lead to liability in that case. We believe, however, that for many cases of this type, a reasonable standard would not make such trading automatically illegal.

The *Adler* case attempted to balance these considerations by means of a "use" test with a strong inference of use from "possession." We propose a somewhat different approach today: a general rule based on "awareness" of the material nonpublic information, with several carefully enumerated exceptions. We believe our proposed Rule would lead to the same outcome as *Adler* in almost all insider trading cases, but will provide greater clarity and certainty than a presumption or "strong inference" approach. Our proposed approach will better enable insiders and issuers to conduct themselves in accordance with the law.

2. Proposed Rule 10b5-1

Proposed Rule 10b5-1 is designed to address only the use/possession issue in insider trading cases under Rule 10b-5. As the Preliminary Note states, the Rule does not modify or address any other aspect of insider trading law, which has been established by case law under Rule 10b-5.

Paragraph (a) sets forth the general prohibition of insider trading contained in existing case law. Under existing law, it is illegal to trade a security "on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information."85 This language incorporates all theories of insider trading liability under the case law – classical insider trading, temporary insider theory, tippee liability, and trading by someone who misappropriated the inside information.86

Paragraph (b) defines trading "on the basis of" material nonpublic information. A trade is on the basis of material nonpublic information if the trader "was aware of" the information when he or she made the purchase or sale. Thus, the general rule is that "awareness" of the inside informationinevitably leads to use of the information, and provides a sufficient basis for liability.

Paragraph (c) provides specific affirmative defenses against liability. A purchase or sale is not "on the basis of" information when a person can establish that one of four exclusive situations is true. These four defenses cover situations in which a person can show that the information he or she possessed was not a factor in the trading decision.

First, an affirmative defense is available if, before becoming aware of material nonpublic information, a person had entered into "a binding contract" to trade "in the amount" and "at the price" and on the date at which he or she ultimately traded.87 This defense permits persons to carry out pre-existing contracts to purchase or sell a specified number (or dollar amount) of shares of a particular security at a specified price (or at the market price), as long as the person was not aware of material nonpublic information when he or she entered into the contract.88

Second, an affirmative defense is similarly available if, before becoming aware of material nonpublic information, a person "had provided instructions to another person to execute" a trade for the instructing person's account, "in the amount, at the price, and on the date" at which that trade was ultimately executed.89 This defense would apply, for example, to an insider who instructs his or her broker to execute a plan to sell stock in accordance with Rule 144 at the expiration of a required holding period. If the insider provides the instructions without awareness of any material nonpublic information, the Rule would permit him or her to complete the previously instructed sales plan even if he or she later became aware of inside information.

Third, the Rule provides an affirmative defense if, before becoming aware of material nonpublic information, a person "[h]ad adopted, and had previously adhered to, a written plan specifying purchases or sales of the security in the amounts, and at the prices, and on the dates at which the person purchased or sold the security."90 This provision is designed to apply in the case of an insider who wishes to establish a regular, pre-established program of buying or selling his or her company's securities. If the plan is established before the insider is aware of material nonpublic information, and provides for specified trades at specified times, the insider will be permitted to engage in those trades even if he or she later becomes aware of material nonpublic information. As discussed below, plans of this type must be entered into in good faith, and not as part of a plan or scheme to evade insider trading prohibitions.91

Fourth, the Rule provides an affirmative defense for purchases or sales that result from a written plan for trading securities that is designed to track or correspond to a market index, market segment, or group of securities.92 This defense would permit trading by an index fund, for example, where the fund's trading strategy was pre-established by the fund or its manager, even if the manager later became aware of material nonpublic information regarding one of the securities in the index. The defense would be available if the plan was sufficiently circumscribed to prevent trading decisions from being affected by the manager's later awareness of material nonpublic information.

The Rule provides one important limitation on the availability of all of the affirmative defenses. Paragraph (c)(1)(ii) states that a defense would be available only if a contract, plan, or instruction to trade relied on for a defense was entered into in good faith, and not as part of a plan or scheme to evade the prohibitions of this Rule. If a person changes a previous contract, plan, or instruction in any respect after becoming aware of material nonpublic information, he or she will lose any defense against liability. Thus, for example, if an insider enters into a contract or plan to sell 1, 000 shares of his or her company's stock without being aware of material nonpublic information, then learns negative material nonpublic information and doubles his or her planned sale to 2, 000 shares, he or she will lose the defense for the entire sale of 2, 000 shares. Similarly, if the insider accelerates the timing of a planned sale in order to complete it before the release of negative corporate news that he or she has recently learned, he or she will have no defense for the transaction.

Paragraph (c)(1)(ii) also specifies that a person will lose any defense for a trade if he or she enters into or alters a "corresponding or hedging transaction or position" with respect to the planned securities trade. This requirement is designed to prevent persons from devising schemes to exploit inside information by setting up pre-existing hedged trading programs, and then canceling execution of the unfavorable side of the hedge, while permitting execution of the favorable transaction. By altering the corresponding position, the insider would lose any defense for the transaction that he or she permitted to be executed.93

The Rule provides an additional, separate affirmative defense designed solely for entities that trade.94 This defense is derived from the defense against liability currently provided in Exchange Act Rule

14e-3(b)[95] regarding insider trading in a tender offer situation. To meet this defense, an entity must demonstrate two things: first, that the individual(s) making the decision on behalf of the entity was not aware of the inside information; and second, that the entity had implemented reasonable policies and procedures (*e.g.*, informational barriers, restricted lists) to prevent insider trading.

3. Request for Comments

We request comments on all aspects of proposed Rule 10b5-1. Is the approach we propose – a general standard of "awareness" of the information, with specific affirmative defenses – the appropriate one? Are the proposed affirmative defenses appropriate? Should we provide additional defenses to liability, and if so, what should they be? Are the provisions defining the "amount" and "price" of pre-planned trades specific enough to permit plans to be made? Should we require written plans or instructions in all cases? Should we require that contracts, instructions, or trading plans be approved by counsel?

We also request comment on whether the defense for institutional traders is appropriate and adequate. Has this provision worked effectively for entities subject to Rule 14e-3? Is there any reason the same type of provision would not be adequate for this Rule?

B. Rule 10b5-2: Duties of Trust or Confidence in Misappropriation Insider Trading Cases

1. Background

In *United States v. O'Hagan*, the Supreme Court upheld the misappropriation theory of insider trading.[96] Under that theory, a person commits fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 by misappropriating material nonpublic information for securities trading purposes, in breach of a duty of loyalty and confidence.

Certain types of businessrelationships by themselves provide the duty of trust or confidence necessary in a misappropriation theory case. In *O'Hagan*, for example, the attorney-client relationship established the duty of confidence. In other cases, the agency relationship inherent in an employer-employee relationship provides the duty.[97] It is not as settled, however, under what circumstances certain non-business relationships, such as family and personal relationships, may provide the duty of trust or confidence required under the misappropriation theory.

Two courts have considered this issue in criminal cases: *United States v. Chestman*[98] and *United States v. Reed*.[99] Although *Chestman* and *Reed* took into account common law notions of fiduciary and confidential relationships, they both took a relatively narrow view of when a duty of confidence exists in the context of criminal liability for insider trading.

In *Reed*, the court did not find a father-son relationship sufficient in itself to provide the required duty of confidence. But it stated that if family members have a prior history of sharing confidences, such that one family member has a reasonable expectation that the other will keep those confidences, there may be a sufficient relationship of trust and confidence. The final determination is left to the fact finder.[100]

In *Chestman*, a narrow majority of the Second Circuit *en banc*, while not overruling *Reed*, took a more restrictive view.[101] The *Chestman* majority held that marriage alone does not suffice to create a fiduciary relationship.[102] It stated that in the absence of an "express agreement of confidentiality, " or a "pre-existing fiduciary-like relationship between the parties" to a family relationship, there is not a sufficient basis for establishing the necessary duty to support a fraud conviction under the misappropriation theory.[103]

Chestman makes clear that its narrow approach, in contrast to the "elastic" definition of confidential relations employed by courts of equity in the civil context, was influenced by the criminal context of the case before it.[104] In our view, however, the *Chestman* majority's approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.[105] For this reason, we believe the *Chestman* majority view does not sufficientlyprotect investors and the securities markets from the misappropriation and resulting misuse of inside information.

We have investigated and prosecuted a large number of insider trading cases that involved trading by friends or family members of insiders. In many of these cases, the evidence supports the claim that the insider intended to give the information to the friend or family member for trading.[106] The evidence in such cases supports liability under a classical tipper-tippee theory.[107]

In other circumstances, however, the evidence does not support the view that the disclosing insider intended or expected that the recipient of the inside information would trade. Instead, the evidence indicates that the insider confided the material nonpublic information to the friend or relation with the reasonable expectation that the recipient of the information would maintain the confidence. In those situations, a classical tipper-tippee theory of liability would probably not be available under the *Dirks* analysis. The misappropriation theory of liability would fit the facts better, because the trader breached a duty of confidentiality to the disclosing insider when he or she traded on the basis of the inside information. However, misappropriation liability is very difficult to establish in these situations under the restrictive analysis of *Chestman*, because *Chestman* appears to require either an express agreement of confidentiality, or a pre-existing fiduciary-like relationship that included the prior sharing of **business** confidences. Stated differently, under *Chestman*, it is not sufficient that the disclosing insider had a reasonable expectation of confidentiality based on his or her prior relationship with the trader.

Chestman thus leads to the following anomalous result. A family member who receives a "tip" (within the meaning of *Dirks*) and then trades violates Rule 10b-5. A family member who trades in breach of an express promise of confidentialityalso violates Rule 10b-5. A family member who trades in breach of a reasonable and legitimate expectation of confidentiality, however, does **not** necessarily violate Rule 10b-5.

We think that this anomalous result harms investor confidence in the integrity and fairness of the nation's securities markets. The family member's trading has the same impact on the market and investor confidence in the third example as it does in the first two examples. In all three examples the trader's informational advantage "stems from contrivance, not luck, " and the informational disadvantage to other investors "cannot be overcome with research or skill."[108] We believe that permitting the trader in the third example to trade legally is inconsistent with investors' expectations about what types of informational advantages can be properly exploited. Moreover, this result provides all trading family members – including those in the classical tipper-tippee example – with a roadmap for concocting a story that could provide a lawful explanation for the trading. Finally, the need to distinguish between the three types of cases may require an unduly intrusive examination of the details of particular family relationships.

Accordingly, we believe that there is good reason for the broader approach we propose today for determining when family or personal relationships create "duties of trust or confidence" under the misappropriation theory. Our proposed approach is not designed to interfere with particular family or personal relationships; rather, our goal is to protect investors and the fairness and integrity of the nation's securities markets against improper trading on the basis of inside information.

2. Proposed Rule 10b5-2

Proposed Rule 10b5-2 sets forth a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As stated in the Preliminary Note to the Rule, the law of insider trading is otherwise defined by judicial opinions interpreting Rule 10b-5, and this Rule is not intended to address or modify the scope of insider trading law in any other respect.

Paragraph (a) states that the Rule applies to any cases based on the misappropriation theory of insider trading, whether involving trading or tipping. Paragraph (b) enumerates a non-exclusive list of circumstances under which a "duty of trust or confidence" shall exist.[109]

a. Agreement Between the Parties

First, whenever a person agrees to maintain information in confidence, a duty of trust or confidence exists.[110] This reflects the common-sense notion, acknowledged in *Reed* and *Chestman*, that reasonable expectations of confidentiality, and corresponding duties, can be created by an agreement between two parties. Although sometimes, most commonly in a business context, the parties will sign an express, written confidentiality agreement, the Rule does not require either a written or an express confidentiality agreement. This approach recognizes the fact that in everyday personal interactions, individuals frequently rely on reasonable, implicit understandings of confidentiality. In some situations, it may not be realistic or socially acceptable to insist that a close friend or relative execute a signed confidentiality agreement, or expressly consent to an oral agreement.

b. Relationships With A History, Pattern, Or Practice Of Sharing Confidences

Second, the Ruleprovides that a duty of trust or confidence exists when two people have a "history, pattern, or practice of sharing confidences, such that the person communicating the material nonpublic information has a reasonable expectation that the other person would maintain its confidentiality."[111] This part of the Rule does not use a bright line test that enumerates specific relationships, but instead sets forth a "facts and circumstances" analysis derived from *Reed*. This standard recognizes that in some circumstances a past pattern of conduct between two parties will lead to a legitimate, reasonable expectation of confidentiality on the part of the confiding person. This analysis does not requirethat the history, pattern, or practice of sharing confidences include the sharing of **business** confidences for there to be a duty of trust or confidence for purposes of misappropriation liability. However, evidence about the type of confidences shared in the past might be relevant to determining the reasonableness of the expectation of confidentiality.

We request comments on the approach proposed in paragraph (b)(2). Does the requirement of a prior "history, pattern, or practice" of sharing confidences provide a sufficiently well-defined standard? Should other factors be relevant to the analysis as well?

c. Enumerated Family Relationships

Third, paragraph (b)(3) sets forth a bright line liability rule for certain enumerated close family relationships, but allows for an affirmative defense. Spousal, parent-child,[112] and sibling relationships would be sufficient in themselves as a basis for misappropriation theory liability. Ourenforcement experience demonstrates that these are the relationships in which family members most commonly share information with alegitimate expectation of trust or confidentiality.[113] These also are normally the types of close familial relationships in which the parties have a history, pattern, or practiceof sharing confidences that would lead to a reasonable expectation of confidentiality.

Paragraph (b)(3) permits the person receiving or obtaining the information to assert an affirmative defense by demonstrating that under the facts and circumstances of that particular family relationship, no duty of trust or confidence existed. To demonstrate this, the person must establish that the disclosing family member did not have a reasonable expectation of confidentiality because the parties had neither: (a) a history, pattern, or practice of sharing confidences; nor (b) an agreement or understanding to maintain the confidentiality of the information. If the person receiving or obtaining the information can satisfy the requirements of the affirmative defense set forth in paragraph (b)(3), he or she would not be liable under Rule 10b5-2.

Paragraph (b)(3) does not reach non-traditional relationships (*e.g.*, domestic partners) or more extended family relationships. However, paragraphs (b)(1) and (b)(2) could reach these relationships, depending on the factual context of the relationship. We request comment on whether this is an appropriate distinction.

Are the family relationships enumerated in paragraph (b)(3) the proper ones to cover, or is the list too narrow or too broad? Should the list of enumerated relationships be limited to family members residing in the same household? Should it expressly encompass step-parents and step-children? Should it expressly encompass non-traditional relationships, and if so, which ones? Should it include additional family relationships, such as the list of family relationships covered in our Section 16 rules?

3. Request for Comments

We request comment on all aspects of Proposed Rule 10b5-2. For non-enumerated relationships, does paragraph (b)(2) focus on the proper factors for determining whether a reasonable expectation of confidentiality exists? Is the approach of paragraph (b)(3) – a per se rule with an affirmative defense for certain enumerated family relationships – the most suitable one, or should a different standard be employed?

IV. General Request for Comments

We invite you to submit comments on proposed Regulation FD, Rule 10b5-1, and/or Rule 10b5-2. If you have empirical data relevant to proposed Regulation FD, Rule 10b5-1, or Rule 10b5-2, please include it with your comments. Please submit three copies of your comment letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. You may also submit comments electronically to the following e-mail address: rule-comments@sec.gov. Refer to File No. S7-31-99. If you are commenting by e-mail, include this file number on the subject line. We will make comments available for public inspection and copying in the Commission's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. In addition, we will post electronically submitted comment letters on our Internet Website (http://www.sec.gov).

V. Paperwork Reduction Act

Certain provisions of Regulation FD, and the related amendments to Form 8-K and Form 6-K under the Exchange Act, contain "collections of information" requirements within the meaning of the Paperwork Reduction Act of 1995,[114] and the Commission has submitted the proposal to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Form 8-K (OMB Control No. 3235-0060)[115] was adopted pursuant to Sections 13, 15, and 23 of the Exchange Act. Form 8-K prescribes information, such as material events or corporate changes, that a registrant must disclose. Form 6-K (OMB Control No. 3235-0116)[116] was adopted pursuant to Sections 13 and 15 of the Exchange Act. Form 6-K prescribes information that foreign private issuers subject to the reporting requirements of the Exchange Act must disclose. The Commission is also proposing to create a new information collection entitled "Reg. FD - Other Disclosure Materials." This information collection will encompass press releases, webcasts, announcements, conference calls, etc. that are conducted pursuant to Regulation FD, which is proposed pursuant to Sections 13, 15, 23, and 36 of the Exchange Act, and that are not filed under cover of Form 8-K or Form 6-K.

The Commission currently estimates that Form 8-K results in a total annual compliance burden of 140, 500 hours. The burden was calculated by multiplying the estimated number of Form 8-K filings annually (approximately 28, 100) by the estimated average number of hours each entity spends completing the form (approximately 5 hours). The Commission based the number of entities that would complete and file each of the forms on the actual number of filers during the 1999 fiscal year. The staff estimated the average number of hours each entity spends completing each of the forms by contacting a number of law firms and other persons regularly involved in completing the forms.

The Commission currently estimates that Form 6-K results in a total annual compliance burden of 91, 848 hours and $515, 000 non-labor burden costs. This was calculated by multiplying the estimated number of Form 6-K filings annually (approximately 11, 481) by the estimated average number of hours each entity spends completing the form (approximately 8 hours) and adding the non-labor burden costs. The Commission based the number of entities that would complete and file each of the forms on the actual number of filers during the 1999 fiscal year. The staff estimated the average number of hours each entity spends completing each of the forms by contacting a number of law firms and other persons regularly involved in completing the forms.

We believe that the proposed Regulation is necessary to provide for fairer and more effective disclosure of issuer information to all investors and thereby bolster investor confidence in the securities markets. Under the proposed Regulation, issuers would be required to simultaneously (or, in some instances, promptly), upon first disclosure of material, nonpublic information, publicly disclose the information broadly. The disclosure could be made by filing a Form 8-K or Form 6-K with the Commission, disseminating a press release to a widely circulated news or wire service, or disseminating the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access.

We estimate that, on average, completing and filing a Form 8-K under proposed Regulation FD would require the same amount of time currently spent by entities completing the Form – approximately 5 hours. We estimate that, on average, completing and filing a Form 6-K under proposed Regulation FD would require the same amount of time spent completing Form 6-K – approximately 8 hours. As noted, however, under the proposed Regulation, companies are exempt from the requirement to file a Form 6-K or Form 8-K if they disseminate a press release to a widely circulated news or wire service or disseminate the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access. We estimate that other methods of disclosure, such as press releases and press conferences, will require no more than the preparation time of Form 8-K – less than 5 burden hours.

We anticipate that, under Regulation FD, companies will make five[117] disclosures per year.[118] Since there are approximately 14, 000 companies affected by this Regulation, we estimate that there will be 70, 000 additional disclosures per year under Regulation FD. Based on a burden hour estimate of five hours, we anticipate that companies will incur 350, 000 additional burden hours under Regulation FD.[119]

Compliance with the disclosure requirements is mandatory. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609, with reference to File No. S7-31-99. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-31-99, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VI. Cost-Benefit Analysis

A. Regulation FD: Selective Disclosure

Proposed Regulation FD would require that when an issuer intentionally discloses material nonpublic information to any person outside the issuer, it must simultaneously make public disclosure, and when it unintentionally discloses material nonpublic information, it must promptly make public disclosure.

Proposed Regulation FD is intended to produce several important benefits to investors and the securities markets as a whole. First, Regulation FD will inhibit current practices of selective disclosure, which damage investor confidence in the fairness and integrity of the markets. One recent study indicates that analysts and institutional investors immediately use information received in conference calls to trade.[120] Traders on the other side of these transactions, who are excluded from the conference calls, do not have the same information as the more informed analysts and selected investors. Numerous individual investors have complained about this practice. By addressing selective disclosure of material information, the proposed Regulation will foster fairer disclosure of information to all investors, and thereby increase investor confidence in market integrity.

By enhancing investor confidence in the markets, we believe the proposed Regulation will encourage continued widespread investor participation in our markets, which will enhance market efficiency and liquidity, and foster more effective capital raising.

Second, we believe that issuers may also benefit from more open and fair disclosure practices. One study concluded that companies that more liberally disclose information have a larger analyst following, a narrower consensus in earnings estimates, and a low stock price volatility, which likely leads to a lower cost of equity capital.[121] Proposed Regulation FD would encourage these beneficial disclosure practices.

Third, the proposed Regulation likely will also provide benefits to securities analysts and others in the market for information. This Regulation will place all analysts on equal competitive footing with respect to access to material information. As well, this Regulation will allow analysts to express their honest opinions without fear of being denied access to valuable corporate information.[122] Analysts will continue to be able to use and benefit from superior diligence or acumen, without facing the prospect that other analysts will have a competitive edge based solely on better access to corporate insiders.

We do not currently have sufficient information to quantify these or other benefits. We therefore request your comments, including supporting data, on the benefits of the Regulation.

The proposed Regulation would impose some costs on issuers. First, there will be some additional cost to publicly disclose material nonpublic information on a non-selective basis. This proposal gives issuers three options for making public disclosure. The issuer can: (1) file a Form 8-K[123] or Form 6-K;[124] (2) disseminate a press release containing the material nonpublic information through a widely circulated news or wire service; or (3) disseminate the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access (*e.g.*, teleconference, web-conference).

Because the Regulation does not require issuers to disclose material information (just to make any disclosure on a non-selective basis), we cannot predict with certainty how many issuers will actually make disclosures under this Regulation. For purposes of the Paperwork Reduction Act, however, we estimate that issuers will make five[125] public disclosures under Regulation FD per year.[126] Since there are approximately 14, 000 issuers affected by this Regulation, we estimate that the total number of disclosures under Regulation FD per year will be 70, 000.

If an issuer files a Form 8-K, we estimate that the issuer would incur, on average, five burden hours per filing. This estimate is based on current burden hour estimates under the Paperwork Reduction Act for filing a Form 8-K and the staff's experience with such filings. We believe that approximately 75% of the burden hours are expended by the company's internal professional staff, and the remaining 25% by outside counsel. Assuming a cost of $85/hour for in-house professional staff and $125/hour for outside counsel, we believe the total cost is $475 per filing.

If an issuer files a Form 6-K, we estimate that the issuer would incur, on average, eight burden hours per filing and other miscellaneous costs of $45 per filing. This estimate is based on estimates under the Paperwork Reduction Act for filing a Form 6-K and the staff's experience with such filings. We believe that approximately 75% of the burden hours are expended by the issuer's internal professional staff, and the remaining 25% by outside counsel. Assuming a cost of $85/hour for in-house professional staff and $125/hour for outside counsel, we believe the total cost is $805 per filing.

We have no hard data on which to base estimates of the costs of other disclosure options. However, we anticipate that other methods of disclosure, such as press releases, may require less preparation time than a Form 8-K. If the costs of the other methods of disclosure are less than the cost of filing the Form 8-K, we presume issuers will choose the other methods of public disclosure. Issuers may, however, choose to use methods of dissemination with higher out-of-pocket costs, presumably because they believe these methods provide additional benefits to the issuer or investor.

Given that we estimate that there will be 70, 000 disclosures under Regulation FD per year at a cost of approximately $475 per disclosure, [127] we estimate that the total paperwork burden of preparing the information for disclosure per year will be approximately $33, 250, 000.

We request your comments, including supporting data, on our estimates of the costs of each disclosure option, the number of times a company will make a disclosure in a year, and which method companies are likely to use.

The proposed Regulation may also lead to some increased costs for issuers resulting from new or enhanced systems and procedures for disclosure practices. We believe that many, if not most, issuers already have internal procedures for communicating with the public; for many issuers, therefore, new procedures to prevent selective disclosures will not be needed. There might be a cost to these issuers, however, for enhancing and strengthening existing procedures to ensure that nonpublic material information is not inadvertently disclosed and for disclosing inadvertently released materials promptly. We do not have data to quantify the cost of enhancing and strengthening existing internal monitoring procedures, and we seek your comments and supporting data on these costs.

We are sensitive to the concern that the proposed Regulation might "chill" corporate disclosures to analysts, investors, and the media. Issuers may speak less often out of fear of a post hoc assessment that disclosed information was material. If the Regulation has such a chilling effect, there would be a cost to overall market efficiency. However, there are numerous practices that issuers may employ to continue to communicate freely with analysts and investors, while becoming more careful in how they disclose information. Moreover, the Regulation only covers the selective disclosure of material nonpublic information; the level of "soft" or non-material information available to the market need not decrease. As well, we believe issuers have strong reasons to continue releasing information, given the market demand for information and a company's desire to promote its products and services. Further, we note that, in light of existing SRO rules and disclosure practice guidance provided by organizations such as NIRI, many issuers are currently conducting their disclosure practices in a manner consistent with the proposed Regulation. In light of these factors, we request your comments on the effect the proposed Regulation will have on information flow. Please support your comments and conclusions with data.

Today's proposal is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act, and the Regulation does not create new duties under Section 10(b) of the Exchange Act. We nevertheless request comments on liability exposure, including the underlying case law if applicable, and we request your estimates of any costs that may result from increased risk of liability.

Are there other costs we have not identified? Please supply data to help us estimate the cost.

B. Proposed Rule 10b5-1: Trading "On the Basis of" Material Nonpublic Information

Proposed Rule 10b5-1 would define when a sale or purchase of a security occurred "on the basis of" material nonpublic information. Under the proposed Rule, a person trades "on the basis of" material nonpublic information if the person making the purchase or sale was aware of the material nonpublic information at the time of the purchase or sale. However, the proposed Rule provides affirmative defenses to liability when a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith.

We anticipate two significant benefits arising from proposed Rule 10b5-1. First, the Rule should increase investor confidence in the integrity and fairness of the market because it clarifies and strengthens existing insider trading law. Second, the proposed Rule will benefit corporate insiders by providing greater clarity and certainty on how they can plan and structure securities transactions. The Rule provides specific guidance on how a person can plan future transactions at a time when he or she is not aware of material nonpublic information without fear of incurring liability. We believe that this guidance will make it easier for corporate insiders to conduct themselves in accordance with the laws against insider trading. We seek your comments and supporting data on these or other benefits that we have not identified.

The Rule does not require any particular documentation or recordkeeping by insiders, although it would, in some cases, require a person to document a particular plan, contract, or instruction for trading if he or she wished to establish an affirmative defense that his or her trading was not "on the basis of" material nonpublic information. We therefore do not attribute any costs to this aspect of the proposed Rule. We seek comments and data on any costs that this Rule would impose.

C. Rule 10b5-2: Duties of Trust or Confidence in Misappropriation Insider Trading Cases

Proposed Rule 10b5-2 would enumerate three non-exclusive bases for determining when a person receiving information was subject to a duty "of trust or confidence" for purposes of the misappropriation theory of insider trading. Two principal benefits are likely to result from this Rule. First, the Rule will provide greater clarity and certainty to the law on the question of when a family relationship will create a duty of trust or confidence. Second, the Rule will address an anomaly in current law under which a family member receiving material nonpublic information may exploit it without violating the prohibition against insider trading. By addressing this potential gap in the law, the Rule would enhance investor confidence in the integrity of the market. We do not attribute any costs to this aspect of the proposed Rule. We seek comments and data on any costs that this Rule would impose.

VII. Consideration of the Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[128] the Commission is requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commenters should provide empirical data to support their views.

Section 23(a) of the Exchange Act[129] requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. Because we do not believe the rules would affect companies differently, we do not believe that the proposals would have any anti-competitive effects. We request comment on any anti-competitive effects of the proposals.

In addition, Section 3(f) of the Exchange Act[130] requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. We believe that the proposals would bolster investor confidence in the securities markets by improving both the actual and perceived equity of the information available to investors from all companies. Accordingly, the proposals should promote capital formation and market efficiency. We anticipate no impact on competition. We request comment on these matters.

VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed new Regulation FD, Rule 10b5-1, and Rule 10b5-2 under the Exchange Act, as amended. The proposed Regulation and Rules address the selective disclosure of material information and clarify two unsettled issues under current insider trading law.

A. Reasons for the Proposed Action

The proposed Rules address three separate issues. Regulation FD addresses the problem of issuers making selective disclosure of material nonpublic information to analysts or particular investors before making disclosure to the investing public. Rules 10b5-1 and 10b5-2 address two unsettled issues in insider trading case law: (1) whether the Commission needs to show that a defendant "used" material nonpublic information in an insider trading case, or merely that the defendant traded while in "knowing possession" of the information; and (2) when a family or other non-business relationship can give rise to liability under the misappropriation theory of insider trading. By addressing these issues, the proposals will enhance investor confidence in the fairness and integrity of the securities markets.

B. Objectives

Proposed Regulation FD would require that when an issuer intentionally discloses material nonpublic information it do so through public disclosure, not selective disclosure. When an issuer has made a non-intentional selective disclosure, Regulation FD would require the issuer to make prompt public disclosure thereafter. The proposed Regulation provides for several alternative methods by which an issuer can make the required public disclosure. We believe that this proposal will provide for fairer and more effective disclosure of important information by issuers to the investing public.

Proposed Rule 10b5-1 would resolve the unsettled case law on whether the Commission must prove that a defendant "used" or traded while in "knowing possession" of material nonpublic information in order to prove insider trading liability. The proposal would provide a general rule that liability arises when a person trades while "aware" of material nonpublic information. It provides four defenses against liability, in cases where a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith. It also provides a defense against liability for trading by entities, including small entities, when the individual making the trade was not aware of the information, and the entity had implemented reasonable procedures to prevent insider trading. We believe this proposed Rule would clarify an important issue in insider trading law, and thereby enhance investor confidence in market integrity.

Proposed Rule 10b5-2 would define when a non-business relationship, such as a family or personal relationship, may provide the duty of trust and confidence required under the misappropriation theory of insider trading. This issue currently is also unsettled in the case law. Moreover, we believe that the main case on the issue, which arose in a criminal prosecution, does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications, and leads to anomalous results in certain situations. Accordingly, the proposed Rule defines the scope of "duties of trust and confidence" for purposes of the misappropriation theory in a manner that more appropriately serves the purposes of insider trading law. Proposed Rule 10b5-2 will have no direct effect on small entities.

C. Legal Basis

We are proposing Regulation FD, Rule 181, the amendments to Forms 6-K and

8-K, Rule 10b5-1, and Rule 10b5-2 under the authority set forth in Sections 10, 19(a) and 28 of the Securities Act,[131] Sections 3, 9, 10, 13, 15, 23, and 36 of the Exchange Act,[132] and Section 30 of the Investment Company Act.[133]

D. Small Entities Subject to the Proposed Regulation and Rules

Proposed Regulation FD would affect issuers and closed-end investment companies that are small entities.[134] As of July 31, 1999, the Commission estimated that there were approximately 830 issuers, other than investment companies, that may be considered small entities.[135] As of December 14, 1999, the Commission estimated that there are approximately 62 closed-end investment companies that may be considered small entities subject to Regulation FD.[136]

Proposed Rule 10b5-1 would apply to any small entities that engage in securities trading while aware of inside information and therefore are subject to existing insider trading prohibitions of Rule 10b-5. This could include issuers, broker-dealers,[137] investment advisers,[138] and investment companies. As of July 31, 1999, the Commission estimated that there were approximately 830 issuers, other than investment companies, that may be considered small entities. As of December 31, 1998, the Commission estimated that there were approximately 970 broker-dealers that may be considered small entities.[139] As of December 15, 1999, the Commission estimated that there were approximately 2, 000 investment advisersthat may be considered small entities.[140] As of December 14, 1999, the Commission estimated that there are approximately 227 investment companies that may be considered small entities. The Commission cannot estimate with certainty how many small entities engage in securities trading while aware of inside information.

E. Reporting, Recordkeeping, And Other Compliance Requirements

1. Regulation FD

When an issuer, large or small, discloses material nonpublic information, proposed Regulation FD would require it to do one of the following: (1) file a Form 8-K or, in the case of a foreign private issuer, a Form 6-K; (2) disseminate a press release containing the information through a widely circulated news or wire service; or (3) disseminate the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access (*i.e.*, a press conference to which the public is granted access such as by a teleconference or other electronic transmission).

The Regulation's "public disclosure" requirement would give small entity issuers flexibility in how to disseminate information (such as telephonic or Internet conference calls). This flexible performance element enables small entity issuers the freedom to select the method of public disclosure that best suits their business operations, and makes it unlikely that this "public disclosure" requirement would have a disproportionate affect on small entity issuers.

2. Rule 10b5-1

Proposed Rule 10b5-1 does not directly impose any recordkeeping or compliance requirements on any small entities. To the extent that an entity engaged in securities trading wished to rely on one of the defenses against liability provided in the Rule, it might be required to take certain steps. For example, to assert the affirmative defense in paragraph (c)(1)(i)(D) for trades that result from a written plan for trading securities designed to track or correspond to a market index, market segment, or group of securities, an entity, large or small, would have to maintain a written record of the trading plan. More generally, any entity, large or small, that sought to rely on the affirmative defense in paragraph (c)(2) for institutional traders would be required to comply with the specific provisions of that defense, including implementing reasonable policies and procedures to prevent insider trading. We believe that most entities to whom this defense would be relevant – *i.e.*, broker-dealers and investment advisers – already have the required procedures in place, because of existing statutory requirements.[141]

3. Rule 10b5-2

Proposed Rule 10b5-2 affects individuals and not entities. Accordingly, we believe that proposed Rule 10b5-2 would not have a significant economic impact on a substantial number of small entities.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with proposed Regulation FD, Rule 10b5-1, or Rule 10b5-2.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entity issuers. In connection with proposed Regulation FD and Rule 10b5-1 we considered the following alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the Regulation or Rule, or any part thereof, for small entities.

With respect to proposed Regulation FD, we believe that different compliance or reporting requirements or timetables for small entities would interfere with achieving the primary goal of protecting investors. For the same reason, we believe that exempting small entities from coverage of proposed Regulation FD, in whole or part, is not appropriate. In addition, we have concluded preliminarily that it is not feasible to further clarify, consolidate, or simplify the proposed Regulation for small entities. We have used performance elements in proposed Regulation FD in two ways. Regulation FD does not require that an issuer satisfy its obligations in accordance with any specific design, but rather allows each issuer, including small entities, flexibility to select the method of compliance that is most efficient and appropriate for its business operations. First, each issuer can select what method(s) to use to avoid selective disclosure (*e.g.*, by designating which authorized official(s) will speak with analysts). Second, each issuer can choose what method(s) to use for "public disclosure" (*e.g.*, filing a Form 8-K, issuing a press release, holding a conference call transmitted telephonically or over the Internet, etc.). We do not believe different performance standards for small entities would be consistent with the purpose of the proposed Regulation.

With respect to proposed Rule 10b5-1, we believe that different compliance requirements for small entities would interfere with achieving the primary goal of protecting investors. For the same reason, we believe that exempting small entities from coverage of proposed Rule 10b5-1, in whole or part, is not appropriate. In addition, we have concluded that it is not feasible to further clarify, consolidate, or simplify the proposed Rule for small entities. First, the aspects of proposed Rule 10b5-1 that indirectly involve compliance requirements are affirmative defenses that are not required to comply with the proposed Rule. Second, we have used performance elements for the affirmative defenses based on an index trading plan or an institutional investor implementing proper informational barriers set forth in paragraphs (c)(1)(i)(D) and (c)(2) of proposed Rule 10b5-1. If an entity decides to assert either of these affirmative defenses, proposed Rule 10b5-1 does not require that it satisfy its obligations under either of the affirmative defenses in accordance with any specific design, but rather allows it flexibility to select which measure(s) it wants to put in place to satisfy the elements of each affirmative defense. We do not believe different performance standards for small entities would be consistent with the purpose of the proposed Rule.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding: (i) the number of small entity issuers that may be affected by the proposed Regulation and Rules; (ii) the existence or nature of the potential impact of the proposed Regulation and/or Rules on small entity issuers discussed in the analysis; and (iii) how to quantify the impact of the proposed Regulation and Rules. Commentators are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed Regulation and/or Rules are adopted, and will be placed in the same public file as comments on the proposed Regulation and Rules themselves.

IX. Statutory Bases

We are proposing Regulation FD, Rule 181, the amendments to Forms 6-K and

8-K, Rule 10b5-1 and Rule 10b5-2 under the authority set forth in Sections 10, 19(a), and 28 of the Securities Act, Sections 3, 9, 10, 13, 15, 23, and 36 of the Exchange Act, and Section 30 of the Investment Company Act.

List of subjects

17 CFR Part 230

Securities, Reporting and recordkeeping requirements, Investment companies.

17 CFR Part 240

Fraud, Reporting and recordkeeping requirements, Securities.

17 CFR Parts 243 and 249

Securities, Reporting and recordkeeping requirements.

Text of Proposed Rules and Rule Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77r, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 78ll (d), 79t, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Section 230.181 is added to read as follows:

§ 230.181 Public disclosures required under Regulation FD.

Notwithstanding Section 5(b)(1) of the Act (15 U.S.C. 77e(b)(1)), any public disclosure that constitutes a prospectus need not satisfy the requirements of Section 10 (15 U.S.C. 77j) of the Act if the prospectus is used only as required under Rule 100(a) of Regulation FD (17 CFR 243.100(a)) and the registrant otherwise complies with the requirements of Regulation FD.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, and 80b-11, unless otherwise noted.

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4. Section 240.10b5-1 is added to read as follows:

§ 240.10b5-1 Trading "on the basis of" material nonpublic information in insidertrading cases.

Preliminary Note to § 240.10b5-1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not address or modify the scope of insider trading law in any other respect.

(a) General rule. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and § 240.10b-5 thereunder are defined to include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

(b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

(c) Affirmative defenses.

(1)(i) Subject to paragraph (c)(1)(ii) of this section, a purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that, before becoming aware of the information, the person:

(A) Had entered into a binding contract to purchase or sell the security in the amount, at the price, and on the date which the person purchased or sold the security;

(B) Had provided instructions to another person to execute a purchase or sale of the security for the instructing person's account, in the amount, at the price, and on the date which that purchase or sale was executed;

(C) Had adopted, and had previously adhered to, a written plan specifying purchases or sales of the security in the amounts, and at the prices, and on the dates at which the person purchased or sold the security; or

(D) Had adopted, and had previously adhered to, a written plan for trading securities that is designed to track or correspond to a market index, market segment, or group of securities, and the amounts, prices, and timing of the purchases or sales actually made were the result of following the previously adopted plan.

(ii) The defenses provided in paragraph (c)(1)(i) of this section shall be available only when the contract, plan, or instruction to purchase or sell securities was entered into in good faith, and not as part of a plan or scheme to evade the prohibitions of this section. For example, if, after becoming aware of material nonpublic information, a person alters a previous contract, plan, or instruction to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or enters into or alters a corresponding or hedging transaction or position with respect to those securities, the person shall not be able to assert the contract, plan, or instruction as a defense to liability.

(iii) For purposes of paragraph (c), the following definitions shall apply:

(A) In the amount(s). A contract, plan, or instruction for a purchase or sale of securities in specified "amount(s)" must specify either the aggregate number of shares or other securities to be purchased or sold, or the aggregate dollar amount of securities to be purchased or sold.

(B) At the price(s). A contract, plan, or instruction for a purchase or sale of securities at specified "price(s)" includes one that specifies a purchase or sale at the market price for a particular date.

(2) In the case of a person other than a natural person, a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that:

(i) The individual(s) making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and

(ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

5. Section 240.10b5-2 is added to read as follows:

§ 240.10b5-2 Duties of trust or confidence in misappropriation insider trading cases.

Preliminary Note to § 240.10b5-2: This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and this section is not intended to address or modify the scope of insider trading law in any other respect.

(a) Scope of Rule. This section shall apply to any violation of Section 10(b) of the Act (15 U.S.C. 78j (b)) and § 240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) Enumerated "duties of trust or confidence." For purposes of this section, the circumstances under which a "duty of trust or confidence" exist shall include, among others, the following:

(1) Whenever a person agrees to maintain information in confidence;

(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the person communicating the material nonpublic information has a reasonable expectation that the other person would maintain its confidentiality; or

(3) Whenever a person receives or obtains material nonpublic information from the person's spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that the spouse, parent, child, or sibling that was the source of the information had no reasonable expectation that the person would keep the information confidential, because the parties had neither a history, pattern, or practice of sharing confidences, nor an agreement or understanding to maintain the confidentiality of the information.

6. Part 243 is added to read as follows:

PART 243 – REGULATION FD

Sec.

243.100 General rule regarding selective disclosure.

243.101 Definitions.

Authority: 15 U.S.C. 78c, 78i, 78j, 78m, 78o, 78w, 78mm, and 80a-29, unless otherwise noted.

§ 243.100 General rule regarding selective disclosure.

(a) Except as provided in paragraph (b) of this section, whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person or persons outside the issuer, the issuer shall:

(1) In the case of an intentional disclosure, make public disclosure of that information simultaneously; and

(2) In the case of non-intentional disclosure, make public disclosure of that information promptly.

(b) Paragraph (a) of this section shall not apply when a disclosure is made to a person who owes a duty of trust or confidence to the issuer (including, for example, an outside consultant such as an attorney, investment banker, or accountant) or to a person who has expressly agreed to maintain such information in confidence.

§ 243.101 Definitions.

For purposes of this Regulation FD (§ 243.101), the following definitions shall apply:

(a) Intentional. A selective disclosure of material nonpublic information is "intentional" when the individual making the disclosure either knew prior to the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic.

(b) Issuer. Every issuer having securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or which is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), including closed-end investment companies (as defined in Section 5(a)(2) of the Investment Company Act of 1940) (15 U.S.C. 80a-5(a)(2)) but not including other investment companies, shall be subject to this Regulation.

(c) Person acting on behalf of an issuer. Any officer, director, employee, or agent of an issuer, who discloses material nonpublic information while acting within the scope of his or her authority, shall be considered to be a "person acting on behalf of the issuer." An officer, director, employee, or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to the issuer shall not be considered to be acting on behalf of the issuer.

(d) Promptly.

(1) "Promptly" shall mean disclosure as soon as reasonably practicable (but in no event more than 24 hours) after a senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser) knows, or is reckless in not knowing, of the non-intentional disclosure.

(2) For purposes of paragraph (d)(1) of this section, a "senior official" means any director, any executive officer (as defined in § 240.3b-7 of this chapter), any investor relations or public relations officer, or any other person with similar functions.

(e) Public disclosure.

(1) Except as provided in paragraph (e)(2) of this section, an issuer shall make the "public disclosure" of information required by § 243.100(a) of this chapter by filing with the Commission a Form 8-K (17 CFR 249.308) disclosing that information, or if the issuer is a foreign private issuer it shall file a Form 6-K (17 CFR 249.306).

(2) An issuer shall be exempt from the requirement to file a Form 8-K or Form

6-K if it instead does one of the following:

(i) Disseminates a press release containing that information through a widely circulated news or wire service; or

(ii) Disseminates the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access, such as announcement at a press conference to which the public is granted access (e.g., by personal attendance or by telephonic or other electronic transmission).

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 249 is amended by adding the following citations:

Authority: 15 U.S.C. 78a,et seq., unless otherwise noted;

Section 249.308 is also issued under 15 U.S.C. 80a-29.

* * * * *

8. Form 6-K (referenced in § 249.306) is amended by revising the phrase "and any other information which the registrant deems of material importance to securityholders" in the second paragraph of General Instruction B to read "information required to be publicly disclosed under Regulation FD (17 CFR 243.100) except information publicly disclosed in accordance with Rule 101(e)(2) of Regulation FD (17 CFR 243.101(e)(2)); and any other information which the registrant deems of material importance to securityholders".

[Note: Form 6-K does not and the amendments will not appear in the Code of Federal Regulations.]

9. Section 249.308 is amended by revising the phrase "Rule 13a-11 or Rule 15d-11 (§ 240.13a-11 or § 240.15d-11 of this chapter)" to read "Rule 13a-11 or Rule 15d-11 (§ 240.13a-11 or § 240.15d-11 of this chapter) and for reports of material nonpublic information required to be disclosed by Regulation FD (§ 243.100 and § 243.101 of this chapter)".

10. Form 8-K (referenced in § 249.308) is amended:

a. in General Instruction A, by revising the phrase "Rule 13a-11 or Rule 15d-11" to read "Rule 13a-11 or Rule 15d-11, and for reports of material nonpublic information required to be disclosed by Regulation FD (17 CFR 243.100 and 243.101)".

b. by adding a sentence to the end of paragraph 1 of General Instruction B;

c. in General Instruction B.4., by revising the phrase "other events of material importance pursuant to Item 5, " to read "other events of material importance pursuant to Item 5 and of reports pursuant to Item 10, ";

d. by adding a new Item 10 under "Information To Be Included in the Report" to read as follows:

[Note: Form 8-K does not and the amendments will not appear in the Code of Federal Regulations.]

FORM 8-K

* * * * *

GENERAL INSTRUCTIONS

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B. Events to be Reported and Time for Filing of Reports

1. * * * A report on this form pursuant to Item 10 shall be filed in accordance with the requirements of Rule 100(a) of Regulation FD (17 CFR 243.100(a)).

* * * * *

INFORMATION TO BE INCLUDED IN THE REPORT

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Item 10. Regulation FD Disclosure.

Report under this item the material nonpublic information required to be disclosed by Regulation FD (17 CFR 243.100 and 243.101).

* * * * *

By the Commission.

Jonathan G. Katz

Secretary

Dated: December 20, 1999

Footnotes

1 17 CFR 243.100 and 243.101.

2 17 CFR 230.181.

3 17 CFR 240.10b5-1.

4 17 CFR 240.10b5-2.

5 17 CFR 249.308.

6 17 CFR 249.306.

7 S. Rep. No. 73-1455, at 68 (1934).

8 "The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. Rep. No. 73-1383, at 11 (1934).

See also S. Rep. No. 73-792, at 10-11, 19-20 (1934).

9 *See* Timely Disclosure of Material Corporate Developments, Securities Act Release No. 5092 (Oct. 15, 1970) (35 FR 16733).

10 *See, e.g.*, NYSE Listed Company Manual, para. 202.05 (Timely Disclosure of Material News Developments); NASD Rules 4310(c)(16), 4320(e)(14), and IM-4120-1 (Disclosure of Material Information).

11 *See, e.g.*, Susan Pulliam and Gary McWilliams, *Compaq Is Criticized for How It Disclosed PC Troubles*, Wall St. J., Mar. 2, 1999, at C1; Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, Wall St. J., Oct. 14, 1999, at C1; Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, Wall St. J., June 21, 1995, at C1; George Anders and Robert Berner, *Webvan to Delay IPO in Response to SEC Concerns*, Wall St. J., Oct. 7, 1999, at C16 (disclosure to institutional investors in road-show presentations). In addition, a recent study of corporate disclosure practices by the National Investor Relations Institute reported that 26% of responding companies stated that they engaged in some types of selective disclosure practices. National Investor Relations Institute, *A Study of Corporate Disclosure Practices, Second Measurement*, 18 (May 1998) (NIRI Corporate Disclosure Study).

12 United States v. O'Hagan, 521 U.S. 642, 658 (1997).

13 *Id.* (citing Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 356 (1979)).

14 *Raymond L. Dirks*, 47 S.E.C. 434, 441(1981). This concern about protecting the legitimate functions of securities analysts was a basis for the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), which addressed an analyst's liability under Rule 10b-5 insider trading law. *See also* Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 Hofstra L. Rev. 127, 142 (1984). *But see* Donald C. Langevoort, *Investment Analysts and The Law of Insider Trading*, 76 Va. L. Rev. 1023, 1044 (1990) (stating that the argument favoring special treatment for analyst disclosures is "substantially overstated"). We discuss the *Dirks* case in greater detail at *infra* pp. 12-13.

15 *See* Richard Frankel, Marilyn Johnson, and Douglas J. Skinner, *An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium*, 37 J. Acct. Res. 133 (Spring 1999). This study revealed that, during and immediately following teleconference calls between analysts and issuers, trading volume in the issuers' stock increased, average trade size increased, and stock price volatility increased. This led the researchers to conclude that material information is released during these selective disclosure periods, which is immediately filtered to a subset of large investors who are able to trade on the information before it is fully disseminated to the market.

16 The NIRI Corporate Disclosure Study indicates that a higher percentage of issuers engaged in possible selective disclosure practices in 1995 than in 1998. *See* NIRI Corporate Disclosure Study, *supra* note 11 at 18.

17 *See SEC v. Phillip J. Stevens*, Litigation Release No. 12813 (Mar. 19, 1991).

18 Fred Barbash, *Companies, Analysts A Little Too Cozy*, Wash. Post, Oct. 31, 1999, at H1 ("Companies coddle analysts to obtain the most favorable coverage, which is critical to their stock price. Analysts covet their access to companies, because special knowledge is the only thing they have to offer clients."); Andrew Hill, *Let the buyer beware*, Fin. Times, Oct. 27, 1999, at 14 ("The death of the 'sell' note is perhaps the clearest signal that big securities houses are suppressing or toning down negative analysis of companies that are clients or potential clients. In a snapshot of 27,700 individual analyst reports, taken at the beginning of this month, First Call/Thomson Financial, the research company, found nearly 70 per cent recommended that investors buy the stock, and just under 1 per cent advised they should sell."); Gretchen Morgenson, *The Earnings Waltz: Is the Music Stopping?*, N.Y. Times, Oct. 24, 1999, at 3 ("As quarterly earnings numbers became paramount, analysts grew more dependent upon company management for 'guidance' to the correct earnings forecast. The more help they received, the less work they did."); Robert McGough, *One Analyst Anticipated IBM News*, Wall St. J., Oct. 22, 1999, at C1 ("Too often, analysts rely on executives at the companies they cover to let them know what's going on in the business."); Jonathan Weil, *In Stock Ratings, Many Analysts Say 'Sell' Is a Four-Letter Word*, Wall St. J., May 6, 1998, at T2 (attributing analysts' "speak no evil" motto to fact that "most analysts don't want to risk offending corporate executives, who have been known to retaliate by restricting access to information or selecting competitors' corporate-finance departments to do lucrative investment-banking deals. So analysts issue watered-down critiques, and shareholders have to read between the lines for suggestions on when to get out of a stock."); Jeffrey M. Laderman, *Who Can You Trust? Wall Street's Spin Game, Stock Analysts Often Have a Hidden Agenda*, Bus. Wk., Oct. 5, 1998, at 148 (referencing a recent survey of Wall Street research, sales, and trading practices in which nearly one-third of the 272 responding large U.S. companies said that in response to an analyst's sell recommendation they would "'reduce communications and reduce access'. . . . The great fear of the analyst when he or she goes calling on a company is to find the door shut.").

19 John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., July 31, 1997, at 5. Professor Coffee also argues that selective disclosure may impair market efficiency in one other respect. If market efficiency is measured by the width of bid/asked spreads, market makers will widen spreads to protect themselves if they fear that others possess and will exploit asymmetric informational advantages. *See also* Amitabh Dugar, Siva Nathan, *Analysts' Research Reports: Caveat Emptor*, 5 J. Investing 13 (1996) ("Analysts depend on corporate management for accurate and timely information about the companies they follow. It is no secret that companies wield restriction of access as a weapon against analysts who issue a negative research report on their stock. Retribution ranges from refusing the analyst's calls for information, to barring the analysts from mailings, conference calls, and meetings, and even threats of legal action and physical harm." (citations and footnote omitted)).

20 *See supra* note 10.

21 National Investor Relations Institute, *Standards of Practice for Investor Relations*, 30 (Apr. 1998).

22 Association for Investment Management and Research, *Standards of Practice Handbook*, 232 (8th ed. 1999).

23 *See, e.g.*, National Investor Relations Institute, Executive Alert, *Investor Relations Officers Report Dramatic Change in Ways Companies Communicate With Key Audiences* (June 18, 1999); Lynn Cowan, *Internet Broadcast of Conference Calls Creates Buzz and Niche for Businesses*, Wall St. J.,

May, 24, 1999, at B9D.

24 We also have greater flexibility and improved technology for widespread dissemination of information. The Commission's EDGAR system permits investors to access issuer information almost as soon as it is filed with us.

25 *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

26 *See SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977). At the same time, however, issuers were encouraged to divulge tidbits of non-material information to analysts to help them piece together more informed opinions. *Id.* The courts reasoned that although giving analysts direct, nonpublic, material information was prohibited, the law should permit "[a] skilled analyst with knowledge of [a] company and the industry [to] piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information." *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980). This theory is known as the "mosaic theory." The resulting tension between prohibited material disclosures and acceptable non-material disclosures led one judge to compare the corporate official's encounter with an analyst to a "fencing match conducted on a tightrope." *Bausch & Lomb*, 565 F.2d at 9.

27 445 U.S. 222 (1980).

28 463 U.S. 646 (1983).

29 In *Dirks*, a securities analyst had been informed about a major fraud at Equity Funding of America by a former officer of the company. Although Dirks made an effort to make the fraud public, he also told his clients, enabling them to sell their Equity Funding securities and avoid losses when the fraud became publicly known. The Commission charged that Dirks was a "tippee" of the insider, and in turn tipped his clients.

30 463 U.S. at 663. On the facts of the case, the Court found that Dirks' source did not breach a duty in disclosing information to Dirks because he did not receive a personal benefit from the disclosure and was clearly motivated by a desire to expose the fraud. Because a tippee's duty is "derivative" from the duty of the tipper, and the insider source did not breach a duty, the Court held that Dirks did not violate Section 10(b) of the Exchange Act or Rule 10b-5.

31 *SEC v. Phillip J. Stevens, supra* note 17 (allegation of personal benefit based on corporate official's desire to protect and enhance his reputation).

32 *See, e.g.,* Paul P. Brountas Jr., *Note: Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 Colum. L. Rev. 1517, 1529 (1992).

33 15 U.S.C. 78m(a) and 78o(d).

34 *See* Proposed Rule 101(b).

35 The proper response in this type of case is to hold the employee or agent responsible for illegal insider trading, not to force the issuer to make a public disclosure due to the misconduct of one of its employees or agents.

36 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see Basic v. Levinson*, 485 U.S. 224, 231 (1988); *see also* Securities Act Rule 405, 17 CFR 230.405; Exchange Act Rule 12b-2, 17 CFR 240.12b-2; Staff Accounting Bulletin No. 99 (Aug. 12, 1999) (64 FR 45150) (discussing materiality for purposes of financial statements).

37 See NIRI Corporate Disclosure Study, supra note 11.

38 If a person receives material nonpublic information subject to such a confidentiality agreement, the use or disclosure of the information for securities trading purposes will lead to insider trading liability under Rule 10b-5.

39 See, e.g., Texas Gulf Sulphur, 401 F.2d at 854; *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

40 *Faberge, Inc.*, 45 S.E.C. 249, 255 (1973). Thus, for purposes of insider trading law, insiders must wait a "reasonable" time before trading. What constitutes a reasonable time prior to trading depends on the circumstances of the dissemination. *Id., citing Texas Gulf Sulphur*, 401 F.2d at 854.

41 *See, infra* Section II.B.5.

42 "Classical" insiders – an issuer's officers, directors, or employees – are of course also subject to duties of trust and confidence and to Rule 10b-5 insider trading liability if they trade or tip.

43 *United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks*, 463 U.S. at 655 n.14.

44 Proposed Rule 101(d)(1). Although requirements for "prompt" disclosure exist elsewhere in the securities laws – *e.g.*, the requirement that amendments to Schedules 13D be filed "promptly" – Proposed Rule 101(d)(1) defines "prompt" disclosure for purposes of Regulation FD. This definition is not meant to apply in any other contexts.

45 *See* Proposed Rule 101(d)(2). For closed-end investment companies that are subject to Regulation FD, the term "senior official" would also cover directors, officers, and employees of the fund's investment adviser.

46 Of course, a pattern of "mistaken" selective disclosures would make less credible the claim that any particular disclosure was not intentional.

47 For example, a senior official may become aware of his mistake when he sees a significant change in the market price and/or trading volume of his company's securities. Alternatively, a senior official might learn that a lower-level employee mistakenly disclosed material information, because an analyst or investor who received the information called the officer to confirm the information.

48 Proposed Rule 101(d)(1) states that the required public disclosure must be made no later than 24 hours after the issuer or a senior official of the issuer knows (or is reckless in not knowing) of the selective disclosure. The 24-hour period takes into account the issuer's potential difficulty in making the disclosure any sooner because of the need to marshal all the information necessary, and reach the

appropriate personnel. In other cases, however, the issuer may well be able to make public disclosure before the maximum allowable 24-hour disclosure period. In such cases, the requirement to disclose "as soon as reasonably practicable" means that the issuer should act sooner than 24 hours later.

49 Proposed Rule 101(e)(1).

50 See NIRI Corporate Disclosure Study, supra note 11, at 9, 21 (finding that 82% of responding issuers used their websites to post disclosures of quarterly financial results).

51 Despite the rapid expansion of Internet access, a significant number of households do not have access. Moreover, simply putting information on a website does not alert investors that it is available.

52 As is the case currently, Form 6-K used to make Regulation FD disclosure would not be deemed to be "filed" for purposes of Section 18 of the Exchange Act or subject to liability under that section.

53 *See supra* note 10.

54 Business development companies ("BDCs"), a category of closed-end investment companies not required to register under the Investment Company Act, are already required to file reports on Form 8-K. Under this proposal, BDCs would continue to be subject to Form 8-K filing obligations, including those imposed by Regulation FD.

55 Courts have held that there is no implied private right of action under Section 13(a) of the Exchange Act. *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024 (6th Cir. 1990), *cert. denied*, 498 U.S. 1086 (1991); *J.S. Service Center Corp. v. General Electric Technical Services Co.*, 937 F. Supp. 216 (S.D.N.Y. 1996).

56 In addition, eligibility to file on a number of "short-form" Securities Act registration statements requires, in part, that the registrant be timely in filing its Exchange Act reports. The obligation to be timely in these filings includes the filing of a required Form 8-K. As such, any required Form 8-K filing under proposed Item 10 would have to be made in a timely manner for the registrant to be eligible to file such a short-form registration statement. If, under today's proposals, the registrant would not be required to file under Item 10 of Form 8-K because it uses an alternative means of public dissemination, the failure to file an Item 10 Form 8-K would not affect that registrant's form eligibility.

57 Regulation FD does not expressly require issuers to adopt policies and procedures to avoid violations, but we expect that most issuers will consider implementing appropriate disclosure policies to guard against selective disclosure. We are aware that many, if not most, issuers already have policies and procedures regarding disclosure practices, the dissemination of material information, and the question of which issuer personnel are authorized to speak to analysts, the media, or investors. The existence of this type of policy, and the issuer's general adherence to it, may often be relevant to determining the issuer's intent with regard to a selective disclosure.

58 Section 21C of the Exchange Act, 15 U.S.C. 78u-3.

59 Section 20(e) of the Exchange Act, 15 U.S.C. 78t(e).

60 *See SEC v. Phillip J. Stevens, supra* note 17.

61 *See generally Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236 (3rd Cir. 1989).

62 *See, e.g., Elkind v. Ligget & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *In the Matter of Presstek, Inc.*, Exchange Act Release No. 39472 (Dec. 22, 1997).

63 15 U.S.C. 78r.

64 15 U.S.C. 77k. This proposal is not intended to change existing liability for forms incorporated by reference.

65 After the registration statement for the IPO becomes effective, however, and the issuer becomes subject to Section 15(d) of the Exchange Act, it would be subject to Regulation FD.

66 Our staff is currently engaged in a more comprehensive review of the regulatory issues raised by "roadshows."

67 15 U.S.C. 77e.

68 15 U.S.C. 77b(a)(10).

69 15 U.S.C. 77j.

70 The Regulation of Securities Offerings, Securities Act Release No. 7606A (Nov. 13, 1998) (63 FR 67174). As discussed below, we also have adopted rules that allow offers in the business combination context to be made before filing a registration statement.

71 Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7760 (Oct. 22, 1999) (64 FR 61408) (effective date Jan. 24, 2000).

72 The proxy rule amendments are not limited to communications concerning business combinations.

73 Written information must be disseminated by filing in order to satisfy the communication exemptions. A news release or other means of dissemination would not meet the requirements of the business combination rules.

74 Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264; Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

75 *O'Hagan*, 521 U.S. at 658.

76 *See Dirks*, 463 U.S. at 654.

77 *See O'Hagan*, 521 U.S. at 651-52.

78 987 F.2d 112 (2d Cir), *cert. denied*, 510 U.S. 976 (1993).

79 *Teicher* was a criminal case premised on the misappropriation theory of insider trading. The court reasoned, in *dicta*, that the simplicity of a "knowing possession" standard recognizes the informational advantage that a trader with inside information has over other traders. "Unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain." *Id.* at 120.

80 137 F.3d 1325 (11th Cir. 1998). *Adler* was a civil action under "classical" insider trading theory. The court stated that trading while "in possession of" the material nonpublic information gives rise to a "strong inference" that the defendant "used" the information in trading, thereby allowing the Commission to establish a *prima facie* case based on possession of the information. The court reasoned that this inference addresses the Commission's proof difficulties by allowing the Commission to make out a *prima facie* case without establishing direct proof of a causal connection between possession of the information and its use. *Id.* at 1337-38. The defendant, however, has the opportunity to rebut this inference by introducing evidence to establish that the information was not used in making the trade. It is left to the fact finder to weigh the evidence to determine whether the information was used. *Id.* at 1337.

81 155 F.3d 1051 (9th Cir. 1998), *cert. denied*, 119 S. Ct. 804 (1999). *Smith* was a criminal case under "classical" insider trading theory. The court expressed no view on whether the *Adler* presumption could be permitted in a civil enforcement case. *Id.* at 1069 & n.27.

82 "We note that if experience shows that this approach unduly frustrates the SEC's enforcement efforts, the SEC could promulgate a rule adopting the knowing possession standard, as the SEC has done in the context of tender offers . . . or a rule adopting a presumption approach in which proof that an insider traded while in possession of material nonpublic information would shift the burden of persuasion on the use issue to the insider." *Adler*, 137 F.3d at 1337 n.33 (citation omitted).

83 Under the classical theory, there is an additional argument why trading in "possession" of inside information is fraudulent. A "classical" insider has a fiduciary duty to the corporation's shareholders. The insider violates this duty, and thereby commits fraud, if he or she trades in the company's securities while in possession of inside information without disclosing the information to the other party. The insider violates this duty regardless of whether he or she "uses" the insider information. *See* Brief of the Securities and Exchange Commission at 22-24, *SEC v. Soroosh* (9th Cir. 1998) (No. 98-35006); Brief of the Securities and Exchange Commission at 18, *SEC v. Adler* (11th Cir. 1997) (No. 96-6084).

84 *Teicher*, 987 F.2d at 120.

85 Proposed Rule 10b5-1(a).

86 *See United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). In *O'Hagan*, the Supreme Court recognized that under the misappropriation theory of insider trading liability, the fraud is consummated when the defendant, without proper disclosure to the source, "uses the information to purchase or sell securities." Proposed Rule 10b5-1 is consistent with this view in that it provides for no liability when a trader can meet one of the stated defenses in paragraph (c) demonstrating lack of use.

87 Proposed para. (c)(1)(i)(A).

88 Proposed para. (c)(1)(iii) defines the terms "[i]n the amount(s)" and "[a]t the price(s)" for purposes of all of paragraph (c)(1)(i)'s affirmative defenses. These definitions are designed to ensure that a contract, plan, or instruction is sufficiently defined to foreclose the use of any inside information of which the person later becomes aware. A trade specified "in an amount" must specify either the number of securities to be traded or the total monetary proceeds to be realized from or spent on the securities to be traded. Thus, a person could plan a sale of, for example, either 1, 000 shares or $10, 000 worth of stock; however, the person could not plan a trade within a range – for example, a sale of between 1, 000 and 2, 000 shares. The term "at the price(s)" includes a purchase or sale at the market price for a particular date. Therefore, persons would not be required to commit to trading at a particular price, but could merely contract, plan, or provide instructions to trade at the market price on the date of the trade.

Under the Rule, a defense would not be available for a contract, plan, or instruction to trade that used a limit order. By using a limit order, the person would not firmly be committing to make a trade, because if the market price at the relevant date exceeded the limit order price, the trade would not be made. We request comment on whether this restriction on the use of limit orders is necessary.

89 Proposed para. (c)(1)(i)(B).

90 Proposed para. (c)(1)(i)(C).

91 This exception does not cover trading for a person's account through a "blind trust." We have not included any express defenses for blind trust trading, because we do not believe this trading creates difficulties under existing insider trading law. When a person places securities in a blind trust, by definition he or she does not make the decisions to purchase or sell securities in that account. Therefore, those trading decisions (which are made by the trustee of the blind trust) should not be attributed to the person for purposes of potential insider trading liability.

92 Proposed para. (c)(1)(i)(D).

93 As a general matter, the Rule requires that any written plan specifying trading at a particular time must be made in good faith. Similarly, paragraph (c)(1)(i)(C) requires that a person have "previously adhered to" the written plan, as a means of demonstrating its bona fides.

94 Proposed para. (c)(2).

95 17 CFR 240.14e-3(b).

96 521 U.S. 642 (1997).

97 *See e.g., United States v. Carpenter*, 791 F.2d 1024, 1028 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12, 15 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729, *cert. denied*, 464 U.S. 863 (1983).

98 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

99 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 447 (2d Cir. 1985).

100 *Reed*, 601 F. Supp. at 717-18.

101 Although the facts alleged in *Reed* were that the father and son had a prior history of sharing business confidences, 601 F. Supp at 690 n.6, the *Reed* court's analysis stated, without limitation to business confidences, that "[t]he repeated disclosure of secrets by the parties or by one party to the other" or a "pre-existing confidential relationship" could be sufficient to establish a duty of trust and confidence. *Id.* at 717-18. The *Chestman* majority, however, limited *Reed*'s holding in a criminal context to its facts – that the repeated sharing of **business** confidences between family members could be the basis of a finding of a relationship of trust and confidence, the functional equivalent of a fiduciary relationship. *Chestman*, 947 F.2d at 569.

102 *Id.* at 568.

103 *Id.* at 571.

104 *Chestman* recognized that although concern about the "rule of lenity" did not permit the use of "an elastic and expedient definition of confidential relations" in criminal cases, such an approach may be useful in the civil context. *Id.* at 570. *See also O'Hagan*, 521 U.S. at 679 (concurring and dissenting opinion of Scalia, J.) (noting applicability of "principle of lenity" in criminal insider trading prosecution, and potential distinction between criminal and civil construction of Rule 10b-5).

105 *Cf. Chestman*, 947 F.2d at 580 (concurring and dissenting opinion of Winter, J.) (calling majority's view "unrealistic" in that "it expects family members to behave like strangers to each other"). Nor does *Chestman* consider the recognition of a fiduciary duty between family members as a matter of common law or statutory enactments.

106 *See, e.g., SEC v. Michelle Nguyen, et al.*, Litigation Release No. 16199 (June 29, 1999); *SEC v. Bharat Kotecha, et al.*, Litigation Release No. 16151 (May 18, 1999); *SEC v. Hahn Truong, et al.*, Litigation Release No. 16080 (Mar. 9, 1999); *SEC v. Roger H. Licht, et al.*, Litigation Release No. 15781 (June 15, 1998); *SEC v. Eugene Dines, et al.*, Litigation Release No. 13900 (Dec. 10, 1993); *SEC v. Steven L. Glauberman, et al.*, Litigation Release No. 12574 (Aug. 9, 1990).

107 *See Dirks*, 463 U.S. at 664 (noting that tipping liability can exist "when an insider makes a gift of confidential information to a trading relative or friend").

108 *O'Hagan*, 521 U.S. at 658-59.

109 Proposed para. (b) does not enumerate relationships that existing case law already recognizes as providing a clear basis for misappropriation liability: for example, lawyer-client, *O'Hagan*; employee-employer, *Carpenter*; psychiatrist-patient, *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). As the *O'Hagan* case demonstrates, an individual working at a professional firm may be liable for misappropriating information about a particular matter even if he or she is not personally working on that matter.

110 Proposed para. (b)(1).

111 Proposed para. (b)(2).

112 We do not intend to limit this to minor children. Our enforcement cases in this area typically involve communications between parents and adult sons or daughters.

113 *See e.g., SEC v. Judy Hockett, et al.*, Litigation Release No. 15377 (May 30, 1997) (spouse); *SEC v. Linda Lou Taylor, et al.*, Litigation Release No. 14775 (Jan. 4, 1996) (spouse); *SEC v. Robert J. Young, et al.*, Litigation Release No.14661 (Sept. 29, 1995) (brother); *SEC v. Jonathan J. Sheinberg, et al.*, Litigation Release No. 13465 (Dec. 10, 1992) (son-father); *SEC v. Thomas C. Reed, et al.*, Litigation Release No. 9537 (Dec. 23, 1981) (son-father).

114 44 U.S.C. 3501 *et seq*.

115 17 CFR 249.308.

116 17 CFR 249.306.

117 In many cases, information disclosed under Regulation FD would be information that an issuer was ultimately going to disclose to the public. Under Regulation FD, that issuer likely will not make any more public disclosure than it otherwise would, but it may make the disclosure sooner and now would be required to file or disseminate that information in a manner reasonably designed to provide broad public access to the information and which does not exclude any members of the public from access.

118 We anticipate that issuers will make one disclosure each quarter under Regulation FD. We also assume that issuers will, on average, make one additional disclosure per year.

119 Although eight burden hours are incurred by issuers filing a Form 6-K, we assume that, since issuers have the option of how to make disclosure under Regulation FD, they will make disclosure under the least burdensome option. Therefore, our burden number for estimation purposes is five burden hours.

120 *See supra* Section II.A. and note 15.

121 *See* National Investor Relations Institute, *Standards of Practice for Investor Relations*, 7 (1st ed. Apr. 1998) (citing Russell Lundholm and Mark Lang, "The Benefits of More Forthcoming Disclosure Practices, " University of Michigan School of Business Administration, Ann Arbor, MI, 1994).

122 *See supra* Section II.A. and notes 18 & 19.

123 17 CFR 249.308.

124 17 CFR 249.306.

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126 In many cases, information disclosed under Regulation FD would be information that an issuer was ultimately going to disclose to the public. Under Regulation FD, that issuer is not going to make any more public disclosure than it otherwise would, but it may make the disclosure sooner and now would be required to file or disseminate that information in a manner reasonably designed to provide broad public access to the information and does not exclude any members of the public from access.

127 While, as discussed, the staff estimates that filing a Form 6-K costs slightly more than filing a Form 8-K, fewer than 1, 000 issuers filed Forms 6-K in fiscal 1999. Therefore, for estimation purposes, we are not accounting for this slightly higher cost in estimating the cost of other disclosure options.

128 Pub. L. No. 104-121, tit. II, 110 Stat. 857.

129 15 U.S.C. 78w(a).

130 15 U.S.C. 78c(f).

131 15 U.S.C. 77j, 77s(a), and 77z-3.

132 15 U.S.C. 78c, 78i, 78j, 78m, 78o, 78w, and 78mm.

133 15 U.S.C. 80a-29.

134 Exchange Act Rule 0-10(a) defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. 17 CFR 240.0-10(a). Investment Company Act Rule 0-10(a) defines an investment company as a "small business" or "small organization" if it, "together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year." 17 CFR 270.0-10(a).

135 The Commission bases its estimate on information from the Insight database from Compustat, a division of Standard and Poors.

136 The Commission bases its estimate on information from Lipper Directors' Analytical Data, Lipper Closed-End Fund Performance Analysis Service, and reports investment companies file with the Commission on Form N-SAR.

137 Exchange Act Rule 0-10(c) defines a broker-dealer as a small entity if it had total capital (net worth plus subordinated liabilities) of less than $500, 000 on the date in the prior fiscal year as of which its audited financial statements were prepared and it is not affiliated with any person (other than a natural person) that is not a small entity. 17 CFR 240.0-10(c).

138 Advisers Act Rule 0-7 defines an investment adviser as a small entity if it (i) manages less than $25 million in assets, (ii) has total assets of less than $5 million on the last day of its most recent fiscal year, and (iii) is not in a control relationship with another investment adviser that is not a small entity. 17 CFR 275.0-7.

139 The Commission bases its estimate on information from FOCUS Reports.

140 The Commission bases its estimate on information from the Commission's database of registration information.

141 *See* Section 15(f) of the Exchange Act (15 U.S.C. 78o(f)); Section 204A of the Investment Advisers Act (15 U.S.C. 80b-4a).

SEC STAFF ACCOUNTING BULLETIN No. 99 -- MATERIALITY

SEC Staff Accounting Bulletin:
No. 99 – Materiality

SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 211
[Release No. SAB 99]
Staff Accounting Bulletin No. 99

AGENCY: Securities and Exchange Commission

ACTION: Publication of Staff Accounting Bulletin

SUMMARY: This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.

DATE: August 12, 1999

FOR FURTHER INFORMATION CONTACT: W. Scott Bayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant (202-942-4400), or David R. Fredrickson, Office of General Counsel (202-942-0900), Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103; electronic addresses: BaylessWS@sec.gov; BurnsR@sec.gov; FredricksonD@sec.gov.

SUPPLEMENTARY INFORMATION: The statements in the staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz
Secretary

Date: August 12, 1999

Part 211 - (AMEND) Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 99 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 99

The staff hereby adds Section M to Topic 1 of the Staff Accounting Bulletin Series. Section M, entitled "Materiality," provides guidance in applying materiality thresholds to the preparation of financial statements filed with the Commission and the performance of audits of those financial statements.

STAFF ACCOUNTING BULLETINS

TOPIC 1: FINANCIAL STATEMENTS

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M. Materiality

1. Assessing Materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from generally accepted accounting principles ("GAAP") is immaterial and that the accounting is permissible.[1]

Question: Each Statement of Financial Accounting Standards adopted by the Financial Accounting Standards Board ("FASB") states, "The provisions of this Statement need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[2] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[3]

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is –

> a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. [4]

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.[5] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature[6] have all considered "qualitative" factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement No. 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a "minority view," stating –

> The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment. [7]

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures.[8] And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income.[9] The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.[10]

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions"[11] in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that –

> [M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.[12]

Evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

> As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.[13]

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are –

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate[14]
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement.[15] Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material.[16] When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.[17]

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial.[18] While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.[19] The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole.[20] "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity"[21] is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information - as with materiality generally -

> situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.[22]

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements.[23] A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in relation to individual line item amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole."[24] This requires consideration of -

> the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole ....[25]

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.[26]

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

> Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.[27]

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements That are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions Under the Exchange Act

Even if misstatements are immaterial,[28] registrants must comply with Sections 13(b)(2) - (7) of the Securities Exchange Act of 1934 (the "Exchange Act").[29] Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act,[30] or required to file reports pursuant to Section 15(d),[31] must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.[32] In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.[33] Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance[34] regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams.[35] In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records."[36] Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) - (7) of the Exchange Act.[37]

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- **The significance of the misstatement.** Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

- **How the misstatement arose.** It is unlikely that it is ever "reasonable" for registrants to record misstatements or not to correct known misstatements – even immaterial ones – as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."[38]

- **The cost of correcting the misstatement.** The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.[39] Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."

- **The clarity of authoritative accounting guidance with respect to the misstatement.** Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."[40]

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act."[41] The statute specifies that these obligations are triggered "whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer . . . ." Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, Statement on Auditing Standards No. ("SAS") 54, "Illegal Acts by Clients," and SAS 82, "Consideration of Fraud in a Financial Statement Audit." Pursuant to paragraph 38 of SAS 82, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS 82 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users."[42] SAS 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements.[43] The clear implication of SAS 82 is that immaterial misstatements may be fraudulent financial reporting. [44]

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.[45]

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.[46] As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

> The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of

the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.47

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements. 48

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.49

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.50 This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

Footnotes

-[1]- American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") § 312, "Audit Risk and Materiality in Conducting an Audit," states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with generally accepted accounting principles. The purpose of this Staff Accounting Bulletin ("SAB") is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (i.e., (b) above). This SAB is not intended to provide definitive guidance for assessing "materiality" in other contexts, such as evaluations of auditor independence, as other factors may apply. There may be other rules that address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

-[2]-As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

-[3]- FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("Concepts Statement No. 2"), 132 (1980). See also Concepts Statement No. 2, Glossary of Terms - Materiality.

-[4]- TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ." TSC Industries, 426 U.S. at 450.

-[5]- See, e.g., Concepts Statement No. 2, 123-124; AU § 312.10 (" . . . materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations."); AU § 312.34 ("Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material."). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

-[6]-See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU §§ 312.10 - .11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release No. ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

-[7]-Concepts Statement No. 2, 131 (1980).

-[8]- Concepts Statement No. 2, 131 and 166.

-[9]- Concepts Statement No. 2, 167.

-[10]- Concepts Statement No. 2, 168-69.

-[11]- Concepts Statement No. 2, 170.

-[12]- Concepts Statement No. 2, 125.

-[13]- AU § 312.11.

-[14]- As stated in Concepts Statement No. 2, 130:

> Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion No. 20, Accounting Changes 10, 11, 31-33 (July 1971).

-[15]- The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about unadjusted misstatements. See generally Big Five Audit Materiality Task Force, "Materiality in a Financial Statement Audit – Considering Qualitative Factors When Evaluating Audit Findings" (August 1998). The Task Force memorandum is available at www.aicpa.org.

-[16]- See Concepts Statement No. 2, 169.

-[17]- If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

-[18]- Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 38 and 50 infra.

-[19]- Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

-[20]- See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

-[21]- AUI § 326.33.

-[22]- Id.

-[23]- The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AU § 312.03. See also AU § 312.04.

-[24]- AU § 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

-[25]- AU § 508.36.

-[26]- AU § 312.34

-[27]- AU § 380.09.

-[28]-FASB Statements of Financial Accounting Standards ("Standards" or "Statements") generally provide that "[t]he provisions of this Statement need not be applied to immaterial items." This SAB is consistent with that provision of the Statements. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

-[29]- 15 U.S.C. §§ 78m(b)(2) - (7).

-[30]- 15 U.S.C. § 78l.

-[31]- 15 U.S.C. § 78o(d).

-[32]- Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. §§ 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, "No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

-[33]- 15 U.S.C. § 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated,

> The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.

Cong. Rec. H2116 (daily ed. April 20, 1988).

-[34]- So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., Lamb v. Phillip Morris Inc., 915 F.2d 1024 (6th Cir. 1990) and JS Service Center Corporation v. General Electric Technical Services Company, 937 F. Supp. 216 (S.D.N.Y. 1996).

-[35]- The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

-[36]- Id. at 46 FR 11546.

-[37]- Id.

-[38]- For example, the conference report regarding the 1988 amendments to the FCPA stated,

> The Conferees intend to codify current Securities and Exchange Commission (SEC)

enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement.

Cong. Rec. H2115 (daily ed. April 20, 1988).

-[39]- As Chairman Williams noted with respect to the internal control provisions of the FCPA, "[t]housands of dollars ordinarily should not be spent conserving hundreds." 46 FR 11546.

-[40]- Id., at 11547.

-[41]- Section 10A(f) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definition of an "illegal act" in AU § 317.02, which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."

-[42]- AU § 316.04. See also AU § 316.03. An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AU §§ 110 n. 1, 316 n. 1, 317.05 and 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case. See AU § 316 note 3.

-[43]- AU § 316.04. Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 82 requires the auditor to evaluate several fraud "risk factors" that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 82 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties. See AU §§ 316.17a and .17c.

-[44]- AU §§ 316.34 and 316.35, in requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, make clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be "inconsequential" and still involve fraud.

Under SAS 82, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at the completion of the audit. SAS 82 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. AU § 316.33. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

-[45]- AU §§ 316.34 and 316.36. Auditors should document their determinations in accordance with AU §§ 316.37, 319.57, 339, and other appropriate sections.

-[46]- See, e.g., AU § 316.39.

-[47]- Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

-[48]- AU § 325.02. See also AU § 380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states,

> The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements....

-[49]- See AU § 411.05.

-[50]- The FASB Discussion Memorandum, Criteria for Determining Materiality, states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters . . . . If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

Selected Staff Accounting Bulletins

Staff Accounting Bulletins reflect the Commission staff's views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws.

Bulletins currently available include:

- **Staff Accounting Bulletin No. 101.** Summarizes certain of the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. The staff is providing this guidance due, in part, to the large number of revenue recognition issues that registrants encounter. (December 3, 1999) (File name: sab101.htm)
- **Staff Accounting Bulletin No. 100.** Expresses views of the staff regarding the accounting for and disclosure of certain expenses commonly reported in connection with exit activities and business combinations, including accrual of exit and employee termination costs pursuant to Emerging Issues Task Force (EITF) Issues No. 94-3 and No. 95-3, and the recognition of impairment charges pursuant to Accounting Principles Board (APB) Opinion No. 17 and Statement of Financial Accounting Standards (SFAS) No. 121 (November 24, 1999). (File name: sab100.htm)
- **Staff Accounting Bulletin No. 99.** Expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold (August 13, 1999). (File name: sab99.htm)
- **Staff Accounting Bulletin No. 98.** Revises the views of the staff contained in certain topics of the staff accounting bulletin series to be consistent with the provisions of certain accounting standards recently adopted by the Financial Accounting Standards Board, including Statement of Financial Accounting Standards No. 128, *Earnings per Share* (February 3, 1998). (File name: sab98.txt)
- **Staff Accounting Bulletin No. 97.** Expresses the views of the staff regarding (1) the inappropriate application of *Staff Accounting Bulletin No. 48* (Transfers of Nonmonetary Assets by Promoters or Shareholders) to purchase business combinations consummated just prior to or concurrent with an initial public offering, and (2) the identification of an accounting acquirer in accordance with *APB Opinion No. 16* (Business Combinations) for purchase business combinations involving more than two entities (July 31, 1996). (File name: sab97.txt)
- **Staff Accounting Bulletin No. 96.** This Staff Accounting Bulletin indicates the views of the staff with regard to treasury stock acquisitions following a business combination that is accounted for as a pooling-of-interests (March 19, 1996). (File name: sab96.txt)
- **Staff Accounting Bulletin No. 95.** This Staff Accounting Bulletin rescinds *Staff Accounting Bulletin 57* (Contingent Stock Purchase Warrants) (December 15, 1995). (File name: sab95.txt).
- **Staff Accounting Bulletin No. 94.** The interpretations in this staff accounting bulletin express the views of the staff regarding the period in which a gain or loss is recognized on the early extinguishment of debt (April 18, 1995). (File name: sab94.txt)

http://www.sec.gov/rules/acctindx.htm
Last update: 12/03/1999

SEC LITIGATION RELEASES

Securities and Exchange Commission

Litigation Release No. 16399 / January 5, 2000

S.E.C. v. Yun Soo Oh Park a/k/a Tokyo Joe and Tokyo Joe's Societe Anonyme Corp., (N.D.IL., Case No. 00C 0049, filed January 5, 2000)

On January 5, 2000, the Securities and Exchange Commission (SEC) filed an action charging that Yun Soo Oh Park a/k/a Tokyo Joe (Park), and Tokyo Joe's Societe Anonyme Corp. (Societe Anonyme), a corporation under Park's control, engaged in a scheme to defraud members of his Internet stock recommendation service and the investing public by, among other things, his undisclosed trading ahead of shares he recommended over the Internet for purchase, posting of false performance results, and recommending the stock of an issuer without disclosing that he had indirectly received compensation from that issuer.

Specifically, the Complaint alleges that Park, a resident of New York, New York and the sole shareholder of Societe Anonyme, provides investment advice over the Internet, including stock picks, to his clients, largely members of an Internet day trading community who pay $100 to $200 per month to Societe Anonyme for the privilege of receiving his advice. Park provides such advice via his own web site, known as "Tokyo Joe's", via e-mails to subscribers of his stock recommendations, and via a real time chat room within his web site where he discusses his picks and other investment matters in more detail.

The Complaint alleges that Park has engaged in a scheme to defraud by trading ahead of his recommendations and has obtained substantial profits from such activity. The Complaint alleges that Park regularly buys shares of a stock before recommending that Societe Anonyme members buy the same stock. He then pumps up his members interest in his upcoming recommendations by sending messages typically describing his picks as a sure thing or something he expects to double. When he identifies his pick of the day, many Societe Anonyme members purchase the stock, driving up the stock's price and volume. Park then quickly sells the same stock during this buying flurry at a profit. often entering sell limit orders within minutes of his buy recommendation. Park fails to adequately disclose his prior ownership of a recommended stock, and his intent to sell his shares while he simultaneously recommends the purchase of such shares.

The Complaint further alleges that Park attracts new Societe Anonyme members and recruits current members to follow his recommendations by posting numerous effusive testimonials as well as false and misleading performance data on his web site. Specifically, the Complaint alleges that his performance data includes winning trades he did not actually make, erroneously reports his actual trading profits or losses and fails to include losing trades and other trades necessary to make such performance data not misleading. Finally, the Complaint alleges that, in at least one instance, Park indirectly received compensation from the issuer of a stock he recommended without disclosing his receipt of that compensation.

Based on the foregoing, the SEC filed a Complaint in the United States District Court for the Northern District of Illinois against Park and Societe Anonyme charging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(b) of the Securities Act of 1933, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. The Complaint seeks the entry of an order of permanent injunction against Park and Societe Anonyme, and ancillary relief in the form of disgorgement of Park's ill gotten gains plus prejudgment interest and the imposition of civil monetary penalties.

http://www.sec.gov/enforce/litigrel/lr16399.htm
Last update: 01/05/2000

Release No. 33-7756 / October 20, 1999

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 7756 / October 20, 1999

ADMINISTRATIVE PROCEEDING
File No. 3-10080

In the Matter of	:	
RICHARD L. DAVIS	:	ORDER INSTITUTING PUBLIC PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that a public cease-and-desist proceeding be, and hereby is, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") to determine whether Richard L. Davis ("Davis" or "Respondent") violated Sections 17(a)(1), 17(a)(3) and 5(c) of the Securities Act.

II.

In anticipation of the institution of this proceeding, Davis has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except that Respondent admits the jurisdiction of the Commission over him and over the subject matter of this proceeding, Davis consents to the issuance of this Order Instituting Public Proceedings, Making Findings, and Imposing a Cease-and-Desist Order ("Order") and to the entry of the findings and the imposition of the relief set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds the following:

Respondent

A. Davis, age 28, resides in Duncanville, Texas and is the founder of a company known as Mindhunt.com. Mindhunt.com purports to be in the process of creating an Internet web site geared to children 16 years old and younger. Mindhunt.com was incorporated in the state of Texas on June 24, 1999. Mindhunt.com has never made any filings with the Commission.

Introduction

B. Davis violated the antifraud provisions of the securities laws, set forth in Sections 17(a)(1) and 17 (a)(3) of the Securities Act, by offering Mindhunt.com securities over an Internet auction site run by eBay, Inc. ("eBay"), while making material misrepresentations about Mindhunt.com. Davis also violated the registration provisions of the securities laws, set forth in Section 5(c) of the Securities Act, by offering Mindhunt.com securities over the eBay Internet site. Davis failed to register this offering with the Commission, and there were no applicable exemptions from registration.

Davis' Offer of Mindhunt.com Securities

C. eBay runs an Internet auction site (http://www.ebay.com) that permits users to buy and sell items 24 hours a day, seven days a week, through on-line auctions. Sellers post descriptions of items they wish to sell on the site. Potential buyers may, in turn, access these descriptions. Over the course of the next several hours or days, potential buyers may bid on the items on-line. At the close of each auction, the highest bidder wins and must purchase the item. eBay receives a flat fee from the seller for posting the item on its site and a percentage of the final sale price.

D. On May 5, 1999, Davis posted an offer to sell a 5% interest in Mindhunt.com on the eBay Internet auction site. The posting stated that Davis had "purchased a public shell" and that Mindhunt.com would "be public within 4 to 5 months." Davis offered the 5% interest for $250,000. There were no bids in response to Davis' offer during the ten days it ran on the eBay auction site.

E. The term "public shell" that Davis used in his posting refers to a company that typically has no current business operations and few, if any, assets and liabilities, but whose shares have been registered with the Commission. In some instances, rather than go through the process of registering shares with the Commission, a privately-held company may look to purchase, or merge with, a public shell in order to take advantage of the shell company's ability to issue new stock to the public.

F. At the time of his posting on the eBay auction site, Davis had not purchased a public shell and there was no reasonable basis for his claim that Mindhunt.com would "be public within 4 to 5 months."

Davis' Violation of Sections 17(a)(1) and 17(a)(3) of the Securities Act

G. Section 17(a)(1) of the Securities Act prohibits, in the offer or sale of securities, the use, with scienter, of any device, scheme or artifice to defraud. Section 17(a)(3) of the Securities Act prohibits, in the offer or sale of securities, any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. No scienter is required for violations of Section 17(a)(3).

H. In offering the Mindhunt.com securities, Davis claimed that he had "purchased a public shell" when, in fact, he had not done so. In addition, Davis claimed that Mindhunt.com would "be public in 4 to 5 months." Because Davis knew that he had not yet purchased a public shell, he also knew that he had no reasonable basis for the claim that Mindhunt.com would be public in 4 to 5 months.

I. Because he made material misstatements of fact in the offer of the Mindhunt.com securities, with scienter, Davis violated Sections 17(a)(1) and 17(a)(3) of the Securities Act.

Davis' Violation of Section 5(c) of the Securities Act

J. Davis also violated Section 5(c) of the Securities Act. Section 5(c), in part, prohibits any offer to sell securities through the mails or by making use of the means or instruments of transportation or communication in interstate commerce, unless a registration statement for the securities has been filed with the Commission.

K. In this case, at the time of Davis' offer, no registration statement for the Mindhunt.com securities had been filed with the Commission. By offering the securities over the Internet, Davis made use of the means or instruments of communication in interstate commerce.

L. There is no exemption from the registration requirements of Section 5(c) available for the offer of the Mindhunt.com securities. Because Davis offered the Mindhunt.com securities over the Internet, Davis engaged in a general solicitation. As a result, Section 4(2) of the Securities Act and the exemptions under Rules 505 and 506 of Regulation D are inapplicable.

M. Rule 504 exempts certain offerings that do not exceed an aggregate amount of $1 million and, until recently, permitted general solicitations and advertising. Effective April 7, 1999, the Commission amended Rule 504 to limit the circumstances where general solicitation is permitted to transactions: (1) registered under state law requiring public filing and delivery of a disclosure document to investors before sale; or (2) exempted under state law permitting general solicitation so long as sales are made only to accredited investors.

N. Davis offered the Mindhunt.com securities nationwide over the Internet without making any of the requisite state filings or disclosures. As a result, Davis' offer, which commenced on May 5, 1999, fails to qualify for exemption from registration under amended Rule 504.

O. Accordingly, Davis violated Section 5(c) of the Securities Act by offering to sell Mindhunt.com securities over the Internet.

IV.

On the basis of this Order and the Offer submitted by Respondent, the Commission finds that Davis violated Sections 17(a)(1), 17(a)(3) and 5(c) of the Securities Act.

V.

Accordingly, **it is hereby ordered**, pursuant to Section 8A of the Exchange Act, that Davis cease and desist from committing or causing any violation, and any future violation, of Sections 17(a)(1), 17(a)(3) and 5(c) of the Securities Act.

By the Commission.

Jonathan G. Katz
Secretary

Release No. 33-7757 / October 20, 1999

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 7757 / October 20, 1999

ADMINISTRATIVE PROCEEDING
File No. 3-10081

In the Matter of

JOHN R. HOFF

ORDER INSTITUTING PUBLIC PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that a public cease-and-desist proceeding be, and hereby is, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") to determine whether John R. Hoff ("Hoff" or "Respondent") violated Section 5(c) of the Securities Act.

II.

In anticipation of the institution of this proceeding, Hoff has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except that Respondent admits the jurisdiction of the Commission over him and over the subject matter of this proceeding, Hoff consents to the issuance of this Order Instituting Public Proceedings, Making Findings, and Imposing a Cease-and-Desist Order ("Order") and to the entry of the findings and the imposition of the relief set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds the following:

Respondent

A. Hoff, age 24, resides in Hudson, Wisconsin and is a co-owner of a company known as AmeriGa.net. AmeriGa.net, an Internet service provider, has never made any filings with the Commission.

Introduction

B. Hoff violated the registration provisions of the securities laws, set forth in Section 5(c) of the Securities Act, by offering AmeriGa.net securities over an Internet auction site run by eBay, Inc.

("eBay"). Hoff failed to register this offering with the Commission, and there were no applicable exemptions from registration.

Hoff's Offer of AmeriGa.Net Securities

C. eBay runs an Internet auction site (http://www.ebay.com) that permits users to buy and sell items 24 hours a day, seven days a week, through on-line auctions. Sellers post descriptions of items they wish to sell on the site. Potential buyers may, in turn, access these descriptions. Over the course of the next several hours or days, potential buyers may bid on the items on-line. At the close of each auction, the highest bidder wins and must purchase the item. eBay receives a flat fee from the seller for posting the item on its site and a percentage of the final sale price.

D. On April 28, 1999, Hoff posted offers to sell 1,000 shares in AmeriGa.net on the eBay Internet site. In response to the postings, several bids were made. No sale of AmeriGa.net shares was consummated.

Hoff's Violation of Section 5(c) of the Securities Act

E. Hoff violated Section 5(c) of the Securities Act. Section 5(c), in part, prohibits any offer to sell securities through the mails or by making use of the means or instruments of transportation or communication in interstate commerce, unless a registration statement for the securities has been filed with the Commission.

F. In this case, at the time of Hoff's offer, no registration statement for the AmeriGa.net securities had been filed with the Commission. By offering the securities over the Internet, Hoff made use of the means or instruments of communication in interstate commerce.

G. There is no exemption from the registration requirements of Section 5(c) available for the offer of the AmeriGa.net securities. Because Hoff offered the AmeriGa.net securities over the Internet, Hoff engaged in a general solicitation. As a result, Section 4(2) of the Securities Act and the exemptions under Rules 505 and 506 of Regulation D are inapplicable.

H. Rule 504 exempts certain offerings that do not exceed an aggregate amount of $1 million and, until recently, permitted general solicitations and advertising. Effective April 7, 1999, the Commission amended Rule 504 to limit the circumstances where general solicitation is permitted to transactions: (1) registered under state law requiring public filing and delivery of a disclosure document to investors before sale; or (2) exempted under state law permitting general solicitation so long as sales are made only to accredited investors.

I. Hoff offered the AmeriGa.net securities nationwide over the Internet without making any of the requisite state filings or disclosures. As a result, Hoff's offer, which commenced on April 28, 1999, fails to qualify for exemption from registration under amended Rule 504.

J. Accordingly, Hoff violated Section 5(c) of the Securities Act by offering to sell AmeriGa.net securities over the Internet.

IV.

On the basis of this Order and the Offer submitted by Respondent, the Commission finds that Hoff violated Section 5(c) of the Securities Act.

V.

Accordingly, **it is hereby ordered**, pursuant to Section 8A of the Exchange Act, that Hoff cease and desist from committing or causing any violation, and any future violation, of Section 5(c) of the Securities Act.

By the Commission.

Jonathan G. Katz
Secretary

http://www.sec.gov/enforce/adminact/33-7757.htm
Last update: 10/22/1999

Release No. 33-7758 / October 20, 1999

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 7758 / October 20, 1999

ADMINISTRATIVE PROCEEDING
File No. 3-10082

In the Matter of	
LOUIS SITARAS	ORDER INSTITUTING PUBLIC PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that a public cease-and-desist proceeding be, and hereby is, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") to determine whether Louis Sitaras ("Sitaras" or "Respondent") violated Section 5(c) of the Securities Act.

II.

In anticipation of the institution of this proceeding, Sitaras has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except that Respondent admits the jurisdiction of the Commission over him and over the subject matter of this proceeding, Sitaras consents to the issuance of this Order Instituting Public Proceedings, Making Findings, and Imposing a Cease-and-Desist Order ("Order") and to the entry of the findings and the imposition of the relief set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds the following:

Respondent

A. Sitaras, age 37, resides in Jupiter, Florida.

Other Relevant Entity

B. Metropolitan Health Networks, Inc. ("MHN") is a Florida-based provider of health care services. Its common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades on the NASDAQ SmallCap Stock Market.

Introduction

C. Sitaras violated the registration provisions of the securities laws, set forth in Section 5(c) of the Securities Act, by offering MHN restricted stock over an Internet auction site run by eBay, Inc. ("eBay"). The restricted MHN stock Sitaras offered was not registered with the Commission, and there were no applicable exemptions from registration.

Sitaras' Offer of Metropolitan Health Networks Securities

D. eBay runs an Internet auction site (http://www.ebay.com) that permits users to buy and sell items 24 hours a day, seven days a week, through on-line auctions. Sellers post descriptions of items they wish to sell on the site. Potential buyers may, in turn, access these descriptions. Over the course of the next several hours or days, potential buyers may bid on the items on-line. At the close of each auction, the highest bidder wins and must purchase the item. eBay receives a flat fee from the seller for posting the item on its site and a percentage of the final sale price.

E. On May 5, 1999, Sitaras posted an offer to sell 2,000 restricted shares in MHN on the eBay Internet site. The posting stated that the stock certificate was dated September 11, 1998 and that the stock could not "be sold publicly until 9-11-99."

F. In response to the postings, several bids were made. No sale of the MHN shares was consummated.

Sitaras' Violation of Section 5(c) of the Securities Act

G. Sitaras violated Section 5(c) of the Securities Act. Section 5(c), in part, prohibits any offer to sell securities through the mails or by making use of the means or instruments of transportation or communication in interstate commerce, unless a registration statement for the securities has been filed with the Commission.

H. In this case, at the time of Sitaras offer, no registration statement for the MHN restricted stock had been filed with the Commission. By offering the securities over the Internet, Sitaras made use of the means or instruments of communication in interstate commerce.

I. There is no exemption from the registration requirements of Section 5 available for the offer of the restricted MHN securities. Because Sitaras offered the restricted MHN securities over the Internet, Sitaras engaged in a general solicitation. As a result, Section 4(2) of the Securities Act and the exemptions under Rules 505 and 506 of Regulation D are inapplicable.

J. Rule 144 exempts certain sales of restricted stock where: (1) adequate information about the issuer is available to the public at the time of sale (17 C.F.R. § 230.144(c)); (2) a one year holding period is met for all restricted securities (17 C.F.R. §230.144(d)); (3) the amount of securities sold by a control person in each three month period does not exceed the greater of 1% of the outstanding volume of trading during the month prior to the sale (17 C.F.R. § 230.144(e)); (4) sales are made in transactions directly with a "market maker" (as defined in Section 3(a)(38) of the Exchange Act) or in "brokers' transactions" (within the meaning of Section 4(4) of the Securities Act) (17 C.F.R. § 230.144 (f)-(g)); and (5) where the seller intends to sell more than 500 shares, or any number of shares for an amount greater than $10,000, he files a notice of intention to sell with the Commission (17 C.F.R. § 230.144

(h)).

K. Sitaras did not satisfy Rule 144's one year holding period. Also, in offering the restricted stock directly to investors, Sitaras did not employ a market maker or engage in a brokers' transaction to sell the MHN securities. Finally, Sitaras failed to file the required notice of intention to sell securities with the Commission. As a result, Sitaras' offer fails to qualify for exemption from registration under Rule 144.

L. Accordingly, Sitaras violated Section 5(c) of the Securities Act by offering to sell MHN securities over the Internet.

IV.

On the basis of this Order and the Offer submitted by Respondent, the Commission finds that Sitaras violated Section 5(c) of the Securities Act.

V.

Accordingly, **it is hereby ordered**, pursuant to Section 8A of the Exchange Act, that Sitaras cease and desist from committing or causing any violation, and any future violation, of Section 5(c) of the Securities Act.

By the Commission.

Jonathan G. Katz
Secretary

NEW YORK STOCK EXCHANGE RULE 202
– MATERIAL INFORMATION –

NYSE Listed Company Manual

Last Modified 07/01/92

202.00 Material Information

202.01 Internal Handling of Confidential Corporate Matters

Unusual market activity or a substantial price change has on occasion occurred in a company's securities shortly before the announcement of an important corporate action or development. Such incidents are extremely embarrassing and damaging to both the company and the Exchange since the public may quickly conclude that someone acted on the basis of inside information.

Negotiations leading to mergers and acquisitions, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, and new contracts, products, or discoveries are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans are most likely to occur. Frequently, these matters require extensive discussion and study by corporate officials before final decisions can be made. Accordingly, extreme care must be used in order to keep the information on a confidential basis.

Where it is possible to confine formal or informal discussions to a small group of the top management of the company or companies involved, and their individual confidential advisors where adequate security can be maintained, premature public announcement may properly be avoided. In this regard, the market action of a company's securities should be closely watched at a time when consideration is being given to important corporate matters. If unusual market activity should arise, the company should be prepared to make an immediate public announcement of the matter.

At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, e.g., business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks of stock, engineering studies and market analyses and surveys. Experience has shown that maintaining security at this point is virtually impossible. Accordingly, fairness requires that the company make an immediate public announcement as soon as disclosures relating to such important matters are made to outsiders.

The extent of the disclosures will depend upon the stage of discussions, studies, or negotiations. So far as possible, public statements should be definite as to price, ratio, timing and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, they should include those disclosures made to outsiders. Where an initial announcement cannot be specific or complete, it will need to be supplemented from time to time as more definitive or different terms are discussed or determined.

Corporate employees, as well as directors and officers, should be regularly reminded as a matter of policy that they must not disclose confidential information they may receive in the course of their duties and must not attempt to take advantage of such information themselves.

In view of the importance of this matter and the potential difficulties involved, the Exchange suggests that a periodic review be made by each company of the manner in which confidential information is being handled within its own organization. A reminder notice of the company's policy to those in sensitive areas might also be helpful.

A sound corporate disclosure policy is essential to the maintenance of a fair and orderly securities market. It should minimize the occasions where the Exchange finds it necessary to temporarily halt trading in a security due to information leaks or rumors in connection with significant corporate transactions.

While the procedures are directed primarily at situations involving two or more companies, they are equally applicable to major corporate developments involving a single company.

Last Modified 07/01/92

202.00 Material Information

202.02 Relationship between Company Officials and Others

(A) Security Analysts, Institutional Investors, Etc.
Security analysts play an increasingly important role in the evaluation and interpretation of the financial affairs of listed companies. Annual reports, quarterly reports, and interim releases cannot by their nature provide all of the financial and statistical data that should be available to the investing public. The Exchange recommends that companies observe an "open door" policy in their relations with security analysts, financial writers, shareholders, and others who have legitimate investment interest in the company's affairs.

A company should not give information to one inquirer which it would not give to another, nor should it reveal information it would not willingly give or has not given to the press for publication. Thus, for companies to give advance earnings, dividend, stock split, merger, or tender information to analysts, whether representing an institution, brokerage house, investment advisor, large shareholder, or anyone else, would clearly violate Exchange policy. On the other hand, it should not withhold information in which analysts or other members of the investment public have a warrantable interest.

If during the course of a discussion with analysts substantive material not previously published is disclosed, that material should be simultaneously released to the public. The various security analysts societies usually have a regular procedure to be followed where formal presentations are made. The company should follow these same precautions when dealing with groups of industry analysts in small or closed meetings.

(B) Member Firm Personnel Serving as Directors or Advisors to the Company
Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself.

Any director of a company who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the company on whose board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments.

Where a representative of a member organization is not a director but acts in an advisory capacity to a company, the rules regarding confidential matters should be substantially the same as those that apply to a director. Should any matter require consultation with other personnel of the organization, adequate measures should be taken to guard the confidential nature of the information to prevent its misuse within or outside the member organization.

Last Modified 07/01/92

202.00 Material Information

202.03 Dealing with Rumors or Unusual Market Activity

The market activity of a company's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect. It is obvious that if such a public statement is contemplated, management should be checked prior to any public comment so as to avoid any embarrassment or potential criticism. If rumors are correct or there are developments, an immediate candid statement to the public as to the state of negotiations or of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration.

The Exchange recommends that its listed companies contact their Exchange representative if they become aware of rumors circulating about their company. Exchange Rule 435 provides that no member, member organization or allied member shall circulate in any manner rumors of a sensational character which might reasonably be expected to affect market conditions on the Exchange. Information provided concerning rumors will be promptly investigated.

Last Modified 07/01/92

202.00 Material Information

202.04 Exchange Market Surveillance

The Exchange maintains a continuous market surveillance program through its Market Surveillance and Evaluation Division. An "on-line" computer system has been developed which monitors the price movement of every listed stock-on a trade-to-trade basis-throughout the trading session. The program is designed to closely review the markets in those securities in which unusual price and volume changes occur or where there is a large unexplained influx of buy or sell orders. If the price movement of a stock exceeds a predetermined guideline, it is immediately "flagged" and review of the situation is immediately undertaken to seek the causes of the exceptional activity. Under these circumstances, the company may be called by its Exchange representative to inquire about any company developments which have not been publicly announced but which could be responsible for unusual market activity. Where the market appears to reflect undisclosed information, the company will normally be requested to make the information public immediately. Occasionally it may be necessary to carry out a review of the trading after the fact, and the Exchange may request such information from the company as may be necessary to complete the inquiry.

The Listing Agreement provides that a company must furnish the Exchange with such information concerning the company as the Exchange may reasonably require.

Special Initial Margin and Capital Requirements-
Occasionally, a listed issue may be placed under special initial margin and capital requirements. Such a restriction in no way reflects upon the quality of corporate management, but, rather indicates a determination by the Floor Officials of the Exchange that the market in the issue has assumed a speculative tenor and has become volatile due to the influence of credit, which, if ignored, may lead to unfair and disorderly trading.

The determination to impose restrictions is based on a careful inspection of the trading for the latest one week period, defined as the previous Friday through subsequent Thursday, matched against various criteria. Other factors, such as the capitalization turnover, the ratio of last year's average weekly volume to the volume for the period considered, arbitrage, stop order bans, short position, earnings and recent corporate news are also reviewed.

The restriction itself is aimed primarily at eliminating the extension of credit to those who buy a security and sell it the same day seeking a short term profit. Such customers must have the full purchase value in the account prior to the entry of an order. Concomitantly, a broader requirement is usually imposed on all other margin customers in that they must put up the full purchase price within five business days, rather than only the percentage required by the Federal Reserve Board. Cash customers, of course, must in all instances put up 100% of the cost in seven days.

Last Modified 07/01/92

202.00 Material Information

202.05 Timely Disclosure of Material News Developments

A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.

A listed company should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

Last Modified 06/01/86

202.00 Material Information

202.06 Procedure for Public Release of Information

(A) Immediate Release Policy
The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press "For Immediate Release."

The spirit of the immediate release policy is not considered to be violated on weekends where a "Hold for Sunday or Monday A.M.'s" is used to obtain a broad public release of the news. This procedure facilitates the combination of a press release with a mailing to shareholders.

Annual and quarterly earnings, dividend announcements, mergers, acquisitions, tender offers, stock splits, major management changes, and any substantive items of unusual or non-recurrent nature are examples of news items that should be handled on an immediate release basis. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same category. Unfavorable news should be reported as promptly and candidly as favorable news. Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar impact.

It should be a company's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projections of financial data, for instance, should be soundly based, appropriately qualified, conservative and factual. Excessive or misleading conservatism should be avoided. Likewise, the repetitive release of essentially the same information is not appropriate.

Few things are more damaging to a company's shareholder relations or to the general public's regard for a company's securities than information improperly withheld. On the other hand, a volume of press releases is not to be used since important items can become confused with trivia.

Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided, as should overly optimistic forecasts, exaggerated claims and unwarranted promises. Should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Judgment must be exercised as to the timing of a public release on those corporate developments where the immediate release policy is not involved or where disclosure would endanger the company's goals or provide information helpful to a competitor. In these cases, the company should weigh the fairness to both present and potential shareholders who at any given moment may be considering buying or selling the company's stock.

(B) Telephone Alert to the Exchange
When the announcement of news of a material event or a statement dealing with a rumor which calls for immediate release is made shortly before the opening or during market hours (presently 9:30 A.M. to 5:00 P.M., New York time)*, it is recommended that the company's Exchange representative be notified by telephone at least ten minutes prior to release of the announcement to the news media. If the Exchange receives such notification in time, it will be in a position to consider whether, in the opinion of the Exchange, trading in the security should be temporarily halted. A delay in trading after the appearance of the news on the Dow Jones, Reuters or Bloomberg news wires provides a period of calm for public evaluation of the announcement. The halt also allows customers to revise the terms of limit orders on the specialist's book in view of the news announcement. Even if limit orders are not canceled or changed during the halt, the fact that

trading is halted results in the reopening being considered a new opening, thereby enabling limit orders to participate at the new opening price regardless of the previously entered limit. A longer delay in trading may be necessary if there is an unusual influx of orders. The Exchange attempts to keep such interruptions in the continuous auction market to a minimum. However, where events transpire during market hours, the overall importance of fairness to all those participating in the market demands that these procedures be followed.

* Effective June 13, 1991 the New York stock Exchange off-hours trading sessions became operational. The facility offers the opportunity to trade at NYSE closing prices after the NYSE's 4:00 P.M. close until 5:00 P.M.

(C) Release to Newspapers and News Wire Services
News which ought to be the subject of immediate publicity must be released by the fastest available means. The fastest available means may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, facsimile, or hand delivery, or some combination of such methods. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to local press would not be sufficient for adequate and prompt disclosure to the investing public.

To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., Reuters Economic Services and Bloomberg Business News.

Companies are also encouraged to promptly distribute their releases to Associated Press and United Press International as well as to newspapers in New York City and in cities where the company is headquartered or has plants or other major facilities.

A copy of any press release which may significantly impact on trading should also be sent promptly to the attention of the company's Exchange representative, by facsimile.

The New York City addresses and telephone numbers of these national news wire services are:

Associated Press, 50 Rockefeller Plaza, (212) 621-1500 24 Hours
Fax - (212) 621-7520
Bloomberg Business News, 499 Park Avenue, (212) 318-2300
Fax - (212) 893-5999
Fax - (609) 497-6577
Dow Jones & Company, Inc., 2, Harborside Financial Center, 600 Plaza, Jersey City, N.J. 07311, (212) 416-2000 or (201) 938-5400
Fax - (201) 938-5600
Reuters Economic Services, 1700 Broadway, (212) 859-1700
Fax - (212) 859-1717
United Press International, 2 Penn Plaza, (212) 564-8815 24 Hours.
(212) 643-8480 (9-5)
Fax - (212) 564-8621

Every news release should include the name and telephone number of a company official who will be available if a newspaper or news wire service desires to confirm or clarify the release.

Last Modified 07/01/98

202.00 Material Information

202.07 Trading Halt Procedures

Whenever the Exchange determines that trading in a listed security should be halted or delayed pending the release of a material news announcement:

•Implementation of the halt or delay will be announced and the reason for the halt or delay will be stated "news pending";

•Thereafter, the Exchange will monitor the situation closely and will commence the opening or reopening of trading in the listed security in accordance with its normal procedures as soon as the material news announcement has been made. If the announcement is not made within a reasonable time after the halt or delay is implemented, trading in the listed security may be opened or reopened in the interests of providing a liquid market. While the time period may vary from case to case as a result of the particular circumstances involved, normally if the announcement is not made within approximately 30 minutes after the delay or halt is implemented, the Exchange may commence the opening or reopening of trading in the listed security. Such action will be preceded by an announcement to the effect that trading is resuming even though the material news announcement has not been released.

The Wall Street Journal, December 29, 1999

Compromised Analysts? The SEC Is Shocked.

By Mark Hulbert

The Securities and Exchange Commission has proposed new regulations to deal with the ways companies talk to Wall Street analysts. Is this really a problem so serious that it demands regulation? Not that I can discover. In fact, I am amazed how quickly the problem evaporates under even the mildest scrutiny.

As best as I can make out, the supposed problem is that companies have developed a chummy relationship with certain analysts and not others, and that both parties take advantage of this arrangement. It seems that companies selectively release information to favored analysts in return for a more agreeable rating.

But what exactly is the harm that this creates? With a straight face, SEC Chairman Arthur Levitt worries that this arrangement compromises analysts' objectivity. Since when has anyone taken analysts' pronouncements at face value? Savvy investors always have been aware that Wall Street analysts operate under serious conflicts of interest and compromised objectivity.

The market already is handling this problem quite well on its own. One inducement for analysts to stay on the straight and narrow is this newspaper. Since 1993 The Wall Street Journal has been rating the predictive prowess of Wall Street analysts, helping readers determine which ones deserve to be listened to. I doubt that an analyst with a top rating would be willing to compromise it merely for short-term gain.

Then there is the advisory newsletter industry, which I've been monitoring since 1980. It's been thriving for decades precisely because millions of investors are aware that Wall Street analysts are compromised by not wanting to alienate companies who already are, or who may become, investment-banking clients. The number of Web-based advisory services is mushrooming, in large part for the same reason. A study of two such Web sites this past summer showed that, on average, they have provided significantly more accurate earnings estimates of 101 high-tech companies than Wall Street analysts have.

It's even possible to benefit from the worthlessness of most analysts' opinions. By studying the timing of each analyst's earnings forecasts, Barclays Global Investors discovered that most analysts merely follow the lead of the select few of their peers whose opinions they genuinely respect (with a couple of weeks lag time, of course, so that they can avoid appearing to be merely following someone else's lead). The BGI mutual funds that are based on this research have beaten the market over the past 15 years simply by paying attention to the earnings revisions of the few analysts who are genuine leaders. In a fairly predictable fashion, a string of other analysts will follow suit after a few weeks, thereby pushing the underlying stocks even further in the direction indicated by the original analysts' revisions. As this example demonstrates, any investor who takes an analyst's report at face value has no one but himself to blame.

Supporters of the proposed SEC rule have identified another potential harm of the current cozy relationship between companies and analysts: initial public offerings' systematic underpricing, which robs new companies of needed capital while enriching the investment bankers. But here again there is no reason to think the market is unable to correct any problem that exists.

No one forces a company going public to sign up with a Wall Street firm that underprices IPOs. That company instead can choose to raise capital via a direct public offering—an alternative the Internet is making easier and easier. Rather than more regulations, I'd much rather see the relaxation of various current regulations that make direct offerings more difficult than they should be.

In any case, it's not at all clear that IPOs are systematically underpriced. Like the visitor to the casino who only remembers the jackpots, it's all too easy for commentators to focus on the small minority of IPOs that go up hundreds of percent on their first day of trading. Most don't. In fact, according to Jay Ritter of the University of Florida, IPOs' average first-day return between 1990-98 was just 14%. And most IPOs decline after their first day. Of 1998's 374 IPOs, according to Mr. Ritter, by the end of that year 207 of them were trading below their respective offering prices.

The problems identified by the SEC can resolve themselves without any additional regulations. Analysts with compromised objectivity already are being marginalized. And, I can confidently predict, the Internet will only accelerate this process.

Mr. Hulbert is editor of the Hulbert Financial Digest.

The Wall Street Journal

Hershey Will Miss Its Lowered Target For 4th Quarter

By Shelly Branch
Staff Reporter of The Wall Street Journal

Hershey Foods Corp., and its shareholders, should be happy to kiss 1999 goodbye.

Citing continued technology and order-fulfillment problems, the maker of Hershey's Kisses chocolates and Reese's Peanut Butter Cups said it would miss already lowered fourth-quarter earnings estimates by as much as 10 cents a share.

The quarter will be the sixth time in seven periods that the company has missed earnings forecasts. The latest warning drove Hershey shares down $2.3125 to $47.8125 at 4 p.m. on the New York Stock Exchange, near their 52-week low of $47.50 and well off the $64.875 high for the year.

Hershey blamed lower-than-expected sales in December for the earnings shortfall. In a statement, the company said the strong customer demand that it experienced in October "was not sustained throughout the fourth quarter." It added: "This slowdown in customer order demand appears to be in part a consequence of the earlier customer-service and order-fulfillment issues."

The company declined to elaborate on the statement.

"The big question now," said Jeffrey Kantor, an analyst with Prudential Securities, "is how much of these customer-service and order-fulfillment issues will spill over into 2000, and could that impact Easter orders?"

Prudential lowered its fourth-quarter estimates for Hershey by seven cents after the announcement yesterday.

Hershey's explanation of lower sales for the earnings pullback surprised analysts as Hershey had already predicted they would be off by as much as $150 million for the year.

Hershey's troubles began in earnest in September, when the company said it would miss third-quarter earnings forecasts due to the problems rolling out new systems designed to take customer orders and make store deliveries. That particularly hurt Hershey during the Halloween season, when it sacrificed some market share to competitors such as closely held Mars Inc.

Since then, the candy maker had said demand for its product had been healthy, though it had admitted it was struggling still to get orders to customers on time and complete.

On Monday, Craig Albert, an analyst with Sanford C. Bernstein, lowered his fourth-quarter estimate on the stock to 70 cents from 73 cents. He noted that the company was improving its on-time deliveries at considerable cost.

Hershey's December woes are somewhat ironic. The candy maker, back in the mid-1990s, managed to boost its Christmas sales considerably. It was one of the first to employ an aggressive seasonal strategy, using festive red and green foil wraps for its Kisses, as well as special in-store displays.

Following this year's Halloween debacle, analysts say the company likely lost valuable retail shelf space for future holidays. While Valentine's Day isn't considered a major sales stimulus for Hershey, Easter, which falls on April 23, is a vital selling period.

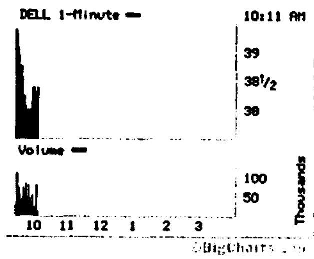
Mars, and Nestle SA's Nestle USA, which also has benefited from Hershey's inability to fulfill orders, wouldn't comment on plans—if any—they might have to exploit Hershey's problems. A spokeswoman for Mars said the company's Easter orders appear very strong, and added that promotional efforts for the season begin more than a year in advance, making "reactive planning" difficult.

Hershey will report final 1999 earnings on or around Jan. 31.

Dell's warning spurs hardware sell-off

By Janet Haney, CBS MarketWatch
Last Update: 5:21 PM ET Jan 27, 2000

NEW YORK (CBS.MW) -- A late-day turnaround spurred by Dell Computer's earnings warning tainted most hardware stocks Thursday, though Intel and Rambus bucked the downward trend in the chip group.



The Philadelphia Semiconductor Index ($SOX: news, msgs) fell 0.6 percent. The Goldman Sachs Computer Hardware Index ($GHA: news, msgs) shed 2.6 percent.

PC maker Dell warned late Wednesday that it will report weaker-than-expected sales and earnings for the fourth quarter. See full story. Its shares fell 2 13/16, or 7 percent, to 37 9/16.

A few Wall Street analysts, though, showed support for the company. Robertson Stephen's analyst Dan Niles upgraded Dell to "buy" from "long-term attractive," saying the shortfall was as expected and on strong growth prospects. Merrill Lynch and Chase H&Q also followed with upgrades.

The company (DELL: news, msgs) blamed an "inconsistent flow" of key semiconductor components and a slower-than-expected rebound in sales to corporate and institutional customers related to the Y2K rollover.

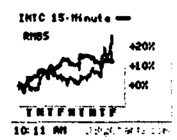
"Anytime there's component constraints, regardless of what area that's in, it's going to disproportionately impact the direct companies like Dell and Gateway," said Art Russell, a technology analyst at Edward Jones in St. Louis. "They operate on such lean inventories. They just don't have any excess supply of those components to fall back on if somebody doesn't deliver on time or if there's a problem with the components."

Russell added that this is a one-time event for Dell.

"Dell made it very clear that they based on one difficult and challenging product transition, they weren't about to abandon their loyalty to Intel and rush out and do anything dramatic," he said.

Hewlett-Packard (HWP: news, msgs) soothed investors' worries and said late Wednesday that its quarter was "on track."

"In view of recent announcements by some of our competitors, we felt it was appropriate to reaffirm revenue and earnings growth guidance in the 12 to 15 percent range for the full year and that our first quarter is in good shape," said Robert P. Wayman, H-P's CFO. H-P shares slipped 1/4 to 108 1/2.



Intel (INTC: news, msgs), which has been blamed for chip shortages, climbed by 1 5/8 to 98 1/8. Rambus (RMBS: news, msgs) jumped 2 13/16, or 3.8 percent, to 77 1/2.

Meanwhile, Apple Computer (AAPL: news, msgs) lost 3/16 to 110. Compaq (CPQ: news, msgs) crept lower by 5/8 to 28 1/4.

In the chip sector, National Semiconductor (NSM: news, msgs) was down 1 7/8 to 48 and KLA-Tencor (KLAC: news, msgs) shed 1 7/16 to 56 15/16. Chip equipment maker Novellus (NVLS: news, msgs) lost 3 to 46 13/16. CBS MW

Janet Haney is a reporter for CBS MarketWatch.

Dell sees softness, joining Gateway

Also reporting: MP3, Broadvision, CA, Exodus, Informix

By Brenon Daly,
CBS MarketWatch
Last Update: 6:55 PM ET Jan 26, 2000

NEW YORK (CBS.MW) -- **Dell** shares initially slipped in evening trading Wednesday after the PC maker warned that a chip shortage and soft business demand will leave fourth-quarter earnings below analysts' profit expectations.

Dell (DELL: news, msgs) joins rival **Gateway** (GTW: news, msgs) in reporting soft results for the most recent quarter.

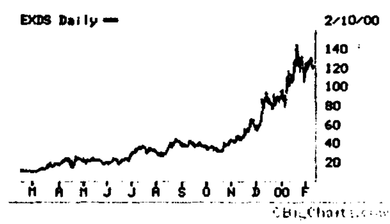
Dell said it expects to earn $430 million, or 16 cents per share. That includes a 1-cent-per-share gain from the sale of investments. The consensus analyst estimate called for 21 cents per share. See related story. The stock finished Nasdaq trading off 1 3/4 at 40 3/8 and traded down to 38 after hours. Most other boxmakers were also weaker in evening trading.

MP3.com, the online music service provider, posted a pro forma loss of $10.6 million, or 17 cents, excluding charges in the quarter. In the same period a year earlier, the company (MPPP: news, msgs) broke even. Analysts polled by First Call had projected a loss of 23 cents a share. Revenue shot up to $15.2 million from $613,116 in last year's fourth quarter and $4 million in the previous quarter. The stock dipped 1 to 30 ahead of the release.

Shares of **BroadVision** rose in after-hours trading after the company exceeded the consensus profit estimate on Wall Street. Fourth-quarter net income totaled $8.1 million, or 9 cents a share, on revenue of $43.7 million. That was up from $2.1 million, or 3 cents a share, on revenue of $16 million in the year-ago quarter. Analysts polled by First Call expected a profit of 6 cents a share. Shares in the company (BVSN: news, msgs) closed down 4 1/2 to 152 1/16 but moved to 157 on Island.

Computer Associates (CA: news, msgs) said third-quarter earnings came in at $424.8 million, or 76 cents a share, compared with $355 million, or 66 cents, in the year-ago period. The consensus estimate was 75 cents a share. Revenue reached $1.81 billion, compared with $1.36 billion in the year-ago period. Shares closed down 1/8 to 74 9/16 and weren't active after hours.

Informix shares rose after the database company (IFMX: news, msgs) doubled fourth-quarter earnings. The company posted fourth-quarter net income of $45.4 million, or 21 cents a share. That's up from last year's $20.5 million, or 11 cents. Analysts surveyed by First Call had expected a profit of 17 cents. The stock closed at 13 11/16 but moved up to 15 on Island. See related story.



Shares of **Exodus Communications** held their closing level in the evening session Wednesday after the Internet hosting company reported a narrower-than-expected loss. Exodus (EXDS: news, msgs) said it lost $44 million, or 25 cents per share, excluding one-time items. That was 2 cents closer to the break-even point than analysts expected, according to First Call. In the fourth quarter last year, the company lost $21.9 million, or 14 cents per share. Ahead of the release, shares fell 9 3/8 to 120. They changed hands at 119 on Island. See related story.

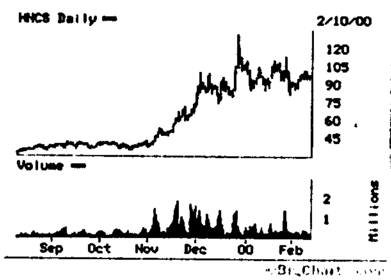
JDS Uniphase (JDUS: news, msgs) posted better-than-expected earnings of $66 million, or 18 cents a share, excluding merger-related charges, in the second quarter. Analysts polled by First Call had projected a profit of 15 cents. In the same quarter a year earlier, the company earned $27 million, or 8 cents. Sales soared to $282 million from $63.8 million a year ago. Shares closed down 15 1/4, or 6.6 percent, at 216 3/4 ahead of the announcement.

Reader's Digest Association (RDA: news, msgs) posted earnings of 90 cents a share for second quarter, up 61 percent from 56 cents in the year-ago period. Analysts expected a profit of 68 cents a share.

year. Shares closed up 1/16 at 33 7/16 and weren't active after hours.

Shares of **Beyond.com** (BYND: news, msgs) edged higher on the heels of the company's better-than-expected fourth-quarter report. Revenue totaled $35.3 million, a 169 percent increase over last year, while the net loss was $22.4 million, or 62 cents a share. Analysts expected a loss of 67 cents a share. Last year, the company recorded a fourth-quarter loss of $13.9 million, or 51 cents a share. Shares fell 5/16 to 6 3/16 in the regular trading day but moved to 6 3/4 after hours.

Anchor Gaming said it earned $15.3 million, or $1.25 per diluted share. In the second quarter last year, the company (SLOT: news, msgs) earned $16.6 million, or $1.34 per diluted share. Analysts surveyed by First Call expected Anchor to earn $1.24 per share. Ahead of the release, Anchor shares slipped 5/8 to 43 1/4.



HNC Software said it lost $8.4 million, or 12 cents per share, excluding one-time items. Analysts surveyed by First Call expected the software company (HNCS: news, msgs) to lose 20 cents per share in the fourth quarter. In the same quarter last year, HNC Software earned $10.5 million, or 27 cents per share. Sales edged up to $53 million from $52.6 million. Shares closed off 4 1/16 at 93 3/8 in a late-day slide. The stock wasn't active after hours. CBS MW

Brenon Daly is an online reporter for CBS MarketWatch.

SELECTED FORMS 8K AND PRESS RELEASES

8K Office Depot Release date 8/30/99

- Pre-Release, Earnings Warning -

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

DATE OF REPORT AUGUST 30 , 1999

COMMISSION FILE NUMBER 1-10948

OFFICE DEPOT, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	59-2663954
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

2200 OLD GERMANTOWN ROAD, DELRAY BEACH, FLORIDA 33445

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) (ZIP CODE)

(561) 438-4800

(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

FORMER NAME OR FORMER ADDRESS, IF CHANGED SINCE LAST REPORT: N/A

ITEM 5. OTHER EVENTS

On August 30, 1999, Office Depot, Inc. issued a press release commenting on earnings in the second half of 1999, and announced a stock repurchase plan which was adopted by Office Depot's Board of Directors. A copy of the press release is attached as Exhibit 99.1 and incorporated by reference herein.

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS

99.1 Press Release dated August 30, 1999

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OFFICE DEPOT, INC.

Date: August 30, 1999

By: /S/ DAVID C. FANNIN

David C. Fannin
Senior Vice President and
General Counsel

Investor Contact: Eileen Dunn
VP, Investor Relations
(561) 438-4930

Media Contact: Gary Schweikhart
VP, Public Relations
(561) 438-4399

OFFICE DEPOT COMMENTS ON EARNINGS IN SECOND HALF OF 1999

QUARTERLY AND FULL YEAR EARNINGS TO BE BELOW EXPECTATIONS
Q3 CHARGE FOR ACCELERATED STORE RELOCATIONS AND INVENTORY WRITE-DOWN
BOARD OF DIRECTORS APPROVES $500 MILLION STOCK REPURCHASE PROGRAM

DELRAY BEACH, FL (August 30, 1999) - Office Depot, Inc. (NYSE:ODP) announced today that based on sales and margin trends during the Company's back-to-school season and a revised forecast of results for the second half of 1999, it anticipates that earnings per share in the second half of 1999 will be in the range of $0.38 to $0.40 versus investment community consensus expectations of $0.50 - $0.52 per share. These estimates exclude the one time charge being announced today and any merger and restructuring costs relating to the Viking acquisition.

Secondly, in addition to announcing the expected earnings shortfall, the Company also announced that it expects to take a $ 28.3 million charge, net of income taxes, in the third quarter of 1999 to reflect the Company's decision to accelerate its store relocation and closing program for older and underperforming stores and a write-down of certain fixed assets. The Company also plans to take a $34.2 million writedown, net of income taxes, of slow moving inventories in its warehouses and stores. The inventory write-downs are primarily related to slow moving technology related products that have been adversely affected by accelerated rates of change in new technology, and a rationalization of the warehouse inventory assortments in conjunction with the Viking warehouse consolidation. The total anticipated size of the charge against third quarter 1999 earnings in these categories is $62.5 million, net of income taxes, or approximately $0.16 per share.

Finally, the Company announced that its Board of Directors today voted to approve a $500 million repurchase of the Company's stock. The stock repurchase program will include open market purchases as well as negotiated block transactions.

EARNINGS SHORTFALL

Commenting on the shortfall in earnings per share, David I. Fuente, Chairman and CEO of Office Depot, stated: "As we indicated in our quarterly release and conference call at the end of the second quarter, we needed to generate a significant improvement in sales momentum in the second half of the year in order to meet our financial objectives for the full year. We have not seen the level of improvement we need to reach our earnings target. In our stores, sales of lower margin technology related products continue to outpace sales of basic office supplies, negatively affecting gross margins. In the Business Services Group, sales are slightly short of expectations. However, contract sales are growing more rapidly than commercial sales, which also negatively affects margins. In all our divisions, paper costs are rising without a corresponding lift in retail prices, further increasing margin pressures. We will also incur increased expenses related to a higher number of new store openings and consolidation of warehouse operations in the balance of the year. On the positive side, we now anticipate that we will open approximately 140 new stores in 1999, while closing 15 older stores. Other increases in expenses for the balance of 1999 include the commencement of a major data warehouse initiative, expanded technology projects, expansion of our Internet capabilities, both domestically and internationally, increased Internet advertising and steps to strengthen our international infrastructure. As a result of these sales and expense trends, we will not meet earnings expectations for the year."

$62.5 MILLION CHARGE, NET OF INCOME TAXES, TO THIRD QUARTER 1999 EARNINGS

Commenting on the one time charge, Mr. Fuente stated, "Our management has targeted approximately 41 older or underperforming stores to be relocated or closed. As a result of our aggressive new store expansion program, we feel that this is also the appropriate time to take a hard look at our real estate portfolio, and in particular underperforming stores. In an increasingly competitive retail environment, we have taken action to close or relocate out-dated and underperforming stores. Our stores need to be in the best possible locations and reflect our most up to date store models."

INVENTORY WRITE-DOWN

Because of rapid changes in office technologies and management's decision to consolidate warehouses and to accelerate relocations and closings of underperforming stores, the Company has identified $34.2 million, net of tax benefits, of slow moving products to be liquidated. This inventory, which is currently occupying existing store and warehouse space, has been identified as merchandise that will not be replenished, either because of newer, more innovative technology products or the rationalization of the merchandise assortment in the combined Viking and Office Depot warehouses. The inventory write-down will be included in cost of goods sold for financial reporting purposes.

ODP BOARD OF DIRECTORS APPROVES STOCK BUYBACK

Earlier today, Office Depot's Board of Directors authorized a $500 million stock repurchase program, effective immediately. Commenting on the repurchase program, Mr. Fuente stated, "Despite the fact that our second half results will not meet our expectations or the expectations of the investment community, we remain very confident in our longer term prospects and our ability to grow earnings and shareholder value. As a result, notwithstanding today's disappointing news, we feel our current stock price represents a significant value. Our Board of Directors today authorized management to implement a $500 million stock repurchase program. This authorization is open-ended, and we will be opportunistic purchasers of Office Depot stock either in the open market or through negotiated purchases."

He continued, "As a result of our strong balance sheet and cash flow, our position as an industry leader and the growth opportunities that lie ahead, our Board of Directors felt the best return on our excess cash at this point in time is the purchase of our stock. And while the investment of $500 million is substantial, Office Depot will continue to maintain a very strong balance sheet."

As of August 30, 1999, the Company operated 768 office supply superstores in the United States and Canada, in addition to a national business-to-business delivery network supported by 30 delivery centers, more than 60 local sales offices and seven regional call centers. Furthermore, the Company owned and operated 22 office supply stores in France and five stores in Japan; had mail order and delivery operations in 10 countries outside of the United States and Canada; and under joint venture and licensing agreements, had 74 additional stores under the Office Depot name in six foreign countries. The Company also operates an award-winning U.S. Internet business at www.officedepot.com where customers can access Office Depot's low competitive prices seven days a week, twenty-four hours a day. Office Depot's common stock is traded on the New York Stock Exchange under the symbol ODP and is in the S&P 500 Index .

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION: Except for historical information, the matters discussed in this press release are, and should be considered to be, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. Forward-looking statements, including any and all projections and anticipated levels of performance, involve risks and uncertainties, which may cause actual results to differ materially from those discussed herein. These risks and uncertainties are detailed from time to time by Office Depot, Inc. in its filings with the United States Securities and Exchange Commission ("SEC"). You are urged to review such filings - including without limitation our Annual Report on Form 10-K, filed March 22, 1999 - for a more detailed discussion of the risks and uncertainties which are specific to the businesses conducted by Office Depot, Inc.

IN ADDITION TO THE CAUTIONARY STATEMENTS CONTAINED IN OUR PRIOR FILINGS WITH THE SEC, Office Depot notes the following additional risks and uncertainties associated with the information contained in this press release: (1) The expenditures to be incurred by the Company and the effect of the charge to earnings referred to in this Press Release may not have the intended effects of making the Company more competitive in the marketplaces in which it competes, and the anticipated benefits of these steps may not be fully realized or realized at all. (2) Remodeling and relocation of certain of the Company's retail stores may not be sufficient to improve top line performance as the competitive environment may change in ways not anticipated by the Company or in other ways that limit the effectiveness of these steps aimed at improving performance. (3) Statements that the Company considers its stock to be a good value at current levels may not be realized, as the price of the Company's stock may decline in the near term, or over time, rather than increasing.

PRE-RECORDED MESSAGE: Office Depot's management will make available a pre-recorded message, which can be accessed at approximately 4:30 p.m. today at 1-800-633-8284.

8K The Kroger Company Release date 12/6/99
- Issuing Earnings Release and Comments by CEO -

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

Date of Report: January 12, 2000

THE KROGER CO.
(Exact name of registrant as specified in its charter)

An Ohio Corporation (State or other jurisdiction of incorporation)	No. 1-303 (Commission File Number)	31-0345740 (IRS Employer Number)

1014 Vine Street
Cincinnati, OH 45201
(Address of principal
executive offices)

Registrant's telephone number: (513) 762-4000

Item 5.

Other Events

On January 12, 2000, representatives of the Company met with analysts. During those meetings, the Company advised that it continues to remain comfortable with its fourth quarter earnings per share estimate of $0.37-0.40, representing a 19-29% increase over the estimated pooled fourth quarter 1998 earnings per share, and its targeted 16-18% EPS growth rate for the fiscal years 2000- 2002, and that its fourth quarter 1999 sales-to-date currently are running slightly ahead of budget. The Company also reaffirmed its belief that it will meet or exceed the previously announced synergy savings from the prior Fred Meyer mergers and the Kroger/Fred Meyer merger of $155 million in fiscal year 1999; $260 million in fiscal year 2000; $345 million in fiscal year 2001; and $380 million in fiscal year 2002.

In its Current Report on Form 8-K dated December 6, 1999, the Company estimated that its sales for the fourth quarter 1998, taking into account the change in its fiscal year and the merger with Fred Meyer would have been approximately $11.1 billion. In its Current Report on Form 8-K dated September 14, 1999, the Company estimated that its earnings per share for that same quarter, and on the same basis, would have been approximately $0.34. Adjusting for the 53rd week calendar in 1998 for pre-merger Kroger, and the normalization of Ralphs' depreciation and amortization adjustment during the fourth quarter of 1998, sales would have been approximately $10.6 billion and earnings per share would have been approximately $0.31. Fred Meyer made the adjustments to depreciation and amortization in the fourth quarter of 1998 in connection with its accounting for the acquisition of Ralphs.

For purposes of completing models, the Company furnished to analysts its best estimates, excluding acquisitions, of reasonable assumptions for fiscal year 2000, a 53 week year containing an extra week in the fourth quarter:

Square footage growth - 4.5-5.0%

Identical store sales growth goal - at least 1% over food cost inflation

Capital expenditures - $1.6 billion

Depreciation - $925-940 million

Amortization of goodwill - $100 million

Interest expense - $620-640 million, based on current rates

Tax rate - 40% (including amortization of goodwill)
38.5% (excluding amortization of goodwill)

Average shares outstanding - 862 million

LIFO charge - $25 million

Attached as Exhibit 99.1 hereto are detailed income statements for the first three quarters of 1999, excluding costs related to mergers, which statements were furnished to analysts on January 12, 2000.

Item 7. Financial Statements, Pro Forma Financial Information and Exhibits

(c) Exhibits:

99.1 Detailed income statements.

Our ability to achieve the expected increases in sales and earnings could be adversely affected by the increasingly competitive environment in which we operate. In addition any labor dispute, delays in opening new stores, or changes in the economic climate could cause us to fall short of our sales and earnings targets. Our capital expenditures could fall outside of the expected range if we are unsuccessful in acquiring suitable sites for new stores, if development costs exceed those budgeted, or if our logistics and technology projects are not completed in the time frame expected or on budget. Square footage growth is dependent upon our ability to acquire desirable sites for construction of new facilities, as well as the timing of completion of projects. Our ability to increase same store sales could be adversely affected by increased competition and sales shifts to other stores that we operate. Depreciation and amortization may vary from our estimates due to the timing of new store openings. Interest expense will vary with changes in capital markets and the amount of debt that we have outstanding. LIFO will be affected by vendor promotions and changes in the cost of inventory. While we expect to achieve benefits through logistics and technology, development of new systems and integration of systems due to our merger with Fred Meyer carry inherent uncertainties, and we may not achieve the expected benefits. Unforeseen difficulties in integrating Fred Meyer with Kroger, or any other acquired entity could cause us to fail to achieve the anticipated synergy savings, and could otherwise adversely affect our ability to meet our other expectations.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereto duly authorized.

THE KROGER CO.

January 12, 2000

By: (Paul Heldman)
Paul Heldman
Senior Vice President, Secretary and General Counsel

EXHIBIT INDEX

Exhibit No.	Exhibit
99.1	Detailed income statements.

Exhibit 99.1

CONSOLIDATED STATEMENT OF EARNINGS
YEAR TO DATE
1999

	1Q	% TO SLS
SALES	13,493,100,231	
COSTS AND EXPENSES:		
MERCHANDISE COSTS, INCLUDING WAREHOUSING AND TRANSPORTATION	9,956,846,538	73.79%
OPERATING GENERAL AND ADMINISTRATIVE	2,469,533,284	18.30%
RENT	199,339,407	1.48%
DEPRECIATION	251,483,029	1.86%
AMORTIZATION OF GOODWILL	29,473,000	0.22%
DIVIDEND AND INTEREST INCOME	(2,733,694)	-0.02%
INTEREST EXPENSE INCL. CAPITAL LEASES	201,609,559	1.49%
TOTAL	13,105,551,123	97.13%
EARNINGS BEFORE TAX EXPENSE AND EXTRAORDINARY ITEM	387,549,108	2.87%
TAX EXPENSE	156,569,845	1.16%
EARNINGS BEFORE EXTRAORDINARY ITEM	230,979,263	1.71%
EXTRAORDINARY ITEM	(19,000)	0.00%
NET EARNINGS	230,960,263	1.71%
EBITDA	879,381,002	6.52%
LIFO	12,000,000	0.09%
NET INTEREST	198,875,865	1.47%

EARNINGS PER COMMON SHARE:	
BASIC FROM OPERATIONS	0.28
EXTRAORDINARY ITEM	0.00
NET EARNINGS PER COMMON SHARE	0.28
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION	827,303,506
EARNINGS PER COMMON SHARE:	
DILUTED FROM OPERATIONS	0.27
EXTRAORDINARY ITEM	0.00
NET EARNINGS PER COMMON SHARE	0.27
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION	863,349,210

	2Q YTD	% TO SLS
SALES	23,781,998,816	
COSTS AND EXPENSES:		
MERCHANDISE COSTS, INCLUDING WAREHOUSING AND TRANSPORTATION	17,534,342,141	73.73%
OPERATING GENERAL AND ADMINISTRATIVE	4,333,567,480	18.22%
RENT	342,114,480	1.44%
DEPRECIATION	449,284,493	1.89%
AMORTIZATION OF GOODWILL	52,667,000	0.22%
DIVIDEND AND INTEREST INCOME	(5,324,390)	-0.02%
INTEREST EXPENSE INCL. CAPITAL LEASES	352,245,904	1.48%
TOTAL	23,058,897,108	96.96%
EARNINGS BEFORE TAX EXPENSE AND EXTRAORDINARY ITEM	723,101,708	3.04%
TAX EXPENSE	290,086,225	1.22%
EARNINGS BEFORE EXTRAORDINARY ITEM	433,015,483	1.82%
EXTRAORDINARY ITEM	(9,836,634)	-0.04%
NET EARNINGS	423,178,849	1.78%
EBITDA	1,583,974,715	6.66%
LIFO	12,000,000	0.05%
NET INTEREST	346,921,514	1.46%

EARNINGS PER COMMON SHARE:	
BASIC FROM OPERATIONS	0.52
EXTRAORDINARY ITEM	-0.01

NET EARNINGS PER COMMON SHARE................	0.51
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION....................	827,870,690
EARNINGS PER COMMON SHARE:	
DILUTED FROM OPERATIONS......................	0.50
EXTRAORDINARY ITEM..........................	-0.01
NET EARNINGS PER COMMON SHARE................	0.49
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION....................	861,422,505

	3Q YTD	% TO SLS
SALES......................................	34,111,157,542	
COSTS AND EXPENSES:		
MERCHANDISE COSTS, INCLUDING WAREHOUSING AND TRANSPORTATION......................	25,122,097,191	73.65%
OPERATING GENERAL AND ADMINISTRATIVE.......	6,216,454,746	18.22%
RENT.....................................	497,987,560	1.46%
DEPRECIATION.............................	647,311,887	1.90%
AMORTIZATION OF GOODWILL..................	76,002,205	0.22%
DIVIDEND AND INTEREST INCOME...............	(8,493,327)	-0.02%
INTEREST EXPENSE INCL. CAPITAL LEASES......	503,340,788	1.48%
TOTAL..................................	33,054,701,050	96.90%
EARNINGS BEFORE TAX EXPENSE AND EXTRAORDINARY ITEM.........................	1,056,456,492	3.10%
TAX EXPENSE................................	421,526,140	1.24%
EARNINGS BEFORE EXTRAORDINARY ITEM...........	634,930,352	1.86%
EXTRAORDINARY ITEM..........................	(9,836,634)	-0.03%
NET EARNINGS	625,093,718	1.83%
EBITDA.....................................	2,280,118,045	6.68%
LIFO.......................................	5,500,000	0.02%
NET INTEREST................................	494,847,461	1.45%

EARNINGS PER COMMON SHARE:	
BASIC FROM OPERATIONS........................	0.77
EXTRAORDINARY ITEM..........................	-0.01
NET EARNINGS PER COMMON SHARE................	0.76
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION....................	829,089,603

EARNINGS PER COMMON SHARE:	
DILUTED FROM OPERATIONS......................	0.74
EXTRAORDINARY ITEM..........................	-0.01
NET EARNINGS PER COMMON SHARE................	0.73
NUMBER OF COMMON SHARES USED IN PER SHARE CALCULATION....................	860,028,747

8K The Kroger Company Release date 1/12/00

- Commenting on Statements Made to Analysts -

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

Date of Report: December 6, 1999

THE KROGER CO.
(Exact name of registrant as specified in its charter)

An Ohio Corporation	No. 1-303	31-0345740
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Number)

1014 Vine Street
Cincinnati, OH 45201
(Address of principal executive offices)

Registrant's telephone number: (513) 762-4000

Item 5. Other Events

A. On December 6, 1999, the Company released its earnings for the third quarter of 1999, separately announcing management changes. Attached hereto as Exhibit 99.1 is the text of that release.

B. On December 6, 1999, the Company conducted an investor conference call. Attached hereto as Exhibit 99.2 is the text of the prepared remarks for that call. The Company also indicated that, excluding its Fry's division, its identical store sales increase thus far for the fourth quarter 1999 was exceeding the 1.9% reported for third quarter 1999.

C. On September 14, 1999, the Company disclosed its estimate of sales and diluted earnings per share for third and fourth quarters 1998, adjusted to take into account the merger with Fred Meyer and the Company's change in its fiscal year. The Company is revising its estimate of what sales would have been for those two quarters, taking into account the merger with Fred Meyer and the change in its fiscal year, to approximately $9.8 billion in the third quarter 1998, and approximately $11.1 billion in the fourth quarter 1998.

Sales as shown above have not been adjusted to account for divested stores. These estimates include the effect of the Company's merger with Fred Meyer, which was accounted for as a pooling-of-interests, and the change in Kroger's fiscal year end that was disclosed in its Current Report on Form 8-K dated January 15, 1999.

Item 7. Financial Statements, Pro Forma Financial Information and Exhibits

(c) Exhibits:

99.1 Earnings release for third quarter 1999.

99.2 Text of prepared remarks for investor conference call.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereto duly authorized.

THE KROGER CO.

December 6, 1999

By: (Paul Heldman)
Paul Heldman
Senior Vice President, Secretary and General Counsel

EXHIBIT INDEX

Exhibit No.	Exhibit

99.1 Earnings release for third quarter 1999.

99.2 Text of prepared remarks for investor conference call.

Exhibit 99.1

From:

[KROGER LOGO]
NEWS

Corporate Affairs Department
The Kroger Co.
1014 Vine Street
Cincinnati, Ohio 45202-1100

Media Contact:	Gary Rhodes, The Kroger Co. (513) 762-1304
Investor Contact:	Kathy Kelly, The Kroger Co. (513) 762-4969

KROGER REPORTS RECORD EARNINGS, BEFORE MERGER COSTS, FOR THIRD QUARTER OF 1999

RESULTS KEYED BY MERCHANDISING PROGRAMS, PRIVATE-LABEL PRODUCTS AND SYNERGY SAVINGS; SEPARATELY, ROBERT MILLER RESIGNS FROM KROGER TO JOIN RITE AID

CINCINNATI, OH, December 6, 1999 -- The Kroger Co. (NYSE: KR) today reported record earnings of $0.24 per diluted share, excluding costs related to mergers, for the third quarter ended November 6, 1999.

These results represent an increase of approximately 33% over estimated combined earnings of $0.18 per diluted share, before an extraordinary item, for the third quarter of 1998. The prior-year estimate includes the actual results of Fred Meyer before merger costs and an estimate of Kroger's pre-merger results to reflect the change to a new fiscal calendar last January.

Including merger-related costs of $93 million pre-tax, Kroger earned $0.15 per diluted share in the third quarter of 1999.

After adjusting for the change in Kroger's fiscal calendar and excluding sales from divested stores, total sales for the third quarter of 1999 increased 6.6% to $10.3 billion. Identical food store sales grew 1.6%. Comparable food store sales, which include relocations and expansions, rose 2.5% for the quarter. Identical and comparable sales include divisions with stores that changed names during the past year. Excluding the Fry's division, which has converted 35 former Smith's stores to the Fry's banner, identical food store sales grew 1.9% and comparable food store sales rose 2.8%.

EBITDA (earnings before interest, taxes, depreciation, amortization, LIFO and unusual items) for the third quarter of 1999 totaled $696 million, an increase of approximately 12.4% over estimated results from the previous year.

"We are very pleased with our sales and earnings performance in the third quarter of 1999," said Joseph A. Pichler, Kroger chairman and chief executive officer. "Our merchandising programs continued to generate positive results, including the introduction of more than 325 new private-label products. Our manufacturing operations also turned in another outstanding performance."

During the third quarter of 1999, Kroger opened, expanded, relocated or acquired 104 stores. Overall square footage, excluding divested stores, increased 5.9% over the prior year. Capital expenditures for the quarter totaled $625 million. Net total debt increased by $247 million to $8.7 billion from a year ago, largely as a result of the Company's decision to build inventory in anticipation of a strong holiday selling season. Net total debt also was affected by the change in Kroger's fiscal calendar.

For the first three quarters of 1999, Kroger reported earnings of $0.74 per diluted share, before an extraordinary item and excluding merger costs. On that basis, these results represent an increase of approximately 25% over estimated combined earnings of $0.59 per diluted share for the first three quarters of 1998. The prior-year estimate includes the actual results of Fred Meyer before merger costs and an estimate of Kroger's pre-merger results, excluding one-time expenses, to reflect the change to a new fiscal calendar. The 1999 figures also include a full 40 weeks of results from Ralphs, which was acquired by Fred Meyer on March 10, 1998, thus contributing only 35 weeks of results during the 1998 period.

Adjusting for these changes, and excluding sales from divested stores, total sales in the first three quarters of 1999 increased approximately 5.7%. EBITDA totaled $2.3 billion for the first three quarters of 1999.

Mr. Pichler said the integration of the Kroger and Fred Meyer organizations is moving forward smoothly. "We are delighted with the progress we have made in combining these two organizations. By consolidating suppliers

and centralizing our purchasing, we have been able to leverage our size to obtain better costs for a wide variety of items, including produce, holiday candy, grocery bags and plastic pharmacy vials, just to name a few. In addition, our new three-tier, private-label strategy has led to the introduction of hundreds of new products that will help strengthen our regional store brands across the country."

Looking ahead, Mr. Pichler said the Company remains comfortable with achieving the projected $155 million in combined synergy savings for the 1999 fiscal year from the Kroger-Fred Meyer merger and from Fred Meyer's previous mergers. He also said the Company expects combined synergy savings to total $260 million in fiscal 2000, $345 million in fiscal 2001 and $380 million in fiscal 2002.

During the third quarter, the Company announced plans to purchase 74 Winn-Dixie stores in Texas and Oklahoma, subject to Federal Trade Commission review. Kroger also added the Jay C Stores chain in southern Indiana and has converted 38 stores in northern California that were acquired from Albertson's, Inc. In addition, the Company last week announced plans to merge with Pay Less Super Markets Inc., a privately owned chain of eight grocery stores in Indiana.

For the fiscal fourth quarter, which ends January 29, 2000, Kroger estimates earnings per share to be in the range of $0.37 to $0.40, excluding merger-related costs. Mr. Pichler said the Company remains comfortable with achieving previously announced annual earnings per share growth of 16%-18% beginning in fiscal 2000.

Separately, Kroger announced that Robert G. Miller, vice chairman and chief operating officer, resigned from the Company, effective December 3, 1999. Mr. Miller has accepted an offer to join Rite Aid Corp. (NYSE, PSE: RAD). In addition, Kroger announced that Kenneth A. Thrasher has been appointed president and chief executive officer of Fred Meyer Stores, Inc. Mr. Thrasher, who previously served as a senior vice president of The Kroger Co., has held a variety of management positions with Fred Meyer, Inc. since joining the company in 1982. He replaces Mary F. Sammons, who also has resigned to join Rite Aid.

Mr. Pichler said, "Kroger has a very strong management team throughout the organization that is firmly committed to building our business and achieving the synergy goals set by the Company."

Mr. Pichler will assume the responsibilities of chief operating officer on an interim basis while the Company's board of directors considers an appropriate organizational structure.

Headquartered in Cincinnati, Ohio, Kroger is the nation's largest retail grocery chain. The Company operates 2,268 supermarkets and multi-department stores in 31 states under more than a dozen banners, including Kroger, Fred Meyer, Ralphs, Smith's, King Soopers, Dillon, Fry's, Food 4 Less and Quality Food Centers. Kroger also operates 794 convenience stores, 383 fine jewelry stores and 42 food processing plants.

# # #

This press release contains certain forward-looking statements about the future performance of the Company. These statements are based on management's assumptions and beliefs in light of the information currently available to it. We assume no obligation to update the information contained herein. These forward-looking statements are subject to uncertainties and other factors that could cause actual results to differ materially from such statements including, but not limited to, material adverse changes in the business or financial condition of Kroger and other factors affecting the businesses of the Company which are described in filings with the Securities and Exchange Commission.

Certain 1998 information included in this release has been estimated in order to present the 1998 information as if the decision to change Kroger's fiscal year had been made at the beginning of 1998. The 1998 information included in the Company's Forms 10-Q filed with the SEC during 1999 will be for different periods than those in the newly adopted fiscal year and may not agree with certain 1998 estimated information included in this release.

THE KROGER CO.
SALES AND EARNINGS
WITHOUT ONE-TIME EXPENSES
(in millions, except per share amounts)

	3rd Quarter		3 Quarters	
	1999	1998(3)	1999	1998
Sales	$10,329	$11,501	$34,111	$31,
EBITDA (1)	$ 696	$ 691	$ 2,280	$ 1,
LIFO	$ (6)	$ 9	$ 6	$
Interest	$ 148	$ 170	$ 495	$
Depreciation	$ 198	$ 200	$ 647	$
Amortization	$ 23	$ 23	$ 76	$
Pre-tax earnings earnings before extraordinary item	$ 333	$ 289	$ 1,056	$
Tax expense	$ 131	$ 119	$ 421	$
Earnings before extraordinary item	$ 202	$ 170	$ 635	$
Extraordinary item (2)	$ -	$ (6)	$ (10)	$ (
Net earnings	$ 202	$ 164	$ 625	$
Diluted earnings per common share:				
From operations	$ 0.24	$ 0.20	$ 0.74	$ 0
From extra-ordinary item (2)	$ -	$ (0.01)	$ (0.01)	$ (0
Diluted net earnings per common share	$ 0.24	$ 0.19	$ 0.73	$ 0
Number of shares used in diluted per share calculation	857	855	860	

(1) EBITDA, as defined in our credit agreements, represents earnings before interest, taxes, depreciation, amortization, LIFO and one-time items.

(2) From the early retirement of debt.

(3) The information for the third quarter of 1998 includes the results of operations of The Kroger Co. for the 16 weeks ended October 3, 1998, its wholly owned subsidiary, Dillon Companies Inc., for the 13 weeks ended September 26, 1998, its wholly owned subsidiary, Fred Meyer, Inc., for the 12 weeks ended November 7, 1998.

(4) The information for the first three quarters of 1998 includes the results of operations of The Kroger Co. for the 40 weeks ended October 3, 1998, Dillon Companies Inc., for the 39 weeks ended September 26, 1998, and Fred Meyer, Inc., for the 40 weeks ended November 7, 1998.

THE KROGER CO.
SALES AND EARNINGS
WITH ONE-TIME EXPENSES
(in millions, except per share amounts)

	3rd Quarter		3 Quarters	
	1999	1998(3)	1999	1998
Sales	$10,329	$11,501	$34,111	$31,
EBITDA (1)	$ 696	$ 691	$ 2,280	$ 1,

LIFO	$ (6)	$ 9	$ 6	$
Interest	$ 148	$ 170	$ 495	$
Depreciation	$ 198	$ 200	$ 647	$
Amortization	$ 23	$ 23	$ 76	$
One-time Items (5)	$ 93	$ 34	$ 363	$
Pre-tax earnings earnings before extraordinary item	$ 240	$ 255	$ 693	$
Tax expense	$ 111	$ 105	$ 301	$
Earnings before extraordinary item	$ 129	$ 150	$ 392	$
Extraordinary item (2)	$ -	$ (6)	$ (10)	$ (
Net earnings	$ 129	$ 144	$ 382	$
Diluted earnings per common share:				
From operations	$ 0.15	$ 0.18	$ 0.46	$ C
From extra-ordinary item (2)	$ -	$ (0.01)	$ (0.01)	$ (C
Diluted net earnings per common share	$ 0.15	$ 0.17	$ 0.45	$
Number of shares used in diluted per share calculation	857	855	860	

(1) EBITDA, as defined in our credit agreements, represents earnings before interest, taxes, depreciation, amortization, LIFO and one-time items.

(2) From the early retirement of debt.

(3) The information for the third quarter of 1998 includes the results of operations of The Kroger Co. for the 16 weeks ended October 3, 1998, its wholly owned subsidiary, Dillon Companies Inc., for the 13 weeks ended September 26, 1998, its wholly owned subsidiary, Fred Meyer, Inc., for the 12 weeks ended November 7, 1998.

(4) The information for the first three quarters of 1998 includes the results of operations of The Kroger Co. for the 40 weeks ended October 3, 1998, Dillon Companies Inc., for the 39 weeks ended September 26, 1998, and Fred Meyer, Inc., for the 40 weeks ended November 7, 1998.

(5) The one-time items in 1999 are costs related to mergers. The one-time items in the third quarter of 1998 are costs related to mergers. The one-time items in the first three quarters of 1998 are costs related to mergers ($246 million), logistics initiatives ($41 million), accounting and operations consolidations in Texas ($11 million), and charges related to an accounting change ($90 million).

Exhibit 99.2

THIRD QUARTER, 1999
INVESTOR CONFERENCE CALL
DECEMBER 6, 1999

KATHY KELLY: Good morning. Before we begin today's call, I must inform you that the discussion today will include forward looking statements. We wish to caution you that such statements are predictions, and actual events or results can differ materially. A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings.

COMMENTS BY: JOE PICHLER

Good morning and welcome to Kroger's third quarter investor conference call. Thanks for joining us. With me today are Dave Dillon, Kroger's President and Rodney McMullen, our Chief Financial Officer.

This morning Kroger released the results of our outstanding third quarter. I am very pleased by the strong sales and EBITDA that our operators achieved.

The release also states that Bob Miller and Mary Sammons have resigned to become Rite Aid's CEO and COO respectively.

We are very pleased to announce that Ken Thrasher, SVP of Kroger, has been appointed president and CEO of Fred Meyer Stores, replacing Mary Sammons. Ken is a 17 year associate of Fred Meyer stores who has earned the respect of our entire organization for his professional expertise, understanding of the multi-department stores and leadership.

I will now review Kroger's third quarter results and update you on the integration activities. Rodney will discuss synergy savings. We will then be happy to answer your questions.

TOTAL SALES WERE $10.3 BILLION DOLLARS - AN INCREASE OF 6.6% over the comparable period in 1998. FOOD STORE SALES ROSE 6.3%. In order to calculate the 1998 sales figure, we adjusted Kroger sales to coincide with the new fiscal year and excluded sales from divested stores. ON THE SAME BASIS, IDENTICAL FOOD STORE SALES rose a strong 1.6%.

The identical store sales calculation excludes expansions and relocations.

COMPARABLE STORE SALES - which include expansions and relocations, rose 2.5%, another good number. Excluding the Fry's division, which converted 35 former Smith's stores to the Fry's banner, identical food store sales increased 1.9% and comparable store sales rose 2.8%. I am very pleased with the continued strength of our sales.

EBITDA:

THIRD QUARTER EBITDA totaled $696.1 million dollars - an increase of approximately 12.4% over estimated results for the third quarter 1998. This was an outstanding performance by our operators.

Excluding all costs related to the merger, THE GROSS PROFIT RATE was 26.54% of sales. The gross profit rate improvement over the first half of 1999 reflects the reduction in product costs generated by our corporate wide purchasing program; a strong increase in private label profitability; excellent manufacturing results; and the benefits being generated by logistics initiatives.

EXCLUDING COSTS RELATED TO THE MERGER, OG&A expense was 18.2% of sales which is flat as compared to the first half of 1999. Kroger remains committed to reducing ALL costs - as a percent of sales, year over year.

COMBINED SYNERGY SAVINGS at the end of the quarter totaled $135 million dollars. The incremental savings were primarily attributable to PURCHASING, MANUFACTURING, AND REDUCTION IN ADMINISTRATIVE COSTS. We are well on our way to achieving the $155 million of synergy savings targeted for fiscal 1999.

COSTS RELATED TO THE MERGER TOTALED $93 million in the quarter. We expect to incur additional costs related to the merger in the next two years. However, the majority of these costs will occur during the first year after the merger closed.

EARNINGS PER DILUTED SHARE, before all costs related to the merger, totaled 24 cents, an increase of 33% over estimated results for the third quarter 1998 . We estimate that 1998 diluted earnings per share would have been approximately 18 cents on a comparable basis.

There were 857.4 MILLION DILUTED SHARES outstanding at the end of the third quarter.

I am DELIGHTED by Kroger's strong performance during the quarter especially in light of all the integration activities that are underway across the company and the mergers we are able to identify and complete on a fill-in basis in addition to achieving the merger synergies at Fred Meyer. And I continue to be impressed by the way our operators are working together as one team.

This merger is off to a solid start and I continue to feel good about our ability to generate EARNINGS PER SHARE GROWTH AT THE TARGETED RATE OF 16 - 18% BEGINNING NEXT YEAR.

FOR THE 4TH QUARTER, WE EXPECT EARNINGS TO BE WITHIN THE RANGE OF 37 - 40 CENTS. Let me explain. The Phoenix integration is taking longer than we expected and sales have been soft at QFC and Smiths since the date of the merger. We expect to achieve the Phoenix synergies in 2000. And we have replaced the leadership at Smith's and QFC with two strong executives, Russ Dispense and Darrell Webb. Both are solid merchants and operators.

We also experienced some information systems issues since the date of the merger at Smith's, QFC and Fry's. These are not control issues but they do affect in-store operations and some of the purchasing. On the in-store systems there were some hardware problems early on as the systems were changed at Smith's and QFC. That changeover began before the merger and some of those problems were identified in the hardware. Those have been fixed. There are still some issues that are targeted for improvement in 2000.

On the purchasing systems side, at the time that Smith's and QFC were acquired by Fred Meyer, the purchasing systems were non-compliant with the year 2000. The decision was made, and I think appropriately, to introduce the Fred Meyer purchasing system, which is a compliant system. That system is designed for multi-department stores and there are some features that are cumbersome for food merchants. We will begin to fix those after the year 2000--we want to make sure we get past the Y2K date.

ACQUISITIONS

Kroger continues to take advantage of strategic acquisition opportunities. During the quarter, we completed our merger with the John C Groub Co. (Jay C stores in Indiana) and the acquisition of 38 Albertsons stores in northern California. Sam Duncan and the Ralphs team are doing a great job of integrating those northern California stores. I might add that Ralphs had a wonderful quarter. We also announced plans to purchase 74 Winn-Dixie stores in Texas and Oklahoma and, last week, announced plans to merge with Pay Less Super Markets Inc., a privately owned chain of eight grocery stores in Indiana. A very busy quarter.

CAPITAL INVESTMENT:

Kroger invested $625 MILLION IN CAPITAL PROJECTS in the third quarter. Excluding acquisition costs associated with the Albertsons stores and the Jay C stores, cap ex was $ 468 million. For the year, we expect to invest approximately $1.95 billion which includes $100 million of merger related capital.

We plan to grow square footage by 4.5 - 5% year over year, excluding acquisitions. Net square footage growth in fiscal 1999 will be in the 4.0 - 4.5% range because of the large number of operational closings this year. We continually review under performing assets and are moving more quickly to turn them around or dispose of them.

During the quarter Kroger opened, acquired, expanded, or relocated 104 stores versus 51 in the comparable period of 1998. We had 11 operational closings and completed 40 within the wall remodels.

Square footage, excluding divested stores, increased 5.9% over 3rd quarter 1998 to 118.1 million square feet. Excluding divested stores and acquisitions, net square footage grew 3.9% over 3rd quarter 1998.

KROGER ENDED THE QUARTER WITH 2268 FOOD STORES, 794 CONVENIENCE STORES, AND 383 JEWELRY STORES.

LIFO posted a $6.5 million dollar CREDIT for the quarter compared to a $9 million dollar charge last year. This is directly attributable to better buying as a result of our centralized procurement program; the stable grocery cost environment in which we are currently operating; and the synergy savings that we are beginning to achieve.

WORKING CAPITAL:

Working capital for the quarter increased $313 million to a level of $354 million. Inventory build was primarily responsible for the increase. Kroger divisions have increased inventory for the holiday season in anticipation of our customers' needs for the millennium. The increase in working capital also reflects the change in the new fiscal calendar, and the effect of the newly acquired stores.

Working capital reduction is a high priority going forward. We expect to take at least $500 million out of working capital over the next 5 years.

DEBT/INTEREST EXPENSE:

NET TOTAL DEBT increased $247 million dollars to $8.7 billion dollars. The increase is due to the inventory build.

NET INTEREST EXPENSE totaled $148 million. Interest expense for the full year should be in the $650 million range, plus or minus $10 million. This increase of $25 million is due to the recent acquisitions, funding out some of the Fred Meyer bank debt to a longer maturity and the inventory build.

We continue to make dramatic progress in integrating the Kroger and Fred Meyer organizations. There are two specific areas that I would like to highlight:

1. ARIZONA

As you recall, Kroger and Fred Meyer only had overlap in Arizona. All 35 former Smith's stores in Phoenix and Tucson have been converted to the Fry's banner. As I mentioned earlier, we are not happy with the results in Phoenix and we have a plan of action to achieve the full synergies.

The Fry's stores, as well as the Fred Meyer Arizona stores, are now receiving all grocery and perishable items from the Tolleson warehouse which formerly served the Smith's and Fred Meyer stores in Arizona. The former Fry's warehouse is still being used for outside storage during the transition, but there is no order assembly being done at that facility. The warehouse conversion was more difficult than we anticipated but service levels have now improved. And the Fry's dairy has been sold.

THE SECOND AREA I WOULD LIKE TO HIGHLIGHT IS PRIVATE LABEL.

Kroger's three tier private label strategy is beginning to generate incremental sales and enhanced profit margins. Our "good, better, best" approach to private label will enable us to serve a much

broader consumer base. Pre-merger Kroger's private label sales accounted for 25% of grocery dollar sales, and 31% of unit sales during the 3rd quarter. Private label sales are about 16-18% of grocery sales in the former Fred Meyer divisions.

I am confident that we can raise the private label sales penetration at the Fred Meyer divisions to the level that the pre-merger Kroger divisions have achieved and that we will continue to grow private label market share across the entire company. We are rolling out the Private Selections premium tier and now have over 70 sku's currently in the stores, with 30 more scheduled to be in place by year end.

We are very pleased with the early results and the incremental sales these premium products are generating.

So far this year, Kroger has introduced 726 new private label products. You can really see the emphasis we are placing on this area. We continue to be very pleased with our three tier strategy and the product cost reductions we are achieving. This is an area of substantial growth potential.

With that, I would like to ask Rodney to update us on synergy savings.

Rodney, . . .

COMMENTS BY: RODNEY MCMULLEN

Thanks Joe and good morning. As Joe mentioned earlier, at the end of the third quarter, we have achieved combined synergies of $135 million, an incremental $15 million over the 2nd quarter 1999. As Joe mentioned before, the areas producing the synergies are administrative cost reductions, purchasing (especially in the private label areas and other purchasing areas), manufacturing, and the offset of some of the negative synergies in Arizona that are reflected in those numbers. We are comfortable that we will meet or beat the projected $155 million in combined synergy savings for the 1999 fiscal year. In addition, we will meet or beat combined synergies of $260 million in fiscal 2000, $345 million in fiscal 2001 and $380 million in fiscal 2002.

Each quarter the finance support team along with each of the transition committee teams updates the synergies and we continue to feel very comfortable with our ability to achieve these numbers.

In addition, this morning we announced a stock repurchase program using option proceeds and the tax deduction from those options. If you look through the end of 2001 we have 5.1 million options that will expire that we would expect to be exercised. By using the proceeds from options and the tax deduction, we would expect to repurchase about half that number of shares going forward.

Now back to Joe.

COMMENTS BY: JOE PICHLER

Thanks Rodney. I am extremely pleased with Kroger's third quarter results. Our divisional operators kept their focus on customer service to produce a strong increase in sales and earnings while, at the same time, working closely with corporate leadership to implement the strategies that will generate $380 million of synergies.

The "new Kroger" is building on the strength of our combined companies: leading market shares in some of the nation's largest and fastest growing metro markets; solid managers throughout the company; sophisticated technology and logistics systems that support retail operations effectively and efficiently; a powerful group of manufacturing plants that provide a strategic advantage in private label categories; and a clarity of purpose throughout the organization

These assets form a solid base for generating the economies of scale made possible by our merger. We are off to a great start. Our team is heavily incentified to achieve the full value of our merger and will be handsomely rewarded as we build shareholder value through our projected EPS growth rate of 16 - 18% beginning next year.

We will now be happy to take your questions.

8K Cendant Corporation Release date 12/7/99
- Relating to Settlement of Securities Class Action and Implementation of Corporate Governance Changes -

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 8-K
CURRENT REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

December 7, 1999 (December 7, 1999)
(Date of Report (date of earliest event reported))

Cendant Corporation
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	1-10308 (Commission File No.)	06-0918165 (I.R.S. Employer Identification Number)
9 West 57th Street New York, NY		10019
(Address of principal executive) office)		(Zip Code)

(212) 413-1800
(Registrant's telephone number, including area code)

None
(Former name, former address and former fiscal year, if applicable)

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Item 5. Other Events

Except as expressly indicated or unless the context otherwise requires, "Cendant", "we", "our", or "us" means Cendant Corporation, a Delaware Corporation, and its subsidiaries.

Preliminary Agreement to Settle Common Stock Securities Class Action. On December 7, 1999, we announced that we reached a preliminary agreement to settle the principal securities class action pending against us in the U.S. District Court in Newark, New Jersey. Under the agreement, we would pay the class members $2.83 billion in cash. The class action was initiated following the discovery in April 1998 of accounting irregularities at former CUC International business units.

We will continue to pursue our claims against CUC's former auditor, Ernst & Young LLP ("E&Y") in relation to the accounting irregularities of the former CUC business units, including claims for professional malpractice, breach of contract and breach of fiduciary duty, and claims seeking contribution from E&Y in connection with our settlement of the PRIDES litigation. As part of the settlement agreement with lead plaintiffs, the class they represent will receive 50% of any recovery by us from E&Y.

With respect to the settlement, we will record a non-cash after-tax charge of approximately $1.8 billion, or $2.39 per share in the fourth quarter of 1999.

Based upon the assumption that district court approval of a definitive settlement agreement will occur at the end of the first quarter of 2000, we currently estimate that the settlement may reduce 2000 earnings per share by between $0.12 and $0.16. The pro forma 12-month earnings impact, assuming the settlement occurred on January 1, 2000, is currently estimated at $0.15 to $0.21 cents per share.

The impact on earnings per share will vary based on factors that include the following:

o First, while we expect to resume share repurchase activity, our repurchase may not equal the $1 billion in stock we originally intended to acquire in the fourth quarter of 1999.

o Second, the exact date on which we may make the actual settlement payment is uncertain, based on the date of final district court order and whether this order is appealed. From the date of the final district court order, we will accrue interest on the unpaid settlement amount. While any appeals are pending, we will deposit a letter or credit or similar security in the amount of the settlement.

- Third, the timing and impact of any securities issued to ultimately finance the settlement payment will depend on market conditions at the time.
- Fourth, while we expect to generate significant tax benefits form the ultimate settlement payment, these will only be recovered on a cash basis over time as we generate taxable income that can be offset against the loss generated by the settlement. Thus, we may only be able to recover the tax deduction over several years. The speed with which we can utilize the tax benefits will affect the EPS impact of the settlement.

The proposed settlement will have no impact on the balance sheet, earnings or cash flow of our independent finance subsidiary, PHH Corporation.

The proposed settlement resolves all class actions brought on behalf of purchasers of securities issued by CUC, HFS Incorporated or us, other than certain remaining claims relating to the FELINE PRIDES securities. The proposed settlement does not encompass all pending litigation asserting claims associated with the CUC accounting irregularities. However, in our opinion, the potential impact of all such unresolved litigation outside of the proposed settlement should not be material.

The timing and manner of distribution of the settlement to members of the class will be subject to a plan of distribution to be developed by plaintiffs' counsel subject to approval by the Court. Questions concerning the terms of the settlement agreement should be directed to lead plaintiffs' counsel: Barrack, Rodos & Bacine, 3300 Two Commerce Sq., Philadelphia, PA 19103 (215) 963-0600 or Bernstein, Litowitz, Berger & Grossmann LLP, 1258 Avenue of the Americas, New York, NY 10019 (212) 554-1400.

Corporate Governance Initiatives. We also announced that we are undertaking additional initiatives in the area of corporate governance, and we expect those initiatives to make an important contribution toward further building shareholder value. These actions include meeting a very strict definition of independence for a majority of our directors; continuing to maintain a compensation committee comprised of only independent directors; continuing to maintain an audit committee comprised of only independent directors and including at least one director with accounting or financial expertise; the establishment of a nominating committee comprised entirely of independent directors; requiring shareholder approval prior to any re-pricing of employee stock options; and asking shareholders to approve a motion by our next annual meeting to elect all directors on an annual basis.

Reference is made to Exhibit 99.1 for the full text of the press release relating to the preliminary settlement, which is incorporated herein by reference in its entirety.

Item 7. Exhibits

Exhibit No.	Description
99.1	Press Release: Cendant Reaches Preliminary Agreement to Settle Common Stock Securities Class Action for $2.83 Billion, dated December 7, 1999.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

CENDANT CORPORATION

By: /s/ James E. Buckman
James E. Buckman
Vice Chairman and General Counsel

Date: December 7, 1999

CENDANT CORPORATION
CURRENT REPORT ON FORM 8-K
Report Dated December 7, 1999 (December 7, 1999)

EXHIBIT INDEX

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99.1	Press Release: Cendant Reaches Preliminary Agreement to Settle Common Stock Securities Class Action for $2.83 Billion, dated December 7, 1999.

TYPE: EX-99.1
SEQUENCE: 2
DESCRIPTION: EX. 99.1 PRESS RELEASE DATED DECEMBER 7, 1999

EXHIBIT 99.1

Cendant Reaches Preliminary Agreement To Settle
Common Stock Securities Class Action for $2.83 Billion

Cendant to Record $1.8 Billion Non-Cash, After-Tax Charge in 4Q 1999

Settlement Expected to Reduce 2000 EPS by $0.12 to $0.16

Cendant to Resume Share Repurchase Activity

Company to Expand Corporate Governance Initiatives

Cendant announced today that it has reached a preliminary agreement to settle the principal securities class action pending against Cendant in the U.S. District Court in Newark, New Jersey. Under the agreement, Cendant would pay the class members $2.83 billion in cash. The class action was initiated following the discovery in April 1998 of accounting irregularities at former CUC International (CUC) business units.

Cendant will continue to pursue its claims against CUC's former auditor, Ernst & Young LLP (E&Y) in relation to the accounting irregularities of the former CUC business units, including claims for professional malpractice, breach of contract and breach of fiduciary duty, and claims seeking contribution from E&Y in connection with Cendant's settlement of the PRIDES litigation. As part of its settlement agreement with lead plaintiffs, the class they represent will receive 50% of any recovery by Cendant from E&Y.

"By eliminating what was by far our largest remaining uncertainty, the settlement effectively brings closure to this most unfortunate event," said Henry R. Silverman, Cendant Chairman, President and CEO. "The resolution announced today will discharge substantially all of our remaining financial exposure from the former CUC. Further action lies in the hands of the U.S. Attorney and the SEC, each of which we believe is aggressively pursuing the responsible parties. While we will continue to actively cooperate, we expect that these matters will not affect the Company or its current officers and directors.

"Cendant can again be valued based on the performance of our businesses, without the overhang of this litigation," continued Silverman. "This settlement allows the fruits of our efforts to again belong to our shareholders, customers and employees.

"The structure of the settlement and our plans to finance it preserve significant flexibility for Cendant," concluded Silverman. "We will enter the year 2000 with significant discretionary cash and the financial resources to pursue shareholder value wherever it lies. Now that we have reached this preliminary agreement, we will resume share repurchase activity."

The Company also announced that it is undertaking additional initiatives in the area of corporate governance, and it expects those initiatives to make an important contribution toward further building shareholder value. These actions include meeting a very strict definition of independence for a majority of the Company's directors; continuing to maintain a compensation committee comprised of only independent directors; continuing to maintain an audit committee comprised of at least three independent directors and including at least one director with accounting or financial expertise; the establishment of a nominating committee comprised entirely of independent directors; requiring shareholder approval prior to any re-pricing of employee stock options; and asking shareholders to approve a motion by the Company's next annual meeting to elect all directors on an annual basis.

The Company has engaged Chase Securities and Goldman Sachs as financial advisors in connection with the funding of the settlement. Bank of America provided credit advisory services to Cendant in connection with the settlement.

With respect to the settlement, Cendant will record a non-cash after-tax charge of approximately $1.8 billion, or $2.39 per share in the fourth quarter of 1999.

Based upon the assumption that district court approval of the settlement will occur at the end of the first quarter of 2000, the Company currently estimates that the settlement may reduce 2000 earnings per share by between $0.12 and $0.16. The pro forma 12-month earnings impact, assuming the settlement occurred on January 1, 2000, is currently estimated at $0.15 to $0.21 cents per share.

The impact on earnings per share in 2000 will vary based on factors that include the following:

o First, while the Company expects to resume share repurchase activity, its repurchases may not equal the $1 billion in stock the Company originally intended to acquire in the fourth quarter of 1999.

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The proposed settlement will have no impact on the balance sheet, earnings or cash flow of Cendant's independent finance subsidiary, PHH Corporation.

The proposed settlement resolves all class actions brought on behalf of purchasers of securities issued by CUC, HFS Incorporated or Cendant, other than certain remaining claims relating to FELINE PRIDES securities. The proposed settlement does not encompass all pending litigation asserting claims associated with the CUC accounting irregularities. However, in the opinion of the Company, the potential impact of all such unresolved litigation outside of the proposed settlement is not material.

The timing and manner of distribution of the settlement to members of the class will be subject to a plan of distribution to be developed by plaintiffs' counsel subject to approval by the Court. Questions concerning the terms of the settlement agreement should be directed to lead plaintiffs' counsel: Barrack, Rodos & Bacine, 3300 Two Commerce Sq., Philadelphia, PA 19103 (215) 963-0600 or Bernstein, Litowitz, Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019 (212) 554-1400.

Statements about future results made in this release may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on current expectations and the current economic environment. The Company cautions that these statements are not guarantees of future performance. They involve a number of risks and uncertainties that are difficult to predict including the outcome of litigation. Actual results could differ materially from those expressed or implied in the forward-looking statements. Important assumptions and other important factors that could cause actual results to differ materially from those in the forward-looking statements are specified in the Company's Form 10-K/A for the year ended December 31, 1998, including completion of the settlement of the class action litigation.

8K Compaq Computer Corporation Release date 1/26/00

- Issuing Earnings Release -

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): January 25, 2000

COMPAQ COMPUTER CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Delaware	**1-9026**	**76-0011617**
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification No.)

20555 SH 249 **Houston, Texas**	**77070**
(Address of Principal Executive Offices)	(Zip Code)

(281) 370-0670
(Registrant's telephone number, including area code)

(Former Name or Former Address, if Changed Since Last Report)

ITEM 5. Other Events.

In a release dated January 25, 2000, Compaq Computer Corporation (NYSE: CPQ) announced worldwide revenue of $10.5 billion for the fourth quarter ended December 31, 1999, a decrease of 4 percent (1 percent at constant currency) compared with the fourth quarter of 1998 and an increase of 14 percent sequentially. Compaq reported fourth quarter 1999 net income totaling $332 million, or $0.19 per diluted common share, compared with $758 million, or $0.43 per diluted common share, in the year-earlier period. The news release is attached as Exhibit 99.

ITEM 7. Exhibits.

Exhibit 99 News Release dated January 25, 2000 is attached.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

COMPAQ COMPUTER CORPORATION

Dated: January 26, 2000

By: /s/ Linda S. Auwers

Linda S. Auwers

Vice President, Associate General

Counsel and Secretary

Compaq Computer Logo

Compaq Computer Corporation
Public Relations Department

P.O. Box 692000
Houston, Texas 77269-2000
Tel 281-514-0484
Fax 281-514-4583
http://www.compaq.com

News Release

FOR IMMEDIATE RELEASE

Compaq Announces Fourth Quarter,

Full Year 1999 Results

HOUSTON, Jan. 25, 2000 - Compaq Computer Corporation (NYSE: CPQ) today announced worldwide revenue of $10.5 billion for the fourth quarter ended December 31, 1999, a decrease of 4 percent (1 percent at constant currency) compared with the fourth quarter of 1998 and an increase of 14 percent sequentially. Compaq reported fourth quarter 1999 net income totaling $332 million, or $0.19 per diluted common share, compared with $758 million, or $0.43 per diluted common share, in the year-earlier period.

In the fourth quarter, the company began to realize the benefits from its strategic investment portfolio. These benefits included a net gain of $50 million (after tax) in other income.

"During the second half of this year we took aggressive action to return Compaq to profitable growth, and fourth quarter results reflect our initial success where it matters most - in the marketplace," said Michael Capellas, Compaq President and Chief Executive Officer.

"At the same time, we focused the company on a clear strategy to secure our global leadership in providing Internet infrastructure, access, services, and solutions. We are beginning to see significant progress in the implementation of that strategy, including the launch of innovative products like our new iPaq access device, partnerships in new areas such as our global alliance with Cable & Wireless, and major account wins with companies like America Online, Merrill Lynch, and Volkswagen. We also took steps to increase our direct capabilities by agreeing to acquire key custom configuration and direct delivery assets from Inacom," said Capellas. "While we have much work to do, the positive response from customers and partners, coupled with the renewed energy of our employees, clearly indicates we are building positive momentum."

Business Overview

In the **Enterprise Solutions and Services Group** (ESSG), revenue was $5.3 billion, down 3 percent year over year and up 8 percent sequentially. Segment operating income was $714 million, a decrease of 17 percent year over year, and an increase of 19 percent sequentially. Overall, fourth quarter ESSG operating income was 13 percent of revenue. The enterprise business represented 51 percent of Compaq's revenue in the fourth quarter.

Enterprise product revenue was approximately $3.5 billion, a decline of 5 percent year over year, and an increase of 7 percent sequentially. On a sequential basis, the Industry Standard Server Division showed revenue growth of 13 percent. Storage products grew 6 percent, underscored by a growing external storage business, and the Business Critical Server Division grew 5 percent.

Service revenue was $1.8 billion, an increase of 3 percent year over year, and 9 percent sequentially.

"We experienced strong sequential growth in the fourth quarter in all segments of our enterprise business," said Capellas. "This clearly indicates the growing market acceptance of Compaq's high end systems, solutions, and services which customers are demanding to build non-stop, 24x7 Internet computing environments."

The **Commercial Personal Computing Group's** revenue was $3.1 billion, a decrease of 19 percent from the fourth quarter 1998 and an increase of 15 percent sequentially. The Commercial PC Group reported an operating loss of $79 million for the fourth quarter, compared to a loss of $169 million in the third quarter, and an operating profit of $157 million in the fourth quarter of 1998. Commercial PC products accounted for 30 percent of Compaq's revenue in the fourth quarter.

"We made significant progress in our Commercial PC business, cutting the loss in half from the previous quarter, and taking several steps to reposition the group for profitable growth, including our recent agreement with Inacom," said Capellas. "The Inacom assets will enable Compaq to accelerate our direct programs, especially in the important major account and small and medium business markets. With this recent agreement to purchase key Inacom assets, the introduction of our iPaq Internet device, and the forthcoming launch of Microsoft's Windows 2000 operating system, I am confident that our Commercial PC group is well positioned to return to profitable growth this year."

Compaq's **Consumer Group** posted record revenue of $2 billion, up 24 percent from fourth quarter 1998 and 34 percent sequentially. Segment operating income was $69 million, compared to $64 million in the fourth quarter of 1998, and $65 million in the third quarter. The consumer business represented 19 percent of the company's revenue in the fourth quarter.

In the fourth quarter, the Consumer business achieved unit growth of 40 percent year over year. Compaq's continued strategy of expansion into overseas markets resulted in notable performances in Latin America, which grew 98 percent, and the Asia Pacific region, which grew 85 percent.

In addition, the Consumer Group continued to drive "beyond the box" revenue through Internet access and traffic, with fourth quarter revenue from these sources up 50 percent sequentially.

"These results, coupled with consistent number one market share position, further reinforce Compaq as the undisputed leader in consumer Internet PCs," said Capellas.

Other revenue and operating losses generated by business activities not included in the three global business groups' results are comprised primarily of Compaq Financial Services and AltaVista Company. Revenue and operating losses generated by AltaVista are included in the fourth quarter 1998 results, as Compaq sold a majority interest in AltaVista during the third quarter of 1999. The three global business groups' results also do not include corporate and unallocated shared expenses of $268 million in the fourth quarter of 1999, $325 million in the third quarter of 1999 and $177 million in the fourth quarter of 1998.

Business Outlook

"During the fourth quarter, we made great strides in defining a clear strategy, realigning for success, getting our cost structure in order, and re-energizing employees. In particular, we were able to leverage more than $1 billion in increased revenue from the previous quarter while bringing down operating expenses. We upped the pace in launching new innovative products, signing strategic partnership deals and alliances, and securing major customer wins," said Capellas. "We do not underestimate the challenges ahead, but are confident of our strategy and we are committed to accelerating our progress and delivering steadily increasing value for our shareholders."

Full Year 1999 Results

Net income for the year ended December 31, 1999 was $569 million, or $0.34 per diluted common share, compared with a net loss of $2.7 billion, or $1.71 per diluted common share, in 1998. Revenue in 1999 totaled $38.5 billion, an increase of 24 percent over the prior year. Compaq's results for 1998 reflect Digital Equipment Corporation operations after June 1998, the date of acquisition, while 1999 results reflect Digital operations for the entire year.

Compaq's full-year 1999 results include a $1.2 billion (pre-tax) gain from the sale of businesses, partially offset by an $868 million (pre-tax) charge for restructuring and related charges. Included in full year 1998 results is a one-time charge for purchased in-process technology of $3.2 billion related to the acquisition of Digital and a $393 million (pre-tax) charge for restructuring and asset impairments in connection with the Digital acquisition and the closing of certain Compaq facilities.

In the **Enterprise Solutions and Services Group,** full year revenue was $20.1 billion, an increase of 39 percent. Segment operating income for the year was $2.3 billion, an increase of 36 percent. The enterprise business represented 52 percent of Compaq's revenue in 1999.

Enterprise product revenue was $13.5 billion, an increase of 26 percent year over year. Service revenue was $6.6 billion, an increase of 74 percent over the prior year.

The **Commercial Personal Computing Group** reported full year revenue of $12.2 billion, an increase of 3 percent. The Commercial PC group reported an operating loss of $448 million for the year, versus a loss of $46 million in the prior year. The Commercial PC group accounted for 32 percent of Compaq's revenue in 1999.

Compaq's **Consumer Group** posted record revenue of $6 billion in 1999, an increase of 22 percent. Segment operating income for the year was $262 million, an increase of 43 percent. The consumer business represented 16 percent of the company's revenue in 1999.

Other revenue and operating losses generated by business activities not included in the three global business groups' results are comprised primarily of AltaVista and Compaq Financial Services. The three business groups' results also do not include corporate and unallocated-shared expenses of $1.3 billion for the full year 1999 and $819 million for the full year 1998.

Company Background

Compaq Computer Corporation, a Fortune Global 100 company, is the second-largest computer company in the world and the largest global supplier of computer systems. Compaq develops and markets hardware, software, solutions, and services, including industry-leading enterprise computing solutions, fault-tolerant business-critical solutions, enterprise and network storage solutions, commercial desktop and portable products, and consumer PCs. The Company is an industry leader in environmentally friendly programs and business practices.

Compaq products are sold and supported in more than 100 countries through a network of authorized Compaq marketing partners. Customer support and information about Compaq and its products are available at http://www.compaq.com.

 This release contains forward-looking statements based on current expectations that involve a number of risks and uncertainties. The potential risks and uncertainties that could cause actual results to differ materially include the failure to close the contemplated transaction with Inacom; failure of systems associated with order fulfillment; the failure to close certain contemplated sales; changes in product mix; inventory risks due to shifts in market demand; continued competitive factors and pricing pressures; and market responses to pricing actions and promotional programs. Further information on the factors that could affect Compaq's financial results are included in its SEC filings, including the annual report on Form 10-K for the year ended December 31, 1998, and the latest quarterly report on Form 10-Q for the quarter ended September 30, 1999.

For further information, contact:

Compaq Media Relations Jim Finlaw 281-514-6137 jim.finlaw@compaq.com

Compaq Media Relations Alan E. Hodel 281-518-8932 alan.hodel@compaq.com

Compaq Investor Relations 281-514-9549 OR 800-433-2391 investor.relations@compaq.com

Compaq Computer Corporation

Consolidated Balance Sheet

(Unaudited)

December 31 (In millions, except par value)	1999	1998
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,666	$ 4,091
Short-term investments	636	----
Accounts receivable, net	6,685	6,998
Inventories	2,008	2,005
Deferred income taxes	1,460	1,602
Other assets	394	471

Total current assets	13,849	15,167
Property, plant and equipment, net	3,249	2,902
Other assets, net	10,179	4,982
	$ 27,277	$ 23,051

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Short-term borrowings	$ 453	$ ----
Accounts payable	4,380	4,237
Deferred income	972	845
Accrued restructuring costs	1,002	1,110
Other current liabilities	5,031	4,541
Total current liabilities	11,838	10,733
Postretirement and other postemployment benefits	605	545
Commitments and contingencies		
Minority interest	----	422
Stockholders' equity:		
Preferred stock, $.01 par value (authorized: 10 million shares; issued: none)		
Common stock and capital in excess of $.01 par value (authorized: 3 billion shares; issued and outstanding: 1,715 and 1,694 million shares, respectively, at December 31, 1999; and 1,698 and 1,687 million shares, respectively, at December 31, 1998)	7,627	7,270
Retained earnings	4,948	4,501
Accumulated comprehensive income (loss)	2,919	(36)
Treasury stock	(660)	(384)
Total stockholders' equity	14,834	11,351
	$ 27,277	$ 23,051

Compaq Computer Corporation
Consolidated Statement of Income
(Unaudited)

(In millions, except per share amounts)	Three months ended December 31, 1999	Three months ended December 31, 1998	Twelve months ended December 31, 1999	Twelve months ended December 31, 1998
Revenue:				
Products	$ 8,715	$ 9,145	$ 31,902	$ 27,372
Services	1,763	1,714	6,623	3,797
Total revenue	10,478	10,859	38,525	31,169
Cost of sales:				
Products	6,915	6,807	25,263	21,383
Services	1,235	1,181	4,535	2,597
Total cost of sales	8,150	7,988	29,798	23,980
Selling, general and administrative expense	1,517	1,561	6,341	4,978
Research and development costs	389	429	1,660	1,353
Purchased in-process technology	----	(38)	----	3,196
Restructuring and related charges	----	----	868	393
Gain on sale of businesses	----	----	(1,182)	----
Other (income) expense, net	(13)	(13)	106	(69)
	1,893	1,939	7,793	9,851
Income (loss) before provision for income taxes	435	932	934	(2,662)
Provision for income taxes	103	174	365	81
Net income (loss)	$ 332	$ 758	$ 569	$ (2,743)

Earnings (loss) per common share:

Basic	$ 0.20	$ 0.45	$ 0.35	$ (1.71)
Diluted	$ 0.19	$ 0.43	$ 0.34	$ (1.71)
Shares used in computing earnings (loss) per common share:				
Basic	1,694	1,682	1,693	1,608
Diluted	1,729	1,742	1,735	1,608

Compaq Computer Corporation
Segment Information
(Unaudited)

(In millions)	Three months ended December 31, 1999	1998	Twelve months ended December 31, 1999	1998
Enterprise Solutions and Services				
Revenue	5,326	5,473	20,136	14,488
Operating income	714	862	2,349	1,724
Commercial Personal Computing				
Revenue	3,133	3,875	12,185	11,846
Operating income (loss)	(79)	157	(448)	(46)
Consumer				
Revenue	1,966	1,582	5,994	4,932
Operating income	69	64	262	183
Other				
Revenue	53	(71)	210	(97)
Operating loss	(1)	(12)	(281)	(115)
Consolidated segment totals				
Revenue	10,478	10,859	38,525	31,169
Operating income	703	1,071	1,882	1,746

A reconciliation of the company's consolidated segment operating income to consolidated income (loss) before provision for income taxes follows:

Consolidated segment operating income	703	1,071	1,882	1,746
Corporate and unallocated shared expenses	(268)	(177)	(1,262)	(819)
Purchased in-process technology	—	38	—	(3,196)
Restructuring and related charges	—	—	(868)	(393)
Gain on sale of businesses	—	—	1,182	—
Income (loss) before provision for income taxes	435	932	934	(2,662)

Certain prior period amounts have been reclassified in order to conform to the current presentation.

8K Tyco International Ltd. Release date 12/9/99

- Disclosing SEC "Non-Public Informal Inquiry -

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Date of Report (Date of earliest event reported) December 9, 1999

001-13836
(Commission File Number)

TYCO INTERNATIONAL LTD.
(Exact name of registrant as specified in its charter)

Bermuda (State of Incorporation)	Not applicable (IRS Employer Identification Number)

The Gibbons Building, 10 Queen Street, Suite 301, Hamilton, HM11, Bermuda
(Address of registrant's principal executive office)

441-292-8674*
(Registrant's telephone number)

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*The executive offices of Registrant's principal United States subsidiary, Tyco International (US) Inc., are located at One Tyco Park, Exeter, New Hampshire 03833. The telephone number there is (603) 778-9700.

B-124

ITEM 5. Other Events

Reference is made to the press release issued to the public by the Registrant on December 9, 1999, the text of which is attached hereto as Exhibit 99.1, for a description of the events reported pursuant to this Form 8-K.

ITEM 7. Financial Statements, Pro Forma Financial Information and Exhibits

(c) Exhibits.

Exhibit Number	Title
99.1	Press Release dated December 9, 1999

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TYCO INTERNATIONAL LTD.

By: /s/ Mark H. Swartz

Mark H. Swartz
Executive Vice President and
Chief Financial Officer
(Principal Accounting and
Financial Officer)

Date: December 9, 1999

Exhibit Index

Exhibit Number	Title
99.1	Press Release dated December 9, 1999

Exhibit 99.1

Tyco International Ltd.
The Gibbons Building
10 Queen Street, Suite 301
Hamilton HM11, Bermuda

FOR IMMEDIATE RELEASE

CONTACT:
J. Brad McGee
Tyco International (US) Inc.
Senior Vice President

(603) 778-9700

Hamilton, Bermuda, December 9, 1999 - Tyco International Ltd. (NYSE-TYC, LSE-TYI, BSX-TYC) said today that it was advised yesterday that the staff of the U.S. Securities and Exchange Commission is conducting a "nonpublic, informal inquiry" relating to charges and reserves taken in connection with the company's acquisitions. Pursuant to this inquiry, Tyco will be providing information and documents to the staff on a voluntary basis.

"In light of the recent market activity in our stock, which is not justified by any development at the company, we welcome the opportunity to respond to this request. We remain confident of our accounting methodology, our public disclosures and the continuing strength of our business," said L. Dennis Kozlowski, Chairman and CEO of Tyco.

The company's Annual Report on Form 10-K for the 1999 fiscal year will be filed on December 13, 1999 as scheduled.

Tyco International Ltd., a diversified manufacturing and service company, is the world's largest manufacturer and servicer of electrical and electronic components and undersea telecommunications systems, the world's largest manufacturer, installer, and provider of fire protection systems and electronic security services, has strong leadership positions in disposable medical products, plastics, and adhesives, and is the largest manufacturer of flow control valves. The Company operates in more than 80 countries around the world and has expected fiscal 2000 revenues in excess of $25 billion.

FORWARD LOOKING INFORMATION

Comments in this release concerning expected fiscal 2000 and Tyco's expectations for continuing business strength are forward-looking statements, which are based on management's good faith expectations and belief concerning future developments. Actual results may materially differ from these expectations as a result of many factors, relevant examples of which are set forth in the "Management Discussion and Analysis" section of the Tyco's 1998 Annual Report to Shareholders, Tyco's 1998 Annual Report on Form 10-K, Tyco's Current Report on Form 8-K filed on June 3, 1999.

# # #
120999 518

8K Tyco International Release date 12/10/99

- Disclosing Filings of Stockholder Putative Class Action Lawsuits and Intent to Vigorously Defend -

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Date of Report (Date of earliest event reported) December 9, 1999

001-13836
(Commission File Number)

TYCO INTERNATIONAL LTD.
(Exact name of registrant as specified in its charter)

Bermuda (State of Incorporation)	Not applicable (IRS Employer Identification Number)

The Zurich Centre, Second Floor, 90 Pitts Bay Road, Pembroke, HM 08, Bermuda
(Address of registrant's principal executive office)

441-292-8674*
(Registrant's telephone number)

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*The executive offices of Registrant's principal United States subsidiary, Tyco International (US) Inc., are located at One Tyco Park, Exeter, New Hampshire 03833. The telephone number there is (603) 778-9700.

ITEM 5. Other Events

On the evening of December 9, 1999, Tyco International Ltd. (the "Company" or "Tyco") read wire reports that six purported damage actions on behalf of putative classes of persons who purchased Tyco common shares at various times since 1998 had been commenced in federal courts in New Hampshire and Florida, alleging violations of federal and state securities laws and the common law, against the Company and certain of its officers and directors. The complaints reportedly allege that these defendants published materially false and misleading statements concerning Tyco's financial condition and future growth prospects and that insiders sold stock to the public prior to the disclosure of the adverse alleged facts at artificially inflated prices.

As of this time, the Company has not received the complaints in such actions nor does it know whether they were the only such actions filed; this disclosure is based solely on wire reports.

The Company and the individual defendants intend to vigorously defend against all such actions. The Company cannot predict whether additional suits will be filed.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TYCO INTERNATIONAL LTD.

By: /s/ Mark H. Swartz

Mark H. Swartz
Executive Vice President and
Chief Financial Officer
(Principal Accounting and
Financial Officer)

Date: December 10, 1999

8K Sunbeam Corporation Release date 8/12/99

- Announcing Settlement of Dispute with Shareholder -

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K

CURRENT REPORT
PURSUANT TO ~~SECTION 13 OF~~ 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Date of report (Date of earliest event reported): August 12, 1998

Sunbeam Corporation
Exact Name of Registrant Specified in Charter

Delaware	0001-000052	25-1638266
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification No.)

1615 South Congress Avenue, Suite 200, Delray Beach, Florida 33445
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: (561) 243-2100

(Former Name or Former Address, if Changed Since Last Report)

ITEM 5. OTHER EVENTS.

On August 12, 1998, Sunbeam Corporation ("Sunbeam") entered into a settlement agreement with MacAndrews & Forbes Holdings, Inc. The agreement releases Sunbeam from any claims MacAndrews & Forbes may have against Sunbeam arising out of Sunbeam's acquisition of MacAndrews & Forbes' interest in The Coleman Company, Inc.; enables Sunbeam to retain the services of MacAndrews & Forbes executive personnel who have been managing Sunbeam since mid-June 1998, including Jerry W. Levin, the Company's Chief Executive Officer; and provides for MacAndrews & Forbes to continue to give other management support to Sunbeam.

Pursuant to the settlement agreement, MacAndrews & Forbes will receive from Sunbeam five-year warrants to purchase an additional 23 million Sunbeam shares at an exercise price of $7.00 per share and containing customary anti-dilution provisions.

A copy of the settlement agreement and copies of the press release and letter to Sunbeam shareholders, each dated August 12, 1998, announcing the execution of the settlement agreement are filed as exhibits hereto and are incorporated by reference herein.

ITEM 7. FINANCIAL STATEMENTS, PRO FORMA FINANCIAL INFORMATION AND EXHIBITS.

(a) Not applicable.

(b) Not applicable

(c) Exhibits.

99.1 Settlement Agreement, dated as of August 12, 1998, by and between Sunbeam Corporation and Coleman (Parent) Holdings, Inc.

99.2 Press Release issued by Sunbeam Corporation on August 12, 1998.

99.3 Letter to Sunbeam shareholders dated August 12, 1998.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

SUNBEAM CORPORATION

By: /s/ Janet G. Kelley

Vice President, General Counsel
and Assistant Secretary

August 14, 1998

EXHIBIT INDEX

99.1 Settlement Agreement, dated as of August 12, 1998, by and between Sunbeam Corporation and Coleman (Parent) Holdings, Inc.

99.2 Press Release issued by Sunbeam Corporation on August 12, 1998.

99.3 Letter to Sunbeam shareholders dated August 12, 1998.

EXHIBIT 99.1

EXECUTION COPY

SETTLEMENT AGREEMENT

SETTLEMENT AGREEMENT, dated as of August 12, 1998, by and between Sunbeam Corporation, a Delaware corporation ("Sunbeam" or the "Company"), and Coleman (Parent) Holdings Inc., a Delaware corporation ("Coleman Parent").

For the purposes of this Agreement, Sunbeam, together with each direct or indirect parent, subsidiary, division, or affiliated corporation or entity, and each employee, agent, attorney, representative, administrator, executor, receiver, officer, director, or stockholder of any such corporation or entity, and any other person, firm, corporation or entity now or hereafter affiliated in any manner with any of them or claiming through or in the right of any of them and all of their respective predecessors, successors, assigns, heirs, executors and administrators (but excluding for all purposes under this Agreement, Mr. Albert J. Dunlap, former Chief Executive Officer of Sunbeam, Mr. Russell A. Kersh, former Executive Vice President of Sunbeam, Arthur Andersen LLP, Sunbeam's independent auditors, PriceWaterhouseCoopers, consultants to Sunbeam, and any financial advisor to Sunbeam, and each employee, agent, attorney, representative, administrator, executor, receiver, officer, director, or stockholder of any such corporation or entity, and any other person, firm, corporation or entity now or hereafter affiliated in any manner with any of them or claiming through or in the right of any of them and all of their respective predecessors, successors, assigns, heirs, executors and administrators), are collectively hereinafter referred to as the "Sunbeam Group"; and Coleman Parent, together with each direct or indirect parent, subsidiary, division, or affiliated corporation or entity, and each employee, agent, attorney, representative, administrator, executor, receiver, officer, director, or stockholder of any such corporation or entity, and any other person, firm, corporation or entity now or hereafter affiliated in any manner with any of them or claiming through or in the right of any of them and all of their respective predecessors, successors, assigns, heirs, executors and administrators, are collectively hereinafter referred to as the "Coleman Group".

W I T N E S S E T H

WHEREAS, CLN Holdings Inc., a Delaware corporation ("CLN Holdings"), was the indirect beneficial owner of approximately 82% of the outstanding common stock, par value $.01 per share (the "Coleman Common Stock"), of The Coleman Company, Inc., a Delaware corporation ("Coleman"); and

WHEREAS, pursuant to an Agreement and Plan of Merger, dated as of February 27, 1998 (the "Holdings Merger Agreement"), by and among Sunbeam, Laser Acquisition Corp., a Delaware corporation and, as of such date, a wholly owned subsidiary of Sunbeam ("Laser Acquisition"), CLN Holdings, as of such date, a wholly owned subsidiary of Coleman Parent, and Coleman Parent, CLN Holdings was merged with and into Laser Acquisition (the "Holdings Merger"), with the surviving corporation becoming an indirect wholly owned subsidiary of Sunbeam, and pursuant to which Coleman Parent received certain shares of common stock, par value $.01 per share, of Sunbeam ("Sunbeam Common Stock"); and

WHEREAS, pursuant to an Agreement and Plan of Merger, dated as of

February 27, 1998 (the "Coleman Merger Agreement"), by and among Sunbeam, Camper Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of Sunbeam ("Camper Acquisition"), and Coleman, Camper Acquisition is to be merged with and into Coleman (the "Coleman Merger"), with the surviving corporation becoming an indirect wholly owned subsidiary of Sunbeam; and

WHEREAS, as a result of the Holdings Merger, Sunbeam acquired an indirect approximately 82% interest in Coleman (the "Coleman Acquisition"); and

WHEREAS, Sunbeam and Coleman Parent are parties to a Registration Rights Agreement, dated as of March 29, 1998 (the "Registration Rights Agreement"), pursuant to which Sunbeam agreed to provide certain registration rights to Coleman Parent; and

WHEREAS, following the dismissal by Sunbeam of certain of its executive officers in mid-June 1998, Coleman Parent has made available to Sunbeam certain senior officers employed by members of the Coleman Group to serve as senior executive officers of Sunbeam (the "Senior Executives") and has provided certain other management support to Sunbeam, and Sunbeam desires to continue the service of the Senior Executives and such management support; and

WHEREAS, Coleman Parent and Sunbeam believe it is desirable that Sunbeam put in place as promptly as possible a permanent management team to prevent jeopardizing the ongoing operations and financial viability of Sunbeam; and

WHEREAS, Coleman Parent believes that it possesses legal and equitable claims against Sunbeam arising out of the Coleman Acquisition and out of what it contends were certain breaches of contract and fraudulent and negligent or other misrepresentations and omissions made to Coleman Parent and its representatives in connection therewith (the "Claims"), and Sunbeam disputes such Claims; and

WHEREAS, there are also now pending or may be filed putative class actions in which Sunbeam is named as a defendant and in which Coleman Parent is a class member (the "Class Actions"), and Sunbeam denies liability with respect to and intends to contest the claims that have been asserted in the Class Actions; and

WHEREAS, the accountants who audited Sunbeam's 1997 financial statements, assisted by another firm of accountants, are in the process of reviewing those financial statements, and believe, as has been publicly announced, that it will be necessary to restate those financial statements by reflecting a variety of adjustments the magnitude of which has not yet been determined; and

WHEREAS, Sunbeam and Coleman Parent desire to terminate the disputes between them, and desire to assure one another that Coleman Parent will not prosecute the Claims or any related or potential claims arising out of or relating to the Coleman Acquisition, directly or indirectly in any capacity, against the Sunbeam Group, so as to avoid the substantial burdens and expense of litigation and the interference with the business and operations of Sunbeam and with the work of its management and employees and to obtain the continued services of certain executives and employees of the Coleman Group, and in accordance with the terms and provisions hereof, that Coleman Parent and Sunbeam each forever release, waive and discharge any and all manner of actions, causes of action, proceedings, suits, claims, demands, liens, debts, accounts, obligations, rights, costs, contracts, agreements, promises, controversies, judgments, expenses, demands, damages and liabilities, of any nature whatsoever, in law or in equity, whether or not now foreseen, known, suspected, matured, accrued or claimed, and whether or not asserted in litigation, including court costs and attorneys' fees (each an "Action and Liability" and collectively, "Actions and Liabilities"), which any member of the Coleman Group controlling, controlled by or under common control with Coleman Parent (such persons, together with Coleman Parent, the "Coleman Controlled Group") may have against any member of the Sunbeam Group and which any member of the Sunbeam Group controlled by Sunbeam (such persons, together with Sunbeam, the "Sunbeam Controlled Group") may have against any member of the Coleman Group as of the effective date hereof or prior thereto in any manner arising out of or relating to the Coleman Acquisition, irrespective of any present lack of knowledge on the part of either of them of any such possible Action and Liability, but excluding any claim for breach of this Agreement or the agreements and documents entered into or delivered pursuant hereto;

NOW, THEREFORE, in consideration of the respective covenants, agreements and conditions hereinafter set forth and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be bound hereby, the parties hereto agree as follows:

1. Issuance of Warrants; Closing.

(a) On the basis of the representations, warranties, covenants and agreements and subject to the satisfaction or waiver (to the extent permitted) of the applicable conditions expressly set forth herein, at the closing of the transactions contemplated by this Section 1 (the "Closing"):

(i) Sunbeam shall issue to Coleman Parent certain warrants to purchase shares of Sunbeam Common Stock (the "Warrants") by duly executing and delivering to Coleman Parent a Warrant Agreement in the form attached as Exhibit A hereto (the "Warrant Agreement");

(ii) Sunbeam and Coleman Parent shall enter into an amendment to the Registration Rights Agreement, in the form attached as Exhibit B hereto (as so amended, the "Amended Registration Rights Agreement");

(iii) Sunbeam and Coleman Parent agree to be bound by the releases and covenants set forth in Section 2 of this Agreement;

(iv) Coleman Parent agrees to supply management services of the Senior Executives, and to the covenants and provisions of Section 3 of this Agreement; and

(v) Sunbeam and Coleman Parent agree to be bound by the provisions regarding the restrictions on transfer on the shares of Sunbeam Common Stock received by Coleman Parent in the Holdings Merger and the Warrants set forth in Section 4 of this Agreement.

(b) The Closing shall take place on the first day when all conditions thereto set forth herein shall be satisfied or waived or such other date as Sunbeam and Coleman Parent may agree in writing (the "Closing Date"), but in no event sooner than the tenth day following the mailing of the letter to Sunbeam shareholders contemplated by Section 7. The Closing shall take place on the Closing Date at 10:00 a.m., New York City time, at the offices of Wachtell, Lipton, Rosen & Katz, 51 West 52nd Street, New York, New York and shall be deemed effective as of the opening of business on the Closing Date.

(c) At the Closing, Sunbeam shall deliver or cause to be delivered to Coleman Parent, in addition to the Warrant Agreement, such other instruments or documents as Coleman Parent may reasonably request.

2. Granting of Releases and Indemnification.

(a) At the Closing, simultaneously with receipt by Coleman Parent of the Warrants, and without any further action by any of the parties hereto, each of the following shall be fully and legally effective:

(i) Coleman Parent shall, on behalf of itself and on behalf of each other member of the Coleman Controlled Group, remise, release and forever discharge the Sunbeam Group of and from all debts, demands, actions, causes of action, suits, accounts, covenants, contracts, agreements, damages, and any and all claims, demands and liabilities whatsoever of every name and nature, both in law and in equity, against any of the Sunbeam Group or any of their predecessors, successors or assigns, which Coleman Parent or any other member of the Coleman Controlled Group has or ever had from the beginning of the world to the Closing with respect to or arising out of the Coleman Acquisition or any alleged misrepresentations and omissions and/or breach of contract by any member of the Sunbeam Group and parties acting on behalf of any member of the Sunbeam Group in connection with the Coleman Acquisition, including with respect to the Actions and Liabilities; provided that neither the foregoing release nor the dismissals or withdrawals described in this Section 2(a) shall apply to the rights of Coleman Parent and any other member of the Coleman Controlled Group under Article IX of the Holdings Merger Agreement, any breach or failure to comply with this Agreement, the Warrant, the Amended Registration Rights Agreement or the transactions contemplated hereby or thereby, the transactions contemplated by the Coleman Merger Agreement (including the Coleman Merger), which shall not be terminated or amended in any respect hereby, or shall otherwise affect Coleman Parent's right to enforce this Agreement, the Warrant or the Amended Registration Rights Agreement in accordance with its or their terms.

(ii) In the event any member of the Coleman Controlled Group pursues a claim against any person(s) not released hereby involving the matters that are the subject of the release set forth in Section 2(a)(i) and it is finally judicially determined that such person(s) are entitled directly or indirectly to indemnification or contribution from any member of the Sunbeam Controlled Group for any amounts they are required to pay to any member of the Coleman Controlled Group in connection with such claims, or to reimbursement of litigation expenses solely attributable to such claims of any member of the Coleman Controlled Group (each a "Sunbeam Group Indemnification Obligation"), Coleman Parent will indemnify and hold harmless each member of the Sunbeam Controlled Group against such Sunbeam Group Indemnification Obligation. No member of the Sunbeam Controlled Group will enter into any settlement of a Sunbeam Group Indemnification Obligation without the prior written consent of Coleman Parent, which shall not be unreasonably withheld. Any amounts so paid by a member of the Sunbeam Controlled Group in a settlement so consented to by Coleman Parent shall be treated for purposes hereof as a Sunbeam Group Indemnification Obligation.

(iii) Sunbeam, on behalf of itself and on behalf of each other member of the Sunbeam Controlled Group, shall remise, release and forever discharge the Coleman Group of and from all debts, demands, actions, causes of action, suits, accounts, covenants, contracts, agreements, damages, and any and all claims, demands and liabilities whatsoever of every name and nature, both in law and in equity, against any of the Coleman Group or any of their predecessors, successors or assigns, which Sunbeam or any member of the Sunbeam Controlled Group has or ever had from the beginning of the world to the Closing with respect to or arising out of the Coleman Acquisition or any alleged misrepresentations and omissions and/or breach of contract by any member of the Coleman Group and parties acting on behalf of any member of the Coleman Group in connection with the Coleman Acquisition, including with respect to the Actions and Liabilities; provided that neither the foregoing release nor the dismissals or withdrawals described in this Section 2(a) shall apply to the rights of Sunbeam and any other member of the Sunbeam Controlled Group under Article IX of the Holdings Merger Agreement, any breach or failure to comply with this Agreement, the Warrant, the Amended Registration Rights Agreement or the transactions contemplated hereby or thereby, the transactions contemplated by the Coleman Merger Agreement (including the Coleman Merger), which shall not be terminated or amended in any respect hereby, or shall otherwise affect Sunbeam's right to enforce this Agreement, the Warrant or the Amended Registration Rights Agreement in accordance with its or their terms.

(iv) In the event any member of the Sunbeam Controlled Group pursues a claim against any person(s) not released hereby involving the matters that are the subject of the release set forth in Section 2(a)(iii) and it is finally judicially determined that such person(s) are entitled directly or indirectly to indemnification or contribution from any member of the Coleman Controlled Group for any amounts they are required to pay to any member of the Sunbeam Controlled Group in connection with such claims, or to reimbursement of litigation expenses solely attributable to such claims of any member of the Sunbeam Controlled Group, (each, a "Coleman Group Indemnification Obligation"), Sunbeam will indemnify and hold harmless each member of the Coleman Controlled Group against such Coleman Group Indemnification Obligation. No member of the Coleman Controlled Group will enter into any settlement of a Coleman Group Indemnification Obligation without the prior written consent of Sunbeam, which shall not be unreasonably withheld. Any amounts so paid by a member of the Coleman Controlled Group in a settlement so consented to by Sunbeam shall be treated for purposes hereof as a Coleman Group Indemnification Obligation.

(v) Sunbeam, on behalf of itself, and on behalf of each other member of the Sunbeam Controlled Group, and Coleman Parent, on behalf of itself and on behalf of each other member of the Coleman Controlled Group, agree to indemnify and hold harmless one another from and against any and all Actions and Liabilities arising from, or in connection with, any action or proceeding, brought by, or prosecuted by, or on the initiative of, either of them, or by any of their predecessors, successors or assigns, contrary to the provisions of this Agreement. It is further agreed that this agreement of indemnity shall be deemed breached and a cause of action shall be deemed to have accrued thereon immediately upon the commencement of any action contrary to this Agreement, and that in any such action this Agreement may be pleaded by either of them as a defense, or either of them may assert this Agreement by way of counterclaim or cross-claim in any such action.

(vi) This Agreement shall inure to the benefit of and shall be binding upon Sunbeam and Coleman Parent, and to the benefit of and shall be binding upon each person or entity in the Sunbeam Group and the Coleman Group.

(b) Coleman Parent agrees that it shall opt out, as to and only as to any claims against any member of the Sunbeam Group, of any class that may be certified in any of the Class Actions or in any other action that may be certified as a class action with respect to or arising out of any other matter released hereby.

3. Provision of Management Services.

(a) The parties hereto acknowledge that Coleman Parent has caused other members of the Coleman Group to make available to Sunbeam the services of certain employees and Senior Executives and has encouraged such persons to continue to provide services to Sunbeam as employees of Sunbeam.

(b) Coleman Parent agrees that it shall, and it shall use its reasonable efforts to cause the other members of the Coleman Group to, continue to, for a minimum period of 36 months from the date hereof, make available to Sunbeam the services of Coleman Group's employees who are Senior Executives, or who become Senior Executives, for so long as they remain employees of a member of the Coleman Group and otherwise to continue to provide advice and assistance to Sunbeam in connection with the business and operations of Sunbeam consistent with that provided to date; provided, however, that, other than pursuant to the employment arrangements currently in place between such employees and members of the Coleman Group, no member of the Coleman Group shall be required bear any incremental expense with respect to any Senior Executive in order to comply with the foregoing.

(c) Sunbeam agrees to pay the compensation of any such persons who become employees of Sunbeam in accordance with the terms of the employment arrangements entered into by Sunbeam with such persons. This Agreement shall not prevent any of the Senior Executives from continuing to perform services for members of the Coleman Group to the extent that the provision of such services does not materially interfere with the performance of services by the Senior Executive for Sunbeam under his employment arrangements with Sunbeam.

(d) Coleman Parent agrees to use its reasonable efforts to cause the other members of the Coleman Group to continue, for a period of 36 months from the date hereof, to provide assistance and support to Sunbeam on a basis consistent with the manner in which such assistance and support are generally provided to other companies in which members of the Coleman Group have a substantial interest (and without the payment of additional consideration by Sunbeam to Coleman Parent, other than with respect to the reimbursement of out-of-pocket expenses paid to third parties) and of a similar nature to those which have been so provided to Sunbeam from time to time from mid-June 1998 through the date hereof, including as to the following matters:

(i) financings, and dealings with financing sources and the capital markets;

(ii) investor and public relations;

(iii) acquisitions, divestitures and other extraordinary transactions;

(iv) executive benefits and compensation and other personnel matters; and

(v) compliance, litigation, insurance, regulatory and other legal matters.

4. Restrictions on Transfer of Securities. Coleman Parent hereby agrees not to, directly or indirectly, for a period of three (3) years from the date hereof, Transfer (as such term is defined in Section 7.1 of the Holdings Merger Agreement) (A) any shares of Sunbeam Common Stock received pursuant to the terms of the Holdings Merger Agreement or (B) any of the Warrants or the Warrant Shares (as defined in the Warrant Agreement), in either case in whole or in part, other than to one of its Affiliates (as such term is defined in the Holdings Merger Agreement) who agrees in writing to be bound by the terms of this Section 4, except that (A) the holder or holders of such shares of Sunbeam Common Stock may at any time or from time to time Transfer so many of such shares of Sunbeam Common Stock as represent in the aggregate seventy-five percent (75%) of such shares of Sunbeam Common Stock, and (B) the holder or holders of the Warrants or the Warrant Shares may at any time or from time to time Transfer so many of the Warrants or the Warrant Shares as represent in the aggregate fifty (50%) of the Warrant Shares Amount (as defined in the Warrant Agreement). The provisions of this Section 4 shall not be applicable, and Coleman Parent shall be free to Transfer any and all shares of Sunbeam Common Stock, Warrants and Warrant Shares, (i) following any change of control of Sunbeam or (ii) in connection with any transaction in which the holders of all of the outstanding shares of Sunbeam Common Stock have the opportunity to Transfer at least 50% of their shares of Sunbeam Common Stock on the same terms. The provisions of this Section 4 shall supersede any and all other restrictions on Transfer that Coleman Parent or any of its Affiliates may have agreed to with Sunbeam or any of its Affiliates.

5. Representations and Warranties of Sunbeam. Sunbeam hereby represents and warrants to Coleman Parent as follows:

(a) Due Authorization. This Agreement has been duly authorized by all necessary corporate action on the part of Sunbeam, and no other corporate actions or proceedings on the part of Sunbeam (including any action on the part of its stockholders) are necessary to authorize this Agreement or the transactions contemplated hereby. This Agreement has been duly executed by a duly authorized officer of Sunbeam and constitutes a valid and binding agreement of Sunbeam enforceable against it in accordance with its terms. The Audit Committee of the Board of Directors of Sunbeam (the "Audit Committee") has expressly approved the transactions contemplated hereby as contemplated by Paragraph 312 ("Paragraph 312") of the New York Stock Exchange ("NYSE") Listed Company Manual and has determined that delay in securing shareholder approval of the transactions contemplated hereby would seriously jeopardize the financial viability of the Company. Upon application duly made by Sunbeam, the NYSE has advised that it has accepted Sunbeam's reliance on the exception to the shareholder approval policy of Paragraph 312 as contained therein in connection with the transactions contemplated hereby (the "Exception").

(b) Due Organization. Sunbeam is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and has the requisite corporate power to enter into and perform this Agreement and to carry on its business as it is now being conducted.

(c) No Conflicts. No filing with, and no permit, authorization, consent or approval of, any governmental or regulatory authority is necessary for the consummation by Sunbeam of the transactions contemplated hereby, other than as may be required under the Hart-Scott-Rodino Antitrust Improvements Act with respect to the exercise of the Warrants. Neither the execution and delivery of this Agreement by Sunbeam nor the consummation by Sunbeam of the transactions contemplated hereby, nor compliance by Sunbeam with any of the provisions hereof, will (i) conflict with or result in any breach of any provisions of the certificate of incorporation or by-laws of Sunbeam; (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration) under, any of the terms, conditions or provisions of any material contract or of any material license, franchise, permit, concession, certificate of authority, order, approval, application or registration of, from or with any governmental authority to which Sunbeam is a party or by which it or any of its properties or assets may be bound; or (iii) violate any order, writ, injunction, decree, statute, rule or regulation applicable to Sunbeam or any of its properties or assets.

(d) Validity of Warrants and Underlying Shares. At the Closing, the issuance of the Warrants will have been duly authorized and, upon their issuance pursuant to the terms of this Agreement, the Warrants will be validly issued and will not be subject to any preemptive or similar right other than the rights and obligations under the Warrant Agreement. All shares of Sunbeam Common Stock to be issued upon the exercise of the Warrants, when issued, will be duly authorized and validly issued, fully paid and nonassessable and will not be subject to any preemptive or similar right.

(e) Capitalization. The authorized capital stock of Sunbeam consists of 500,000,000 shares of Sunbeam Common Stock, and 2,000,000 shares of preferred stock, par value $.01 per share, of Sunbeam. As of the date hereof, (i) 100,860,129 shares of Sunbeam Common Stock were issued and outstanding (excluding any shares of Sunbeam Common Stock issued upon the exercise of Sunbeam Stock Options (as defined below) since August 6, 1998); (ii) 7,199,452 shares of Sunbeam Common Stock were issuable upon the consummation of the Coleman Merger Agreement; (iii) 13,242,050 shares of Sunbeam Common Stock were issuable in accordance with the terms of the Zero Coupon Convertible Senior Subordinated Debentures due 2018 of the Company; and (iv) no shares of Sunbeam preferred stock were issued and outstanding. As of the date hereof, not more than 9,000,000 shares of Sunbeam Common Stock were issuable upon exercise of vested and unvested employee and non-employee stock options (the "Sunbeam Stock Options") outstanding under all stock option plans of Sunbeam or granted pursuant to employment agreements (although Sunbeam is contesting the validity of certain of such Sunbeam Stock Options). As of the date hereof, no shares of Sunbeam Common Stock were held as treasury shares. All of the issued and outstanding shares of Sunbeam Common Stock are validly issued, fully paid and nonassessable and free of preemptive rights. As of the date hereof, except as set forth above, there are no shares of capital stock of Sunbeam issued or outstanding or, except as set forth above, any options, warrants, subscriptions, calls, rights, convertible securities or other agreements or commitments obligating Sunbeam to issue, transfer, sell, redeem, repurchase or otherwise acquire any shares of its capital stock or securities, or the capital stock or securities of Sunbeam. There are no notes, bonds, debentures or other indebtedness of Sunbeam having the right to vote (or convertible into or exchangeable for securities having the right to vote) on any matters upon which stockholders of Sunbeam may vote.

(f) Brokers. Other than Blackstone Financial Group, which has acted as financial advisor to the Special Committee of the Sunbeam Board, no broker, investment banker or other person is entitled to any broker's, finder's or other similar fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of Sunbeam or any member of the Sunbeam Group.

6. Representations and Warranties of Coleman Parent. Coleman Parent hereby represents and warrants to Sunbeam as follows:

(a) Due Authorization. This Agreement has been duly authorized by all necessary corporate action on the part of Coleman Parent, and no other corporate actions or proceedings on the part of the Coleman Parent (including any action on the part of its stockholders) are necessary to authorize this Agreement or the transactions contemplated hereby. This Agreement has been duly executed by a duly authorized officer of Coleman Parent and constitutes a valid and binding agreement of Coleman Parent enforceable against it in accordance with its terms.

(b) Due Organization. Coleman Parent is a corporation duly organized, validly existing and in good standing under the laws of State of Delaware and has the requisite corporate power to enter into and perform this Agreement.

(c) No Conflicts. No filing with, and no permit, authorization, consent or approval of, any governmental or regulatory authority is necessary for the consummation by Coleman Parent of the transactions contemplated hereby, other than as may be required under the Hart-Scott-Rodino Antitrust Improvements Act with respect to the exercise of the Warrants. Neither the execution and delivery of this Agreement by Coleman Parent nor the consummation by Coleman Parent of the transactions contemplated hereby, nor compliance by Coleman Parent with any of the provisions hereof, will (i) conflict with or result in any breach of any provisions of the certificate of incorporation or by-laws of Coleman Parent; (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration) under, any of the terms, conditions or provisions of any material contract or of any material license, franchise, permit, concession, certificate of authority, order, approval, application or registration of, from or with any governmental authority to which Coleman Parent is a party or by which it or any of its properties or assets may be bound; or (iii) violate any order, writ, injunction, decree, statute, rule or regulation applicable to Coleman Parent or any of its properties or assets.

(d) Acquisition of Warrants for Investment. Coleman Parent is acquiring the Warrants (and will acquire any Warrant Shares upon exercise of the Warrants) for its own account for investment purposes only and not with a view toward or for a sale in connection with, any distribution thereof, or with any present intention of distributing or selling any of such in violation of federal or state securities laws.

(e) Brokers. No broker, investment banker or other person is entitled to any broker's, finder's or other similar fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of Coleman Parent or any member of the Coleman Group.

7. Covenants.

(a) Within one day following the date hereof, Sunbeam shall cause to be mailed to all shareholders of Sunbeam a letter informing them of the transactions contemplated hereby as contemplated and required by Paragraph 312 of the NYSE Listed Company Manual and indicating that the Audit Committee has expressly approved the Exception in light of the Audit Committee's determination that delay in securing shareholder approval of the transactions contemplated hereby would seriously jeopardize the financial viability of the Company and that the NYSE has accepted the Company's reliance on the Exception .

(b) The anti-dilution provisions of the Warrant shall be given retroactive effect to the date hereof.

8. Specific Performance. The parties acknowledge that money damages are an inadequate remedy for breach of this Agreement. Therefore, the parties agree that each of them has the right, in addition to (and not in lieu of) any other right they may have under this Agreement or otherwise, to specific performance of this Agreement in the event of any breach hereof by any other party.

9. Conditions to the Obligations of both Parties. The obligations of each of Sunbeam and Coleman Parent to effect the transactions contemplated hereby shall be conditioned on the non-existence of any order, decree or injunction of a court of competent jurisdiction which restrains the consummation of the transactions contemplated by this Agreement.

10. Termination. This Agreement may be terminated at any time prior to the Closing:

(a) by mutual agreement of the Boards of Directors of Coleman Parent and Sunbeam; or

(b) by Coleman Parent if the Warrants to be issued to Coleman Parent pursuant hereto have not been issued or will not be issued at the Closing or if there has been a material violation or breach by Sunbeam of any agreement, representation or warranty contained in this Agreement which has rendered the satisfaction of any condition to the obligations of Coleman Parent impossible and such violation or breach has not been waived by Coleman Parent; or

(c) by Sunbeam if there has been a material violation or breach by Coleman Parent of any agreement, representation or warranty contained in this Agreement which has rendered the satisfaction of any condition to the obligations of Sunbeam impossible and such violation or breach has not been waived by Sunbeam.

In the event of termination and abandonment of this Agreement by Coleman Parent or Sunbeam or both of them pursuant to the terms of this Section 10, written notice thereof shall forthwith be given to the other party and this Agreement shall terminate and the transactions contemplated hereby shall be abandoned, without further action by any of the parties hereto.

11. Expenses. All costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby will be paid by the party incurring such costs and expenses.

12. Tax Matters. Coleman Parent shall in good faith provide to Sunbeam information concerning the tax treatment under the Internal Revenue Code of 1986, as amended (the "Code"), of the transactions contemplated hereby. Sunbeam shall report such transactions for all tax purposes consistent with such information and take no position with any taxing authority inconsistent therewith. Coleman Parent and Sunbeam shall report the Holdings Merger as a reorganization within the meaning of Code Section 368(a) for all tax purposes.

13. Best Efforts. Each of the parties hereto agrees to use its best efforts to take, or cause to be taken, all action, and to do, or cause to be done, all things necessary, proper or advisable under applicable laws and regulations to consummate and make effective the transactions contemplated by this Agreement. In case at any time after the Closing any further action is necessary or desirable to carry out the purposes of this Agreement, the proper officers and directors of each corporation which is a party to this Agreement shall take all such necessary action.

14. Parties in Interest; Assignments. This Agreement is binding upon and is solely for the benefit of the parties hereto, the Sunbeam Group and the Coleman Group and their respective successors and legal representatives.

15. Entire Agreement. This Agreement and the agreements to be entered into and delivered pursuant hereto constitutes the entire agreement between Sunbeam and Coleman Parent with respect to the subject matter hereof, and it is expressly understood and agreed that this Agreement may not be altered, amended, modified, or otherwise changed in any respect or particular whatsoever, except by a writing duly executed by authorized representatives of both Sunbeam and Coleman Parent. No party to this Agreement has relied upon any representation or warranty, written or oral, except as expressly included herein.

16. Amendments. This Agreement may not be modified, amended, altered or supplemented except upon the execution and delivery of a written agreement executed by the parties hereto.

17. Notices. All notices, requests, claims, demands and other communications hereunder shall be in writing and shall be given (and shall be deemed to have been duly given upon receipt) by delivery in person, by telecopy or other standard form of telecommunication, or by registered or certified mail, postage prepaid, return receipt requested, addressed as follows:

If to Coleman Parent:

Coleman (Parent) Holdings Inc.
c/o MacAndrews & Forbes Holdings Inc.
35 East 62nd Street
New York, New York 10021
Attention: Barry F. Schwartz, Esq.
Facsimile: (212) 572-5056

with a copy to:

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, New York 10019
Attention: Adam O. Emmerich, Esq.
Facsimile: (212) 403-2000

If to Sunbeam:

Sunbeam Corporation
1615 South Congress Avenue, Suite 200
Delray Beach, Florida 33445
Attention: Corporate Secretary
Facsimile: (561) 243-2191

with copies to:

Skadden, Arps, Slate, Meagher & Flom LLP
919 Third Avenue
New York, New York 10022

Attention: Blaine V. Fogg, Esq.
Facsimile: (212) 735-3597

and

Weil, Gotshal & Manges LLP
767 Fifth Avenue
New York, New York 10152
Attention: Stephen E. Jacobs, Esq.
Facsimile: (212) 310-8007

or to such other address as any party may have furnished to the other parties in writing in accordance herewith.

18. Governing Law; Forum.

(a) This Agreement shall be governed by and construed in accordance with the laws of the State of Delaware without regard to its conflict of law rules.

(b) The parties hereto irrevocably and unconditionally consent to submit to the exclusive jurisdiction of the courts of the State of Delaware and/or of the United States of America located in the State of Delaware for any actions, suits or proceedings out of or relating to this Agreement and the transactions contemplated hereby.

19. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed to be an original but all of which together shall constitute but one agreement.

20. Effect of Headings. The descriptive headings contained herein are for convenience only and shall not affect in any way the meaning or interpretation of this Agreement.

21. Interpretation. When a reference is made in this Agreement to an Article or Section, such reference shall be to an Article or Section of this Agreement unless otherwise indicated. Whenever the words "include", "includes" or "including" are used in this Agreement, they shall be deemed to be followed by the words "without limitation". The words "hereof", "herein" and "hereunder" and words of similar import when used in this Agreement shall refer to this Agreement as a whole and not to any particular provision of this Agreement. The definitions contained in this Agreement are applicable to the singular as well as the plural forms of such terms and to the masculine as well as to the feminine and neuter genders of such term. References to a person are also to its permitted successors and assigns and, in the case of an individual, to his heirs and estate, as applicable.

IN WITNESS WHEREOF, the parties have caused this Agreement to be duly executed on the day and year first above written.

COLEMAN (PARENT) HOLDINGS INC.

By: /s/ Barry F. Schwartz

Name: Barry F. Schwartz
Title: Executive Vice President and General Counsel

SUNBEAM CORPORATION

By: /s/ Howard Kristol

Name: Howard Kristol
Title: Chairman of the Special Committee

EXHIBIT A

SUNBEAM CORPORATION
WARRANT FOR THE PURCHASE OF SHARES OF
COMMON STOCK OF SUNBEAM CORPORATION
ISSUE DATE: AUGUST__, 1998

WARRANT NO. W-1 23,000,000 WARRANT SHARES

THIS WARRANT AND THE SHARES OF COMMON STOCK PURCHASEABLE HEREUNDER HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR UNDER THE SECURITIES LAWS OF ANY STATE OR OTHER JURISDICTION AND MAY NOT BE SOLD OR OTHERWISE TRANSFERRED OR DISPOSED OF UNLESS REGISTERED OR QUALIFIED UNDER SAID ACT AND APPLICABLE STATE SECURITIES LAWS OR UNLESS SUCH REGISTRATION, QUALIFICATION OR OTHER SUCH ACTIONS ARE NOT REQUIRED UNDER ANY SUCH LAWS.

FOR VALUE RECEIVED, SUNBEAM CORPORATION, a Delaware corporation (the "Company"), hereby certifies that Coleman (Parent) Holdings Inc., its successor or permitted assigns (the "Holder"), is entitled, subject to the provisions of this Warrant, to purchase from the Company, at the times specified herein, a number of the fully paid and non-assessable shares of Common Stock of the Company, par value $.01 per share (the "Common Stock"), equal to the Warrant Share Amount (as hereinafter defined) at a purchase price per share equal to the Exercise Price (as hereinafter defined).

SECTION 1. DEFINITIONS. (a) The following terms, as used herein, have the following meanings:

"AFFILIATE" shall have the meaning given to such term in Rule 12b-2 promulgated under the Securities and Exchange Act of 1934, as amended.

"BUSINESS DAY" means any day except a Saturday, Sunday or other day on which commercial banks in The City of New York are authorized by law to close.

"CERTIFICATE OF INCORPORATION" means the Restated Certificate of Incorporation of the Company.

"CLOSING PRICE" on any day means (1) if the shares of Common Stock then are listed and traded on the New York Stock Exchange, Inc. ("NYSE"), the Closing Price on such day as reported on the NYSE Composite Transactions Tape; (2) if shares of Common Stock then are not listed and traded on the NYSE, the Closing Price on such day as reported by the principal national securities exchange on which the shares of Common Stock are listed and traded; (3) if the shares of Common Stock then are not listed and traded on any such securities exchange, the last reported sale price on such day on the National Market of The National Association of Securities Dealers, Inc. Automated Quotation System ("NASDAQ"); or (4) if the shares of Common Stock then are not traded on the NASDAQ National Market, the average of the highest reported bid and the lowest reported asked price on such day as reported by NASDAQ.

"COMMON SHARE EQUIVALENT" means, with respect to any security of the Company and as of a given date, a number which is, (i) in the case of a share of Common Stock, one, (ii) in the case of all or a portion of any right, warrant or other security which may be exercised for a share or shares of Common Stock, the number of shares of Common Stock receivable upon exercise of such security (or such portion of such security), and (iii) in the case of any security convertible or exchangeable into a share or shares of Common Stock, the number of shares of Common Stock that would be received if such security were converted or exchanged on such date.

"COMMON STOCK" shall have the meaning set forth in the first paragraph hereof.

"COMPANY" shall have the meaning set forth in the first paragraph hereof.

"CONVERTIBLE SECURITIES" shall have the meaning set forth in Section 7(d).

"DETERMINATION DATE" shall have the meaning set forth in Section 7(f).

"EXERCISE PRICE" means a price per Warrant Share equal to $7.00.

"EXPIRATION DATE" means 5:00 p.m. New York City time on August __, 2003 [the fifth anniversary of the date of this Warrant].

"FAIR MARKET VALUE" as at any date of determination means, as to shares of the Common Stock, if the Common Stock is publicly traded at such time, the average of the daily Closing Prices of a share of Common Stock for the ten (10) consecutive trading days ending on the most recent trading day prior to the date of determination. If the shares of Common Stock are not publicly traded at such time, and as to all things other than the Common Stock, Fair Market Value shall be determined in good faith by an independent nationally recognized investment banking firm selected by the Company and acceptable to a majority of the Holders and which shall have no other substantial relationship with the Company.

"HOLDER" shall have the meaning set forth in the first paragraph hereof.

"OPTIONS" shall have the meaning set forth in Section 7(d).

"PERSON" means an individual, partnership, corporation, limited liability company, trust, joint stock company, association, joint venture, or any other entity or organization, including a government or political subdivision or an agency or instrumentality thereof.

"SECURITIES ACT" means the Securities Act of 1933, as amended.

"SUBSIDIARY" means, with respect to any Person, any corporation or other entity of which a majority of the capital stock or other ownership interests having ordinary voting power to elect a majority of the board of directors or other persons performing similar functions are at the time directly or indirectly owned by such Person.

"WARRANT SHARE AMOUNT" means 23,000,000 (Twenty Three Million) shares of Common Stock as such number may be adjusted pursuant to Sections 7 and 8.

"WARRANT SHARES" means the shares of Common Stock deliverable upon exercise of this Warrant, as adjusted from time to time.

SECTION 2. EXERCISE OF WARRANT. (a) The Holder is entitled to exercise this Warrant in whole or in part at any time, or from time to time, until the Expiration Date or, if such day is not a Business Day, then on the next succeeding day that shall be a Business Day. To exercise this Warrant, the Holder shall deliver to the Company this Warrant, including the Warrant Exercise Subscription Form forming a part hereof duly executed by the Holder, together with payment of the applicable Exercise Price. Upon such delivery and payment, the Holder shall be deemed to be the holder of record of the number of Warrant Shares equal to the Warrant Share Amount (or, in the case of a partial exercise of this Warrant, a ratable number of such shares), notwithstanding that the stock transfer books of the Company shall then be closed or that certificates representing such shares shall not then be actually delivered to the Holder.

(b) At the option of the Holder, the Exercise Price may be paid in cash (including by wire transfer of immediately available funds) or by certified or official bank check or bank cashier's check payable to the order of the Company or by any combination of such cash or check. At the option of the Holder, the Exercise Price may in the alternative be paid in whole or in part by reducing the number of shares of Common Stock issuable to the Holder by a number of shares of Common Stock that have a Fair Market Value equal to the Exercise Price which otherwise would have been paid (so that the net number of shares of Common Stock issued in respect of such exercise shall equal the number of shares of Common Stock that would have been issuable had the Exercise Price been paid entirely in cash, less a number of shares of Common Stock with a Fair Market Value equal to the portion of the Exercise Price paid in kind); provided that this option shall be available only with respect to the exercise of this Warrant with respect to not more than one-half of the total number of Warrant Shares. The Company shall pay any and all documentary, or similar issue or transfer taxes payable in respect of the issue or delivery of the Warrant Shares. The Company shall not, however, be required to pay any transfer tax which may be payable in respect of any transfer involved in the issue or delivery of Warrants or Warrant Shares (or other securities or assets) in a name other than that in which the Warrants so exercised were registered, and no such issue or delivery shall be made unless and until the person requesting such issue has paid to the Company the amount of such transfer tax or has established, to the satisfaction of the Company, that such transfer tax has been paid.

(c) If the Holder exercises this Warrant in part, this Warrant shall be surrendered by the Holder to the Company and a new Warrant of the same tenor and for the unexercised number of Warrant Shares shall be executed by the Company. The Company shall register the new Warrant in the name of the Holder or in such name or names of its transferee pursuant to Section 6 as may be directed in writing by the Holder and deliver the new Warrant to the Person or Persons entitled to receive the same.

(d) Upon surrender of this Warrant in conformity with the foregoing provisions, the Company shall, subject to the expiration of any applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act, transfer to the Holder of this Warrant appropriate evidence of ownership of the shares of Common Stock or other securities or property (including any money) to which the Holder is entitled, registered or otherwise placed in, or payable to the order of, the name or names of the Holder or such transferee as may be directed in writing by the Holder, and shall deliver such evidence of ownership and any other securities or property (including any money) to the Person or Persons entitled to receive the same, together with an amount in cash in lieu of any fraction of a share as provided in Section 5, subject to any required withholding.

SECTION 3. RESTRICTIVE LEGEND. Each certificate representing shares of Common Stock issued pursuant to this Warrant, unless at the time of exercise such shares are registered under the Securities Act, shall bear a legend substantially in the form of the legend set forth on the first page of this Warrant.

SECTION 4. RESERVATION OF SHARES. The Company hereby agrees that at all times there shall be reserved for issuance and delivery upon exercise of this Warrant such number of its authorized but unissued shares of Common Stock or other securities of the Company from time to time issuable upon exercise of this Warrant as will be sufficient to permit the exercise in full of this Warrant. The Company hereby represents and agrees that all such shares shall be duly authorized and, when issued upon such exercise, shall be validly issued, fully paid and non-assessable, free and clear of all liens, security interests, charges and other encumbrances or restrictions on sale and free and clear of all preemptive or similar rights, except to the extent imposed by or as a result of the status, act or omission of, the Holder.

SECTION 5. FRACTIONAL SHARES. No fractional shares or scrip representing fractional shares shall be issued upon the exercise of this Warrant and in lieu of delivery of any such fractional share upon any exercise hereof, the Company shall pay to the Holder an amount in cash equal to such fraction multiplied by the Fair Market Value thereof; provided, however, that, in the event that the Company combines or reclassifies the outstanding shares of its Common Stock into a smaller number of shares, it shall be required to issue fractional shares to the Holder if the Holder exercises all or any part of its Warrants, unless the Holder has consented in writing to such reduction and provided the Company with a written waiver of its right to receive fractional shares in accordance with this Section 5.

SECTION 6. TRANSFER, EXCHANGE OR ASSIGNMENT OF WARRANT. (a) Each taker and holder of this Warrant by taking or holding the same, consents and agrees that the registered holder hereof may be treated by the Company and all other persons dealing with this Warrant as the absolute owner hereof for any purpose and as the person entitled to exercise the rights represented hereby.

(b) Subject to the requirements of state and federal securities laws, the Holder of this Warrant shall be entitled, without obtaining the consent of the Company to assign and transfer this Warrant, at any time in whole or from time to time in part, to any Person or Persons. Subject to the preceding sentence, upon surrender of this Warrant to the Company, together with the attached Warrant Assignment Form duly executed, the Company shall, without charge, execute and deliver a new Warrant in the name of the assignee or assignees named in such instrument of assignment and, if the Holder's entire interest is not being assigned, in the name of the Holder and this Warrant shall promptly be canceled.

(c) Upon receipt by the Company of evidence satisfactory to it (in the exercise of its reasonable discretion) of the loss, theft, destruction or mutilation of this Warrant, and (in the case of loss, theft or destruction) of indemnification or security reasonably required by the Company, and upon surrender and cancellation of this Warrant, if mutilated, the Company shall execute and deliver a new Warrant of like tenor and date.

(d) The Company shall pay all expenses, taxes (other than transfer taxes) and other charges payable in connection with the preparation, issuance and delivery of Warrants hereunder.

SECTION 7. ANTI-DILUTION PROVISIONS. So long as any Warrants are outstanding, the Warrant Share Amount shall be subject to change or adjustment as follows:

(a) Common Stock Dividends, Subdivisions, Combinations. In case the Company shall (i) pay or make a dividend or other distribution to all holders of its Common Stock in shares of Common Stock, (ii) subdivide or split the outstanding shares of its Common Stock into a larger number of shares, or (iii) combine the outstanding shares of its Common Stock into a smaller number of shares (which shall not in any event be done without the express written approval of Holders of a majority of the outstanding Warrants), then in each such case the Warrant Share Amount shall be adjusted to equal the number of such shares to which the holder of this Warrant would have been entitled upon the occurrence of such event had this Warrant been exercised immediately prior to the happening of such event or, in the case of a stock dividend or other distribution, prior to the record date for determination of shareholders entitled thereto. An adjustment made pursuant to this Section 7(a) shall become effective immediately after the effective date of such event retroactive to the record date, if any, for such event.

(b) Reorganization or Reclassification. In case of any capital reorganization or any reclassification of the capital stock of the Company (whether pursuant to a merger or consolidation or otherwise), or in the event of any similar transaction, this Warrant shall thereafter be exercisable for the number of shares of stock or other securities or property receivable upon such capital reorganization or reclassification of capital stock or other transaction, as the case may be, by a holder of the number of shares of Common Stock into which this Warrant was exercisable immediately prior to such capital reorganization or reclassification of capital stock; and, in any case, appropriate adjustment (as determined in good faith by the Board of Directors of the Company) shall be made for the application of the provisions herein set forth with respect to the rights and interests thereafter of the Holder of this Warrant to the end that the provisions set forth herein shall thereafter be applicable, as nearly as reasonably practicable, in relation to any shares of stock or other securities or property thereafter deliverable upon the exercise of this Warrant. An adjustment made pursuant to this Section 7(b) shall become effective immediately after the effective date of such event retroactive to the record date, if any, for such event.

(c) Distributions of Assets or Securities Other than Common Stock. In case the Company shall, by dividend or otherwise, distribute to all holders of its Common Stock shares of any class of its capital stock (other than Common Stock), or other debt or equity securities or evidences of indebtedness of the Company, or options, rights or warrants to purchase any of such securities, cash or other assets, then in each such case the Warrant Share Amount shall be adjusted by multiplying the Warrant Share Amount immediately prior to the date of such dividend or distribution by a fraction, of which the numerator shall be the Fair Market Value per share of Common Stock at the record date for determining shareholders entitled to such dividend or distribution, and of which the denominator shall be such Fair Market Value per share less the Fair Market Value of the portion of the securities, cash, other assets or evidences of indebtedness so distributed applicable to one share of Common Stock. An adjustment made pursuant to this Section 7(c) shall become effective immediately after the effective date of such event retroactive to the record date, if any, for such event.

(d) Below Market Issuances of Common Stock and Convertible Securities. In case the Company shall issue Common Stock (or options, rights or warrants to purchase shares of Common Stock (collectively, "Options") or other securities convertible into or exchangeable or exercisable for shares of Common Stock (such other securities, collectively, "Convertible Securities")) at a price per share (or having an effective exercise, exchange or conversion price per share together with the purchase price thereof) less than the Fair Market Value per share of Common Stock on the date such Common Stock (or Options or Convertible Securities), is sold or issued (provided that no sale of securities pursuant to an underwritten public offering shall be deemed to be for less than Fair Market Value), then in each such case the Warrant Share Amount shall thereafter be adjusted by multiplying the Warrant Share Amount immediately prior to the date of issuance of such Common Stock (or Options or Convertible Securities) by a fraction, the numerator of which shall be (x) the sum of (i) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such issuance and (ii) the number of additional Common Share Equivalents represented by all securities so issued multiplied by (y) the Fair Market Value of a share of Common Stock immediately prior to the date of such issuance, and the denominator of which shall be (x) the product of (A) the Fair Market Value of a share of Common Stock immediately prior to the date of such issuance and (B) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such issuance plus (y) the aggregate consideration received by the Company for the total number of securities so issued plus, (z) in the case of Options or Convertible Securities, the additional consideration required to be received by the Company upon the exercise, exchange or conversion of such securities; provided that no adjustment shall be required in respect of issuances of Common Stock (or options to purchase Common Stock) pursuant to stock option or other employee benefit plans in effect on the date hereof, or approved by the Board of Directors of the Company after the date hereof. Notwithstanding anything herein to the contrary, (1) no further adjustment to the Warrant Share Amount shall be made upon the issuance or sale of Common Stock pursuant to (x) the exercise of any Options or (y) the conversion or exchange of any Convertible Securities, if in each case the adjustment in the Warrant Share Amount was made as required hereby upon the issuance or sale of such Options or Convertible Securities or no adjustment was required hereby at the time such Option or Convertible Security was issued, and (2) no adjustment to the Warrant Share Amount shall be made upon the issuance or sale of Common Stock upon the exercise of any Options existing on the original issue date hereof, without regard to the exercise price thereof. Notwithstanding the foregoing, no adjustment to the Warrant Share Amount shall be made pursuant to this paragraph upon the issuance or sale of Common Stock, Options, or Convertible Securities in a bona fide arm's-length transaction to any Person or group that, at the time of such issuance or sale, is not an Affiliate of the Company (including any possible issuance of Common Stock, Options, or Convertible Securities to the public stockholders of The Coleman Company, Inc. ("Coleman") in connection with the acquisition of their shares of Coleman common stock pursuant to the Agreement and Plan of Merger, dated as of February 27, 1998 (the "Coleman Merger Agreement"), by and among Sunbeam, Camper Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of Sunbeam, and Coleman, or otherwise). An adjustment made pursuant to this Section 7(d) shall become effective immediately after such Common Stock, Options or Convertible Securities are sold.

(e) Below Market Distributions or Issuances of Preferred Stock or Other Securities. In case the Company shall issue non-convertible and non-exchangeable preferred stock (or other debt or equity securities or evidences of indebtedness of the Company (other than Common Stock or Options or Convertible Securities) or options, rights or warrants to purchase any of such securities) at a price per share (or other similar unit) less than the Fair Market Value per share (or other similar unit) of such preferred stock (or other security) on the date such preferred stock (or other security) is sold (provided that no sale of preferred stock or other security pursuant to an underwritten public offering shall be deemed to be for less than its fair market value), then in each such case the Warrant Share Amount shall thereafter be adjusted by multiplying the Warrant Share Amount immediately prior to the date of issuance of such preferred stock (or other security) by a fraction, the numerator of which shall be the product of (i) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such issuance and (ii) the Fair Market Value of a share of Common Stock immediately prior to the date of such issuance, and the denominator of which shall be (x) the product of (A) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such issuance and (B) the Fair Market Value of a share of the Common Stock immediately prior to the date of such issuance minus (y) the difference between (1) the aggregate Fair Market Value of such preferred stock (or other security) and (2) the aggregate consideration received by the Company for such preferred stock (or other security). Notwithstanding the foregoing, no adjustment to the Warrant Share Amount shall be made pursuant to this paragraph upon the issuance or sale of preferred stock (or other securities of the Company other than common Stock or Options or Convertible Securities) in a bona fide arm's-length transaction to any Person or group that, at the time of such issuance or sale, is not an Affiliate of the Company (including any possible issuance of preferred stock (or other securities of the Company other than common Stock or Options or Convertible Securities) to the public stockholders of Coleman in connection with the acquisition of their shares of Coleman common stock pursuant to the Coleman Merger Agreement, or otherwise). An adjustment made pursuant to this Section 7(e) shall become effective immediately after such preferred stock (or other security) is sold.

(f) Above Market Repurchases of Common Stock. If at any time or from time to time the Company or any Subsidiary thereof shall repurchase, by self-tender offer or otherwise, any shares of Common Stock of the Company (or any Options or Convertible Securities) at a purchase price in excess of the Fair Market Value thereof, on the Business Day immediately prior to the earliest of (i) the date of such repurchase, (ii) the commencement of an offer to repurchase, or (iii) the public announcement of either (such date being referred to as the "Determination Date"), the Warrant Share Amount shall be determined by multiplying the Warrant Share Amount immediately prior to such Determination Date by a fraction, the numerator of which shall be the product of (1) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such Determination Date minus the number of Common Share Equivalents represented by the securities repurchased or to be purchased by the Company or any Subsidiary thereof in such repurchase and (2) the Fair Market Value of a share of Common Stock immediately prior to such Determination Date, and the denominator of which shall be (x) the product of (A) the number of Common Share Equivalents represented by all securities outstanding immediately prior to the Determination Date and (B) the Fair Market Value of a share of Common Stock immediately prior to such Determination Date minus (y) the sum of (1) the aggregate consideration paid by the Company in connection with such repurchase and (2) in the case of Options or Convertible Securities, the additional consideration required to be received by the Company upon the exercise, exchange or conversion of such securities. Notwithstanding the foregoing, no adjustment to the Warrant Share Amount shall be made pursuant to this paragraph upon the repurchase, by self-tender offer or otherwise, of Common Stock (or any Options or Convertible Security) in a bona fide arm's-length transaction from any Person or group that, at the time of such repurchase, is not an Affiliate of the Company.

(g) Above Market Repurchases of Preferred Stock or Other Securities. If at any time or from time to time the Company or any Subsidiary thereof shall repurchase, by self-tender offer or otherwise, any shares of non-convertible and non-exchangeable preferred stock (or other debt or equity securities or evidences of indebtedness of the Company (other than Common Stock or Options or Convertible Securities) or options, rights or warrants to purchase any of such securities), at a purchase price in excess of the Fair Market Value thereof, on the Business Day immediately prior to the Determination Date, the Warrant Share Amount shall be determined by multiplying the Warrant Share Amount immediately prior to the Determination Date by a fraction, the numerator of which shall be the product of (i) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such Determination Date and (ii) the Fair Market Value of a share of Common Stock immediately prior to such Determination Date, and the denominator of which shall be (x) the product of (A) the number of Common Share Equivalents represented by all securities outstanding immediately prior to such Determination Date and (B) the Fair

Market Value of a share of Common Stock immediately prior to such Determination Date minus (y) the difference between (1) the aggregate consideration paid by the Company in connection with such repurchase and (2) the aggregate Fair Market Value of such preferred stock (or other security). Notwithstanding the foregoing, no adjustment to the Warrant Share Amount shall be made pursuant to this paragraph upon the repurchase, by self-tender offer or otherwise, of non-convertible and non-exchangeable preferred stock (or other securities of the Company other than Common Stock or Options or Convertible Securities) in a bona fide arm's-length transaction from any Person or group that, at the time of such repurchase, is not an Affiliate of the Company.

(h) Readjustment of Warrant Share Amount. If (i) the purchase price provided for in any Option or the additional consideration, if any, payable upon the conversion or exchange of any Convertible Securities or the rate at which any Convertible Securities, in each case as referred to in paragraphs (b) and (f) above, are convertible into or exchangeable for Common Stock shall change at any time (other than under or by reason of provisions designed to protect against dilution upon an event which results in a related adjustment pursuant to this Section 7), or (ii) any of such Options or Convertible Securities shall have irrevocably terminated, lapsed or expired, the Warrant Share Amount then in effect shall forthwith be readjusted (effective only with respect to any exercise of this Warrant after such readjustment) to the Warrant Share Amount which would then be in effect had the adjustment made upon the issuance, sale, distribution or grant of such Options or Convertible Securities been made based upon such changed purchase price, additional consideration or conversion rate, as the case may be (in the case of any event referred to in clause (i) of this paragraph (h)) or had such adjustment not been made (in the case of any event referred to in clause (ii) of this paragraph (h)).

(i) Exercise Price Adjustment. Upon each adjustment of the Warrant Share Amount pursuant to this Section 7, the Exercise Price of each Warrant outstanding immediately prior to such adjustment shall thereafter be equal to an adjusted Exercise Price per Share determined (to the nearest cent) by multiplying the Exercise Price for the Warrant immediately prior to such adjustment by a fraction, the numerator of which shall be the Warrant Share Amount in effect immediately prior to such adjustment and the denominator of which shall be the Warrant Share Amount in effect immediately after such adjustment.

(j) Consideration. If any shares of Common Stock, Options or Convertible Securities shall be issued, sold or distributed for cash, the consideration received in respect thereof shall be deemed to be the amount received by the Company therefor, before deduction therefrom of any reasonable, customary and adequately documented expenses incurred in connection therewith. If any shares of Common Stock, Options or Convertible Securities shall be issued, sold or distributed for a consideration other than cash, the amount of the consideration other than cash received by the Company shall be deemed to be the Fair Market Value of such consideration, before deduction of any reasonable, customary and adequately documented expenses incurred in connection therewith. If any shares of Common Stock, Options or Convertible Securities shall be issued in connection with any merger in which the Company is the surviving corporation, the amount of consideration therefor shall be deemed to be the Fair Market Value of such portion of the assets and business of the non-surviving corporation as shall be attributable to such Common Stock, Options or Convertible Securities, as the case may be. If any Options shall be issued in connection with the issuance and sale of other securities of the Company, together comprising one integral transaction in which no specific consideration is allocated to such Options by the parties thereto, such Options shall be deemed to have been issued without consideration.

(k) No Impairment. The Company will not, by amendment of its Certificate of Incorporation or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but will at all times in good faith assist in the carrying out of all the provisions of this Section 7 and in the taking of all such action as may be necessary or appropriate in order to protect the conversion rights of the Holder against impairment. Without limiting the generality of the foregoing, the Company will not increase the par value of any shares of Common Stock receivable on the exercise of the Warrants above the amount payable therefor on such exercise.

(l) Certificate as to Adjustments. Upon the occurrence of each adjustment or readjustment of the Warrant Share Amount pursuant to this Section 7, the Company at its expense shall promptly compute such adjustment or readjustment in accordance with the terms hereof and furnish to the Holder a certificate setting forth such adjustment or readjustment and showing in detail the facts upon which such adjustment or readjustment is based. The Company shall, upon the written request at any time of the Holder, furnish or cause to be furnished to Holder a like certificate setting forth (1) such adjustments and readjustments and (2) the number of shares of Common Stock and the amount, if any, of other property which at the time would be received upon the exercise of this Warrant.

(m) Proceedings Prior to Any Action Requiring Adjustment. As a condition precedent to the taking of any action which would require an adjustment pursuant to this Section 7, the Company shall take any action which may be necessary, including obtaining regulatory approvals or exemptions, in order that the Company may thereafter validly and legally issue as fully paid and nonassessable all shares of Common Stock which the Holders are entitled to receive upon exe rcise thereof.

(n) Notice of Adjustment. Upon the record date or effective date, as the case may be, of any action which requires or might require an adjustment or readjustment pursuant to this Section 7, the Company shall forthwith file in the custody of its Secretary or an Assistant Secretary at its principal executive office and with its stock transfer agent or its warrant agent, if any, an officers' certificate showing the adjusted number of Warrant Shares determined as herein provided, setting forth in reasonable detail the facts requiring such adjustment and the manner of computing such adjustment. Each such officers' certificate shall be signed by the chairman, president or chief financial officer of the Company and by the secretary or any assistant secretary of the Company. Each such officers' certificate shall be made available at all reasonable times for inspection by the Holder or any Holder of a Warrant executed and delivered pursuant to Section 6(b) and the Company shall, forthwith after each such adjustment, mail a copy, by first-class mail, of such certificate to the Holder or any such holder.

(o) Payments in Lieu of Adjustment. The Holder shall, at its option, be entitled to receive, in lieu of the adjustment pursuant to Section 7(c) otherwise required thereof, on (but not prior to) the date of exercise of the Warrants, the evidences of indebtedness, other securities, cash, property or other assets which such Holder would have been entitled to receive if it had exercised its Warrants for shares of Common Stock immediately prior to the record date with respect to such distribution. The Holder may exercise its option under this Section 7(o) by delivering to the Company a written notice of such exercise simultaneously with its notice of exercise of this Warrant.

SECTION 8. CONSOLIDATION, MERGER OR SALE OF ASSETS. In case of any consolidation of the Company with, or merger of the Company into, any other Person, any merger of another Person into the Company (other than a merger which does not result in any reclassification, conversion, exchange or cancellation of outstanding shares of Common Stock) or any sale or transfer of all or substantially all of the assets of the Company to the Person formed by such consolidation or resulting from such merger or which acquires such assets, as the case may be, the Holder shall have the right thereafter to exercise this Warrant for the kind and amount of securities, cash and other property receivable upon such consolidation, merger, sale or transfer by a holder of the number of shares of Common Stock for which this Warrant may have been exercised immediately prior to such consolidation, merger, sale or transfer. Adjustments for events subsequent to the effective date of such a consolidation, merger, sale or transfer of assets shall be as nearly equivalent as may be practicable to the adjustments provided for in this Warrant. In any such event, effective provisions shall be made in the certificate or articles of incorporation of the resulting or surviving corporation, in any contract of sale, merger, conveyance, lease, transfer or otherwise so that the provisions set forth herein for the protection of the rights of the Holder shall thereafter continue to be applicable; and any such resulting or surviving corporation shall expressly assume the obligation to deliver, upon exercise, such shares of stock, other securities, cash and property. The provisions of this Section 8 shall similarly apply to successive consolidations, mergers, sales, leases or transfers.

SECTION 9. WARRANT AGENT. At the written request of the Holders of a majority of the outstanding Warrants, the Company shall as soon as is reasonably practicable:

(i) appoint a warrant agent to act as agent for the Company in connection with the issuance, transfer and exchange of the Warrants and shall enter into an agreement with such warrant agent reflecting the terms and conditions of such appointment, which terms and conditions shall be customary for such appointments, and such other matters as are customarily included in such agreements so as to facilitate the transfer and registration of the Warrants; and

(ii) use its reasonable best efforts to cause the Warrants to be eligible to be publicly traded, including, without limitation, amending this Warrant to provide terms and conditions necessary and appropriate for the Warrants to be publicly traded.

SECTION 10. NOTICES. Any notice, demand or delivery authorized by this Warrant shall be in writing and shall be given to the Holder or to the Company, as the case may be, at its address (or facsimile number) set forth below, or such other address (or facsimile number) as shall have been furnished to the party giving or making such notice, demand or delivery:

If to the Company:
Sunbeam Corporation
1615 South Congress Avenue, Suite 200
Delray Beach, Florida 33445
Attention: Corporate Secretary
Facsimile: (561) 243-2191

with copies to:
Skadden, Arps, Slate, Meagher & Flom LLP
919 Third Avenue
New York, New York 10022
Attention: Blaine V. Fogg, Esq.
Facsimile: (212) 735-3597

and to:
Weil, Gotshal & Manges LLP
767 Fifth Avenue
New York, New York 10153
Attention: Stephen E. Jacobs, Esq.
Facsimile: (212) 310-8007

If to the Holder:
Coleman (Parent) Holdings Inc.
c/o MacAndrews & Forbes Holdings Inc.
35 East 62nd Street
New York, New York 10021
Attention: Barry F. Schwartz, Esq.
Facsimile: (212) 572-5056

with copies to:
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, New York 10019
Attention: Adam O. Emmerich, Esq.
Facsimile: (212) 403-2000

Each such notice, demand or delivery shall be effective (i) if given by telecopy, when such telecopy is transmitted to the telecopy number specified herein and the intended recipient confirms the receipt of such telecopy, or (ii) if given by any other means, when received at the address specified herein.

SECTION 11. RIGHTS OF THE HOLDER. Prior to the exercise of any Warrant, the Holder shall not, by virtue hereof, be entitled to any rights of a shareholder of the Company, including, without limitation, the right to vote, to receive dividends or other distributions, to exercise any preemptive right or to receive any notice of meetings of shareholders or any notice of any proceedings of the Company except as may be specifically provided for herein.

SECTION 12. GOVERNING LAW. THIS WARRANT AND ALL RIGHTS ARISING HEREUNDER SHALL BE CONSTRUED AND DETERMINED IN ACCORDANCE WITH THE INTERNAL LAWS OF THE STATE OF DELAWARE, AND THE PERFORMANCE THEREOF SHALL BE GOVERNED AND ENFORCED IN ACCORDANCE WITH SUCH LAWS.

SECTION 13. AMENDMENTS; WAIVERS. Any provision of this Warrant may be amended or waived if, and only if, such amendment or waiver is in writing and signed, in the case of an amendment, by the Holder and the Company, or in the case of a waiver, by the party against whom the waiver is to be effective. No failure or delay by either party in exercising any right, power or privilege hereunder shall operate as a waiver thereof nor shall any single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or privilege. The rights and remedies herein provided shall be cumulative and not exclusive of any rights or remedies provided by law.

SECTION 14. Interpretation. When a reference is made in this Warrant to a Section such reference shall be to a Section of this Warrant unless otherwise indicated. Whenever the words "include", "includes" or "including" are used in this Warrant, they shall be deemed to be followed by the words "without limitation". The words "hereof", "herein" and "hereunder" and words of similar import when used in this Warrant shall refer to this Warrant as a whole and not to any particular provision of this Warrant. The definitions contained in this Warrant are applicable to the singular as well as the plural forms of such terms and to the masculine as well as to the feminine and neuter genders of such term. References to a person are also to its permitted successors and assigns and, in the case of an individual, to his heirs and estate, as applicable.

IN WITNESS WHEREOF, the Company has duly caused this Warrant to be signed by its duly authorized officer and to be dated as of the date first above written.

SUNBEAM CORPORATION

By: ______________________________
Name:
Title:

ATTEST:

By: ____________________________
Name:
Title:

ACKNOWLEDGED AND AGREED:
COLEMAN (PARENT) HOLDINGS INC.

By: ____________________________
Name:
Title:

WARRANT EXERCISE SUBSCRIPTION FORM

(To be executed only upon exercise of the Warrant after delivery of the Warrant Exercise Notice)

To: Sunbeam Corporation

The undersigned irrevocably exercises the Warrant for the purchase of __________ shares (the "Shares") of Common Stock, par value $.01 per share, of Sunbeam Corporation (the "Company") ("Common Stock") at an exercise price of $_______ per Share and herewith makes payment of $__________ (such payment being made in cash or by certified or official bank or bank cashier's check payable to the order of the Company or by any permitted combination of such cash or check or by the reduction of the number of shares of Common Stock that otherwise would be issued upon this exercise by the number of shares of Common Stock that have a value equal to such exercise price), all on the terms and conditions specified in this Warrant, surrenders this Warrant and all right, title and interest therein to the Company and directs that the Shares deliverable upon the exercise of this Warrant be registered or placed in the name and at the address specified below and delivered thereto.

Date: _______ __, ____.

____
(Name - Please Print)

____
(Signature of Owner)

____
(Street Address)

____
(City) (State) (Zip Code)

Securities and/or check to be issued to:

Please insert social security or identifying number:

Name:

Street Address:

City, State and Zip Code:

Any unexercised portion of the Warrant evidenced by the within Warrant to be issued to:

Please insert social security or identifying number:

Name:

Street Address:

City, State and Zip Code:

WARRANT ASSIGNMENT FORM

Dated ___________ __, ____

FOR VALUE RECEIVED, _______________________ hereby sells, assigns and transfers unto ____________________________________ (the "Assignee"),
(please type or print in block letters)

____
(insert address)

its right to purchase up to _____ shares of Common Stock represented by this Warrant and does hereby irrevocably constitute and appoint _________________________ Attorney, to transfer the same on the books of the Company, with full power of substitution in the premises.

Signature: ______________________________

EXHIBIT B

AMENDMENT TO REGISTRATION RIGHTS AGREEMENT

AMENDMENT, dated as of August ___, 1998 (this "Amendment"), to the REGISTRATION RIGHTS AGREEMENT, dated as of March 29, 1998 (the "Registration Rights Agreement"), by and among SUNBEAM CORPORATION, a Delaware corporation ("Laser" or "Sunbeam"), and COLEMAN (PARENT) HOLDINGS INC., a Delaware corporation ("Parent Holdings"). Capitalized terms used in this Amendment have the meanings ascribed to them in the Registration Rights Agreement unless otherwise defined herein. References to Articles and Sections shall, unless otherwise stated, be to the Articles and Sections of the Registration Rights Agreement. In all respects not inconsistent with the terms and provisions of this Amendment, the Registration Rights Agreement shall continue to be in full force and effect in accordance with the terms and conditions thereof, and is hereby ratified, adopted, approved and confirmed. From and after the date hereof, each reference to the Registration Rights Agreement therein or in any other instrument or document shall be deemed a reference to the Registration Rights Agreement as amended hereby, unless the context otherwise requires, and this Amendment and the Registration Rights Agreement shall for all purposes and matters be considered as one agreement, including that all of the ministerial and miscellaneous provisions of the Registration Rights Agreement shall apply equally thereto as so amended and to this Amendment.

WHEREAS, pursuant to the Holdings Merger Agreement, by and among Sunbeam, a subsidiary of Sunbeam, CLN HOLDINGS INC., a Delaware corporation and wholly owned subsidiary of Parent Holdings ("Holdings"), and Parent Holdings, the Holdings Merger was consummated on March 30, 1998 and Holdings became an indirect wholly owned subsidiary of Sunbeam; and

WHEREAS, following consummation of the Holdings Merger, the shares of Holdings Common Stock issued and outstanding immediately prior to the effective time of the Holdings Merger were converted into an aggregate of (A) 14,099,749 fully paid and nonassessable shares of common stock, par value $.01 per share, of Sunbeam ("Laser Common Stock") and (B) $159,956,756 in cash, without interest thereon; and

WHEREAS, following the dismissal by Sunbeam of certain of its executive officers in mid-June 1998, Sunbeam retained certain senior officers employed by Affiliates of Parent Holdings as executive officers of Sunbeam; and

WHEREAS, Sunbeam and Parent Holdings have entered into a Settlement Agreement (the "Settlement Agreement") pursuant to which Sunbeam will issue to Parent Holdings certain warrants to purchase shares of Laser Common Stock (the "Warrants") and has agreed to enter into this Agreement; and

WHEREAS, in order to induce Parent Holdings to enter into the Settlement Agreement, Sunbeam has agreed to amend the Registration Rights Agreement and modify the registration rights with respect to the shares of Laser Common Stock issued to Parent Holdings in the Holdings Merger and to provide for registration rights with respect to the Warrants and Laser Common Stock issuable upon exercise of the Warrants.

NOW, THEREFORE, in consideration of the mutual covenants and agreements set forth herein and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, and intending to be legally bound hereby, the parties agree as follows:

ARTICLE I

DEFINITIONS

Section 1.1 is amended with respect to certain of the definitions therein as follows:

The definition of the term "Agreement" is amended and restated in its entirety to mean the Registration Rights Agreement as amended by this Amendment.

The definition of the term "Registrable Securities" is amended and restated in its entirety to mean (i) the Holdings Merger Stock, (ii) the Warrants, and (iii) any shares of Laser Common Stock issued pursuant to the Warrants, and, in each case, any other securities issued or issuable upon or in respect of such securities by way of conversion, exchange, dividend, split or combination, recapitalization, merger, consolidation, other reorganization or otherwise. As to any particular Registrable Securities, such securities shall cease to be Registrable Securities when such securities have been sold or otherwise transferred by Parent Holdings pursuant to the Shelf Registration Statement or pursuant to Rule 144 under the Securities Act.

The following defined term shall be added to the list of definitions in their respective alphabetically ordered positions:

The term "Holdings Merger Stock" shall mean the shares of Laser Common Stock issued to Parent Holdings in the Holdings Merger.

The term "Warrants" shall mean the warrants to purchase 23,000,000 (Twenty-Three Million) shares of Laser Common Stock issued to Parent Holdings pursuant to Warrant No. W-1 dated August ___, 1998.

ARTICLE II

REQUIRED REGISTRATION

Sections 2.1, 2.2 and 2.3 of Article II are amended and restated to read in their entirety as follows:

Section 2.1 Required Registration.

(a) Form S-3. Promptly following a demand to such effect from any holder of Registrable Securities, Laser shall prepare and file with the SEC a registration statement (the "Shelf Registration Statement") on an appropriate form permitting registration of the Registrable Securities so as to permit the resale of the Registrable Securities pursuant to an offering on a delayed or continuous basis under the Securities Act and shall use reasonable best efforts to (i) cause the Shelf Registration Statement to be declared effective by the SEC as promptly as practicable thereafter and (ii) permit the Shelf Registration Statement to be used by Affiliates of Camper for resales of shares of Laser Common Stock held by such Affiliates ; provided, however, that any such Affiliate using the Shelf Registration Statement shall agree in writing to be bound by all of the restrictions, limitations and obligations of Parent Holdings contained in this Agreement.

(b) Effectiveness. Laser shall use reasonable best efforts to keep the Shelf Registration Statement continuously effective under the Securities Act until the date that is the earliest to occur of (i) the date by which all Registrable Securities have been sold and (ii) the date by which all Registrable Securities are eligible for immediate sale to the public without registration under Rule 144 under the Securities Act, with such sale not being limited by the volume restrictions thereunder or otherwise.

(c) Amendments/Supplements. Laser shall amend and supplement the Shelf Registration Statement and the prospectus contained therein if required by the rules, regulations or instructions applicable to the registration form used by Laser for such Shelf Registration Statement, if required by the Securities Act.

(d) Offerings. At any time from and after the date on which the Shelf Registration Statement is declared effective by the SEC (the "Effective Date"), Parent Holdings, subject to the restrictions and conditions contained herein and in the Merger Agreement and the Warrants to the extent applicable, and subject further to compliance with all applicable state and federal securities laws, shall have the right to dispose of all or any portion of the Registrable Securities.

Section 2.2 Holdback Agreement.

From and after the Effective Date, upon the request of Laser, Parent Holdings shall not effect any public sale or distribution (including sales pursuant to Rule 144) of Registrable Securities that are equity securities of Laser, or any securities convertible into or exchangeable or exercisable for such securities, including the Warrants, (other than any such sale or distribution of such securities pursuant to registration of such securities on Form SB-8 or any successor form) during the period commencing on the date on which Laser commences a Laser Offering through the sixty (60)-day period immediately following the closing date of such Laser Offering; provided, however, that Parent Holdings shall not be obligated to comply with this Section 2.2 on more than two (2) occasions in any twelve (12)-month period; and provided, further, that notwithstanding anything to the contrary in this Section 2.2 or Section 2.3, in no event shall Parent Holdings be disabled from effecting offers or sales of Registrable Securities for more than one-hundred-and-twenty (120) days during any twelve (12)-month period.

Section 2.3 Blackout Provisions.

In the event that, at any time while the Shelf Registration Statement remains effective, Laser determines in its reasonable judgment and in good faith that the sale of Registrable Securities would require disclosure of material information which Laser has a bona fide business purpose for preserving as confidential, Parent Holdings shall, upon receiving written notice from Laser of such good faith determination, suspend sales of the Registrable Securities for a period beginning on the date of receipt of such notice and expiring on the earlier of (i) the date upon which such material information is disclosed to the public or ceases to be material or (ii) forty-five (45) days after the receipt of such notice from Laser; provided, however, that Parent Holdings shall not be obligated to comply with this Section 2.3 on more than two (2) occasions in any twelve (12) month period; and provided, further, that notwithstanding anything to the contrary in this Section 2.3 or Section 2.2, in no event shall Parent Holdings be disabled from effecting offers or sales of Registrable Securities for more than one-hundred-and-twenty (120) days during any twelve (12)-month period.

* * *

Section 2.4(a) of Article II is hereby amended by deleting the word "and" from the end of paragraph (12) thereof, replacing the period at the end of paragraph (13) thereof with "; and" and adding the following additional paragraph:

(14) will enter into customary agreements (including an underwriting agreement in customary form) and take such actions as are reasonably required in order to expedite or facilitate the sale of such Registrable Securities, including, without limitation, cooperation, and causing its officers, employees and advisors to cooperate, with the sellers of such Registrable Securities and the underwriter(s), if any, including participation in meetings and road shows held in connection with such sale.

ARTICLE III

TRANSFERS OF REGISTRABLE SECURITIES

Sections 3.1 and 3.2 of Article III are amended and restated to read in their entirety as follows:

Section 3.1 Transferability of Registrable Securities.

(a) Parent Holdings may not Transfer the Registrable Securities, other than

(1) pursuant to Rule 144;

(2) pursuant to the Shelf Registration Statement; or

(3) in any other Transfer exempt from registration under the Securities Act, and as to which Laser has received an opinion of counsel, reasonably satisfactory to Laser, that such Transfer is so exempt;

and shall in no event Transfer any Registrable Securities in violation of the Settlement Agreement.

Section 3.2 Restrictive Legends.

Parent Holdings hereby acknowledges and agrees that, during the term of this Agreement, all of the Registrable Securities shall include the legend set forth in Section 7.2 of the Holdings Merger Agreement, the legend set forth on the Warrants or as provided in the Warrants or as may otherwise be reasonably appropriate to reflect the fact that such Registrable Securities have not been issued in transactions registered under the Securities Act, unless at the time such Registrable Securities have been registered under the Securities Act.

ARTICLE IV

MISCELLANEOUS

Sections 4.5 and 4.11 of Article IV are amended and restated in their entirety to read as follows:

Section 4.5 Binding Effect; Assignment.

This Agreement and all of the provisions hereof shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, executors, successors and permitted assigns, but, except as expressly contemplated herein, neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned, directly or indirectly, by Laser or Parent Holdings without the prior written consent of the other (except in the case of any assignment in whole or in part by Parent Holdings to any Affiliate, as to which no such consent shall be required); provided, that in connection with a bona fide pledge of any Registrable Securities to secure indebtedness or other obligations, Parent Holdings may assign its rights, interests and obligations hereunder to the beneficiary of such pledge in whole or in part. Upon any permitted assignment (other than in connection with any such bona fide pledge), this Agreement shall be amended to substitute or add the assignee as a party hereto in a writing reasonably acceptable to the other party.

Section 4.11 Termination; Restrictive Legend.

This Agreement shall terminate only following such time as Sunbeam shall have no further obligation under Section 2.1(b) to use its reasonable best efforts to keep the Shelf Registration Statement effective; provided, however, that the provisions of Section 2.6 hereof shall survive termination of this Agreement. It is understood and agreed that any restrictive legends set forth on any Registrable Securities shall be removed by delivery of substitute certificates without such legends and such Registrable Securities shall no longer be subject to the terms of this Agreement or upon the resale of such Registrable Securities in accordance with the terms of this Agreement.

ARTICLE V

OTHER

The following provisions shall also apply to this Amendment:

Section 5.1 Effectiveness of this Amendment. The provisions of this Amendment shall be effective as of the date hereof.

Section 5.2 Counterparts. This Amendment may be executed in counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

Section 5.3 Governing Law. This Amendment shall be governed by the laws of the State of New York, without regard to the principles of conflicts of law thereof.

Section 5.4 No Waiver. The execution, delivery and performance of this Amendment shall not operate as a waiver of any condition, power, remedy or right exercisable in accordance with the Registration Rights Agreement, and shall not constitute a waiver of any provision of the Registration Rights Agreement, except as expressly provided herein.

Section 5.5 Descriptive Headings. The article and section headings contained in this Amendment are solely for the purpose of reference, are not part of the agreement of the parties and shall not in any way affect the meaning or interpretation of this Amendment.

IN WITNESS WHEREOF, the undersigned hereby agree to be bound by the terms and provisions of this Amendment as of the date first above written.

SUNBEAM CORPORATION

By: ______________________________
Name:
Title:

COLEMAN (PARENT) HOLDINGS INC.

By: ______________________________
Name:
Title:

EXHIBIT 99.2

Contacts: Investment Community — Marc R. Shiffman, Sunbeam Corporation, (561) 243-2142
Media — George Sard/Maureen Bailey, Sard Verbinnen & Co., (212) 678-8080

SUNBEAM TO ISSUE 5-YEAR WARRANTS TO MACANDREWS & FORBES TO SETTLE ITS CLAIMS RELATING TO COLEMAN ACQUISITION AND TO SECURE CONTINUING SERVICES OF SUNBEAM'S TOP OFFICERS

DELRAY BEACH, FL, AUGUST 12, 1998 -- Sunbeam Corporation (NYSE: SOC) today announced it has entered into a settlement agreement with MacAndrews & Forbes Holdings, Inc. The agreement releases Sunbeam from any claims MacAndrews & Forbes may have against Sunbeam arising out of Sunbeam's acquisition of MacAndrews & Forbes' interest in The Coleman Company, Inc.; enables Sunbeam to retain the services of MacAndrews & Forbes executive personnel who have been managing Sunbeam since mid-June 1998, including Jerry W. Levin, the Company's Chief Executive Officer; and provides for MacAndrews & Forbes to continue to give other management support to Sunbeam.

MacAndrews & Forbes currently owns approximately 14 million Sunbeam shares, or approximately 14% of Sunbeam's presently outstanding shares, which it received in the Coleman transaction in March 1998 when Sunbeam was trading at prices above $40 per share. Pursuant to the settlement agreement, MacAndrews & Forbes will receive from Sunbeam five-year warrants to purchase an additional 23 million Sunbeam shares at an exercise price of $7.00 per share and containing customary anti-dilution provisions.

In connection with the agreement, Levin and certain other Sunbeam executives are signing three-year employment agreements with Sunbeam. The others include Paul Shapiro, Executive Vice President and Chief Administrative Officer, and Bobby Jenkins, Executive Vice President and Chief Financial Officer.

The settlement agreement with MacAndrews & Forbes, including the terms of the warrants, was negotiated and approved on behalf of Sunbeam by a Special Committee of four outside directors, none of whom has any affiliation with MacAndrews & Forbes. The members of the Special Committee are Howard Kristol (Chairman), Charles Elson, Peter Langerman, and Faith Whittlesey. They were assisted by an independent financial advisor, The Blackstone Group, and independent legal counsel, Weil, Gotshal & Manges.

The transaction normally would require shareholder approval under New York Stock Exchange policy. However, the Audit Committee of Sunbeam's Board of Directors determined that the delay that would be necessary to secure shareholder approval prior to the issuance of the warrants would be extensive, particularly in light of the ongoing investigation by the Securities and Exchange Commission of Sunbeam's accounting practices and policies and the Company's previously disclosed intention to restate its historical financial statements; would inhibit Sunbeam's ability to reach a settlement with MacAndrews & Forbes and to retain and hire senior management essential to Sunbeam's business; and thus would seriously jeopardize the financial viability of the Company. Accordingly, the Audit Committee, pursuant to an exception provided in the NYSE shareholder approval policy for such a situation, expressly approved the Company's omission to seek the shareholder approval that would otherwise have been required under that policy. The NYSE has accepted the Company's application of the exception.

In reliance on the NYSE exception, Sunbeam is mailing to all shareholders a letter notifying them of its intention to issue the warrants without seeking their approval. Ten days after such letter is mailed, the Company will consummate the transaction and issue the warrants.

"The Special Committee unanimously determined that this settlement agreement is in the best interest of all Sunbeam shareholders," said Peter Langerman, Chairman of Sunbeam. "It will immediately give Sunbeam a strong senior management team that knows the business, will eliminate the risk of protracted legal proceedings, as well as the costs, burdens and substantial potential liability inherent in any such litigation, and will position Sunbeam to move ahead."

"We are fully committed to helping Sunbeam succeed. Our interests are aligned with all other Sunbeam shareholders because these warrants will only have value if Sunbeam shares appreciate from current levels," said Howard Gittis, Vice Chairman of MacAndrews & Forbes.

"I am very pleased that this complex issue has been satisfactorily resolved and our senior management team can devote its full attention to completing the new organization and revitalizing Sunbeam's business. We will have more to announce shortly, concerning our new strategy, organizational structure and senior management team," said Jerry W. Levin.

Sunbeam Corporation is a leading consumer products company that designs, manufactures and markets, nationally and internationally, a diverse portfolio of consumer products under such world-class brands as Sunbeamregistered trademark, Osterregistered trademark, Grillmasterregistered trademark, Colemanregistered trademark, Mr. Coffeeregistered trademark, First Alertregistered trademark, Powermateregistered trademark, Health o meterregistered trademark, Eastpakregistered trademark and Compingazregistered trademark.

EXHIBIT 99.3

SUNBEAM LETTERHEAD

August 12, 1998

Dear Fellow Sunbeam Shareholder:

I am writing to let you know about an important development announced today concerning Sunbeam.

I am pleased to report that Sunbeam has entered into a settlement agreement with MacAndrews & Forbes Holdings, Inc. The agreement releases Sunbeam from any claims MacAndrews & Forbes may have against Sunbeam arising out of Sunbeam's acquisition of MacAndrews & Forbes' interest in The Coleman Company, Inc; enables Sunbeam to retain the services of MacAndrews & Forbes executive personnel who have been managing Sunbeam since mid-June 1998, including Jerry W. Levin, the Company's Chief Executive Officer; and provides for MacAndrews & Forbes to continue to give other management support to Sunbeam.

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In connection with the agreement, Jerry W. Levin and certain other Sunbeam executives are signing three-year employment agreements with Sunbeam. The others include Paul Shapiro, Executive Vice President and Chief Administrative Officer, and Bobby Jenkins, Executive Vice President and Chief Financial Officer.

The transaction normally would require shareholder approval under New York Stock Exchange policy. However, the Audit Committee of Sunbeam's Board of Directors determined that the delay that would be necessary to secure shareholder approval prior to the issuance of the warrants would be extensive, particularly in light of the ongoing investigation by the Securities and Exchange Commission of Sunbeam's accounting practices and policies and the Company's previously disclosed intention to restate its historical financial statements; would inhibit Sunbeam's ability to reach a settlement with MacAndrews & Forbes and to retain and hire senior management essential to Sunbeam's business; and thus would seriously jeopardize the financial viability of the Company. Accordingly, the Audit Committee, pursuant to an exception provided in the NYSE shareholder approval policy for such a situation, expressly approved the Company's omission to seek the shareholder approval that would otherwise have been required under that policy. The NYSE has accepted the Company's application of the exception.

In reliance on the NYSE exception, Sunbeam is mailing to all shareholders a letter notifying them of its intention to issue the warrants without seeking their approval. Ten days after such letter is mailed, the Company will consummate the transaction and issue the warrants.

The settlement agreement with MacAndrews & Forbes, including the terms of the warrants, was negotiated and approved on behalf of Sunbeam by a Special Committee of four outside directors, none of whom has any affiliation with MacAndrews & Forbes. The Committee - Howard Kristol (Chairman), Charles Elson, Faith Whittlesey and myself - was assisted by independent financial advisors (The Blackstone Group) and legal counsel (Weil, Gotshal & Manges).

The Special Committee unanimously determined that this settlement agreement is in the best interest of all Sunbeam shareholders. It will immediately give Sunbeam a strong senior management team that knows the business, eliminate the risk of protracted legal proceedings, as well as the costs, burdens and substantial potential liability inherent in any such litigation, and position Sunbeam to move ahead.

As you know, the Sunbeam Board initially turned to MacAndrews & Forbes, Jerry Levin and their team shortly after dismissing Albert Dunlap as Chief Executive Officer and Russell Kersh as Chief Financial Officer in mid-June 1998. We felt it was essential to act quickly to secure their services and continued support as the Company seeks to resolve the serious problems it currently faces and to eliminate any uncertainty that might result from the continued pendency of claims by MacAndrews & Forbes arising out of the Coleman acquisition. Therefore, the Special Committee concluded it was advisable to settle and obtain a release of the MacAndrews & Forbes claims and give them and their team a real incentive to work to turn around the Company.

We believe MacAndrews & Forbes is fully committed to helping Sunbeam succeed. Their interests are aligned with all other Sunbeam shareholders because these warrants will only have value if Sunbeam shares appreciate from current levels. In addition. Sunbeam's new senior management team can devote its full attention to completing the new organization and revitalizing Sunbeam's business.

Sincerely,

Peter Langerman
Chairman of the Board

8K The Coca-Cola Company Release date 1/26/00

- Announcing Earnings for Quarter and Also that Future Earnings will be Impacted by Organizational Realignment -

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): January 26, 2000

THE COCA-COLA COMPANY
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation)	001-02217 (Commission File Number)	58-0628465 (IRS Employer Identification No.)

One Coca-Cola Plaza Atlanta, Georgia (Address of principal executive offices)	30313 (Zip Code)

Registrant's telephone number, including area code: (404)676-2121

Item 5. Other Events

On January 26, 2000, The Coca-Cola Company (the "Company") issued a press release announcing its financial results for the fourth quarter of 1999 and for the full fiscal year 1999. The press release is filed as Exhibit 99.1 hereto and is incorporated herein by reference.

On January 26, 2000, the Company also issued a press release announcing a major organizational realignment and reduction in the Company's workforce. The press release is filed as Exhibit 99.2 hereto and is incorporated herein by reference.

Item 7. Financial Statements and Exhibits

(c) Exhibits:

99.1 Press release of The Coca-Cola Company issued January 26, 2000: The Coca-Cola Company Announces Fourth Quarter and Full Year Volume and Earnings Per Share Results

99.2 Press release of The Coca-Cola Company issued January 26, 2000: The Coca-Cola Company Announces Major Organizational Realignment

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

THE COCA-COLA COMPANY
(REGISTRANT)

Date: January 26, 2000

By:/s/ Gary P. Fayard

Gary P. Fayard
Senior Vice President and
Chief Financial Officer

Exhibit Index

Exhibit No.	
99.1	Press release of The Coca-Cola Company issued January 26, 2000: The Coca-Cola Company Announces Fourth Quarter and Full Year Volume and Earnings Per Share Results
99.2	Press release of The Coca-Cola Company issued January 26, 2000: The Coca-Cola Company Announces Major Organizational Realignment

EXHIBIT 99.1

FOR IMMEDIATE RELEASE

CONTACT:
Rob Baskin
(404) 676-2683

THE COCA-COLA COMPANY ANNOUNCES
FOURTH QUARTER AND FULL YEAR
VOLUME AND EARNINGS PER SHARE RESULTS

Fourth-quarter worldwide unit case volume increased 6 percent. Comparable unit case volume increased 4 percent and approximately 2 points of growth was attributable to brands acquired from Cadbury Schweppes.

Fourth-quarter diluted earnings per share were $0.31, before considering non-recurring items. Non-recurring items in the quarter included certain asset write-downs, the continued impact of the European product withdrawal, and one-time charges by certain equity investees.

The Company commented that its 2000 earnings will be impacted by an organizational realignment and its plans to reduce concentrate inventory levels at selected bottlers.

ATLANTA, January 26, 2000 -- The Coca-Cola Company reported another year of record volume with annual worldwide unit case volume exceeding 16 billion unit cases for the first time in the Company's history. This reflects the 45th consecutive year that the Company has increased unit case volume.

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"We are currently in a period of economic recovery in many parts of the world," commented Douglas N. Daft, president and chief operating officer. "During this year of recovery, our business system will remain focused on creating long-term value for our customers, our bottling partners, and The Coca-Cola Company."

"Our management team is performing an on-going assessment of our worldwide operations to ensure that our organization is appropriately structured to capture the vast opportunities in front of us. By challenging how we look at the business, we will be able to ensure we meet consumer and customer needs at a local level and that we are best able to maximize value for our share owners and our partners within the Coca-Cola system."

Mr. Daft continued, "Throughout this Company's great history, our success has been achieved through the magic of our great brands and through our ability to bring refreshment and enjoyment to consumers all over the world. Going forward, we plan to continue connecting with consumers and customers at a local level to ensure we are engrained in the fabric of all communities."

EARNINGS RESULTS

For the fourth quarter, reported diluted loss per share was $0.02. This amount includes $0.31 per share after tax related to asset write-downs in certain countries, approximately $0.01 per share after tax related to the impact of the European product withdrawal, and $0.01 per share after tax associated with one-time charges by certain equity investees.

For the full year, diluted earnings per share were $0.98. The full year results include $0.31 per share after tax related to asset write-downs in certain countries, approximately $0.06 per share after tax related to the impact of the European product withdrawal, and $0.01 per share after tax associated with one-time charges by certain equity investees. The overall impact of the European product withdrawal reflects the loss of sales in several key markets in Europe, the resulting impact on

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equity income, and incremental marketing expenses associated with maintaining brand strength in Europe. In 1998, diluted earnings per share were $1.42, including net $0.02 per share driven primarily by bottling transactions.

VOLUME RESULTS

For the full year, reported worldwide unit case volume grew nearly 2 percent and comparable worldwide unit case volume increased 1 percent. In the fourth quarter, reported worldwide unit case volume grew 6 percent. Of this amount, comparable worldwide unit case volume increased 4 percent and approximately 2 points of growth were attributable to brands acquired from Cadbury Schweppes. Reported worldwide gallon shipments for the full year were even with the prior year and increased 8 percent in the fourth quarter. (References to "comparable" changes in unit case volume are computed based on the exclusion of brands acquired from Cadbury Schweppes during the third quarter of 1999.)

In the NORTH AMERICA GROUP, full-year unit case volume advanced 1 percent including growth of 1 percent in the United States. Throughout the year, unit case growth in the industry was below historic growth levels as bottlers were focused on improving retail soft drink prices in order to increase the overall returns for the entire value chain. As consumers are adjusting to these slightly higher price points, unit case volume demonstrated improving trends in the second half of the year. In addition, non-carbonated beverages continued to exhibit strong double-digit growth led by Dasani, Fruitopia, POWERaDE and Nestea products.

Fourth-quarter unit case volume increased 3 percent in North America and 3 percent in the United States. North America gallon shipments of concentrates and syrups grew 1 percent in 1999 and increased 5 percent in the fourth quarter versus the prior year.

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In the LATIN AMERICA GROUP, unit case volume increased 3 percent and gallon shipments declined 1 percent for the year on a reported basis. On a comparable basis, full year unit case volume increased 2 percent for the Group, with growth of 6 percent in Mexico, 2 percent in Argentina, 4 percent in the Central America and Caribbean division and 1 percent in Brazil. These results reflect the difficult economic environments that the Company faced in many parts of Latin America throughout the year. As the year progressed, the Company continued to see increasing levels of economic stabilization in most countries, while a few areas such as Venezuela and Colombia continue to be extremely challenging. In markets not impacted by the economic challenges, the Company continued to see solid growth.

Fourth-quarter unit case volume in the Latin America Group grew 8 percent on a reported basis and 6 percent on a comparable basis. Reported gallon shipments in the fourth quarter increased 8 percent.

In the MIDDLE AND FAR EAST GROUP, unit case volume increased 1 percent and gallon shipments declined 1 percent in 1999 on a reported basis. For the year, comparable unit case volume grew 1 percent for the Group, with gains of 6 percent in Japan, 2 percent in China, 9 percent in India and 4 percent in the Middle East and North Africa division. Japan achieved its third straight quarter of strong unit case growth and the overall business environment is showing improving trends. While many Asian markets are improving economically, the Company is continuing to see difficult conditions in markets such as the Philippines. During the year, extensive flooding, negative American sentiment and slightly slower economic trends hampered growth in China.

In the fourth quarter in the Middle and Far East Group, unit case volume increased 4 percent on a reported basis and 2 percent on a comparable basis. Reported gallon shipments increased 6 percent in the fourth quarter. Beginning in

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2000, this Group will no longer include the Middle East and North Africa Division and will be known as the Asia Pacific Group.

In the GREATER EUROPE GROUP, reported unit case volume was even with the prior year and gallon shipments declined 1 percent in 1999. For the year, comparable unit case volume declined 1 percent for the Group with increases of 9 percent in Spain, 4 percent in CCE Europe territories, 2 percent in Germany and a decline of 16 percent in the Nordic and North Eurasia division. Full year results for the group were negatively impacted by difficult economic conditions in Russia and parts of Eastern Europe, the European product withdrawal, and events such as the earthquakes in Turkey and the war in Kosovo. Countries such as Spain that were not impacted by these factors delivered solid growth for the year.

Fourth-quarter unit case volume in the Greater Europe Group grew 6 percent on a reported basis and 3 percent on a comparable basis. Reported gallon shipments in the fourth quarter increased 11 percent.

In the AFRICA GROUP, full-year unit case volume increased 5 percent and gallon shipments increased 2 percent on a reported basis. Comparable full-year unit case volume increased by 1 percent for the Group with a 2 percent increase in the Northern Africa Division and flat volume in the Southern Africa Division. Growth continued to be hampered throughout the year by difficult economic conditions in Southern Africa and political instability in Northern Africa.

Unit case volume in the Africa Group increased 15 percent in the fourth quarter on a reported basis and 5 percent on a comparable basis. Reported gallon shipments increased 25 percent in the fourth quarter. Beginning in 2000, this Group will include the Middle East and North Africa Division and will be known as the Africa and Middle East Group.

At THE MINUTE MAID COMPANY, full-year volume increased 4 percent as a result of continued strong growth by Minute Maid Premium ready-to-drink orange

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juice, especially calcium-fortified varieties. Minute Maid Premium was the fastest-growing national brand of ready-to-drink orange juice in U.S. supermarkets during 1999, with sales up nearly 22 percent. During the quarter, an alliance with J&J Snack Foods Corp. was announced to increase U.S. distribution of Minute Maid and Hi-C brand frozen snacks. Total fourth-quarter volume increased 2 percent for The Minute Maid Company.

GLOBAL MARKETING ACTIONS

The Company continues to focus on increasing the value of its brands to customers and consumers around the world to ensure long-term brand relevance and to maximize profitable growth opportunities. The Company recently unveiled a new marketing campaign for Coca-Cola designed to reconnect every day with people around the world. Over the next year, many new marketing initiatives will be introduced throughout the world to take full advantage of the magical qualities of Coca-Cola and connecting those to the values that people care most deeply about in their everyday lives.

Mr. Daft commented, "Our strategy is designed to renew the passion for the world's greatest brand. We sell one drink at a time, to one person at a time, more than a billion times a day. Our continued success will be based on our ability to connect our brands in relevant ways to every local community. Throughout the year, we will remind consumers how Coca-Cola adds a little magic to the real moments in people's everyday lives."

ASSET WRITE-DOWNS

During the quarter, the Company recorded a charge of $813 million in selling, administrative and general expenses to primarily reflect the impairment of certain

- more -

bottling assets and the streamlining of manufacturing facilities in Russia, the Baltics, Japan and various other countries around the world.

Mr. Daft commented, "Despite these accounting write-downs, we remain fully committed to growing our business in these countries and believe the regions offer tremendous opportunity for per capita growth."

The fourth quarter charge associated with the impairment of the Company's Russian and Baltic bottling operations resulted from the extremely challenging economic environments the Company has faced in these countries over the last year and a half. The impairment of certain assets in the Japanese vending business resulted from a comprehensive review and the strong steps taken by the Company to streamline these operations to position them for the future.

Nearly all of the asset write-downs recorded in the fourth quarter do not generate a tax benefit for financial reporting purposes in 1999. As a result, the Company's effective tax rate increased to 36% for the full year. Looking forward, the Company expects its effective tax rate on operations to remain 31%.

Over the past several years, the Company acquired numerous local bottling franchises in India for the purposes of establishing the appropriate infrastructure for sustainable long-term growth. The Company expects to complete a comprehensive review of these operations during the first quarter of this year with the intent of streamlining the business. Based on this review, as well as the current excise tax levels in India, the Company will be evaluating the carrying value of these assets.

INCOME STATEMENT REVIEW

Revenues increased 5 percent in 1999 reflecting structural change in the bottling system and selective price increases, partially offset by the negative impact of a stronger U.S. dollar. Full year gross margins declined slightly from the prior

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year as the Company began consolidating bottling operations in India and Company-owned vending operations in Japan.

On a reported basis, operating income declined 20 percent for the year. This amount includes the previously disclosed fourth-quarter charges associated with certain asset write-downs and the estimated impact of the European product withdrawal. Operating income, excluding unusual items (asset write-downs and the impact of the European product withdrawal), declined 1 percent for the year reflecting the challenging economic conditions in many markets throughout the world, structural changes, the negative impact of foreign currencies, and the continued investment in long-term brand building activities. The impact of currencies on operating income for the year was an approximate negative 4 percent.

Equity income for the year was also negatively impacted by global economic conditions, as well as continued structural change and non-recurring charges within the global Coca-Cola bottling system. During the fourth quarter, equity income was impacted by $0.01 per share after tax associated with one-time charges by our equity investees in countries such as Venezuela and the Philippines.

As disclosed during the year, other income includes a foreign currency gain to reflect the economic benefit received by hedging the Company's resources in Brazil. As the Brazilian Real depreciated during the year, the Company entered into financial instruments to protect its resources. From an economic standpoint, the amount offsets the impact of converting local Brazilian operating results into U.S. dollars at lower rates.

During 1998, the Company's results included net $0.02 per share of after-tax gains resulting primarily from bottling transactions in Italy and Germany.

Over the past year, the Company did not repurchase any of its shares due to pending brand acquisitions. However, the Company remains committed to its consistent long-term program of using excess cash to repurchase its shares. Since

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the initiation of its first share repurchase program in 1984, the Company has repurchased 32 percent of its common shares then outstanding, or a cumulative total of over 1 billion shares, at an average cost of approximately $12.46 per share.

OUTLOOK FOR THE YEAR 2000

The Company commented that year 2000 reported results will be impacted by the financial effect of the separately announced organizational realignment and an intent to reduce concentrate inventory levels at selected bottlers.

Throughout the past several months, The Coca-Cola Company has worked with bottlers around the world to determine the optimum level of bottler inventory levels. Based on this review, management of the Coca-Cola system determined that opportunities exist to reduce the level of concentrate inventory carried by bottlers in selected regions of the world, such as Eastern Europe, Japan, and Germany. As such, bottlers in these regions have indicated that they intend to reduce their inventory levels during the first half of the year 2000. This reduction in bottler inventory levels will result in the Company shipping less concentrate and is therefore expected to reduce the Company's diluted earnings per share by approximately $0.11 - $0.13 after tax during the first half of the year 2000.

Mr. Daft commented, "These steps are designed to ensure we have the strongest and most efficient bottling system in the world. With an even tighter management of inventory levels, our bottlers will free up additional working capital as they continue to take steps to increase their returns on invested capital."

The Coca-Cola system first proactively reduced the worldwide bottler inventory levels in the third quarter of 1996. At that time, average days of inventory in the worldwide bottling system exceeded 45 days. This move is intended to take the average bottler inventories to the optimal worldwide level of 34 days.

- more -

This news release contains forward-looking statements concerning long-term volume and EPS objectives and should be read in conjunction with cautionary statements contained in Exhibit 99.1 in the Company's most recent Form 10-K.

# # #

THE COCA-COLA COMPANY AND SUBSIDIARIES
(In Millions, except per share data)

	Fourth Quarter		
	1999	1998	% Change
NET OPERATING REVENUES	$ 4,931	$ 4,458	11
Cost of Goods Sold	1,464	1,299	13
GROSS PROFIT	3,467	3,159	10
Selling, Administrative and General Expenses	2,305	2,222	4
Other Operating Charges - Primarily Asset Write-downs	813	----	----
OPERATING INCOME	349	937	(63)
Interest Income	70	48	46
Interest Expense	93	68	37
Equity Income (Loss)	(112)	(71)	----
Other Income - Net	16	19	----
INCOME BEFORE INCOME TAXES	230	865	(73)
Income Taxes	275	268	3
NET INCOME (LOSS)	$ (45)	$ 597	----
DILUTED NET INCOME (LOSS) PER SHARE*	$ (0.02)	$ 0.24	----
Average Shares Outstanding - Diluted*	2,487	2,489	----

* For the fourth quarter, "Basic Net Income (Loss) Per Share" was ($0.02) for 1999 and $0.24 for 1998 based on "Average Shares Outstanding - Basic" of 2,471

and 2,465 for 1999 and 1998, respectively.

THE COCA-COLA COMPANY AND SUBSIDIARIES
(In Millions, except per share data)

	Twelve Months Ended December 31		
	1999	1998	% Change
NET OPERATING REVENUES	$ 19,805	$ 18,813	5
Cost of Goods Sold	6,009	5,562	8
GROSS PROFIT	13,796	13,251	4
Selling, Administrative and General Expenses	9,001	8,211	10
Other Operating Charges - Primarily Asset Write-downs	813	73	----
OPERATING INCOME	3,982	4,967	(20)
Interest Income	260	219	19
Interest Expense	337	277	22
Equity Income (Loss)	(184)	32	----
Other Income - Net	98	257	----
INCOME BEFORE INCOME TAXES	3,819	5,198	(27)
Income Taxes	1,388	1,665	(17)
NET INCOME	$ 2,431	$ 3,533	(31)
DILUTED NET INCOME PER SHARE*	$ 0.98	$ 1.42	(31)
Average Shares Outstanding - Diluted*	2,487	2,496	----

* For the full year, "Basic Net Income Per Share" was $0.98 for 1999 and $1.43 for 1998 based on "Average Shares Outstanding - Basic" of 2,469 and 2,467 for 1999 and 1998, respectively.

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EXHIBIT 99.2

FOR IMMEDIATE RELEASE

CONTACT:
Rob Baskin
(404) 676-2683

THE COCA-COLA COMPANY ANNOUNCES
MAJOR ORGANIZATIONAL REALIGNMENT

Will Result in Annual Expense Reductions of $300 Million; Net Job Reductions-Voluntary and Involuntary-of approximately 6,000; Pre-Tax Charge to Earnings of approximately $800 Million During the Year 2000

Focus on Localization Puts More Responsibility, Accountability and Resources in Hands of Local Business Units

ATLANTA, January 26, 2000 -- The Coca-Cola Company today announced a major organizational realignment that will put more responsibility, accountability and resources in the hands of the local business units in the more than 200 countries where the Company does business.

Specifically, this realignment will reduce the Company's workforce around the world while transferring responsibilities from corporate to revenue-generating operating units, fueling further investment in profit-driving activities by reducing costs, and enhancing effectiveness by establishing greater role clarity and accountability between corporate and field offices.

Said Doug Daft, president and chief operating officer and chairman-elect, The Coca-Cola Company: "Today's announcement is the culmination of a careful review during the past six months of each of our business functions. The world in which we

- more -

operate has changed dramatically, and we must change to succeed. This realignment will better enable the Company to serve the changing needs of its customers and consumers at the local level and ensure that Coca-Cola complements the local culture in every community where it is sold.

"Together with our bottling partners, we've spent years building the brands, infrastructure and technology needed to be successful at the local level," said Daft. "The actions we announced today will effectively align our corporate resources, support systems and business culture to fully leverage the local capabilities of our system.

"As we enter the 21st century, we need to build on the greatness and historic strengths of the company and be sure it is optimally positioned for the changing world. We must also take our business to where our business is. Now is the time for us to take those steps."

Under the realignment, approximately 6,000 positions will be reduced during the current year through early retirement, outsourcing or job eliminations. Of these, approximately 2,500 are located in Atlanta, 800 are located in U.S. cities outside of Atlanta, and another 2,700 are based outside the U.S.

"As necessary as this realignment is, it carries with it the most difficult decision a management team can make: job reductions," Mr. Daft said. "This is painful both for those within the Company who will be directly affected and for those responsible for making this decision. But this management team is committed to doing what is necessary to ensure a strong future for The Coca-Cola Company.

- more -

"We are equally committed to proceeding with care and sensitivity," Mr. Daft continued. "Ensuring that all associates are treated fairly and with dignity and respect is a top priority for me, personally, and the Company, and we've put processes in place to ensure that happens."

Employees separating from the Company as a result of the realignment will be offered severance packages, outplacement and counseling services, and other assistance to help with the transition.

The Company estimates this initiative will yield annual expense reductions of $300 million following full implementation of the new organizational structure. As a result of the realignment, the Company will take a pre-tax charge of approximately $800 million during the year 2000.

Following the structural changes, roles and responsibilities within the Company will be redefined. The Company's corporate headquarters will retain responsibility for setting policy and strategy for the Company as a whole; the Company's revenue-generating units will assume all other responsibilities.

Said Mr. Daft: "No matter where we operate around the world, we're a local business. Our success depends on our ability to make billions of individual connections each day in every community around the world. With the pace of change in global markets increasing every day, we have to redouble our efforts to remain close to the customers and consumers we serve.

"One thing that won't change is the significant opportunity before us," added Mr. Daft. "And we view the future's tremendous growth opportunities with great

- more -

anticipation and excitement. With our strong new marketing platform for Coca-Cola, the right people in the right places around the world, and our intensified focus behind serving customers and consumers at the local level, we have in place the necessary elements to more fully realize the promise of this great Company today and for years to come."

# # #

8K The Coca-Cola Company Release date 12/21/99

- Announcing that S&P Lowered Its Debt Ratings for the Company -

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported):
December 21, 1999

THE COCA-COLA COMPANY
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation)	001-02217 (Commission File Number)	58-0628465 (IRS Employer Identification No.)

One Coca-Cola Plaza Atlanta, Georgia (Address of principal executive offices)	30313 (Zip Code)

Registrant's telephone number, including area code: (404)676-2121

Item 5. Other Events

On December 21, 1999, Standard & Poor's lowered its ratings for The Coca-Cola Company, among other entities, as described in a press release of Standard & Poor's attached as Exhibit 99.

Item 7. Financial Statements and Exhibits

(c) Exhibits:

99 Press release of Standard & Poor's issued December 21, 1999

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

THE COCA-COLA COMPANY

Date: December 21, 1999

By:/s/ Gary P. Fayard
Gary P. Fayard
Senior Vice President and
Chief Financial Officer

Exhibit Index

Exhibit No.	
99	Press release of Standard & Poor's issued December 21, 1999

EXHIBIT 99

S&P: Coke Rtgs, CCE & CCA Long-Term Rtgs Lwrd; Off Watch

NEW YORK (Standard & Poor's CreditWire) Dec. 21, 1999 -- Standard & Poor's today lowered its ratings for The Coca-Cola Co. (Coke), as indicated in the table below. In addition, Standard & Poor's lowered its long-term ratings for Coca-Cola Enterprises Inc. (CCE), Coca-Cola Amatil Ltd. (CCA), Coca-Cola Amatil N.Z. Ltd., and Coca-Cola Amatil (Australia) Pty Ltd. (see list). These ratings are removed from CreditWatch, where they were placed with negative implications Sept. 9, 1999, following Coke's announcement that its third-quarter earnings were expected to fall below earlier expectations. In its Sept. 9 press release, Standard & Poor's indicated its expectation that recovery of already weakened credit measures for the Coke system would be slower than anticipated.

The short-term ratings for CCE, CCA, and related entities were affirmed, as listed below. These ratings were not previously on CreditWatch.

About $6.3 billion of total debt was outstanding at Coke and about $11.2 billion at CCE as of Sept. 30, 1999, and about Australian dollar (A$) 2.9 billion of total debt was outstanding at CCA as of July 2, 1999.

Standard & Poor's views Coke and its bottlers as a system and analytically reconsolidates key bottlers, including CCE and CCA, as well as Coca-Cola Beverages plc (the former European bottling system of CCA). The Coke bottling system has been active in pursuing acquisitions in recent periods, which has raised consolidated debt levels. In particular, Coke's debt-financed acquisition of the Cadbury Schweppes brands in 155 countries outside of the U.S. raised system net debt levels by close to $1 billion, and additional Cadbury acquisitions are still pending in several countries. Increased debt levels, along with weaker-than-expected operating performance at Coke and its key bottlers in 1999 due to weak global economies and European product recalls, have weakened creditor protection measures for the system below ranges considered appropriate for the former ratings (these measures included pretax interest coverage in the 6.5 times (x) - 7.5x range).

Global operating performance began to show signs of improvement in the third quarter of 1999, and the European product recall problems appear to be largely behind Coke and its bottlers. However, Standard & Poor's does not believe credit measures are likely to improve to levels consistent with the previous double-'A'-minus rating for Coke or the previous single-'A' -plus rating for CCE and CCA over the next two years, while leaving enough financial flexibility for further system acquisitions, investments, and/or share repurchases.

The ratings reflect Coke's position as the world's largest manufacturer of soft-drink concentrates and syrups, as well as its geographic diversification, which translates into strong profitability and cash flow. Strong brand awareness has contributed to Coke's leading 45% share in the more mature U.S. market, and growth to a 51% worldwide market share. While Coke has no legal obligation for the debt of CCE, CCA, or Coca-Cola Beverages, Standard & Poor's ratings for CCE and CCA are based on Coke's significant incentive to keep these bottlers viable because of their strategic importance, Coke's ownership positions, the size of its investments, and its unique customer/supplier relationship.

OUTLOOK: STABLE

Standard & Poor's expects the Coke system to maintain credit measures appropriate for the revised rating categories, despite anticipated continued bottler consolidation, investment, and share repurchases, -- CreditWire

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RATINGS LOWERED AND REMOVED FROM CREDITWATCH

	To	From
Coca-Cola Co.		
Corporate credit rating	A+/A-1	AA-/A-1+
Senior unsecured debt	A+	AA-
Shelf registration (preliminary)	A+	AA-
Commercial paper	A-1	A-1+
Coca-Cola Enterprises Inc. (CCE)		
Long-term corporate credit rating	A	A+
Senior unsecured debt	A	A+
Shelf registration (preliminary)	A	A+
Coca-Cola Enterprises (Canada) Bottling Finance Ltd.		
Medium-term note program (Gtd: CCE)	A	A+
Coca-Cola Amatil Ltd. (CCA)		
Long-term corporate credit rating	A	A+
Senior unsecured debt	A	A+
Subordinated debt	A-	A
Bank loan rating	A	A+
Coca-Cola Amatil (Australia) Pty Ltd.		
Bank loan rating (Gtd: CCA)	A	A+
Coca-Cola Amatil N.Z. Ltd.		
Senior unsecured debt	A	A+

RATINGS AFFIRMED

Coca-Cola Enterprises Inc.	
Short-term corporate credit rating	A-1
Commercial paper	A-1
Coca-Cola Amatil Ltd.	
Short-term corporate credit rating	A-1
Commercial paper	A-1
Coca-Cola Amatil (Australia) Pty Ltd.	
Commercial paper (Gtd: Coca-Cola Amatil Ltd.)	A-1
Coca-Cola Amatil N.Z. Ltd.	
Commercial paper (Gtd: Coca-Cola Amatil Ltd.)	A-1

Contact: Nicole Delz Lynch, New York (1) 212-438-7846
Jeanette Ward, Melbourne (61) 3-9631-2075

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8K The Coca-Cola Company Release date 12/6/99

- Announcing Board's Acceptance of Resignation of CEO -

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported):
December 5, 1999

THE COCA-COLA COMPANY
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation)	001-02217 (Commission File Number)	58-0628465 (IRS Employer Identification No.)

One Coca-Cola Plaza
Atlanta, Georgia 30313
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (404)676-2121

Item 5. Other Events

As disclosed in the press release attached as Exhibit 99.1, at a special meeting of the Board of Directors of The Coca-Cola Company held December 5, 1999, the Board accepted the decision of M. Douglas Ivester, the Company's chairman of the board and chief executive officer, to retire in April 2000; elected Douglas N. Daft president and chief operating officer, effective immediately; and indicated that it intends to elect Mr. Daft chairman of the board and chief executive officer upon Mr. Ivester's retirement in April.

Item 7. Financial Statements and Exhibits

(c) Exhibits:

99 Press release of The Coca-Cola Company issued December 6, 1999

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

THE COCA-COLA COMPANY
(REGISTRANT)

Date: December 6, 1999

By: /s/ JOSEPH R. GLADDEN, JR.

Joseph R. Gladden, Jr.
Senior Vice President and
General Counsel

Exhibit Index

Exhibit No.	
99	Press release issued December 6, 1999

EXHIBIT 99

FOR IMMEDIATE RELEASE

M. DOUGLAS IVESTER ANNOUNCES PLAN TO RETIRE
FROM THE COCA-COLA COMPANY IN APRIL 2000;
BOARD ELECTS DOUGLAS N. DAFT PRESIDENT, COO
AND ANNOUNCES INTENTION TO ELECT DAFT CHAIRMAN, CEO IN APRIL

Atlanta, December 6, 1999 - M. Douglas Ivester, chairman of the Board and chief executive officer of The Coca-Cola Company, has informed the Company's Board of Directors of his intention to retire in April 2000, following the Company's annual meeting of share owners.

Yesterday, at a special meeting, the Board elected Douglas N. Daft president and chief operating officer, effective immediately. The Board also indicated that it intends to elect Mr. Daft chairman of the Board and chief executive officer following Mr. Ivester's retirement in April.

"Doug has informed the Board of his desire to retire as chairman and chief executive officer in April, a decision the Board has reluctantly accepted," said James B. Williams, a member of the Board. "Over the last 20 years, The Coca-Cola Company has been fortunate to have someone of Doug's wisdom and dedication in its leadership ranks. We are pleased

that he has agreed to stay on until April to assist the Company in this change."

"After extensive reflection and thought, I have concluded that it is time for me to move on to the next stage of my life and, therefore, to put into place an orderly transition for this great Company," said Mr. Ivester.

"During the past two years, against the backdrop of an unprecedented downturn in the global economy, we have put into place systems necessary to redesign the organization going forward. The Company has weathered the economic storm extremely well and I believe the customers and share owners of Coca-Cola have been well served," Mr. Ivester said.

"One of the great strengths of The Coca-Cola Company is the depth of its management team," he added. "Doug Daft brings 30 years of experience in the Company's global business to the role of chief operating officer. He is perfectly suited to lead this Company in its continuing efforts to build value for all its share owners."

Mr. Daft, 56, began his career with the Company in 1969 in his native Australia. For much of his career, he served in planning, marketing and operations positions in Asia. In 1984, he was named president of the Central Pacific Division, which included responsibility for China, Indonesia, and Thailand.

In 1988, he was named president of the North Pacific Division and president of Coca-Cola (Japan) Company. In 1991, he moved to the Company's Atlanta headquarters to assume the responsibility of president of the Pacific Group. He was named to his previous position as head of the Middle and Far East and Africa Groups, as well as the Schweppes Beverages Division, in October of this year.

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Contact: Randy Donaldson
(404) 676-3853

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Press Release Dell Computer Corporation Release date 1/26/00

DELL
News

38 1/4 , - 17/32

Dell Fourth-Quarter Revenue, Earnings Will Be Lower Than Expected; Supply Constraints, Y2K Held Back Growth

Wednesday, January 26, 2000 04:25 PM

ROUND ROCK, Texas--(BUSINESS WIRE)--Jan. 26, 2000--Despite revenue that is again expected to rise two to three times faster than the rate of the worldwide computer systems market, Dell Computer Corporation (Nasdaq:DELL, news, msgs) announced today that it will report lower-than-anticipated revenue and earnings for the fourth fiscal quarter ending Jan. 28.

The company said an inconsistent flow of key semiconductor components and a slower-than-expected rebound in sales to corporate and institutional customers related to the Y2K rollover were primary reasons for the shortfall.

The company announces its full financial results on Feb. 10.

Dell said it expects to report revenue of about $6.7 billion for the fourth quarter, which would be up 30 percent from the prior-year period. Unit volumes are expected to increase more than 30 percent on a fiscal-quarter basis, and 50 percent on a calendar-quarter basis, which is the way industry analysts report rankings.

Earnings are expected to be about $430 million, or 16 cents per share, including a per-share gain of about 1-cent from the sale of investments. The consensus of analysts' earnings estimates for the quarter was 21 cents per share.

For the full year, Dell expects to report revenue of more than $25 billion, which would be an increase of 38 percent over the prior year. Annual earnings are expected to be about $1.8 billion, or 68 cents per share, up 28 percent over prior-year earnings of 53 cents per share.

Current-year per-share earnings exclude a previously announced 7-cent charge associated with the third-quarter acquisition of ConvergeNet Technologies Inc.

Dell said that a significant factor behind the revised outlook was an uneven and constrained supply of semiconductor components during the quarter. This caused $300 million in lost sales, primarily of newly introduced consumer products. Revenue from the worldwide consumer and small-business segment is still expected to be more than 50 percent higher than the prior-year quarter, a growth rate of better than three times the level of Dell's nearest direct competitor.

Additionally, corporate demand following the Y2K rollover was lower than anticipated, reducing expected revenue by about $500 million. The company nonetheless expects its global fourth-quarter sales to corporate and institutional accounts to increase more than 20 percent from the year-ago period, which the company believes is a multiple of the industry rate.

Healthy Environment and Outlook Going Forward

"While we're clearly disappointed with our operating results, our overall business is healthy and we believe Dell will continue to significantly outpace the revenue and profit growth of our major competitors and of the industry at large," said Tom Meredith, Dell's chief financial officer.

"Our consumer and small-business unit now has significantly improved component supplies and shorter lead-times, and is achieving record days in orders and shipments. Excellent growth and profitability in sales to small businesses are helping to fuel that rise. And our enterprise business continues to be strong, with sales of network servers, storage products and workstations expected to rise more than 50 percent in the fourth quarter from the previous year."

Meredith said that server sales benefited from an upsurge in demand from "dot com" companies and Internet service providers, and added that Dell is well positioned to capture a significant share of the estimated $180 billion that companies are expected to spend for server and storage hardware over the next six years as they build their Internet infrastructures.

According to Meredith, revenue from notebook computers and sales of all types of products via www.dell.com continue to grow robustly. So, too, does the level of profits from "beyond-the-box" revenue such as from Internet access, financing and warranty services.

Appropriate financial goals for Dell in the new fiscal year would be annual revenue growth in the low 30-percent range, with net margins in the low to mid 7-percent range, Meredith said.

Ranked No. 78 among the Fortune 500 companies and No. 210 in the Fortune Global 500, Dell Computer Corporation is the world's leading direct computer systems company, based on revenues of $23.6 billion for the past four quarters. Dell designs, manufactures and customizes products and services to customer requirements and offers an extensive selection of software and peripherals. Information on Dell and its products can be obtained through its toll-free number 800/388-8542 or by accessing the Dell World Wide Web site at www.dell.com.

SPECIAL NOTE: This press release contains forward-looking statements, including statements concerning the company's expected financial results for its fourth fiscal quarter, statements concerning the outlook and prospects for the company and the industry and statements concerning the company's financial goals for the upcoming fiscal year. These and other statements that relate to future results and events are based on the company's current expectations. Actual results in future periods may differ materially from those currently expected or desired because of a number of risks and uncertainties, including the level of demand for the company's products; the intensity of competition; currency fluctuations; the cost and availability of key components; and the company's ability to effectively manage product transitions, to minimize excess and obsolete inventory and to continue to expand and improve its infrastructure (including personnel and systems) to meet the demands of its growth. These and other factors affecting the company's business and prospects are discussed in the company's periodic filings with the Securities and Exchange Commission.

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Press Release Dell Computer Corporation
- Conference Call Advisory, January 26, 2000 -

DELL
News

38 3/16 , - 19/32

ADVISORY/Dell Computer Corporation Announces Analyst Conference Call

Wednesday, January 26, 2000 04:32 PM

ADVISORY...for Wednesday (Jan. 26)

--(BUSINESS WIRE)--

WHAT: Dell Computer Corporation analyst conference call to discuss the current outlook for the company's fiscal fourth quarter

WHO: Hosted by Tom Meredith, Dell's chief financial officer, and Michael Dell, chairman and chief executive officer

WHEN: TODAY, Wednesday, Jan. 26, at 4:30 P.M. (Central Daylight Time)

WHERE: Webcast "live" via the Internet, at www.dell.com. Analysts and reporters may also access the call by dialing 913/981-4900. For telephone access, we recommend connecting 15 minutes prior to the scheduled start time.

CONTACT: Dell Computer Corp.

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8K Tyco International Limited Release date 1/17/00
- Re: Business Development -

FOR IMMEDIATE RELEASE

CONTACT:
J. Brad McGee
Senior Vice President
Tyco International (US) Inc.
(603) 778-9700

TYCO INTERNATIONAL TO BUILD LARGEST, MOST TECHNOLOGICALLY ADVANCED GLOBAL UNDERSEA FIBER OPTIC NETWORK

Hamilton, Bermuda, January 17, 2000 -- Tyco International Ltd. (NYSE-TYC, LSE-TYI, BSX-TYC), a diversified manufacturing and service company, announced today that its undersea fiber optics business will design, build, operate and maintain its own global undersea fiber optic communications network. Upon its completion, the system, to be known as the TyCom Global NetworkTM (TGN), will be the largest and most advanced global undersea telecommunications fiber optic network.

Phase 1 of TGN will offer a minimum capacity of 2.56 terabits over a fully integrated system that will span more than 85,000 undersea kilometers and connect 25 major telecommunications cities around the globe, including: New York, London, Tel Aviv, St. Petersburg, Hong Kong, Tokyo, Guam, Hawaii, Seattle, Los Angeles and 15 other major European cities. Tyco will utilize its own state-of-the-art technology to design and manufacture all the cable, optical amplifiers and terminal equipment needed for Phase 1. Tyco will also design, build and equip the requisite network operating centers, telehouses and cable stations which route the bandwidth traffic flowing over TGN. Finally, Tyco's own fleet of 13 ships will install and maintain TGN. Tyco Submarine Systems Ltd. (TSSL), a wholly-owned subsidiary of Tyco, has begun the implementation of the first phase of TGN construction.

The Transatlantic portion of the first phase will be completed and operational by the end of 2001. The remainder of the first phase, consisting of the Transpacific and European systems, will be completed and operational by the end of 2002. The timing and sequence of implementing additional phases of the network will be based on future requirements of global and regional demand.

"Undersea cable has been a contributor of strong earnings and cash flow to Tyco for nearly 30 years," said L. Dennis Kozlowski, Chairman and Chief Executive Officer of Tyco. "In recent years, due to both growing demand and Tyco's market leadership, the undersea fiber optics business has significantly increased its backlog of undersea contracts; developed and implemented several breakthrough technologies in undersea telecommunications, primarily related to increasing undersea cable capacity; partnered with key customers through equity participations; and created innovative long-term maintenance contracts such as the previously announced SEAHORSE(TM) global operation and maintenance program. The TyCom Global Network will enable Tyco to realize additional value for our shareholders by putting our expertise to work not just as a designer, builder and maintainer of systems, but also as an owner and seller of undersea cable bandwidth to the telecommunications carriers of the world."

"The concept of building our own global network has intrigued us since the creation of Tyco Submarine Systems two years ago. Our undersea fiber optics business is ideally positioned for this undertaking based on its knowledge of the market, expertise in designing, building, installing and maintaining successively advanced undersea fiber optic networks, and its relationships with the world's telecommunications carriers. Recent and planned capacity additions now enable us to devote resources to the construction of TGN, as well as to continue serving our customers' current and projected needs," he continued.

The decision to commit Tyco's undersea fiber optics business to implement TGN was based on the demand for undersea fiber optic networks to serve the growing worldwide communication needs. The integration of the Internet into the daily lives of the world's population, combined with the burgeoning needs

of global commerce and industry for data and other broadband applications, continue to drive growth and demand. As broadband terrestrial fiber optic networks are completed, they require the availability of undersea systems to connect with the rest of the world. Tyco's current position as the premier independent, fully integrated supplier and maintainer of the newest technologies for undersea fiber optic networks provides it with a unique set of abilities to meet the current and ongoing needs of a true global telecommunications network.

TGN will be constructed in a number of phases. Construction scheduling has been designed to offer global telecommunication connectivity to those hubs around the world where voice, data and Internet demand for bandwidth are growing the fastest. The TSSL Labs in Eatontown, New Jersey will direct the deployment of emerging fiber optic technology on TGN. Installation, operation and maintenance of TGN will be provided within the expanded SEAHORSE global operation and maintenance programs developed and offered by TSSL. When complete, TGN will be the largest independent, open-access undersea fiber optic network, linking more than 80% of the world's population.

In addition to TGN, Tyco will continue to provide its technology and services for the design, development, construction and maintenance of telecommunication systems for customers around the world.

Tyco intends to offer up to 20% percent of its undersea fiber optic cable business for sale in an initial public offering. Tyco expects that a registration statement will be filed with the Securities and Exchange Commission in the first calendar quarter of 2000 and to complete the offering by mid-year, subject to market conditions. The new company will continue to be managed by the Tyco and TSSL management team that has been responsible for the market achievements of its undersea fiber optics business, including Mr. Kozlowski, who will serve as Executive Chairman.

Tyco acquired Simplex in 1974 and combined it with the Submarine Systems division of AT&T in 1997 to create TSSL, the premier fully integrated supplier of undersea fiber optic telecommunications and services. TSSL manufactures cable, repeater and transmission equipment at facilities located in New Hampshire, New Jersey and Virginia. Its internationally distinguished TSSL Labs, located in Eatontown, New Jersey, provide leading edge fiber optic technology. Additionally, TSSL owns and operates 13 world class cable ships for the installation and maintenance of undersea communication network systems. TSSL has successfully completed 85 undersea fiber optic networks, consisting of more than 350,000 kilometers of fiber optic cable and connecting over 100 countries.

Tyco International Ltd., a diversified manufacturing and service company, is the world's largest manufacturer and servicer of electrical and electronic components and undersea telecommunications systems, the world's largest manufacturer, installer, and provider of fire protection systems and electronic security services, has strong leadership positions in disposable medical products, plastics, and adhesives, and is the largest manufacturer of flow control valves. The Company operates in more than 80 countries around the world and has expected fiscal 2000 revenues in excess of $26 billion.

This release is not an offering of securities, which will be made only by a prospectus.

FORWARD LOOKING INFORMATION

Certain comments in this release including, but not limited to, the growth in worldwide demand for undersea telecommunications bandwidth; the timing, size, and capacity of Phase 1; the timing and potential for additional phases; the ability to secure funding for Phase 1 and any additional phases; the timing, size and implementation of an initial public offering; and expected fiscal 2000 revenue are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are based on management's good faith expectations and belief concerning future developments. Actual results may materially differ from these expectations as a result of many factors, relevant examples of which are set forth in the "Management Discussion and Analysis" section of the Company's 1999 Annual Report on Form 10-K and the Company's 1999 Annual Report to Shareholders.

[TYCO INTERNATIONAL LTD. LOGO]

Tyco International Ltd.
The Gibbons Building
10 Queen Street, Suite 301
Hamilton, HM11, Bermuda

Tele: 441-292-8674

FOR IMMEDIATE RELEASE

CONTACT:
J. Brad McGee
Senior Vice President
Tyco International (US) Inc.
(603) 778-9700

TYCO INTERNATIONAL REPORTS 48 PERCENT FIRST QUARTER
EARNINGS PER SHARE INCREASE

EARNINGS PER SHARE RISE TO 46 CENTS FROM 31 CENTS

Hamilton, Bermuda, January 18, 2000 -- Tyco International Ltd. (NYSE-TYC, LSE-TYI, BSX-TYC), a diversified manufacturing and service company, reported today that diluted earnings per share, before non-recurring charges and credits and extraordinary item, for its first quarter of fiscal 2000 ended December 31, 1999 were 46 cents per share, a 48 percent increase over last year's 31 cents per share. Net income rose to $784.3 million, an increase of 54 percent over last year's $509.3 million. Sales for the quarter rose 27 percent to $6.64 billion compared with last year's $5.21 billion. Last year's results have been restated to reflect the merger with AMP, which occurred on April 2, 1999 and was accounted for as a pooling of interests, and are before non-recurring charges and extraordinary item. After giving effect to acquisition related and other non-recurring charges and credits, diluted earnings per share were 46 cents in 2000 compared to a loss of 7 cents in 1999.

"Organic growth across each of our four business segments and all geographies drove Tyco's performance in the first quarter," said L. Dennis Kozlowski, Tyco's Chairman and Chief Executive Officer. "Free cash flow was improved as well. The strength of our core businesses combined with strong cash flows are indicative of another strong year for Tyco," he added.

The quarterly operating profits and margins for the Company's four business segments that are presented in the discussions below are stated before charges and credits for merger, restructuring and other non-recurring charges, charges for impairment of long-lived assets, and goodwill amortization. All dollar amounts are in millions.

TELECOMMUNICATIONS AND ELECTRONICS

	December 31, 1999	December 31, 1998
Sales	$ 2,739.2	$ 1,804.0
Operating profits	$ 571.7	$ 257.9
Operating margins	20.9%	14.3%

The 52% increase in sales resulted from both acquisitions and strong organic growth. Acquisitions included Temasa and Raychem in Fiscal 1999 and Siemens Electromechanical Components and Praegitzer in Fiscal 2000. In addition, Tyco Electronics, which includes AMP, Tyco Submarine Systems Ltd. (TSSL) and Tyco Printed Circuit Group (TPCG), achieved significant organic growth quarter over quarter. Demand remains especially strong for TSSL.

Operating profits more than doubled due to improved margins at AMP and Raychem, increased service and maintenance revenues at TSSL, increased sales at TPCG, and the acquisitions noted above. Margin improvements at AMP and Raychem were driven by increased volume, improved pricing and continuing cost reduction programs.

HEALTHCARE AND SPECIALTY PRODUCTS

	December 31, 1999	December 31, 1998
Sales	$ 1,563.8	$ 1,342.8
Operating profits	$ 362.1	$ 293.2
Operating margins	23.2%	21.8%

Healthcare and Specialty Products sales increased almost 17% over the prior year, principally as a result of organic growth in both Tyco Healthcare and Tyco Plastics. Of particular note was Tyco Healthcare's especially strong growth outside the U.S. Additionally, Tyco Healthcare experienced strong organic growth in the U.S. Surgical product lines resulting from the combined sales efforts and bundling of products with the Kendall and Sherwood lines. Tyco Plastics sales benefited from both increased volume and an increase in resin prices as compared to the same quarter last year.

The 24% increase in operating profits at Tyco Healthcare was driven by volume and cost savings from the consolidation of facilities. Tyco Plastics and ADT Automotive also had significant increases in operating profit as compared to the same period a year ago.

FIRE AND SECURITY SERVICES

	December 31, 1999	December 31, 1998
Sales	$ 1,449.7	$ 1,259.7
Operating profits	$ 244.1	$ 196.9
Operating margins	16.8%	15.6%

Tyco Fire and Security Services achieved a 15% increase in sales as compared with the same quarter last year, resulting primarily from organic growth in both the fire and security divisions within the segment. Service revenues and contract backlog continues to increase in the fire protection division around the world.

Operating profits rose 24% as the security business continues to enjoy healthy incremental margins on new monitoring accounts and fire protection benefitted from its efforts at increasing its service and maintenance business. Cost reduction programs in both fire and security contributed as well.

FLOW CONTROL PRODUCTS AND SERVICES

	December 31, 1999	December 31, 1998
Sales	$ 886.1	$ 807.0
Operating profits	$ 170.7	$ 129.2
Operating margins	19.3%	16.0%

Sales figures for the first quarter of fiscal 2000 include the acquisitions of Glynwed, the heat tracing business of Raychem, Central Sprinkler and AFC Cable, which were acquired after the first quarter of fiscal 1999. Sales figures for the first quarter of 2000 exclude the revenues of Mueller and Grinnell Supply Sales, which were divested in August 1999. Excluding the impact of these items, sales for Flow Control experienced low double digit growth. Allied, EarthTech and Tyco Valves and Controls continue to enjoy increased demand.

Operating profits increased 32% as a result of organic growth from cost reduction programs, efficiency improvements and an increase in the component of service work, as well as, the acquisitions noted above. These increases are net of a reduction in operating profits as a result of the sale of Grinnell Supply Sales and Mueller, which was partially offset by royalty and licensing fee income from certain intellectual property associated with these divested businesses.

FREE CASH FLOW

Tyco management refers to the net amount of cash generated from operating activities less capital expenditures and dividends as "free cash flow." Free cash flow was in excess of $400 million in the first quarter of fiscal 2000, compared with negative cash flow of $617 million in the first quarter of fiscal 1999, resulting in an improvement of over $1 billion. Included as a reduction of operating cash flows is $58 million in the first quarter of fiscal 2000 as compared to $207 million in the first quarter of fiscal 1999 related to cash spending on restructurings. Historically, the first fiscal quarter is the lowest generator of free cash flow, primarily due to the payment of year end cash bonuses to employees based on the results of the fiscal year just ended.

In addition, the Company paid out $113 million in the first quarter of fiscal 2000, compared to $51 million in first quarter of fiscal 1999, in cash related to purchase accounting spending. This amount is not included in the calculation of free cash flow.

SHARE BUYBACK

The Company also announced that the Board of Directors of the Company has approved the expenditure of up to an additional $2.0 billion to repurchase shares of the Company. The exact timing and amount of the repurchases will be subject to market conditions and other factors.

Tyco International Ltd., a diversified manufacturing and service company, is the world's largest manufacturer and servicer of electrical and electronic components and undersea telecommunications systems, the world's largest manufacturer, installer, and provider of fire protection systems and electronic security services, has strong leadership positions in disposable medical products, plastics, and adhesives, and is the largest

manufacturer of flow control valves. The Company operates in more than 80 countries around the world and has expected fiscal 2000 revenues in excess of $26 billion.

The company will discuss first quarter results on a conference call for investors today at 11:00 am (EST). The conference call can be accessed at the following website: investors.tycoint.com/medialist.cfm

FORWARD LOOKING INFORMATION

Certain comments in this release including, but not limited to, the current year outlook for Tyco and expected fiscal 2000 revenues are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are based on management's good faith expectations and belief concerning future developments. Actual results may materially differ from these expectations as a result of many factors, relevant examples of which are set forth in the "Management Discussion and Analysis" section of the Company's 1999 Annual Report on Form 10-K and the Company's 1999 Annual Report to Shareholders.

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table following

TYCO INTERNATIONAL LTD.

RESULTS OF OPERATIONS (1)(2)
(in millions, except per share data)

	Three Months Ended 12/31/1999	Three Months Ended 12/31/1998
SALES		
Telecommunications and Electronics	$ 2,739.2	$ 1,804.0
Healthcare and Specialty Products	1,563.8	1,342.8
Fire and Security Services	1,449.7	1,259.7
Flow Control Products and Services	886.1	807.0
Total Sales	$ 6,638.8	$ 5,213.5
OPERATING PROFITS		
Telecommunications and Electronics	$ 571.7	$ 257.9
Healthcare and Specialty Products	362.1	293.2
Fire and Security Services	244.1	196.9
Flow Control Products and Services	170.7	129.2
Total operating profits	1,348.6	877.2
Corporate Expenses	(54.3)	(19.0)
Goodwill amortization expense	(83.9)	(44.4)
Interest expense, net	(164.7)	(101.3)
Income before income taxes	1,045.7	712.5
Income taxes	(261.4)	(203.2)
INCOME BEFORE EXTRAORDINARY ITEM	$ 784.3	$ 509.3
EARNINGS PER SHARE:		
BASIC	$ 0.46	$ 0.31
DILUTED (3)	$ 0.46	$ 0.31
WEIGHTED AVERAGE COMMON SHARES:		
BASIC	1,693.2	1,622.0
DILUTED	1,716.8	1,655.5

(1) Three months ended December 31, 1999 are before credits associated with the revision of estimates of restructuring costs of $137.6 million ($92.6 million, after tax) and restructuring and impairment charges of $113.4 million ($85.5 million, after tax) associated primarily with the exiting of the interventional cardiology business. Including these credits and charges, income before extraordinary item is $0.46 per diluted share. Three months ended December 31, 1999 are before extraordinary losses of $0.2 million after tax relating to the early extinguishment of debt.

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Date of Report (Date of earliest event reported)
January 17, 2000

001-13836
(Commission File Number)

TYCO INTERNATIONAL LTD.
(Exact name of registrant as specified in its charter)

Bermuda (State or other jurisdiction of Incorporation)	Not applicable (IRS Employer Identification Number)

The Zurich Centre, Second Floor, 90 Pitts Bay Road,
Pembroke, HM 08, Bermuda
(Address of registrant's principal executive office)

441-292-8674*
(Registrant's telephone number)

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*The executive offices of Registrant's principal United States subsidiary, Tyco International (US) Inc., are located at One Tyco Park, Exeter, New Hampshire 03833. The telephone number there is (603) 778-9700.

ITEM 5. Other Events

Reference is made to the press release issued by the Registrant on January 17, 2000, the text of which is attached hereto as Exhibit 99.1, and to the press release issued by the Registrant on January 18, 2000, the text of which is attached hereto as Exhibit 99.2, for descriptions of the events reported pursuant to this Form 8-K.

ITEM 7. Financial Statements, Pro Forma Financial Information and Exhibits

(c) Exhibits.

Exhibit Number	Title
99.1	Press Release dated January 17, 2000
99.2	Press Release dated January 18, 2000

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TYCO INTERNATIONAL LTD.

By: /s/ Mark H. Swartz

Mark H. Swartz
Executive Vice President and
Chief Financial Officer
(Principal Accounting and
Financial Officer)

Date: January 20, 2000

Exhibit Index

Exhibit Number	Title
99.1	Press Release dated January 17, 2000
99.2	Press Release dated January 18, 2000

[TYCO INTERNATIONAL LTD. LOGO]

Tyco International Ltd.
The Gibbons Building
10 Queen Street, Suite 301
Hamilton, HM11, Bermuda

Tele: 441-292-8674

Press Release
Consumer Product Safety Commission and Black & Decker Corporation
Release date April 1998
- Announcing Settlement of Administrative Complaint Over Alleged Inadequacy Of Remedy and Disclosure By the Company -

NEWS from CPSC

U.S. Consumer Product Safety Commission

Office of Information and Public Affairs — Washington, DC 20207

FOR IMMEDIATE RELEASE
April 23, 1998

CPSC CONTACT: Russ Rader
(301) 504-0580 Ext. 1166
BLACK & DECKER CONTACT: Suzanne Jones
(203) 926-3447

Release # 98-097

CPSC, Black & Decker Settle Toaster Lawsuit; Improve Recall Remedy

WASHINGTON, D.C. - The U.S. Consumer Product Safety Commission (CPSC) and The Black & Decker Corp. announced today the resolution of CPSC's administrative Complaint against Black & Decker and an improved nationwide recall of the Spacemaker Optima Model T1000 Type 1 Horizontal Toasters. In its Complaint, CPSC alleged that Black & Decker's unilateral recall announcement of October 27, 1997, did not go far enough in notifying the public of the recall or the potential fire hazard associated with the toasters, and the consumer remedy was not adequate. In its Answer, Black & Decker denied the allegations contained in the administrative Complaint. After the Complaint and Answer were filed, CPSC and Black & Decker began working cooperatively to modify and improve Black & Decker's original recall program.

Black & Decker is improving its recall by offering consumers their choice of a free Spacemaker Optima Toaster or other selected replacement product instead of a coupon toward the purchase of a product. Consumers who have already contacted Black & Decker about the toaster recall and used a coupon to purchase another product will now be able to select from a list of replacement Black & Decker products, also for free. Extensive measures are underway to get word of the risk and new remedy to consumers.

The toasters are being recalled because they can allow food to catch on fire, and when the toaster door automatically opens and the food rack extends beyond the door, flames from the food can escape the unit and expose kitchen cabinets and their contents to the fire. When the unilateral recall was first announced, the firm reported 242 incidents. Now Black & Decker has received 1,066 food fire complaints involving these toasters; 656 of these involved property damage ranging from kitchen cabinet damage to one kitchen fire. Eight burn injuries have been reported.

Of approximately 234,000 toasters sold, to date only about 19,000 consumers have participated in the unilateral recall announced last October.

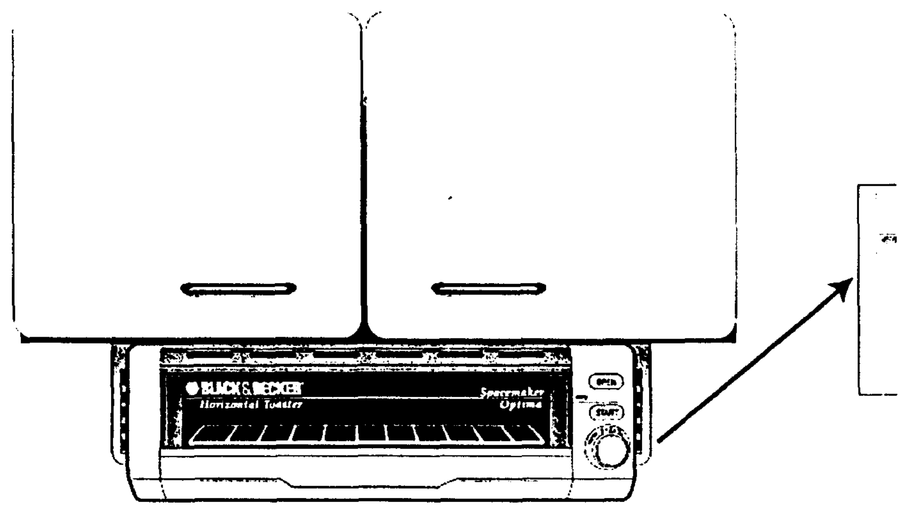
The Black & Decker Spacemaker Optima T1000 Type 1 Horizontal Toasters were sold through retail stores nationwide from 1994 through 1996 for about $50 to $64. Consumers can easily identify these recalled toasters because they are the only Spacemaker Optima Toasters that have an "OPEN" button. This "OPEN" button is located on the right side of the control panel. The words "Black & Decker...Spacemaker...Horizontal Toaster...Optima" appear on the toaster door. "MODEL NO. T1000 TY1" is stamped on the back of the toaster. Date codes 405 through 504 appear on the outer prong of the plug blade.

Consumers should stop using these toasters immediately, and contact Black & Decker at (800) 746-2159 between 7 a.m. and midnight EDT Monday through Friday and between 9 a.m. and 10 p.m. EDT Saturday and Sunday.

Black & Decker is expanding its efforts to notify consumers by mailing letters directly to consumers, purchasing advertising, providing retailers with new safety notices for in-store displays and posting recall information on its web site. Black & Decker is issuing this press release to media outlets nationwide and broadcasting video by satellite so that local television stations can report on this recall announcement by showing the product and the potential fire hazard.

To ensure that the improved recall runs smoothly, Black & Decker also has set up and staffed a special toll-free hotline for consumers to call to participate in this recall.

CPSC believes that for a recall to be effective, people need to know about it and be moved to act on it. CPSC asks companies to use appropriate resources to make sure the public is aware of the hazard associated with a recalled product. With this program, CPSC believes that Black & Decker is now being more aggressive in its attempt to obtain an effective recall. CPSC and Black & Decker, by this modified and improved recall program announced today, strive to ensure that the public is well aware of the risk associated with the toaster. They urge consumers to act quickly and call Black & Decker to participate in the improved recall.



CONFIDENTIALITY AGREEMENT

For Analysts and Other Persons Afforded Access to Executives and Information of [Company Name]

In connection with your being granted interview or other access to executives of _______________ (the "Company"), you hereby agree to the following:

1. While the Company does not intend to disclose to you material nonpublic information ("Nonpublic Information"), both you and the Company recognize that such Nonpublic Information may be inadvertently disclosed to you by the Company or discerned by you from information which is not in itself material, but which may, in context with other non-material information, lead you to conclusions that may constitute Nonpublic Information about the Company.

2. You agree that at least two persons from the Company shall be in attendance at all times during your interview of, or discussions with, designated executives of the Company (herein an "Interview"). If the Company elects, it may take complete notes, make a tape recording or other recording of the Interview. If it does so, it agrees to provide you with a copy of such recording.

3. You agree that for a period of forty-eight (48) hours following the Interview you will not publish any analyst's report or update any existing report or otherwise disclose any information from the Interview to any other person without the prior written consent of the Company.

4. If the Company determines during such 48 hour period that any information disclosed or discernible from the Interview may constitute Nonpublic Information, and so notifies you in writing (the "48 Hour Notice"), identifying in reasonable detail the content of such information, then you hereby agree that you shall retain such information in strictest confidence and shall neither use the information so identified in the 48 Hour Notice in preparing or updating any analyst's report or for any other purpose without the prior written consent of the Company.

5. In the event the Company does not provide the 48-Hour Notice within 48 hours following an Interview, then you are free to use all information from the Interview, and the restrictions and limitations set forth herein shall terminate and cease when such 48-hour period concludes.

6. In the event that you are requested or required (by oral questions, interrogatories, requests for information or documents in legal proceedings, subpoena, civil investigative demand or other similar process) to disclose any of the Nonpublic Information to any governmental agency or in the course of any litigation, you shall provide the Company with prompt written notice of any such request or requirement so that we may seek a protective order or other appropriate remedy and/or waive compliance with the provisions of this agreement. If, in the absence of a protective order or other remedy or the receipt of a waiver from the Company, you are nonetheless, in the written opinion of legal counsel, legally compelled to disclose the Nonpublic Information to any tribunal or else stand liable for contempt or suffer other censure or penalty, then you may, without liability hereunder, disclose to such tribunal only that portion of the Nonpublic Information which such counsel advises you is legally required to be disclosed, and you shall exercise your best efforts to preserve the confidentiality of the balance of such Nonpublic Information

7. In the event we provide you with any documentary or written materials in connection with the Interview, such materials shall be treated the same as the content of the Interview, and the 48 Hour Notice may require you to return or destroy such written materials, and you hereby agree to abide by any such directive in the 48 Hour Notice.

8. The laws of the State of _______________ shall govern this Agreement.

IN WITNESS WHEREOF, the parties have signed this Agreement as of the date written below.

Date: ____________________

NAME: NAME:

By: ____________________ By: ____________________
Name: Name:
Title: Title:

Accepted by Company Name

Date____________________

By ____________________________

Its ____________________________

FINANCIAL REPORTING

AND ACCOUNTING ISSUES

J. Richard Dietrich
Office of the Chief Accountant
U.S. Securities and Exchange Commission
Washington, D.C.

SECTION C

FINANCIAL REPORTING AND ACCOUNTING ISSUES
— Quality: Tomorrow and Today —

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Quality—Tomorrow and Today

Lynn E. Turner
Chief Accountant, U.S. Securities and Exchange Commission

(Originally presented November 9, 1999)

Today, over 65 years after the Securities and Exchange Commission was created, our objective continues to be the protection of investors through the fair and orderly operation of the markets. In satisfying its objective, the SEC has long relied upon transparent financial reporting, based on full and fair disclosure, to promote honest and efficient markets and allow for informed investment decision making. Transparency in financial reporting—that is, the extent to which financial information about a company or bank is visible and understandable to investors, other market participants, and regulators—has played a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

As the financial services industry evolves and becomes more complex, I believe that transparent financial reporting will take on an even greater role in the regulation of financial institutions. I'm not alone in this view. The Federal Reserve Board's Director of Supervision and Regulation recently stated:

"[T]he key to effective supervision in the next millennium...seems to me to depend on... [s]ubstantial improvement in public disclosures by banks and greater reliance on financial markets to discipline and 'regulate' bank risk-taking."

Transparency in a Changing World

The global world we live in today is quickly transforming how business is conducted, how markets react to economic events, how investors trade, and how regulators regulate. From a manufacturing-based economy, we have spawned the service and high technology industries, including the explosive growth in e-commerce. In banking, we have seen the introduction of drive-up banking, automated teller machines, electronic banking, and now Internet banking.

The lines dividing commercial banks, thrifts, investment banks, brokerages, insurance companies and finance companies are fading. Going forward, these lines will continue to blur and even to disappear. Many believe that the convergence that we have seen in the past year in the financial services industry will accelerate as a result of the financial reform legislation.

Clearly, advancements in technology have also contributed to the evolution of the banking industry. For example, in today's financial markets, modern technology allows institutions to move funds anywhere in the world at lightning speed, more than $1.5 trillion every day—a sum equal to world trade for four months. New breakthroughs in technology have fundamentally changed the ways in which banks and financial services companies communicate with customers, competitors, investors and regulators.

And with these changes, we have also come to see some of the accompanying transformations such as greater product and investment risks, use of greater leverage by some institutions, increased volatility in the worldwide capital markets, and markets where liquidity can disappear overnight, creating international financial instability.

I believe that with these changes in business, we must continue to explore ways to improve the transparency of our public disclosures and business reporting model. We need to focus on understanding what are the key drivers of value in a business. We need to be identifying the significant risks affecting businesses today as well as into the future. And we need to convey this information in a transparent way to investors, markets, and regulators on a timely basis.

This will certainly be a guiding light to the staff as we consider ways to improve our current disclosures in Guide 3 and address allowances for loan losses. We also expect it will provide the framework for the AcSEC task force. For example, we will be asking if appropriate risks, such as in the credit quality of the loan portfolio, those resulting from products and leverage, and those resulting from securitizations all have been made transparent to investors in a meaningful manner.

In October of 1999, Chairman Levitt asked Professor Jeffrey Garten, Dean of Yale's School of Management, to assemble a group of leaders from the financial community to examine, in an expeditious manner, whether and how our current business reporting framework can more effectively capture these momentous changes in our economy. This group, and others that have been convened, will continue to address innovations in accounting and reporting to match innovations in business so that we can maintain transparency. Accounting standards must continue to evolve—standards and disclosure requirements that may have been acceptable in the past decade may no longer serve well in the future.

Quality of Financial Reporting Today

But let's move back from the future to today, and look at the status of financial reporting. A little over a year ago, Chairman Levitt highlighted the need to improve the quality of financial reporting. Chairman Levitt feared that emerging trends, if not reversed, would lead to a lack of investor confidence in the "numbers" they have come to rely on for making investment decisions.

Oprah Winfrey said that "Lots of people want to ride with you in the limo, but what you want is someone who will take the bus with you when the limo breaks down." Well, that's just what we have found in fellow Commissioners, staff, and many in the business community who have taken up the charge against abusive practices that include not only fraud, but also financial reporting in what I label the "gray zone." These practices mask economic reality. Rather than managing the business and letting the numbers reflect reality, some are managing the numbers to reflect an imaginary business. This is a battle about doing what is right for investors and markets, and ultimately the American economy.

Audit Committees

Since we began our initiative to address the "Numbers Game" concerns, the results have been extremely encouraging. First of all, many in the financial community have joined together in a partnership that is improving the quality of financial reporting.

In one instance, a group of investors, business executives, CEOs in the accounting profession, and leading legal experts formed the "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees." In just four months, this Committee produced ten recommendations. Those recommendations, and just as important, the best practices included in the report, are beginning to be used by audit committees. The stock exchanges have proposed changes to their listing standards as recommended to them by the Blue Ribbon Committee, with some minor modifications.

The Auditing Standards Board ("ASB") recently issued a very good proposal in response to the recommendations of the Blue Ribbon Committee to the auditing profession. I strongly support this proposal which would require a discussion between the auditor, the audit committee, and management regarding the quality of the Company's financial reporting. These discussions, which I believe must involve all three members of what I call the "three legged stool," will provide an open dialogue amongst its participants that cannot be anything but healthy. The ASB and its hard-working staff also have issued an outstanding toolkit on revenue accounting and auditing issues that every CFO, controller, and auditor should read. Additionally, the ASB is preparing a revenue audit guide and is undertaking to provide further guidance on auditing loss accruals—that is, "reserves."

At the SEC, the Commission has issued proposed rules to implement certain of the recommendations made by the Blue Ribbon Committee. The proposals follow the Committee's recommendations with a couple of exceptions. First, we did not include a proposal to require the audit committee to disclose whether it had complied with its charter. We were concerned that such a requirement would lead to watered-down, meaningless charter provisions. Second, we modified the requirement to have the audit committee, based on input from internal and external financial professionals, report on whether the financial statements were in compliance with generally accepted accounting principles ("GAAP"). We heard the concerns of those who wondered whether an audit committee had the expertise to make such a report. As a result, we met with members of the legal, accounting, and financial management communities. We asked them for their best thinking on alternative approaches. We received some very good input from the legal community as well as from the accounting profession. The legal profession supplied us with an idea for a negative assurance type report that we had already been thinking about internally. In addition, Ernst & Young prepared a very good survey of audit committee practices and worked with other members of the profession on this issue. They met with us and suggested an alternative type of report. This proactive leadership and participation has assisted us in crafting what we put into the final rule proposal. I want to thank those who have shown such leadership on this critical issue.

We also heard concerns about the possibility of increased exposure for audit committee members. We share that concern. Accordingly, we have included a safe harbor in our rule proposal. In addition, I am told that a good process—one that properly informs the board—goes a long way in providing insulation from liability under both the business judgment rule and traditional duties of care. As a result, an audit committee that follows a reasonable process, based on the best practices and recommendations set forth in the Blue Ribbon Committee's recommendations, should enjoy less, rather than more, liability exposure.

Materiality

In addition to the rule proposal on audit committees, the staff recently issued Staff Accounting Bulletin ("SAB") No. 99 on materiality. That SAB reiterates, and brings into a retrievable format, the guidance currently found in legal case law, and in accounting and auditing literature. We hope it will level the playing field for those of you who work hard to prepare high quality financial reports.

As noted in the SAB and in existing guidance, both qualitative and quantitative factors must be considered when assessing materiality. The SAB also notes that intentional errors made to manage earnings are not considered appropriate and are unlikely to comply with the Foreign Corrupt Practices Act ("FCPA") requirements to maintain books, records, and accounts which, in reasonable detail, accurately and fairly reflect transactions.

One question I often am asked is whether any adjustment that is not booked is an illegal act. The answer to that question is no. As a former CFO, I clearly understand that there are adjustments that arise as a result of the normal closing process which, depending on the facts and circumstances, may not always be recorded. As noted in footnotes 18 and 50 of the SAB, insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business would need to be assessed against the various factors and criteria set forth, such as those on aggregating and netting, in determining whether such adjustments would need to be recorded.

While we have made some initial progress towards improved financial reporting, there are still troublesome issues we continue to confront. Let me address a few of those that relate specifically to financial institutions.

Effective Internal Controls

For the past couple of years, the SEC staff and banking regulators have identified issues and expressed concerns particular to the banking industry. Our three interagency announcements issued during this past year highlight a number of our joint concerns.

One of the specific concerns expressed by the banking regulators is the need for appropriate underwriting standards and internal controls related to the accounting for and financial reporting of the allowance for loan losses. I must strongly echo those views and also note that we have recently seen questions raised in the press regarding other activities such as money laundering, basic account reconciliations, and misappropriation of funds to manage earnings. These press accounts raise fundamental questions about the adequacy and effectiveness of an institution's internal accounting controls and the quality of work being performed by the independent auditors.

An institution's internal accounting controls for loan loss allowances should assure compliance with the authoritative accounting guidance contained in accounting and auditing pronouncements, including Statements of Financial Accounting Standards ("SFAS") 5 and 114, and the recent FASB Staff Viewpoints article included in Emerging Issues Task Force ("EITF") Topic D-80. The accounting controls should assure timely and accurate reporting for financial reporting purposes including for losses and changes in the credit quality of the loan portfolio in accordance with GAAP. Auditors should also assure that there has been compliance with Statement of Auditing Standards ("SAS") 54, *Illegal Acts by Clients*, and SAS 82, *Consideration of Fraud in a Financial Statement Audit*, the FCPA, and Section 10A of the Securities Exchange Act of 1934.

In the course of reviewing registrant filings in the past year, the staff noted certain instances in which creditors did not appear to have adequate controls in place to assure that loan loss allowances and provisions were determined and reported in accordance with GAAP. In some cases, institutions did not have adequate documentation and clear, concise internal communication of their policies and procedures related to loan loss allowances. As an example, we noted instances where there was a distinct disconnect between an institution's credit administration function and its financial reporting group in the accounting for loan loss allowances.

I encourage financial institutions and their auditors to put renewed focus and emphasis on the existence and effectiveness of internal controls to assure compliance with the FCPA and on the determination of loan loss provisions and allowances in accordance with

GAAP. Additionally, institutions, and their auditors, should assure that appropriate supporting documentation exists for the policies, procedures, and methodologies used, as well as for the amounts in the financial statements.

I would also remind you of particular disclosures the staff expects to see in filings by financial institutions which are set forth in the letter on this topic at our website, http://www.sec.gov/rules/othern/bankl1a.txt.

Segment Disclosures

SFAS 131 requires companies to report financial and descriptive information about their reportable operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available, and that is evaluated regularly by the "chief operating decision maker" in deciding how to allocate resources and to assess segment performance.

In some cases, however, financial statements of public companies have not conformed with these requirements. We have seen instances where: (1) the internal reporting package included operating information on more segments than were disclosed in the financial statements; (2) those additional segments were discussed in MD&A or analysts' reports; and (3) the company's executives also discussed the additional segments in press releases or business periodicals.

When reviewing segment information as part of its normal filing review and comment process, the staff is not reticent to ask registrants for a copy of the internal reports or other materials supplied to the "chief operating decision maker" of the company, as well as analysts' reports and press releases. Assuring quality implementation of SFAS 131 on segment disclosures is clearly in the interest of investors. Consequently, if the segment information provided in the financial statements does not reflect a similar breakdown of company segments as is evident in the internal reports and other materials, the staff will seek amendment of the registrant's filings.

Special Purpose Entities

Another example of an area in which we have seen problems in financial reporting is the use of special purpose entities ("SPEs"). SPEs have legitimate uses and the Financial Accounting Standards Board ("FASB") and the EITF have issued guidance to account for certain transactions involving SPEs. For example, SFAS 125 and EITF Issue 96-20 provide the relevant accounting guidance for qualifying special purpose entities ("QSPEs"). The appropriate accounting guidance for other SPEs is provided in EITF Topic D-14 and Issues 90-15 and 96-21.

While we know that legitimate SPE transactions exist, we have also become aware of SPE transactions that have not complied with all of the relevant accounting requirements specified in EITF Topic D-14 and Issues 90-15 and 96-21. We have seen what appear to be contrived, structured transactions that defy transparency, and we are prepared to challenge registrants in instances where they have not complied with the appropriate accounting and reporting guidance. For example, there is specific and very clear guidance in Issue 90-15 that discusses the minimum substantive amount of real equity needed by an SPE. SPEs that do not comply with these rules, such as when they use subordinated debt rather than equity, or do not have the minimum amount of equity as discussed in the staff's announcement in Issue 90-15, will be required to be consolidated. In an effort to improve the guidance in this area, we have asked the FASB to address the consolidation of SPEs in its consolidation project. In the interim, those who do not comply with existing rules may be feeling like a long-tailed cat in a room full of rocking chairs.

Implementation of SFAS 133

In 1998, I challenged financial management and the accounting profession to take the high road in implementing new accounting standards, and I specifically mentioned SFAS 133. As you know, the FASB deferred the effective date of SFAS 133 for one year, and this standard will now be effective for fiscal years beginning after June 15, 2000. This deferral should help assure a high quality implementation of this standard. Both the Financial Executives Institute ("FEI") and the American Bankers Association ("ABA") noted in press releases announcing the deferral that the additional year would be used to prepare for implementation of the standard, make necessary systems changes, and allow for an orderly transition to the new accounting requirements. As a result, we do not expect any further deferral of the effective date of this pronouncement. In this context, we continue to encourage registrants and the accounting profession to bring issues and questions to the Derivatives Implementation Group ("the DIG") on a proactive and timely basis to help promote an effective implementation.

The SEC staff will also continue to closely monitor the implementation of this standard in its review of filings with the Commission. During this past year we have observed that certain early adopters of SFAS 133 have not complied with the relevant requirements of this standard and, as a result, we have requested restatement. In particular, the standard requires contemporaneous documentation for transactions that are to be accounted for using hedge accounting. I emphasize that the documentation must be prepared contemporaneously on the date of initial adoption or, if later, at the inception of the hedge and not at a later date, such as at the end of a subsequent quarter or at year-end. Accordingly, I urge companies to assure that the policies, procedures, and internal controls they put in place to implement SFAS 133 are appropriate. In addition, auditors will need to assure that their audit programs include appropriate and timely tests related to SFAS 133 implementation. I once again challenge auditors and management to take the high road in helping achieve a quality implementation of this standard.

Intercompany Derivatives

The last issue I want to touch upon is hedging with intercompany derivative instruments. In December 1998, the SEC staff advised registrants that, under GAAP, an intercompany derivative designated as a hedging instrument should be supported by documentation, prepared contemporaneously, which demonstrates that the notional amount, duration, interest rate risk, currency risk, commodity risk, and other risks associated with such intercompany derivative contracts have been laid off to unrelated third parties. The staff indicated that for hedging instruments designated after January 1, 1999, the staff expects registrants to comply with GAAP. The SEC staff has become aware that, in some instances, practice may continue to diverge from GAAP; the staff intends to challenge the appropriateness of the accounting in these instances. In such instances, a registrant will be required to eliminate the impact of intercompany derivative contracts in preparing consolidated financial statements in accordance with ARB No. 51. Additionally, in accordance with SFAS No. 80, these intercompany derivative contracts may not qualify as hedging instruments in the consolidated financial statements.

Conclusion

Lord Kelvin, a noted English scientist and president of the Royal Society who lived from 1824 to 1907, once said: "Radio has no future; heavier-than-air flying machines are impossible; X-rays will prove to be a hoax. I have not the smallest molecule of faith in aerial navigation other than ballooning." So here we are today, a century older and wiser. The dawn of a new millennium is upon us. If we are to succeed, to accomplish what those before us could not foresee, we must be willing to think beyond the outer limits that serve as a glass wall to what no doubt lies beyond.

Today, I challenge those of you who comprise the accounting profession and who reap the benefits of the world's greatest capital markets to seek out ways we can improve the quality of financial reporting. In that regard, I've outlined a number of important issues. We need to maintain and adjust our high quality accounting standards as technology changes business activities. Managers and audit committees need to work together to assure that financial statements provide full and fair disclosure to investors and others. And auditors need to work to maintain the public's confidence in their integrity and in the credibility of the financial statements that they audit. By working together, we can continue to enjoy the rewards of our collective endeavor—new and expanded business opportunities, more jobs, and a better future for those who invest their hard-earned dollars for a child's college education, for retirement, or for a rainy day.

CURRENT ISSUES AND RULEMAKING PROJECTS

SECURITIES AND EXCHANGE COMMISSION

DIVISION OF CORPORATION FINANCE

John R. White
Securities and Exchange Commission
Division of Corporation Finance
Washington, D.C.

SECTION D

CURRENT ISSUES AND RULEMAKING PROJECTS
DIVISION OF CORPORATION FINANCE

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CURRENT ISSUES AND RULEMAKING PROJECTS
DIVISION OF CORPORATION FINANCE
DECEMBER 10, 1999

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- Releases, Staff Legal Bulletins, Staff Accounting Bulletins
- Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance
- Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations (including updates)

A number of the forms and regulations administered by the Division are available in the "Small Business Information" section of the web site.

I. DIVISION ORGANIZATION AND EMPLOYMENT OPPORTUNITIES

The Division's organizational structure follows:

Division Director - Brian Lane (202) 942-2929
Deputy Director - Michael McAlevey (202) 942-2810

Operations

Associate Director (Disclosure Operations)
- Martin P. Dunn (202) 942-2890

Associate Director (Disclosure Operations)
- Shelley Parratt (202) 942-2830

Associate Director (Small Business)
- (vacant) (202) 942-2880

Disclosure Support

Associate Director (Legal)
-(vacant) (202) 942-2820

Associate Director (Regulatory Policy, Mergers & Acquisitions)
- Mauri Osheroff (202) 942-2840

Associate Director (International)
- (vacant) (202) 942-2870

Associate Director (Chief Accountant)
- Robert Bayless (202) 942-2850

Senior Counsel to the Director
- Anita Klein (202) 942-2980

Assistant Directors

Health Care and Insurance
- Jeffrey P. Riedler (202) 942-1840

Consumer Products
- H. Christopher Owings (202) 942-1900

Computers and Office Equipment
- James Daly (202) 942-1800

Natural Resources
- Roger Schwall (202) 942-1870

Transportation and Leisure
- William L. Tolbert, Jr. (202) 942-1850

Manufacturing and Construction
- Steven Duvall (202) 942-1950

Financial Services
- Todd Schiffman (202) 942-1760

Real Estate and Business Services
- Paula Dubberly (202) 942-1960

Small Business
- Richard Wulff (202) 942-2950

Electronics and Machinery
- Peggy Fisher (202) 942-1880

Telecommunications
- Barry Summer (202) 942-1990

Structured Finance and New Products
- Mark W. Green (202) 942-1940

Other Offices

Office of Chief Counsel
- Catherine Dixon, Chief (202) 942-2900

Office of Mergers and Acquisitions
- Dennis O. Garris, Chief (202) 942-2920

Office of International Corporate Finance
- Paul Dudek, Chief (202) 942-2990

Office of EDGAR and Information Analysis
- Herbert Scholl, Chief (202) 942-2930

Division Employment Opportunities for Accountants and Attorneys

Accountants

The Division has about 100 staff accountants with specialized expertise in the various industry offices. The Division provides a fast-paced, challenging work environment for accounting professionals. Our staff works on hot IPOs and current and emerging accounting issues. We influence accounting standards and practices and interact with the top professionals in the securities industry.

A staff accountant's responsibilities include examining financial statements in public filings and finding solutions to the most difficult and controversial accounting issues. A minimum of three years' experience in a public accounting firm or public company dealing with SEC reporting is required. If you want to experience a unique learning opportunity and explore the depth and breadth of accounting theory, principles, and practices, call (202) 942-2960 for information on employment opportunities in the Division.

Attorneys

From time to time, the Division of Corporation Finance has positions available for law school graduates with solid legal skills and experience. Applicants should demonstrate an ability to accept major responsibilities. We prefer applicants who have had extensive experience in securities transactions involving public companies. It is also helpful, but not necessary, if applicants have accounting and/or business training.

Responsibilities include analyzing and commenting on disclosure documents in public offerings. The positions involve working directly with companies, their executives, underwriters, outside counsel and outside accountants. Working on transactions in today's market requires people that are dynamic and fast-paced. The work involves innovative cutting-edge financing and business structures. Interested persons should send a resume to Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

II. REGULATION OF SECURITIES OFFERINGS PROPOSING RELEASE (the "AIRCRAFT CARRIER")

A. Background

The Commission for the past several years has been actively reevaluating the current registration system. Recent Commission steps in that process have included:

- the Report of the Task Force on Disclosure Simplification (March 1996);
- the Report of the Advisory Committee on the Capital Formation and Regulatory Process (July 1996); and
- the Securities Act Concept Release (July 1996).

In 1996, Congress for the first time granted the Commission broad general exemptive authority. Thereafter the Commission began to consider more broadly how to improve the present system using this new authority. On November 13, 1998 the Commission published a proposing release (Securities Act Release No. 7606A) that would modernize the regulation of capital formation. These proposals would provide significant benefits to issuers of securities, securities professionals and public investors. The public comment period has been extended to June 30, 1999.

Briefly, the proposals cover five major topics. First, the proposals would create a three-tiered registration system that would extend the some of the advantages of private offerings - timing and disclosure flexibility - to many registered offerings. The registration proposals also would permit more issuers to take advantage of the streamlined small business requirements by increasing the small business issuer threshold. Second, the proposals would lift many of the restrictions on communications around the time of an offering and provide certainty and clarity in the areas of "gun jumping" and the "quiet period." Accordingly, the current limitations on free writing would be loosened and the current safe harbors for research reports would be significantly expanded. Third, the proposals would re-focus prospectus delivery requirements to ensure that investors receive prospectus information when they need it most: before their investment decisions. Today, only delivery of final prospectuses is usually required and they are typically delivered with the confirmation. Fourth, the proposals would provide issuers with integration safe harbors so that they could convert a private offering to a public offering (or vice versa) in response to changing market conditions. This flexibility also would permit "testing the waters" for all issuers, while maintaining investor protection. Finally, to reduce concerns about selective disclosure, the proposals seek better and more timely disclosure in Exchange Act reports.

B. The Registration System

We now have a number of forms for registration of securities offerings under the Securities Act. All of these forms require issuers to file specified disclosure. The proposed system would eliminate Forms S-1, S-2, S-3, S-4, S-11, F-1, F-2, F-3 and F-4. In their place the proposed system would add Forms A, B and C. Forms A, B and C would be available for offerings by both foreign and domestic issuers. Form A would be available for smaller or unseasoned issuers. Form B would be available for offerings by larger, seasoned well followed issuers and for offerings made to informed or sophisticated investors. Form C would be available for business combinations.

C. Communications

The current system imposes certain restrictions on communications before and during the time an issuer is "in registration." In the pre-filing period, no offers may be made and, during the waiting period, written offers may be made only through a mandated-content prospectus. The net effect of these existing restrictions is to inhibit communications by the issuer and underwriter around the time of an offering. The proposals would lift these restrictions for many offerings.

1. Form B Offerings

In Form B offerings, there would be no restrictions on communications. Issuers would be permitted to make offers, orally or in writing, before filing a registration statement. Communications during the offering period would have to be filed, either as offering information or free writing materials. The offering period would be defined as the period beginning 15 days before the first offer was made, by or on behalf of the issuer, and ending at the completion of the offering. Offering information would be filed as part of the registration statement and be subject to Sections 11 and 12(a)(2) as well as the antifraud provisions of the federal securities laws. Free writing materials would be filed under proposed Rule 425 and be subject to Section 12(a)(2) and the antifraud provisions. Offering information and free writing used in the 15 days before filing the registration statement would be filed at the time the registration statement is filed; such materials used after the filing of the registration statement would be filed at the time of first use.

2. Other Offerings

The proposals include a bright line communications exemption that would permit any communication made by or on behalf of the issuer more than 30 days before a Form A registration statement is filed. The Form A issuer must take reasonable steps to prevent distribution of communications made before the 30 day pre-filing period from being distributed during this time.

During the 30 day pre-filing period, free writing would remain restricted. The proposals, however, do permit certain communications during the 30 day pre-filing period: factual business communications and, for reporting companies, regularly released forward looking information.

The proposals would eliminate all restrictions on free writing after the filing of a registration statement if the issuer complies with the prospectus delivery requirements in proposed Rule 172, files the free writing used during the offering period pursuant to proposed Rule 425 and files a final prospectus before the first sale. Free writing materials would be filed at the time of first use and would be subject to Section 12(a)(2) and the antifraud provisions of the federal securities laws.

The proposed communications exemptions do not apply to business combinations. A separate regulatory scheme addressing communications involving business combinations has been adopted in rulemaking on Takeovers and Security Holder Communications (see Section IV.A of this outline).

3. Research Reports

The communications exemptions for research reports currently contained in Rules 137, 138 and 139 would be significantly expanded to provide for greater communications during the offering period.

D. Prospectus Delivery Requirements

Currently, all issuers must send a final prospectus to purchasers. A preliminary prospectus is required to be delivered only in limited situations. The proposed prospectus delivery requirements contemplate that the investor receives information when it needs it most, prior to its investment decision. As with other reforms, what prospectus information is required to be delivered, and when, will depend on the nature of the issuer and the offering.

1. Form B Offerings

In Form B offerings, a prospectus meeting the requirements of Section 10 would not be required to be delivered. A term sheet would be required to be delivered. These reforms also apply to seasoned Schedule B filers registering an offering of more than $250 million that is underwritten on a firm commitment basis and is registered more than a year after the effective date of its IPO.

2. Offerings by Small or Unseasoned Issuers

For other offerings, a prospectus meeting the requirements of Section 10 must be delivered before the investment decision is made. For an IPO or offerings registered within one year of the IPO, the proposals require delivery 7 calendar days before the securities are priced (in a firm commitment offering) or before the investor makes a purchase commitment (in a best efforts offering). For offerings by more seasoned issuers, a prospectus must be delivered 3 calendar days before pricing or commitment. If a material change has occurred that was not described in the delivered prospectus, the issuer must disclose the information about the change at least 24 hours before either pricing or the purchase commitment. Smaller, unseasoned Schedule B filers would be treated like Form A issuers.

3. **Final Prospectuses**

There is no delivery requirement for final prospectuses in most offerings, although final prospectuses would still be filed with the Commission. Pursuant to proposed Rule 173, most issuers would be exempt from delivering a final prospectus if the following conditions are met: the issuer files a Section 10(a) prospectus (minus Rule 430A price-related information) before confirmations are sent; investors are informed before confirmation where they may obtain a final prospectus, free of charge; and a prospectus is delivered pursuant to proposed Rule 172. Final prospectuses still would be required to be delivered in business combinations on Forms C, SB-3, F-8 and F-80.

4. **Aftermarket Prospectus Delivery**

Dealers are currently required to deliver prospectuses in certain offerings for a specified period of time after effectiveness of a registration statement. They are subject to this requirement even though they may not have participated in the offering. Proposed revisions to Rule 174 would extend dealers' aftermarket delivery obligation to all offerings. This aftermarket delivery obligation would exist for 25 calendar days after the later of the effectiveness of a registration statement or the first date on which the securities were offered. The proposals, however, would deem the aftermarket delivery obligation to be satisfied if the final prospectus (excluding Rule 430A price-related information) is on file with the Commission and the dealer informs the investor, before or at confirmation, where it may obtain the final prospectus, free of charge. The proposals would also repeal Rule 153, which deems the prospectus delivery requirement to be met by delivery to an exchange.

E. **Integration of Public and Private Offerings**

The proposals permit issuers flexibility in determining whether to proceed on a registered or unregistered basis, provided that key investor protections are maintained. The revisions eliminate many of the uncertainties while permitting testing the waters. Safe harbors would be provided for converting public offerings to private offerings and vice versa.

Proposed revisions to Rule 152 would provide guidance on when a private placement is considered completed. Proposed Rule 159 would codify the current staff position concerning lock-up agreements before business combinations.

F. **Exchange Act Reporting Revisions**

In order to provide better and more timely disclosure and prevent selective disclosure, the Exchange Act proposals expedite the reporting of certain information and add requirements to report certain material events. These proposals would:

- require risk factor disclosure in Exchange Act annual reports and registration statements with quarterly updates in Forms 10-Q and 10-QSB;
- accelerate the due dates for most Forms 8-K from 15 days to 5 days;
- require the filing of Form 8-K for additional events including:

  -material defaults on senior securities;

  -material modifications to the rights of security holders;

  -company name change;

  -departure of CEO, CFO, COO or President;

  -notification that reliance on prior audit is no longer permissible, or that auditor will not consent to use of its report in a Securities Act filing;

- require the filing of Form 8-K in one business day for certain items;
- require the filing of Form 8-K for selected financial information as specified in Item 301 of Regulation S-K (60 days after the end of the fiscal year and 30 days after the end of the quarter); and
- accelerate the filing of Form 20-F from 6 months to 5 months.

The proposals also solicit comment on:

- accelerating the Form 10-K filing period from 90 days to 60 or 70 days;
- accelerating the Form 10-Q filing period from 45 days to 30 or 35 days; and
- revising Form 6-K to mandate reporting of Form 8-K events if the information is disclosed under applicable foreign requirements.

The Exchange Act proposals also would:

- treat information set forth in Part I of Forms 10-Q and 10-QSB as filed for purposes of Section 18;
- require the principal executive officers and a majority of the board of directors to sign Exchange Act reports;
- require signers of Exchange Act filings to certify that they have read the filing and that, to their knowledge, the filing does not contain an untrue statement of a material fact or an omission of a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; and
- permit concurrent registration under the Securities Act and the Exchange Act by checking a box on the Securities Act registration statement.

III. PLAIN ENGLISH INITIATIVE

In August 1995, Chairman Arthur Levitt created a staff Task Force on Disclosure Simplification to review rules and forms relating to capital raising transactions, periodic reporting pursuant to the Exchange Act, proxy solicitations, and tender offers and beneficial ownership reporting under the Williams Act. On March 5, 1996, the Commission published the Report of the Task Force on Disclosure Simplification.

One of the Task Force's major concerns was the lack of readability of prospectuses and other disclosure documents. The report noted that issuers, underwriters and their lawyers draft defensively written documents that place a premium on legal jargon and over-inclusive disclosures. The Task Force recommended requiring plain English disclosure to improve the readability of the prospectus.

To implement the Task Force recommendations, the SEC issued proposed rules for public comment (Securities Act Release No. 7380 (January 14, 1997)). On January 22, 1998, the Commission adopted the final plain English rules (Securities Act Release No. 7497). These rules apply to public companies and mutual funds. The Division of Corporation Finance issued Staff Legal Bulletin No. 7 on the new rules, and updated it on June 7, 1999.

1. New Rule 421(d) - The Plain English Rule

This rule requires public companies and mutual funds to prepare the front portion of their prospectuses in plain English. They must use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors section. Also, when writing these portions of the prospectus, they must comply substantially with six basic principles:

- Short sentences;

- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation or bullet list for complex material, whenever possible;
- No legal jargon or highly technical business terms; and
- No multiple negatives.

In addition, public companies and mutual funds must design the cover page, summary, and risk factors section to make them easy to read. They must format the text and design the document to highlight important information for investors. The rule also permits them to use pictures, charts, graphics, and other design features throughout the prospectus to make it easier to read.

2. <u>Amended Rule 421(b) - The Clear, Concise, and Understandable Rule</u>

Rule 421(b) currently requires that the *entire* prospectus be clear, concise, and understandable. To provide guidance on this rule, we adopted amendments that set out four general writing techniques that public companies and mutual funds must use throughout their prospectuses:

- Present information in clear, concise sections, paragraphs, and sentences. Whenever possible, use short explanatory sentences and bullet lists;
- Use descriptive headings and subheadings;
- Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information in the prospectus. Define terms in a glossary or other section of the document only if the meaning is unclear from the context. Use a glossary only if it facilitates understanding of the disclosure; and
- Avoid legal and highly technical business terminology.

We also added a new note to Rule 421(b) that lists writing conventions to avoid because they make prospectuses harder to read:

- Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;
- Vague boilerplate explanations that are readily subject to differing interpretations;
- Complex information copied directly from legal documents without any clear and concise explanation of the provision(s); and
- Repetitive disclosure that increases the size of the document but does not enhance the quality of the information.

3. <u>Amendments to Regulation S-K and Regulation S-B</u>

To implement the changes we made to Rule 421, we also adopted amendments to Regulations S-K and S-B.

4. <u>Plain English Handbook</u>

"A Plain English Handbook—How to Create Clear SEC Disclosure Documents," issued by the Office of Investor Education and Assistance, is now available in final form. You can download a copy from our web site at *http://www.sec.gov* or request a paper copy by calling 1-800-SEC-0330.

IV. MERGERS AND ACQUISITIONS

In addition to the matters in this section, see Section XI.G below, "Financial Statements in Hostile Exchange Offers."

A. Regulation of Takeovers and Security Holder Communications

On October 22, 1999, the Commission adopted a new regulatory scheme for business combination transactions and security holder communications (Securities Act Release No. 7760). The new rules and amendments are effective January 24, 2000. The amendments significantly update the existing regulations to meet the realities of today's markets while maintaining important investor protections. Specifically, the amendments reduce restrictions on communications, balance the regulatory treatment of cash and stock tender offers, and update, simplify and harmonize the disclosure requirements.

1. Reduce Restrictions on Communications

Currently, the Securities Act, as well as the proxy and tender offer rules, restrict communications. The new rules and amendments relax these restrictions by permitting the dissemination of more information on a timely basis without triggering the need to file a mandated disclosure document. Under the new scheme, a complete disclosure document still must be provided before a security holder may vote or tender securities, but other communications regarding the transaction are permitted. This should permit more informed voting and tendering decisions. The content of communications is not restricted, but anyone relying on the new rules must file written communications relating to the transaction on the date of first use, so that all security holders have access to the information. In particular, the amendments permit more communications:

- before the filing of a registration statement relating to either a stock merger or a stock tender offer transaction;
- before the filing of a proxy statement (regardless of the subject matter or contested nature of the solicitation); and
- regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.

The amendments also harmonize the various communications principles applicable to business combination transactions under the Securities Act, tender offer rules and proxy rules. Confidential treatment of merger proxy statements is retained, but only under limited circumstances. Under the new scheme, if parties to a transaction publicly disclose information beyond that specified in Rule 135, the proxy statement must be filed publicly. If a proxy statement is filed confidentially, but later the parties disclose information beyond Rule 135, then the proxy statement must be re-filed publicly.

2. Balance the Regulatory Treatment of Cash and Stock Tender Offers

Currently, registered stock tender offers (exchange offers) are subject to regulatory delays not imposed on cash tender offers. A cash tender offer may commence as soon as a tender offer schedule is filed and the information disseminated to security holders while an exchange offer may not commence before a registration statement is filed and becomes effective. The delay associated with exchange offers may cause some bidders to favor cash over stock as consideration in a business combination transaction. In addition, the different regulatory treatment can give a bidder offering cash a timing advantage over a competing bidder offering stock. The amendments adopted will balance the regulatory treatment of cash and stock tender offers to the extent practicable.

Under the new rules third-party or issuer exchange offers may commence as early as the filing of a registration statement, or on a later date selected by the bidder, before effectiveness of the registration statement. As a result, a bidder offering securities will not need to wait until effectiveness to commence an exchange offer. Early commencement is not mandatory, but rather at the election of the bidder. A bidder may file a registration statement, wait for staff comments, if any, and then decide to commence its offer. Any securities tendered in the offer could not be purchased until after the registration statement becomes effective, the minimum 20 business day tender offer period has expired, and all material changes are disseminated to security holders with adequate time remaining in the offer to review and act upon the information. A bidder need not deliver a final prospectus to security holders. Security holders may withdraw tendered securities at any time before they are purchased by the bidder.

3. Updating, Simplifying and Harmonizing the Disclosure Requirements

Currently, the procedural and disclosure requirements for business combination transactions vary depending upon the form of the transaction. Many of the differences can be minor and unnecessary. The amendments clarify and harmonize many of the requirements. The amendments also make the requirements easier to understand and facilitate compliance with the regulations.

The substantive disclosure requirements for tender offers, going-private transactions and other extraordinary transactions remain substantially the same, but are moved to one central location within the rules, called "Regulation M-A." In some cases, harmonization reduces the disclosure requirements. The amendments also update the rules in several respects. The more significant amendments will:

- combine the existing schedules for issuer and third-party tender offers into one new schedule available for all tender offers, called "Schedule TO";
- require a plain English summary term sheet in all tender offers, mergers and going-private transactions, except when the transaction is already subject to the plain English requirements of the Securities Act rules;
- update and generally reduce the financial statements required for business combinations;
- require pro forma and related financial information in negotiated cash tender offers when the bidder intends to engage in a back-end securities transaction;
- permit an optional subsequent offering period after completion of a tender offer during which security holders can tender their shares without withdrawal rights;
- revise Rule 13e-1, which requires issuers to report intended repurchases of their own securities once a third-party tender offer has commenced, so that the required information need not be disseminated to security holders and to provide an exclusion from the rule for certain periodic, routine purchases;
- conform the current security holder list requirement in the tender offer rules with the comparable provision in the proxy rules so that the list will include non-objecting beneficial owners; and
- clarify the rule that prohibits purchases outside a tender offer (Rule 10b-13), codify prior interpretations of and exemptions from the rule; add several new exceptions to the rule, and redesignate it as new Rule 14e-5.

B. Cross Border Tender Offers, Rights Offers and Business Combinations

The Commission has adopted exemptive provisions to facilitate the inclusion of U.S. investors in tender and exchange offers, business combinations and rights offerings for the securities of foreign companies. (Securities Act Release No. 7759, October 22, 1999).

1. Reasons for the Exemptions

Although it is very common for U.S. persons to hold securities of foreign companies, they often are unable to participate fully in tender offers, rights offerings and business combinations involving those securities. Offerors often exclude U.S. security holders due to conflicts between U.S. regulation and the regulation of the home jurisdiction or the perceived burdens of complying with multiple regulatory regimes.

In tender offers where the bidder is offering its own securities and rights offers where existing shareholders are offered the opportunity to buy more stock, in the absence of an exemption (such as the new exemptions contained in the release), inclusion of U.S. holders would require registration under the Securities Act. Registration requires the issuer to provide to shareholders financial statements prepared in accordance with U.S. accounting standards. Also, the issuer would incur an ongoing reporting obligation in the United States.

2. Harmful Effects of Excluding U.S. Investors

U.S. investors often are unable to receive the full benefits offered to other investors in these types of offshore transactions. When bidders exclude the U.S. security holders from tender or exchange offers, the U.S. investors are denied the opportunity to receive the full value of the premium offered for their shares. (In some cases, these holders may eventually have their securities acquired in a compulsory acquisition when the offeror completes the acquisition.) Similarly, when issuers exclude their U.S. security holders from participation in rights offerings, the U.S. investors lose the opportunity to retain their relative ownership position or possibly to purchase at a discount. (In some instances, they may be able to receive the cash value of their rights.)

These offshore transactions may affect the interests of the U.S. investors in the foreign securities, regardless of whether they receive information about the transaction or are able to participate directly in the offer. For example, market activity in the stock after announcement of a tender offer may affect the price of the stock. Even though U.S. investors cannot participate in the tender offer, they must react to the event by deciding whether to sell, hold, or buy additional securities. Offerors will often take affirmative steps to prevent their informational materials from being disseminated in the United States as a means to avoid triggering U.S. regulatory requirements. U.S. investors, therefore, must make this decision without the benefit of information required by either U.S. or foreign securities regulation.

3. The Exemptions

The new exemptions balance the need to promote the inclusion of U.S. investors in these types of cross-border transactions against the need to provide U.S. investors with the protections of the U.S. securities laws. The U.S. anti-fraud and anti-manipulation rules and civil liability provisions will continue to apply to these transactions. The rule changes are effective January 24, 2000.

New provisions in the tender offer rules exempt:

- tender offers for the securities of foreign private issuers from most provisions of the Exchange Act and rules governing tender offers when U.S. security holders hold 10 percent or less of the foreign company's securities that are subject to the offer (the "Tier I exemption").
- tender offers from certain limited provisions of the Securities Exchange Act of 1934 and rules governing tender offers when U.S. security holders hold 40 percent or less of a foreign private issuer's securities that are subject to the offer (the "Tier II exemption"). The Tier II exemption represents a codification of current exemptive and interpretive positions that eliminate frequent areas of conflict between U.S. and foreign regulatory requirements.
- tender offers for the securities of foreign private issuers from Rule 10b-13 of the Exchange Act (redesignated Rule 14e-5 in the Regulation M-A rulemaking), which will permit purchases outside the tender offer during the offer when U.S. security holders hold 10 percent or less of the subject securities.

In addition, two new exemptions from the Securities Act registration and Trust Indenture Act provisions exempt:

- under new Rule 801, rights offerings of equity securities by foreign private issuers from the registration requirements of the Securities Act when U.S. security holders hold 10 percent or less of the securities.

- under new Rule 802, securities issued in an exchange offer, merger or similar transaction for a foreign private issuer from the registration requirements of the Securities Act and the qualification requirements of the Trust Indenture Act when U.S. security holders hold 10 percent or less of the subject class of securities.

Some of the more significant changes from the November 1998 proposals include:

- The U.S. ownership thresholds for the Rule 801 and Rule 802 registration exemptions have been increased from five to 10 percent.
- Under a "cash-only alternative" for Tier I tender offers, bidders will be permitted to offer cash in the United States while offering securities offshore without violating the equal treatment requirements of the tender offer rules. The bidder must have a reasonable basis to believe that the cash being offered to U.S. security holders is substantially equivalent to the value of the consideration being offered to non-U.S. holders.
- holders in both rights offerings and exchange offers would receive restricted stock under Rule 144 only to the extent their existing holdings were restricted. We had proposed treating all securities issued in rights offerings as restricted.
- In determining U.S. ownership, an offeror would be required to "look through" the record ownership of certain brokers, dealers, banks or nominees holding securities for the accounts of their customers. Ten percent holders, foreign or domestic, are excluded from the calculation, rather than just foreign 10 percent holders as had been proposed. Securities held by the bidder also are excluded from the calculation.

C. Amendments To Beneficial Ownership Reporting Under Exchange Act Section 13(d)

On January 12, 1998, the Commission adopted amendments to its beneficial ownership disclosure rules under Section 13(d) of the Exchange Act of 1934 to reduce the reporting obligations of certain investors. See Exchange Act Release No. 39538 (January 12, 1998). The rules had been published for comment in Exchange Act Release No. 37403 (July 3, 1996). The new provisions include the following:

- Unless they were qualified institutional investors, most investors previously were required to file a long-form Schedule 13D disclosing detailed information about the "investor and the purpose and background of the acquisitions. The revised rules now allow passive investors (those that do not have the purpose or effect of changing or influencing control of the issuer) to report their greater than 5% ownership on the short-form Schedule 13G if they do not own 20% or more of the outstanding securities.
    - The initial schedule must be filed within 10 days.
    - The schedule must be amended annually to reflect any changes in the information.
    - The schedule must be amended promptly if ownership increases by more than 10% and thereafter promptly upon increasing or decreasing by more than 5%.
    - If the reporting person no longer has a passive investment purpose or increases his or her ownership to 20% or more, a Schedule 13D must be filed within ten days. Upon those events, the person may not vote the securities or acquire additional equity securities of the issuer until 10 days after the Schedule 13D is filed.

- A reporting person may re-establish its Schedule 13G-eligibility and switch from Schedule 13D to Schedule 13G once it becomes a passive investor and its ownership decreases below 20%.
- The list of qualified institutional investors who are eligible to file on Schedule 13G, regardless of their percentage ownership, is expanded to include the following:
- employee benefit plans maintained primarily for the benefit of state or local government employees;
- savings associations;
- church employee benefit plans;
- control persons of qualified institutional investors who have a passive investment purpose and do not own directly, or indirectly through an ineligible entity, more than 1% of the issuer's stock;
- investment advisers prohibited from registering under the Investment Advisers Act of 1940 pursuant to Section 203A of that Act.
- Copies of Schedule 13G are no longer required to be sent to the exchanges on which the securities trade.
- Under interpretive guidance provided by the Commission in adopting the amendments, the Commission clarified that beneficial ownership by a subsidiary or other business unit may not have to be attributed to the subsidiary's parent entity if the voting and investment powers over the subsidiary's shares are exercised independently from the parent. This determination is based on the facts and circumstances.
- One circumstance in which beneficial ownership may not be required to be attributed to the parent is when these entities have in place certain informational barriers that ensure that the voting and investment powers are exercised independently.
- If informational barriers are relied upon, written policies and procedures should be used, annual independent assessments of the informational barriers should be made, and the entities should not share common officers, directors or employees that are involved in the exercise of the voting and investment powers.

The Commission also provided guidance regarding the impact of soliciting activities by a shareholder with respect to shareholder proposals on the use of Schedule 13G by that shareholder. Soliciting activity that does not have the purpose or effect of changing or influencing control does not prevent the use of Schedule 13G. That determination is based on the facts and circumstances. The release highlights five relevant factors to consider in assessing the purpose and effect of the proposal and related soliciting activity.

D. Current Issues

1. Disclosure Issues Arising in Tender Offers for Limited Partnership Units

Several tender offers for limited partnership interests have commenced where the price offered is significantly below the amount originally paid for the units, prices paid for the interests in the secondary markets, and/or recent appraisals of the assets owned by the partnership. Some of these tender offers have been conducted by the general partner of the limited partnership, while others have been conducted by unaffiliated parties.

Since most of these transactions have been structured as cash offers for less than all of the outstanding limited partnership units, these transactions generally have not been subject to the roll-up or going private rules, both of which require enhanced disclosure regarding the fairness of the transaction and any conflicts of interests presented by the party making the transaction. However, many of the same concerns that led to the development of a specialized regulatory scheme for roll-ups of limited partnerships are raised by these transactions — notably the conflict of interest presented by the participation of affiliated entities in purchasing the limited partnership interests and the inability of these investors to realize fair market value for their interests through a trading market, as opposed to accepting what is perceived as an "inadequate offer."

In preparing disclosure documents for these transactions, bidders are advised to remember that the 1991 release adopting the roll-up provisions specifically addresses transactions which, although by definition not roll-ups, raise similar concerns. The release states that the disclosure required by the roll-up rules must be considered from an antifraud perspective (Securities Act Release No. 6922 (October 30, 1991)). Bidders are also advised to provide balanced disclosure as required by Securities Act Release No. 6900 (June 17, 1991), including describing risks of the transaction in bullet form on the cover page, providing a detailed table of contents and writing the document in "plain English."

The staff is closely reviewing the disclosure in these transactions and expects that bidders, whether or not affiliated with the general partner, will provide investors with sufficient disclosure to consider adequately the conflicts presented by any affiliation between the bidder and the general partner and disparities between the value of their interests and the consideration offered, including whether any reports or appraisals that are materially related to the transaction have been prepared by a third party. Financial information relating to the partnership also should be provided, such as selected financial data required by Item 301 of Regulation S-K. If the target partnership is a real estate limited partnership, disclosure comparable to that required by Items 14 (description of real estate) and 15 (operating data) of Form S-11 should be provided. An unaffiliated bidder is required to disclose only information that is otherwise publicly available unless it has received non-public information from the target, in which case the non-public information also would need to be disclosed. Soliciting dealer fees or any other payments to brokers, dealers or agents for soliciting tenders should be prominently disclosed in the offering documents.

2. <u>Investment Banking Firm Disclaimers</u>

Boards of directors of companies soliciting shareholder voting and/or investment decisions in connection with mergers and other extraordinary transactions often retain investment banking firms as financial advisors, in many cases to render an opinion on the financial fairness of the transaction. In connection with its review of proxy statements, Securities Act registration statements and other Commission filings made in this context, the staff increasingly has observed the appearance of disclaimers by or on behalf of the financial advisor regarding shareholders' right to rely on a fairness opinion that the advisor has furnished to the registrant's board, a special committee of the board, and/or the registrant. Examples of such disclaimers include the following:

- "No one other than the Board of Directors [or the Special Committee and/or the Company] has the right to rely on this opinion;"
- "This opinion is provided solely/only to the Board of Directors [or the Special Committee and/or the Company];"
- "This opinion is solely/only for the benefit of the Board of Directors [or the Special Committee and/or Company];"
- "No one may rely on this opinion without the prior consent of the Financial Advisor;" and

- "This opinion is addressed [solely/only] to the Board of Directors [Special Committee and/or the Company] and is not intended to be relied upon by any shareholder."

During the review and comment process, the staff has objected to such statements as inconsistent with the balance of the registrant's disclosure addressing the fairness to shareholders of the proposed transaction from a financial perspective. Specifically, the staff has requested that any such direct or indirect disclaimer of responsibility to shareholders, whether made by or on behalf of the financial advisor, be deleted from any portion of the disclosure document in which it appears (including exhibits). Alternatively, the registrant may add an explanation that clarifies:

(a) the basis for the advisor's belief that shareholders cannot rely on its opinion, including (but not limited to) whether the advisor intends to assert the substance of the disclaimer as a defense to shareholder claims that might be brought against it under applicable state law;

(b) whether the governing state law has addressed the availability of such a defense to the advisor in connection with any such shareholder claim; if not, a statement must be added that the issue necessarily would have to be resolved by a court of competent jurisdiction; and

(c) that the availability or non-availability of such a defense will have no effect on the rights and responsibilities of the board of directors under governing state law, or the rights and responsibilities of the board or the advisor under the federal securities laws.

3. Securities Act Registration Issues Arising in Connection With Mergers and Other Extraordinary Transactions

[Note: These procedures will change after effectiveness of the new regulatory scheme for business combinations discussed in Section IV. A.]

Third parties often urge shareholders to vote against a pending merger on the basis that the third party is proposing its own competing acquisition proposal. When the competing acquisition proposal involves the use of the third party's securities as consideration (through an exchange offer or merger), communications by the third party to shareholders regarding its competing bid may, depending on the facts and circumstances, be an "offer to sell" or "solicitation of an offer to buy" the third party's securities. As a result, the opposition solicitation triggers the registration requirements of Section 5 of the Securities Act, as well as the proxy disclosure and dissemination requirements.

Generally speaking, a third party's written communications in connection with its solicitation in opposition to a pending merger or business combination would not raise Section 5 concerns if the communications fall within the safe harbor provisions of Securities Act Rules 145(b) and 135. Parties should consider the following matters in order to avoid Section 5 concerns.

Under Rule 145(b)(1) of the Securities Act, a written communication would not be deemed an offer to sell if it contains no more than: (i) the name of the third party or other person or entity that might be issuing securities in the potential competing transaction, as well as the names of any other parties to such transaction, (ii) a brief description of the potential competing transaction and the basis upon which such transaction will be made, and (iii) any legend or similar statement required by State or federal law or administrative authority. See also Rule 135 of the Securities Act.

Under Rule 145(b)(2) of the Securities Act, any written communication that is subject to and meets the requirements of Exchange Act Rule 14a-12, and is filed in accordance with paragraph (b) of that rule, would not be deemed an "offer to sell" under Section 5. Rule 14a-12 provides that a solicitation (other than one subject to Rule 14a-11, which pertains to election contests) may be made before furnishing security holders a written proxy statement meeting the requirements of Rule 14a-3(a) if:

(1) the solicitation is made in opposition to a prior solicitation or an invitation for tenders or other publicized activity, which if successful, could reasonably have the effect of defeating the action proposed to be taken at the meeting;

(2) no form of proxy is furnished to security holders before the written proxy statement required by Rule 14a-3(a) is furnished to security holders;

(3) the identity of the "participants" in the solicitation and a description of their interests, direct or indirect, by security holdings or otherwise, are set forth in each communication published, sent or given to security holders in connection with the solicitation, and

(4) a written proxy statement meeting the requirements of Regulation 14A is sent or given to solicited security holders at the earliest practicable date.

However, the safe harbor provisions of Securities Act Rules 145(b) and 135 only protect written communications made before a registration statement is filed. Accordingly, oral communications made before a registration statement is filed may still raise Section 5 concerns. If a person is relying on Rule 14a-12 and Rule 145(b)(2) to disseminate information to shareholders before filing a registration statement, the information must be in written form and filed with the Commission when first disseminated. These issues arise often in meetings and conference calls with analysts or shareholders before filing a registration statement.

The staff also notes that Rule 14a-12 only applies to solicitations that are made before furnishing security holders a written proxy statement meeting the requirements of Rule 14a-3(a). The proxy statement is required to be sent or given to solicited security holders "at the earliest practicable date." The safe harbor cannot be relied upon if the soliciting person challenging a proposed merger does not intend to file and deliver a Rule 14a-3 proxy statement within a reasonable period of time.

Where the third party's proxy solicitations trigger the need for compliance with the registration and prospectus delivery provisions of the Securities Act, the third party should file promptly a registration statement to cover the securities offering to target shareholders.

In view of the number of communications the third party may disseminate in opposition to the "friendly" transaction during the "waiting period," the staff will not object if the "core" proxy statement/prospectus is not redelivered with each additional communication, so long as:

- Before dissemination of additional communications, the preliminary proxy statement/prospectus (without a proxy card containing a proposal directed to the third party's competing package) is sent or given to all target company shareholders eligible to vote at the shareholders' annual or special meeting at which shareholders will consider and vote on the "friendly" proposal.
- Each additional communication is filed as a pre-effective amendment to the registration statement. In lieu of filing a pre-effective amendment, a registrant eligible to use Form S-3 or F-3 may file the additional communications under cover of a Form 8-K that is incorporated by reference into the proxy statement/prospectus, which is part of the registration statement.
- Each additional communication used after delivery of the preliminary prospectus includes a statement to the effect that the third party has filed a registration statement, that the preliminary prospectus has been sent or given to all shareholders eligible to vote at the meeting at which the "friendly" transaction will be considered, and that the proxy statement/prospectus is incorporated by reference into the communication.

The staff's procedures outlined above are limited solely to the dissemination of additional communications and are not applicable to the dissemination of revisions to the "core" document.

Securities Act registration issues also may arise in connection with the announcement of a negotiated, stock-for-stock merger by one or both of the parties to the prospective transaction. Such announcements, which typically are accompanied or followed by various other market communications regarding the planned transaction, frequently are made by the parties' senior management, their respective investment bankers and/or other representatives before the filing of the required Securities Act registration statement. While issuers in these circumstances may have obligations under federal securities antifraud and stock exchange rules to make timely disclosure of the impending transaction, they should remember that such pre-filing communications may go beyond what arguably is necessary and appropriate for compliance with applicable antifraud and SRO provisions and, as such, could be deemed to constitute market conditioning that violates Section 5. Whatever its content, moreover, the information conveyed in these pre-filing communications must be reflected in the offering documents subsequently filed with the Commission and delivered to shareholders.

4. <u>Identifying the Bidder in a Tender Offer</u>

Rule 14d-1(c)(1) of Regulation 14D defines "bidder" in a tender offer as "any person who makes a tender offer or on whose behalf a tender offer is made." The term bidder, for Regulation 14D purposes, does not include an issuer that makes a tender offer for its own securities. Each bidder in a tender offer subject to Regulation 14D must file a Schedule 14D-1 (Schedule TO after the Regulation M-A rules become effective) and disseminate the information required by that schedule.

The determination of who is the bidder does not necessarily stop at the entity used to make the offer and purchase the securities. Rule 14d-1(c)(1) also requires persons "on whose behalf" the tender offer is being made to be included as bidders. For instance, where a parent company forms an acquisition entity for the purpose of making the tender offer, both the acquisition entity and the parent company are bidders even though the acquisition entity will purchase all securities tendered. The staff views the acquisition entity as the nominal bidder and the parent company as the real bidder. They both should be named bidders in the Schedule 14D-1. Each offer must have at least one real bidder, and there can be co-bidders as well.

The fact that the parent company or other persons control the purchaser through share ownership does not mean that the entity is automatically viewed as a bidder. Instead, we look at the parent's or control person's role in the tender offer. Bidder status is a question that is determined by the particular facts and circumstances of each transaction. A similar analysis of bidder status is made in a tender offer subject only to Regulation 14E. When we analyze who is the bidder, some relevant factors include:

- Did the person play a significant role in initiating, structuring, and negotiating the tender offer?
- Is the person acting together with the named bidder?
- To what extent did or does the person control the terms of the offer?
- Is the person providing financing for the tender offer, or playing a primary role in obtaining financing?
- Does the person control the named bidder, directly or indirectly?
- Did the person form the nominal bidder, or cause it to be formed?, and
- Would the person beneficially own the securities purchased by the named bidder in the tender offer or the assets of the target company?

One or two of these factors may control the determination, depending on the circumstances. These factors are not exclusive.

We also consider whether adding the person as a named bidder means shareholders will receive material information that is not otherwise required under the control person instruction, Instruction C to Schedule 14D-1. However, this issue is not dispositive of bidder status. A person who qualifies as a bidder under Rule 14d-1(c)(1) must be included as a bidder on the Schedule 14D-1 even if the disclosure in the Schedule 14D-1 will not change as a result. Instruction C elicits information about the control persons of the bidder. Merely disclosing the Instruction C information does not eliminate the requirement that the real bidder sign the Schedule 14D-1 and take direct responsibility for the disclosure. Where the real bidder does not sign the Schedule 14D-1 and does not provide the required disclosure, the parties run the risk of having to extend the offer to provide a full 20 business day period for shareholders to consider the new information.

If a named bidder is an established entity with substantive operations and assets apart from those related to the offer, the staff ordinarily will not go further up the chain of ownership to analyze whether that entity's control persons are bidders. However, it still would be possible for other parties involved with the offer to be co-bidders. The factors listed above would be used in the analysis. In addition, we would consider the degree to which the other party acted with the named bidder, and the extent to which the other party benefits from the transaction.

5. <u>Schedule 13E-3 Filing Obligations of Issuers or Affiliates Engaged in a Going-Private Transaction</u>

Generally, Exchange Act Rule 13e-3 requires that each issuer and affiliate engaged, directly or indirectly, in a going-private transaction file a Schedule 13E-3 with the Commission and furnish the required disclosures (e.g., the statement of "reasonable belief" as to the fairness or unfairness of the proposed transaction) directly to the holders of the class of equity securities that is the subject of the transaction. A joint filing may be permissible in this situation, provided each filing person individually makes the required disclosures and signs the Schedule 13E-3.

Two separate but related issues may be raised with respect to the determination of "filing-person" status in situations where a third party proposes a transaction with an issuer that has at least one of the requisite "going-private" effects: first, what entities or persons are "affiliates" of the issuer within the scope of Rule 13e-3(a)(1) and, second, when should those affiliates be deemed to be engaged, either directly or indirectly, in the going-private transaction. Resolution of both issues necessarily turns on all relevant facts and circumstances of a particular transaction. The following considerations should be noted:

> (a) The staff consistently has taken the position that members of senior management of the issuer that is going private are affiliates of that issuer. Depending on the particular facts and circumstances of the transaction, such management also might be deemed to be engaged in the transaction. As a result, such management-affiliates may incur a Schedule 13E-3 filing obligation separate from that of the issuer. For example, the staff has taken the position that members of senior management of an issuer that will be going private are required to file a Schedule 13E-3 where the transaction will be effected through merger of the issuer into the purchaser or that purchaser's acquisition subsidiary, even though:
>
> > (i) such management's involvement in the issuer's negotiations with the purchaser is limited to the terms of each manager's future employment with and/or equity participation in the surviving company; and
> >
> > (ii) the issuer's board of directors appointed a special committee of outside directors to negotiate all other terms of the transaction except management's role in the surviving entity.

An important aspect of the staff's analysis was the fact that the issuer's management ultimately would hold a material amount of the surviving company's outstanding equity securities, occupy seats on the board of this company in addition to senior management positions, and otherwise be in a position to "control" the surviving company within the meaning of Exchange Act Rule 12b-2 (<u>i.e.</u>, "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.").

> (b) Questions have arisen regarding the nature and scope of the Schedule 13E-3 filing obligation of an acquiring person, or "purchaser," in a merger or other going-private transaction. In the situation described in (a) above, where management of the issuer-seller that will be going private is essentially "on both sides" of the transaction, the purchaser also may be deemed to be an affiliate of the issuer engaged in the transaction and, as a consequence, required to file on

Schedule 13E-3. See Exchange Act Release No. 16075 (August 2, 1979) (noting that "affiliates of the seller often become affiliates of the purchaser through means other than equity ownership, and thereby are in control of the seller's business both before and after the transaction. In such cases the sale, in substance and effect, is being made to an affiliate of the issuer ...."). Accordingly, the issuer-seller, its senior management and the purchaser may be deemed Schedule 13E-3 filing persons in connection with the going-private transaction. Where the purchaser has created a merger subsidiary or other acquisition vehicle to effect the transaction, moreover, the staff will "look through" the acquisition vehicle and treat as a separate, affiliated purchaser the intermediate or ultimate parent of that acquisition vehicle. Accordingly, both the acquisition vehicle and the entity or person who formed it to acquire the issuer would have separate filing obligations (although, as noted, a joint filing may be permitted by the staff).

V. ELECTRONIC FILING AND TECHNOLOGY

A. EDGAR

The Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system has been operational since 1992, with mandated electronic filing by those subject to the Division's review beginning in April 1993. Electronic filings are publicly available on a 24-hour delayed basis in the "EDGAR Database" area of the Commission's website, *http://www.sec.gov*. This area also contains other information about EDGAR, including an outline entitled "Electronic Filing and the EDGAR System: A Regulatory Overview." The following events are of current interest:

1. EDGAR Modernization and Related Rule Amendments

On June 22, 1998, the Commission awarded to TRW, Inc. a three year contract for the modernization of the EDGAR System, with options for contract extensions for up to five years. The EDGAR architecture will be converted to an Internet-based system using Hyper Text Markup language ("HTML") as the filing format, and also will support the attachment of graphical files. The new system is expected to reduce costs and efforts of preparing and submitting electronic filings, as well as permit more attractive and readable documents.

On May 17, 1999, the Commission issued Securities Act Release No. 7684 adopting new rules and amendments to existing rules and forms in connection with the first stage of EDGAR modernization. The rules become effective June 28, 1999.

On June 28, the Commission began accepting live filings submitted in HTML, as well as documents submitted in the currently required American Standard Code for Information Interchange ("ASCII") format. Filers have the option of accompanying their required filings with unofficial copies in Portable Document Format ("PDF"). Filers also are encouraged to submit test filings that include documents in HTML and PDF format.

2. Paper Filings No Longer Accepted

The Commission has adopted a new electronic filing rule (Rule 14 of Regulation S-T) to make it clear that it will no longer accept filings made in paper that should have been filed electronically. See Release No. 33-7472 (October 24, 1997). The rule became effective January 1, 1998. If a filer submits a paper document required to be filed electronically, and does not follow the appropriate procedures for a temporary or continuing hardship exemption outlined in Rules 201 and 202 of Regulation S-T, the filing will not be accepted or processed. If the filing desk receives a document by courier it will be given back to the courier, and if received through the mail or other delivery service, it will be returned by mail.

B. Electronic Delivery of Information

The Commission has issued interpretive releases and rules addressing the use of electronic media to deliver or transmit information under the federal securities laws. These initiatives reflect the

Commission's continuing recognition of the benefits that electronic technology provides to the financial markets. These releases are premised on the belief that the use of electronic media should be at least an equal alternative to the use of paper delivery.

The first interpretive release (Securities Act Release No. 7233 (October 6, 1995)) provides guidance to issuers who use electronic media in complying with the applicable delivery requirements of the federal securities laws. Information distributed through electronic means may be viewed as satisfying the delivery requirements of the federal securities laws if it results in the delivery to the intended recipients of substantially equivalent information as they would have had if the information were delivered in paper form. The interpretive release advises issuers to consider the following:

- Has timely and adequate notice been provided to the investor that the information is available?
- Does the investor have access to the information? Specifically:
  - is it practically accessible?
  - is it available on-line for as long as a delivery requirement applies?
  - does the investor have the opportunity to retain the information or have ongoing access equivalent to personal retention?
  - is it available in paper upon request?
- Does the selected distribution method provide reasonable assurance that it will result in delivery? Examples for consideration by persons with delivery obligations include:
  - an investor has given an informed consent to receive the information through a particular electronic medium and been provided appropriate notice and access;
  - there is evidence that the investor actually received the information (e.g., electronic mail return receipt or confirmation of downloading);
  - the information is provided by facsimile to an investor who has provided a fax machine number;
  - the investor has accessed an electronic document with hypertext linking to a document required to be delivered; or
  - an investor returns an order form available only through an electronically delivered document.

The release also contains numerous examples applying these concepts to specific fact situations.

On May 9, 1996, the Commission issued a second interpretive release primarily addressing issues associated with the electronic delivery of information by broker-dealers, transfer agents, and investment advisers under certain Exchange Act and Advisers Act rules (Securities Act Release No. 7288). This release also contains a section following up the 1995 release with additional examples. A third interpretive release issued in 1998 is discussed below.

On May 9, 1996, the Commission also adopted a number of technical amendments to its rules and forms intended to codify some interpretations set out in the interpretive release (Securities Act Release No. 7289). Most changes relate to rules that require distribution of information by mail, or rules that require presentation of information in a specified type size or font, or in red ink or bold-face type. For example, if a rule requires presentation of a legend using a specified type size and font, the rule now provides that if an electronic medium is used, the legend must be presented using any means reasonably calculated to draw attention to it.

Guidance in this area also is provided by interpretive letters addressing particular issues regarding electronic dissemination. See Section XII. In addition, the staff has issued two letters addressing the identification of an issuer's web site in a prospectus: ITT Corporation (December 6, 1996) and Baltimore Gas and Electric Company (January 6, 1997).

C. Interpretive Release Relating to Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore

The Commission issued an interpretive release on March 23, 1998, that provides guidance on the application of the registration requirements of the U.S. securities laws to offers of securities or investment services made on Internet Web sites by foreign issuers, investment companies, investment advisers, broker-dealers and exchanges. In the release (Securities Act Release No. 7516), the Commission expresses its views on when the posting of offering or solicitation materials on Internet Web sites would not be considered to be an offering "in the United States."

The release states that, for purposes of the registration requirements only, offshore Internet offers and solicitation activities would not be considered to be made "in the United States" if Internet offerors implement measures that are reasonably designed to ensure that their offshore Internet offers are not targeted to the United States or to U.S. persons. In the Commission's view, offshore Internet offers that are not targeted to the United States would not trigger the registration requirements of the U.S. securities laws, even if U.S. persons are able to access the Web site offers.

The interpretation suggests measures that Web site offerors could implement to guard against targeting their offers to the United States. The measures outlined in the release are not exclusive. Other procedures may suffice to guard against sales to U.S. persons. Under the interpretation's general approach, a foreign offeror could post an offer on its Web site without registering the offer, if: i) the offeror puts a meaningful disclaimer on the Web site that would specify intended offerees by identifying the jurisdictions in which the offer is or is not being made; and ii) the offeror implements measures reasonably designed to prevent sales to U.S. persons.

The release explains that the measures suggested under the general approach may not be adequate for U.S. offerors making offshore Internet offers. Because domestic offerors are very likely to have significant contacts with the United States, and because investors may reasonably assume SEC regulation of the Internet offers of domestic entities, the Commission believes that U.S. offerors making offshore Internet offers should, in addition to following the general approach, password protect their Web sites to ensure that only non-U.S. persons may access their unregistered Web site offers.

Offerors may wish to post their offerings on third-party Internet sites or communicate with offerees through forms of Internet communication that are more directed than through an Internet Web site posting. Depending on the activities and status of the offerors, implementation of the measures described under the general approach may not be adequate to guard against targeting the United States. For example:

- If an offeror seeks to have its offshore offer posted on the Web sites of third parties that are acting on its behalf, such as Web site service providers or underwriters, the offeror should only use third parties that employ at least the same level of precautions against targeting the United States as would be adequate for the offeror to employ.
- If, to generate interest in their offshore Internet offers, offerors use the services of investment-oriented Web site sponsors that have a significant number of U.S. clients or subscribers, then those offerors should employ measures to ensure that only non-U.S. persons may access the offering materials on their Web sites.
- Offerors that address or direct communications, such as e-mail, about their offers to particular U.S. persons or groups must assume the responsibility of determining when their offering communications are being sent to persons in the United States, and must fully comply with U.S. securities laws.

The release discusses issues that arise under the Securities Act of 1933 when foreign issuers make offshore Internet offers at the same time they make other offers in the United States. Offerors of concurrent offerings should consider whether, in addition to following the general approach, they should implement more restrictive measures to avoid targeting the United States. The release indicates that:

- Offerors of concurrent offshore Internet and U.S. private offers may not use their Web site offers as a means to solicit investors for their U.S. private offerings. The release suggests two non-exclusive ways to reach that result. These offerors could either: i) allow unrestricted access to their offshore Internet offers, but implement procedures to identify respondents to their Web site offers and restrict them from participating in their U.S. private offers; or ii) limit access to their offshore Internet offers to only those respondents who first provide the offerors with information indicating that they are not U.S. persons.
- Offerors of concurrent offshore Internet and U.S. registered offers should keep in mind U.S. securities laws limitations on pre-filing and waiting period communications.

In addition to addressing issues under the Securities Act of 1933, the release provides guidance on the application of the general approach to the registration obligations under the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the broker-dealer and exchange registration provisions under the Securities Exchange Act of 1934.

D. Year 2000 Interpretive Release and Frequently Asked Questions

The "Year 2000 problem" arose because many existing computer programs use only the last two digits to refer to a year. Therefore, these computer programs do not properly recognize a year that begins with "20" instead of the familiar "19." If not corrected, many computer applications could fail or create erroneous results. The extent of the potential impact of the Year 2000 problem is not yet known, and if not timely corrected, it could affect the global economy.

On July 29, 1998, the Commission issued an interpretive release on Year 2000 disclosure, Securities Act Release No. 7558 (effective August 4). This release is meant to elicit more meaningful Year 2000 disclosure from public companies, investment advisers, investment companies and municipal securities issuers.

For public companies that make filings with the Division of Corporation Finance, the Commission's authority basically is directed toward eliciting disclosure. The disclosure framework requires companies to disclose material information that enables investors to make informed investment decisions. The interpretive release provides specific guidance for public companies making disclosure called for by Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), financial statement requirements and other rules and regulations.

MD&A (Item 303 of Regulation S-B and S-K) is the regulation that requires companies to disclose known events, trends, and uncertainties — forward-looking information. Most discussions of Year 2000 issues contain forward-looking elements. Under the release's interpretation of MD&A, a company would provide Year 2000 disclosure if:

(1) its assessment of its Year 2000 issues is not complete, or

(2) management determines that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition, without taking into account the company's efforts to avoid those consequences.

The Commission believes that the vast majority of companies have material Year 2000 issues, and therefore expects them to address this topic in their MD&A. In almost all cases, this disclosure should be updated in each quarterly and annual periodic report.

When a company has a Year 2000 disclosure obligation, the release states that full and fair disclosure includes:

(1) the company's state of readiness;

(2) the costs to address the company's Year 2000 issues;

(3) the risks of the company's Year 2000 issues; and

4) the company's contingency plans.

Each company must consider if its own Year 2000 circumstances require disclosure of other matters to meet their disclosure obligations. The release provides suggestions for some of these other matters.

To encourage companies to provide meaningful disclosure, the release provides interpretive guidance on the application of the statutory safe harbors for forward-looking information provided by the Private Securities Litigation Reform Act of 1995. These safe harbors provide protection for forward-looking information accompanied by meaningful cautionary statements. The safe harbors provide protection from class action lawsuits in federal court.

The release also addresses investment advisers and investment companies. The Commission, which has direct regulatory authority over these entities, has concluded that the best approach to monitor the year 2000 readiness of investment advisers and investment companies is to require the investment advisers to provide publicly available reports to the Commission. In June 1998, the Commission proposed to require these reports. The release also discusses the importance of disclosure by investment companies and investment advisers if the Year 2000 issue is material to their operating results or financial conditions, and provides guidance for such disclosure.

The Commission's regulatory authority over disclosure by issuers of municipal securities is not as broad as its authority over disclosure by public and investment companies. Generally, municipal securities offerings are, by statute, exempt from registration and municipal securities issuers are exempt from the reporting provisions of the federal securities law, including line-item disclosure rules. Under an anti-fraud standard, the release provides guidance to municipal securities issuers on how to disclose their Year 2000 issues.

On November 9, 1998, the Commission gave additional guidance on the interpretive release by publishing Frequently Asked Questions to clarify some recurring issues (Securities Act Release No. 7609).

VI. SMALL BUSINESS ISSUES

A. Recent Small Business Initiatives

The Commission has undertaken several initiatives to help small businesses, including the following:

- A special Corporation Finance headquarters unit specializes in small company filings and the needs of small businesses, including crafting rules to lessen the burden of Commission's regulation on these issuers. The telephone number for the unit is (202) 942-2950.
- The Commission's Internet site (*http://www.sec.gov*) has been enhanced to provide information specifically designed for small business and access to such Commission publications as "Q & A: Small Business and the SEC."
- The Division has added a new section to the Small Business Information page on the Commission's Internet site. The new section, Small Business Forms and Associated Regulations, will provide guidance to small businesses as they prepare their SEC filings under the Securities Act of 1933 and Securities Exchange Act of 1934. The new section

contains the text of a number of forms and regulations of interest to small businesses. Hypertext links between the forms and the regulations are provided, and updates will be made to reflect the adoption of new rules or changes to existing rules. More forms and rules will be added in the future.

- Since 1996, a number of town hall meetings between the Commission and small businesses have been conducted throughout the United States. These town hall meetings convey basic information to small businesses about fundamental requirements that must be addressed when they wish to raise capital through the public sale of securities. In addition, the Commission hopes to learn more about the concerns and problems facing small businesses in raising capital so that programs can be designed to meet their needs, consistent with the protection of investors. The most recent town hall meeting was held in Albuquerque, New Mexico on October 21, 1999.

- The 18th annual Government-Business Forum on Small Business Capital Formation was held in Washington, D.C. on September 13-14, 1999. This platform for small business is the only governmentally-sponsored national gathering for small business, which offers annually the opportunity for small businesses to let government officials know how the laws, rules and regulations are affecting their ability to raise capital. Next year's Government-Business Forum will be in Texas in September.

B. Small Business Rulemaking

1. Rule 504 of Regulation D

On February 25, 1999, the Commission issued a release (Securities Act Release No. 7644) adopting amendments to Rule 504, the limited offering exemption under Regulation D. Rule 504 permits non-reporting issuers to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information. The aggregate offering price of this exemption is limited to $1 million in any 12-month period, and certain other offerings must be aggregated with the Rule 504 offering in determining the available sales amount. Before these amendments were adopted, general solicitation and advertising was permitted and the securities sold under this exemption could be resold freely by non-affiliates of the issuer.

Unfortunately, there have been some recent disturbing developments in the secondary markets for some securities initially issued under Rule 504, and to a lesser degree, in the initial Rule 504 issuances themselves. These offerings generally involve the securities of "microcap" companies. Recent market innovations and technological changes, most notably, the Internet, have created the possibility of nation-wide Rule 504 offerings for securities of non-reporting companies that were once thought to be sold locally.

As part of the Commission's comprehensive agenda to deter registration and trading abuses, particularly by microcap issuers, in May 1998, the Commission proposed amendments to Rule 504 to eliminate the freely tradable nature of the securities issued under the exemption (Securities Act Release No. 7541). Under the proposals, these securities could only have been resold only after the one-year holding period of Rule 144, through registration, or through another exemption (such as Regulation A) if available. The Commission also solicited comment on an alternative to revise Rule 504 so it would be substantially similar to its pre-1992 format, permitting public offerings only where the issuer complies with state registration processes that require the preparation and delivery of a disclosure document to investors before sale of the securities. Comment also was solicited on the appropriate treatment for offerings made under certain state exemptions, such as the one recently developed for sales to accredited investors (e.g., the Model Accredited Investor Exemption).

Almost all commenters objected to the proposal to make all securities issued in a Rule 504 transaction restricted, since it would require issuers to offer a substantial liquidity discount in all Rule

504 issuances, even fully state registered ones, causing a significant reduction of capital. Commenters believed that the alternative approach, which was to reinstitute the rule largely as it had been in effect for a number of years before 1992, would be equally, if not more, effective. If an issuer goes through state registration and must deliver a disclosure document to investors, sufficient information ought to be available in the markets to permit investors to make more informed investment decisions and thus deter manipulation of Rule 504 securities.

After consideration of the comments, the Commission decided to return to the pre-1992 approach, which should deter microcap fraud without unduly penalizing small businesses. As amended, Rule 504 establishes the general principle that securities issued under the exemption, just like the other Regulation D exemptions, will be restricted, and prohibits general solicitation and general advertising, unless the specified conditions permitting a public offering are met. These conditions are:

- the transactions are registered under a state law requiring public filing and delivery of a substantive disclosure document to investors before sale. For sales to occur in a state without this sort of provision, the transactions must be registered in another state with such a provision and the disclosure document filed in the state must be delivered to all purchasers before sale in both states; or
- the securities are issued under a state law exemption that permits general solicitation and advertising, so long as sales are made only to accredited investors as that term is defined in Regulation D.

Most Rule 504 offerings are private. Private Rule 504 offerings are still permitted for up to $1 million in a 12-month period, under the same terms and conditions, except for the specific disclosure requirements, as offerings under Rules 505 and 506. Securities in these offerings would be restricted, and these offerings would no longer involve general solicitation and advertising.

The amendments became effective on April 7, 1999. Rule 504 offerings that begin on or after this date will have to comply with the new rule. With respect to Rule 504 offerings that are ongoing on the effective date, issuers will have to discontinue offers and register under a state law requiring the preparation and delivery of a disclosure document to investors before sale in order to issue freely tradable securities.

In response to questions the staff has received about the Rule 504 amendments, we would like to point that for public offerings registered under the provisions of a complying state registration system (New York and the District of Columbia do not have such a system), such offerings must be made exclusively to the citizens of the state(s) of registration. Registration in one state and attempted sale to the citizens of another state (except for New York and the District of Columbia) would not meet the public offering requirements and also may violate the law of the state where registration was not effected. Registration under a state law with sales to citizens of a foreign jurisdiction would not meet the standards for a public offering under revised Rule 504.

2. <u>Rule 701</u>

On February 25, 1999, the Commission issued a release (Securities Act Release No. 7645) adopting amendments to Rule 701 under the Securities Act of 1933, which allows private companies to sell securities to their employees without the need to file a registration statement, as public companies do. Rule 701 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemptive scope covers securities offered or sold under a plan or agreement between a non-reporting company (or its parents or majority-owned subsidiaries) and the company's employees, officers, directors, partners, trustees, consultants and advisors Before these amendments were adopted, the total amount of securities that could be offered in the preceding 12 months could not exceed the greater of $500,000 or an amount determined under one of two formulas (i.e., 15% of the issuer's total assets or 15% of the outstanding securities of the class being offered), but in no event more than $5 million.

In February 1998, the Commission proposed a number of revisions to increase the flexibility and usefulness of Rule 701, as well as to simplify and clarify the rule (Securities Act Release No. 7511). On February 25, 1999, the Commission issued an adopting release that:

- removes the $5 million aggregate offering price ceiling and, instead, sets the maximum amount of securities that may be sold in a year at the greatest of :

  —$1 million (rather than the current $500,000);

  —15% of the issuer's total assets; or

  —15% of the outstanding securities of the class;

- requires issuers to provide specific disclosure if more than $5 million worth of securities are to be sold (i.e., a copy of the compensatory benefit plan or contract; a copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 ("ERISA"), or if the plan is not subject to ERISA, a summary of the plan's material terms; risk factors associated with investment in the securities under the plan or agreement; and the financial statements required in an offering statement on Form 1-A under Regulation A);

- does not count offers for purposes of calculating the available exempted amounts;

- harmonizes the definition of consultants and advisors permitted to use the exemption to the narrower definition of Form S-8, thereby narrowing the scope of eligible consultants and advisors;

- amends Rule 701 to codify current and more flexible interpretations; and

- simplifies the rule by recasting it in plain English.

Non-reporting foreign private issuers will be required to provide the same disclosure as non-reporting domestic issuers if sales under Rule 701 exceed $5 million in a 12-month period. When, and if, the Commission accepts international accounting standards or guidelines for filing and reporting purposes, Rule 701 will be amended to allow theses standards to satisfy Rule 701's financial statement disclosure obligations for foreign private issuers. For issuers making smaller offerings, the foreign companies may continue to follow the rule as they have in the past, which means that "home country" reports may be used, as necessary, to satisfy the antifraud standards. However, both domestic and foreign private issuers that cross the $5 million barrier will have to provide the disclosure required under Regulation A, which includes unaudited financial statements. Where financial statements prepared in accordance with U.S. GAAP are not provided by the foreign private issuer, a reconciliation to such principles must be attached.

These amendments to Rule 701 became effective on April 7, 1999. The changes to the rule are not retroactive. Offers and sales made in reliance before the effective date will continue to be valid if they meet the conditions of the rule before its revision.

Because of errors in the Federal Register version of the adopting release, a different way of calculating the amount of the exempt offering appears in the Code of Federal Regulations than that approved by the Commission. On November 5, 1999, the Secretary of the Commission issued a release (Securities Act Release No. 7645A) to correct the errors. The correction deletes a reference to the necessity of only making calculations based upon an annual balance sheet. The original intention was to permit calculations to be made on the basis of interim balance sheets as long as they were no older than the issuer's most recent fiscal year end.

VII. INTERNATIONALIZATION OF THE SECURITIES MARKETS

A. Foreign Issuers in the U.S. Market

Foreign companies raising funds from the public or having their securities traded on a national exchange or the Nasdaq Stock Market are generally subject to the registration requirements of the Securities Act and the registration and reporting requirements of the Exchange Act. The Commission has provided a separate integrated disclosure system for foreign private issuers that provides a number of accommodations to foreign practices and policies. These accommodations include:

- interim reporting on the basis of home country and stock exchange practice rather than quarterly reports;
- exemption from the proxy rules and the insider reporting and short swing profit recovery provisions of Section 16;
- aggregate executive compensation disclosure rather than individual disclosure, if so permitted in an issuer's home country;
- acceptance of three International Accounting Standards relating to cash flow statements (IAS # 7), business combinations (IAS # 22) and operations in hyperinflationary economies (IAS # 21);
- offering document financial statements updated principally on a semi-annual, rather than a quarterly basis; and
- an exemption from Exchange Act registration under Section 12(g) for foreign private issuers that have not engaged in a U.S. public offering or whose securities are not traded on a national exchange or the Nasdaq Stock Market.

Additionally, the Commission staff has implemented procedures to review foreign issuers' disclosure documents on an expedited basis and in draft form, if requested by the issuer. This helps to facilitate cross-border offerings and listings in light of potentially conflicting home-country schedules and disclosure requirements. Over the last five years, the number of foreign companies accessing the U.S. public markets has increased dramatically. As of June 30, 1999 there were over 1200 foreign companies from 57 countries filing periodic reports with the Commission.

In addition to the topics discussed below in this "Internationalization" section, the Commission has issued an interpretive release on offshore Internet offerings; see Section V.C.

B. Abusive Practices under Regulation S and Amendments to the Rule

The Commission adopted Regulation S in 1990 to clarify the applicability of the Securities Act registration requirements to offshore transactions. Since the adoption of Regulation S, a number of abusive practices have developed involving unregistered sales of equity securities by U.S. companies purportedly in reliance upon Regulation S. These transactions have resulted in indirect distributions of those securities into the United States without the investor protection provided by registration.

Regulation S has been used as a means of perpetrating fraudulent and manipulative schemes. In these schemes, the securities are being placed offshore temporarily to evade U.S. registration requirements, but the ownership of the securities never leaves the U.S. market, or a substantial portion of the economic risk is left in or is returned to the U.S. market during the restricted period, or there is no reasonable expectation that the securities could be viewed as coming to rest abroad.

In June 1995, the Commission issued an interpretive release that described certain abusive practices under Regulation S and requested comment on whether the regulation should be revised to limit its vulnerability to abuse, Securities Act Release No. 7190 (June 27, 1995). To address continued abuses of this rule, the Commission published for comment a proposal to amend Regulation S, Securities Act Release No. 7392 (February 20, 1997). In February 1998, the Commission adopted most of these proposed amendments, Securities Act Release No. 7505 (Feb. 17, 1998).

The amendments are designed to eliminate abusive practices under Regulation S, while preserving the benefits of the rule for capital formation. As a result of these amendments, securities sold by domestic issuers pursuant to the Regulation S exemption will be treated in a manner similar to securities sold under the Regulation D exemption from registration.

The amendments to Regulation S affect offshore offerings of equity securities, including convertible securities, by U.S. companies. The amendments are as follows:

- Equity securities of domestic issuers placed offshore pursuant to Regulation S are classified as "restricted securities" within the meaning of Rule 144, so that resales without registration or an exemption from registration will be restricted;
- To avoid confusion between the holding period for "restricted securities" under Rule 144 and the "restricted period" under Regulation S, the term "restricted period" is renamed the "distribution compliance period;"
- The distribution compliance period for these securities is lengthened from 40 days to one year;
- Certification, legending and other requirements, which were applicable only to sales of equity securities by non-reporting issuers, are imposed on these equity securities;
- Purchasers of these equity securities are required to agree that their hedging transactions with respect to these securities will be conducted in compliance with the Securities Act, such as Rule 144 thereunder; and
- Domestic issuers are able to report sales of equity securities pursuant to Regulation S on a quarterly basis, rather than on Form 8-K. This change in reporting requirement was not effective until January 1, 1999, to allow Commission staff to monitor developments under the new amendments.

In addition, the amendments codify an existing Commission interpretive position that resales of these equity securities offshore do not "wash off" the restrictions applicable to these securities.

C. International Accounting Standards

The Commission has been working with the International Accounting Standards Committee (IASC) through the International Organization of Securities Commissions (IOSCO) since 1987 in an effort to develop a set of accounting standards for cross-border offerings and listings. The IASC is an independent, private sector body that was formed in 1973 by the professional accounting bodies in the U.S. and eight other industrialized countries to improve and harmonize accounting standards.

In July 1995, IOSCO and the IASC joined in an announcement that the IASC had developed a work program focusing on a core set of standards previously identified by IOSCO as being the necessary components of a reasonably complete set of accounting standards. The announcement noted that completion of comprehensive core standards that are acceptable to the IOSCO Technical Committee would allow the Technical Committee to recommend endorsement of the standards for cross-border capital raising and listing purposes in all global markets.

In April 1996, the IASC announced that it had accelerated its work program, and the Commission responded with a press release expressing support for the IASC's objective. The Commission's statement noted that the standards should include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting; that the standards be of high quality, i.e., they must result in comparability and transparency, and they must provide for full disclosure; and that the standards must be rigorously interpreted and applied. In October 1997, the Commission published a report to Congress that discussed the progress of the IASC. The report is available on the Commission's web site.

The IASC has completed substantially all the components of its core standards project, and both IOSCO and the Commission currently are engaged in a detailed assessment of the completed standards.

D. International Disclosure Standards—Amendments to Form 20-F

On September 28, 1999, the Commission adopted changes to its non-financial statement disclosure requirements for foreign private issuers, to conform those requirements more closely to the International Disclosure Standards endorsed by IOSCO in September 1998 (Securities Act Release No. 7745). The changes are intended to harmonize disclosure requirements on fundamental topics among the securities regulations of various jurisdictions.

1. Background

The Commission has long supported the concept of a harmonized international disclosure system, and for a number of years has been working with other members of IOSCO to develop a set of international standards for non-financial statement disclosures that could be used in cross border offerings and listings. The International Disclosure Standards developed by IOSCO reflect a consensus among securities regulators in the major capital markets as to the types of disclosures that should be required for cross border offerings and listings. The Standards cover fundamental disclosure topics such as the description of the issuer's business, results of operations and management and the securities it plans to offer or list.

2. Changes to Foreign Integrated Disclosure System

The Commission amended Form 20-F, the basic Exchange Act registration statement and annual report form used by foreign issuers, to incorporate the International Disclosure Standards. The Commission also revised the Securities Act registration forms designated for use by foreign private issuers, and related rules and forms, to reflect the changes in Form 20-F. The amendments do not change the financial statement reconciliation requirements for foreign issuers, and the Commission will continue to require disclosure on topics not covered by the International Disclosure Standards, such as disclosures relating to market risk and specialized industries such as banks. Unlike the IOSCO International Disclosure Standards, which were intended to apply only to offerings and listings of common equity securities and only to listings and transactions for cash, the amendments to Form 20-F apply to all types of offerings and listings and to annual reports. The Commission also revised the definition of "foreign private issuer," which determines an issuer's eligibility to use certain Commission forms and benefit from certain accommodations under Commission rules, to clarify how issuers should calculate their U.S. ownership for purposes of the definition.

The changes to Form 20-F, the Securities Act registration forms and the "foreign private issuer" definition become effective beginning in September 2000, but foreign registrants are encouraged to use the new forms before that date.

VIII. OTHER PENDING RULEMAKING AND RECENT RULE ADOPTIONS

A. Proposed Amendment to Options Disclosure Document Rule

On June 25, 1998, the Commission issued a release soliciting comments on a proposal to revise Rule 135b (Securities Act Release No. 7550). The proposal provides that an options disclosure document prepared in accordance with Rule 9b-1 under the Securities Exchange Act of 1934 is not a prospectus, and accordingly is not subject to civil liability under Section 12(a)(2) of the Securities Act. The proposal is intended to codify a long-standing interpretive position that was issued immediately after the Commission adopted the current registration and disclosure system applicable to standardized options. The proposed revision is intended to eliminate any legal uncertainty in this area.

B. Amendments Regarding Segment Disclosure

On January 5, 1999, the Commission adopted technical amendments to conform its rules with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 131 (Securities Act Release No. 7620). The amendments harmonize the narrative disclosure rules with recently revised GAAP financial reporting standards by requiring disclosure of a business enterprise's "operating segments," rather than its "industry segments," as previously required.

C. Final and Proposed Amendments to Form S-8

Form S-8 is the short-form Securities Act registration statement that is available for offers and sales of securities to employees. Unlike other Securities Act registration forms, Form S-8 does not contain a separate prospectus. Instead, Form S-8 relies on employee benefit plan disclosure documents otherwise provided by the employer to satisfy the disclosure obligations of the Securities Act. This abbreviated disclosure is available for offers and sales of securities to employees because of the compensatory nature of these offerings and employees' familiarity with the company's business due to the employment relationship. In 1990, the Commission revised the Form S-8 definition of "employee" to permit the form to be used for offers and sales of securities to consultants or advisors who provide legitimate services to the issuer that do not involve the offer or sale of securities in a capital-raising transaction.

Since adoption of the 1990 revisions, some companies have used Form S-8 improperly to compensate consultants whose primary service to the company is promotion of the company's securities. This practice has been used in fraudulent promotions of microcap and other securities. In other cases, Form S-8 has been used to distribute securities to public investors through so-called "consultants" whose service to the issuer is selling the securities into the market. This practice, which deprives public investors of the disclosure and liability protections of the Securities Act, has been the subject of Commission enforcement action. On February 25, 1999, the Commission issued Securities Act Release No. 7646 ("Adopting Release"), adopting amendments to Form S-8 and related rules designed to deter these abuses. The Adopting Release:

- amends Form S-8 and the definition of "employee benefit plan" in Securities Act Rule 405 so that the form is not available for sales to consultants and advisors who directly or indirectly promote or maintain a market for the company's securities; and
- amends Securities Act Rule 401(g) so that registration statements, such as Form S-8, that become effective automatically upon filing will not be presumed to be filed on the proper form.

The Adopting Release also includes interpretive guidance regarding the types of consulting activities that may - or may not - be compensated with securities registered on Form S-8.

Form S-8, of course, is used primarily for legitimate employee benefit plans. The Adopting Release also amends Form S-8 to simplify the registration of securities underlying stock options issued under employee benefit plans. Because stock options have become an increasingly important component of employee compensation, employees are more likely to face circumstances - such as estate planning and property settlements in connection with divorce - that may require the transfer of options to their family members.

These amendments permit employees' family members, as well as the employees themselves, to use Form S-8 to exercise options issued under employee benefit plans. "Family members" are defined to include persons with specified relationships to the employee, and specified entities that either benefit or are controlled by these persons. A corresponding amendment to General Instruction I.B.4 to Form S-3 makes Form S-3 equally available for the offer and sale of securities underlying both warrants and options, without regard to whether either class of derivative security is transferable.

The Adopting Release also amends the executive compensation disclosure requirements of Item 402 of Regulations S-K and S-B to clarify that an option issued as executive compensation remains reportable, even if the executive subsequently transfers it.

In Securities Act Release 7647 ("Proposing Release"), also issued February 25, 1999, the Commission proposed additional amendments to Form S-8 designed to further deter abuse of this form without imposing undue burdens on companies more likely to be operating legitimate employee benefit plans. The new proposal would require, before filing a registration statement on Form S-8, that:

- any company be timely in its Exchange Act reports during the 12 calendar months and any portion of a month before the Form S-8 is filed; and
- a company formed by merger of a nonpublic company into an Exchange Act reporting company with only nominal assets at the time of the merger (a "shell" company) wait until it has filed an annual report

on Form 10-K or Form 10-KSB containing audited financial statements reflecting the merger.

The Proposing Release requests comment on other potential amendments, such as requiring Exchange Act reports to disclose aggregate issuances of securities registered on Form S-8 during the preceding 12 months in excess of a specified percentage of the number of securities of the same class outstanding.

Finally, the Proposing Release also extends the comment period on some of the proposed amendments to Form S-8 and requests for comment that were issued in Securities Act Release 7506 (February 17, 1998). These are:

- the proposed disclosure in Part II of Form S-8 of the names of any consultants or advisors to whom the company will issue securities under the registration statement, as well as the amount of securities to be offered to each and the nature of the consulting or advisory services; and
- the requests for comment:
  - whether companies should be required to disclose Form S-8 sales of securities to consultants or advisors in their Exchange Act reports — either in Form 10-K and Form 10-Q, or on Form 8-K;
  - whether the aggregate percentage of securities that may be sold to consultants and advisors on Form S-8 during the company's fiscal year should be limited to a specified percentage of the number of securities of the same class outstanding;
  - whether the existing requirement that the company certify "that it has reasonable grounds to believe that it meets all of the requirements for filing on Form S-8" should be expanded also to require the company to certify that any consultant or advisor who receives securities registered on the form does not, and will not, engage in capital-raising or promotional activities; and
  - whether the Form S-8 cover page should include a box that the company would be required to check if any securities registered on the form are offered and sold to consultants and advisors.

The Commission will consider these ideas along with those proposed or discussed in the Proposing Release.

D. Shareholder Proposals

On September 18, 1997, the Commission issued a release (Exchange Act Release No. 39093) proposing amendments to Rule 14a-8, the shareholder proposal rule, and related amendments to Rules 14a-4, 14a-5, 14a-2 and 13d-5. The proposals represented a package of reforms to address a range of concerns raised by both shareholder and corporate participants in the proposal process. The Commission adopted amendments to Rule 14a-8 and related amendments to Rules 14a-4 and 14a-5 on May 21, 1998 (Exchange Act Release No. 40018). The revisions:

- recast Rule 14a-8 into a plain English question and answer format;
- reverse the Cracker Barrel interpretive position so that employment-related shareholder proposals raising social policy issues are not automatically excludable on ordinary business grounds;
- amend Rule 14a-4 to provide shareholders and companies with clearer guidance on companies' exercise of discretionary voting authority.The

revisions did not include some of the more controversial amendments suggested in the proposing release, such as:

- increasing the percentage of the vote a proposal must receive before it can be resubmitted;
- implementing an override mechanism to permit the inclusion of certain proposals if sufficient shareholder interest was demonstrated;
- streamlining the exclusion for matters considered irrelevant to corporate business;
- modifying the personal grievance exclusion; and
- requiring a separate box on a company's proxy card permitting shareholders to withhold discretionary authority from management on a non-rule 14a-8 proposal.

E. Financial Statements and Periodic Reports For Related Issuers and Guarantors

On February 26, 1999, the Commission proposed rules concerning the financial statement and Exchange Act reporting requirements for subsidiary guarantors and subsidiary issuers of guaranteed securities (Securities Act Release No. 7649). These proposals include revisions to Rule 3-10 of Regulation S-X and new Rule 12h-5 under the Exchange Act.

The proposed amendments to Rule 3-10 would, with one principal difference, codify the staff's current positions as articulated in Staff Accounting Bulletin No. 53 and the interpretive positions that the staff has taken with respect to SAB 53. The principal difference between the proposed financial statement requirements and existing practice is that the proposal would eliminate the presentation of summarized financial information. Rather, it would require companies to present condensed consolidating financial information in all situations in which they currently may present summarized financial information about their subsidiaries.

Proposed Rule 12h-5 eliminates the need for subsidiaries to request an exemption from Exchange Act reporting and removes uncertainty regarding the availability of an exemption from Exchange Act reporting. As proposed, Rule 12h-5 would exempt from Exchange Act reporting any subsidiary issuer or subsidiary guarantor permitted to omit financial statements by proposed Rule 3-10.

F. Delivery of Disclosure Documents to Households

On November 4, 1999, the Commission issued two releases concerning the delivery of a single disclosure document to two or more investors sharing the same address ("householding"). The first release sets forth final rules regarding the householding of prospectuses, annual reports and, in the case of investment companies, semiannual reports (Securities Act Release 33-7766). New Rule 154 permits issuers and broker-dealers to satisfy the Security Act's prospectus delivery requirements by sending a single prospectus to two or more investors residing at the same address if the investors have consented to householding on a written or implied basis. Consent can be implied if four conditions are met:

- the investors have the same last name or are reasonably believed to be members of the same family;
- investors are given advance notice of householding and an opportunity to opt out;
- the investors do not opt out of householding; and
- the prospectus or shareholder report is delivered to a residential street address or a post-office box.

The second release proposes similar changes to the proxy rules to permit the householding of proxy and information statements (Securities Act Release 33-7767). A separate proxy card still would need to be delivered to each shareholder in the household. This release also proposes some modifications to new Rule 154 and the adopted requirements pertaining to householding of annual reports.

Among other things, the proposing release would amend Rule 154 to permit the householding of combined proxy statement -prospectuses.

The adopted and proposed householding amendments are intended to reduce the amount of duplicative information that investors receive, and to lower printing and mailing costs to companies that ultimately are borne by investors.

IX. STAFF LEGAL BULLETINS FOR DIVISION OF CORPORATION FINANCE

The Division of Corporation Finance publishes Staff Legal Bulletins to provide advice to the public on frequently recurring issues. Copies of the bulletins may be obtained from the Commission's web site (*http://www.sec.gov*) or by writing to, or making a request in person at, the Public Reference Room, Securities and Exchange Commission, 450 5th Street, N.W., Room 1024, Washington, DC, 20549 ((202) 942-8090). These are the Staff Legal Bulletins the Division has issued to date:

- Staff Legal Bulletin No. 1 (CF) - Confidential Treatment Requests
- Staff Legal Bulletin No. 2 (CF) - Modified Exchange Act Reporting for Companies in Bankruptcy
- Staff Legal Bulletin No. 3 (CF) - Reliance on the Section 3(a)(10) exemption from the Securities Act of 1933 registration requirements (Updated October 20, 1999)
- Staff Legal Bulletin No. 4 (CF) - Spin-Offs
- Staff Legal Bulletin No. 5 (CF/IM) - Year 2000 Disclosure Issues.

  [This Staff Legal Bulletin is superseded by the Year 2000 interpretive release, Securities Act Release No. 7558. See Section V.D of this outline.]
- Staff Legal Bulletin No. 6 (CF/MR/IM) - Euro Conversion Issues
- Staff Legal Bulletin No. 7 (CF) - Plain English (Updated June 7, 1999)

X. CURRENT DISCLOSURE, LEGAL AND PROCESSING ISSUES

A. Disclosure Issues

1. Third-Party Derivative Securities

In Morgan Stanley & Co., Inc. (June 24, 1996), the Division addressed disclosure issues relating to Securities Act Section 5 registered offerings of securities that are exchangeable, on either an optional or a mandatory basis ("Exchangeable Securities"), for the equity securities (or the cash value thereof) of another issuer ("Underlying Securities").

The Division took the view that complete disclosure regarding the issuer of the Underlying Securities is material to investors at the time of both the initial sale of the Exchangeable Securities and on a continuous basis thereafter until the Underlying Securities (or the cash value thereof) have been exchanged for the Exchangeable Securities and other payment obligations on the Exchangeable Securities, if any, have been satisfied. The Division also took the view that this complete disclosure is not required to be set forth in the filings of the issuer of the Exchangeable Securities where there is sufficient market interest and publicly available information regarding the issuer of the Underlying Securities.

The Division stated that sufficient market interest and publicly available information exists where the issuer of the Underlying Securities (i) has a class of equity securities registered under Exchange Act Section 12; and (ii) is either (a) eligible to use Securities Act Form S-3 or F-3 for a primary offering of non-investment grade securities pursuant to General Instruction B.1 of such forms; or (b) meets the listing criteria that an issuer of the Underlying Securities would have to meet if the class of Exchangeable Securities was to be listed on a national securities exchange as equity linked securities, such as American Stock Exchange Rule 107.B.

The Division also stated that where there is sufficient market interest and publicly available information, as described above, the issuer of the Exchangeable Securities may include abbreviated disclosure about the issuer of and terms of the Underlying Securities in its Securities Act registration statement and Exchange Act periodic reports. Abbreviated disclosure in a report is adequate only where there is sufficient market interest and publicly available information at the time the report is filed.

Finally, the Division stated that the abbreviated disclosure would include at least: (i) a brief discussion of the business of the issuer of the Underlying Securities; (ii) disclosure about the availability of information with respect to the issuer of the Underlying Securities similar to that required by Regulation S-K Item 502(a); and (iii) information concerning the market price of the Underlying Securities similar to that called for Regulation S-K Item 201(a).

EITF Issues Nos. 86-28 and 96-12 address certain aspects of the accounting for third-party derivative securities.

2. <u>Management's Disclosure Obligation Regarding Non-Management Nominees for Election of Directors</u>

In connection with the preparation of proxy material for an annual meeting, an issues has arisen that concerns the obligation of a company to disclose information about non-management nominees of a shareholder who has provided adequate notice pursuant to a company by-law regarding his or her intention to nominate certain persons as candidates for the election of directors. An interpretive issue arises as to whether Item 7 of Schedule 14A and Items 401 and 404 of Regulation S-K, whose requirements are incorporated into the schedule through Item 7, obligate the company to furnish line-item disclosure about those shareholder nominees. Similarly, an issue arises as to whether the company is required to place the shareholder nominees on its form of proxy.

Under these circumstances, the staff has taken the position that Note B to Schedule 14A obligates the company to provide line-item disclosure only with respect to proposals made by or on behalf of the company, including the election of the company's nominees for directors. In addition, a soliciting party is required under Exchange Act Rule 14a-4 to include on its proxy card only the names of nominees for which the soliciting party is seeking proxy authority. In rendering this advice, the staff did not address the issue of the disclosure otherwise necessary in the proxy statement, pursuant to the proxy antifraud provisions of Exchange Act Rule 14a-9, with respect to the existence of opposition candidates for election to the board.

B. <u>Legal and Processing Issues</u>

1. <u>Coordination with Other Government Agencies</u>

On occasion, the staff communicates with other government agencies when disclosure indicates that the rules and regulations enforced by that government entity may materially effect the issuer's operations. For example, the staff continues to have an informal understanding with the staff of the Environmental Protection Agency ("EPA") whereby the Commission staff receives from the EPA lists of companies identified as potentially responsible parties on hazardous waste sites; companies subject to cleanup requirements under Resource Conservation and Recovery Act; and companies named in criminal and civil proceedings under environmental laws. The staff uses this information in its review process.

2. <u>Monitor of Form 12b-25 Notices</u>

The staff has implemented procedures to strengthen its monitoring efforts of all Forms 12b-25 notices of late filing. Notices are being monitored, with appropriate action taken depending upon the issuer's reason for delay and whether the subject filing is subsequently filed during the extension period. Possible staff action includes referral to the Division of Enforcement and prioritization of the subject report for staff review.

3. Related Public and Private Offerings

Some companies with pending registration statements have advised the staff that they intend to withdraw the registration statement and shortly thereafter complete the offering without registration in reliance upon the Section 4(2) private offering exemption. This appears to be proposed for both timing and disclosure reasons. In the staff's view, this procedure ordinarily would not be consistent with Section 5 of the Securities Act. The filing of a registration statement for a specific securities offering (as contrasted with a generic shelf registration) constitutes a general solicitation for that securities offering rendering Section 4(2) unavailable for the same offering. In addition, the procedure raises significant integration issues under the traditional five factor test and the staff's integration policy positions since the subsequent private offering does not appear to be a separate offering.

A related issue arises when a company files a registration statement to register issuances of securities to purchasers who committed to purchase securities from the issuer prior to the filing of the registration statement on the condition that the securities be registered prior to issuance. It appears that the purpose of this procedure is to provide the purchasers with registered (rather than restricted) securities. The staff does not believe that this procedure is consistent with the registration provisions of the Securities Act, which cover offers and sales of securities, not issuances. In this situation, it appears that the offers were made and the commitments obtained prior to filing in reliance upon the Section 4(2) private placement exemption. If so, the registration statement should cover resales by the purchasers, not issuances to the purchasers.

The use of "lock-up agreements" in business combination transactions is common. What is not common or consistent is the extent to which these agreements are now used to lock up target shareholders beyond key executives and "blocking" shareholders of the target. While the signing of a lock-up agreement may constitute the making of an investment decision, the staff, noting the realities of these transactions, traditionally has not raised issues with respect to these agreements in connection with acquisitions of public companies. However, the staff has raised issues concerning recently filed acquisition registration statements where 100% of the target shares are locked up or the "lock-up" group is expanded to include non-traditional "members" such as middle management.

4. Equity Swap Arrangements

Equity swap arrangements (including the related equity security) and similar devices typically shift some or all of the economic interests and risks of an equity security. These arrangements raise a number of legal and regulatory issues under the federal securities laws. Application of Exchange Act Section 16 to these arrangements is addressed in Exchange Act Releases No. 34514 and 37260. Those releases stated that equity swaps and similar transactions are subject to Section 16, and discussed the manner in which they should be reported. The staff continues to consider the issues raised by equity swaps and other risk-shifting transactions in other areas, including disclosure of security holdings and executive compensation, Schedule 13D reporting and transactions subject to Rule 144, Rule 144A and Regulation S. The treatment of these transactions under Rule 144 is addressed in Securities Act Release No. 7391. The treatment of these transactions under Regulation S is addressed in Securities Act Release Nos. 7392 and 7505; see Section VII.B.

5. Non-Qualified Deferred Compensation Plans

A typical non-qualified deferred compensation plan permits an employee to defer compensation over a set dollar amount. Those monies are retained by the employer. The employee will then either receive a fixed rate of return on the deferred monies or the employer may permit the employee to index the return on those monies off of a number of investment return alternatives.

In a number of no-action positions, the Division has indicated that it would not recommend enforcement action if transactions in non-qualified deferred compensation plans were not registered. The requests in those instances set forth two bases for the determination that registration under the Securities Act was not required. First, those requests set forth the argument that the offer and sale of interests in the deferred compensation plan did not involve the offer or sale of a security because the decision to participate in those plans was based primarily on tax management, not investment, purposes. Second, the requests contained the argument that the employees participating in the plan were top-level executives who did not need the protections provided by registration under the Securities Act.

In providing the no-action position requested, the Division's responses state that, while not agreeing with the analysis in the request, it would not recommend enforcement action if transactions under the plans were not registered. The Division has not taken such a no-action position since 1991.

Due to a number of market and regulatory factors, non-qualified deferred compensation plans have greatly proliferated, both with respect to the number of employers offering such plans and the number of employees participating. At this time, the Division is not prepared to disregard the argument that the debt owing to plan participants is analogous to investment notes, which typically are viewed as debt securities. Further, the staff is not persuaded that there is a meaningful distinction between those plans that offer returns tied to different investment alternatives and those that offer only a fixed rate. The Division, therefore, will not grant requests for no-action with respect to any non-qualified deferred compensation plan, including those that have an interest only return. The Division has not stated affirmatively, however, that all interest only deferred compensation plans involve securities. Instead, the Division currently is leaving that question for counsel's analysis of the facts and circumstances. To the extent that interests in a non-qualified deferred compensation plan are securities, registration would be required unless the offerings under the plan would qualify for an exemption, e.g., Section 4(2).

Form S-8 would be available when an employer registers the offer and sale of interests in the deferred compensation plan under the Securities Act. The filing fee should be based on the amount of compensation being deferred, not on the ultimate investment return. As the "deferred compensation obligations" to be registered are obligations of the issuer/employer, not interests in the plan, the registration of the "deferred compensation obligations" would not result in a requirement that a deferred compensation plan file a Form 11-K with respect to those securities. Further, based on the unique terms of the "deferred compensation obligations" (both with respect to interest and maturity), compliance with the Trust Indenture Act of 1939 has not been required.

6. **Trust Indenture Act Issues Arising in Certain Transactions Exempt from Securities Act Registration**

Offerings exempt from registration under Sections 3(a)(9) and 3(a)(10) of the Securities Act and Section 1145(a) of the Bankruptcy Code are not exempt from qualification under the Trust Indenture Act. Like Section 5 of the Securities Act, Section 306 of the Trust Indenture Act works transactionally. Unless the indenture for a debt security is qualified under Section 305 of the Trust Indenture Act, which covers registered offerings, or exempt from qualification under Section 304, the sale of the debt security violates Section 306 of the statute. Section 306(c) forbids any offer of the debt security until an application for qualification of the related indenture has been filed with the Commission.

The Division has recently noted a number of offerings of debt securities for issuers in Chapter 11 proceedings where the applications for qualification on Form T-3 were not filed until after approval of the plans of reorganization by both creditors and other claimants and the bankruptcy courts. The Division's view is that the offering event in bankruptcy is the solicitation of plan approval from creditors and other claimants. Accordingly, the application for qualification in these cases should be filed before such approval is sought.

7. **Legality Opinion Issues**

It is customary practice for counsel drafting legality opinions regarding securities whose issuer is incorporated in Delaware to limit their opinion to "the Delaware General Corporation Law." In these situations, we ask that counsel revise its opinion to make clear that the law covered by the opinion includes not only the Delaware General Corporation Law, but also the applicable provisions of the Delaware Constitution and reported judicial decisions interpreting these laws.

Recently, we discussed this limitation with the Ad Hoc Committee on Legal Opinions in SEC Filings of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association. In those discussion, the Ad Hoc Committee emphasized that the reference to the "Delaware General Corporations Law" was an opinion drafting convention and that the practicing bar understood this phrase to mean the Delaware General Corporation Law, the applicable provisions of the Delaware Constitution, and reported judicial decisions interpreting these laws.

Based on these discussions, we have revised our procedures for reviewing a legality opinion filed as an exhibit to a registration that includes a statement that it is "limited to the Delaware General Corporation Law." Our new procedures are as follows:

- We will issue a comment asking counsel to confirm to us in writing that it concurs with our understanding that the reference and limitation to "Delaware General Corporate Law" includes the statutory provisions and also all applicable provisions of the Delaware Constitution and reported judicial decisions interpreting these laws. As part of this standard comment, we will ask that counsel file this written confirmation as correspondence on the EDGAR system. As such, it will be part of the Commission's official file regarding the related registration statement.

- Once we receive this written confirmation from counsel, we will not comment further on the inclusion of this language in the opinion for that registration statement.

C. Industry-Specific Issues

1. Real Estate

a. Review of Filings

The Division has issued three releases regarding real estate disclosure in the last few years. On June 17, 1991, the Commission issued an interpretive release relating to partnership offerings and reorganizations (Securities Act Release No. 6900); on October 30, 1991, final rules concerning disclosure of roll-up transactions were issued (Securities Act Release No. 6922). On December 1, 1994, the Commission adopted amendments to its roll-up rules (Securities Act Release No. 7113). The staff considers the disclosure guidelines of each of these releases in connection with its reviews of registration statements and proxy statements filed by limited partnerships and real estate investment trusts.

Current real estate filings relate primarily to real estate investment trusts (REITs) and, to a lesser extent, limited partnerships and limited liability companies. Frequently, REIT filings contain an UPREIT structure which includes an Umbrella Operating Partnership formed by the sponsor and affiliated partnerships to contribute properties or partnership interests to the REIT. In connection with REIT initial public offerings, the staff considers the availability of any claimed exemption from Securities Act registration for the pre-formation roll-up transactions undertaken to form the operating partnership.

Primary offerings by Operating Partnerships must comply with appropriate form requirements. Operating Partnerships may use Form S-3 if the applicable requirements are met, specifically, Instruction I.C., but since the Operating Partnership is unlikely to be able to meet the requirements of Staff Accounting Bulletin 53, separate financial statements and related disclosure must be provided either in the registration statement or through incorporation by reference of a voluntary Form 10. Following the offering, applicable reports must be filed by the Operating Partnership.

Reviews of limited partnership offerings and proxy solicitation materials continue to focus on prior performance and on claims made by sponsors concerning investment obligations and future performance. These reviews also focus on changes to partnership objectives and structure. Finally, the staff continues to examine the practices and disclosure associated with the solicitation of proxies and registration statements related to roll-ups, pursuant to the revised rules. See also Section IV.D.1 for a discussion of the disclosure required in tender offers for limited partnership units.

b. Sales Literature Used in Connection with the Offering of Limited Partnerships

Item 19 of Industry Guide 5 requires that sales literature used in the offering of limited partnership units, including material marked for "Broker Dealer Use Only," be submitted for staff review. These materials should provide a balanced presentation of the risks and rewards involved in the offering. All information must be consistent with the information and representations contained in the prospectus and the sales literature should not be presented in a manner which obscures the prospectus cover page. Registrants should contact the staff before using submitted sales materials.

c. Low Income Housing, Rehabilitation, and Historic Tax Credit Real Estate Limited Partnerships

Certain real estate limited partnership offerings indicate the sponsor's intention to invest in low income housing or other programs eligible for federal or state income tax credits. Most of these offerings highlight the percentage returns to the investor of the tax credits on a simple annualized basis. Since the tax credits are available for only 10 years and the enabling statutes require a 15-year holding period for the property, the rate of return disclosure should include the effects of the time value of money. Further, since it is possible that the property may have no or little residual value at the end of the 15-year holding period, the disclosure of the rate of return should assume a zero resale value of the property.

Further, prior performance disclosure of the results of earlier tax credit offerings by the sponsor should be included. Disclosure of the total amount of tax credits generated for each year should be included as should the amount of tax credits per $1000 invested.

2. Exemption from Registration for Bank and Thrift Holding Company Formations

Section 3(a)(12) of the Securities Act provides an exemption from registration for securities issued in connection with the formation of a bank or savings association holding company where shareholders maintain the same proportional interest in the holding company as they had in the bank or savings association; the rights and interests of the shareholders are substantially the same after the transaction as before it; and the holding company has substantially the same assets and liabilities, on a consolidated basis, as the bank or savings association had before the transaction. The staff has informally taken the position that the exemption would not be available if the new holding company's corporate charter contained antitakeover provisions that were not in the governing documents of the predecessor bank or thrift.

3. Structured Financings

In fall 1992, the Commission extended the benefits of Rule 415 "shelf" registration through the expansion of the availability of Form S-3 to investment grade asset-backed securities offerings (Securities Act Release No. 6964 (October 22, 1992)(the "Shelf Release")). Shortly thereafter, the Commission adopted Rule 3a-7 under the Investment Company Act of 1940 excluding from the definition of "investment company" structured financings that meet the rule's conditions (Investment Company Act Release No. 19105 (November 19, 1992)). These changes appear to have precipitated, or at least coincided with, a movement in the structured finance market toward securitization of assets in the public markets that previously were offered in the private markets. Significant disclosure and eligibility issues continue to come up as a result of market developments.

a. Asset Concentration

The Shelf Release expressly does not adopt a specific asset concentration test. Instead, asset concentration questions have been addressed through existing disclosure rules. While an asset concentration test was not included, the release indicates that the definition of asset-backed security does not encompass securities issued in structured financings for one obligor or group of related obligors.

(i) Multiple Core Prospectuses

Another issue involving asset concentration arises in the context of pooling several different types of underlying assets. The staff permits issuers to register on a single shelf registration statement asset-backed securities supported by more than one category of underlying assets without specifying the amount of each type to be offered. The registration statement must specifically identify the various asset categories and include a separate core prospectus for each such category. In considering whether a separate core prospectus is required, the staff will consider whether the assets described are intended to be pooled together or securitized separately. If the latter, separate core prospectuses ordinarily would be required.

(ii) Commercial Mortgages

For securitization of commercial mortgages and leases, where the mortgage loan is a non-recourse obligation of the mortgagor, disclosure related to the operating property(ies) will be required where concentration exists. The staff applies the standards described in Staff Accounting Bulletin 71/71A ("SAB 71/71A"). SAB 71/71A generally employs a 20% asset concentration test to determine whether audited property financial statements are required. At concentration levels between 10-20%, financial and other information regarding the underlying properties is required. In determining whether these concentration thresholds are crossed, loans to the same obligor, group of related obligors, or loans on related properties may be aggregated.

In addition, where a mortgage loan or loans of a single obligor, or group of related obligors, accounts for more than 45% of the pool assets, one or more co-issuers may exist. See FBC Conduit Trust I, First Boston Mortgage Securities Corporation (October 6, 1987).

b. Securitizing Outstanding Securities

(i) Corporate Debt Securities

The pooling and securitization of outstanding corporate debt securities of other issuers may be registered on Form S-3 if the requirements of the Form for asset-backed securities offerings are met, provided that the depositor would be free to publicly resell the securities without registration. Thus, a depositor generally cannot include restricted securities (i.e., privately-placed securities where the Rule 144(k) two-year holding period has not run) nor can it include registered securities if the securitization is part of the original distribution. To provide certainty in deciding what is part of the original distribution in resecuritizations by affiliates of underwriters involved in the original offering, the staff has used a bright line test (i.e., securities purchased in the secondary market and at least three months after the depositor had sold out any unsold allotment are not viewed as part of the original dispatch).

Where 20% or more of the pool consists of the securities of a single issuer, the staff requires audited financial statements of such issuer to be included in the prospectus. However, if the underlying issuer is eligible to use Form S-3 for a primary common stock offering, and the depositor's transaction in the securities is purely secondary (e.g., there is no tie to the issuer or the issuer's distribution), the staff would accept a reference in the prospectus to the issuer's periodic reports on file with the Commission. Of course, the prospectus must include a description of the material terms of the pooled securities.

In connection with Exchange Act reporting, reference to the S-3 eligible underlying issuer's periodic reports on file with the Commission will be accepted in lieu of direct disclosure of this information. In addition, the staff generally requires the depositor to undertake to provide financial and other information relating to such underlying issuer directly in its reports in the event such underlying issuer terminates reporting after the pooling transaction.

(ii) Asset-Backed Securities

Securitization of outstanding asset-backed securities is treated similarly if the underlying trust has outstanding securities held by non-affiliates in excess of $75 million and files periodic reports with the Commission. The securities of government-sponsored enterprises ("GSE") which have a comparable market float and which make information publicly available comparable to that of Exchange Act reporting entities are treated similarly.

(iii) Municipal Securities

The offering of asset-backed securities supported by pools of municipal bonds where asset concentration exists, in general, requires that financial statements and other information relating to the underlying municipal issuer be provided. This information must be included directly in the prospectus, must be current, and must otherwise satisfy fully the disclosure requirements under the federal securities regulations.

While there may be instances where financial statements of the municipal issuer are not material to the investor in the asset-backed security, such instances would appear to be rare and the staff will require appropriate legal opinions and other documentation necessary to support the conclusion that financial and other information relating to the municipal issuer is not material to investors.

c. Structuring the Offering

Often the payment terms of asset-backed securities are tailored to meet the particular investment needs of the investor. Prior to effectiveness of the registration statement, investors often ask the underwriter for various computational materials so as to analyze prepayment and other assumptions affecting yield. These computational materials are not permissible prospectuses under the Securities Act and the Commission's rules and regulations. However, recognizing the realities of the asset-backed market, the staff has issued three no-action letters that recognize the industry's practice of providing written information (other than the statutory prospectus) to prospective purchasers of asset-backed securities when negotiating and structuring the securities to meet purchasers' investment criteria. These letters generally permit the provision of limited information outside the preliminary prospectus to purchasers, provided that the final information is filed as part of the registration statement.

d. Delinquent Assets

The definition of "asset-backed security" in Form S-3 states that the assets must "by their terms convert into cash within a finite time period." The staff issued a no-action letter in which it acknowledged that an offering that includes a concentration of delinquent assets may be eligible to be offered on Form S-3 so long as the concentration is less than 20% of the assets. A concentration of 20% or more would not appear to be eligible to be offered on Form S-3 because foreclosure on an asset is not converting to cash by its terms. See The Bond Market Association (Oct. 16, 1997), described in Section XII.K.

4. Credit Linked Securities of Bank Subsidiaries

Recently, a number of banks proposed the following transaction structure:

- the bank forms a limited purpose finance subsidiary;
- the bank transfers mortgages or asset-backed securities to the subsidiary;
- the bank owns all of the subsidiary's common stock; and
- the subsidiary registers the sale of its preferred stock to the public.

The source of funds for dividend payments on the preferred stock would be limited to the income generated by the finance subsidiary's assets. The banks proposed this structure because the preferred securities of the subsidiary may, under relevant risk based capital guidelines, qualify as capital of the bank.

Under bank regulations, if a financial regulatory event occurs, banks must retrieve, or "claw back," the assets of these subsidiaries. Because the assets of these subsidiaries are subject to this claw back, this structure raises significant registration and disclosure issues.

Under one structure, the preferred securities of the subsidiary automatically convert into securities of the bank. Therefore:

- the bank and the subsidiary must be co-registrants on the registration statement for the initial sale of the preferred stock since the bank is also offering preferred stock;
- the full audited financial statements of the bank must be included in this registration statement; and
- if the bank's financial statements are not in US GAAP, they must be reconciled to US GAAP.

If the bank regulators can require the bank to claw back the subsidiary's assets, the financial condition of the bank is material to the subsidiary preferred stockholder at all times. Therefore:

- the full audited financial statements of the bank must be in the registration statement and in the subsequent periodic reports of the subsidiary; and
- if the bank's financial statements are not in US GAAP, they must be reconciled to US GAAP.

XI. ACCOUNTING ISSUES

A. Initiative to Address Improper Earnings Management

Many in the financial community have expressed concern that market pressures are driving more public companies to use improper earnings management tricks. In remarks made to the NYC Center for Law and Business in September 1998, Chairman Levitt identified several areas where accounting rules have been abused by some companies to manage earnings: "big bath" restructuring charges, "creative" acquisition accounting, miscellaneous "cookie jar" reserves, intentional "immaterial" errors, and manipulative revenue recognition. The Chairman outlined a plan to address the threat to the integrity of financial reporting posed by improper earnings management. The Chairman's speech can be found at *www.sec.gov/news/spchindx.htm*.

The Division of Corporation Finance established an Earnings Management Task Force that focused staff resources on the review of filings where potential improper earnings management issues could be present. A primary objective of the reviews has been to elicit improved disclosure in financial statements and MD&A about charges involving asset impairments, restructuring charges, purchased in-process research and development, and similar items. Disclosure sought by the staff has included explanation of the types and amounts of restructuring liabilities and valuation reserves, the timing and amount of increases and decreases in these accounts, and the nature and amount of any changes in estimates. The Task Force also examined filings for indicia of earnings management and other accounting abuses involving revenue recognition, unreasonable valuations of purchased in-process research and development, and manipulation of loss allowances and estimated liabilities. Also, as part of its proactive disclosure program, the Division of Corporation Finance sent letters alerting companies, before their filing 1998 annual reports, of disclosures that are often needed to give transparency to significant charges. Samples of those letters are available at the SEC web site.

In further response to the Chairman's earnings management initiative, the AIPCA published *Issues in Revenue Recognition*, available at *www.aicpa.org*, to help auditors evaluate assertions about revenue. The Office of the Chief Accountant is working closely with the FASB to establish clearer standards concerning liability recognition. The Public Oversight Board has established a distinguished committee to review the way audits are performed today and assess the impact of recent trends in business and the accounting profession on the effectiveness of the audit. Other actions taken in connection with the Chairman's earnings management initiative include issuance of staff interpretive guidance and rulemaking proposals discussed elsewhere in this outline.

B. Materiality in the Preparation or Audit of Financial Statements

On August 12, 1999, the staff published Staff Accounting Bulletin No. 99. That SAB expressed the staff's view that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing or auditing financial statements is inappropriate. The SAB states that the staff has no objection to the use of a percentage threshold as an initial assessment of materiality, but exclusive use of such thresholds has no basis in law or in the accounting literature. The staff stresses that evaluations of materiality require registrants and auditors to consider *all* of the relevant circumstances, and that there are numerous circumstances in which misstatements below that percentage threshold could be material. Some of the circumstances listed in the SAB that should be considered are:

- whether the misstatement masks a change in earnings or other trends,
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise,
- whether a misstatement changes a loss into income or vice versa,

- whether the misstatement concerns a segment of the registrant's business that plays a significant role in the registrant's present or future operations or profitability,
- whether the misstatement affects compliance with loan covenants or other contractual requirements,
- whether the misstatement has the effect of increasing management's compensation.

The SAB observes that managers should not direct or acquiesce to immaterial misstatements in the financial statements for the purpose of managing earnings. The SAB indicates that investors generally would consider significant an ongoing practice to over- or understate earnings up to an amount just short of some percentage threshold in order to manage earnings.

The SAB also notes that even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, it may, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. The SAB, therefore, provides guidance on when and how to aggregate and net misstatements to see if they materially misstate the financial statements.

The SAB advises that, even if management and auditors find that a misstatement is immaterial, they must consider whether the misstatement results in a violation of the books and records provisions in Section 13(b) of the Exchange Act. Section 13(b) requires that public companies make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets of the registrant, and that they maintain internal accounting controls that are sufficient to provide reasonable assurances that financial statements are prepared in conformity with GAAP. In this context, what constitutes "reasonable assurance" and "reasonable detail" are not based on a "materiality" standard but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

The SAB sets forth various factors, in addition to those used to evaluate materiality, that a company may consider in deciding whether a misstatement violates its obligation to keep books and records that are accurate "in reasonable detail." Some of these factors are:

- the significance of the misstatement,
- how the misstatement arose,
- the cost of correcting the misstatement, and
- the clarity of the authoritative accounting guidance with respect to the misstatement.

Finally, the SAB reminds auditors of their obligations under Section 10A of the Exchange Act and auditing standards to inform management and, in some cases, audit committees of illegal acts, such as violations of the books and records provisions of the Exchange Act, coming to the auditor's attention during the course of an audit.

C. Proposals Implementing Blue Ribbon Committee's Recommendations Regarding Audit Committee Effectiveness

The Commission has proposed new rules to improve disclosure about the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies (Securities Act Release No. 7754 (October 14, 1999)). The proposed disclosures will help inform investors about the role audit committees play in overseeing the preparation of financial statements and underscore the importance of their participation in the financial reporting process. In addition, by requiring companies to have their auditors review interim financial statements, the proposals should facilitate early identification and resolution of significant accounting issues.

The proposals are part of the Commission's continuing efforts to improve the quality of financial reporting. In his September 1998 speech entitled The Numbers Game, Chairman Arthur Levitt set forth an action plan to address certain abuses in financial reporting, better known as "earnings management." These proposals represent further progress on that plan.

The Commission's proposals are part of a broader effort by the securities exchanges and the accounting profession to improve the oversight of financial reporting by corporate boards. Proposals for action by each of the different groups were set forth in the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The Blue Ribbon Committee was a prestigious group of business, accounting, and securities professionals led by John Whitehead and Ira Millstein. These proposals coincide with proposed rule changes by the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers. The proposed rule changes by the securities markets would:

- define "independence" more rigorously for audit committee members;
- require audit committees to include at least three members and be comprised solely of "independent" directors who are financially literate;
- require companies to adopt written charters for their audit committees; and
- require at least one member of the audit committee to have accounting or financial management expertise.

Recently, the AICPA's Auditing Standards Board proposed to require independent auditors to discuss with the audit committee the auditors' judgment about the quality, and not just the acceptability under Generally Accepted Accounting Principles, of the company's accounting principles as applied in its financial reporting.

The Commission's rule proposals would require, among other things, that:

- companies' interim financial statements be reviewed by independent auditors before companies file their Forms 10-Q and 10-QSB with the Commission;
- companies provide in their proxy statements a report from the audit committee that discloses whether the audit committee reviewed and discussed certain matters with management and the auditors, and whether anything came to the attention of audit committee members that caused them to believe that the audited financial statements contain any materially misleading statements or omit any material information;
- companies disclose in their proxy statements whether the audit committee has a written charter, and file a copy of their charter every three years; and
- companies whose securities are listed on the NYSE or AMEX or are quoted on Nasdaq disclose certain information about any audit committee member who is not "independent" within their proposed definition. (All other companies must disclose, if they have an audit committee, whether the members are "independent" based on the definition proposed by the SROs.)

D. Mandatorily Redeemable Securities of Subsidiaries Holding Debt of Registrant

Registrants should consider the adequacy of disclosures about mandatorily redeemable securities issued by a finance subsidiary of a parent company when the financial subsidiary holds only debt instruments issued by the parent, particularly if the outstanding security of the finance subsidiary is guaranteed by the parent and mirrors the cash flows of the debt of the parent held by the finance subsidiary. The staff believes that disclosures in these situations often must be expanded to provide investors with a fair and balanced picture of the registrant's effective capitalization and leverage. Inclusion of the outstanding public security in minority interest with minimal disclosure of its characteristics is not adequate, particularly when Section 12(h) reporting relief is requested by registrants for the finance subsidiary. In those situations, the parent should disclose the subsidiary's outstanding securities as a separate line item in the parent's balance sheet captioned "Company-obligated mandatorily redeemable security of subsidiary holding solely parent debentures," "Guaranteed preferred beneficial interests in Company's debentures," or similar descriptive wording. Notes to the financial statements should describe fully the terms of the securities and explain that those terms parallel the terms of the company's debentures which comprise substantially all of the assets of the consolidated trust or subsidiary.

E. Accountant's Refusals to Re-issue Audit Reports

Some accounting firms have adopted risk management policies that lead them to refuse to re-issue their reports on the audits of financial statements that have been included previously in Commission filings. In some cases, accountants whose reports on acquired businesses were included in a registrant's Form 8-K have declined to permit that report to be included in a registrant's subsequent registration statement. In other cases, accountants have declined to reissue their reports on the registrant's financial statements after the registrant engaged a different auditor for subsequent periods. The Commission's staff is not in a position to evaluate the reasons for an accountant's refusal to re-issue its report and will not intervene in disputes between registrants and their auditors. Moreover, the staff will not waive the requirements for the audit report or the accountant's consent to be named as an expert in filings. If a registrant is unable to re-use the previously issued audit report in a current filing, the registrant must engage another accountant to re-audit those financial statements. A registrant that is unable to obtain either re-issuance of an audit report or a new audit by a different firm may be precluded from raising capital in a public offering.

When registrants engage an accountant to perform audit services, they should consider the need for the accountant to re-issue its audit report in future periods. It may be appropriate to address in the audit services contract the registrant's expectations regarding the use of the audit report in filings that it or its successors may make under either the Exchange Act or the Securities Act and the circumstances under which the accountant may decline to permit its re-use.

F. Market Risk Disclosures

On January 28, 1997, the Commission adopted amendments to Regulation S-K, Regulation S-X, and various forms (Securities Act Release No. 7386) to clarify and expand existing requirements for disclosures about derivatives and market risks inherent in derivatives and other financial instruments. Derivative financial instruments are defined in FASB Statement No. 119 to include futures, forwards, swaps, and options. Derivative commodity instruments are defined in the Release to be commodity contracts that are permitted by contract or business custom to be settled in cash or with another financial instrument (e.g., commodity futures, commodity forwards, commodity swaps, and commodity options). Other financial instruments are defined in FASB Statement No. 107 to include, for example, investments, including structured notes, loan receivables, debt obligations, and deposit liabilities. The requirements for quantitative and qualitative information about market risk apply to all registrants except registered investment companies and small business issuers.

In general, the release:

(i) requires enhanced descriptions of accounting policies for derivatives in the footnotes to the financial statements;

(ii) requires quantitative and qualitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements; and

(iii) provides a reminder to registrants to supplement existing disclosures about financial instruments, commodity positions, firm commitments, and other anticipated transactions with related disclosures about derivatives.

On July 31, 1997, the staff released Questions and Answers about the New "Market Risk" Disclosure Rules. The interpretive answers were prepared by the staffs of the Office of the Chief Accountant and the Division of Corporation Finance. This publication is posted at the Commission's Internet site; *http://www.sec.gov*.

Based on the Division's reviews of filings by some registrants required to provide the disclosures about derivatives and market risks inherent in derivatives and other financial instruments, we have the following suggestions:

Accounting policies for derivatives

Remember to provide all of the disclosures regarding accounting policies for certain derivative financial instruments and derivative commodity instruments, to the extent material, as required by Rule 4-08(n) of Regulation S-X and SFAS 119. Include clear disclosure of the method used to account for each type of derivative financial instrument and derivative commodity instrument.

General

Remember to cite the new Item specifically (e.g. Item 7A for Form 10-K or Item 9A for Form 20-F) in the form. Registrants can include the quantitative and qualitative disclosures under the Item reference, cross-reference from the Item reference to the disclosures elsewhere in the filing, or indicate under the Item reference that the disclosures are not required (See Rule 12b-13).

Registrants may need to discuss a material exposure under the Item even though they do not invest in derivatives. For example, registrants that have investments in debt securities or have issued long-term debt should discuss risk exposure if the impact of reasonably possible changes in interest rates would be material. Likewise, registrants that have invested or borrowed amounts in a currency different from their functional currency should discuss risk exposure if the impact of reasonably possible changes in exchange rates would be material.

The market risk disclosures can refer to the financial statements but disclosures required by the new rules should be furnished outside the financial statements. The "safe harbor" established under the new rules does not extend to information presented in the financial statements.

Quantitative disclosures

Tabular presentation. Include all relevant terms of the related market sensitive instruments. In addition, disclose the method and assumptions used to determine estimated fair value, cash flows and future variable rates. In addition, segregate instruments by common characteristics and by risk classification.

Sensitivity analysis and Value at Risk (VAR). Disclose the types of instruments (e.g., derivative financial instruments, other financial instruments, derivative commodity instruments) included in the sensitivity analysis and VAR analysis and provide an adequate description of the model and the significant assumptions used, such as the magnitude and timing of selected hypothetical changes in market prices, method for determining discount rates, or key prepayment or reinvestment assumptions. Indicate whether other instruments are included voluntarily, such as certain commodity instruments and positions outside the required scope of the rule, cash flows from anticipated transactions, etc.

Qualitative disclosures

Explain clearly how the company manages its primary market risk exposures, including the objectives, general strategies and instruments, if any, used to manage those exposures. Explain clearly the changes in how the company manages its exposures during the year in comparison to the prior year and any known or expected changes in the future.

G. Financial Statements in Hostile Exchange Offers

In registration statements that require financial statements of a company other than the registrant (such as when the registrant acquires or will acquire another entity), the audit report of the target's independent accountants must be included in the registration statement. The consent of the target's auditor to the inclusion of its report in the registration statement is required pursuant to Rule 436 of Regulation C.

A registrant offering its own securities in a hostile exchange offer for the target's stock may seek and not be able to obtain the target's cooperation in providing either its audited financial statements or the target auditor's consent to the use of its report in the required registration statement. In this situation, the registrant should follow the guidance in SAB Topic 1A. If the target is a public company, SAB Topic 1A requires that any publicly filed financial information of the target, including its financial statements, be included in the registrant's filing or incorporated by reference into, and therefore made a part of, that filing.

The acquirer/registrant should use its best efforts to obtain the target's permission and cooperation for the filing or incorporation by reference of the target's financial statements, and the target auditor's consent to including its report on the financial statements. At a minimum, a registrant is expected to write to the target requesting these items and to allow a reasonable amount of time for a response prior to effectiveness of the filing. The target may, however, fail to cooperate with the registrant.

Under Rule 437 of Regulation C, a registrant may request a waiver of the target auditor's consent by filing an affidavit that states the reasons why obtaining a consent is impracticable. The affidavit should document the specific actions taken by the registrant to obtain the cooperation of the target for the filing of its financial statements as well as the efforts made to obtain the target auditor's consent. As stated in SAB Topic 1A, the staff will request copies of correspondence between the registrant and the target evidencing the request for and the refusal to furnish financial statements.

If the registrant uses its best efforts but is still unsuccessful in obtaining the target's permission and cooperation on a timely basis, the staff will generally agree to waive the requirement to include or incorporate by reference the target auditor's audit report, but not the target's financial statements. If target financial statements are incorporated by reference into the acquirer's registration statement from the target's public filings, disclosure should be made that, although an audit report was issued on the target's financial statements and is included in the target's filings, the auditor has not permitted use of its report in the registrant's registration statement. The auditor should not be named. Any legal or practical implication for shareholders of either the registrant or the target of the inability to obtain the cooperation of the target or consent of the target's auditor should be explained. No disclosure in the registration statement should expressly or implicitly purport to disclaim the registrant's liability for the target's financial statements. In the event that circumstances change, for example, if the deal turns friendly, the registration statement should be amended to include the audited financial statements and the auditor's consent required by the form.

H. Restructuring Charges, Impairments, and Related Issues (SAB 100)

On November 24, 1999, the staff published Staff Accounting Bulletin No. 100, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges.

The Emerging Issues Task Force addressed Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) in Issue No. 94-3. Generally, that consensus limits costs that may be recognized solely pursuant to management's plan to incur them to those costs which result directly from an exit activity, are not associated with and do not benefit continuing activities, and for which there is appropriate authorization, specification, and commitment to execute. SAB 100 discusses the EITF criteria and related disclosure requirements in particular circumstances encountered by the staff in its review of filings by public companies. The SAB expresses the staff's view that a company's exit plan should be at least comparable in its level of detail and precision of estimation to the company's other operating and capital budgets, and should be accompanied by controls and procedures to detect and explain variances and adjust accounting accruals. The SAB discusses disclosures in financial statements and MD&A that are often necessary to make the effects of restructuring activities on reported results sufficiently transparent to investors.

SAB 100 also addresses issues that arise in the application of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of. The SAB reminds registrants that the operational requirement to continue to use an asset disallows accounting for the asset as held for sale. If the asset is held for use, its carrying value must be systematically amortized to its salvage value over its remaining economic life. If management contemplates the removal or replacement of assets more quickly than implied by their depreciation rates, the useful lives of the assets and rates of depreciation must be re-evaluated. The SAB also provides the staff's views regarding the assessment and measurement of any impairment of enterprise level goodwill, and it specifies the accounting policy disclosures that should be provided.

The SAB also highlights the staff's concerns when a registrant records liabilities assumed in a business combination at amounts materially greater than historically reported by the acquired company. That circumstance could indicate that costs incurred before or after the merger were not properly recognized in the reported results of one or the other combining company. The SAB reminds registrants that, if the acquired company's historical accounting for a liability is based on reasonable estimates of undiscounted future cash flows, the estimated undiscounted cash flows underlying the liability recorded by the acquiring company would not be expected to differ materially from those estimates unless the acquirer intends to settle the liability in a manner demonstrably different from that contemplated by the acquired company.

I. Interpretive Guidance on Revenue Recognition (SAB 101)

On December 3, 1999, the staff published Staff Accounting Bulletin 101 to provide guidance on the recognition, presentation and disclosure of revenue in financial statements. The SAB draws on the existing accounting rules and explains how the staff applies those rules, by analogy, to other transactions that the rules do not specifically address. The SAB spells out basic criteria that must be met before registrants can record revenue.

Specific fact patterns discussed in the SAB include bill-and-hold transactions, long-term service transactions, refundable membership fees, contingent rental income, and up-front fees when the seller has significant continuing involvement. The SAB also addresses whether revenue should be presented at the full transaction amount or on a fee or commission basis when the seller is acting as a sales agent or in a similar capacity. Finally, the SAB provides guidance on the disclosures registrants should make about their revenue recognition policies and the impact of events and trends on revenue.

Registrants may need to change their accounting policies to comply with the SAB. Provided the registrant's former policy was not an improper application of GAAP, registrants may adopt a change in accounting principle to comply with the SAB no later than the first fiscal quarter of the fiscal year beginning after December 15, 1999.

XII. SIGNIFICANT NO-ACTION AND INTERPRETIVE LETTERS THROUGH OCTOBER 1999

A. Section 2(a)(1) of the Securities Act

American Stock Exchange - NASD -July 10, 1998

The Division expressed the view that the American Stock Exchange (the "Exchange") memberships, or "seats," described in the letter are not securities within the meaning of Section 2(a)(1) under the Securities Act. The Division also expressed the view that the described transaction, in which substantially all of the assets and liabilities of the Exchange would be transferred to a limited liability company (the "LLC") in exchange for i) an interest in the LLC and ii) contractual obligations of the NASD under the agreement governing the transaction, would not involve a distribution of the securities issued by the LLC under Securities Act Rule 145(a)(3).

B. Section 2(a)(3) of the Securities Act

First Mutual Savings Bank - October 8, 1999

The Division stated that it no longer responds to requests for no-action advice under Sections 2(a)(3) and 5 for holding company formations structured to occur without a vote of shareholders.

Vanderkam & Sanders - January 27, 1999;
Simplystocks.com - February 4, 1999

In each of these letters, the Division expressed the view that the issuance of securities in consideration of a person's registration or visit to an issuer's internet site would be an event of sale within the meaning on Section 2(a)(3), and would violate Section 5 of the Securities Act unless it were the subject of a registration statement or a valid exemption from registration.

C. Section 2(a)(10) of the Securities Act

Net Roadshow, Inc. - July 30, 1997

The Division took the position that it would not recommend enforcement action if Net Roadshow transmits roadshows via the Internet:

- for the purposes and according to the procedures described in the request; and
- in reliance on counsel's opinion that the transmissions are not prospectuses within the meaning of Securities Act Section 2(a)(10).

Some of the key procedures described in the request include:

(1) an entire "live" roadshow, including any questions and answers, will be transmitted on the Internet and editing (except in limited circumstances) and staging are not permitted;

(2) transmissions of the roadshow will not be available until a registration statement has been filed with the Commission for the subject offering;

(3) transmissions will not be made widely available; access is password-protected and limited only to those "qualified" investors who customarily are invited to attend a "live" roadshow (e.g., registered broker-dealers and investment advisers);

(4) the roadshow may be viewed for one day only by each person or entity given password access;

(5) viewers must agree not to copy, download or further distribute the transmissions (Net Roadshow has also installed technology to prevent copying, downloading or printing of transmissions other than the filed prospectus);

(6) each transmission will include visual statements or "crawls" emphasizing the prohibition on copying, downloading or further distributing;

(7) a copy of the filed prospectus will be available on-line before and during each roadshow transmission, and will be able to be downloaded by the viewer in its entirety; and

(8) issuers and underwriters will be required to take reasonable steps to ensure that information disclosed in the transmission is not inconsistent with the filed prospectus.

Private Financial Network ("PFN") - March 12, 1997

The Division took the position that it would not recommend enforcement action if PFN transmits by satellite, telephone or cable a video of an issuer's road show presentation to PFN's subscribers for the purposes and pursuant to the procedures described in reliance on counsel's opinion that the transmissions are not prospectuses within the meaning of Securities Act Section 2(a)(10).

The procedures described in the request include: (1) transmissions will be available only to PFN's subscribers who agree not to videotape, copy or further distribute the transmissions; (2) before a transmission, each of PFN's subscribers will receive a filed prospectus from the issuer or the underwriter; (3) issuers and underwriters will be required to take reasonable steps to ensure that information disclosed in the road show is not inconsistent with the filed prospectus; and (4) each transmission will include visual statements or "crawls" emphasizing the prohibition on videotaping, copying or further distributing.

Dissemination of Research Materials Relating to Asset-Backed Securities - February 7, 1997

The Division stated that, under the conditions specified, the publication or distribution by a broker or dealer (collectively, "Broker/Dealer") of information, an opinion or a recommendation as to investment grade asset-backed securities (as defined for Securities Act Form S-3 eligibility purposes) ("ABS") will not be deemed, for purposes of Securities Act Sections 2(a)(10) and 5(c), to be an offer of ABS registered or proposed to be registered under the Securities Act ("Registered Securities") whether or not the Broker/Dealer is or will be a participant in the distribution of the Registered Securities.

The conditions relate to (i) the Broker/Dealer's previous publication or distribution of opinions or recommendations on specified types of ABS collateral; (ii) the sufficiency of public information to provide a basis for the Broker/Dealer's expressed view; (iii) relationships between the Broker/Dealer and a participant in the offering; (iv) whether the Broker/Dealer makes a specific recommendation on a specific ABS of a specific issuer; and (v) whether the Broker/Dealer recommends ABS backed by collateral substantially similar to that backing the Registered Securities.

In addition, the Division stated that more conditions must be met if the Registered Securities have not yet been offered or are part of an unsold allotment or subscription. The Division also stated that, in the case of a multi-tranche offering of ABS, each tranche, as described, is treated as a different Registered Security. Finally, the Division stated that its position may be modified or withdrawn if the Commission or the Division determines that this is necessary or appropriate in the public interest or otherwise in furtherance of the federal securities laws.

D. Section 3(a)(2) of the Securities Act

State Street Bank and Trust Company ("State Street") - August 1, 1996

The Division (as well as the Divisions of Investment Management and Market Regulation) addressed State Street's proposal to offer units ("Units") in specified collective trust funds ("Funds") it maintains to plans ("457 Plans") meeting the definition of "eligible deferred compensation plan" in Section 457 of the Internal Revenue Code where specified restrictions are imposed on the ability of employers to withdraw assets from the 457 Plans. The Divisions also addressed past no-action letters as to 457 Plans.

The Division stated that it would not recommend enforcement action if State Street, in reliance on an opinion of counsel that the exemptions under Section 3(a)(2) of the Securities Act and Section 3(a)(12) of the Exchange Act are available, offers Units to 457 Plans without registration under these Acts. The Division of Market Regulation concurred with the Division as to the Exchange Act. The Division of Investment Management stated that it would not recommend enforcement action if State Street offers and sells Units to 457 Plans without registering the Funds as investment companies in reliance on Section 3(c)(11) of the Investment Company Act.

The Divisions noted that they previously had issued a number of no-action letters relating to 457 Plans based largely on the general representation that plan assets would not be used for any purpose other than the exclusive benefit of participants except to the extent that plan assets must remain subject to the claims of general creditors of the employer to preserve the plan's qualification under Section 457. The Divisions also noted, however, that they now believe that this general representation no longer provides an adequate basis for no-action relief without specific additional restrictions on the ability of an employer to withdraw assets similar to those specified by State Street.

An agreement ("Agreement") between State Street and a 457 Plan would, among other things, specifically prohibit an employer from withdrawing 457 Plan assets except for the following purposes: (1) to transfer 457 Plan assets to a trustee in bankruptcy in the event of the employer's insolvency or bankruptcy, or to any other agent independent of the employer authorized to act in such proceedings; (2) to satisfy the claims of the employer's general creditors in the event of the employer's insolvency or bankruptcy; (3) to pay benefits to an employee participating in a 457 Plan; (4) to transfer assets to a 457 Plan's custodian or other person designated by a sponsoring employer in case the Agreement is terminated or a withdrawal is made for the purpose of using another investment manager or investment arrangement; (5) to distribute 457 Plan assets to participating employees in the event a 457 Plan is terminated pursuant to a plan of liquidation; or (6) to reimburse an employer for any 457 Plan benefits that the employer may have paid out of its other assets, or to correct an excess deferral or other mistaken investment in a Fund.

The Divisions concluded that, consequently, the prior no-action letters no longer represent the Divisions' position on enforcement action in the 457 Plan area. The Divisions stated, however, that to facilitate an orderly transition to their current position, they will not recommend enforcement action for a period of 12 months from the date of the response if persons continue to rely on prior letters. Finally, the Divisions took the position that at the end of that period, however, banks and insurance companies wishing to continue including 457 Plans in their collective trust funds or separate accounts should, for new contracts, enter into an agreement similar to the Agreement with the sponsor of each such 457 Plan, and for existing contracts, use reasonable efforts to amend plan documents and/or supporting contracts to conform to the Agreement (or an agreement similar to the Agreement).

E. Section 3(a)(10) of the Securities Act

Food Lion, Inc. - January 13, 1999

The Division stated that it would not object if , based on counsel's opinion that the exemption from registration provided by Section 3(a)(10) is available, the described exchange of securities traded on the Nasdaq National Market were conducted as proposed.

In reaching its position, the Division noted the recent enactment of the Securities Litigation Uniform Standards Act of 1998 (105 P.L. 353, 112 Stat. 3227), which amended Section 18(b)(4)(C) of the Securities Act to include a reference to Section 3(a)(10). Section 18 of the Securities Act creates an exemption from state securities law registration requirements for "covered securities", and defines "covered security" to include any security listed on the Nasdaq National Market System. As amended, Section 18(b)(4)(C) removes securities that are otherwise covered securities from the definition if they are offered and sold in reliance on certain federal exemptions, including Section 3(a)(10). The Division expressed the view that, as a result of the amendment, state securities law provisions authorizing the approval of certain exchanges of securities may be used to perfect an exemptive claim under Section 3(a)(10) where the security is otherwise a "covered security". The Division stated that, because of this Congressional action, statements to the contrary in Staff Legal Bulletin No. 3, as published on July 25, 1997, are no longer valid.

The Division also addressed other questions raised with respect to the proposed exchange.

Maverick Networks - January 25, 1999

The Division expressed the view that an exemptive claim under Section 3(a)(10) for securities listed on the New York Stock Exchange, the American Stock Exchange, or the Nasdaq Market System in a transaction reviewed under Section 25142 of the California Corporations Code would not be impaired by Section 18(b) of the Securities Act. The Division noted that through the recent amendment to Section 18(b)(4)(C) of the Securities Act, such securities, which otherwise would be "covered securities" exempted by Section 18 from state securities law regulatory requirements, are removed from the definition of covered securities if they are offered and sold in reliance on Section 3(a)(10). As a result, the Division stated, state securities law provisions (such as the California provision at issue) authorizing the approval of certain exchanges of securities may again be used to perfect exemptive claims under Section 3(a)(10) with respect to securities that otherwise would be covered securities.

F. <u>Section 5 of the Securities Act</u>

<u>Wit Capital- July 14, 1999</u>

The Division, without concurring in counsel's analysis, agreed not to recommend enforcement action to the Commission under section 5(a) or 5(b) against Wit Capital for its conduct of initial public offerings using the procedures described in Wit's request.

Under the procedures, Wit circulates an e-mail notice conforming to rule 134 after preliminary prospectus in a segregated area within Wit's web site. The segregated area in Wit's web site, the "cul de sac," separates information concerning the IPO from other information on Wit's web site. A person entering the cul de sac cannot link other sites on the Internet, such as the issuer's web site. The cul de sac includes only a notice conforming to rule 134, the preliminary prospectus, and information on Wit's general account and subscription procedures.

A person visiting the cul de sac who does not hold accounts with Wit must open the account before submitting an offer to buy shares in the IPO. A minimum of $2,000 must be deposited to open the account. The amount deposited is independent of the amount that may be required to purchase shares and remains in the control of the investor. Persons holding accounts who wish to participate in the offering may make offers to buy through the subscription documents included in the cul de sac. Offers to buy may specify the price the investor is willing to pay. Offers to buy that do not specify a price are treated as limit orders at the maximum estimated public offering price disclosed in the prospectus.

Approximately 48 hours before the anticipated effectiveness of the registration statement, Wit sends an e-mail notice requesting reaffirmation of the offers to buy. Persons who do not confirm their earlier offers will not receive allocations. The confirmation will be valid for a maximum of seven business days from this e-mail notice. A further reconfirmation will be required at any time the public offering price deviates from the estimate and at any time the preliminary prospectus is recirculated.

After the registration statement is effective and shortly before the IPO is priced using rule 430A procedures, Wit will send an e-mail notice to each bidder stating that the offering is about to price and that unless the bidder withdraws the offer to buy within a brief period (the minimum is an hour), Wit may accept the offer. Notices of acceptance are sent to persons who have received allocations. The notice will be followed by a confirmation that satisfies Exchange Act rule 10b-10 and the final prospectus required by section 5(b)(2).

<u>American Re Corporation (the "Company") - May 15, 1998</u>

The Division addressed the Company's Charter Partners insurance program (the "Program"). The Program was to involve (i) the sale of insurance policies to members of associations or other organizations (each an "Association") of smaller and middle sized commercial businesses with similar business risks, and (ii) the reinsurance of a portion of the liabilities arising from those policies by a Bermudan "rent-a-captive."

Under the Program, each Association would act as settlor of a trust ("Trust") for the benefit of its members who purchase insurance through the Program ("Policyholders"). Each Trust would purchase, for a nominal amount, one share of non-voting preferred stock in the holding company ("Holding Company") that owns the rent-a-captive. The Company or one of its affiliates would hold all of the common stock in the Holding Company. Should an Association have an overall positive result because of its favorable loss experience, the rent-a-captive would pay dividends to the Holding Company with respect to that Association's policies. The Holding Company would then pay a dividend to the Trust on the preferred stock. Any distribution from the rent-a-captive to the Holding Company, and from the Holding Company to the Trust, would be made pursuant to a predetermined formula set forth in a shareholder agreement between the Holding Company and the Trust. After deduction of certain administrative expenses, all of the dividends paid by the rent-a-captive to the Holding Company would then be distributed to the Policyholders. The distributions to the Policyholders would be based on a separate formula that took into account each Policyholder's premium volume and loss experience.

The Division took the position that it would not recommend enforcement action to the Commission if, in reliance upon counsel's opinion that registration was not required, the Program were operated without registration of the Trust interests or the Holding Company preferred stock under the

Securities Act. In reaching this position, the Division noted, among other things, that (1) no Policyholder would ever be liable for any dollar amount in excess of the premium paid by the Policyholder for insurance; and (2) any dividends distributed to a Policyholder would be allocated pursuant to a predetermined formula and based primarily upon the Policyholder's own loss experience.

<u>Net Roadshow, Inc. ("Net Roadshow") - January 30, 1998</u>

The Division stated that it would not recommend enforcement action if Net Roadshow transmits road shows over its Internet website solely to "qualified institutional buyers" ("QIBS") within the meaning of Securities Act Rule 144A(a)(1) on behalf of a QIB (or person acting on its behalf) that purchases securities from an issuer for resale to other QIBS under Rule 144A ("Seller"). The Division noted counsel's opinion that the activities described would be consistent with Rule 144A(d)(1) and conditioned its position on Net Roadshow's compliance with the following conditions in connection with each road show.

(1) Net Roadshow will deny access to its website for viewing a particular road show (including any notice of the road show posted on Net Roadshow's website) to all but:

(A) New Roadshow's or the Seller's employees or authorized agents for that road show; and

(B) the institutions for which the Seller has confirmed its reasonable belief regarding their QIB status.

(2) The confidential password assigned to QIBS for a particular road show will be unique to that road show, and will expire no later than the date the related offering terminates.

(3) Each Seller's confirmation to Net Roadshow will include the following:

(A) a representation that the Seller is a QIB;

(B) an adequate basis for the Seller's representation of its "reasonable belief" that:

(i) each entity to which the Seller has assigned a confidential password is a QIB; and

(ii) the offering to which the particular road show relates is not subject to Securities Act registration.

(4) Net Roadshow otherwise has no actual knowledge or reason to believe, that:

(A) the Seller is not a QIB;

(B) any of the entities to which the Seller has assigned a confidential password is not a QIB; or

(C) the securities offering to which a particular road show relates is subject to Securities Act registration.

(5) Net Roadshow is not an affiliate of any Seller or issuer of a security that is the subjectof a particular road show.

Finally, the Division stated that the Commission or staff may reevaluate this no-action position in the future because regulatory responses to legal issues raised by technological developments may evolve.

<u>Internet Capital Corporation. ("ICC") - December 24, 1997</u>

The Division (as well as the Division of Market Regulation) addressed ICC's electronic posting and delivery of prospectuses and other offering materials for unaffiliated issuers.

ICC will provide this service in connection with Securities Act registered offerings, Securities Act Regulation A offerings and SCOR offerings. ICC will not provide this service in connection with offerings under Securities Act Regulation D Rules 505 and 506. For example, as to registered offerings, ICC will post on its website notices that comply with Securities Act Rule 134 and related preliminary prospectuses that comply with Securities Act Rule 430 and final prospectuses.

The Division stated that it would not recommend enforcement action as a result of the electronic posting and delivery. The Division expressly disclaimed providing a view on whether:

- ICC, in engaging in the activities described, would be an "underwriter" within the meaning of Securities Act Section 2(a)(11); and
- the prospectus delivery procedures described would satisfy the standards set forth in Securities Act Release Nos. 7233 (October 6, 1995) and/or 7288 (May 9, 1996).

The Division of Market Regulation took the position that it would not recommend enforcement action under Exchange Act Section 15(a) if ICC establishes and operates the described Internet web site without registering as a broker-dealer under Exchange Act Section 15(b). The Divisions noted that their positions were based in part on the oral representation that no ICC affiliate will do business with an issuer or assist an issuer in connection with the issuer's offering of its securities on ICC's web site. Finally, the Divisions noted that their no-action positions may be reevaluated in the future because regulatory responses to ongoing technological developments may evolve.

<u>The Securities Transfer Association, Inc. - October 24, 1997</u>

The Division took the position that it would not recommend enforcement action if, in reliance on an opinion of counsel that registration under the Securities Act is not required, a bank or issuer uses its Internet Web site in connection with an open-market stock purchase plan ("Plan") as described in the request and without compliance with the Securities Act's registration provisions.

The uses described in the request include the following:

- an issuer places on its Web site a notice of Plan availability and a hypertext link to the bank Plan sponsor's Web site; and
- a bank Plan sponsor places on its Web site a list of issuers for which it sponsors Plans and the related Plan materials.

<u>Brown & Wood LLP - February 7, 1997</u>

The Division addressed the resale by specified holders ("Holders") of securities ("Exchange Capital Securities") acquired in a Securities Act registered exchange offer ("Exchange Offer") for substantially similar privately placed financing trust issued securities ("Capital Securities").

The Division concluded that a Holder may resell the Exchange Capital Securities without compliance with Securities Act registration and delivery requirements where the Holder acquires the Exchange Capital Securities in the ordinary course of its business and has no arrangement or understanding with any person to participate in the distribution of the Exchange Capital Securities.

In reaching this position, the Division particularly noted (1) the described characteristics of the Capital Securities; and (2) the described actions to be taken in connection with the Exchange Offer.

<u>Dissemination of Research Materials Relating to Asset-Backed Securities – February 7, 1997</u>

The Division addressed the publication or distribution by a broker or dealer of information, an opinion or a recommendation as to asset-backed securities. See Section XII.C for a discussion of this letter.

IPONET - July 26, 1996

With respect to public offerings, the Division addressed the application of Securities Act Rule 134 to an electronic coupon or card. The Division stated that the reference in Rule 134(d) to "an enclosed or attached coupon or card, or in some other manner" would be equally applicable to the acceptance of indications of interest via electronic coupon or card as well as paper coupon or card. In this regard, the Division noted the representation that Rule 134(d)'s other requirements will be satisfied in connection with the acceptance of such indications of interest.

The Division also addressed, in the electronic context, the definitions of "general solicitation" and "general advertising" under Securities Act Regulation D Rule 502(c). The Division took the position that the initial qualification of accredited or sophisticated investors by means of a generic questionnaire, followed by the subsequent posting of a notice of a private offering in a password-protected page of IPONET accessible only to IPONET members who previously qualified as accredited investors, would not involve any form of "general solicitation" or "general advertising" within the meaning of Rule 502(c).

In reaching this conclusion, the Division noted that (i) both the invitation to complete the questionnaire used to determine whether an investor is accredited or sophisticated and the questionnaire itself will be generic in nature and will not reference any specific transactions posted or to be posted on the password-protected page of IPONET; (ii) the password-protected page of IPONET will be available to a particular investor only after the supervisor of IPONET has made the determination that the particular potential investor is accredited or sophisticated; and (iii) a potential investor could purchase securities only in transactions that are posted on the password-protected page of IPONET after that investor's qualification with IPONET. In this regard, the Division stated that it took no position as to whether the information obtained by the supervisor is sufficient to form a reasonable basis for believing an investor to be accredited or sophisticated.

Real Goods Trading Corporation (the "Company") - June 24, 1996

The Division (as well as the Divisions of Investment Management and Market Regulation) addressed the Company's proposed trading system ("System") that would provide information about prospective buyers and sellers (the "Participants") of the Company's common stock ("Common Stock"). The Division took the position that the Company's activities in connection with the establishment and maintenance of the System would not require that offers or sales made through the System be registered under the Securities Act. The Division of Investment Management took the position that the Company may engage in the activities specified without registering under the Investment Advisers Act. The Division of Market Regulation took the position that it would not recommend enforcement action under Exchange Act Section 5, 6 or 15 if the Company operates the System in the manner specified without registration as a national securities exchange under Section 6 or as a broker-dealer under Section 15 of the Exchange Act.

In reaching these positions, the Divisions noted that (i) the Company will provide specified notices regarding operation of and participation on the System that will be set forth or contained on the screens and/or hard copy by which System information is provided; (ii) the Company is an Exchange Act Section 12 registrant and will retain that status or, if it should cease to be a Section 12 registrant, otherwise undertake to make publicly available the information required by Exchange Act Section 13(a) in the same manner that Participants will obtain access to the System (e.g., electronic mail, facsimile, mail, the Company's World-Wide Web site, etc.); (iii) the Company will keep records of all quotes entered into the System and make those records available to the Commission and the Pacific Stock Exchange (or any other regulated market on which Company securities are listed) upon reasonable request; (iv) the Company's advertising will comply with specified representations; (v) neither the Company nor any affiliate of the Company will use the System, directly or indirectly, to offer to buy or sell securities, except in compliance with the securities laws, including any applicable registration requirements (absent an available exemption therefrom); and (vi) neither the Company nor any affiliate of the Company will (a) receive any compensation for creating or maintaining the System; (b) receive any compensation for the use of the System; (c) be involved in any purchase or sale negotiations arising from the System; (d) provide information regarding the advisability of buying or selling Common Stock or any other securities; or (e) receive, transfer or hold funds or securities as an incident of operating the System.

G. Rules 144, 145, and 144A

Mandatorily Exchangeable Issuer Securities October 25, 1999

The Division addressed the eligibility of a security for resale under Rule 144A, where that security, itself eligible to be resold in reliance on Rule 144A(d)(3), is exchangeable at the issuer's election for securities of unrelated issuers. The securities of the unrelated person could be resold by the issuer of the overlying security in reliance on Section 4(1), either because they were not restricted securities within the meaning or Rule 144(a)(3) or because they could be sold in reliance on Rule 144(k). The Division expressed the view that, under the circumstances described, the overlying security would be eligible for resale under Rule 144A. The Division expressed no view on the application of the conversion premium test of Rule 144A(d)(3) to securities of this description.

Verio Inc. ("Verio") - May 25, 1999

The Division expressed the view that, once Verio has fully and unconditionally guaranteed a debt security of its wholly owned subsidiary, holders of warrants to purchase Verio common stock who pay the warrant exercise price by surrendering the guaranteed debt instrument may use their holding periods on the warrants and debt securities to calculate their holding periods for the common stock received on exercise. In reaching its position, the Division particularly noted that the addition of the Verio guarantee would allow Verio and its wholly owned subsidiary to be considered the same issuer for purposes of Rule 144(d)(3)(ii). The Division noted that warrant holders paying the exercise price with any consideration other than the guaranteed debt securities or other Verio securities would use the date of exercise of the warrant and payment of its exercise price as the beginning of the holding period for the Verio common stock received upon exercise. The Division stated that *Amdahl Corp.* (February 27, 1999) and *American Telephone and Telegraph Company* (May 1, 1999) no longer represent the Division's view on this issue.

CommScan, LLC - February 3, 1999

The Division expressed the view that sellers may rely on the Company's qualified institutional buyers list ("QIB List"), which would be published on an Internet web site accessible only by registered broker/dealers, as a method for establishing a reasonable belief that a prospective purchaser is a "qualified institutional buyer" within the meaning of Rule 144A(a)(1) under the Securities Act. Information underlying inclusion of an entity in the QIB List must be as of a date within 16 months before the date of sale of securities in the case of a United States purchaser, and within 18 months before such date of sale for a foreign purchaser.

Elliott Associates, L.P. and Westgate International, L.P. -January 18, 1999

The Division expressed the view that that the Rule 144(d) holding period for common shares issuable to holders of described outstanding debt of the issuer, in satisfaction of terms in the Trust Deed governing the debt providing for contingent issuance of the common shares, would be identical to the holding period for the debt securities themselves. The Division noted that the obligation to issue the common shares is subject only to conditions outside the control of the parties, and that the issuances will not be made against the payment of any new consideration.

The Petersen Companies, Inc. ("Company") - July 16, 1998

The Division expressed the view that the Rule 144(d) holding period for shares of Company common stock exchanged for limited liability company interests in Petersen Holdings, L.L.C. ("Petersen") began on October 1, 1997, the date of the exchange. The Division stated that the holding period could not "tack" to an earlier date because the agreement Petersen interest holders signed when Petersen was formed, granting the Company (in its capacity as Petersen's manager) the right to control all aspects of any initial public offering, did not expressly contemplate conversion from a limited liability company to corporate form in advance of a public offering of securities, with holders of Petersen units retaining no veto or other voting power with respect to the conversion. The Division referred specifically to *Peapod, Inc.* (Nov. 10, 1997).

Peapod, Inc. ("Peapod") - November 10, 1997

The Division took the position that limited partners of a partnership and the shareholders of its corporate general partner could "tack," under Securities Act Rule 144(d), their holding periods for their limited partnership interests and shares, respectively, onto their holding periods for the shares of Peapod received in a conversion (and, in the case of the general partner's shareholders, the general partner's subsequent liquidation).

In the conversion,

- all the equity interests in the partnership were exchanged for Peapod shares;
- the partnership was dissolved; and
- all of the partnership's assets and liabilities were transferred to Peapod.

In reaching this conclusion, the Division noted in particular specified agreements and their contemplation of the partnership's conversion to corporate form in advance of, and to facilitate, the new corporation's public offering.

Rite Aid Corporation - October 20, 1997

The Division expressed the view that, where securities originally issued in a Securities Act Rule 145(a) transaction are transferred as gifts to third parties by a person Rule 145(c) deems an underwriter, the donees in the transfers who are not the issuer's affiliates may make unregistered public resales of the securities in the same manner and to the same extent as the donor.

Nextel Communications, Inc. - August 19, 1997

The Division stated that, where securities originally issued in a Securities Act Rule 145(a) transaction are privately sold by a person deemed an underwriter by Rule 145(c) (other than an affiliate of the issuer), an unaffiliated purchaser of the securities may make unregistered public resales of the securities to the same extent and in the same manner as the private seller.

First Bank System, Inc. - July 30, 1997

The Division stated that when an affiliate pledgor defaults on a loan that is collateralized by securities that are not "restricted" in the hands of the pledgor, and the pledgee bank forecloses on the pledge, the pledgee bank may sell those securities without regard to the holding period requirement of Securities Act Rule 144.

H. Rule 701

Morgan, Lewis & Bockius - November 3, 1999

The Division provided further guidance for issuers when transitioning from former Rule 701 to the new version. The Division expressed these views concerning the treatment of options:

- an issuer could rely on the grant date method for options granted in the 12 months before effectiveness of the revised rule up to the ceiling permitted under the old rule. Excess options - option grants over the ceiling in the old rule - could be considered against the available ceiling under the revised rule either when the excess options become exercisable or when they are actually exercised, whichever is most advantageous;
- the disclosure required by the revised rule where the $5 million ceiling is exceeded must be provided to investors a reasonable time before the exercise of options, even if those options were granted long before the rule revision; and

- the "clean slate" method is appropriate only if the available ceiling under the revised rule is not exceeded when offers and sales under the former rule are combined with sales under the revised rule.

Occidental Petroleum Corporation - August 3, 1999

The Division expressed the view that a private subsidiary of Occidental, a publicly reporting company, may use Rule 701 to offer or sell its securities to its employees.

American Bar Association - August 3, 1999

The Division stated that, subject to preliminary note 5 to Rule 701, a private subsidiary of a publicly reporting company may use Rule 701 to offer or sell its securities, including deferred compensation arrangements whether guaranteed or not guaranteed by the parent, to its employees, officers, directors, partners, trustees, consultants or advisors, or those of its parents or other majority-owned subsidiaries of its parent.

American Bar Association - August 3, 1999

With respect to issues of transition from the former Rule 701 to the new version, the Division expressed the view that the grant date method, the effective date method and the exercisable date method described, each appear to be appropriate ways of handling unexercisable options under the new provision. The Division also concurred with the view that options issued in reliance upon the prior version of Rule 701 regardless of their exercisability would not be subject to the new disclosure requirements at the time of the option grants.

I. Regulation S

Initial Public Offerings of U.S. Companies on EASDAQ - July 27, 1999

The Division took the position that it would not recommend enforcement action if equity securities of non-reporting, U.S. companies are offered and sold in initial public offerings offshore pursuant to Regulation S in connection with a listing on EASDAQ without implementation of the stop-transfer and other provisions set forth under Rule 903(b)(3)(iii)(B), Rule 903(b)(3)(iv) and Rule 904(b)(1)(ii). In reaching its position, the Division relied on counsel's opinion that the alternative restrictions and arrangements described in the request provide reasonable procedures to prevent public distribution of these equity securities in the United States. The Division also noted that U.S. firms are not permitted to participate in the EASDAQ market, either as brokers or market-makers, and that no EASDAQ trading screens will be placed in the United States.

Sales of Convertible Securities Under Regulation S - August 26, 1998

The Division stated that it would not recommend enforcement action if convertible securities of U.S. reporting companies that are eligible for resale under Rule 144A and that are held in global certificated from (as either registered or bearer securities) by a depository for a book-entry clearance facility are offered and resold pursuant to Regulation S without implementation of the stop-transfer provisions or other procedures set forth under Rule 903(b)(3)(iii)(B)(4) of Regulation S, as long as certain procedures are followed during the applicable distribution compliance period. The Division stated that its view was limited to convertible securities offered or resold under Regulation S, and would not affect the applicability of Rule 903(b)(3)(iii)(B)(4) to any equity securities issued upon the conversion of the convertible securities during the distribution compliance period.

The Division also indicated that debt securities convertible into the equity securities of a person other than the issuer ("exchangeable" securities) would be considered convertible securities for Regulation S purposes.

J. <u>Section 18(b)(4)(A) of the Securities Act</u>

<u>David M. Katz, Esq. - April 24, 1997</u>

The Division addressed one of the definitions of "covered security" provided by Securities Act Section 18(b). Section 18(b)(4)(A) states that a security is a "covered security" as to a transaction that is exempt from Securities Act registration under Securities Act Section 4(1) or 4(3), provided that the issuer "files reports" with the Commission under Exchange Act Section 13 or 15(d). The Division stated that an issuer "files reports" for purposes of Section 18(b)(4)(A) if it has completed a registered initial public offering under the Securities Act, but has not yet been required to file any reports under Section 13 or 15(d).

K. <u>Securities Act Forms</u>

<u>Ropes & Gray - October 30, 1997</u>

The Division stated that post-effective amendments to deregister unsold shares are not required in fee transfers from Securities Act registration forms other than Form S-8 or in fee transfers from Form S-8 solely of fees paid pursuant to Rule 457(h)(3) with respect to additional securities offered for resale.

The Division also stated that the filing of the Securities Act registration statement to which the fee is transferred is deemed to deregister the unsold shares for which the transferred fee originally was paid.

Finally, the Division stated that registrants who wish to transfer Securities Act registration fees also should consult the Rule 429 interpretations in the latest version of the Division of Corporation Finance Manual of Publicly Available Telephone Interpretations, which is available on the Commission's Internet web site (*http://www.sec.gov*), and Securities Act Rel. 7168 (May 11, 1995).

<u>The Bond Market Association - October 16, 1997</u>

The Division provided its views on the availability of Securities Act Form S-3 to asset-backed securities.

The Division stated that an asset-backed security will not fail to meet the definition of "asset-backed security" in Form S-3, General Instruction I.B.5, solely because the security is supported by assets having total delinquencies (as described in the request) of up to 20% at the time of the proposed offering.

The Division also stated that, regardless of whether an asset-backed security meets the definition of "asset-backed security" in General Instruction I.B.5, the security may nevertheless be eligible for registration on Form S-3 as long as the issuer satisfies General Instruction I.A.'s registrant requirements and General Instruction I.B.2.'s transaction requirements.

<u>Merrill Lynch & Co., Inc. (the "Company") - May 16, 1996</u>

The Division stated that it would not object if the Company uses Form S-8 under the Securities Act in connection with exercises of transferable stock options ("Transferable Stock Options") subject to specified transfer restrictions by former employees and by executors, administrators and beneficiaries of estates of employees or former employees, provided that the Transferable Stock Options being exercised have never been transferred by the original grantees and are only exercisable by executors, administrators and beneficiaries of their estates due to such grantees' deaths.

In reaching this position, the Division noted in particular that a Transferable Stock Option is not transferable by any person other than the original grantee or the estate of the original grantee (which is permitted to transfer such Transferable Stock Option only to the beneficiaries of such estate).

L. Sections 13 and 15(d) of the Exchange Act

Time Warner Inc. (the "Company") - June 10, 1998

The Division stated that it would not object if each of two Company subsidiaries (each a "Subsidiary") did not file reports under Sections 13 and 15(d) of the Exchange Act with respect to its securities guaranteed i) by the Company and ii) by the other Subsidiary (a "Cross Guarantee"). In reaching its conclusion the Division noted, among other factors, that the Company had fully and unconditionally guaranteed the Cross Guarantees. The Division's position was conditioned on the inclusion of certain narrative and financial statement disclosure in the Company's Exchange Act reports.

Pioneer Americas Acquisition Corp. - April 3, 1998

The Division stated that it would not object if an issuer (the "Issuer") of securities guaranteed by its parent (the "Parent Guarantor") and by other wholly-owned subsidiaries of its parent (the "Affiliate Guarantors") did not file reports under Sections 13 and 15(d) of the Exchange Act with respect to the guaranteed securities. The Division also stated that it would not object if the Affiliate Guarantors did not file reports under Sections 13 and 15(d) with respect to the guarantees. In reaching its conclusion the Division noted, among other factors, that the Parent Guarantor and the Affiliate Guarantors had fully and unconditionally guaranteed the Issuer's securities on a joint and several basis. The Division's position was conditioned on the inclusion of certain narrative and financial statement disclosure in the Parent Guarantor's Exchange Act reports.

M. Proxy Rules

Johnson Controls, Inc. ("Johnson") - October 26, 1999

The Division addressed whether a proposal recommending certain disclosure in the financial statements included in Johnson's Commission-prescribed documents could be omitted from Johnson's proxy material under Rule 14a-8(i)(7), as relating to Johnson's ordinary business operations. In expressing its view that the proposal could be omitted, the Division stated that it has determined that proposals requesting additional disclosures in Commission-prescribed documents should not be omitted under the "ordinary business" exclusion solely because they relate to the preparation and content of documents filed with or submitted to the Commission. This interpretive approach reverses the Division's prior approach to such proposals. Beginning with *Johnson Controls*, when evaluating such proposals the Division will consider whether the subject matter of the additional disclosure sough in a particular proposal involves a matter of ordinary business. Where it does, the Division believes the proposal may be excluded under Rule 14a-8(i)(7).

Chevron Corporation — March 4, 1999

The Division took the position that it would not recommend enforcement action if Chevron omitted a shareholder proposal requesting the board of directors to review and report on Chevron's code of business conduct under Rule 14a-8(i)(12)(ii). The Division noted that the current proposal, when viewed together with the proposals submitted in 1996 and 1997, all appear to focus on Chevron's operations in Nigeria. Furthermore, changing circumstances are not a consideration under Rule 14a-8(i)(12). On this basis, the Division continued to follow the precedent established by a prior staff no-action letter issued to Florida Progress Corporation on January 8, 1997.

General DataComm Industries, Inc. - December 9, 1998

The Division stated that it did not believe that General DataComm could rely on Rule 14a-8(i)(7) as a basis to exclude a shareholder proposal mandating a bylaw amendment on stock option repricing from its proxy materials. The Division noted that in view of the widespread public deate concerning option repricing and the increasing recognition that this issue raises significant policy issues, its view is that proposals relating to option repricing no longer can be considered matters relating to a registrant's ordinary business. This letter reverses a prior staff no-action letter issued to Shiva Corporation on March 10, 1998.

Tenet Healthcare Corporation (the "Company") - July 1, 1998

The Division was unable to concur in the Company's view that Rule 14a-8(c)(7) provides a basis for the Company to omit from its proxy material a proposal requesting that the board of directors prepare a report regarding the status of the Company's computer system preparedness for the Year 2000. The Division expressed the view that the proposal raises significant policy issues that are beyond the ordinary business operations of the Company.

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Company") - October 24, 1997

The Division took the position that it would not recommend enforcement action if the Company prepares and disseminates research reports in accordance with Securities Act Rule 138 or 139 in connection with registered securities transactions, without compliance with the filing, disclosure and dissemination requirements of the proxy rules under Exchange Act Section 14(a).

The Division stated that its position was conditioned on the research report referring, as required by law or applicable rules, to any relationship that may exist between the Company, as issuer of a particular research report, and any participant in a relevant proxy solicitation. The Division also stated that its position did not address the applicability of the federal securities laws' anti-fraud provisions to the activities described in the request.

Finally, the Division stated that it may re-evaluate its no-action position in the future because the request raises issues in an evolving area of the federal securities laws.

N. Section 16 Rules

American Bar Association - October 15, 1999

The staff addressed the application of Rule 16b-3(c) to open market stock purchase plans that, under the standards of Securities Act Release No. 4790, are not required to be registered under Section 5 of the Securities Act. The Division said that the acquisition of issuer stock pursuant to accumulated payroll deductions under such a plan is a transaction with "an employee benefit plan sponsored by the issuer" for purposes of Rule 16b-3(a) where:

- the issuer deducts funds from compensation;
- deducted funds accumulate for a regular, specified interval no shorter than a pay period;
- accumulated funds are invested in issuer stock; and
- the open market plan restricts participation to employees of the issuer and its parents or subsidiaries who would be eligible to purchase securities of the issuer under a registration statement on Form S-8.

Such an acquisition is exempt under Rule 16b-3(c) if the open market plan meets the conditions of Rule 16b-3(b)(5), the definition of a Stock Purchase Plan. Because subsequent sales or transfers of the securities so acquired would be outside the plan, these transactions would not be exempt under Rule 16b-3. Acquisitions pursuant to additional voluntary contributions, although not exempt under Rule 16b-3, would not make the exemption unavailable for acquisitions pursuant to payroll deductions.

Select Sector SPDR Trust (the "Trust") - May 6, 1999

In a joint letter with the Division of Investment Management, the Division addressed the application of Section 16(a) to shares issued by the Trust, a registered open-end management investment company, in its nine separate investment portfolios (the "Funds"). The Divisions stated that, having expressed in this letter and in *PDR Services Corporation* (December 14, 1998) their views as to whether insiders and five percent beneficial owners of exchange-traded products, such as the shares issued by the Funds, must file ownership reports under Sections 16(a) and 13(d), respectively, the Divisions will no longer respond to requests for no-action relief in this area unless the request presents a novel or unusual issue.

American Bar Association - February 10, 1999

The Division addressed the application of Exchange Act Rule 16b-3 to transactions occurring in the following contexts:

- A transaction in issuer securities by the issuer's officer or director with the issuer's majority-owned subsidiary (or an employee benefit plan sponsored by a majority-owned subsidiary) will be considered a transaction with the issuer for purposes of Rule 16b-3(a). However, the approval requirements of Rule 16b-3(d) and 16b-3(e) must be satisfied at the issuer—rather than the subsidiary—level.

The following salary limitations implement "benefit or contribution limitations set forth in the Internal Revenue Code" for purposes of Rule 16b-3(b)(2): (a) the annual compensation limit in Internal Revenue Code Section 401(a)(17); and (b) the Internal Revenue Code Section 415 exclusion from taxable compensation of salary that has been deferred into a non-qualified plan. A supplemental plan that permits employer contributions that otherwise would have been made to the related qualified plan but for either of these limitations will be an Excess Benefit Plan.

- The following plans are not Excess Benefit Plans because the amount of issuer securities acquired will be determined based on the amount of salary the officer or director chooses to defer: (a) a non-qualified deferred contribution plan; and (b) a supplemental plan that provides an employer matching contribution based on the employee's deferral of salary into a non-qualified plan.
- Periodic acquisitions of phantom stock under a non-qualified deferred compensation plan or a supplemental plan that is not an Excess Benefit Plan that are exempted by Rule 16b-3(d) may be reported on an aggregate basis on Form 5.
- Rule 16b-3 is available to exempt an officer's or director's indirect interest in transactions, reportable by the officer or director, between the issuer and the following entities if the approving entity for purposes of Rules 16b-3(d) and 16b-3(e) knows (and the document evidencing approval specifies) the existence and extent of the officer's or director's indirect interest and that the approval is granted for purposes of Rule 16b-3:
  - a partnership or corporation;
  - a member of the officer's or director's immediate family; and
  - a trust.

Skadden, Arps, Slate, Meagher & Flom LLP - January 12,1999

The Division addressed the application of Exchange Act Rule 16b-3 to transactions occurring in the context of corporate mergers.

Where the conversion or cancellation is simultaneous with or immediately before the related merger, each of the following transactions constitutes a disposition to the issuer of target equity securities eligible for exemption under Rule 16b-3(e), even if the acquiror pays the merger consideration directly to target equity security holders:

- the conversion of target nonderivative equity securities into acquiror equity securities, debt, cash or a combination of different forms of merger consideration; and
- the conversion of target derivative securities into acquiror derivative securities or acquiror nonderivative equity securities, or the cancellation of target derivative securities for cash.

The approval conditions of Rule 16b-3(e) may be satisfied only by the target.

The acquisition of acquiror equity securities (including acquiror derivative securities) by officers and directors of the acquiror through the conversion of target equity securities in connection with a merger constitutes an acquisition from the acquiror eligible for exemption under Rule 16b-3(d). This position applies equally to employees and directors of the target who become officers and/or directors of the acquiror before, or at the time of, the merger ("New Acquiror Insiders"). The approval conditions of Rule 16b-3(d) may be satisfied only by the acquiror.

In the case of both dispositions and acquisitions, the approval conditions of Rule 16b-3 may be satisfied at the same time as, or following, approval of the merger agreement by the respective issuer's board of directors, as long as they are satisfied before consummation of the merger. Guidance is provided as to the specificity required if approval is granted by the full board or a committee of two or more Non-Employee Directors. Approval of an acquisition may be granted before a New Acquiror Insider becomes an officer or director of the acquiror.

Peter J. Kight - October 16, 1997

The Division addressed the application of Exchange Act Section 16 to transactions involving an irrevocable grantor retained annuity trust ("GRAT").

A grantor ("Grantor"), subject to Section 16 because an officer of a company ("Company") with common stock registered under Exchange Act Section 12, proposes to create a GRAT for estate planning purposes. Grantor proposes to transfer ("Transfer") to the GRAT shares of Company common stock Grantor now owns ("Shares") that constitute less than ten percent of the Company's outstanding common stock.

The GRAT will make a series of fixed annuity payments ("Annuity Payments") to Grantor, payable in either cash or Shares, over a specified time period ("Annuity Period"). During the Annuity Period, Grantor is the GRAT's trustee and beneficiary. After the Annuity Period, Grantor's minor children who share Grantor's household ("Children") are the GRAT's beneficiaries. The dollar amount of the Annuity Payments is established at the time of the Transfer. The present value of the Annuity Payments does not exceed the fair market value of the Shares at the time of the Transfer.

The Division took the position that Rule 16a-13 (exempting changes in form of ownership from Section 16) applies to the Transfer and any Annuity Payments paid in Shares. The Division stated that other transactions in the Shares by the GRAT during the Annuity Period are considered the Grantor's transactions. The Division also stated that the Annuity Period's termination effects a gift of Shares to the Children eligible both for exemption under Rule 16b-5 (exempting bona fide gifts from Section 16(b)) and deferred reporting on Form 5. Finally, the Division stated that after the Annuity Period ends, under Rule 16a-1(a)(2)(ii)(A) Grantor continues to report the Shares the Children hold as beneficially owned by Grantor as long as the Children share Grantor's household

MIDWEST/MIDSOUTH

SECURITIES LAW CONFERENCE

- 2000 GUEST LUNCHEON SPEAKER -

John A. Byrne
Senior Writer - Business Week
New York, New York

SECTION E

Chainsaw : The Notorious Career of Al Dunlap in the Era of Profit-At-Any-Price

by John A. Byrne

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About the Author

John A. Byrne is a senior writer for *Business Week*. He has written extensively on Al Dunlap's career over the years. Byrne is the author of *Informed Consent* and *The Whiz Kids* and the co-author, with John Sculley, of *Odyssey*.

The author, John A. Byrne , October 1, 1999

Why I wrote Chainsaw

A confession: I have never been one of Albert J. Dunlap's favorite journalists. There were far too many other reporters and writers who won his favor over the years. Not me. As a senior writer at Business Week magazine, I first encountered "Chainsaw Al," the 1990's champion of downsizing, in late 1995 shortly after Kimberly-Clark Corp. had purchased Scott Paper Co. I had closely watched his widely celebrated "turnaround" of stodgy Scott from the sidelines, growing increasingly skeptical as Dunlap became ever more boastful. I found it odd that a man who virtually based his career on laying off people could do so without expressing regret or sympathy for those he fired. Indeed, I found it appalling that an executive could lay off hundreds of thousands of people and speak almost gleefully about the experience. My subsequent cover story for Business Week, "The Shredder," wasn't one that Dunlap would paste in his scrapbook. It reported that Dunlap was largely an opportunist who simply prettied up Scott Paper for a quick sale. He cut muscle along with the fat, sacrificed the long-term future of a once-great company and its people for a quick buck, and took credit for the achievements and hard work of others. Though he claimed a turnaround and too many journalists believed him, Scott had lost market share in all three of its major product areas during Dunlap's tenure. He and his executives reaped tens of millions in gains while thousands of his employees lost their jobs and their livelihoods. Yet, Dunlap, $100 million richer himself from his 18-month stint at Scott, received an avalanche of acclaim. He was worshiped on Wall Street, elevated to hero status by many shareholders who profited from his handiwork. His fame and popularity helped to make his vainglorious Mean Business, part-biography, part-advice book, a bestseller. I would like to think that Chainsaw is something of an antidote to Dunlap's own Mean Business, which might best be described in CEO biography terms as Iaccoca on steroids. Chainsaw is, in some way, the non-fiction version of a book that is sadly at home on the shelves of too many people in business. The readers of Chainsaw will find themselves laughing out loud at how absurd things became at a billion-dollar-plus public corporation. They'll also find a storehouse of amusing and shocking anecdotes to entertain friends and guests for weeks and months. And if I've done my job right, they'll also come away with an important lesson or two about leadership and management that they will never forget.

Editorial Reviews

Amazon.com
Al Dunlap was so ruthless in downsizing corporations for short-term shareholder profit that he earned nicknames such as "Chainsaw Al" and "Rambo in Pinstripes." Wall Street loved Dunlap at Scott Paper, where he laid off thousands, but then hated him at Sunbeam, where he himself was finally fired. *Chainsaw*, by *Business Week* writer John A. Byrne, dramatically documents the rise and fall of Dunlap, the havoc he wreaked on companies and people's lives, and how he came to power in the first place.

"Chainsaw Al was a creation of the Street and its ceaseless lust for profit at any cost. He came of age when the market routinely rewarded layoffs with lofty stock prices. The more people he tossed out in the street, the higher stock values went," writes Byrne, who cites "cutthroat investors" such as Michael Price and Ronald Perelman for helping Dunlap's rise. Superbly written and researched, the book vividly describes characters and scenes, and reveals the fictions that Dunlap told about himself. How cold was Chainsaw Al? Byrne writes that Dunlap never even attended the funerals for his mother and father. Byrne also tells the story of the questionable accounting and business practices that ultimately brought down Sunbeam and Dunlap, and the investigations that led to a restatement of the company's finances. Dunlap, unhappy about Byrne's reporting, once said of the *Business Week* writer, "If he were on fire, I wouldn't piss on him." It's a quote that Byrne uses to kick off his last chapter. *Chainsaw* is a compelling read for those interested in the inner workings of Wall Street and business, or just a well-told story. *--Dan Ring*

From Booklist, November 1, 1999
Al Dunlap, called "Chainsaw" because of his propensity for, even love of, corporate downsizing, made himself a legend when heading up the in-need-of-resuscitation Sunbeam Corporation. He displayed the disposition of a dictator, sitting at conference tables like "an imperial demagogue." He was a product of his times: the 1980s and early 1990s, when investors rewarded companies for going lean and mean. "To enhance profits and boost stock prices, American corporations shed millions of employees and thousands of plants." But Dunlap could not deliver the goods; despite his draconian measures, he did not turn Sunbeam around in terms of profits, and, as the French Revolution finally consumed its own engine, Robespierre, the downsizing trend finally consumed the downsize king. Dunlap fell because of hubris, and his story told here, based largely on Byrne's several *Business Week* articles on the subject, leaves us not only with a fascinating inside look at business but also a moral lesson about getting too big for one's britches. *Brad Hooper*

Washington Monthly
"Byrne's rendition of Dunlap's year-and-a-half tantrum is remarkable,enriched by interviews with most of the top players in thedrama...Byrne does an excellent job of chronicling the human tormentresulting from plant closures where experienced and efficient life-timeemployees of Sunbeam were suddenly thrown onto unemployment rolls."

-Tom Peters, author of Thriving on Chaos and Liberation Management
"John Byrne is simply the best investigative business journalist in the land. Byrne rightfully nails an executive who sorely deserves nailing. The documentation is powerful and chilling. Moreover, this extraordinary yarn also provides a cautionary tale that should be read closely on Wall Street as well as in the boardroom."

-Noel Tichy, author with Eli Cohen of The Leadership Engine, and University of Michigan professor
"From Greek Tragedy through Shakespearean tragedy, we have learned important human and leadership lessons. John Byrne has written a business history tragedy. The Al Dunlap failure is a must read for its lessons in leadership. Through detailed story telling, Byrne not only gives us the story but provides a set of tragic lessons on how bad leadership ultimately destroys shareholder value and people's lives."

-Bob Waterman, coauthor, In Search of Excellence
"I haven't been consciously searching for the antithesis of excellence, but I think I've found it anyway. In this extremely well-researched and well written book, Byrne shows us how the American system of market capitalism can be completely perverted. Under the banner (false as it turns out) of shareholder value, Chainsaw Al has repeatedly destroyed people, companies, and ultimately, himself.

-Gerard R. Roche, chairman, Heidrick & Struggles, Inc.
"This is a captivating book that deserves to be a movie. Chainsaw is to the nineties what Barbarians at the Gate was to the eighties. It is a riveting story filled with compelling characters who wrestle with one of today's most important business issues: The enduring value of the long-term versus what is simply short-term and expedient. Never before has this question been more dramatized than in this remarkable tale."

-James C. Collins, coauthor of Built to Last
"A superbly written book. John Byrne provides a riveting and frightening tale of how egos and greed can destroy a company and people's lives. Every person who cares about the long-term health of American business should read this book, and shudder at its implications."

-Warren Bennis, University of Southern California Distinguished Professor of Business Administration and coauthor of Organizing Genius
"John Byrne has done us a great favor with his magnificent book on 'Chainsaw Al.' It is a fitting tribute for a CEO who has defined for our age the worst of Corporate Darwinism and brutal short-termism. This book will serve as a template every senior executive and corporate ethicist will use to evaluate the responsibilities and consequences of leadership in Corporate America."

★★★★★ **Sad commentary on our business culture**

Reviewer: **Srikumar S. Rao** from Long Island, New York   January 17, 2000

John Byrne has taken a non fiction theme and turned it into a gripping page turner. Virtually everyone I know has read this book in one or two sittings. There is a bright future for him in thrillers!

Al Dunlap was so lionized by Wall Street that the market capitalization of Sunbeam went up by billions of dollars simply because of the announcement that he was taking charge. The subsequent fiasco is well documented. Byrne takes us behind the scenes and shows us what exactly happened, and when and why. Based on exhaustive interviews and examination of public and private records, the tale is both gripping and revealing.

Accounting norms were stretched to the point of outright fraud. Those who tried to sound alarms were silenced by various means ranging from firing to being bought off with options. Characters are finely drawn to the extent that you feel you know each one personally. Telling incidents reveal the essence of each player. During a major crisis, for example, Dunlap dispatches his major henchman to adjudicate a minor dispute with his club. The movers and shakers of business - Michael Price, Ron Perelman and others of that ilk - are shown to have poor judgment coupled with incredible arrogance, the same traits amply displayed by Dunlap. All have overwhelming greed. There are no heroes in this book.

The author documents that Dunlap's "successes" had much less substance than media accounts would lead you to believe. It was luck that prevented Scott Paper, for example, from being the first debacle. This is no hatchet job despite Dunlap's visceral hate for the author. The author does not reveal many damaging tidbits in this book which he has recounted elsewhere - such as the fact that Dunlap refused to contibute to the medical expenses of a niece suffering from cancer.

Far from being a "leader" or even "manager", Dunlap was a tyrant who preyed on the weak, fawned on the strong and endlessly feathered his nest. Media and Wall Street colluded in his successful-for-too-long image building. Byrne has the courage to point this out.

It is a sad commentary on our business culture that Dunlap flourished for so long despite so many people knowing what was really going on.

Read this book to understand what is going on behind the scenes in too many companies. Dunlap did not grow in a vacuum.

UPDATE ON

PRIVATE SECURITIES LITIGATION

Plaintiff Views:

"What News From the Front?"
The Litigation Experience of Four Years Under
The Private Securities Litigation Reform Act of 1995

Kevin P. Roddy
Milberg Weiss Bershad Hynes & Lerach LLP
Los Angeles, California

SECTION F

UPDATE ON PRIVATE SECURITIES LITIGATION
– PLAINTIFF VIEWS –

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"What News From The Front?" The Litigation Experience Of Four Years Under The Private Securities Litigation Reform Act Of 1995

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I. INTRODUCTION

A. Supposed Purpose Of PSLRA

Several district courts have stated that the Private Securities Litigation Reform Act of 1995 ("PSLRA") was enacted by Congress on December 22, 1995 over President Clinton's veto in order "to combat the filing of abusive and meritless lawsuits." *Carson v. Merrill Lynch, Pierce, Fenner & Smith*, No. 97-5147, 1998 U.S. Dist. LEXIS 6903, at *10 (W.D. Ark. Mar. 30, 1998) (citing Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995), *reprinted in*, 1995 U.S. Code Cong. & Admin. News 730)); *see also In re Milestone Scientific Sec. Litig.*, 187 F.R.D. 165, 174 (D.N.J. 1999) ("Congress enacted the PSLRA to remedy perceived abuses in private securities class action litigation.") (citing, *inter alia*, *In re Cendant Corp. Sec. Litig.*, 182 F.R.D. 144, 145 (D.N.J. 1998)).

While reasonable people could endlessly debate the need for securities litigation "reform," *compare* Harvey L. Pitt, et al., *Promises Made, Promises Kept: The Practical Implications of the Private Securities Litigation Reform Act of 1995*, 33 San Diego L. Rev. 845 (1996) ("Pitt, *Promises Made*") *with* Leonard B. Simon and William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 San Diego L. Rev. 959 (1996), it cannot be disputed that since December 1995 the procedural skirmishing in class actions brought under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") has been more intense and time-consuming than that experienced under the prior statutory scheme, adding time and expense to the burdens inherent in such cases. *See generally* Sherrie R. Savett, *The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995*, 39 Ariz. L. Rev. 525, 531 (1997) ("Savett, *Observations*") (observing that the PSLRA "produces great delay in getting the case moving to the merits") (emphasis omitted).

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B. Effectiveness Of Statutory Reforms Of Securities Litigation

If, as several commentators have asserted, the purpose of the PSLRA was to remedy perceived securities litigation "abuses" by empowering "institutional investors" with the incentive and ability to control such cases, then the statutory purpose has gone unfulfilled because such institutions have shown limited interest in becoming involved as lead plaintiffs. *See generally* Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation,* 39 Ariz. L. Rev. 533, 537-50 (1997) ("Fisch, *Class Action Reform*"). As one commentator concluded:

> [T]he [PSLRA] has not yet brought the dramatic revolution in the leadership of these actions Congress intended. According to several studies, institutional investors have remained passive observers in securities litigation, volunteering to serve as lead plaintiff only infrequently. The institutional default has allowed the traditional plaintiffs bar to consolidate its control over these cases....
>
> Moreover, institutional investors have not maximized their influence over the actions in which they have intervened....
>
> What must be most disappointing to reform proponents ... is that the historic indifference of institutional investors has continued ....

Seth Goodchild, *Nothing Ventured, Nothing Gained: Ten Lessons for Institutional Investors From the 1995 Reform Act,* 4 Securities Reform Act Litig. Rptr. 583, 583-84 (Feb.-Mar. 1998) (footnotes omitted); *see also* Peter M. Saparoff & Adam L. Sisitsky, *The Role of Institutional Investors in Class Actions Under the PSLRA - Are They Walking on a Slippery Slope? Two Years Later*, Securities News 9 (ABA Sec. of Litig. Winter 1999) ("Saparoff & Sisitsky, *Two Years Later*") ("The predicted trend of institutional investors hesitating to assume the role of lead plaintiff in class action lawsuits in the wake of the [PSLRA's] enactment continues.") (footnote omitted); Paul Paradis, *Appointing Lead Plaintiff, Counsel: Securities Class Action Background*, N.Y.L.J. (Nov. 23, 1998) at S3 ("While Congress purportedly intended to encourage institutional investors to step forward and serve as lead plaintiffs, for a variety of reasons this has largely failed to materialize.").

Indeed, the SEC has drawn the same conclusion:

> Congress' efforts to encourage more active participation by institutional and other large investors has not yet taken hold.... In the 105

> cases filed in the first year after passage of the [PSLRA], we have found only eight cases in which institutions have moved to become lead plaintiff.

SEC Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* 51 (Apr. 15, 1997), *reprinted in* 3 Securities Reform Act Litig. Rptr. 27, 56 (May 1998); *see also* Memorandum of the Securities and Exchange Commission, Amicus Curiae at 16, *In re Oxford Health Plans, Inc. Sec. Litig.*, MDL Docket No. 1222 (S.D.N.Y.) ("Few institutions have instituted securities fraud class actions after passage of" the PSLRA).

As another commentary has stated:

> The jury appears still to be out on the question of whether institutions will take advantage of the invitation presented by the [PSLRA] to participate actively as a plaintiff in securities fraud actions. To date, only a handful of institutions have sought appointment as lead plaintiff, and it is too early to tell whether this provision will have its intended effect.

Richard L. Jacobson & Joshua R. Martin, *The Private Securities Litigation Reform Act of 1995: A Survey of the First Two Years*, 5 Securities Reform Act Litig. Rptr. 168, 173 (May 1998) ("Jacobson & Martin, *Survey*").

It is also unclear that the presence of such institutional investors as plaintiffs in securities class actions will increase the size of the recoveries obtained for the class relative to claimed damages. *See* Savett, *Observations*, 39 Ariz. L. Rev. at 531-32; *but see* Richard Schmitt, *Pension Fund Plans Crucial Role in Suit*, Wall St. J., Dec. 17, 1998, at B19 (lead plaintiff State of Wisconsin Investment Board agreed to $14.6 million settlement of *CellStar* securities litigation; settlement reportedly amounted to more than 40% of estimated damages incurred by investors).

C. Effective Date Of PSLRA

The PSLRA, Pub. L. No. 104-67, 109 Stat. 737 (1995), which amended the Securities Act, 15 U.S.C. §§77a-77bbbb, and the Exchange Act, 15 U.S.C. §§78a-78lll, applies to private securities actions brought pursuant to the Federal Rules of Civil Procedure. *See* 15 U.S.C. §77z-1(a)(1); *Lax v. First Merchants Accep. Corp.*, No. 97-C-2715, 1997 U.S. Dist. LEXIS 11866, at *5 (N.D. Ill. Aug. 6, 1997).

The PSLRA does *not* apply to actions commenced before and pending on its effective date - December 22, 1995. *See* Pub. L. No. 104-67, 109 Stat. 737, 758, §108; *compare Stevens v. O'Brien Environ. Energy, Inc.*, Civil Action No. 94-4577, 1999

U.S. Dist. LEXIS 6660, at *3 n.1, Fed. Sec. L. Rep. (CCH) ¶90,475 (E.D. Pa. May 10, 1999) (PSLRA "do[es] not apply to this action because it was commenced before the Reform Act became effective") (citation omitted); *Lyons v. Scitex Corp.*, 987 F. Supp. 271, 273 n.3 (S.D.N.Y. 1997) (PSLRA did not apply to securities class action "commenced on December 14, 1995") *with Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group*, 985 F. Supp. 427, 429 (S.D.N.Y. 1997) ("The PSLRA applies here because SDG's complaint, which asserts claims under the Exchange Act, was filed on September 5, 1997, and related to events which occurred in 1997."); *In re Westinghouse Sec. Litig.*, 982 F. Supp. 1031, 1036 (W.D. Pa. 1997) (same - because dismissed securities class action complaint was filed after enactment of PSLRA, district court was required to make findings regarding whether plaintiff has complied with requirements of Rule 11(b)); *see also Wilson Land Corp. v. Smith Barney, Inc.*, No. 5:97-CV-519-BR(2), 1999 U.S. Dist. LEXIS 12879, at *46 (E.D.N.C. May 17, 1999) (PSLRA applied to case filed in 1997).

What if the securities class action was filed after December 22, 1995, but concerns alleged wrongdoing predating the PSLRA's effective date? In one case, *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096 (D. Nev. 1998), plaintiffs' securities fraud claims arose out of a secondary stock offering commenced on December 19, 1995, and the alleged class period continued until July 1996, thereby "straddling" the effective date of the PSLRA. Judge Pro held that the PSLRA could be applied retroactively to encompass defendants' alleged wrongdoing in connection with that securities offering, reasoning that retroactive application would not result in the impairment of any rights because intentional material misstatements of the type alleged by plaintiffs were actionable before and after enactment of the PSLRA. *Id.* at 1104-06.

D. Elimination Of So-Called "Professional Plaintiffs"

One supposed problem confronting private securities litigation when the PSLRA was enacted was the so-called "professional plaintiff," defined by one court as "persons who purchase a nominal number of securities and then bring [complaints alleging] violations of the federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation." *Carson*, 1998 U.S. Dist. LEXIS 6903, at *11 (citing 1995 U.S. Code Cong. & Admin. News 731-32); *see also Gluck v. CellStar Corp.*, 976 F. Supp. 542, 543-44 (N.D. Tex. 1997).

In this regard, the PSLRA clearly changed the rules of the game, requiring plaintiffs who bring securities class actions to comply with certain procedural requirements codified at 15 U.S.C. §§77z-1(a) and 78u-4(a). Since the statute's enactment, research does not reveal any reported cases addressing the problem of so-called "professional plaintiffs" or "repeat players."

E. Small vs. Institutional Shareholders

Judge Coar has asserted: "'The manifest intent of the [PSLRA] is determining the plaintiff most capable of pursuing the action and representing the interests of the class.'" *Lax*, 1997 U.S. Dist. LEXIS 11866, at *5 (quoting *Fischler v. Amsouth Bancorp.*, No. 96-1567-CIV-T-17A, 1997 U.S. Dist. LEXIS 2875, at *2 (M.D. Fla. Feb. 6, 1997)).

Judge Black has stated that the PSLRA "appears to reflect a congressional intent to transfer power from counsel who win the race to the courthouse to those shareholders who possess a sufficient financial interest in the outcome to maintain some supervisory responsibility over both the litigation and their counsel." *In re Horizon/CMS Healthcare Corp. Sec. Litig.*, 3 F. Supp. 2d 1208, 1212 (D.N.M. 1998) (citing Michael Y. Scudder, Comment, *The Implications of Market-Based Damages Caps in Securities Class Actions*, 92 Nw. U. L. Rev. 435, 437 (1997), and Note, *Investor Empowerment Strategies in the Congressional Reform of Securities Class Actions*, 109 Harv. L. Rev. 2056, 2058 (1996)). Once again citing these law review articles, Judge Black stated that "Congress appears to have harbored the hope that substantial institutional investors ... would advance their resources and expertise to fulfill this responsibility." *Horizon/CMS*, 3 F. Supp. 2d at 1212 n.5 (citations omitted). *See also* Pitt, *Promises Made*, 33 San Diego L. Rev. at 882-83 ("Part of Congress' intent in adopting the [PSLRA] was to ... attempt[] to *encourage*, but not *require*, institutional shareholders to supervise this litigation, and to select their own counsel whom these institutions would monitor and supervise."); Fisch, *Class Action Reform*, 39 Ariz. L. Rev. at 537-41 (same).

Given the passage of more than four years since the enactment of the PSLRA and the filing of more than 1,000 securities class actions during that period, it should be conceded that this supposed salutary purpose of the statute has largely gone unfulfilled; however, Professor Weiss has stated:

> It is far too early to draw many definitive - or even tentative-conclusions. Indeed, given the pace at which securities class actions typically had proceeded, and the slower pace at which they seem to be proceeding under the [PSLRA], it probably will be five years or more before we have enough data to reach more than very tentative conclusions as to how the lead plaintiff provisions have affected the conduct of securities class actions.

Elliott J. Weiss, *The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39

Ariz. L. Rev. 561, 563 (1997) ("Weiss, *The Impact to Date*").

In his law review article, Professor Weiss could point to only one reported case in which a "major institutional investor has moved successfully to be appointed lead plaintiff and has appointed new lead counsel," *id.* at 565 (referring to Judge Buchmeyer's August 1997 decision in *CellStar* litigation), and he acknowledged that Professor Jill Fisch has identified a number of factors which may well preclude institutional investor participation in securities class actions. *Id.* at 563 n.16; *see also* Fisch, *Class Action Reform*, 39 Ariz. L. Rev. at 541-50; Pitt, *Promises Made*, 33 San Diego L. Rev. at 882-90 (discussing institutional investors' motivations vis-a-vis participating in securities litigation).

As two securities practitioners have stated:

> The number of institutional investors who have sought to participate as lead plaintiffs in securities class actions has still remained relatively few. In recent cases where institutional investors have undertaken to participate, however, courts have refrained from automatically conferring lead plaintiff status upon them, in some cases ordering that the role be shared instead. Such judicial resistance likely will only continue the trend of institutional investors "shying away" from pursuing the role of lead plaintiff in class actions, thus undermining one of the important purposes of the PSLRA.

Saparoff & Sisitsky, *Two Years Later*, Securities News at 11.

II. PSLRA DISCLOSURE REQUIREMENTS

A. Plaintiff's Sworn Certification

The PSLRA imposes strict disclosure requirements upon plaintiffs in securities fraud actions, requiring that a plaintiff "seeking to serve as a representative party on behalf of a class shall provide a sworn certification" with the complaint. 15 U.S.C. §§77z-1(a)(2)(A) and 78u-4(a)(2)(A). The sworn statement must certify that the plaintiff (1) reviewed and authorized the filing of the complaint; (2) did not purchase the securities at the direction of counsel or in order to participate in a lawsuit; and (iii) is willing to serve as the lead plaintiff on behalf of the class. *Id.* In addition, the statement must also identify any of the plaintiff's transactions in the security that is at issue. *Id.; see Carson*, 1998 U.S. Dist. LEXIS 6903, at *11-12 (explicating disclosures required in securities class action complaints under PSLRA); *Gluck*, 976 F. Supp. at 544 (same).

It would appear that the PSLRA's certification requirement has not impeded the filing or effective prosecution of securities class actions. Moreover, it can and should be argued that a plaintiff's filing of a sworn certification obviates the need for expensive and time-consuming "class certification discovery" that defendants' counsel often seek to engage in once plaintiffs have filed a motion for class certification under Fed. R. Civ. P. 23.

In *Epstein v. MCA*, 54 F.3d 1422, 1423 (9th Cir. 1995), a tender offer case, the Ninth Circuit reversed a trial court's order that plaintiff investors and their counsel be held in contempt for refusal to comply with irrelevant discovery requests. Defendants had sought discovery of what the appellate court described as "detailed information" about whether plaintiffs owned MCA shares, how they invested their tender offer proceeds, whether their investment history made it likely they would have elected to receive preferred stock instead of cash and whether they would pay taxes on cash proceeds they received. As the Ninth Circuit stated: "The first piece of information Matsushita sought to obtain through discovery - whether plaintiffs owned MCA stock - is without doubt relevant to the subject matter of this litigation. The other information Matsushita sought to discover however, is not."). *See also Schlagal v. Learning Tree Int'l*, No. CV 98-6384 ABC (Ex), 1999 U.S. Dist. LEXIS 2157, at *14-18, Fed. Sec. L. Rep. (CCH) ¶90,435 (C.D. Cal. Feb. 25, 1999) (granting plaintiffs' class certification motion and denying defendants' request to conduct discovery of proposed lead plaintiffs and class representatives).

B. Notice Provisions

1. Application Of Notice Provisions

The PSLRA amended the Exchange Act by adding Section 21D, which is codified at 15 U.S.C. §78u-4. Section 21D(a)(i), 15 U.S.C. §78u-4(a)(1), entitled "Private class actions," states that the provisions of that subsection "shall apply in each private action arising under this chapter that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure." *See Simon DeBartolo Group*, 985 F. Supp. at 430 (express language means that Congress intended to limit application of §21D(a) to class actions).

2. Statutory Text

Section 21D(a)(3) sets forth procedures for early notice to potential class members of the filing of a securities class action. The relevant notice provision states:

> Not later than 20 days after the date on which the complaint is filed, the plaintiff or plaintiffs shall cause to be published, in a widely circulated national business-oriented publication or wire

service, a notice advising members of the purported plaintiff class -

(I) of the pendency of the action, the claims asserted therein, and the purported class period; and

(II) that, not later than 60 days after the date on which the notice is published, any member of the purported class may move the court to serve as lead plaintiff of the purported class.

15 U.S.C. §§77z-1(a)(3)(A)(i) and 78u-4(a)(3)(A)(i). *See Yousefi v. Lockheed Martin Corp.*, 70 F. Supp. 2d 1061, 1066 (C.D. Cal. 1999) (detailing notice procedures under PSLRA); *see also* Pitt, *Promises Kept*, 33 San Diego L. Rev. at 883 (discussing notice provision); Weiss, *The Impact to Date*, 39 Ariz. L. Rev. at 564-65 (lauding notice provisions of PSLRA).

3. Obligation To Give Notice

If multiple actions are filed on behalf of a class asserting substantially the same claim or claims arising under either the Securities Act or the Exchange Act, only the plaintiff -- or plaintiffs -- who filed *first* shall be required to cause notice to be published. *See id.*; Julia C. Kou, Note, *Closing the Loophole in the Private Securities Litigation Reform Act of 1995*, 73 N.Y.U.L. Rev. 253, 265-66 (1998) ("Kou, *Closing the Loophole*") (explicating notice provisions of PSLRA).

4. Timing And Content Of Notice

Under these statutory provisions, the named plaintiff in the first filed action must file notice within twenty days of filing suit in order to inform potential class members of their right to move to be appointed lead plaintiff. *See* 15 U.S.C. §§77z-1(a)(3)(A)(i) and 78u-4(a)(3)(A)(i); Kou, *Closing the Loophole*, 73 N.Y.U.L. Rev. at 265-66.

This notice must identify the claims alleged in the lawsuit and the purported class period, and inform potential class members that within sixty days, they may move to serve as the lead plaintiff. *See Lax*, 1997 U.S. Dist. LEXIS 11866, at *10-16 (explicating notice requirements of PSLRA); *accord In re Aetna, Inc. Sec. Litig.*, Civil Action MDL No. 1219, 1999 U.S. Dist. LEXIS 12546, at *2-3 (E.D. Pa. Aug. 6, 1999); *see also* Kou, *Closing the Loophole*, 71 N.Y.U. L. Rev. at 265-66. Judge Waters has stated: "The notice requirement was included in the PSLRA to provide a method for determining the most adequate plaintiff." *Carson*, 1998 U.S. Dist. LEXIS 6903, at *12 (citing 1995 U.S. Code Cong. & Admin. News 732).

5. Publication Of Notice

Such notice must be published in a "widely circulated national business publication or wire service." *See* Kou, *Closing the Loophole*, 73 N.Y.U.L. Rev. at 265-66. In *Lax*, 1997 U.S. Dist. LEXIS 11866, at *15, Judge Coar rejected the contention that publication of notice in *Investor's Business Daily* failed to satisfy the statutory requirement:

> The PSLRA does not define "widely circulated." Thus, the court must make its own interpretation as to what the term means. In this case, the court finds that, while Investor's Business Daily might not have as large a circulation as the Wall Street Journal, it is nevertheless widely circulated and, more importantly, apparently read by sophisticated investors. The likelihood of a First Merchants' investor actually seeing a notice in the Investor's Business Daily "is arguably as great as finding such information by skimming the back pages of the Wall Street Journal."

Id. (quoting *Greebel v. FTP Software*, 939 F. Supp. 57, 63 (D. Mass. 1996)). *Accord In re Nice Sys. Sec. Litig.*, 188 F.R.D. 206, 216 & n.8 (D.N.J. 1999); *see also D'Hondt v. Digi Int'l*, No. 97-5(JRT/RLE), 1997 U.S. Dist. LEXIS 17700, at *5 (D. Minn. Apr. 2, 1997) ("Defendants do not challenge the sufficiency of the Notice provided by means of Business Wire and, in fact, at least one Court has held that this wire service adequately seeks to provide notice to potential class members, including institutional investors, of pending class claims that are subject to the provisions of the [PSLRA]") (citing *Greebel*, 939 F. Supp. at 64); *Yousefi*, 70 F. Supp. 2d at 1067 ("Since the passage of the [PSLRA], district courts, including this Court, have repeatedly recognized that the *Business Wire* as a 'widely circulated national business-oriented ... wire service,' as required by the [PSLRA].") (citations omitted); *cf. In re Party City Sec. Litig.*, 189 F.R.D. 91, 105 n.10 (D.N.J. 1999) ("The *PR Newswire* appears to be a business-oriented wire service within the meaning of the PSLRA.") (citations omitted).

6. Effect Of Failure To Give Notice

In *Carson*, 1998 U.S. Dist. LEXIS 6903, where plaintiff brought a purported class action on behalf of a class of persons who purchased warrants from a Merrill Lynch offering, plaintiff failed to comply with the disclosure and notice provisions of the PSLRA. *Id.* at *10. Granting plaintiff's motion to amend his complaint, Judge Waters held that the failure to comply with the provisions of the PSLRA is not fatal to the maintenance of a securities class action:

> The PSLRA does not direct a court to dismiss a complaint when a plaintiff fails to comply with either the certification requirement or the notice provisions.... [I]f Congress had wanted the courts to dismiss a complaint when a plaintiff failed to file a sworn certification or publish timely notice, then Congress could have included such language in the PSLRA.

Id. at *16.

Accordingly, in *Carson* Judge Waters distinguished as dicta language to the contrary in Chief Judge Tauro's opinion in *Greebel*, 939 F. Supp. at 60, where the district court stated that "[f]ailure of the named plaintiff to file a certification with the complaint and to serve notice to class members are fatal to maintenance of the putative class action." As Judge Waters explained:

> Defendants contend that *Greebel* stands for the proposition that the complaint must be dismissed when the plaintiff fails to comply with either the certification or the notice requirements of the PSLRA. We disagree. The court in *Greebel* was simply stating in dicta that if a plaintiff never complies with the provisions of the PSLRA, then the class action cannot go forward. The court did not state that a named plaintiff could not correct such a failure to comply by filing a certification with an amended complaint and serving such notice within 20 days of the amended complaint. Therefore, we conclude that nothing under the PSLRA prohibits the court from allowing a plaintiff to file a sworn certification with an amended complaint and to publish belated notice to the other purported class members.

Carson, 1998 U.S. Dist. LEXIS 6903, at *16-17 (footnote omitted).

Judge Waters also stated:

> The facts in *Greebel* are also dissimilar to the facts in the present case. In *Greebel*, the parties had already reached the stage in the lawsuit where notice had been published and other class members had come forward and moved the court to be appointed lead plaintiff. Thus, the court was in the process of determining which plaintiff should be appointed lead plaintiff. At that point, it is important that a plaintiff has properly complied with the certification and notice provisions of the PSLRA, so that the court can determine the most adequate plaintiff to represent the class.

Id. at *17 n.3.

The PSLRA's notice requirement has, according to one commentary, provided unexpected benefits for plaintiffs' counsel:

> One clearly unintended effect [of the PSLRA's notice provision] has been that the notices issued by law firms announcing the filing of class actions and providing notice of the opportunity to seek appointment as lead plaintiff have served as public relations material for the plaintiffs' bar in soliciting new business.

Jacobson & Martin, *Survey*, 5 Securities Reform Act Litig. Rptr. at 176 n.8.

One plaintiffs' lawyer has similarly observed that "the plaintiff's counsel publishing the notice may attract other shareholders who consult with and retain him, thus enhancing his position and enabling that law firm to become lead counsel." Savett, *Observations*, 39 Ariz. L. Rev. at 529.

III. APPOINTMENT OF LEAD PLAINTIFFS

A. Outline Of Procedures

The PSLRA establishes new rules requiring (and governing) the appointment of lead plaintiff(s). Professor Weiss has stated that the statute's lead plaintiff provisions "actually comprise four elements," the first of which - notice to class members - has been discussed above:

> *First*, the Act requires any person filing a securities class action to provide early notice to members of the purported class of the filing of the action, the nature of the claims made, and the purported class period. *Second*, the Act instructs courts (a) to provide an opportunity for members of the purported class to seek appointment as lead plaintiff and (b) to appoint to that position the "most adequate plaintiff," which a court must presume is the aspiring plaintiff "with the largest financial interest in the relief sought by the class." *Third*, the Act directs courts to allow other members of the purported class to engage in discovery relating to appointment of the lead plaintiff only if they "first demonstrate[] a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class." *Finally*, the Act authorizes the most adequate plaintiff, subject to court approval, to "select and retain counsel to represent the class."

Weiss, *The Impact to Date*, 39 Ariz. L. Rev. at 563-64 (emphasis added; footnotes omitted); *see also Pindus v. Fleming Cos.*, 146 F.3d 1224, 1225 n.1 (10th Cir. 1998) (under PSLRA, "within 110 days of the date a class action is filed, the district court must resolve any outstanding motions from putative class members who wish to be appointed as lead plaintiff.

As a result, §78u-4(a) effectively requires the district court to appoint a lead plaintiff and lead counsel at the very beginning of a class action litigation"); *Christman v. Brauvin Realty Advisors, Inc.*, No. 96 C 6025, 1999 U.S. Dist. LEXIS 929, at *32 (N.D. Ill. Jan. 22, 1999) ("The PSLRA contemplates that a lead plaintiff will be appointed early in the litigation. The PSLRA requires that notice be filed within 20 days after the complaint is filed, that motions for appointment as lead plaintiffs be filed within 60 days after the notice is published, and that the court consider any such motions within 90 days after the notice is published."); *Cendant*, 182 F.R.D. at 146-47 (outlining procedures for selection of lead plaintiff(s) and lead counsel); *Chill v. Green Tree Fin. Corp.*, 181 F.R.D. 398, 407 (D. Minn. 1998) (same); *see also Yousefi*, 70 F. Supp. 2d at 1066 (same).

B. Purpose Of Lead Plaintiff Provisions

In *Greebel*, Chief Judge Tauro stated that the "inspiration" for the PSLRA's lead plaintiff provisions was a law review article that Professor Weiss co-authored with Professor John S. Beckerman. 939 F. Supp. at 58 n.2. Professor Weiss claims in a subsequent law review article that "[o]ur goal in proposing a notice requirement was to provide institutional and other investors with early notice of the pendency of a class action that had the potential to affect their rights." Weiss, *The Impact to Date*, 39 Ariz. L. Rev. at 564 (citing Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2108-09 (1995)); *see also* Fisch, *Class Action Reform*, 39 Ariz. L. Rev. at 537-39.

In a recent case, Judge Green commented on the procedures for selecting lead plaintiffs under the PSLRA:

> The PSLRA envisions a mixed inquisitorial/ adversarial model for developing a record to make the Lead Plaintiff decision. In a case where more than one group vies for Lead Plaintiff status, the Court usually receives the benefit of the adversarial process to have the merits developed before rendering a decision ... [W]here no opposition has been noted, Congress envisioned that the courts still would play an independent, gatekeeping role to implement the PSLRA. At the

same time, Congress envisioned that the Court would do this with dispatch.

In re The Baan Co. Sec. Litig., No. 98-2465 (JHG), 1999 U.S. Dist. LEXIS 5219, at *3-4 (D.D.C. Apr. 12, 1999) (footnote omitted).

C. Time Periods

In several cases where the appointment of lead plaintiffs has been contested, the time periods prescribed by Congress have not been met. As Magistrate Judge Lefkow commented:

> Because the issue of appointment of lead plaintiffs has been contested, the statutory requirement to appoint the lead plaintiff within 90 days after the publication of early notice to class members of the litigation has not been accomplished. See SEC Report to President and Congress on the First Year of Practice Under the [Reform Act] at 43 (Part VI, C. 3, "The Lead Plaintiff Provision Has Added Delay and Expense"). In light of the inevitable delay necessitated by the motions, including an effort to launch discovery under §78u-4(a)(3)(B)(iv), the court has appointed the Minnesota State Board of Investment (MSBI), the plaintiff which it has preliminarily concluded is the presumptively most adequate plaintiff to represent the class, to act as interim lead plaintiff. The court has also approved MSBI's counsel, Heins, Mills & Olson, to serve as interim lead counsel in order that this bottleneck not prevent the litigation from moving forward.

Raftery v. Mercury Fin. Co., No. 97 C 624, 1997 U.S. Dist. LEXIS 12439, at *2-3 (N.D. Ill. Aug. 7, 1997).

In a similar vein, one plaintiff's lawyer has asserted:

> *The [PSLRA] produces great delay in getting the case moving to the merits.* Under the [PSLRA], the early notice to potential class members must be filed twenty days after the first complaint is filed. The notice allows sixty days for applications to be made for lead plaintiff, and the lead plaintiff, once selected, hires lead counsel subject to court approval. The [PSLRA] provides that the court should select lead plaintiff and lead counsel by ninety days, provided consolidation has occurred.
>
> It often takes even longer than ninety days for the court to select lead plaintiffs and lead counsel, especially if there are competing applications.

Savett, *Observations*, 39 Ariz. L. Rev. at 531 (footnotes omitted).

D. Statutory Provisions

Section 21D of the Exchange Act establishes a rebuttable presumption that the "most adequate plaintiff," for purposes of appointment as lead plaintiff, is "the person or group of persons" that

> (aa) has either filed the complaint or made a motion [seeking appointment as lead plaintiff];
> (bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and
> (cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.

15 U.S.C. §78u-4(a)(3)(B)(iii)(I). *See Reiger v. Altris Software*, No. 98cv0528J(JFS), 1998 U.S. Dist. LEXIS 14705, at *5-6 (S.D. Cal. Sept. 11, 1998) (outlining lead plaintiff appointment procedure); *Yousefi,* 70 F. Supp. 2d at 1066 (same); *Cendant*, 182 F.R.D. at 146-47 (same).

E. Rebutting The Presumption

As Judge Buchmeyer has explained the applicable procedures governing appointment of lead plaintiffs:

> The court is directed to consider all motions made by purported class members seeking to be appointed Lead Plaintiff and to determine the "member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members." 15 U.S.C. §78u-4(a)(3)(B)(i). In so determining the "most adequate plaintiff," the court is directed to adopt a presumption that the most adequate plaintiff is the person or group of persons that filed a motion, that "has the largest financial interest in the relief sought by the class," and that "otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure." 15 U.S.C. §78u-4(a)(3)(B) (iii)(I). This presumption may be rebutted only by proof of another member of the purported plaintiff class that the presumptively most adequate plaintiff "will not fairly and adequately protect the interests of the class" or "is subject to unique defenses that render such plaintiff incapable of adequately representing the class." 15 U.S.C. §78u-4(a)(3)(B) (iii)(II).

Gluck, 976 F. Supp. at 544.

Thus, a member of the purported plaintiff class who wishes to challenge the appointment of a presumptively most adequate plaintiff must present proof that the presumptively most adequate plaintiff "either (i) will not fairly and adequately protect the interests of the class or (ii) is subject to unique defenses that render that plaintiff incapable of adequately representing the class." *Id.* at 547 (citing 15 U.S.C. §78u-4(a)(3)(B)(iii)(II)); *see also Reiger*, 1998 U.S. Dist. LEXIS 14705, at *14-15.

F. Combinations Of Persons Or Entities

The district courts remain somewhat divided as to whether members of the class or a group of persons (or entities) may *combine* to constitute the "largest financial interest" and thereby *jointly* serve as the "most adequate plaintiff"; however, the great majority of cases hold that such combinations are proper. *See Yousefi*, 70 F. Supp. 2d at 1067 ("[T]he majority of courts addressing this issue have permitted the aggregation of claims.") (citing *In re Advanced Tissue Sciences Sec. Litig.*, 184 F.R.D. 346, 353 (S.D. Cal. 1998) (allowing aggregation of six plaintiffs); *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 45-48 (S.D.N.Y. 1998) (appointing three plaintiffs as lead plaintiffs); and *Chill*, 181 F.R.D. at 409 (aggregating six plaintiffs)).

In one case, however, Judge Cedarbaum rejected the appointment of six lead plaintiffs in a securities class action, asserting that it would defeat the purpose of the PSLRA:

> To allow an aggregation of unrelated plaintiffs to serve as lead plaintiffs defeats the purpose of choosing a lead plaintiff. One of the principal legislative purposes of the PSLRA was to prevent lawyer-driven litigation. Appointing lead plaintiff on the basis of financial interest, rather than on a "first come, first serve" basis, was intended to ensure that institutional plaintiffs with expertise in the securities market and real financial interests in the integrity of the market would control the litigation, not lawyers. See H.R. Conf. Rep. No. 104-369, at 31-35 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 730, 730-34. To allow lawyers to designate unrelated plaintiffs as a "group" and aggregate their financial stakes would allow and encourage lawyers to direct the litigation. Congress hoped that the lead plaintiff would seek the lawyers, rather than having the lawyers seek the lead plaintiff.... Counsel have not offered any reason for appointing an aggregation of unrelated institutional and individual investors as lead plaintiffs other than the argument that the language of the statute does not expressly forbid such a result.

In re Donnkenny Inc. Sec. Litig., 171 F.R.D. 156, 157-58 (S.D.N.Y. 1997).

Thus, the aggregation of plaintiffs has been disallowed by several district courts. *See, e.g., In re Network Assocs., Inc. Sec. Litig.*, No. C 99-01729, 1999 WL 1095313, at *7 (N.D. Cal. Nov. 22, 1999) (based upon assumption that "[t]he whole point of the [PSLRA] was to install a lead plaintiff with substantive decisionmaking ability and authority"; court held that aggregations of unrelated investors cannot satisfy lead plaintiff provisions of PSLRA); *Aronson v. McKesson HBOC, Inc.*, No. C 99-20743, 1999 U.S. Dist. LEXIS 19276, at *18-19 (N.D. Cal. Nov. 2, 1999) ("The strictest approach forbids aggregation of unrelated plaintiffs.... *** The court adopts this narrow view...."); *In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 813 (N.D. Ohio 1999) ("[T]he context and structure of the PSLRA evince an intent that a 'group' consist of more than a mere assemblage of unrelated persons who share nothing in common *other* than the twin fortuities that (1) they suffered losses and (2) they entered into retainer agreements with the same attorney or attorneys") (emphasis in original); *Gluck*, 976 F. Supp. at 549 (same). *See generally* R. Chris Heck, Comment, *Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA*, 66 U. Chi. L. Rev. 1199, 1214-16 (1999). But, as Judge Baird stated after summarizing the recent case law, the PSLRA "clearly contemplates the appointment of multiple plaintiffs to manage the litigation." *Yousefi*, 70 F. Supp. 2d at 1067.

In *Oxford Health Plans*, the Colorado Public Employees Retirement Association (ColPERA) sought appointment as sole lead plaintiff in a securities class action. In its motion, ColPERA alleged losses in excess of $20 million due to Oxford's allegedly fraudulent activities. A second movant for appointment of lead plaintiff, a group consisting of 35 individuals (the "Vogel Group"), alleged collective losses of $10 million. Another institution, PHBG Funds ("PHBG"), alleging an estimated $2.76 million in losses, also moved for appointment as lead plaintiff.

The SEC filed an *amicus curiae* brief in support of ColPERA's motion, "urging the court to reject the request for multiple lead plaintiffs because it would undercut Congress' intent to curb lawyer-driven cases." Karen Donovan, *Oxford Suits Raise Lead Counsel Issue*, Nat'l L.J., June 15, 1998 at B-1; *see also* Saparoff & Sisitsky, *Two Years Later*, Securities News at 9. Judge Brieant, however, overruled the SEC's argument, stating that "in the circumstances of this particular case, the interests of the proposed class will be best served by a group of three co-lead plaintiffs." *Oxford Health Plans*, 182 F.R.D. at 45. Accordingly, the court appointed ColPERA, the Vogel Group and PHBG as co-lead plaintiffs. *Id.* at 49. The court then appointed the three law firms proposed by each of the respective co-lead plaintiffs as co-lead counsel. *Id.* at 50. In October 1998, the Second Circuit held that it did not have subject matter jurisdiction to consider ColPERA's appeal of the district court's denial of its motion for sole lead plaintiff status. *Metro Svcs., Inc. v. Wiggins*, 158 F.3d 162 (2d Cir. 1988).

The position taken by Judge Brieant in *Oxford Health Plans* regarding the aggregation of individual investors to serve as co-lead plaintiffs clearly represents the majority - and correct - view of the statute. *See, e.g., Yousefi,* 70 F. Supp. 2d at 1067 (quoted above); *Baan,* 1999 U.S. Dist. LEXIS 5219, at *7 ("The text of the PSLRA does not limit the composition of a 'group of persons' to those only with a pre-litigation relationship, nor does the legislative history provide a sound enough foundation to support such a gloss"; appointing three individual members of 466-person shareholder group as co-lead plaintiffs); *Reiger,* 1998 U.S. Dist. LEXIS 14705, at *13 ("By using the phrase 'group of persons,' Congress made clear that a court can consider the aggregate group's losses in determining which group has the largest financial interest."); *In re Ride, Inc. Sec. Litig.*, No. C-97-402WD, Order at 3 (W.D. Wash. Aug. 5, 1997) ("On its face, this [statutory] language calls for aggregation. Any suggestion to the contrary, based on legislative history, cannot prevail against the statute's plain wording."); *In re Diamond Multimedia Sys., Inc. Sec. Litig.*, No. C-96-2644-SBA, Order at 2-4 (N.D. Cal. Jan. 13, 1997) (proposed lead plaintiffs can pool their shares together to form the largest financial interest); *Horizon/CMS,* 3 F. Supp. 2d at 1211 (six lead plaintiffs appointed); *Malin v. IVAC Corp.*, No. 96-1843-CIV-Moreno, Order at 4-8 (S.D. Fla. Nov. 1, 1996) (holding that the plaintiff group with the largest number of shares is the most adequate plaintiff); *Nager v. Websecure, Inc.*, No. 97-10662-GAO, 1997 U.S. Dist. LEXIS 19601, at *3, Fed. Sec. L. Rep. (CCH) ¶90,111 (D. Mass. Nov. 26, 1997) (group of 10 plaintiffs appointed as lead plaintiffs); *D'Hondt,* 1997 U.S. Dist. LEXIS 17700, at *4-19 (21 persons appointed as lead plaintiffs); *Zuckerman v. Foxmeyer Health Corp.*, No. 3:96-CV-2258-T, Order at 5 (N.D. Tex. Mar. 28, 1997) (11 individual plaintiffs with largest financial interest collectively appointed as lead plaintiff); *Chan v. Orthologic Corp.*, No. Civ. 96-1514 PHX RCB, Order at 13 (D. Ariz. Dec. 19, 1996) (plaintiffs from five separate actions collectively appointed as lead plaintiffs); *Powers v. Eichen*, No. 96-1431-B(AJB), Order at 1 (S.D. Cal. Nov. 15, 1996) (nine individual plaintiffs collectively appointed as lead plaintiffs); *cf. Gluck,* 976 F. Supp. at 546, 549 (recognizing that "aggregating the shares of several plaintiffs for purposes of this calculation is proper under the statutory language," but finding that the financial interest of a group of plaintiffs was "significantly smaller" than that of an institutional investor, which was appointed as lead plaintiff; declining to appoint co-lead plaintiffs "as it would inevitably delegate more control and responsibility to the lawyers for the class and make the class representatives more reliant on the lawyers") (citing *Donnkenny,* 171 F.R.D. at 157-58). *Cf. In re*

Stratosphere Corp. Sec. Litig., Master File No. CV-S-96-00933-PMP (RLM) Order (D. Nev. Jan. 15, 1997) (defendants stipulated to 36 plaintiffs who were appointed lead plaintiffs); *see also Chill*, 181 F.R.D. at 409 ("We do not suggest that either Rule 23, or the PSLRA, warrants an arbitrary limit on the number of proposed Lead Plaintiffs, for we only hold that, in a case-by-case inquiry, a rule of reason prevails.").

Several courts have determined, however, that a large group of lead plaintiffs would be unable to control the litigation, effectively negotiate retention agreements, and supervise the conduct of counsel. *See, e.g., Yousefi*, 70 F. Supp. 2d at 1068 (refusing to appoint group consisting of three named plaintiffs and "134 unrelated class members"; court appointed as lead plaintiffs two shareholders - one institutional holder and one individual holder - who had sustained largest losses); *Baan*, 1999 U.S. Dist. LEXIS 5219, at *8-14 (rejecting proposal that 466-member shareholder group or 20-person committee be appointed as co-lead plaintiffs and appointing three shareholders, each with unrealized losses in excess of $300,000, as co-lead plaintiffs); *Advanced Tissue Sciences*, 184 F.R.D. at 352-53 ("The idea of appointing over 250 unrelated individual investors as lead plaintiffs runs afoul of Congress's intent in enacting the PSLRA"; granting alternate motion to appoint six designated group members as co-lead plaintiffs); *Chill*, 181 F.R.D. at 408-09 (winnowing 300-person plaintiffs group to six co-lead plaintiffs).

The SEC has taken the position that "ordinarily this should be no more than three to five persons." *Baan*, 1999 U.S. Dist. LEXIS 5219, at *9 (citing *amicus curiae* brief submitted by SEC); *see also Yousefi*, 70 F. Supp. 2d at 1068 ("In fact, when courts appoint multiple class members as lead plaintiffs, they typically appoint less than ten plaintiffs.") (citations omitted); Memorandum of the Securities and Exchange Commission, Amicus Curiae at 8, *LaPerriere v. Vesta Ins. Group, Inc.*, No. CV-98-AR-1407-S (N.D. Ala. 1998) ("[T]he Court should limit the proposed lead plaintiff 'group' to a small number capable of most effectively managing the litigation and exercising control over counsel.").

G. Discovery Regarding Most Adequate Plaintiff(s)

The PSLRA directs that discovery regarding whether a member of the purported plaintiff class is the most adequate plaintiff may be conducted by a plaintiff *only* if that plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class. *See* 15 U.S.C. §78u-4(a)(3)(B)(iv); *Gluck*, 976 F. Supp. at 547 ("If the challenging member of the purported class can demonstrate a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class, then discovery on the issue may be conducted before the Court appoints a Lead Plaintiff.")

In *In re Cephalon Sec. Litig.*, No. 96-CV-0633, 1996 U.S. Dist. LEXIS 10546, at *1-2 (E.D. Pa. July 18, 1996), Judge Green addressed the issue of discovery in the context of a leadership struggle:

> Pursuant to Private Securities Litigation Reform Act of 1995 ... limited discovery relating to whether a member of the purported plaintiff class may be had where there is a reasonable basis for finding that the presumptively most adequate plaintiff is incapable of adequately representing the class. As Sands Point has asserted that it is a uniquely situated institutional investor to which the Act affords preference in appointing the lead plaintiff, and as the Hooshmand plaintiffs have raised concerns challenging this position, this court finds that discovery on the issue of determining the most adequate plaintiff is appropriate.

Id.; see also Party City, 189 F.R.D. at 106.

H. What Do Defendants Have To Say?

What is the position of defendants in the event of a leadership fight? In the words of Magistrate Judge Erickson, "it is doubtful" that defendants "have standing to object to the adequacy of the Lead Plaintiffs that have been proposed." *D'Hondt*, 1997 U.S. Dist. LEXIS 17700, at *11 n.6 (citing *Greebel*, 939 F. Supp. at 60). *See also Nice Sys.*, 188 F.R.D. at 218 n.11 ("A defendant or defendants may not object to the adequacy or typicality of the proposed lead plaintiff at this preliminary stage of the litigation.") (citations omitted); *Baan*, 1999 U.S. Dist. LEXIS 5219, at *4 n.1 ("Defendants generally have been held to lack standing to challenge appointment of lead plaintiffs.") (citations omitted); *Fischler*, 1997 U.S. Dist. LEXIS 2875, at *6 ("The plain language of the [PSLRA] dictates only members of the plaintiff class may offer evidence to rebut the presumption in favor of the most adequate plaintiff."). *But see King v. Livent, Inc.*, 36 F. Supp. 2d 187, 190 (S.D.N.Y. 1999) ("[N]othing in the text of the [PSLRA] precludes or limits the right of defendants to be heard on this issue"); *Koppel v. 4987 Corp.*, No. 96 Civ. 7570 (RLC), 1999 U.S. Dist. LEXIS 12340, at *24-25, Fed. Sec. L. Rep. (CCH) ¶90,640 (S.D.N.Y. Aug. 11, 1999) (stating that "[t]here is some disagreement as to whether the PSLRA grants standing to defendants to challenge a motion to appoint a lead plaintiff and class counsel") (citations omitted).

One recent commentary states:

> A recurring issue in lead plaintiff cases under the [PSLRA] is whether defendants have standing to challenge the presumption that a particular plaintiff is the most adequate plaintiff. The

> courts have generally held that defendants do not have such standing, but each court also has noted that defendants would have the opportunity to raise any objections in subsequent class certification proceedings.

Jacobson & Martin, Survey, 5 Securities Reform Act Litig. Rptr. at 173. *See also* Seth Goodchild & Stephenie L. Brown, *Do Defendants Have Standing To Challenge Lead Plaintiff Applicants Under the PSLRA?*, 4 Securities Reform Act Litig. Rptr. 145, 148 (Nov. 1997) (asserting that "allowing defendants standing to raise challenges to the lead [plaintiff] applicants is antithetical to the purpose underlying the PSLRA").

It should be noted that the opportunity for defendants to subsequently contest class certification on various grounds under Fed. R. Civ. P. 23 "is preserved." *Nice Sys.*, 188 F.R.D. at 218 n.11 (citations omitted); *accord Party City*, 189 F.R.D. at 106 n.12 ("The opportunity for Party City and/or the Individual Defendants to contest class certification on these grounds is preserved.") (citations omitted).

I. Criteria For Determining Most Adequate Plaintiff

In *Gluck*, 976 F. Supp. at 545-47, Judge Buchmeyer ruled that an institutional investor was the presumptively most adequate plaintiff, noting that (i) its motion for appointment as lead plaintiff was timely; (ii) it had the largest financial interest of any class member; and (iii) it met the class requirements of Rule 23. In *Lax*, 1997 U.S. Dist. LEXIS 11866, Judge Coar further stated:

> The PSLRA does not state how the court should determine who has the largest financial interest, but four factors are surely relevant: (1) the number of shares purchased; (2) the number of net shares purchased; (3) the total net funds expended by the plaintiffs during the class period; and (4) the approximate losses suffered by the plaintiffs.

Id. at *17.

Any member of the purported class may rebut the presumption upon proof "that the presumptively most adequate plaintiff ... will not fairly and adequately protect the interests of the class ... [or] is subject to unique defenses that render such plaintiff incapable of adequately representing the class." 15 U.S.C. §78u-4(a)(3)(B)(iii)(II)(aa), (bb). *See In re Nanophase Tech. Corp. Litig.*, No. 98 C 3450, 1999 U.S. Dist. LEXIS 16171, at *15 (N.D. Ill. Sept. 30, 1999).

In *Ravens v. Iftikar*, 174 F.R.D. 651 (N.D. Cal. 1997), Judge Walker held that the proposed plaintiffs did not meet the statutory requirement of "most adequate plaintiff" because they did not purchase their stock until the class period was one-half over and after the defendant company had issued partial disclosures.

IV. APPOINTMENT OF LEAD COUNSEL

A. Statutory Text

The PSLRA requires the lead plaintiff, "subject to the approval of the court, [to] select and retain counsel to represent the class." 15 U.S.C. §78u-4(a)(3)(B)(v); *see also Nanophase*, 1999 U.S. Dist. LEXIS 16171, at *15 n.3; *Yousefi*, 70 F. Supp. 2d at 1071; *Gluck*, 976 F. Supp. at 545; *Donnkenny*, 171 F.R.D. at 158. A court may disturb the lead plaintiffs' choice of counsel only if it appears necessary to "protect the interests of the class." *Advanced Tissue*, 184 F.R.D. at 353; *see also Milestone*, 187 F.R.D. at 175-76 (detailing statutory provisions governing appointment of lead counsel).

B. Multiple Lead Counsel

In *Nager*, 1997 U.S. Dist. LEXIS 19601, at *4-5, Judge O'Toole approved the selection of three law firms to serve as an "executive committee" to manage the litigation, stating in pertinent part:

> There is no question that any of the firms is qualified to represent the plaintiff class. There is some question whether it is necessary to approve the selection of a "committee," when any one firm would be qualified to handle the matter. However, because this matter now involves five consolidated cases, each initially brought by particular plaintiffs represented by different law firms, it seems sensible to employ the "committee" approach to minimize the potential for disputes about the direction of the litigation. There should be no concern that duplicative legal efforts will result in higher legal costs to the class because the statute limits total attorneys' fees to "a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class." 15 U.S.C. §78u-4(a)(6). That limit should make it a matter of indifference to the class whether a reasonable fee is paid to one or divided among cooperating recipients.

Id.; see also Advanced Tissue, 184 F.R.D. at 353 (approving appointment of three law firms to represent lead plaintiffs); *Reiger*, 1998 U.S. Dist. LEXIS 14705, at *15-16 (same); *In re Sunbeam Sec. Litig.*, No. 98-8258-CIV-MIDDLEBROOKS, 1998 U.S. Dist. LEXIS 21490, at *15-16 (S.D. Fla. Dec. 7, 1998) (appointing four law firms as co-lead counsel and appointing two law firms as co-liaison counsel); *Lax*, 1997 U.S. Dist. LEXIS 11866, at *26 (approving retention of two law firms to serve as co-lead counsel, "provided that there is no duplication of attorneys' services, and the use of co-lead counsel does not in any way increase attorneys' fees and expenses"); *In re Cephalon Sec. Litig.*, No. 96-CV-0633, 1996 U.S. Dist. LEXIS 13492, at *2, Fed. Sec. L. Rep. (CCH) ¶99,313 (E.D. Pa. Aug. 27, 1996) (appointing three law firms as co-lead counsel for plaintiffs); *but see Yousefi*, 70 F. Supp. 2d at 1072 (refusing to appoint three law firms as co-lead counsel; "the Court will only permit one law firm to serve as lead counsel in this case on the basis that class interests are better served by a central law firm"); *Milestone*, 187 F.R.D. at 180 (rejecting proposal that court appoint several co-lead counsel, executive committee and liaison counsel); *accord In re Orbital Sciences Corp. Sec. Litig.*, 188 F.R.D. 237, 240 (E.D. Va. 1999) ("[T]he purpose of the [PSLRA] favors the choice of one law firm to act in this capacity absent a specific reason to use multiple firms") (citing *Milestone*).

V. RULE 9(b) PARTICULARITY REQUIREMENTS

A. Level of Particularity Required

Rule 9(b) requires that allegations of fraud be specific enough to give defendants notice of the particular misconduct so that they can defend against the charge(s) and not just deny that they have done anything wrong. *Powers*, 977 F. Supp. at 1036. Rule 9(b) requires that plaintiff plead with sufficient particularity attribution of the alleged misrepresentations or omissions to each defendant; the plaintiff is obligated to "'distinguish among those they sue and enlighten each defendant as to his or her part in the alleged fraud.'" *Id.* at 1036-37 (citation omitted); *see also Silva Run Worldwide v. Gaming Lottery Corp.*, No. 96 Civ. 3231(RPP), 1998 U.S. Dist. LEXIS 4699, at *27, Fed. Sec. L. Rep. (CCH) ¶90,196 (S.D.N.Y. Apr. 8, 1998). However, "the complaint need only provide a reasonable delineation of the underlying acts and transactions allegedly constitut[ing] the fraud." *Fischler v. AmSouth Bancorp*, No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670, at *7 (M.D. Fla. Nov. 14, 1996) (citation omitted).

A sufficient level of factual support for a Rule 10b-5 claim may be found where the circumstances of the fraud are pled "in detail." *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1251 (N.D. Ill. 1997). Thus, plaintiff's complaint must set forth in detail such matters as the time, place and contents of the false representations and the identity of the person making each representation. In other words, the complaint must specify the "who, what, when, where, and how" of the alleged fraud. *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273, 1281 (D. Minn. 1997); *see also Cherednichenko v. Quarterdeck Corp.*, Case No. CV 97-4320 GHK, 1997 U.S. Dist. LEXIS 23107, at *5, Fed. Sec. L. Rep. (CCH) ¶90,108 (C.D. Cal. Nov. 26, 1997); *Varljen v. H.J. Meyers, Inc.*, No. 97 Civ. 6742(DLC), 1998 U.S. Dist. LEXIS 10493, at *6-7, Fed. Sec. L. Rep. (CCH) ¶90,259 (S.D.N.Y. July 14, 1998); *Bryant v. Apple South*, 25 F. Supp. 2d 1372, 1379 (M.D. Ga. 1998) (plaintiffs adequately pled that defendants' statements were false when made); *Robertson v. Strassner*, 32 F. Supp. 2d 443, 448 (S.D. Tex. 1998) (same).

In the recent words of Judge Kimball, the PSLRA "imposes even more rigorous pleading requirements on plaintiffs alleging fraud in the securities context" because the complaint "must 'specify each statement alleged to have been misleading' as well as 'the reason or reasons why the statement is misleading.'" *Karacand v. Edwards*, 53 F. Supp. 2d 1236, 1242 (D. Utah 1999) (quoting 15 U.S.C. §78u-4(b)(1)). Thus, plaintiff's complaint must set forth with particularity facts which create a strong inference that defendants knew that their statements were false or misleading at the time they were made. *See Grand Casinos*, 988 F. Supp. at 1281 (allegations of fraud concerning construction of casino were adequately pled); *Stratosphere*, 1 F. Supp. 2d at 1110-12 (same). However, Rule 9(b)'s particularity requirement is relaxed where factual information is peculiarly within defendant's knowledge or control. *See Bell v. Fore Sys., Inc.*, 17 F. Supp. 2d 433, 437 (W.D. Pa. 1998); *Tse v. Ventana Med. Sys.*, No. 97-37-SLR, 1998 U.S. Dist. LEXIS 16760, at *18 (D. Del. Sept. 23, 1998); *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1354 (D. Colo. 1998); *In re MobileMedia Sec. Litig.*, 28 F. Supp. 2d 901, 935 (D.N.J. 1998).

B. Allegations Based On Information And Belief

Under the PSLRA, a complaint must specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if the allegation is based on information and belief, the complaint must state with particularity all facts on which that belief is formed. *See In re Ancor Communs., Inc. Sec. Litig.*, 22 F. Supp. 2d 999, 1003 (D. Minn. 1998); *Queen Uno*, 2 F. Supp. 2d at 1354; *In re Olympic Fin. Ltd. Sec. Litig.*, No. 97-496 (MJD/AJB), 1998 U.S. Dist. LEXIS 14789, at *6-7 (D. Minn. Sept. 10, 1998).

C. Allegations Based On Investigation Of Attorney

Plaintiffs are not required to meet the PSLRA's heightened standards of particularity when pleading allegations based on the investigation of plaintiffs' counsel and not upon information and belief. *See Queen Uno*, 2 F. Supp. 2d at 1354; *In re Employee Solutions Sec. Litig.*, No. CIV 97-545-PHX-RGS-OMP, 1998 U.S. Dist. LEXIS 16444, at *13, Fed. Sec. L. Rep. (CCH) ¶90,293 (D. Ariz. Sept. 22, 1998); *Lister*, 1999 U.S. Dist. LEXIS 389, at *7; *Lister v. Oakley, Inc.*, No.

SACV-97-809-GLT(EEx), 1999 U.S. Dist. LEXIS 384, at *5, Fed. Sec. L. Rep. (CCH) ¶90,409 (C.D. Cal. Jan. 14, 1999).

VI. PLEADING SECTION 10(b) VIOLATIONS

A. Primary Violators Only: No Aiding Or Abetting Liability

Only primary participants in a §10(b) violation may be held liable. Section 10(b) did not create liability for aiding and abetting the securities violations of others; such secondary participation is beyond the scope of the statute. *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994); *see also Powers v. Eichen*, 977 F. Supp. 1031, 1040 (S.D. Cal. 1997) (dismissing claims against defendants who were not specifically alleged to have made false or misleading statements that did not fall within scope of group-published information).

B. "Secondary" Actor's Misconduct May Lead To Primary Liability

However, primary liability under §10(b) and/or SEC Rule 10b-5 may be imposed "'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'" *SEC v. First Jersey Sec.*, 101 F.3d 1450, 1471 (2d Cir. 1996) (quoting *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994)); *see also In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997). The Second Circuit has held that more than significant participation by the "secondary" actor is needed to incur primary liability. *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). The misrepresentation must be attributed to that specific actor at the time of publication dissemination, that is, in advance of the investment decision. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998). The Ninth Circuit has held that "secondary" parties may be primarily liable for statements made by others in which the former significantly participated. *In re Software Toolworks Sec. Litig.*, 50 F.3d 615 (9th Cir. 1995). *See generally* Jill E. Fisch, *Symposium: The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 Colum. L. Rev. 1293 (1999).

C. The Elements Plaintiff Must Allege To State A Claim

To state a valid claim for violations of §10(b)/Rule 10b-5, plaintiff must allege that defendant (1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff relied, and (6) that reliance proximately caused the plaintiff's injury. *Bryant*, 25 F. Supp. 2d at 1377; *see also Powers*, 977 F. Supp. at 1037.

1. Falsity

Plaintiff's complaint must set forth *what* is false and misleading about the statement and *why* it is false. *See Marksman Partners*, 927 F. Supp. at 1308 (complaint alleged in sufficient detail precise dates, manner, content and nature of statements alleged to be fraudulent); *Warman v. Overland Data, Inc.*, Case No. 97cv833 JM, 1998 U.S. Dist. LEXIS 2009, at *9-10, Fed. Sec. L. Rep. (CCH) ¶90,167 (S.D. Cal. Feb. 23, 1998) (same); *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *6 (same). Plaintiffs may satisfy this requirement by alleging facts demonstrating "'that the statements failed to reflect the company's true condition at the time the statements were made.'" *Id.* (citation omitted).

A complaint must set forth precisely *what* statements or omissions were made in what documents or oral presentations, *who* made the statements, the *time* and *place* of the statements, the *contents* of the statements or *manner* in which they misled the plaintiff, and what defendants gained as a consequence. *In re Valujet, Inc., Sec. Litig.*, 984 F. Supp. 1472, 1477 (N.D. Ga. 1977); *see also* Summit Med., 10 F. Supp. 2d at 1071 (Rule 9(b) pleading requirements held satisfied).

2. Materiality

A fact is material if it is substantially likely that the fact would be viewed by a reasonable investor as significantly altering the "total mix" of information available, and if there is a substantial likelihood that a reasonable investor would consider it important to the investment decision. *Cooperman v. Individual, Inc.*, 171 F.3d 43, 49 (1st Cir. 1999); *Marksman Partners*, 927 F. Supp. at 1305; *see also Bryant*, 25 F. Supp. 2d at 1379; *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *12; *Valujet*, 984 F. Supp. at 1478; *Varljen*, 1998 U.S. Dist. LEXIS 10493, at *18. Ordinarily, whether a fact is material is a jury question requiring assessment of inferences that a reasonable investor would draw from a given set of facts. *Marksman Partners*, 927 F. Supp. at 1306; *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *12-13 (refusing to dismiss complaint on materiality grounds; "[W]e cannot conclude that none of the alleged misrepresentations would have significantly altered the 'total mix' of information available to the market"); *Valujet*, 984 F. Supp. at 1478 (same; airline's safety record was material).

3. Duty to Disclose

If defendant chooses to reveal relevant, material information even though it had no duty to do so, there is a duty to make the disclosure complete and accurate. *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1167 (W.D. Wash. 1998); *see also Schaffer v. Evolving Sys., Inc.*, 29 F. Supp. 2d 1213, 1221 (D. Colo. 1998) (defendants released only positive financial information but should have revealed potentially negative information as well).

Plaintiff must show that the defendant had a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. *Vento & Co. of New York, LLC v. Metromedia Fiber Network, Inc.*, No. 97 Civ. 7751 (JGK), 1999 U.S. Dist. LEXIS 3020, at *25, Fed. Sec. L. Rep. (CCH) ¶90,460 (S.D.N.Y. Mar. 18, 1999). A duty to disclose arises when there is (1) insider trading; (2) a statute or regulation requiring disclosure; (3) an inaccurate, incomplete or misleading prior disclosure; and/or (4) when one of two parties to a securities transaction "'possess superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.'" *Id.* at *26 (citation omitted). Insiders are defined as those who are in a special relationship with the corporation and are thereby privy to confidential information. Insiders assume an affirmative duty of disclosure when trading in shares of their own corporation. *Tse v. Ventana Med. Sys., Inc.*, Civil Action No. 97-37-SLR, 1998 U.S. Dist. LEXIS 16760, at *28, *30 n.11 (D. Del. Sept. 23, 1998).

Statements may be rendered false and misleading by the failure to fully disclose information. A "'"duty to speak the full truth arises when a defendant undertakes the duty to say anything."'" *Zuckerman*, 4 F. Supp. 2d at 624 (defendants' statements held actionable as unfounded predictions) (citation omitted). Defendant has duty to disclose or abstain from insider trading. *See Bryant*, 25 F. Supp. 2d at 1381 (plaintiffs satisfied pleading requirements for Rule 10b-5 violation based upon insider trading); *Voit*, 977 F. Supp. at 368-69 (trading on non-public information creates duty to disclose).

D. Pleading Scienter Under The PSLRA

1. Introduction

To sufficiently allege scienter, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2). The circuit and district courts are divided as to the methods by which a plaintiff can establish scienter. *See, e.g., Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999) ("We have not yet determined which pleading standard best effectuates Congress's intent. Nor need we do so here because the stockholders have failed to allege facts sufficient to meet even the most lenient standard possible under the PSLRA, the two-pronged Second Circuit test."); *Harris v. Ivax Corp.*, 182 F.3d 799, 804 (11th Cir. 1999) ("We do not address ... the question of what exactly a 'strong inference' of the appropriate scienter is, an issue that has vexed the courts since the PSLRA's enactment.") (citing circuit and district court opinions); *In re Next Level*

Sys., Inc. Sec. Litig., Case No. 97 C 7362, 2000 U.S. Dist. LEXIS 149, at *3-13 (N.D. Ill. Jan. 6, 2000) (surveying decisions); *In re Orbital Sciences Corp. Sec. Litig.*, 58 F. Supp. 2d 682, 688 n.6 (E.D. Va. 1999) (after noting that the "[t]he Fourth Circuit has yet to determine the point at which a Complaint will suffice to meet this standard" and that "the other circuits are deeply divided in this regard," stating that "[t]he Court need not determine the appropriate interpretation [of the PSLRA] to use, because whether applied to a test of motive and opportunity or to a test of heightened recklessness, unusual insider trading is sufficient to create a strong inference of recklessness") (citation omitted). *See generally* Laura R. Smith, Comment, *The Battle Between Plain Meaning and Legislative History: Which Will Decide the Standard for Pleading Scienter After the Private Securities Litigation Reform Act of 1995?*, 39 Santa Clara L. Rev. 577 (1999).

2. Second Circuit: "Motive and Opportunity"

Prior to the PSLRA's enactment, in the Second Circuit a strong inference of fraudulent intent could be established either (1) "by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness" or (2) "by alleging facts to show that defendants had both motive and opportunity to commit fraud." *The High View Fund, L.P. v. Hall*, 27 F. Supp. 2d 420, 426 (S.D.N.Y. 1998) (quoting *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *see also In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 138 (S.D.N.Y. 1999); *Holding v. Nu-Tech Bio-Med, Inc.*, No. 98 Civ. 0764 (HB), 1998 U.S. Dist. LEXIS 20399, at *11, Fed. Sec. L. Rep. (CCH) ¶90,417 (S.D.N.Y. Jan. 5, 1999) ("The PSLRA raised the bar at the pleading stage and requires the allegation of facts that give rise to a strong inference of reckless or conscious behavior on behalf of the defendant.") (*citing In re Glenayre Techs., Inc. Sec. Litig.*, 982 F. Supp. 294, 297 (S.D.N.Y. 1997)); *accord Salomon Smith Barney v. Asset Securitization Corp.*, No. 98 Civ. 4186 (BSJ), 1999 U.S. Dist. LEXIS 19030, at *13-14 (S.D.N.Y. Dec. 3, 1999); *In re APC Telesvcs., Inc. Sec. Litig.*, No. 97 Civ. 9145 (BSJ), 1999 U.S. Dist. LEXIS 17908, at *16-17 (S.D.N.Y. Nov. 19, 1999).

Following enactment of the PSLRA, there was some confusion among the district courts as to the level of pleading scienter required by the statute. *See High View Fund*, 27 F. Supp. 2d at 426 n.2 (collecting cases). In one of the first appellate court opinions addressing the issue, however, the Second Circuit held (albeit without much analysis) that the PSLRA "heightened the requirement for pleading scienter to the level used by the Second Circuit." *Press v. Chemical Inv. Svcs. Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999). *See also Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group*, 186 F.3d 157, 172 (2d Cir. 1999); *Stevelman v. Atlas Research, Inc.*, 174 F.3d 79, 84 (2d Cir. 1999);

Kalnit v. Eichler, No. 99 Civ. 3306 (SAS), 1999 U.S. Dist. LEXIS 19545, at *24-36 (S.D.N.Y. Dec. 22, 1999) (offering extensive analysis of plaintiffs' scienter allegations before finding them insufficient); *In re Scholastic Corp. Sec. Litig.*, No. 97 Civ. 2447 (JFK), 2000 U.S. Dist. LEXIS 791, at *34-40 (S.D.N.Y. Jan. 27, 2000) (same); *In re Computer Assocs. Class Action Sec. Litig.*, No. 98-CV-4839 (TCP), 1999 U.S. Dist. LEXIS 17874, at *12-13 (E.D.N.Y. Nov. 15, 1999) (elucidating Second Circuit standard for pleading scienter); *Herzog v. GT Interactive Software Corp.*, No. 98 Civ. 0085 (DNE), 1999 U.S. Dist. LEXIS 18380, at *22-23 (S.D.N.Y. Nov. 29, 1999) (same); *In re Hudson Tech., Inc. Sec. Litig.*, No. 98 Civ. 1616 (JGK), 1999 U.S. Dist. LEXIS 15032, at *16-17 & n.4, Fed. Sec. L. Rep. (CCH) ¶90,661 (S.D.N.Y. Sept. 28, 1999) (noting that Second Circuit "recently reiterated" in *Press* and *Stevelman* that "fraud may be inferred from motive and opportunity") (citation omitted); *SEC v. Drescher*, No. 99 Civ. 1418 (SAS), 1999 U.S. Dist. LEXIS 16033, at *9-10, Fed. Sec. L. Rep. (CCH) ¶90,681 (S.D.N.Y. Oct. 19, 1999) (same); *Ruskin v. TIG Holdings, Inc.*, No. 98 Civ. 1068 (LLS), 1999 U.S. Dist. LEXIS 14860, at *10-11, Fed. Sec. L. Rep. (CCH) ¶90,657 (S.D.N.Y. Sept. 24, 1999) (applying "motive and opportunity" test); *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, No. 99 Civ. 342 (DLC), 1999 U.S. Dist. LEXIS 11378, at *23, Fed. Sec. L. Rep. (CCH) ¶90,534 (S.D.N.Y. July 27, 1999); *Fant v. Perelman*, No. 97 Civ. 8435 (LAP), 1999 U.S. Dist. LEXIS 5694, at *16-17, Fed. Sec. L. Rep. (CCH) ¶90,477 (S.D.N.Y. Apr. 9, 1999); *Rubinstein v. Skyteller, Inc.*, No. 98 Civ. 4620 (SAS), 1999 U.S. Dist. LEXIS 2149, at *9, 1999 WL 105025, at *3, Fed. Sec. L. Rep. (CCH) ¶90,442 (S.D.N.Y. Mar. 2, 1999).

Numerous district courts in other circuits "have concluded that Congress did not intend for the [PSLRA] to abolish" the "motive and opportunity" formulation for pleading scienter. *McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 408 (E.D. Tex. 1999) (citations omitted); *see also Next Level*, 2000 U.S. Dist. LEXIS 149, at *12 (asserting that "[t]he majority of courts agree with the Second Circuit, including those within this district [N.D. Ill.]") (citations omitted); *In re Transcrypt Int'l Sec. Litig.*, No. 4:98CV3099, 1999 U.S. Dist. LEXIS 17540, at *23 (D. Neb. Nov. 4, 1999) ("The Second Circuit has led the way in interpreting the PSLRA and specifically addressing the scienter requirement for claims under § 10(b) and Rule 10b-5.") (citing *Press*); *Coates v. Heartland Wireless Communs., Inc.*, 55 F. Supp. 2d 628, 642 (N.D. Tex. 1999) ("This court ... holds that scienter can be pleaded based on motive and opportunity to commit fraud.") (footnote omitted); *Robertson v. Strassner*, 32 F. Supp. 2d 443, 447 (S.D. Tex. 1998) (same). *See generally* Lisa A. Herrera, Comment, *Will Motive, Opportunity or Recklessness No Longer Constitute Scienter for Fraud? A Survey of Recent Federal District Court Decisions After the Enactment of the 1995 Private Securities Litigation Reform Act*, 26 Pepp. L. Rev. 379 (1999).

3. The Third Circuit Follows The Second Circuit

In a recent case, *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999), the Third Circuit stated that the PSLRA's requirement for pleading scienter mirrors that previously adopted in the Second Circuit, holding that it "remains sufficient" for plaintiffs to plead scienter by alleging facts "establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior." *Id.* at 534-35 (citations omitted). "Motive and opportunity, like all other allegations of scienter (intentional, conscious, or reckless behavior) must now be supported by facts stated 'with particularity' and must give rise to a 'strong inference' of scienter." *Id.* at 535 (quoting 15 U.S.C. §78u-4(b)(2)). *See also In re Cendant Corp. Sec. Litig.*, Civ. No. 98-1664 (WHW), 1999 U.S. Dist. LEXIS 18199, at *10-23 (D.N.J. Nov. 29, 1999) (offering lengthy analysis of, and upholding, plaintiffs' allegations regarding defendants' scienter); *In re Tel-Save Sec. Litig.*, Master File No. 98-CV-3145, 1999 U.S. Dist. LEXIS 16800, at *16, Fed. Sec. L. Rep. (CCH) ¶90,693 (E.D. Pa. Oct. 19, 1999) ("After the [PSLRA], catch-all allegations that defendants stood to benefit from wrongdoing and had the opportunity to implement a fraudulent scheme are no longer sufficient, because they do not state facts with particularity or give rise to a strong inference of scienter ... a defendant's motive and opportunity to commit fraud must be clearly stated by the plaintiff"); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 627-28 (E.D. Pa. 1999) (elucidating Third Circuit standard); *Buck v. Piercing Pagoda, Inc.*, Civil Action No. 98-5535, 1999 U.S. Dist. LEXIS 16092, at *2-3 (E.D. Pa. Oct. 12, 1999) (same); *Silverman v. Ernst & Young, LLP*, Civil No. 99-856, 1999 U.S. Dist. LEXIS 17703, at *26-27 (D.N.J. Aug. 3, 1999) (same); *TFM Inv. Group v. Bauer*, Civil Action No. 99-840, 1999 U.S. Dist. LEXIS 15821, at *4-6 (E.D. Pa. Sept. 30, 1999) (applying *Advanta* standard and finding plaintiffs' allegations of scienter insufficient); *In re Cendant Corp. Sec. Litig.*, 60 F. Supp. 2d 354, 369 (D.N.J. 1999); *Kenilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp. 2d 417, 427 (D.N.J. 1999); *In re Walnut Leasing Co., Inc. & Equip. Leasing Corp. of America, Inc. Official Committee of Unsecured Creditors v. Shapiro*, No. 99-526, 1999 U.S. Dist. LEXIS 14517, at *18 (E.D. Pa. Sept. 9, 1999).

Unlike the Second Circuit's opinion in *Press*, 166 F.3d at 538, in *Advanta* the Third Circuit conducted an in-depth analysis of the PSLRA's legislative history to arrive at a similar standard. 180 F.3d at 530-33. *Advanta* sought to determine congressional intent by reviewing the legislative debate surrounding the Securities Litigation Uniform Standards Act of 1998, which included a discussion regarding the pleading requirements necessary to allege scienter under the PSLRA. *Id.* at 533.

District courts from other circuits have followed the Third Circuit's approach. *See, e.g., In re Green Tree Finan. Corp. Stock Litig.*, 61 F. Supp. 2d 860, 870 (D. Minn. 1999) ("The Court believes the *Advanta* court's analysis of the issue may be the most persuasive, and, to the extent 'motive and opportunity' remains a valid inquiry, *Advanta*'s admonishment regarding the PSLRA's heightened pleading requirements correctly states the plaintiffs' burden."); *In re Spyglass, Inc. Sec. Litig.*, No. 99 C 512, 1999 U.S. Dist. LEXIS 11382, at *20, Fed. Sec. L. Rep. (CCH) ¶90,607 (N.D. Ill. July 21, 1999) ("[t]he scienter requirement can still be established by a motive and an opportunity to commit fraud, or by establishing facts that constitute circumstantial evidence of reckless or conscious behavior"; "The change made by the PSLRA is that the complaint itself now must allege particular facts supporting a strong inference of scienter as to each defendant.") (citations omitted); *Coates v. Heartland Wireless Comm., Inc.*, 55 F. Supp. 2d 628, 635 (N.D. Tex. 1999) (indicating that in the absence of post-PSLRA guidance from the Fifth Circuit, it would follow the Third Circuit's approach); *Hartsell v. Source Media, Inc.*, No. 3:98-CV-1980-R, 1999 U.S. Dist. LEXIS 13082, at *4 (N.D. Tex. Aug. 24, 1999) (reiterating that "allegations of 'motive and opportunity' are sufficient to satisfy" scienter pleading requirement); *accord RGB Eye Assocs., P.A. v. Physicians Res. Group, Inc.*, Civil Action No. 3:98-CV-1715-D, 1999 U.S. Dist. LEXIS 17665, at *25 (N.D. Tex. Oct. 28, 1999) (same).

4. Other Formulations Of Scienter Pleading Requirement

Some courts hold that "motive facts can be considered in determining whether the complaint raises a strong inference of scienter, even though satisfaction of the motive test alone does not conclusively establish an inference of the required state of mind" under the PSLRA. *McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 411 (E.D. Tex. 1999) (collecting cases).

In a significant decision, the Ninth Circuit held that a private securities plaintiff must plead in great detail "facts that constitute circumstantial evidence of deliberate reckless or conscious misconduct." *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F. 3d 970, 974 (9th Cir. 1999). *See also Heliotrope Gen'l, Inc. v. Ford Motor Co.*, 189 F.3d 971, 980 (9th Cir. 1999) (plaintiff's complaint did not "state facts that create a strong inference of the required degree of intent") (citing *Silicon Graphics*); *In re Sonus Pharmaceuticals, Inc. Sec. Litig.*, No. C98-1164Z, 1999 U.S. Dist. LEXIS 11517, at *3-4 (W.D. Wash. July 21, 1999) (sustaining plaintiffs' amended complaint against motion to dismiss where allegations that Sonus failed to report FDA inspections revealing problems with pending approval of drug showed strong inference that defendants acted with required state of mind). Thus far, none of the other circuit courts have adopted the Ninth Circuit's formulation of the scienter pleading requirement. *See generally* Susan J. Becker, *Circuit Courts Split on Scienter Pleading and Proof Requirements*, 25 Litigation News, No. 2, at 1, 4-5 (ABA Section of Litigation Jan. 2000) ("Becker, *Circuit Courts*").

In contrast to the approach taken in the Second and Third Circuit, other appellate courts have held that alleging defendants' "motive and opportunity" is no longer sufficient to plead scienter, reasoning that the PSLRA was enacted to heighten pleading standards for securities fraud claims. A recent Sixth Circuit decision, *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549-51 (6th Cir. 1999), holds that under the PSLRA, plaintiffs may plead scienter by alleging facts giving rise to strong inference of recklessness, but not by alleging facts merely establishing that defendant had motive and opportunity to commit securities fraud. *Accord Hines v. ESC Strategic Funds, Inc.*, Case No. 3:99-0530, 1999 U.S. Dist. LEXIS 15790, at *31-32 (M.D. Tenn. Sept. 17, 1999) (applying *Comshare* standard); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283, 1285 (11th Cir. 1999) ("[W]e are in basic agreement with the Sixth Circuit.... * * * [W]e reject the notion that allegations of motive and opportunity to commit fraud, standing alone, are sufficient to establish scienter in this Circuit."); *In re Ceridian Corp. Sec. Litig.*, Civ. No. 97-2044 MJD/AJB, 1999 U.S. Dist. LEXIS 15611, at *38-39 (D. Minn. Mar. 29, 1999) (same). *See also New England Health Care Employees Pension Fund v. Fruit of the Loom, Inc.*, Civil Action No. 1:98-CV-99-M, 1999 U.S. Dist. LEXIS 12999, at *23-27 (W.D. Ky. Aug. 18, 1999) (holding that plaintiffs' allegations regarding defendants' scienter satisfied *Comshare* test).

In a recent decision, *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), the First Circuit generally followed the Sixth Circuit's approach, offering an extensive analysis of the PSLRA's statutory language and legislative history, *id.* at 191-97, before adopting the following standard for pleading scienter:

> Our view of the [PSLRA] is thus close to that articulated by the Sixth Circuit [in *Comshare*]....
>
> Without adopting any pleading litany of motive and opportunity, we reject defendants' argument that facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter. But ... merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough. [The Second, Third and Fifth] [C]ircuits have interpreted the PSLRA as permitting use of motive and opportunity type pleading if it raises a strong inference. Like the Third Circuit, we caution that "catch-all allegations that defendants stood to

benefit from wrongdoing and had the opportunity to implement a fraudulent scheme are [not] sufficient."

> Similarly, the PSLRA neither prohibits nor endorses the pleading of insider trading as evidence of scienter, but requires that the evidence meet the "strong inference" standard. Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter. The vitality of the inference to be drawn depends on the facts, and can range from marginal to strong. This continues to be true in litigation after the effective date of the PSLRA. Indeed, ... we still think today, that allegations of unusual insider trading by a defendant with access to material non-public information can support a strong inference of scienter. We similarly caution that mere pleading of insider trading, without regard to either context or the strength of the inferences to be drawn, is not enough. At a minimum, the trading must be in a context where defendants have incentives to withhold material, non-public information, and it must be unusual, well beyond the normal patterns of trading by those defendants.

194 F.3d at 197-98 (footnotes and citations omitted) (quoting *Advanta,* 180 F.3d at 535). *See also Geffon v. Micrion Corp.*, Civil Action No. 96-11596-REK, 1999 U.S. Dist. LEXIS 19246, at *45-48 (D. Mass. Dec. 6, 1999) (construing First Circuit's opinion in *Greebel*). *See generally* Matthew Roskoski, Note, *A Case-By-Case Approach to Pleading Scienter Under the Private Securities Litigation Reform Act of 1995,* 97 Mich. L. Rev. 2265 (1999); Ryan G. Meist, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud,* 82 Minn. L. Rev. 1103, 1126 (1998).

It is perceived by most commentators that in *Comshare* the Sixth Circuit adopted a slightly more restrictive pleading standard than that adopted by the Second Circuit in *Press* (and the Third Circuit in *Advanta*), but far less restrictive than that adopted by the Ninth Circuit in *Silicon Graphics*. *See* Herbert E. Milstein, *Recent Developments in the Private Securities Litigation Reform Act,* 5 Securities Litig. & Regulation, No. 9, at 12 (Jan. 12, 2000); Becker, *Circuit Courts,* 25 Litigation News at 1 (contrasting the Sixth Circuit's "low threshold for pleading scienter" with the Ninth Circuit's approach, and characterizing the Second and Third Circuits as having "found middle ground").

VII. ACCOUNTING FRAUD: PLEADING SCIENTER UNDER THE PSLRA

A. SEC Focus On Accounting Fraud

In response to the erosion in the quality of financial reporting, the SEC has commenced an intensive initiative to challenge what it deems "accounting hocus pocus." Such practices, which include the immediate write-off of a huge percentage of an acquired company's value as a charge to in-process research and development ("IPR&D"), and avoiding future earnings degradation from the amortization of goodwill, manipulate earnings revenue and diminish the integrity and reliability of financial reporting in the U.S. securities markets. *See* Remarks by SEC Chairman Arthur Levitt made at the Center for Law and Business at New York University (Sept. 28, 1998), available at <<www.sec.gov/news/speeches/spch220.txt>> and comment letter submitted by SEC Chief Accountant Lynn Turner to the American Institute of Certified Public Accountants (Oct. 9, 1998).

B. Specific Allegations Of Accounting Fraud Supporting Strong Inference Of Scienter Under The PSLRA

1. Earnings/Revenue Misrepresentations

A number of district courts have held that misrepresentations about the company's earnings or revenue, if pled with requisite particularity, satisfy the standard for pleading scienter. *See Gross*, 977 F. Supp. at 1472 (allegation that insiders engaged in elaborate accounting fraud scheme designed to ensure that company met earnings and revenue projections); *In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997) (allegation that corporate insider approved of plans for accounting fraud and false revenue recognition evidence of scienter); *In re Wellcare Mgmt. Group, Inc. Sec. Litig.*, 964 F. Supp. 632, 640 (N.D.N.Y. 1997) (allegation that corporate executive "had knowledge of, condoned, and/or encouraged ... the deliberate overstatement of earnings by a number of means"); *Rehm*, 954 F. Supp. at 1255-56 (overstatement of earnings by persons responsible for calculating and releasing financial information shows scienter); *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *11-12 (court found strong circumstantial evidence of conscious behavior); *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*, 927 F. Supp. 1297, 1313-14 (C.D. Cal. 1996) (overstated revenues when method of recognition was inconsistent with SFAS 48); *In re Summit Med. Sys., Inc. Sec. Litig.*, 10 F. Supp. 2d 1069, 1069 (D. Minn. 1998) (restating earnings with 11% reduction of revenues); *Varljen*, 1998 U.S. Dist. LEXIS 10493, at *2, *15 (defendants falsely inflated earnings by including income from fraudulent medical billings); *In re Miller Indus., Inc. Sec. Litig.*, 12 F. Supp. 2d 1323, 1329 (N.D. Ga. 1998) (defendants understated acquired companies' pre-merger revenues which overstated growth of company's post-merger revenues, overstated company's revenue growth in core manufacturing business by combining it with revenue from non-manufacturing activities, reported income misrepresented size of one-time gain from litigation settlement, accounted for trade-ins at cost which was substantially greater than market price, misrepresented other one-time gains, engaged in "channel stuffing" by artificially stimulating revenues by offering extraordinary discounts and trade-ins and extended payment terms and other unusual financing arrangements to mask deterioration in revenues); *Employee Solutions*, 1998 U.S. Dist. LEXIS 16444, at *3, *8 (setting aside low workers' compensation reserves enabled defendants to present falsely as a highly profitable company); *In re Fine Host Corp. Sec. Litig.*, 25 F. Supp. 2d 61, 70 (D. Conn. 1998) (plaintiffs alleged that top officer admitted in phone call that he knowingly capitalized certain expenses to increase earnings); *In re Olympic Finan. Ltd. Sec. Litig.*, Civil File No. 97-496 (MJD/AJB), 1998 U.S. Dist. LEXIS 14789, at *11 (D. Minn. Sept. 10, 1998) (defendants knowingly overstated quality of loan portfolio); *Hudson Venture Partners, L.P. v. Patriot Aviation Group, Inc.*, No. 98 Civ. 4132 (DLC), 1999 U.S. Dist. LEXIS 1518, at *11 (S.D.N.Y. Feb. 17, 1999) (closely-held corporation underreported losses and accounts payable and overreported accounts receivable and overstated profits by 80% for first two months of fiscal year).

2. Violations of GAAP Can Form Part Of The Basis Supporting Strong Inference Of Scienter

A violation of GAAP is generally insufficient to establish fraud but, when combined with other circumstances suggesting fraudulent intent, "such violation may be used to show scienter." *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *10 (citing *Marksman Partners*, 927 F. Supp. at 1313) (premature recognition of earnings from consignment sales, combined with significant extent of alleged overstatement, as well as other factors, created strong inference that defendants acted with either specific or reckless intent to defraud), and *Wellcare Mgmt.*, 964 F. Supp. at 640 (finding that knowledge of deliberate overstatement of earnings and other accounting improprieties, as well as other misconduct, tended to show scienter)); *see also Gross*, 977 F. Supp. at 1472 (allegations that corporate insiders "improperly recognized income that [d]efendants knew should not have been recognized under GAAP principles" is sufficient to establish scienter); *Ancor Communs.*, 22 F. Supp. 2d at 1005-06 (overstating revenues by reporting consignment sales in violation of GAAP; defendants continually represented in SEC filings that financial results were prepared in accordance with GAAP); *Marksman Partners*, 927 F. Supp. at 1313 (violating GAAP by early recognition of consignment sales resulting in overstated revenues); *Health Mgmt.*, 970 F. Supp. at 203 (violations of GAAP without corresponding fraudulent intent are insufficient to state claim); *Miller Indus.*, 12 F. Supp. 2d at 1332 (overstatement of revenues and income in violation of GAAP may constitute violation of Rule 10b-5).

3. Improper Revenue Recognition Of A Significant Portion Of Revenues

"While it is true that the mere fact that a company's financial reporting was inaccurate does not establish scienter, the magnitude of reporting errors may lend weight to allegations of recklessness where defendants were in a position to detect the errors. The more serious the error, the less believable are defendants protests that they were completely unaware of [the Company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy." *Rehm*, 954 F. Supp. at 1256 (citations omitted); *see also Marksman Partners*, 927 F. Supp. at 1314 (overstated revenues constituted significant portion of company's total revenues); *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *7 (substantial overstatement by reporting consignment sales as revenues); *Varljen*, 1998 U.S. Dist. LEXIS 10493, at *15 (defendants falsely inflated earnings by including income from fraudulent Medicare billings).

4. Pleading That Accountant Had Motive And Opportunity

As a matter of law, it is insufficient to allege that an outside auditor's motive for committing fraud is a desire to continue as that client's accountant and accrue the benefits in the form of fees. *See Retsky*, 1998 U.S. Dist. LEXIS 17459, at *24-25 (rejecting "boilerplate" claims that accounting firm's interest in gaining fees is sufficient to show motive and commit fraud); *see also Health Mgmt.*, 970 F. Supp. at 202 (fraudulent conduct is not within auditor's economic self-interest).

C. Standard of "Recklessness" For Accountant's Liability

1. Plaintiff's Burden

Plaintiffs must show "'highly unreasonable [omissions or acts], involving not merely simple negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *Retsky*, 1998 U.S. Dist. LEXIS 17459, at *26-27 (citation omitted); *see also First Merchants*, 1998 U.S. Dist. LEXIS 17760, at *29 (same).

"[Plaintiffs] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or "an egregious refusal to see the obvious or to investigate the doubtful," or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.'" *Retsky*, 1998 U.S. Dist. LEXIS 17459, at *27 (citation omitted); *see also Rehm*, 954 F. Supp. at 1255; *First Merchants*, 1998 U.S. Dist. LEXIS 17760, at *29; Health Mgmt., 970 F. Supp. at 202; *see also Jacobs v. Coopers & Lybrand, L.L.P.*, No. 97 Civ. 3374 (RPP), 1999 U.S. Dist. LEXIS 2102, at *44, Fed. Sec. L. Rep. (CCH) ¶90,443 (S.D.N.Y. Mar. 1, 1999) ("Failing to adhere to one or two Auditing Interpretations may be only negligence, but Coopers is alleged to have disregarded many different Auditing Interpretations. Based on the facts as alleged, a trier of fact could find Cooper's audit so reckless that Coopers should have had knowledge of the underlying fraud, and acted in blind disregard that there was a strong likelihood that Happiness was engaged in the underlying fraud.") (citation omitted).

2. Ignoring "Red Flags" Of Accounting Fraud

Circumstances suggesting fraudulent intent can include the presence of "red flags" or warning signs. *See Transcrypt Int'l*, 1999 U.S. Dist. LEXIS 17540, at *29 (denying motions to dismiss because "plaintiffs have specifically alleged 'red flag' GAAP violations by Transcrypt and numerous GAAS violations by Coopers"); *Rehm*, 954 F. Supp. at 1256 ("[T]he more serious the error, the less believable are defendants['] protests that they were completely unaware of [the company's] true financial status and the stronger the inference that defendants must have known about the discrepancy."); *Health Mgmt.*, 970 F. Supp. at 199 (outside auditor's ignorance of "red flags" present evidence of its fraudulent intent) (citation omitted); *In re Leslie Fay Cos., Inc. Sec. Litig.*, 835 F. Supp. 167, 175 (S.D.N.Y. 1993) (rejecting independent auditor's motion to dismiss where allegations of large accounting errors gave rise to inference of scienter).

In *Retsky*, 1998 U.S. Dist. LEXIS 17459, at *29-32, plaintiffs satisfied the applicable pleading requirements by alleging that Price Waterhouse knew of "red flags" involved with customer contract because (1) Price Waterhouse reviewed and commented on a report prepared by the Company's internal audit department noting concerns of premature revenue booking; (2) Price Waterhouse noted that contract contingencies set forth in contract precluded certain revenue recognition; and (3) Price Waterhouse noted that the MD&A discussion in the Form 10-K report concerning product risks failed to comply with Reg S-K.

In *First Merchants*, 1998 U.S. Dist. LEXIS 17760, at *17-20, plaintiffs satisfied pleading requirements by alleging that accountants should have known of "red flags" including (1) bad debt reserves were out of line with bad debt write-offs; (2) there were dramatic increases in the rate of 60- and

90- day delinquencies; and (3) there was an increase in the average length of loans reflecting higher risk borrowers.

VIII. PRIMARY AND SECONDARY LIABILITY

A. Primary Liability

In *Central Bank*, the Supreme Court held that there can be no liability under Section 10(b)/Rule 10b-5 for aiding and abetting securities fraud. Unless the defendant committed a manipulative or deceptive act within the meaning of Section 10(b), the defendant has not violated the securities laws. *See also Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1998) (denying Deloitte's motion to* dismiss when complaint alleged that accountants certified false revenues).

B. Secondary Actor's Conduct May Constitute Primary Liability

However, primary liability under Rule 10b-5 may be imposed "'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'" *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996) (quoting *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994)); *see also Health Mgmt.*, 970 F. Supp. at 209. More than significant participation by the secondary actor is needed to incur primary liability. *Shapiro*, 123 F.3d at 720. The misrepresentation must be attributed to that specific actor at the time of publication dissemination, that is, in advance of the investment decision. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998). Secondary parties may be primarily liable for statements made by others in which the secondary party significantly participated. *Software Toolworks*, 50 F.3d 615.

C. Fraudulent Scheme Liability

Although in *Central Bank* the Supreme Court eliminated liability for aiders and abettors of securities fraud, under §10(b)/Rule 10b-5 primary liability may be imposed not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration. *See Health Mgmt.*, 970 F. Supp. at 203; *Page*, 1997 U.S. Dist. LEXIS 3673, at *11-15; *Marksman Partners*, 1998 U.S. Dist. LEXIS 12743, at *4 (defendants' involvement in ship-hold-and-return scheme).

D. "Group Published" Doctrine

When alleging securities fraud based on false and misleading statements in prospectuses, registration statements, annual reports, press rleases, or other "group published" information, there is a presumption that these statements are the collective work of those individuals who have high level positions with the issuer; are involved in the day-to-day operations; directly participate in management; and were involved in drafting, reviewing, and/or disseminating the false and misleading statements. Prospectuses, registration statements, annual reports, press releases, or other group published information are presumed to be *collective* actions. *Schaffer v. Evolving Sys., Inc.*, 29 F. Supp. 2d 1213, 1225 (D. Colo. 1998).

While many defendants have argued that the so-called "group pleading" doctrine was abolished by the PSLRA, the weight of authority is to the contrary. *See In re Oxford Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 142 (S.D.N.Y. 1999) ("The PSLRA has not altered the group pleading doctrine...."); *accord In re BankAmerica Corp. Sec. Litig.*, MDL No. 1264, 1999 U.S. Dist. LEXIS 19306, at *23 (E.D. Mo. Dec. 15, 1999) ("[B]ecause the group pleading doctrine is a rebuttable presumption applicable only to a limited group of persons within the company, the Court finds that the presumption is not inconsistent with the PSLRA") (citations omitted); *In re Livent, Inc. Sec. Litig.*, No. 98 Civ. 5686 (RWS), 1999 U.S. Dist. LEXIS 19329, at *68-69 (S.D.N.Y. Dec. 13, 1999) (same); *Miller Indus.*, 12 F. Supp. 2d at 1329 (same); *Stratosphere*, 1 F. Supp. 2d at 1108 (holding that the PSLRA did abolish the "group pleading" doctrine).

IX. THE SAFE HARBOR FOR "FORWARD-LOOKING" STATEMENTS AND THE "BESPEAKS CAUTION" DOCTRINE

A. When Forward-Looking Statements Are Protected

The PSLRA's safe harbor provision prohibits liability based on forward-looking statements if such statements (1) are identified as such and are accompanied by cautionary language, (2) were immaterial, (3) plaintiff fails to establish that the person (or entity) making the statement had actual knowledge of its falsity. *See Karacand*, 53 F. Supp. 2d at 1243; *Ceridian*, 1999 U.S. Dist. LEXIS 15611, at *18-19; *Valujet*, 984 F. Supp. at 1479; *see also Stratosphere*, 1 F. Supp. 2d at 1106. A forward-looking statement includes (a) statements containing projections of revenues, income, earnings per share, or other financial items; (b) statements of the plans and objectives of management for future operations; and (c) statements of future economic performance. 15 U.S.C. §78u-5(i)(1); *see Karacand*, 53 F. Supp. 2d at 1243; *Ceridian*, 1999 U.S. Dist. LEXIS 15611, at *18; *Bryant*, 25 F. Supp. 2d at 1382; *Voit*, 977 F. Supp. at 372; *Queen Uno*, 2 F. Supp. 2d at 1356; *see also Stratosphere*, 1 F. Supp. 2d at 1114 (statements regarding casino marketing plans were forward-looking); *Employee Solutions*, 1998 U.S. Dist. LEXIS 16444, at *9 (statements about accounting reserves were statements of historical fact).

An oral forward-looking statement is protected if it (1) is accompanied by a cautionary statement specifying first that the particular oral statement is a forward-looking statement and second that the "'actual results might differ materially from those projected in the forward-looking statement;' or (2) is accompanied by an oral statement expressing that 'additional information concerning factors that could cause actual results to materially differ from those in the forward-looking statement is contained in a readily available written document.'" *Queen Uno*, 2 F. Supp. 2d at 1355-56 (citing 15 U.S.C. §78u-5(c)(2)(B)).

SEC Rule 3b-6 provides a safe harbor for forward-looking statements made in quarterly or annual reports if it was made with a "reasonable basis" and "in good faith." Valujet, 984 F. Supp. at 1479 (citing 17 C.F.R. §240.3b-6). When forecasts, opinions, or projections in a disclosure statement are accompanied by meaningful warnings and cautionary language, the forward looking statements may be deemed immaterial as a matter of law. *Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190, 1197 (N.D. Ill. 1997); *Grand Casinos*, 988 F. Supp. at 1279.

B. When Forward-Looking Statements Are Not Protected

A prediction may be actionable as a false statement of fact if (1) the speaker did not genuinely believe the statement was true; (2) there was no reasonable basis for the speaker to believe the statement; and (3) the speaker was aware of an undisclosed fact tending to undermine the accuracy of the statement. *Berti v. VideoLan Tech.*, Civil Action No. 3:97-CV-296-H, 1998 U.S. Dist. LEXIS 18066, at *13-14 (W.D. Ky. June 10, 1998); *see also Karacand*, 53 F. Supp. 2d at 1243 ("The Safe Harbor does not apply to the extent a statement was made by a person or entity having actual knowledge that it was false or misleading.") (citing 15 U.S.C. §78u-5(c)(1)(B)).

Thus, in *Stratosphere*, 1 F. Supp. 2d at 1111-12, plaintiffs alleged that defendants knew that their predications that a hotel-casino construction project would be on budget were false because they had received construction estimates showing that the project would have cost overruns. The court held that those allegations were sufficient to withstand dismissal under the PSLRA's "actual knowledge" scienter standard for forward-looking statements. *See also In re Stratosphere Corp. Sec. Litig.*, 66 F. Supp. 2d 1182, 1191-93 (D. Nev. 1999) (material issues of fact regarding defendants' knowledge of cost overruns on construction project and generation of change orders and extra work orders without apparent regard for budgetary constraints precluded summary judgment on defendants' claim that prospectus statements regarding financial condition were not made with required scienter); *Weiss v. Mentor Graphics Corp.*, No. CV-97-1376-ST, 1999 U.S. Dist. LEXIS 17026, at *45-46 (D. Or. Oct. 6, 1999) ("[T]his court interprets actual knowledge to mean that defendants knew - not should have known - of facts which seriously undermined their prediction or knew - not should have known - there was no reasonable basis for their prediction").

A forward-looking statement is insulated from liability unless the defendant fails to make accompanying cautionary statements or the plaintiff proves the defendant actually knew the statements were false when made. *See Schaffer*, 29 F. Supp. 2d at 1224 (defendants knew truth about future business based on company's financial statements which revealed downturn in new business); *Kensington Capital*, 1999 U.S. Dist. LEXIS 385, at *10-11 (plaintiffs pled facts sufficient to create strong inference of defendants' knowledge of falsity of statements regarding introduction of new sunglass line).

The safe harbor explicitly *excludes* from protection forward-looking statements included in financial statements prepared in accordance with GAAP; statements contained in registration statements; or statements made in connection with a tender offer or initial public offering. *See Queen Uno*, 2 F. Supp. 2d at 1360 (particular and detailed representations regarding expected production levels of specific facilities may be actionable).

The safe harbor provision does not insulate statements that "misrepresent historical/hard or current facts." *Ceridian*, 1999 U.S. Dist. LEXIS 15611, at *19 (citations omitted); *see also Geffon v. Micrion Corp.*, No. 98-11596-REK (D. Mass. Sept. 24, 1998) (statement of present fact, "although they may affect the future performance of the company," are not protected under the PSLRA's safe-harbor provision); *accord APAC Telesvcs.*, 1999 U.S. Dist. LEXIS 17908, at *23 ("Linking future success to present and past performance does not render statements immune from liability."). Courts must determine, at the pleading stage, whether a forward-looking statement falls within the "safe harbor." 15 U.S.C. §78u-5(e); *Karacand*, 53 F. Supp. 2d at 1243. Because the PSLRA "closes the universe of supposedly false statements under scrutiny to those 'specif[ied]' in the complaint," the statute's legislative history "implies piecemeal examination of the statements found in a company communication." *Harris*, 182 F.3d at 804 (quoting 15 U.S.C. §78u-4(b)(1)).

C. The "Bespeaks Caution" Doctrine: When Cautionary Language Protects Misleading Statements

"Proving that Defendant has provided enough cautionary language as a matter of law is a high standard." Lister, 1999 U.S. Dist. LEXIS 384, at *9; *see also Kensington Capital*, 1999 U.S. Dist. LEXIS 385, at *8. "The 'bespeaks caution' doctrine is applied narrowly because an overbroad interpretation would encourage management to conceal deliberate misrepresentations beneath the mantle of broad cautionary language." *Boeing*, 1998 U.S. Dist. LEXIS 14803, at *24.

Whether a statement is misleading may be determined as a matter of law *only* when reasonable minds could not disagree as to whether the mix of information is misleading. *Powers*, 977 F. Supp. at 1043; *Grand Casinos*, 988 F. Supp. at 1279; *Boeing*, 1998 U.S. Dist. LEXIS 14803, at *24-25 (reasonable minds could differ as to whether cautionary language was sufficient).

Under the judicially created "bespeaks caution" doctrine, misstated "'forecasts, opinions, or projections' do not amount to 'material misrepresentations' if 'meaningful cautionary statements' accompany the forward-looking statements." *Valujet*, 984 F. Supp. at 1479 (alleged misrepresentation was not based on forward-looking statements, but rather existing facts) (citation omitted).

A claim can only be dismissed under the "bespeaks caution" doctrine if defendants' forward looking statements are accompanied by enough cautionary language or risk disclosure that "'reasonable minds' could not disagree that the challenged statements were not misleading." *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *17 (citation omitted); *Olympic Fin.*, 1998 U.S. Dist. LEXIS 14789, at *12; *Boeing*, 1998 U.S. Dist. LEXIS 14803, at *17, *24; *Kensington Capital*, 1999 U.S. Dist. LEXIS 385, at *8.

The bespeaks caution doctrine provides a mechanism by which a court can rule as a matter of law that defendants' forward looking statements contained enough cautionary language or risk disclosure to protect the defendant against securities fraud. *Hoffman v. Avant! Corp.*, No. C97-20698(RMW), 1997 U.S. Dist. LEXIS 21823, at *4 (N.D. Cal. Dec. 16, 1997) (citation omitted). The doctrine reflects nothing more than the unremarkable proposition that statements must be analyzed in context. *See Powers*, 977 F. Supp. at 1043. Dismissing a securities action under the bespeaks caution doctrine represents a conclusion that, as a matter of law, a securities prospectus as a whole is not misleading due to the risks disclosed and the nature and extent of the other cautionary language employed. *Hoffman*, 1997 U.S. Dist. LEXIS 21823, at *5.

D. Cases In Which Cautionary Disclosures Were Insufficient To Bespeak Caution

See Bryant, 25 F. Supp. 2d at 1382 (no defense when cautionary statements regarding forward-looking information are separate statements or documents from those listed in complaint); *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *17-18 (warnings appeared in documents that did not accompany allegedly misleading oral representations, thus diminishing their cautionary effect); *Powers*, 977 F. Supp. at 1043-44 (information does not clearly preclude reasonable minds from differing); *Fugman*, 961 F. Supp. at 1199-98 (statements concerning marketability of medical diagnostic test); *Voit*, 977 F. Supp. at 371 (cautionary warning itself was actionable as material misstatement); *Hoffman*, 1997 U.S. Dist. LEXIS 21823, at *5 (representations regarding merits of defendants' legal position may be misleading and substantially minimize impact of company's risk disclosures); *Olympic Fin.*, 1998 U.S. Dist. LEXIS 14789, at *13 (documents containing some cautionary language did not specifically address heart of plaintiffs' claim); *Boeing*, 1998 U.S. Dist. LEXIS 14803, at *19, *31 (no cautionary language in press release to warn of steeper decline in productivity or extension of period of inefficiency); *Schaffer*, 29 F. Supp. 2d at 1224 (misleading quarterly earnings are present factual conditions); *Kensington Capital*, 1999 U.S. Dist. LEXIS 385, at *8 (same; statements concerning introduction of new sunglass line).

E. Boilerplate Warnings Are Insufficient To Bespeak Caution

To determine whether the doctrine immunizes defendants from liability, the court analyzes whether the cautionary statements are "precise" and directly addressed to the future risk at issue. *Hoffman*, 1997 U.S. Dist. LEXIS 21823, at *5; *Olympic Fin.*, 1998 U.S. Dist. LEXIS 14789, at *12. "To immunize the type of conduct alleged here would be to give companies a license to issue groundless appraisals to investors so long as they include a modest footnote or appendix with a kernel of truth that might enable an analyst or accountant to spot the inconsistencies." *Marksman Partners*, 927 F. Supp. at 1307.

To be meaningful, cautionary statements must identify important facts that could cause actual results to differ materially from the forward looking statement. *Boeing*, 40 F. Supp. 2d at 1169-71 (warnings did not speak to factors that could adversely affect company's development of systems to improve efficiency).

If a party is aware of an actual danger or cause for concern, the party may not rely on a generic disclaimer in order to avoid liability under the bespeaks caution doctrine. *In re Credit Suisse First Boston Corp. Sec. Litig.*, No. 97 Civ. 4760, 1998 U.S. Dist. LEXIS 16560, at *21, Fed. Sec. L. Rep. (CCH) ¶90,306 (S.D.N.Y. Oct. 20, 1998) (blanket disclaimer that defendant/ market maker "may from time to time have long or short positions" not enough to protect defendants); *Feiner v. SS&C Tech.*, 11 F. Supp. 2d 204, 209 (D. Conn. 1998) ("[W]arning is not so precise and obvious that it renders plaintiffs' allegations unactionable as a matter of law."); *Warman*, 1998 U.S. Dist. LEXIS 2009, at *15 (rejecting defendants' bespeaks caution defense because cautionary statements did not directly address defendants' projections and "even if the statements were forward looking, the language used by the defendants appears to be merely a boilerplate disclaimer"); *Cherednichenko*, 1997 U.S. Dist. LEXIS 23107, at *17 (rejecting bespeaks caution defense because "many of the disclosures appear to be merely boilerplate disclaimers") (citation omitted); *Stratosphere*, 1 F. Supp. 2d at 1118 (plaintiffs alleged that because defendants knew of existing, specific cost overruns and construction delays which would necessarily affect operating revenues once hotel-casino opened, they cannot insulate these statements with general language about risks inherent in every construction enterprise).

F. The "Bespeaks Caution" Doctrine Is Not Applicable When Misrepresentations Or Omissions Concern Historical/Hard Or Current Facts

Predictive statements contain the factual assertions that the speaker genuinely believes the statement is accurate, that there is a reasonable basis for that belief, and that the speaker is unaware of any undisclosed facts that would tend to seriously undermine the accuracy of the statement. It follows that statements of opinion are actionable if they are made in bad faith or are not reasonably supported by evidence available to the person that issues the statements. *See Credit Suisse*, 1998 U.S. Dist. LEXIS 16560, at *14; *Grand Casinos*, 988 F. Supp. at 1279-1280 (forward-looking cautionary language does not render immaterial presently known facts regarding cost overruns and other construction difficulties); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 47 (D. Mass. 1997) (while defendants disclosed "risk" that existing products may become obsolete by introduction of new products by partners, defendants' failure to disclose that such new product had already been created, was about to be introduced to market, and would render company's "current product line obsolete within the industry and, thus, materially lower [the company's] revenues and earnings for the second quarter of fiscal year 1996" held actionable); *Page v. Derrickson*, Case No. 96-842-CIV-T-17C, 1997 U.S. Dist. LEXIS 3673, at *33-34, 10 Fla. Law W. Fed. D 586 (M.D. Fla. Mar. 25, 1997) ("bespeaks caution" doctrine inapplicable when plaintiffs allege misstatements of *existing* facts); *Powers*, 977 F. Supp. at 1043 (rejected defendants' bespeaks caution defense because cautionary language "does not directly address the delays that Plaintiffs claim Proxima was then experiencing with its laser-projector development"); *Valujet*, 984 F. Supp. at 1479 (plaintiffs alleged that defendants misrepresented and failed to disclose poor safety record and fact that FAA approval was required before expansion could be consummated); *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 372 (E.D. Pa. 1997) (allegations that defendants made omissions of present fact regarding CEO departure and that stock plummeted following announcement contradicted defendants' contention that omission was soft information); *Fugman*, 961 F. Supp. at 1197 n.9 (cautionary statements cannot render immaterial company's factual representations regarding the adequacy of one component in a medical diagnostic testing system).

X. Liability Of Securities Issuers And Their Officers And Directors For Securities Analysts' Statements

A. The Fraud-On-The-Market Doctrine

In open market securities cases brought by defrauded investors under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5, 17 C.F.R. §240.10b-5, plaintiffs often employ the "fraud-on-the-market" theory endorsed by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988): "[M]ost publicly available information is reflected in market price, [and therefore] an investor's reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b-5 action."

As the *Basic* Court recognized, the fraud-on-the-market theory presupposes that the securities market "'transmits information to the investor in the processed form of a market price.... The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.'" Id. at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).[2]

B. The Important Role Played By Securities Analysts

In explaining how the securities market translates company-specific information into a stock price, the *Basic* Court emphasized the importance of "market professionals":

> We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, *we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.*

485 U.S. at 247 n.24 (emphasis added). Prominent among these "market professionals" are securities analysts; indeed, district courts have frequently stated that the number of such analysts reporting on a particular security is one of the factors to be examined in determining whether the fraud-on-the-market theory is to be applied in a particular case. *See,*

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[2] *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059 (1990).

e.g., *In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 804-05 (S.D. Cal. 1990); *Cammer v. Bloom*, 711 F. Supp. 1264, 1286 (D.N.J. 1989).[3]

Courts have recognized that earnings forecasts disseminated by securities analysts are of particular importance because such analysts are theoretically independent of the companies they follow and, as a result, they can be expected to provide more objective projections than the companies themselves:

> [T]he corporation's own officers are not likely to be the most reliable source of projections of future corporate performance. Officers and internal analysts may be biased by their personal goals in evaluating the corporation's prospects for short- and long-term success. [So] long as the corporation provides accurate hard data to the market, professional analysts and investors are in at least as good and probably a better position to make the predictions about a corporation's future which are relevant to the valuation of corporate securities.
>
> This is true for a number of reasons. First, the professional analyst has more interest in making the most accurate prediction possible, because the analyst's reputation and livelihood depend solely on the analyst's ability to be correct. The corporate officer's success does not depend primarily or even significantly on an ability to predict stock prices. Second, the analyst has the benefit of objectivity because the analyst is removed from the daily operations of the corporation, whereas the corporate officer is in the thick of these developments. Finally, and most importantly, the analyst is skilled in combining the specific data disclosed by the corporation with general knowledge about the industry and the national and international economies in which the corporation competes. Corporations call on their officers for other skills.

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[3] *See also Brad M. Barber, et al., The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, 19 J. Corp. L. 285, 305 (1994) (number of analysts following stock and trading volume are only factors having independent statistical significance in determining market efficiency); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 Va. L. Rev. 1023, 1024 (1990) (academic commentary supports the proposition that "[i]nvestment analysts are crucial players in the mechanisms of marketplace efficiency that lead to optimal allocations of capital resources").

In re Verifone Sec. Litig., 784 F. Supp. 1471, 1481-82 (N.D. Cal. 1992), aff'd, 11 F.3d 865 (9th Cir. 1993) (footnote omitted).[4]

C. Liability Of Securities Issuers For Statements And Projections Disseminated By Securities Analysts

1. Introduction

Several legal theories impose liability upon securities issuers and their officers and directors for statements or projections made by securities analysts, as Judge Legge has cogently explained:

> If defendants made misleading statements to securities analysts regarding expected licensing revenues, they may be liable for securities fraud, even if the company did not adopt the analysts' subsequent reports. If a company chooses to speak to the market on a subject, through an analyst or otherwise, it must make a full and fair disclosure to ensure that its statements are not materially misleading. A company may be liable under Rule 10b-5 for misrepresentations to analysts that reach the market.
>
> Although a company is not generally responsible for the accuracy of statements made by securities analysts, a company may adopt or endorse an analyst's report, causing the report to be attributed to the company. A defendant may become sufficiently entangled by reviewing the analysts' reports and making representations that the information is true or in accordance with the company's views, or by exercising some measure of control over the content of the reports. For liability to attach, plaintiffs must demonstrate: 1) that a corporate insider adopted the analysts' forecasts; and 2) that the insider knew the analysts' forecasts were unreasonable when made, yet failed to disclose their unreasonableness to investors. Generally, a company is liable for analysts' forecasts that it fostered and reviewed but failed to correct if the company expressly or

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[4] *See also In re Compaq Sec. Litig.*, 848 F. Supp. 1307, 1315 (S.D. Tex. 1993) ("market makers often use analysts' opinions rather than management's to form the basis for their decisions about the appropriate market price for a company's stock") (footnote omitted); William O. Fisher, *The Analyst-Added Premium as a Defense in Open Market Securities Fraud Cases*, 53 Bus. Law. 35, 38-43 (Nov. 1997) (recognizing influence that securities analysts have upon stock prices).

> impliedly represented that the information in the forecasts was accurate or coincided with the company's views.

In re DSP Group Sec. Litig., No. C 95-4025-CAL, 1997 U.S. Dist. LEXIS 11942, at *19-21, Fed. Sec. L. Rep. (CCH) ¶99,525 (N.D. Cal. Mar. 5, 1997) (citations omitted).

2. PressTek

On December 22, 1997, the Securities and Exchange Commission ("SEC") issued an Enforcement Release defining the circumstances under which a securities issuer may be held liable for statements, including earnings forecasts, contained in a securities analyst's report. *See In the Matter of Presstek, Inc.*, Administrative Proceeding File No. 3-9515, 1997 SEC LEXIS 2645 (Dec. 22, 1997). In an accompanying civil action brought against Presstek's chairman, Robert Howard, and president, Robert Verrando, the SEC alleged that Howard and Verrando caused Presstek to disseminate, through its own statements and its distribution of analysts' statement, materially misleading information concerning its sales and business prospects.[5] In 1994 and 1995, Howard directed Presstek to distribute several thousand copies of several editions of the Cabot Market Letter, a financial newsletter that aggressively touted Presstek and which contained excessive earnings projections for the company. Howard knew, or was reckless in not knowing, that those earnings projections far exceeded Presstek's contemporaneous internal projections. Presstek adopted those unrealistic projections by distributing the Cabot Market Letters without disclaimer, and during a time when Presstek elected not to make public its own projections because management did not view them as reliable.

In November 1995, Howard reviewed and edited the draft of a research analyst's report on Presstek and had Presstek distribute the report, which in final form substantially overstated Presstek's sales and earnings expectations. For example, the report projected 1996 sales of a Presstek laser imaging product of $26 million, when Presstek internally projected only $10 million. It also projected 1996 sales of consumable printing plates of $33.2 million, contrasted with Presstek's internal projection of $8.7 million. It projected 1997 earnings of $2.42 per share, 80% more than Presstek's internal projection of $1.34 per share. Howard did not correct those errors, and Presstek distributed the erroneous report for more than six months to investors without disclaimer. Verrando was aware that projections in the analyst's report were significantly greater than Presstek's

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[5] *SEC v. Robert Howard, et al.*, No. 97 Civ. 9378 (SWK), Litigation Release No. 15599, 1997 SEC LEXIS 2623 (Dec. 22, 1997).

contemporaneous projections, but failed to halt its distribution.

In its release, the SEC recognized "entanglement" liability (see discussion below), stating that "[a]n issuer is liable for inaccuracies in a research report published by someone else" if it "'sufficiently entangled itself' with such information to render them attributable to the issuer." *Presstek,* 1997 SEC LEXIS 2645, at *29 (citation omitted). The SEC also recognized "adoption" liability (see discussion below), stating that "[a]n issuer may also be liable for false statements contained in a third-party report if it adopts, expressly or impliedly, the statements after they are published, even if management had no role in preparing the reports." Id. at *31. Analyzing the facts of the case, the SEC held that Presstek was liable under both theories. *Id.* at *34-39.

D. The "Entanglement" Theory

As a general rule, securities issuers are not liable for statements or forecasts disseminated by securities analysts; however, reference to reported cases demonstrates numerous exceptions which nearly swallow this rule. Thus, issuers can be held liable under §10(b)/Rule 10b-5 if they have "sufficiently entangled [themselves] with the analysts' forecasts [so as] to render those predictions 'attributable to [the issuers].'" *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980). In that case, the Second Circuit explained the rationale for its holding:

> We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views.

Id.; accord Presstek, 1997 SEC LEXIS 2645, at *29-30 (explicating "entanglement" theory and collecting cases). In order for the securities issuer to be held liable for the securities analysts' statements or projections under the so-called "entanglement" theory, the issuer must have placed its "imprimatur, expressly or impliedly, on the analysts' projections." *Elkind,* 635 F.2d at 163; *see also Presstek,* 1997 SEC LEXIS 2645, at *30.[6]

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[6] *See also In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1410 (9th Cir. 1996); *In re Nokia Corp. Sec. Litig.*, No. 96 Civ. 3752 (DC), 1998 U.S. Dist. LEXIS 4100, at *31, Fed. Sec. L. Rep. (CCH) ¶90,195 (S.D.N.Y. Mar. 31, 1998); *Verifone,* 784 F. Supp. at 1486; *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 603 (N.D. Cal.

At least one district court has observed that there are "sound reasons ... to construe the entanglement requirement strictly." *In re Caere Corp. Sec. Litig.*, 837 F. Supp. 1054, 1059 (N.D. Cal. 1993). As Judge Williams explained:

> In today's complex and highly competitive financial markets, countless analysts ... issue earnings and revenue forecasts on virtually every publicly-traded corporation. Forecasts may vary a great deal. If corporate insiders are held liable under Rule 10b-5 every time one of these forecasts proves to be incorrect, they would likely spend more time in court than running their companies.
>
> Also, if a loose and capricious entanglement standard is allowed to develop, it will be very difficult for corporate insiders to know how to regulate their behavior in such a way as to adopt only with those forecasts which they have carefully examined and have determined to be reasonably accurate. Corporate insiders should not be exposed to Rule 10b-5 liability for an analyst's forecast unless it is clear, based on the insider's conduct, that he could have reasonably foreseen that he would be held liable if the forecast turned out to be unreasonable when made and materially misleading to the investing public.

Id.; see also In re Syntex Corp. Sec. Litig., 95 F.3d 922, 934 (9th Cir. 1996) (quoting *Caere* court's "strict construction" language with approval). Relying upon *Caere*, 837 F. Supp. at 1059, Judge Lasker recently posited the standard for liability under the "entanglement" theory in the following terms:

> Courts concluding that an issuer may be liable under the statute for failure to correct an analyst statement have generally required that the plaintiff allege that: (1) the issuer "entangled" itself in the making of a statement by the analyst; (2) the issuer knew that the statement (commonly a prediction) was false or lacked a reasonable factual basis when made; and (3) the issuer failed to disclose the falsity or the unreasonableness to investors. The element of entanglement may be satisfied by the issuer having either "fostered," "induced," or otherwise caused the statement to be made in the first place, or having adopted, ratified, or otherwise "endorsed" the statement after it was made. In either instance, the issuer must have "sufficiently entangled itself with the analysts' [statements] to render [them] attributable to it."

1991).

In re Boston Tech. Sec. Litig., 8 F. Supp. 2d 43, 55 (D. Mass. 1998) (citations omitted); *accord Peritus Software,* 52 F. Supp. 2d at 230; *In re Number Nine Visual Tech. Corp. Sec. Litig.,* 51 F. Supp. 2d 1, 30 (D. Mass. 1999).[7]

Under this line of authority, courts typically hold that a so-called "one-way flow of information, from [issuer] representatives to analysts and from the analysts to their customers" is not sufficient "entanglement" to render the issuer liable for the analysts' statements or projections. *Syntex,* 95 F.3d at 934. Those courts which strictly construe the requirements of the "entanglement" theory require plaintiffs to allege with particularity the time, place, content, and speaker of the issuer's communications with the securities analysts, and explain why the communications were fraudulent. *See Suna v. Bailey Corp.*, 107 F.3d 64, 73-74 (1st Cir. 1997) (declining to reach ultimate issue of whether action against issuer could lie on basis of analyst statements, but dismissing case on grounds of plaintiffs' failure to plead issuer's "entanglement" sufficiently, indicating that if squarely faced with issue, it might well permit findings of liability for analyst statements); *accord Peritus Software,* 52 F. Supp. 2d at 230; *Number Nine Visual,* 51 F. Supp. 2d at 30-31.[8]

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[7] *See also In re Crown Am. Realty Trust Sec. Litig.*, No. 95-202J, 1997 U.S. Dist. LEXIS 14609, at *54 (W.D. Pa. Sept. 15, 1997) (to plead "imputation" theory with sufficient particularity to avoid dismissal under Rule 9(b), plaintiffs "'must (1) identify specific analyst opinions and name the insider who adopted them; (2) point to specific interactions between the insider and the analyst which gave rise to the entanglement; and (3) state the dates on which the acts which allegedly gave rise to the entanglement occurred'") (citation omitted).

[8] *See also In re Health Mgmt. Sys., Inc. Sec. Litig.*, No. 97 Civ. 1865 (HB), 1998 U.S. Dist. LEXIS 8061, at *15 n.2, Fed. Sec. L. Rep. (CCH) ¶90,235 (S.D.N.Y. May 27, 1998) ("The complaint alleges that a report published by the firm of Robinson-Humphrey Co. is attributable to defendants because it was written by a former CFO of HMS and because the information is of sufficient detail that it could only have come from defendants. I find that these allegations do not sufficiently plead with particularity that defendants so thoroughly 'entangled' themselves with such report as to render them liable for such reports."); *DSP Group,* 1997 U.S. Dist. LEXIS 11942, at *27 ("Plaintiffs have not alleged [with particularity] which securities analysts provided draft reports to DSP corporate insiders, when they provided those reports, or which corporate insiders reviewed and approved the draft reports."); *Colby v. Hologic, Inc.*, 817 F. Supp. 204, 215 (D. Mass. 1993) (holding that plaintiff failed to adequately plead "entanglement" or misstatements of facts to analysts). *But see Harvey M. Jasper Retirement Trust v. Ivax Corp.*, 920 F. Supp. 1260, 1267 (S.D. Fla.

Not surprisingly, with a liability standard phrased as "entanglement" or "imprimatur," the courts have experienced difficulty in determining when an issuer may be held liable for a securities analyst's statement or projection. Some cases addressing the question have held that an issuer who simply provides background information to a securities analyst will not be liable for statements in the analyst's subsequent report. As Judge Patel explained in Padnes v. Scios Nova Inc., No. C95-1693 MHP, 1996 WL 539711 (N.D. Cal. Sept. 18, 1996):

> Here, plaintiffs have pled only that the analysts' reports were based on information provided by the defendants. This, without more, in [sic] insufficient under the great weight of authority in this district to attribute third-party statements to a defendant company. Mere provision of information cannot amount to entanglement sufficient to sustain liability under *Elkind*.

Id. at *10 (citations omitted).[9]

On the other hand, in *Presstek*, 1997 SEC LEXIS 2645, the SEC held that the following facts constituted "entanglement":

> Presstek's management directly participated in preparing a report that it knew, or was reckless in not knowing, included forecasts that were far more optimistic than Presstek's contemporaneous internal projections. For example, the PMG Report quoted management's projection of "a few 100" Pearlsetter sales for 1996. However, Howard and Verrando knew, or were reckless in not knowing, that Presstek's internal forecasts projected only half as many Pearlsetter sales for 1996 as were forecast in the PMG Report. Moreover, in an effort to give added weight to the inaccurate Pearlsetter forecast, Howard falsely attributed it to "industry experts."

1995) ("At the pleading stage, all plaintiffs need allege is that defendants provided the information to the securities analyst, upon which the reports were based.").

[9] *See also In re Rasterops Corp. Sec. Litig.*, No. C-93-20349RPA(EAI), 1994 U.S. Dist. LEXIS 18245, at *9, Fed. Sec. L. Rep. (CCH) ¶98,231 (N.D. Cal. Oct. 31, 1994) ("[I]t is not enough to simply allege that the reports were based on information provided by the company and that the company received and reviewed a draft of the report."); *O'Sullivan v. Trident Microsystems*, No. C 93-20621 RMW (EAI), 1994 U.S. Dist. LEXIS 17065, at *46, Fed. Sec. L. Rep. (CCH) ¶98,116 (N.D. Cal. Jan. 31, 1994) ("While the company may have provided the information on which the reports were based, this does not mean the company is liable for the contents of the reports.").

> Howard also failed to lower the PMG Reports 1996 or 1997 revenue forecasts to conform them to Presstek's contemporaneous internal projections. Although Howard edited the PMG Report's 1996 EPS projection, he did not correct its 1997 EPS projection ($2.42), which far exceeded Presstek's internal projection ($1.34). By revising certain forecasts concerning Presstek's revenues and earnings, Howard impliedly represented to PMG that those he did not revise were accurate.

Id. at *34-35. "Such involvement by management in the preparation, review, and editing of the PMG Report establishes Presstek's liability for the report's forecasts." Id. at *35-36.

E. The "Conduit" Theory

The "entanglement" analysis applies where the securities analyst's statement forecast is the product of his own work on which the issuer has placed its imprimatur by entangling conduct. When plaintiffs allege that the issuer consciously planted false information with an analyst, so that the analyst acted as a *conduit* for introducing the false information into the market, the company may be liable whether or not it entangled itself by review of draft reports. In the words of one recent commentary:

> If an issuer intentionally or recklessly misleads securities analysts, then the analyst reports are relevant to determine securities fraud liability. Adoption or entanglement is not required in such circumstances and an issuer cannot avoid liability just because the fraud is perpetrated through thirdparties.

Robert Norman Sobol, *The Tangled Web of Issuer Liability for Analyst Statements: In re Cirrus Logic Securities Litigation*, 22 Del. J. Corp. L. 1051, 1057-58 (1997) ("Sobol, *Tangled Web*") (footnotes omitted).[10]

Section 10(b) of the Exchange Act prohibits the use of "any manipulative or deceptive device or contrivance," whether practiced "directly or indirectly." 15 U.S.C. §78j(b). Section 20(b) of the Exchange Act specifies that it is unlawful for a person "to do any act or thing which it would be unlawful for such person to do ... through or by means of any other person." 15 U.S.C. §78t(b). As a result,

> [m]anipulation of the prices of securities by the dissemination of false and misleading information

[10] It should be noted that in *Presstek*, 1997 SEC LEXIS 2645, the SEC did not address the "conduit" theory of liability.

> through analysts is exactly the type of conduct section 10(b) prohibits. When an issuer communicates such misleading information to investment analysts there is an expectation that the false information will reach the marketplace and influence prices.

Sobol, *Tangled Web,* 22 Del. J. Corp. L. at 1058 (footnote omitted).[11]

In *Warshaw v. Xoma Corp.*, 74 F.3d 955 (9th Cir. 1996), the Ninth Circuit reversed dismissal of a securities fraud complaint which alleged that the securities issuer intentionally used securities analysts and the press to disseminate false information to the investing public:

> [I]f defendants intentionally misled securities analysts and the press in order to stave off a Xoma stock sell off, then these third-party reports would be relevant to determine Xoma's securities fraud liability. The Complaint asserts that Xoma intentionally used these third parties to disseminate false information to the investing public. If this is true, Xoma cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties. The Complaint should not have been dismissed under 12(b)(6), without a contextual, "delicate assessment" of the facts presented-including the statements of third-party analysts.

Id. at 959 (citing *Fecht v. Price Co.*, 70 F.3d 1078, 1080-81 (9th Cir. 1995)). *Accord DSP Group,* 1997 U.S. Dist. LEXIS 11942, at *25 ("If defendants provided inflated or otherwise misleading licensing revenue projections to the analysts, that could qualify as misleading the analysts.").

In another case, *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446 (N.D. Cal. 1996), the district court observed:

> Defendants also argue that they cannot be held liable for allegedly misleading statements made to analysts, unless plaintiffs can prove Cirrus's entanglement with, or adoption of, the analysts' reports. This is not the law.... The Court finds that a company may be liable under Rule 10b-5 for its own intentional or reckless misrepresentations

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11 *See also Kirby v. Cullinet Software, Inc.*, 116 F.R.D. 303, 307 (D. Mass. 1987) (stating that reliance on the market also includes reliance on third party statements that just relayed the misstated information from securities issuers).

> to analysts that reach the market, whether or not the company adopts the resulting analysts' reports.

Id. at 1466-67. Similarly, in *Simon v. American Power Conversion Corp.*, 945 F. Supp. 416 (D.R.I. 1996), the court denied a motion to dismiss that part of the complaint alleging liability for statements made by analysts because

> [t]here are sufficient facts to support a finding that any misstatements in the analysts' reports were caused by APC's management. The reports reference numerous conversations with APC management on the question of APC's build-up of inventories, during which APC gave its explanation for the increase in inventories. From that, it would be reasonable for the fact-finder to infer that any misrepresentations in the reports were based on or caused by false or misleading information obtained directly from APC. Such causation, if proven, is sufficient to support APC's liability through the attribution of the statements.

Id. at 429-30 (footnote omitted).

In *Schaffer v. Timberland Co.*, 924 F. Supp. 1298 (D.N.H. 1996), the court denied defendant's motion to dismiss because

> [s]ignificantly, the plaintiffs have identified specific analyst statements and the insider information, sometimes directly quoted, upon which they allege the statements were based.... Jeffrey Swartz is alleged to have made direct statements, excerpted verbatim, statements of approval of erroneous projections of outside analysts, and statements concerning the size and nature of Timberland's inventory and the demand for its product. The plaintiffs next allege, again in detail, that the following day Merrill Lynch directly relied on and incorporated Swartz's remarks into its report.

Id. at 1312.

It is not unusual for plaintiffs to allege several alternative theories of issuer liability for analyst statements. *See Gross*, 977 F. Supp. at 1474 ("Plaintiffs sufficiently allege that the [analysts'] reports were based on misleading information provided by Defendants. Finally, Plaintiffs allege that Defendants, without any reasonable basis, endorsed and adopted each of the analysts' reports by, among other things, expressing comfort with the third and fourth quarter earnings estimates contained in one of the reports.") (citations omitted); *In re Wall Data Sec. Litig.*, No. C95-0528Z, 1996 U.S. Dist. LEXIS 14052, at *14, Fed. Sec. L. Rep. (CCH) ¶99,292 (W.D. Wash. June 25, 1996) (granting motion to dismiss as to entanglement theory, but not as to conduit theory; "Plaintiffs' allegations that the Company made false and misleading statements to analysts, however, are relevant to plaintiffs' claim under §10(b) that the Company made false and misleading statements about acceptance of Wall Data products and the Company's potential for growth."). Judge Smith has agreed that

> [i]t is also possible for liability to attach if a corporate officer or employee makes false and misleading statements to an analyst, who then in good faith incorporates them into his or her report. Because a company official spoke ... this is a form of direct liability and does not involve the imputation of the analyst's statements back to the company. Under such a theory, the plaintiff must "plead with the requisite specificity precisely what misstatements were made by which defendants to which analysts, and precisely how that specific misinformation reached the market through a specific analyst report."

Crown Am. Realty, 1997 U.S. Dist. LEXIS 14609, at *54 n.2 (citations omitted) (quoting *Rubin v. Trimble*, No. C-95-4353 MMC, 1997 U.S. Dist. LEXIS 14011, at *55-57 (N.D. Cal. Apr. 28, 1997)).

The Ninth Circuit has held that the Supreme Court's decision in *Central Bank*, which abolished aiding and abetting liability, does not foreclose such a theory, at least where the securities analysts act wittingly. In *Cooper*, 137 F.3d 616, where the court reversed dismissal of securities fraud claims, the securities issuer argued that "it is not responsible for the recommendations of securities analysts, even if it provided information on which the analysts' assessments were based." *Id.* at 623-24. The Ninth Circuit rejected this argument, noting that it had held in *Warshaw*, 74 F.3d at 959, that "corporate defendants may be directly liable under [Rule] 10b-5 for providing false or misleading information to third-party securities analysts." *Cooper*, 137 F.3d at 624. Further rejecting the issuer's argument that "*Central Bank* precludes holding it liable for the analysts' statements," *id.*, Judge Fletcher stated:

> Merisel is alleged to have made misleading statements to the analysts with the intent that the analysts communicate those statements to the market. This is not aiding and abetting or secondary liability; the complaint alleges that Merisel is [responsible] for its own false statements to the analysts.

Id.

Judge Fletcher concluded her analysis of this issue by stating that

> [p]laintiffs' claims ... are not barred by *Central Bank* in that they are asserting that Merisel, through false statements to analysts, and those analysts, by issuing reports based on statements they knew were false, together engaged in a scheme to defraud the shareholders.

Cooper, 137 F.3d at 625.

F. Securities Issuer's Review, Correction And/Or Dissemination Of Securities Analysts' Reports

In *Elkind*, following a jury trial the Second Circuit affirmed that the securities issuer, Liggett & Myers, was not liable for securities analysts' projections. 635 F.2d at 163. In so holding, it noted that Liggett had hired a public relations firm in order to specifically encourage "closer contact between analysts and company management" because management "concluded that the company's stock was underpriced, due in part to lack of appreciation in the financial community for the breadth of its market activity." Id. at 159. While the Second Circuit noted that Liggett's officers had received drafts of analysts' reports and corrected them, the court stressed that the company's review and correction did not extend to forecasts:

> [W]e find no reason to reverse as clearly erroneous the district court's finding that Liggett did not place its imprimatur, expressly or impliedly, on the analysts' projections. The company did examine and comment on a number of reports, but its policy was to refrain from comment on earnings forecasts. Testimony at trial indicated that the analysts knew the were not being made privy to the company's internal projections. While the evidence leaves little doubt that Liggett made suggestions as to factual and descriptive matters in a number of the reports it reviewed, the record does not compel the conclusion that this conduct carried a suggestion that the analysts' projections were consistent with Liggett's internal estimates.... Thus, Liggett assumed no duty to disclose its own forecasts or to warn the analysts (and the public) that their optimistic view was not shared by the company.

Id. at 163 (footnotes omitted).

Subsequent decisions have reached varying results on the precise question of whether review and correction of draft securities analysts' reports by an officer or employer of the securities issuer constitutes sufficient "entanglement" to attribute the analysts' statements to the issuer. In *SEC v.*

Wellshire Sec., Inc., 773 F. Supp. 569, 572 (S.D.N.Y. 1991), the court denied a permanent injunction as to two individual defendants and dissolved an injunction against a corporate defendant, finding that statements in a broker's market letter were not attributable to those defendants. The district court so held even though the brokers sent a draft of a market letter to the defendants, the defendants corrected the draft and sent it back to the broker, and the broker then incorporated that corrected draft into its market letters. Contrasting the facts of that case with *Elkind*, the court wrote:

> The facts of the case at bar indicate less entanglement that in *Elkind*, where the court was not inclined to find entanglement because the company's general policy was not to involve itself with forecasting. No evidence has been presented as to any meetings between the ... defendants and [the broker] in preparing the drafts at bar or [the] Market Letters.

Id. at 573.

On the other hand, there are a number of decisions holding on their particular facts that review and correction of analysts' draft reports by a securities issuer's officer or employee is sufficient to constitute entanglement. For example, in *In re ICN/Viratek Sec. Litig.*, No. 87 Civ. 4296, 1996 U.S. Dist. LEXIS 4407, at *10, Fed. Sec. L. Rep. (CCH) ¶99,213 (S.D.N.Y. Apr. 4, 1996), where the court denied defendants' summary judgment motion, Judge Wood noted that plaintiffs had "submitted evidence indicating not only that defendants reviewed the PaineWebber report, but also that defendants *did* fail to correct factual statements in the report that they knew were erroneous - while at the same time making other corrections and additions to the report." (Emphasis in original.) The district court contrasted the facts before the Second Circuit in *Elkind,* where the corporation reviewed and commented on an early *draft* of an analyst's report but "did not review the actual text of the *final* report just prior to issuance," and noted that in the case at bar, defendants' "review and amendment of the final draft of the report just before its issuance" made a difference. Id. at *16, *18 (emphasis in original). *Accord Presstek*, 1997 SEC LEXIS 2645, at *35-36 (citing *ICN/Viratek* with approval).

In *Stack v. Lobo*, 903 F. Supp. 1361 (N.D. Cal. 1995), the court denied a motion to dismiss, noting that plaintiffs alleged "that the analyst who wrote each of these reports sent copies to three Quickturn insiders (Lobo, D'Amour and Ostby), and that all three of these insiders reviewed and approved of the report during the week prior to the report's publication." *Id.* at 1372. *See also In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1237 (N.D. Cal. 1994) (denying motion to dismiss because plaintiffs made "detailed allegations that Gupta insiders provided information and guidance to analysts to assist the analysts in creating forecasts for the company" and alleged, although generally, "that defendants reviewed and approved analysts' reports before publication").

G. "No Comment" Policies

Cases that follow *Elkind* and find defendants not liable for analysts' forecasts frequently emphasize that the issuer had a policy of refraining from comment on such forecasts, or point to statements by the issuer's management distancing the company from the forecasts. *See, e.g.*, *Syntex*, 95 F.3d at 934 (affirming dismissal of securities fraud claims; "when Defendant Freiman (Syntex's CEO) was asked about the analysts' predictions related to future earnings per share, Mr. Freiman stated, 'We don't forecast earnings,' and emphasized that such estimates should not be attributed to Syntex").[12] As the district court noted in *Caere*:

> The only specific statements alleged in the Amended Complaint which suggest an entanglement are Caere's Chief Financial Officer's March 15, 1993, comments regarding analysts' forecasts, indicating that Caere did not have "sufficient information" upon which to base a comment, that "the first quarter is typically slower, reflecting seasonality in Caere's business," and that "as a result, results for the [first] quarter are always difficult to predict." It strains the intellect to imagine how this statement could constitute an entanglement. Caere's Chief Financial Officer was not embracing the analysts' forecasts when she made this statement. To the contrary, she was suggesting that the analysts' forecasts might be overly optimistic.

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[12] *See also In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995) (granting summary judgment for defendants as to all statements in analysts' reports; "Rodgers and Allen both testified that Cypress does not give its forecasts to analysts and has a policy of not commenting on analysts' forecasts. Plaintiffs have failed to present any credible evidence that Cypress ever deviated from this policy during the class period.") *aff'd sub nom. Eisenstadt v. Allen*, No. 95-16255, 1997 U.S. App. LEXIS 9587 (9th Cir. Apr. 28, 1997); *In re Seagate Tech. II Sec. Litig.*, No. C-89-2493(A)-VRW, 1995 U.S. Dist. LEXIS 2052, at *13-14, Fed. Sec. L. Rep. (CCH) ¶98,530 (N.D. Cal. Feb. 8, 1995) (granting summary judgment for defendants because Seagate's president "testified that throughout fiscal 1988, the company had a strict policy not to comment upon analysts' financial projections. Analysts themselves confirm Seagate's adherence to this policy. Plaintiffs fail to present evidence that defendants departed from their policy of not commenting on analysts' forecasts."), *aff'd*, 98 F.3d 1346 (9th Cir. 1996).

837 F. Supp. at 1060; *see also Cirrus Logic*, 946 F. Supp. at 1466 (granting summary judgment for company defendants for liability on opinions contained in 32 analyst reports; company personnel who were authorized by internal policy to talk with analysts stated that "they never commented on analysts' financial projections, and never provided to analysts internal earnings or revenue forecasts or other specific financial guidance").

As a result of plaintiffs' claims of issuer liability for statements or projections contained in securities analysts' reports, some issuers have reassessed their policies regarding corporate communications with analysts. *See Dale E. Barnes, Jr. & Constance E. Bagley, Great Expectations: Risk Management Through Risk Disclosures,* 1 Stan. J. L. Bus. & Fin. 155, 182 (1994) (citing to various articles indicating that companies such as Exabyte Corp., Software Toolworks and Oracle Systems Corp. now have stringent guidelines on the content and manner of such communications as a result of securities litigation involving those companies).

H. "Adoption" Or "Ratification" Of Analysts' Reports

While in *Elkind* the Second Circuit addressed pre-publication "entanglement," several cases hold that an issuer can be held liable for post-publication *adoption* or *ratification* of a securities analyst's statement or projection. *See Sobol, Tangled Web*, 22 Del. J. Corp. L. at 1065 (distinguishing "[p]republication entanglement" from post-publication "adoption" of analysts' statements or projections); *Presstek*, 1997 SEC LEXIS 2645, at *29-33 (same); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1429 (3d Cir. 1997) (holding that use of word "comfortable" by corporate officer in regard to his views of certain analysts' estimates clearly evidenced adoption).

For example, a securities issuer might ratify, endorse, or adopt an analyst's report (including presumably any forecasts contained therein) by *distributing copies* of the report to shareholders or potential investors:

> The act of circulating the reports amounts to an implied representation that the information contained in the reports is accurate or reflects the company's views.... By passing out the favorable analyst reports, Rasterops was clearly implying that the company agreed with the forecasts contained in the reports.

Rasterops, 1994 U.S. Dist. LEXIS 18245, at *10, *11 (N.D. Cal. Oct. 31, 1994) (denying motion to dismiss and noting that plaintiff alleged that "the company provided false information to the [securities] analysts and approved drafts of the reports").[13] As the SEC recently concurred:

> In the Commission's view, under certain circumstances an issuer that disseminates false third party reports may adopt the contents of those reports and be fully liable for the misstatements contained in them, even if it had no role whatsoever in the preparation of the report. If an issuer knows, or is reckless in not knowing, that the information it distributes is false or misleading, it cannot be insulated from liability because management was not actively involved in the preparation of that information.

Presstek, 1997 SEC LEXIS 2645, at *33-34; see also *Id.* at *38 (citing *Rasterops* opinion with approval).

In *Stratosphere*, 1 F. Supp. 2d at 1115, Judge Pro granted defendants' motions to dismiss plaintiffs' claims based upon the "entanglement" theory, finding that the complaint "fail[s] to allege specific interactions between the insider and the analyst giving rise to the entanglement, or allege when these interactions occurred." *Id.* However, the court reached a different conclusion as to other allegations:

> Plaintiffs also point to two facsimile cover sheets from an analyst to [Stratosphere chief financial officer] Lettero for the proposition that Lettero endorsed or approved the reports, and allege that certain analysts testified in depositions that Lettero was sent drafts of letters and sent drafts of reports prior to issuance by the analysts. Plaintiffs also contend that Stratosphere and the Individual Defendants distributed copies of analysts' reports and/or provided a list of analysts' coverage of Stratosphere in the packages that the company sent to potential investors. These allegations are sufficient to meet the pleading requirements for liability, and this Court does not dismiss liability based on these claims.

Id. at 1115-16.

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[13] *See also Strassman v. Fresh Choice, Inc.*, No. C-95-20017 RPA, 1995 U.S. Dist. LEXIS 19343, at *31 (N.D. Cal. Dec. 7, 1995) (stating that "[i]n addition to pre-publication entanglement ... this Court has held that a company may also be liable if it ratifies an analysts' report after the report has been published," but granting motion to dismiss because plaintiffs failed to alleged which reports were circulated by defendants, which defendant circulated reports and to whom reports were circulated).

In *Stack v. Lobo*, No. 95-20049SW, 1995 U.S. Dist. LEXIS 19966, at *24 (N.D. Cal. Apr. 19, 1995), Judge Williams observed that "[b]y reproducing and including these [securities analysts'] reports in their own stockholder informational materials, Quickturn may have impliedly represented that the information contained in those reports was accurate or reflected the company'[s] own views"; however, the court granted defendants' motion to dismiss because plaintiffs did "not identify the particular 'investor relations package' or provide the date on which it was sent out." In a later opinion in the same case, however, the district court seemed to reconsider its earlier ruling and found plaintiffs' allegations to be sufficient, thereby denying defendants' motion to dismiss as to securities analysts' reports that had been included in investor relations packets:

> Plaintiffs here have pled sufficient facts with regard to the investor relations package to satisfy Rule 9(b). Plaintiffs allege that specific Quickturn insiders approved the inclusion of specific analysts' reports and brochures in the package. Requiring Plaintiffs to identify each package that was sent out and the date on which it was sent would be unduly burdensome and unrealistic.

Stack, 903 F. Supp. at 1374.

UPDATE ON

PRIVATE SECURITIES LITIGATION

Defense Views

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SECTION G

UPDATE ON PRIVATE SECURITIES LITIGATION

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UPDATE ON PRIVATE SECURITIES LITIGATION

Thomas J. Allingham II[1]

I. INTRODUCTION

Congress enacted the Private Securities Litigation Reform Act of 1995 (the "Reform Act") in December 1995 to provide "protections to discourage frivolous [securities] litigation." H.R., Conf. Rep. No. 104-369, 104th Cong., 1st Sess. at 32 (1995) (Nov. 28, 1995). The Reform Act contains provisions intended to combat certain abusive practices associated with private securities litigation.[2] Yet, as we move into the fourth year since the Reform Act was enacted, the resulting landscape appears very different from the one that Congress envisioned. Studies conducted since the passage of the Reform Act show the following:

<u>Increase in securities class actions in state court</u>
<u>Overall increase in litigation rates</u>
<u>Inconsistent interpretations of the 1995 Reform Act's pleading standard</u>
<u>Long delays in case disposition</u>
<u>Higher defense and settlement costs</u>[3]

Congress recently attempted to counteract some of these effects by changing the legislative history of the Reform Act by adding comments into the legislative history of the Securities Litigation Uniform Standards Act of 1998 (the "Uniform Standards Act") (P.L. 105-353). The goal of the Uniform Standards Act is to prevent certain state private securities class actions alleging fraud from being used to frustrate the goals of the Reform Act. The legislative history of the Uniform Standards Act directs federal courts to interpret the pleading standards of the Reform Act as unchanged from the pre-Reform Act law. Through this mechanism, Congress sought to halt the wave of cases being channeled into state courts and create clarity and consistency in pleading standards.

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[2] Among the abusive practices identified by Congress were: the routine of filing lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process would lead to a plausible cause of action; targeting of deep pocket defendants (accountants, underwriters, and individuals who might have insurance coverage) without regard to their actual culpability; and abuse of the discovery process to impose costs so burdensome that it becomes more economical to settle.

[3] <u>See</u> <u>generally</u> Stanford Securities Litigation Clearinghouse Website http://securities.stanford.edu; <u>see</u> <u>also</u> Joseph A. Grundfest et al., <u>Securities Class Action Litigation in Q1 1998: A Report to NASDQ from the Stanford Law School Securities Class Action Clearinghouse</u> 1070 PLI/Corp 71 (June 2, 1998).

This outline addresses four aspects of the cases being litigated under the Reform Act: (1) requirements for pleading facts sufficient to raise a "strong inference" of scienter; (2) pleading misrepresentations with particularity; (3) the safe harbor for forward-looking statements; and (4) the "limited" discovery rules and their effect on securities litigation. Additionally, the outline examines key provisions of the Uniform Standards Act.

II. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

A. Pleading Scienter Under The Reform Act

1. **The Reform Act Language:** The Reform Act purported to clarify the allegations necessary to satisfy the scienter element of a securities fraud claim. It provides:

> Required State of Mind: In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. S78u-4(b)(2)

2. **A Split of Authority Developed on the Pleading Standard**

(a) **Pre-Reform Act split on the definition of recklessness:** Prior to the enactment of the Reform Act, lower courts held that "recklessness" was a permissible basis for pleading scienter -- an issue the Supreme Court had previously reserved when it decided that negligent conduct alone could not create liability in § 10(b) and Rule 10(b)(5) causes of action. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976). After the Hochfelder decision, lower courts held that recklessness was sufficient to cause liability, but they were not in agreement with respect to the definition of recklessness. As discussed below, this issue has been revisited in the cases interpreting the heightened pleading requirements of the Reform Act.

(b) **The Second Circuit standard before the Reform Act:** Before the Reform Act, the Second Circuit standard was widely regarded as imposing the toughest pleading standard on plaintiffs, and it was this standard that many believe was codified by the Reform Act. The pre-Reform Act standard in the Second Circuit required that the facts alleged in the complaint give rise to a "strong inference of fraudulent intent." In re Time Warner, Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993) citing O'Brien v. Nat'l Property Analysts Partners, 936 F.2d 674, 676 (F.2d Cir. 1991) (internal quotations omitted). Two tests were established by the

Second Circuit under which a plaintiff might plead "scienter" without direct knowledge of the defendants' state of mind:

(i) The "motive and opportunity" test under which plaintiffs could plead scienter by alleging facts demonstrating both motive and opportunity to commit fraud. In re Time Warner, Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993).

(ii) The "strong circumstantial evidence" test under which plaintiffs could plead scienter by alleging facts constituting circumstantial evidence of either reckless or conscious behavior. Id.

(c) **Three interpretations of the Reform Act's pleading standard:** Since the enactment of the Reform Act, courts have struggled to interpret the appropriate pleading standard. The courts are split over whether the Reform Act should be read to codify the Second Circuit standard or raise the pleading standard further. Generally, the district and circuit courts have adopted one of three approaches: (1) they have treated the Reform Act as having codified the previous standards in effect in the Second Circuit; (2) they have modified the Second Circuit standard holding that the Reform Act adopted a pleading standard more stringent than that of the Second Circuit, but that some form of recklessness remains a substantive basis for pleading scienter; and (3) they have wholly departed from the Second Circuit standard, holding that Congress intended to include only complaints that contain strong circumstantial evidence of "heightened recklessness."

3. **Recent Case Law**

(a) **Cases carrying over the existing Second Circuit Standard:** The Second, Third, and Fifth Circuits have interpreted the Reform Act pleading standards as carrying over the standard in effect in the Second Circuit at the time the Reform Act was enacted. See Williams v. WMX Tech. Inc., 12 F.3d 175 (5th Cir. 1997); In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999); Press v. Chemical Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999). See also, Epstein v. Itron Inc., 993 F. Supp. 1314 (E.D. Wash. 1998); Robertson v. Strassner, 32 F. Supp. 2d 443, 447 (S.D. Tex. 1998); In re Wellcare Management Group, Inc. Sec. Litig., 964 F. Supp. 632 (N.D.N.Y.1997).

(i) In Press, the court found that the complaint's motive-and-opportunity allegations were sufficient. The court articulated its reluctance to raise the bar for pleadings further:

> [W]e are not inclined to create a nearly impossible pleading standard when the 'intent' of a corporation is at issue.... [A heightened requirement of motive] would make virtually impossible a plaintiff's ability to plead scienter in a financial transaction involving a corporation, institution, bank or the like that did not involve specifically greedy comments from an authorized corporate individual.

Press, 166 F.3d at 538.

(ii) In Advanta, the Third Circuit concluded that the Reform Act's pleading standard is approximately equal to the Second Circuit's old standard, but the court pointed out that the "with particularity" provision represented a difference. Therefore, even though the scienter requirement itself remains unchanged, the "particularity" provision raises the bar for plaintiffs over the standard of pre-Reform Act law. See Advanta, 180 F.3d at 534. "Motive and opportunity, like all other allegations of scienter (intentional, conscious, or reckless behavior), must now be supported by facts stated 'with particularity' and must give a 'strong inference' of scienter." Id. at 535 (citations omitted).

(b) **Cases modifying the Second Circuit standard to hold that allegations of intent without more will not give rise to a presumption of intent:** The second line of cases (arising in the First, Sixth and Eleventh Circuits) has modified the Second Circuit standard, rejecting the sufficiency of allegations of mere motive and opportunity, but accepting as well-pleaded, a complaint that alleges strong circumstantial evidence of recklessness. See In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999); Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999); Bryant v. Avado Brands, Inc., 187 F.3d 1271 (11th Cir. 1999).

(i) Acknowledging disagreement with Advanta, the Sixth Circuit in Comshare wrote, "[W]e cannot agree that under the [Reform Act], plaintiffs may establish a 'strong inference' of scienter merely by alleging facts demonstrating motive and opportunity where those facts do not simultaneously establish that the defendants acted recklessly or knowingly, or with the requisite state of mind." Comshare, 183 F.3d at 551.

(ii) Recently, the First Circuit expressly stated that its view of the issue tracks that of the Sixth Circuit. Greebel, 194

F.3d at 197. The court found the legislative history inconclusive on whether the Reform Act was meant to embody or reject the Second Circuit's pleading standard. Id. at 195. The court held:

> Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6). Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and "strong" inferences.

Id. at 195-96 (citation omitted). The Court further commented that:

> In the guise of tinkering with procedural requirements, Congress has effectively, for policy reasons, made it substantively harder for plaintiffs to bring securities fraud cases, through the "strong inference" of scienter requirement.

Id. at 196 n. 9.

(iii) The Eleventh Circuit recently also adopted this middle-of-the-road approach. Bryant, 187 F.3d at 1283. The court held that "the Reform Act does not prohibit the practice of alleging scienter by pleading facts that denote severe recklessness, the standard previously approved of by this Circuit; but we also hold that the Reform Act does not codify the 'motive and opportunity' test formulated by the Second Circuit." Id.

(c) **Cases Rejecting the Second Circuit Standard and Requiring a New Higher Standard:** A third line of cases, led by a divided Ninth Circuit panel in In re Silicon Graphics Sec. Litig., 183 F.3d 970 (9th Cir. 1999), applies the most stringent pleading standard. The Ninth Circuit held that to raise a "strong inference" of intent, not only are allegations of motive and opportunity insufficient, but circumstantial evidence of "mere recklessness" is also insufficient. Id. at 974. Although the Ninth Circuit's requirement of "heightened recklessness" seems to constitute a substantive change in the law of scienter, the court did not phrase it as such. The court pointed to a distinction between a "reasonable inference" and the Reform Act's "strong inference," saying,

> We hold that although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness. In order to show a strong inference of deliberate recklessness, plaintiffs must state facts that come closer to demonstrating intent as opposed to mere motive and opportunity. Accordingly, we hold that particular facts giving rise to a strong inference of deliberate recklessness, at a minimum, is required to satisfy the heightened pleading standard under the [Reform Act].

Id. See also Voit v. Wonderware Corp., 977 F. Supp. 363 (E.D. Pa. 1997); Powers v. Eichen, 977 F. Supp. 1031 (S.D. Cal.1997); Friedberg v. Discreet Logic Inc., 959 F. Supp. 42 (D. Mass. 1997); Norway Venture Corp. v. Converse, Inc., 959 F. Supp. 205, 209 (S.D.N.Y. 1997).

4. **Congress Attempts to Influence Judicial Construction of the Reform Act Through The Legislative History of the Uniform Standards Act:** In 1998, Congress attempted to shed light retrospectively on the legislative intent underlying the Reform Act. In connection with the Uniform Standards Act, the bill's sponsors, the SEC, and the White House agreed to insert language into the legislative history suggesting that the Reform Act did not intend to rule out recklessness as a basis for scienter. (See infra III.B.) As discussed below, the courts are divided over the weight to be given to this post hoc addition to the "legislative history" of the Reform Act.

B. Pleading Misleading Statements With Particularity

1. **The Reform Act Language:** Although Federal Rule of Civil Procedure 9(b) already requires particularity in pleading fraud claims, the Reform Act addressed claims made on "information and belief" against individual officers and directors, and on claims requiring heightened pleading of scienter (discussed above). The Reform Act states:

> Misleading statements and omissions: In any private action arising under this chapter in which the plaintiff alleges that the defendant-- (A) made an untrue statement of a material fact; or (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, ... and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1).

2. **Pre-Reform Act Interpretations:** Similar to the Reform Act language, prior to the Reform Act, the Ninth Circuit had required that plaintiffs not only identify the allegedly false and misleading statements, but also that the complaint explain why the statements were misleading. See, e.g., In re GlenFed Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir. 1994); see also Queen Uno L.P. v. D'Alene Mines Corp., 2 F. Supp. 2d 1345, 1353 (D. Colo. 1998) (Reform Act is in large part a codification of preexisting 10th Circuit law). However, some cases viewed the standard as "relaxed" where the facts were particularly within defendants' control, despite the fact that Rule 9(b) requires that facts based on information and belief set forth the basis for the belief. See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1417-18 (3d Cir. 1997); Vento & Co. v. Metromedia Fiber Network, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 90,460, at 92,160 (S.D.N.Y. Mar. 18, 1999).

3. **Since the Reform Act was Enacted, Many Courts Continue to Accept the "Relaxed" Standard** even though many commentators believe that the Reform Act called for a heightened standard.[4] See, e.g., Queen Uno Ltd., 2 F. Supp. 2d at 1354 ("Although Plaintiffs could have stated they were seeking to plead on information and belief, and consequently sought entitlement to an assumed relaxation of the Reform Act's particularity requirements, they have not done so"); Howard Gunty Profit Sharing Plan v. Quantum Corp., No. 96 20711 SW, 1997 WL 514993, at *3 (N.D. Cal. Aug. 14, 1997) ("Because Plaintiffs' allegations [based on 'investigation of counsel'] are not based on information and belief, the Court will not relax the pleading requirements of Rule 9(b)").

    (a) **Pleading on "information and belief" since the Reform Act:** Some courts have adopted a very narrow reading of the Reform Act, holding that a complaint is not pleaded on "information and belief" unless the plaintiff expressly says so. See, e.g., Howard Gunty Profit Sharing Plan v. Quantum Corp., No. 96 20711 SW, slip op. at 8 (N.D. Cal. Apr. 6, 1998). Others courts have taken a broader approach, holding that if facts are not pleaded as within the plaintiff's personal knowledge, they necessarily are pleaded on "information and belief." See, e.g., In re Boston Tech. Inc. Sec. Litig., 8 F. Supp. 2d 43, 53 (D. Mass. 1998) (referring to pleading on information and belief "either explicitly or implicitly"); Chan v. Orthologic Corp., No. 96-Civ-1514 PHX RCV, 1998 WL 1018624 at *16 (D. Ariz. Feb. 5, 1998) (requiring specific statement of sources underlying allegations pertaining to meeting where "Plaintiffs have no apparent first-hand knowledge of the meeting").

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4 See e.g., James B. Weidner, 1999 Update -- Pleading Motions under the Reform Act, 1136 PLI/Corp 61 (1999); Jonathan C. Dickey, et al., Developments in Securities Litigation and SEC Enforcement Actions, ALA-ABA Course of Study, July 22, 1999.

(b) **Pleading based on "investigation of counsel":** Discrepancies also exists as to whether statements alleged based on "investigation of counsel" are based on "information and belief." Some courts take the position that any allegations not made on personal knowledge are, by necessity, made on "information and belief." In Havenick v. Network Express, Inc., the court held that "the law now requires a plaintiff to draw a specific nexus between the allegedly fraudulent statements and the facts upon which the allegation of fraud is dependent, or, at least, a clear statement of why and how the plaintiff has reached the conclusion that a particular statement is fraudulent." 981 F. Supp. 480, 526 (E.D. Mich. 1997) (complaint alleged on investigation of counsel). Other courts have held that allegations based on investigation of counsel are not pleaded on information and belief. See, e.g., Queen Uno Ltd., 2 F. Supp. 2d at 1353; Warman v. Overland Data Inc., No. 97CV833 JM, 1998 WL 110018, at *3 (S.D. Cal. Feb. 20, 1998); Schlagel v. Learning Tree Int'l, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,403, at 91,814 n.4 (C.D. Cal. Dec. 23, 1998); Howard Gunty, 1997 WL 514993, at *3.

(c) **Importance of the interpretation:** If plaintiffs are required to set forth the basis for their fraud allegations, the lack of factual support for many allegations would be readily apparent, exposing such allegations (particularly scienter allegations) as little more than plaintiffs' own guesswork -- and subject, therefore, to a Rule 12(b)(6) motion to dismiss. (This, in turn, itself, has important ramifications. See infra II.B.5) Moreover, a very strict reading of the information and belief pleading standard would require plaintiffs to divulge confidential sources, such as former employees or consultants, which plaintiffs may be quite reluctant to do. One trial court held that plaintiffs must name sources when pleading on information and belief. See Lirette v. Shiva Corp., 999 F. Supp. 164, 165 (D. Mass. 1998) (dismissing complaint and requiring plaintiffs to "specify, as to each particular allegation (i.e., every sentence or clause separated by a comma or conjunction), whether that allegation is made upon information and belief or is supported by some document or statement on personal knowledge by a potential witness" and explaining that, "[a]s to statements made upon information and belief, the Court will assure that the factual averments set out 'with particularity all the facts upon which the belief is formed' "). Another court reached the opposite conclusion. In re Digi Int'l Sec. Litig., 6 F. Supp. 2d 1089, 1096-97 (D. Minn. 1998) (holding that pleading on information and belief does not require disclosure of underlying evidence).

4. **The "Group Published" Pleading Doctrine:** Prior to the Reform Act, the group-published doctrine essentially replaced the particularity requirements of Rule 9(b) with a presumption that information contained in certain documents, such as prospectuses, registration statements, annual reports, and SEC filings,

was part of a collective work. A plaintiff invoking the group-published doctrine did not need to attribute an allegedly false or misleading statement directly to a defendant, but instead only had to allege that the defendant "either participated in the day-to-day corporate activities or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times." See, e.g., Allison v. Brooktree Corp., 999 F. Supp. 1342, 1350 (S.D. Cal. 1998) (quoting In re GlenFed, Inc., 60 F.3d 591, 593 (9th Cir. 1995)).

(a) **Some Post-Reform Act courts hold the group-published doctrine abolished:** Since the enactment of the Reform Act, some courts have held that the group-published doctrine is no longer valid, noting that the Reform Act requires a plaintiff to make specific allegations as to each defendant. See, e.g., Mara v. Tele-Save Holdings, Inc., 1999 WL 317103 (E.D. Pa. May 18, 1999) (concluding that the presumptions inherent in group pleading are inconsistent with the Reform Act's purposes); Allison v. Brooktree Corp., 999 F. Supp. at 1350 ("To permit a judicial presumption as to particularity simply cannot be reconciled with the statutory mandate that plaintiffs must plead specific facts as to each act or omission by the defendant").

(b) **Some Post-Reform Act courts continue to apply the doctrine:** Other courts continue to apply the group-published doctrine to sustain complaints that do not specify the precise connection between a defendant and the alleged misstatement or omission. In re Bankamerica Corp. Sec. Litig.,1999 WL 1211839 (E.D. Mo. Dec. 15, 1999) (holding that the doctrine has nothing to do with scienter; rather, it is a rebuttable presumption that the contents of certain documents are attributable to officers and directors, which is not inconsistent with the Reform Act); Schlagel, ¶ 90,403, at 91,815-16 (leaving it up to defendants to identify which executives made which statements); accord, e.g., In re Digi Int'l Sec. Litig., 6 F. Supp. 2d at 1101; Zuckerman v. Foxmeyer Health Corp., 4 F. Supp. 2d 618, 622 (N.D. Tex. 1998); Robertson v. Strassner, 32 F. Supp. 2d 443, 446 (S.D. Tex. 1998); In re Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1108 (D. Nev. 1998).

(c) **Some Post-Reform Act courts apply a modified doctrine:** Still other courts have applied a modified group-published doctrine requiring plaintiffs to plead with particularity defendants' participation in the day-to-day control of the corporation and their participation in the preparation of the allegedly false statements. In re Oak Tech. Sec. Litig., No. 96-20552 SW, 1997 WL 448168, at *10-11 (N.D. Cal. July 1, 1997)); Molinari v. Symantec Corp., No. C-97-20021 JW, 1998 WL 78120, at * 10-11 (N.D. Cal. Feb. 17, 1998).

5. **What Evidence The Court May Consider On Motions to Dismiss:** Prior to the Reform Act, most courts held that it was proper to consider copies of

documents specifically mentioned in the complaint, such as 10-Qs, press releases, analyst reports, etc. Although the Reform Act does not address this subject, following the enactment of the Reform Act, defendants have sought to have other items considered at the pleadings stage, such as Form 4's reflecting defendants' trading, stock price data, proxy statements showing total holdings by defendants, transcripts of analyst conference calls, etc.

(a) **Judicial notice of SEC filings:** Recently, in Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1275-76 (11th Cir. 1999), the Eleventh Circuit reversed the trial court grant of a motion to strike exhibits because defendants included matters outside the pleadings. Included among the documents that the court held were improperly stricken were Form 4s. Id. at 1275 n. 5 The court held that it may judicially notice documents that are required to be and actually are filed with the SEC, and that such action is consistent with the aim of the Reform Act -- to curb abusive securities litigation. Id. at 1278 (noting that an important component of achieving Congress' goal is to structure litigation to permit dismissal at the earliest feasible stage of litigation).

(b) Trial courts have also allowed documents referenced in the complaint to be considered. In Plevy v. Haggerty, 38 F. Supp. 2d 816, 820-21 (C.D. Cal. 1998), the court considered a variety of SEC filings, press releases, etc., on the grounds that they were generally averred to have been part of the plaintiff's "basis of allegations." In Polk v. Fritz, No. C-96-2712 MHP, slip op. at 4 (N.D. Cal. Mar. 5, 1998), the court agreed to consider auditors' workpapers. See Rhodes v. Omega Research, Inc., 38 F. Supp. 2d 1353, 1358 n.6 (S.D. Fla. 1999) (judicial notice of newspaper articles not cited in complaint proper).

C. The Safe Harbor For Forward-Looking Statements

1. Background

(a) **SEC attempts to encourage publication of forward-looking statements:** Rule 175 of the Securities Act of 1933 (the "1933 Act") and Rule 3b-6 of the Securities Exchange Act of 1934 ("1934 Act") created a safe harbor protection for certain specific forward-looking statements. These rules, which applied only to statements made, reaffirmed or later published in documents filed with the SEC, added additional pleading and proof burdens, and shielded defendants from securities claims where the forward-looking statements were made in good faith and with a reasonable basis. Although the issuer was not required to state the assumptions underlying the covered statements, the assumptions, if stated, would also fall within the scope of the safe harbor. See SEC Securities Act Release No. 33-6084, 44 F.R. 33810 (June 25, 1979). Nevertheless, issuers were reluctant to take advantage of the safe harbor, and the rules did not spur the quantity or quality of forward-looking disclosures that the SEC had desired.

(b) **"The bespeaks caution" doctrine:** The judicially-created "bespeaks caution" doctrine provided issuers with additional protection against securities claims based on allegedly false and misleading forward-looking statements. The doctrine holds that certain types of predictions may be rendered immaterial as a matter of law if accompanied by appropriately specific cautionary language. As articulated by the Ninth Circuit in 1994, "the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance." In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir. 1994); In re Boeing Sec. Litig., 40 F. Supp. 2d 1160, 1169-72 (W.D. Wash. 1998). The doctrine has been widely accepted in the courts. See, e.g., Parnes v. Gateway 2000, Inc., 122 F.3d 539, 548 (8th Cir. 1997); Grossman v. Novell, 120 F.3d 1112, 1121 (10th Cir. 1997); Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 5 (2d Cir. 1996); Rubenstein v. Collins, 20 F.3d 160, 166-68 (5th Cir. 1994); In re Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 364, 371-73 (3d Cir. 1993); Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991); Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1040-41 (6th Cir. 1991); Rhodes v. Omega Research, Inc., 38 F. Supp. 2d 1353, 1363-1364 (S.D. Fla. 1999).

(i) Although courts have widely accepted the "bespeaks caution" doctrine, they have differed in the extent to which they take into account the defendant's good faith or reasonable belief in the truth of the statement. Thus, for example, in In re Donald J. Trump Casino Securities Litigation, 7 F.3d at 372, the court affirmed the District Court's dismissal of an action based on the "abundant and meaningful cautionary language contained in the prospectus." See also Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1033 (2d Cir. 1993) (holding an investor's recklessness may preclude recovery for false and misleading statements and declining to impose liability for allegedly false and misleading oral statements where prospectus and partnership brochure disclosed the risks of the venture). In contrast, in Mayer v. Mylod, 988 F.2d 635, 639-41 (6th Cir. 1993), the court held that an action should not have been dismissed based solely on the presence of cautionary statements because "[m]aterial statements which contain the speaker's opinion are actionable under Section 10(b) of the ... Exchange Act if the speaker does not believe the opinion and the opinion is not factually well-grounded." See also Rubenstein v. Collins, 20 F.3d 160, 168 (5th

Cir. 1994) ("The appropriate inquiry is whether, under all the circumstances, the omitted fact or the prediction without a reasonable basis 'is one [that] a reasonable investor would consider significant in [making] the decision to invest, such that it alters the total mix of information available about the proposed investment'").

(ii) Variation also exists as to how closely the cautionary language must correlate to the challenged forward-looking statement in order to "bespeak caution." Some courts required that the cautionary statements be "substantive and tailored to the specific future projections, estimates or opinions" challenged by plaintiffs. E.g., Kline v. First Western Government Securities, Inc., 24 F.3d 480, 489 (3d Cir.). Others took a broader view, holding that cautionary statements in one document may shield forward-looking statements in other documents. E.g., Grossman v. Novell, 120 F.3d at 1121. The Ninth Circuit has drawn a distinction between the "bespeaks caution" doctrine and the "truth-on-the-market" defense, noting that truth-on-the-market requires the disclosed information to have entered the market in such a way as to "counterbalance" the alleged misstatements, whereas the "bespeaks caution" doctrine focuses on whether cautionary language in a particular document is sufficient to render the "total mix of information" not misleading. See Provenz v. Miller, 102 F.3d 1478, 1492-93 (9th Cir. 1996).

2. **The Statutory Safe Harbor Under the Reform Act:** Congress included as part of the Reform Act a statutory safe harbor for certain forward-looking statements. By reducing the threat of liability, Congress sought to increase the quantity and quality of forward-looking information disseminated to investors. See H.R. Rep. No. 105-369, 104th Cong., 1st Sess. at 43 (Joint Explanatory Statement Of The Committee Of Conference) (Nov. 28, 1995).

(a) **The safe harbor codifies parts of the "bespeaks caution" doctrine** (Conference Report at 43), and immunizes forward-looking statements that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially ...." 15 U.S.C. S 78u-5(c)(1)(A)(i).

(b) **Under the safe harbor, oral statements may also qualify for protection** if they (1) identify the statement as forward-looking; (2) state that actual results could differ materially; and (3) identify a "readily available" written document containing additional factors that could cause results to differ materially from the forward-looking statement. 15 U.S.C. S 78u-5(b)(2).

(c) **No duty to update:** The safe harbor expressly disclaims imposing any duty to update any forward-looking statements. 15 U.S.C. S 78u- 5(d). There may, however, be a duty to update if a statement's terms imply continuing validity, but subsequent events render the initial statement false or materially misleading. See, e.g., Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990) (en banc).

(d) **Recent Cases**

(i) Courts applying the statutory safe harbor have indicated that a company need not identify "all" factors that might affect the validity of a projection, as long as it discloses some of them. See, e.g., Rasheedi v. Cree Research, Inc., No. 1:96CV000890, 1997 WL 785720, at *1-*2 (M.D.N.C. Oct. 17, 1997). Many courts have applied the safe harbor to dismiss claims based on allegedly false or misleading forward-looking statements. See, e.g., P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp., 47 F. Supp. 2d 546, 556-557 (D.N.J. 1999).

(ii) However, as was true under the judicially created "bespeaks caution" doctrine, general "boilerplate" warnings will not suffice to immunize a forward-looking statement. See, e.g., Harris v. IVAX Corp., 998 F. Supp. 1449, 1454 (S.D. Fla. 1998), aff'd, 182 F.3d 799 (11th Cir. 1999). Thus, in several Reform Act cases, trial courts have denied motions to dismiss, finding that the cautionary statements were not sufficiently particular. See In re PLC Sys., Inc. Sec. Litig., 41 F. Supp. 2d 106, 121 (D. Mass. 1999); In re Stratosphere Sec. Litig., 1 F. Supp. 2d 1096, 1117-18 (D. Nev. 1998); In re Employee Solutions Sec. Litig., No. CIV 97 545 PHX RGS, 1998 WL 1031506, at *4-*5 (D. Ariz. Sept. 22, 1998); In re Boeing Securities Litigation, 1998 WL 1012783, at *6-7.

(iii) A few courts have held that claims based on forward-looking statements should be dismissed for failure to allege "actual knowledge." See, e.g., Hockey v. Medhekar, No. C-96-0815, 1997 WL 203704, at *9-*10 (N.D. Cal. Apr. 15, 1997); In re Advanta Corp. Sec. Litig., No. 97-CV-4343, 1998 WL 387595, at *8 (E.D. Pa. July 9, 1998), aff'd, 180 F.3d 525 (3d Cir. 1999).

3. **Impact of the Safe Harbor:** The prevailing view thus far has been that the statutory safe harbor has not had the desired effect of increasing the quantity or quality of published forward-looking information. See Committee on Securities Regulation, Forward-Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act, The Record, Vol. 53, No. 6 at 726 (Nov/Dec. 1998) (citation omitted).

   (a) **Quantity of information:** Although issuers appear to be relying on the safe harbor in making oral statements, it seems that companies are continuing to rely on such oral statements in communicating to analysts and institutional investors, thereby taking advantage of the ability to cross-reference published risk disclosures to immunize their oral statements, but not making significant additional written disclosure. The ease of shielding oral statements minimizes the incentives for companies to make written forward-looking statements, as there is no institutional pressure to do so. A recent study has concluded that there was "no meaningful change in the nature or extent of written forward-looking statements" as a result of the Reform Act. Id. at 736.

   (b) **Quality of information:** The SEC has criticized the cautionary language used in various disclosure documents as "boilerplate" and overly general, and has indicated a desire to see companies provide more forward-looking information and improve the quality of the cautionary statements. Id. at 728. Many companies continue to be reluctant to disclose extensive forward-looking information because of confusion in the courts as to what constitutes "meaningful" cautionary statements sufficient to immunize a forward-looking statement. Because the Reform Act codified a version of the "bespeaks caution" doctrine, courts may rely on pre-Reform Act precedent, which, as described above, imposed varying standards of what types of warnings are sufficient to immunize a predictive statement. Also, the safe harbor does not apply to actions brought by the SEC, leaving companies open to enforcement actions. Moreover, the Reform Act applies only to federal claims, so issuers remained subject to liability under state law.

D. Discovery Limitations Imposed By The Reform Act

1. **Reform Act language:** The Reform Act provides for a stay of discovery until after pending motions to dismiss or other challenges to the sufficiency of the complaint are decided. Specifically, the Reform Act provides:

   > Stay of discovery; preservation of evidence
   >
   > (1) In general In any private action arising under this subchapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is

necessary to preserve evidence or to prevent undue prejudice to that party.

(2) Preservation of evidence During the pendency of any stay of discovery pursuant to this subsection, unless otherwise ordered by the court, any party to the action with actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.

(3) Sanctions for willful violation A party aggrieved by the willful failure of an opposing party to comply with paragraph (2) may apply to the court for an order awarding appropriate sanctions.

15 U.S.C. S 77z-1(b).

2. Since the Reform Act was enacted, plaintiffs have sought relief from the discovery stay provisions; however, most of these efforts have been denied. See e.g., Powers v. Eichen, 961 F. Supp. 233 (S.D. Cal. 1997) (staying all discovery during the pendency of a motion for reconsideration); Novak v. Kasaks, C.A. No. 96 CIV 3073, 1996 WL 467534 (S.D.N.Y. Aug. 16, 1996); In re Trump Hotel Shareholder Derivative Litig., No. 96 CIV 7820, 1997 WL 442135 (S.D.N.Y. Aug 5, 1997) (finding that stay apples to all Exchange claims including § 14(a) claim alleged in complaint with a derivative claim).

(a) In Hockey v. Medhekar, 932 F. Supp. 249 (N.D. Cal. 1996), the court granted the plaintiffs' motion for some discovery. The court ruled that the plaintiffs were entitled to the "automatic disclosures" required under Federal Rule of Civil Procedure 26. Id. The Ninth Circuit reversed the lower court, holding that any discovery is unavailable until after the resolution of motions to dismiss because Congress intended to prevent plaintiffs from filing first and then searching for evidence to support their claims. Medhekar v. United States Dist. Court, 99 F.3d 325 (9th Cir. 1996).

(b) Although the discovery-stay provision states that discovery may be granted on a showing of "undue prejudice," the standard is difficult to meet.

(i) In SG Cowen Securities Corp. v. United States Dist. Court, 189 F.3d 909 (9th Cir. 1999), the court reversed the lower court's grant of limited discovery where the plaintiffs claimed failure to allow the discovery would result in "undue prejudice." The court held that "[d]istilled to its essence, the district court granted plaintiffs leave to conduct discovery so that they might uncover facts sufficient to satisfy the [Reform] Act's pleading requirements. This is not a permissible reason for lifting the discovery stay under the Act." Id. at 912. The court further held that the Reform Act "clearly contemplates that 'discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint.'" Id. at 912-13.

(ii) A similar result has been reached in many other courts. See, e.g., Mishkin v. Ageloff, 220 B.R. 784, 793 (S.D.N.Y. 1998) (finding "particularized discovery" requirement linked to both undue-prejudice and preservation-of-evidence exceptions to stay); Powers v. Eichen, 961 F. Supp. 233, 234-36 (S.D. Cal. 1997) (construing statutory term "pendency" broadly to prohibit discovery during district court's determination on motion to dismiss, any motions for reconsideration, and any interlocutory appeal, noting that if plaintiffs wanted to plead prejudice due to lack of discovery, they had to point to "particular circumstances or evidence"); Medical Imaging Ctrs. of Am., Inc. v. Lichtenstein, 917 F. Supp. 717, 721 (S.D. Cal. 1996) (noting "destruction" language refers primarily to possible death of witness, and undue prejudice standard requires a plaintiff to establish "unique" need for discovery); Novak v. Kasaks, 99 CIV 3073, 1996 WL 467534, at *1 (S.D.N.Y. Aug. 16, 1996) (staying discovery where plaintiffs failed to demonstrate exceptional circumstances to justify exception; noting that plaintiffs must demonstrate "great risk" of loss of highly relevant evidence or "undue prejudice").

(iii) Yet some plaintiffs have met the standard. See Nager v. Websecure, Inc. (In re Websecure, Inc. Sec. Litig.), 1997 WL 773717 (D. Mass. Nov. 26, 1997) (granting expedited discovery where plaintiffs made a "particularized" request on issues of use of initial public offering proceeds and company's business plans and prospects and, given preliminary injunction request and bankruptcy context, plaintiffs met "undue prejudice" test).

III. THE SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

On November 3, 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998 (P.L. 105-353) ("Uniform Standards Act"). The Uniform Standards Act sought to correct the shift of securities class action litigation from federal to state courts caused by the heightened pleading standards and discovery restrictions in federal court instituted by the Reform Act. *See* 105 P.L. 353, § 2 (Findings).

A. Key Provisions Of The Uniform Standards Act

1. **Federal Preemption of Claims Arising Under State Law:** The Uniform Standards Act amends the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") to prohibit class actions brought under state law in either federal or state court by any private party alleging (1) "an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security;" or (2) "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." *See 105* P.L. 353 § I 0 1 (amending Section 16 of the 1933 Act and Section 28 of the 1934 Act).

   (a) **Exclusions from preemption:**

   (i) The Uniform Standards Act preemption provisions exclude class actions brought under the law of the state of incorporation and involving either (1) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or (2) any recommendation, position, or other communication with respect to the sale of securities of the issuer that is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer and that concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights. 105 P.L. 353 § 101. Known as the "Delaware carve out," this exclusion is designed to preserve remedies available under Delaware law.

   (ii) The Uniform Standards Act preemption provisions also do not apply to actions brought by states, political subdivisions thereof, or state pension plans, either on their own behalf or as members of a class comprised solely of other states, political subdivisions or state pension plans. 105 P.L. § 101.

(iii) Also excluded are actions brought under contractual agreements between issuers and indenture trustees. 105 P.L. 353 § 101.

(iv) The Uniform Standards Act preserves the jurisdiction of the securities commission (or agency or office performing similar functions) of any state under the laws of such state to investigate and bring securities enforcement actions.

2. **Removal:** The Uniform Standards Act provides defendants with an absolute right to remove to federal court "any covered class action brought in any State court involving a covered security." A "covered security" is defined to include securities that satisfy the standards for a covered security under paragraph 18(b)(1) or 18(b)(2) of the 1933 Act; that is, securities listed on NYSE, NASDAQ and other national exchanges with similar listing standards, as well as securities senior to such securities.

3. **Definition of "Covered Class Action":** The Uniform Standards Act broadens the definition of a class action to include (1) any action, brought on behalf of 50 or more persons or prospective class members, in which questions of law and fact exist that are common to those persons, and those questions predominate over questions pertaining to only individuals; (2) any action in which one or more parties seeks to recover damages on behalf of themselves and other unnamed parties similarly situated in which questions of law and fact common to those persons predominate over questions affecting only individuals; (3) any group of lawsuits filed or pending in the same court and involving common questions of law or fact, in which damages are sought on behalf of more than 50 persons and the lawsuits are joined, consolidated or otherwise proceed as a single action for any purpose. 105 P.L. § IO1 . "Covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

4. **Remand:** Actions removed to federal court shall be remanded to state court if the federal court determines that the action may be maintained in state court. 15 U.S.C. § 78bb(f)(3)(A)(ii). See Derdiger v. Tallman, 75 F. Supp. 2d 322, 324 (D. Del. 1999) (remanding to the Delaware Court of Chancery where plaintiff contended that defendant committed equitable fraud that involved communications to stockholders in connection with a vote on the merger agreement).

5. **Discovery:** Recognizing that plaintiffs' class-action lawyers frequently pursue "parallel litigation between state and federal courts in an apparent effort to avoid the federal discovery stay or other provisions of [the Reform Act]" (see Joint Explanatory Statement of the Committee of Conference, S. 1260, 104th Cong., 2d Sess., Cong. Rec. H10774 (daily ed. Oct 13, 1998)), the Uniform Standards Act provides that upon a proper showing, a federal court may stay discovery

proceedings in any private securities action in a state court, "as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery." Thus defendants sued in both state and federal courts may now seek an order from the federal court staying discovery in the state court proceedings. (See infra III.C.3)

6. **Elimination of Concurrent Jurisdiction Over 1933 Act Claims:** The Uniform Standards Act eliminates state court jurisdiction over claims brought pursuant to the 1933 Act, creating exclusive federal jurisdiction over 1933 Act claims.

B. Pleading Standards Under The 1998 Act

1. **The Joint Explanatory Statement Submitted for Publication with the Conference Report to the 1998 Act (S. 1260)** attempts to clarify -- retrospectively -- Congressional intent in passing the 1995 Act with respect to the pleading standards for scienter. The statement reads, in part:

> It is the clear understanding of the managers that Congress did not, in adopting the Reform Act, intend to alter the standards of liability under the Exchange Act.
>
> The managers understand, however, that certain Federal district courts have interpreted the Reform Act as having altered the scienter requirement. In that regard, the managers again emphasize that the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor S. 1260 in any way alters the scienter standard in Federal securities fraud suits.
>
> Additionally, it was the intent of Congress, as was expressly stated during the legislative debate on the Reform Act, and particularly during the debate on overriding the President's veto, that the Reform Act establish a heightened uniform Federal standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the Reform Act itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the state of mind." The managers emphasize that neither the Reform Act nor S. 1260 makes any attempt to define that state of mind.

H.R. Conf. Rep. No. 105-803, 105th Cong., 2d Sess. (1998).

C. Cases Decided Since The Enactment Of The 1998 Uniform Standards Act

1. **Retroactive Legislative History**

(a) In In re Glenayre Technologies, Inc. Securities Litig., No. 96 CIV 8252 (HB), 1998 WL 915907, at *2 n.3 (S.D.N.Y. Dec. 30, 1998) the court rejected plaintiffs' arguments that statements made during the enactment of the 1998 Act established that allegations of motive and opportunity were sufficient to plead scienter, stating that "[t]his contention is without merit since post-enactment legislative history plays no role in statutory interpretation."

(b) The court in Sturm v. Marriot Marquis Corp., 26 F. Supp. 2d 1358 (N.D. Ga. 1998) recognized the legislative history of the Uniform Standards Act as having at least persuasive authority when it held that the Reform Act incorporates the Second Circuit pleading standards. See also Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1338-1339 (N.D. Ga. 1998) (same).

(c) Without regard to whether it could properly consider the Uniform Standards Act, the First Circuit apparently took notice of the Uniform Standards Act but concluded that the legislative history, including the Uniform Standards Act, was unhelpful. Thus, the court in Greebel v. FTP Software, Inc., found that "[t]he legislative history [including the history of the Uniform Standards Act] is inconclusive on whether the [Reform] Act was meant to either embody or to reject the Second Circuit's pleading standards." 195 F.3d 185, 194 (1st Cir. 1999). Citing the Third Circuit opinion in In re Advanta, the court found that "[t]he Reform Act's legislative history on this point is ambiguous and even contradictory." Id.

2. Limited to Prospective Application

(a) The Uniform Standards Act states that its provisions "shall not affect or apply to any action commenced before and pending on the date of enactment of this Act"; that is, November 3, 1998.

(b) In Diamond Multimedia Systems, Inc v Superior Court of Santa Clara County, 968 P.2d 539 (Cal.), cert. denied, 119 S. Ct. 2338 (1999), a class action brought under California securities laws, the Supreme Court of California held that the prohibition in the California code against market manipulation provided a cause of action to out-of-state purchasers and sellers of securities, even if the purchase or sale of securities took place outside of the state of California. The court rejected arguments that pre-1998 Uniform Standards Act law provided for any implied preemption of existing California securities law, noting "except to the extent it has been subsequently modified by the Securities Litigation Uniform Standards Act of 1998, federal law in this arena supplements, but does not displace state regulations and remedies." Id. at 552. With respect to the 1998 Uniform Standards Act, the California court noted that "[i]nsofar as class actions are concerned, recently enacted federal legislation, which is inapplicable to pending actions, may accomplish what defendants urge" by preempting most securities class actions. Id. at 545 n.12. While a dissenting justice argued for implied preemption under pre- Uniform Standards Act law, the majority responded that by allowing pending securities-fraud class actions in state court to continue and leaving individual actions unrestricted, Congress "confirmed the independent force of state securities law. Had Congress believed that its goals could not be accomplished if suits based on state law were permitted or that any conflict between state and federal law existed, all actions based on state law, not simply class actions, would have been banned." Id.

3. **Discovery:** By its terms, the discovery provision might be applied to individual actions as well as class actions. But after an exhaustive review of the Act's legislative history, the first court to consider the issue has held that it should be applied to class actions only. In re Transcrypt Int'l Sec. Litig., 57 F. Supp. 2d 836 (D. Neb. 1999).

E-COMMERCE ISSUES

Legal Issues Relating To Internet Securities Offerings

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SECTION H

LEGAL ISSUES RELATING TO INTERNET SECURITIES OFFERINGS

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Legal Issues Relating to Internet Securities Offerings

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I. Free Writing Issues

A. Statutory and Regulatory Provisions

1. Section 5(b)(1) of the Securities Act

Section 5(b)(1) of the Securities Act makes it unlawful

> ". . . to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of Section 10."

Section 10 of the Securities Act sets forth the information required to be included in a preliminary or final prospectus. A Section 10 prospectus is commonly referred to a "statutory prospectus." Prospectuses that do not satisfy the requirements of Section 10 are sometimes referred to as "illegal prospectuses" or "free writings."

A broker-dealer conducting business on the Internet must ensure that the communications on its website are not viewed by the SEC staff as illegal prospectuses in violation of Section 5(b)(1).

2. Section 2(10) of the Securities Act

Section 2(10) of the Securities Act defines the term "prospectus" broadly as

> ". . . any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."

Section 2(10) contains two exceptions from the definition of prospectus:

- ***Communications delivered with or after delivery of a final prospectus***

  "... (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of Section 10) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of Section 10 at the time of such communication was sent or given to the person to whom the communication was made.. . ."

- ***Communications authorized by the Commission***

  "... (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of Section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit."

3. Rule 134

a. Exclusion from prospectus definition

Pursuant to the second exception under Section 2(10) quoted above, the Commission in 1955 adopted Rule 134.

Rule 134 provides that the term prospectus

> "... shall not include a notice, circular, advertisement, letter, or other communication published or transmitted to any person after a registration statement has been filed . . ."

if it contains only the statements required or permitted to be included pursuant to Rule 134.

b. Information permitted in a Rule 134 notice

Rule 134(a) sets forth the information permitted in a Rule 134 notice, including the following:

- the name of the issuer;
- the full title of the security;
- the amount being offered;
- a brief indication of the general type of business of the issuer;
- the price of the security, or if the price is not known, the method of its determination or the probable price range;
- the name and address of the sender of the communication and the fact that it is participating in the offering;
- the names of the managing underwriters; and
- the approximate date of the proposed sale to the public.

c. Required disclosures in a Rule 134 notice

Rule 134(b) sets forth three required disclosures:

- A legend that offers to buy cannot be accepted until effectiveness and that the communication is not an offer to sell or the solicitation of an offer to buy in any state where the sale or solicitation would be unlawful.
- A statement whether the security is being offered in a distribution by the issuer or a selling shareholder and whether the issue represents new financing, refunding or both.
- The name and address of a person or persons from whom a Section 10 prospectus may be obtained.

Rule 134(c) provides that the required Rule 134(b) disclosures are not required in a communication:

> "(i) which does no more than state from whom a written prospectus meeting the requirements of Section 10 of the Act may be obtained, identify the security, state the price thereof and sate by whom orders will be executed; or

(ii) which is accompanied or preceded by a prospectus or a summary prospectus which meets the requirements of Section 10 of the Act at the date of such preliminary communication."

Based upon the principles set forth in the Commission's 1995 release on the "Use of Electronic Media for Delivery Purposes" (Rel. No. 33-7233, October 6, 1995), the Rule 134(b) disclosures should not be required in a Rule 134 notice that contains a hyperlink to an electronic preliminary prospectus. However, many issuers and broker-dealers include these disclosures in the Rule 134 notice because they are not difficult to make.

d. Can issuance of Rule 134 notice precede availability of preliminary prospectus?

Although the wording of Rule 134 is unclear, the SEC staff interprets Rule 134(b)(3) as prohibiting the posting of a Rule 134 notice on a website until a preliminary prospectus has been made available on the website.

e. Solicitation of indications of interest and conditional offers to buy

Rule 134(d) provides that written solicitations of indications of interest and conditional offers to buy are not illegal free writings if the following disclosure is provided in the solicitation:

> No offers to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date. An indication of interest in response to this advertisement will involve no obligation or commitment of any kind."

Part III below discusses the legality of soliciting indications of interest and conditional offers to buy under Section 5(a) of the Securities Act, which prohibits sales prior to effectiveness.

4. Section 2(9) of the Securities Act - electronic communications are treated as written communications

Under Section 2(9) of the Securities Act, the term "written" includes "printed, lithographed, or any means of graphic communication." "Graphic communication" is understood to include "magnetic impulses or other forms of computer data compilation." See, for example, Rule 405 under the Securities Act.

B. Free Writing Problem for Internet Offerings

The use of the Internet to offer and sell securities in public offerings presents free writing concerns. All communications on an issuer's or a broker-dealer's website are potentially illegal free writings.

Free writing is a greater concern for an Internet broker-dealer than for a broker-dealer that solicits and communicates with its customers by telephone. The term prospectus covers writings, which include electronic communications, but not oral statements, except by radio or television broadcast. As a result, a registered representative at a broker-dealer can telephone his or her customer and make an oral offer during the waiting period without any free writing concerns. In contrast, if an Internet broker-dealer sends its customers an e-mail regarding an offering or posts information on its website regarding an offering, the broker-dealer must be careful that none of this information is deemed to be a "free writing" in violation of Section 5(b)(1).

C. What Written Communications are Free Writings?

1. Does the communication offer or confirm the sale of a security?

Not all written communications are free writings. In analyzing a communication, the key factor is whether the communication "offers any security for sale or confirms the sale of any security."

2. Commission releases on free writing

The Commission has provided guidance on free writing.

In a 1957 release ("Publication of Information Prior to or After the Effective Date of a Registration Statement," Securities Act Release No. 3844 (October 8, 1957)), the Commission attempted to distinguish between disclosures that are intended to relay important business and financial developments and disclosures that are intended to condition the market for an upcoming offering. In the 1957 release the Commission wrote:

> "There has been an increasing tendency, particularly in the period since World War II, to give publicity through many media concerning corporate affairs which goes beyond the statutory requirements. This practice reflects a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments.
>
> This trend should be encouraged."

The 1957 release proceeded to contrast these types of permitted communications with other communications made with the intent to condition the public mind for, or arouse public interest in, an offering. The Commission wrote:

> "It follows from the express language and the legislative history of the Securities Act that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. It apparently is not generally understood, however, that the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.
>
> Nor is it generally understood that the release of publicity and the publication of information between the filing date and the effective date of a registration statement may similarly raise a question whether the publicity is not in fact a selling effort by an illegal means; i.e., other than by means of the statutory prospectus.
>
> . . . .
>
> Instances have come to the attention of the Commission in which information of a misleading character, gross exaggeration and outright falsehood have been published by various means for the purpose of conveying to the public a message designed to stimulate an appetite for securities -- a message which could not properly have been included in a statutory prospectus in conformity with the standards of integrity demanded by the statute."

In a 1969 release ("Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement under the Securities Act of 1933," Securities Act Release No. 5009 (October 7, 1969)), the Commission provided further guidance on this issue. In the 1969 release, the Commission wrote that the

> ". . . flow of normal corporate news, unrelated to a selling effort for an issue of securities is natural, desirable and entirely consistent with the objectives of disclosure to the public which underlies [sic] the federal securities laws."

The Commission further wrote that

> ". . . disclosure of a material event would ordinarily not be subject to restriction under Section 5 of the Securities Act if it is purely factual and does not include predictions or opinions."

D. The Wit Capital No-Action Letter

1. Relief granted and not granted

In the Wit Capital Corporation no-action letter (July 14, 1999), the SEC Staff granted no-action relief for communications on "cul de sacs" that Wit Capital establishes for each offering. The no-action relief did not extend to communications on Wit Capital's general website.

2. Wit Capital's communications

In its request for no-action relief, Wit Capital described the following communications with its customers:

a. E-mail notices

Wit Capital commences the offering process by sending an e-mail notice to its customers notifying them of an upcoming offering. The e-mail notice contains only the information required or permitted under Rule 134.

b. Cul de sacs for each offering

The e-mail notice contains a hyperlink to a separate area of its website that Wit Capital establishes for each offering (a "cul de sac"). Each cul de sac contains:

- a copy of the preliminary prospectus for the offering in electronic format;
- a page for entering conditional offers to buy shares in the offering;
- account opening forms; and
- Wit Capital's rules and procedures for public offerings.

c. Wit Capital's general website

Wit Capital also has a webpage on its general website that lists public offerings. From this page, the viewer can hyperlink to the cul de sac for each offering. A viewer cannot hyperlink from the cul de sac for an offering to Wit Capital's general website.

3. Analysis of Wit Capital's communications

In its request for no-action relief, Wit Capital analyzed these communications as follows:

- The e-mail notices comply with Rule 134.
- The webpage for entering conditional offers is permitted under Rule 134(d).
- The account opening and rules and procedures pages are merely the broker-dealer's operating procedures and, accordingly, should not be deemed free writings.

The establishment of the cul de sac separates the information on the cul de sac from other information on Wit's general website and from information that can be reached by hyperlink from Wit Capital's general website.

4. SEC staff's response to request for no-action relief

In its response, the SEC staff wrote that it would not treat communications on the cul de sac as illegal free writings. However, the SEC staff wrote as follows with respect to communications on Wit Capital's general website:

> "You have not asked, and we do not address, Wit Capital's responsibilities under the federal securities laws to cleanse (or otherwise modify) its general website of any information that could be deemed illegally to condition the market for a particular IPO security. These and other issues arising from the use of electronic communications media in the context of registered and exempt securities offerings (including, but not limited to, those identified in the preceding paragraph) are under consideration, or will be considered, by the Commission."

5. Guidance for other Internet brokers-dealers

Many Internet broker-dealers do not separate out public offering information in cul de sacs. This presents the concern that research and similar information relating to an issuer or the issuer's industry that is readily accessible from the public offering webpages could be deemed to be illegal free writings. As indicated by the SEC staff's response in the Wit Capital no-action letter, the Commission and the SEC staff are still considering this issue. For more information, see the discussion below regarding hyperlinks and the electronic envelope theory.

E. Format of Rule 134 Notices

The traditional Rule 134 notice has taken the format of a tombstone advertisement. Internet broker-dealers have adopted a more "plain english" format for Rule 134 notices. In some cases, particularly for affinity offerings, the Rule 134 notice describes the procedures for participating in a public offering through the broker-dealer. A sample of this type of notice was included as an exhibit to the Wit Capital no-action letter, evidencing the staff's acceptance of this type of communication.

F. Hyperlink Issues and the Electronic Envelope Theory

1. Electronic envelope theory, research and hyperlinks to third-party information providers

The Internet presents difficult free writing issues because of the viewer's ability to navigate among webpages through browsers and hyperlinks. The Commission has attempted to apply the principles that apply to paper communications to electronic communications, but in some cases it is difficult to apply these principles.

In example 16 from the 1995 release, the Commission set forth the electronic envelope theory:

> "(16) Company XYZ places a preliminary prospectus on its Internet Web site and provides direct access via a hyperlink to a research report on the Company written by ABC Corporation, a registered brokerage firm. The investor reviewing the preliminary prospectus can click on a box marked "ABC's research report" and the investor will be linked to the brokerage firm's Web site where the research report is available.
>
> The hyperlink function provides the ability to access information located on another Web site almost instantaneously. This direct and quick access to ABC's research report would be similar to the Company including the paper version of the research report in the same envelope that it is using to mail the paper version of the preliminary prospectus to potential investors. During the waiting period, the Company may make offers only through the use of a preliminary prospectus, whether in paper or electronic format; therefore, its use of the research report under these circumstances would not be permissible."

This example presents a clear case of free writing. However, where the link between the prospectus and the research or similar information is less direct, the analysis becomes more difficult. For example, what if the research or similar information is contained on a third-party website that can be reached by hyperlink from the broker-dealer's website? In its request for no-action relief, Wit Capital argued that the key factor to consider is whether the purpose or reasonably foreseeable effect of the hyperlinks provided by the broker-dealer is, our would be, to lead the customer to illegal free writing information.

One approach that provides some protection is to notify the customer prominently when the customer is exiting the broker-dealer website. A broker-dealer concerned about this issue also should avoid framing the website of the third-party information provider.

2. Rule 134 notices

A Rule 134 notice may contain only the information permitted or required pursuant to Rule 134. If an issuer places a Rule 134 notice on its website, does the notice incorporate the other information on the issuer's website in violation of Rule 134? Based upon the following example from the 1995 release, it should be permissible for an issuer to place a Rule 134 notice on its web site:

> "(18) Company XYZ places a tombstone advertisement complying with Securities Act Rule 134 on its Internet website.
>
> This would be permissible, provided that the advertisement otherwise complies with Rule 134."

Although it is not explicitly stated, the Commission presumably would not allow a Rule 134 notice if the Rule 134 notice contained a hyperlink to illegal free writing, whether on the issuer's or a third-party website.

3. Prospectus on the issuer's or the broker-dealer's website

The 1995 release contemplates that an issuer may include a prospectus on its website. See, for example, examples 3, 4, 6, 7, 9, 12 and 16 (issuer placing a preliminary prospectus on its website), and example 5 (issuer placing all offering documents on its website). The principles that would permit an issuer to place a prospectus on its web site should be equally applicable to permitting a broker-dealer to place a prospectus on its website.

4. Hyperlink from the broker-dealer's website to the issuer's website

A hyperlink from the broker-dealer's website to the issuer's website could present a free writing problem. Why would the broker-dealer provide this hyperlink except to provide information regarding the issuer that is not included in the prospectus?

The exception to this general rule is where the broker-dealer has an independent business purpose in providing a hyperlink to the issuer's website. For example, in an IPO for a company that provides news and research to customers of the broker-dealer (by hyperlink from the broker-dealer's website), the independent purpose for providing the hyperlink would be to continue to make this service available to the broker-dealer's customers.

5. Hyperlink from the issuer's website to the broker-dealer's web site; hyperlink from an e-mail sent by the issuer to the broker-dealer's website

Hyperlinks from the issuer's communications to the broker-dealer's website should not be a problem if the issuer's communications are not illegal free writings. However, when providing this hyperlink, the issuer should review the broker-dealer's website to ensure that there is no illegal free writing on the broker-dealer's website.

6. Banner ads

Banner ads should not contain information that would not be permitted in a Rule 134 notice. The SEC staff has expressed concern regarding banner ads in some offerings, but the Commission's releases do not provide guidance regarding banner ads.

7. Confirmations of Sale

The term "prospectus" includes any written communication that "confirms the sale of any security." This presents a free writing issue for the Internet broker-dealer. The traditional procedure has been for the registered representative to telephone the customer after pricing to confirm the customer's allocation. This procedure does not work for the Internet broker-dealer. Instead, customers of the Internet broker-dealer expect that the broker-dealer will send them a notice after pricing confirming the customer's allocation. However, this presents a free writing concern.

In the Wit Capital no-action letter, the SEC staff granted no-action relief for an e-mail that Wit Capital sends to a customer after pricing notifying the customer of his or her allocation. The e-mail notice indicates that a Rule 10b-10 confirmation will be sent to the customer concurrently with the final prospectus.

G. Aircraft Carrier Release

In the so-called "aircraft carrier release" (Release No. 33-7606A, 63 Fed. Reg. 67174 (December 4, 1998)), the Commission wrote as follows on the issue of free writing:

> "During the waiting period, oral offers may be made without content restrictions other than due to liability concerns. Written offers, however, must have Section 10 contents or they cannot be used. This distinction appears to do little to enhance investor protection or facilitate the capital formation process. One can argue that it creates an incentive for issuers and underwriters to omit information or to provide it in a manner that is not readily available to investors for later reference. …

We believe that the waiting period should be a time of open dialogue between the registrant and its potential investors, provided that the registrant is accountable for the accuracy and completeness of its communications. The medium in which disclosure is made should not be dictated by the regulatory structure but, rather, by the needs of investors."

The Commission has proposed in the aircraft carrier release that issuers and underwriters be entitled to disseminate free writing materials (i.e., materials that would otherwise be deemed illegal prospectuses), subject to the following conditions:

- the free writing materials would have to include a prominent legend advising investors to read the other disclosure documents filed with the Commission;
- to reduce selective disclosure, the free writing materials would have to be filed with the Commission; and
- the free writing materials would be subject to Section 12(a)(2) of the Securities Act (see discussion in Part II below).

H. Affinity Offerings

In many public offerings the issuer requests that a percentage of the shares being offered be reserved for issuance to employees, customers or subscribers of the issuer, or other persons with some business relationship to the issuer. These reservations of shares are sometimes referred to as "friends and family," "directed share," or "affinity" offerings.

Shares in the affinity portion of an offering are sold through one or more underwriters or dealers who are participating in the offering. An affinity offering presents a challenge to a broker-dealer because the broker-dealer generally must communicate with customers who are not customers of the broker-dealer when the offering is commenced.

When conducting an affinity offering, the broker-dealer must communicate with the persons selected by the issuer and explain to them the process for participating in the affinity offering. This process includes opening an account with the broker-dealer.

The SEC staff generally takes the view that communications to affinity persons that indicate that a portion of shares in an offering are to be allocated to affinity persons and that describe the procedure for participating in the affinity offering (including the procedure for opening an account with the broker-dealer) should not be considered illegal free writings. See, for example, the exhibits to the Wit Capital no-action letter.

However, in some cases, the SEC staff has been concerned that either the issuer or a broker-dealer managing the affinity offering may have made communications to customers that constitute illegal free writings. In these cases, the SEC has required the issuer to include a risk factor in the prospectus on this issue. A risk factor in the prospectus for the Engage Technologies public offering reads as follows:

> "Prior to the effectiveness of the registration statement covering the shares of our common stock being sold in this offering, Hambrecht & Quist, an underwriter of this offering, provided written materials to approximately 80 employees of Engage that we had designated as potential purchasers of up to 300,000 shares of common stock in this offering through a directed share program. These materials may constitute a prospectus that does not meet the requirements of the Securities Act of 1933. No employee who received these written materials should rely upon them in any manner in making a decision whether to purchase shares of common stock in this offering.
>
> If the distribution of these materials by Hambrecht & Quist did constitute a violation of the Securities Act of 1933, the recipients of these materials who purchased common stock in this offering would have the right, for a period of one year from the date of their purchase of common stock, to obtain recovery of the consideration paid in connection with their purchase of common stock or, if they had already sold the stock, sue us for damages resulting from their purchase of common stock. These damages could total up to approximately $4.5 million plus interest, based on the initial public offering price of $15.00 per share, if these investors seek recovery or damages after an entire loss of their investment. If this occurs, our business, results of operations and financial condition would be harmed."

II. Section 12(a)(2) Liability

A. Section 12(a)(2)

Section 12(a)(2) of the Securities Act provides liability for, and a right of rescission against, any person who offers or sells a security,

> ". . . by means of any prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. . . ."

B. Internet Communications

Related to the concern regarding free writing is the concern that website communications, if characterized as prospectuses, could subject the issuer or underwriters to liability under Section 12(a)(2). However, the significance of Section 12(a)(2) for these communications is unclear. If the communication is made prior to delivery of a final prospectus, it is true that the communication, if deemed a prospectus and determined to be misleading, would give rise to liability under Section 12(a)(2). However, the communication would necessarily be an illegal prospectus in violation of Section 5(b)(1), giving rise to liability under Section 12(a)(1) (in other words, Section 12(a)(2) would not impose any additional liability). If the communication is made with or after delivery of a final prospectus, the language of Section 2(10) would appear to rule out Section 12(a)(2) liability because, under Section 2(10), a prospectus excludes a communication sent with or after delivery of a final prospectus.

C. Aircraft Carrier Release

In the aircraft carrier release, the Commission proposes to lift the restrictions on free writing in most cases, subject to certain conditions, including that the free writings are filed with the Commission and are subject to liability under Section 12(a).

III. Solicitation and Acceptance of Conditional Offers to Buy

A. Section 5(a) of the Securities Act

Section 5(a) of the Securities Act makes it unlawful to sell a security prior to the effectiveness of the registration statement for the security.

B. The Staff's View on Reconfirmations

1. Affirmative reconfirmations after effectiveness

Prior to the Wit Capital no-action letter, members of the SEC staff took the position that it is a violation of Section 5(a) to solicit conditional offers from customers during the waiting period and accept those conditional offers after effectiveness and pricing without an affirmative reconfirmation from the customer after effectiveness.

This position presents an operational problem for the Internet broker-dealer because it is difficult to get reconfirmations from customers in the short period after effectiveness and before a security opens for trading. This is a particular concern when an offering is declared effective prior to or during the trading day, rather than after the close of trading.

In the Wit Capital no-action letter, the SEC staff agreed to modify its position on affirmative reconfirmations somewhat subject to Wit Capital following the procedures described in its request for no-action relief.

2. Reconfirmations after repricings and pricing outside the range

The SEC staff also takes the view that an affirmative reconfirmation from the customer is required after a change in the estimated priced range of an offering (sometimes referred to as a "repricing") or after an offering has priced outside the expected price range. The theory behind this position presumably is that a repricing or a pricing outside the range is material information and, accordingly, the failure to get the customer's affirmative reconfirmation after notification of this event is tantamount to a material omission. The SEC staff has rejected a proposal (intended to address the SEC's concern) whereby customers would submit minimum and maximum price conditional offers outside the expected price range for an offering and the broker-dealer could accept the customer's conditional offer without affirmative reconfirmation if the offering were to price within the minimum and maximum prices specified by the customer.

The staff's position on this point presents a problem for a broker-dealer because it may be difficult to get affirmative reconfirmations in the short period after a repricing and before the market opens for trading. This problem is made more difficult when an offering prices prior to or during the trading day. In this situation, when an offering trades down from its public offering price, the broker-dealer is exposed to significant market risk if it is unable to obtain reconfirmation of all conditional offers prior to the start of trading.

C. Wit Capital's Legal Argument -- Distinguishing Indications of Interest and Conditional Offers to Buy

In its request for no-action relief, Wit Capital argued that Section 5(a) does not require post-effective reconfirmation from customers who place conditional offers to buy.

Wit Capital argued as follows:

- Conditional offers to buy must be distinguished from indications of interest. Indications of interest involve no contractual obligation on the customer. Accordingly, all indications of interest must be firmed up after effectiveness and pricing. In contrast, conditional offers to buy are contractual offers made by the customer, subject to the right of the broker-dealer to accept the conditional offer by notice sent after effectiveness and pricing. Accordingly, the broker-dealer is permitted to accept the customer's conditional offer to buy without reconfirmation from the customer after effectiveness and pricing.

- In 1954, Section 5 of the Securities Act was expressly amended to permit offers to sell and the solicitation of conditional offers to buy during the waiting period. This assertion is supported by the changes made to Section 5 and by the legislative history.

- Although Rule 134(d), adopted in 1955, is a free writing provision, the wording of Rule 134(d) evidences the Commission's acknowledgment and acceptance of the common practice, at that time, of soliciting conditional offers during the waiting period.

D. Wit Capital's Procedures for Soliciting Conditional Offers

While the staff did not fully agree with the legal arguments made by Wit Capital in its request for no-action relief, the staff agreed that Wit Capital would not have to obtain affirmative reconfirmations of conditional offers after effectiveness and pricing based upon Wit Capital's agreement to comply with the following procedures:

1. Notice of offering

When the preliminary prospectus for an offering becomes available, Wit Capital posts the preliminary prospectus in electronic format on its website and sends an e-mail to its customers notifying them of the offering.

2. Solicitation of conditional offers

The e-mail contains a hyperlink to a cul de sac established by Wit Capital for each offering. The cul de sac contains a copy of the preliminary prospectus as well as a webpage through which the customer can enter a conditional offer to buy shares in the offering.

3. Reconfirmation of conditional offers approximately two business days prior to effectiveness

Approximately two business days prior to the date upon which Wit Capital expects the offering to be declared effective, Wit Capital will send a notice to its customers requesting that they reconfirm their conditional offers before effectiveness. If there is a delay in the offering, reconfirmations are valid for a period of five business days.

4. Period after effectiveness and pricing to cancel conditional offers

Wit Capital affords the customer a period after effectiveness and pricing during which the customer can cancel his or her conditional offer. If the offering prices after the close of trading, customers have until 11 p.m. to cancel their conditional offers. If the offering prices during the day, customers have two hours to cancel their conditional offers.

5. Repricings and Recirculations

All conditional offers must be reconfirmed after repricings and recirculations.

The Wit Capital no-action letter involves a liberalization of the staff's position on reconfirmations after effectiveness. The staff, in essence, accepts the combination of the customer's reconfirmation just prior to effectiveness and the customer's opportunity to cancel after effectiveness and pricing as the substantial equivalent of a post-effective reconfirmation from the customer.

E. Principal Concerns Regarding the Wit Capital No-Action Letter

One of the principal concerns for broker-dealers with the conditions imposed in the Wit Capital no-action letter is the requirement to offer customers an opportunity to cancel their conditional offers after pricing. This is a particular concern when an offering prices during the trading day because it affords customers the opportunity to rescind their purchases after trading in a stock has commenced.

A second principal concern is the requirement that all conditional offers be reconfirmed after a repricing or the pricing of a transaction outside the expected price range. The Internet broker-dealer may be exposed to liability if it is unable to obtain affirmative reconfirmations of all conditional offers between the time that a stock prices outside the expected price range and the commencement of trading in the stock.

F. Developments since Wit Capital No-Action Letter

The SEC staff has indicated that it would not object if other broker-dealers follow the procedures set forth in the Wit Capital no-action letter. The SEC staff also has indicated that the Wit Capital procedures are not the only procedures that would be acceptable to the staff, and that the staff would consider other proposals that achieved the same objectives. Since that time, the SEC staff has reviewed and approved procedures submitted by other broker-dealers.

In offerings that include Internet distribution, the staff generally has requested detailed information from broker-dealers in the offering who are involved in Internet distribution. However, if an Internet broker-dealer submits its procedures for review by the SEC staff, and the staff finds that these procedures are consistent with the principles of the Wit Capital no-action letter, the staff will not continue to request in comment letters for specific offerings that the broker-dealer describe its procedures in detail. Rather, the staff will request that the broker-dealer confirm that it continues to follow the procedures previously reviewed by the staff.

In some cases, the SEC staff has further liberalized the requirements of the Wit Capital no-action letter. For example, it appears that the SEC will allow a cancellation period of one hour, with the one-hour period commencing at the time of effectiveness. Of course, if, subsequent to effectiveness there is a repricing or a pricing outside the expected price range, the broker-dealer would have to affirmatively reconfirm all previously transmitted conditional offers.

G. Application of Reconfirmation Requirements to Dutch Auctions

The SEC staff has indicated that the reconfirmation requirements also apply in the context of offerings that involve a Dutch auction. In a Dutch auction, customers receive priority for shares based upon the price that they bid for shares in the offering (i.e., customers who submit a higher bid have priority over customers who submit a lower bid). The offering price is determined based upon the "clearing price," which is the highest price contained in valid conditional offers at which all of the shares in the offering can be sold to potential investors. For example, if 1,000 shares are being offered and customers bid for 500 shares at up to $7.00, 500 shares at up to $6.00 and 500 shares at up to $5.00, the clearing price will be $6.00.

The following is a summary of the procedures for the Dutch auction described in the registration statement for the Andover.net initial public offering. These procedures incorporate many of the principals set forth in the Wit Capital no-action letter.

1. Before the registration statement becomes effective

a. Solicitation of conditional offers

Before the registration statement becomes effective, the underwriters and participating dealers solicit conditional offers. Conditional offers are not binding and may be withdrawn by the customer at any time prior to notice of acceptance from the underwriter or dealer.

b. Reconfirmation of conditional offers

To remain valid, conditional offers must be reconfirmed at least one business day and not more than seven days before the expected effective date for the offering. If the effective date extends beyond the seven-day period, conditional offers must be reconfirmed again.

All conditional offers must be reconfirmed if the expected price range for the offering is changed.

2. After the registration statement becomes effective

a. Closing of auction

The auction may close no earlier than one hour after notice of effectiveness is sent to investors.

b. Placing and reconfirmation of conditional offers after effectiveness

New conditional offers may be placed at any time before the auction closes, even after effectiveness. If the expected price range for the offering does not change, and the offering prices within the expected price range, any conditional offer to purchase shares that is within the price range is deemed valid without any further reconfirmation from the customer. If the expected price range changes, or the offering prices outside the expected price range, reconfirmation is required.

c. Determination of offering price and acceptance of conditional offers

Once the clearing price has been determined, the issuer and underwriters will determine the offering price, which may be lower, but not higher, than the clearing price.

H. Follow-On and Shelf Offerings

The application of the Wit Capital principles to follow-on and shelf offerings is unclear. A primary distinction between initial public offerings and follow-on offerings is that follow-on offerings generally are priced at the close of trading at a slight discount to the market price. Accordingly, there are no "expected price ranges" as there are in the case of initial public offerings. Does this mean that all conditional offers must be affirmatively reconfirmed after pricing? Alternatively, can the broker-dealer be exempted from this requirement if the price is within an acceptable price range established by the customer or established by the broker-dealer and agreed to by the customer?

IV. Prospectus Delivery

A. Rule 15c2-8 under the Exchange Act

Rule 15c2-8 under the Exchange Act requires a broker-dealer to

> ". . . deliver a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale [for the purchase of shares in the offering] at least 48 hours prior to the sending of such confirmation."

B. Section 5(b)(2) of the Securities Act

Section 5(b)(2) makes it unlawful for any person to deliver a security through the mails or in interstate commerce unless accompanied or preceded by a final prospectus. The prospectus delivery requirement does not apply to private placements and other exempt transactions.

C. 1995 Release

The Commission's 1995 release sets forth various methods for satisfying the delivery requirements under the securities laws, including prospectus delivery requirements. One of these methods is to satisfy the consent, access and notice requirements described in the 1995 release. Another method is to obtain evidence that an investor actually received and accessed the prospectus. A third method is to obtain evidence that the investor used forms or other material available only upon accessing the prospectus. With regard to the first method:

1. Consent

The issuer or broker-dealer must obtain the customer's informed consent to electronic delivery of the prospectus. The 1995 release provides that:

> "If a consent if used, the consent should be an informed consent. Recipients generally should be apprised: that information provided would be available through a specific electronic medium or source (e.g., via a limited proprietary system, or at a World Wide website); of the potential that investors may incur costs (e.g., on-line time); and of the period during, and the documents for, which the consent will be effective. For instance, investors should be made aware of whether the consent extends to more than one type of document. If an investor revokes a consent that extends to more than one document, and consent is being relied upon by the provider of the information to ensure effective delivery of transmission, future documents should be delivered in paper unless the provider of the information has an alternative mechanism for ensuring effective electronic delivery."

2. Access

The issuer or broker-dealer must provide the customer access to the prospectus. Access to the prospectus must not be unduly burdensome. The 1995 release provides that:

> "... the use of a particular medium should not be so burdensome that intended recipients cannot effectively access the information provided. Moreover, as is the case with a paper document, a recipient should have the opportunity to retain the information or have ongoing access equivalent to personal retention."

3. Notice

The issuer or broker-dealer must put the customer on notice that the prospectus has been delivered. The 1995 release provides that:

> ". . . . those providing electronic information should consider the extent to which the electronic communication provides timely and adequate notice to investors that information for them is available and, if necessary, consider supplementing the electronic communication with another communication that would provide notice similar to that provided by delivery in paper. If an electronic document itself is provided --- for example, on computer disk, CD-ROM, audio tape, videotape, or e-mail -- that communication itself should generally be sufficient notice. If the document is provided on an Internet website, however, separate notice would be necessary to satisfy the delivery requirements unless the issuer can otherwise evidence that delivery to the investor has been satisfied or the document is not required to be delivered under the federal securities laws."

D. Delivery of Prospectuses for After-Market Purchases

Pursuant to Section 4(3) of the Securities Act and Rule 174, transactions by a dealer in the after-market are exempt from the prospectus delivery requirements of Section 5(b)(2), except that after an IPO distribution has been completed, delivery of a final prospectus is required for a period of 25 days (in the case of NASDAQ securities or securities listed on a national securities exchange) or 90 days (in the case of other securities) after the offering. Rule 153 sets forth alternative delivery procedures in the case of transactions effected on a national securities exchange.

The Internet broker-dealer can effect delivery of the final prospectus by sending an e-mail to the purchaser with a hyperlink to the final prospectus.

The prospectus delivery requirement does not apply to unsolicited brokerage transactions. However, when a broker-dealer participates in an offering, the cautious approach is to comply with the prospectus delivery requirement for all transactions during the applicable 25 or 90 day period.

V. Private Placements

In a line of no-action letters, the Staff has permitted broker-dealers to solicit a significant number of offerees for a private placement, subject to various conditions. See, for example, E.F. Hutton & Co. (December 3, 1985); Bateman Eichler, Hill Richards, Inc. (December 3, 1985); and H.B. Shaine & Co., Inc. (May 1, 1987). One of these conditions is that the broker-dealer must have established a pre-existing substantive relationship with each offeree. A "substantive relationship" may be established with an offeree (even if the offeree has not previously purchased securities from the broker-dealer) who has provided satisfactory responses to a questionnaire if the responses to the questionnaire provide the broker-dealer with sufficient information to evaluate the offeree's level of sophistication and financial circumstances.

The questionnaires and the broker-dealer's mailings accompanying the questionnaires may not make reference to any specific investments which are currently being offered or contemplated for offering by the broker-dealer. In addition, sufficient time must elapse between a respondent's completion of the questionnaire and the solicitation of the respondent in any particular offering. A specific time period generally is not specified in the no-action letters. However, Bateman Eichler agreed in its letter that,

> "Under no circumstances would any offering materials [relating to a specific offering] be sent for a minimum of 45 days after the mailing . . . ,"

of the questionnaire.

A. IPONet

The IPONet no-action letter (July 26, 1996), the SEC staff has applied the principles of the line of no-action letters cited in the preceding subsection to the offer and sale of securities in private placements over the Internet. As in the other no-action letters, all investors must be pre-qualified prior to participating in any specific offering. All private offerings are made through a password-protected area of the website.

Two issues left open in the IPONet letter are (i) the appropriate time period after qualification (by questionnaire) after which it is permissible to solicit qualified customers for a particular offering, and (ii) the requirements regarding verification of the information provided by the customer.

The SEC staff issued similar no-action relief to Lamp Technologies (May 29, 1998) relating to the solicitation of interests in a private investment fund whose participants are limited to "qualified purchasers" (to comply with the Section 3(c)(7) exemption from Investment Company Act registration) and "accredited investors" (to comply with the Regulation D exemption from Securities Act registration).

VI. Blue Sky Issues Relating to Public Offerings and Private Placements

A. NSMIA; Section 18(a)

Section 18(a) of the Securities Act, adopted as part of the National Securities Markets Improvements Act of 1986 (commonly known as NSMIA), provides that,

> ". . . no law, rule, regulation, or order, or other administrative action of any state or any political subdivision thereof:

(1) Requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that:

(A) Is a covered security; or

(B) Will be a covered security upon completion of the transaction. . . ."

Covered securities include securities listed on the NYSE or AMEX, NASDAQ national market securities and securities listed on certain regional exchanges, but exclude NASDAQ SmallCap and non-NASDAQ over-the-counter securities.

Pursuant to Section 18(b)(4)(D) of the Securities Act, a

"... security is a covered security with respect to a transaction that is exempt from registration pursuant to

...

(D) Commission rules or regulations under Section 4(2) . . .,"

except that a state may still impose certain notice filing requirements.

B. Public Offering Issues

Section 18(a) applies not only to securities listed on a national securities exchange and NASDAQ national market securities, but also to securities that will become listed on a national securities exchange or be approved for trading on NASDAQ NMS upon completion of an offering. This means that offerings can be made through the Internet prior to the approval of listing or trading, if the approval of listing or trading is obtained prior to or upon completion of the transaction.

A potential problem occurs if offers are made through the Internet but exchange or NASDAQ NMS approval is not subsequently obtained. This could occur if the offering is canceled or if the offering does not qualify for exchange or NASDAQ NMS approval.

C. Private Placement Issues

Based upon the definition of "covered security," an issuer and placement agent can minimize blue sky concerns by structuring an offering to comply with Rule 506 under Regulation D. Rule 506 is a commission rule under Section 4(2).

Rule 506 sets forth various requirements, including the following: (1) the filing of a Form D with the Commission; (2) a prohibition on any form of general solicitation or advertising; (3) the imposition of restrictions on transfer; and (4) restricting participation in the offering to accredited investors and up to 35 other investors (sometimes referred to as "sophisticated investors"), each of whom,

> ". . . has such knowledge and experience in financial and business maters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description. . . ."

Many states require that a copy of the Form D be filed with the state prior to the commencement of a Regulation D offering in that state.

VII. NASD Notice to Members 99-11

A. Notice to Members 99-11

In NASD Notice to Members 99-11, NASD Regulation issued guidance to broker-dealers regarding stock volatility. NTM 99-11 suggests disclosures that firms can make to retail customers to educate them about the risks of price and volume volatility. NTM 99-11 also describes steps taken by some on-line brokers to respond to volatility.

B. Discussion of IPOs in NTM 99-11

NTM 99-11 notes that there is particular volatility in the case of "hot IPOs" (i.e., IPOs trading at a premium to the offering price in the after-market). NTM 99-11 recommends that firms disclose the risk of placing market orders to buy hot IPO stocks and inform customers that their risk can be reduced by placing limit orders. NTM 99-11 notes that some firms do not accept market orders for hot IPO stocks and that other firms do not accept any orders for IPO stocks until the IPO begins trading in the secondary market.

VIII. U.S. Regulation of Offshore Offerings

A. Offerings not Targeted to U.S. Investors are Exempt

In its interpretation on the "Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore" (March 23, 1998), the Commission wrote that,

> "Internet postings would not, by themselves, result in a registration obligation under the U.S. securities laws."

Rather, the Commission wrote,

> ". . . application of the registration provisions of the U.S. securities laws depends on whether Internet offers, solicitations or other communications are targeted to the United States."

The Commission further wrote:

> "We would not view issuers, broker-dealers, exchanges, and investment advisers that implement measures that are reasonably designed to guard against sales or the provision of services to U.S. persons to have targeted person in the United Sates with their Internet offers."

According to the interpretation,

> "What constitutes adequate measures will depend upon all the facts and circumstances of any particular situation."

B. U.S. Offerors and Non-U.S. Offerors

In the interpretation, the Commission applies different principles for U.S. offerors and non-U.S. offerors.

1. Non-U.S. offerors

The Commission would not consider an Internet offer made by a **non-U.S. offeror** as targeted at the United States if the following two conditions are satisfied:

a. Web site includes prominent disclaimer

The first condition for this safe harbor is that:

> "The Web site includes a prominent disclaimer making it clear that the offer is directed only to countries other than the United States. For example, the Web site could state that the securities or services are not being offered in the United States or to U.S. persons, or it could specify those jurisdictions (other than the United States) in which the offer is being made. . . ."

b. Offeror implements procedures reasonably designed to guard against sales to U.S. persons

The second condition for the safe harbor is that:

> "The Web site offeror implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering. For example, the offeror could ascertain the purchaser's residence by obtaining such information as mailing addresses or telephone numbers (or area code) prior to the sale. . ."

2. U.S. offerors

The Commission would not consider an Internet offer made by a **U.S. offeror** as targeted at the United States if the following three conditions are satisfied:

a. Web site includes prominent disclaimer

See discussion above.

b. Offeror implements procedures reasonably designed to guard against sales to U.S. persons

See discussion above.

c. Offeror implements password-type procedures

The third condition for the safe harbor for a U.S. offeror is that,

> ". . . the U.S. issuer implements password-type procedures that are reasonably designed to ensure that only non-U.S. persons can obtain access to the offer. Under this procedure, persons seeking access to the Internet offer would have to demonstrate to the issuer or intermediary that they are not U.S. persons before obtaining the password for the site."

C. Foreign Underwriters

If the issuer is a U.S. entity but the underwriter or distributor is a foreign entity, the underwriter or distributor, as agent of the issuer, must ensure compliance with all three conditions that apply for a U.S. issuer.

D. Procedures are not exclusive

The procedures described in the interpretation are not the exclusive procedures for demonstrating that offers are not targeted at U.S. customers. On the other hand, offerings that comply with the technical requirements, but not the intent, of the interpretation (i.e., to protect against unregistered public offers and sales to U.S. persons), will be deemed targeted at U.S. customers.

IX. Electronic Road Shows

A. Restrictions on Road Shows Generally

As discussed in Part I above of this outline, Section 5(b)(1) of the Securities Act prohibits prospectuses during the waiting period other than statutory prospectuses. The term prospectus is broadly defined in Section 2(10) of the Securities Act to include all written communications and all communications by radio or television, subject to specified exceptions.

B. Traditional Road Shows

The traditional road show presentation generally has been permitted on the grounds that it constitutes an oral, rather than a written, communication. While attendees may view written materials at the road show, attendees are not permitted to take these materials with them.

The audience for the traditional road show has generally been limited to institutional investors.

C. Electronic Road Shows

1. Writing or broadcast

The problem with the electronic road show is that it can be characterized as either a written communication or a communication by radio or television.

a. Written communications

As discussed above, the Commission considers electronic communications to be written communications.

b. Broadcasts

In no-action letters relating to traditional broadcast media, the SEC staff has distinguished between communications made available to the public, which would be deemed illegal prospectuses, and communications with a limited audience, which would not be deemed illegal prospectuses. In these letters the staff has interpreted the prohibition on radio and television communications in Section 2(3) as a prohibition on public broadcasts. See <u>Exploration, Inc.</u> (November 10, 1986), <u>Merchants National Corporation</u> (January 12, 1976), <u>Producers Funding Corporation</u> (April 9, 1982) and <u>Transamerica Corporation</u> (May 24, 1978) no-action letters.

2. Two general approaches

There have been two general approaches to address the writing and broadcast concerns:

- The first approach has been to structure the road show so that it does not constitute a writing or broadcast. This is the approach adopted in the following no-action letters:

Private Financial Network (March 12, 1997)

Net Roadshow, Inc. (September 8, 1997)

Bloomberg L.P. (December 1, 1997)

Thomson Financial Services, Inc. (September 4, 1998)

Activate.net Corporation (June 3, 1999)

Charles Schwab & Co., Inc. (November 12, 1999)

- The second approach involves treating the communication as a prospectus.

3. Structuring the road show so it does not constitute a writing or broadcast

The Commission has granted no-action relief to Private Financial Network (March 12, 1997), Net Roadshow, Inc. (September 8, 1997), Bloomberg L.P. (December 1, 1997), Thomson Financial Services, Inc. (September 4, 1998), Activate.net Corporation (June 3, 1999) and Charles Schwab & Co., Inc. (November 12, 1999) relating to the transmission of road shows over the Internet or another electronic communications systems in a manner that simulates the traditional road show. In the no-action letters, the parties request that the transmission of road shows for public offerings as described in the letters not be characterized as the distribution of a prospectus under Section 2(10) of the Securities Act.

The letters are based upon two basic principles:

- the road show communications are not writings because, as in the case of the traditional road show, investors are not permitted to keep (i.e., print or download) any road show materials; and

- the road show materials are not transmitted by "radio or television" for purposes of Section 2(10) because the audience for the road show transmissions is limited.

In a subsequent no-action letter (January 30, 1998), Net Roadshow obtained similar relief for the transmission of road shows over the Internet in connection with Rule 144A offerings.

Each of the letters contains similar conditions and restrictions. This outline refers below primarily to the conditions set forth in the Net Roadshow and Bloomberg letters, but these conditions are representative of the conditions set forth in the other letters.

The conditions and restrictions in the electronic road show no-action letters can be grouped into four categories.

a. Conditions to ensure that the road show is not a broadcast.

Must limit access to road shows to qualified investors

To ensure that the road show is not a broadcast, access to the road show is restricted to qualified investors. Qualified investors generally are investors "typical of the investors who would customarily be invited to attend a live road show, such as registered broker/dealers and investment advisers" and qualified institutional money managers. Net Roadshow letter. See also PFN and Thomson no-action letters. See also Activate.net (access restricted to "qualified investors who would customarily be invited to attend a traditional road show, such as institutional investors, securities firms, trading and sales personnel from participants in the offering and research analysts").

In the Bloomberg letter, the audience for any road show is limited to subscribers of THE BLOOMBERG service who have been specifically enabled by an underwriter to receive transmission of the particular road show. Each underwriter must agree with Bloomberg that the underwriter will not enable a viewer to receive a transmission unless the viewer is an institutional investor, investment adviser or other person customarily invited to a road show.

Charles Schwab no-action letter

The Charles Schwab no-action letter represents a significant departure from the SEC staff's requirement in prior letters that access to road shows be limited to institutional investors.

In the Charles Schwab letter, the SEC staff allows Schwab to transmit electronic road shows to its Signature Services Gold level customers. These are the only Schwab customers who have access to Schwab's public offering website. To qualify as Gold level customers, customers must either:

- Have at least $500,000 equity in household investment positions; or

- Execute at least 24 trades per year.

The SEC staff has indicated its reluctance to provide similar no-action relief to other parties, but has instead indicated its preference to provide guidance on this issue in the SEC's upcoming release on electronic communication issues.

In his grant of relief in the Schwab no-action letter, Brian Lane, the former head of the Division of Corporation Finance and the author of the letter, clearly states that the relief is being provided on policy considerations alone, and the letter should not be interpreted as an expression of any legal position by the Division or the staff.

b. Conditions to ensure that the road show is not a writing

Period for viewing, the road show is limited

In the PFN letter, viewers may not view a road show more than 2 times. In the Net Roadshow letter, each qualified investor is allowed to view a road show for one day only. In the Bloomberg and Activate.net letters, viewers are able to view the road show any number of times during a single 24-hour period but not thereafter.

Editing of road show is limited

In the Net Roadshow letter, the live road show, including all questions and answers, is filmed in its entirety and replayed over the Internet at a similar speed as the live road show. Net Roadshow may edit out "dead time" and give the issuer and/or underwriter(s) the opportunity to edit out misstatements or mistakes.

In the Bloomberg letter, road shows are not edited for content. However, in the case of road shows transmitted on a delayed basis, Bloomberg may edit out dead time and give the issuer and/or underwriter(s) the opportunity to edit out misstatements or mistakes.

Must prohibit viewer from copying or downloading road show material

In the Net Roadshow letter, the screen, throughout each road show, carries a disclaimer at all times stating that the copying, downloading or distribution of any road show material is not permitted. In the Net Roadshow letter, the viewer is able to print the entire preliminary prospectus but is not able to copy, download or print any other portion of the road show transmission.

In the Bloomberg letter, if the road show is transmitted during the waiting period, viewers are not permitted to copy, print or download information from the BLOOMBERG service.

c. *Conditions to ensure the primacy of the prospectus*

Registration statement must be filed prior to road show

Road shows are not transmitted for an offering until a registration statement relating to the offering has been filed with the SEC.

Must notify viewer of changes from live road show

In the Net Roadshow, Bloomberg and Thomson Financial letters, if information changes from the time of the live road show, the screen will include a periodic crawl providing a synopsis of the changes and notify the viewer that the viewer may contact his or her salesperson for further information.

Must prominently notify viewer of, and provide viewer access to, the preliminary prospectus

In the Net Roadshow letter, a large and obvious button reading "PRELIMINARY PROSPECTUS" is displayed at all times through the road show. A viewer may review the preliminary prospectus in its entirety by clicking on the appropriate area of the screen.

In the Bloomberg letter, if the road show is transmitted during the waiting period, a preliminary prospectus is distributed to the viewer. If the road show is transmitted after the registration statement has been declared effective, a final prospectus is distributed to the viewer.

Must provide specified disclosures to viewer

In the Net Roadshow letter, before viewing any road show, the viewer is required to view (and acknowledge and agree to) a disclosure that includes the following statements:

- downloading of road show material is not permitted;
- the internet road show does not constitute a prospectus;
- it is strongly recommended that the viewer read the prospectus;
- the prospectus is available on the website;
- a registration statement has been filed but not yet become effective; and
- the securities may not be sold prior to the registration statement becoming effective.

In the Bloomberg letter, before and after each road show, viewers receive the following notice:

- a preliminary prospectus has been furnished to each authorized viewer;
- the viewer should refer to the prospectus (and the registration statement of which it is a part) for more complete information about the offering;
- by electing to view the transmission, the viewer has agreed not to videotape, record or re-transmit the contents of the transmission; and
- if a registration statement has been filed but not yet become effective, the securities may not be sold prior to the registration statement becoming effective.

Must notify viewer of the importance of the preliminary prospectus

In the Net Roadshow letter, the viewer is informed by a periodic crawl across the screen or by prominent text of the importance of viewing the filed prospectus.

In the Bloomberg letter, before and after each road show, viewers are notified that a preliminary prospectus has been furnished to each authorized viewer, and that the viewer should refer to the prospectus (and the registration statement of which it is a part) for more complete information about the offering.

Issuers and underwriters must ensure that Internet road show is not inconsistent with preliminary prospectus

In the Bloomberg letter, the underwriters have exclusive control over the content of each road show and will agree in writing with Bloomberg to ensure that the information disclosed in the road show is not inconsistent with the prospectus furnished to viewers.

d. ***Condition to ensure that sponsor of road show is not required to register as a broker-dealer***

Sponsor's fees cannot be contingent upon success or size of offering

In the Net Roadshow letter, the road show developer's fees are not contingent upon the degree of success or size of an offering.

In the Bloomberg letter, Bloomberg's compensation consists of customary rental fees paid by subscribers to THE BLOOMBERG service (which is not increased as a result of the road show transmissions) and reimbursement by the issuer or sponsoring underwriter(s) of any special expenses, neither of which is contingent on the size or successful conclusion of any offering. Bloomberg also may decide to collect fees for access to a road show on a subscription/pay-per-view basis for the viewers authorized by the underwriters.

4. Filing the electronic road show as a prospectus

A second approach has been to treat the electronic road show materials as a prospectus. This involves filing the road show materials as a separate prospectus or as an appendix to the statutory prospectus. The road show materials then become subject to review by the SEC staff. In addition, as discussed above, the information in the electronic road show becomes subject to Section 12 liability.

D. Aircraft Carrier Release

1. Commission proposals

The Commission's proposals regarding free writing in the aircraft carrier release would allow for road show presentations to be made available to all investors. The proposals also would allow viewers of the presentations to keep materials distributed at the road show. These permitted activities, as proposed, would be subject to certain conditions, including the filing of the content of the road show presentation with the Commission. In addition, the information in the road show presentation would be subject to Section 12 liability.

The proposals described in the preceding paragraph are consistent with the Commission's concerns regarding the current road show process, as expressed in the aircraft carrier release:

> "It is common for issuers and underwriters to conduct road show presentations during the waiting period for selected broker-dealers and large institutional investors. While these road shows are valuable to some investors because they provide a forum for investors' questions, their value is curtailed because of the limited audience invited to attend and the fact that issuers and underwriters do not allow participants to retain materials used during the presentation (other than the preliminary prospectus). These restrictions raise concerns regarding selective disclosure of material information. They also raise concerns about whether investors have been informed as well as they might have been absent those restrictions."

The Commission's proposals in the aircraft carrier release thus far would not affect the electronic road show no-action letters since the SEC staff has agreed that these communications are not prospectuses. However, in footnote 313 to the aircraft carrier release, the Commission requests comments,

> ". . . on whether video road shows should be deemed free writing and therefore would be required to be filed under these proposals."

Although not specified in the request for comments, it appears from the context of the request that it relates to the limited audience video road shows described in this section.

2. Comment letters

Comment letters generally have opposed the characterization of video road shows as free writings. Bloomberg L.P., in its comment letter, wrote as follows:

> "Bloomberg strongly recommends that the Commission not treat electronic road shows as writings that would have to be filed with the Commission in connection with offerings registered under the Securities Act of 1933. Securities underwriters would be unlikely, we believe, to continue to use electronic road shows if they were required, as a result of such use, to file copies of the road shows with the Commission."

X. Free Stock Offerings

In various no-action letters the SEC staff has expressed the view that

> ". . . the issuance of securities in consideration of a person's registration on or visit to an issuer's internet site would be an event of sale within the meaning of section 2(a)(3) of the Securities Act of 1933. As a result, such an issuance would violate section 5 of the Act unless it was the subject of a registration statement or a valid exemption from registration."

See Vanderkam & Sanders (January 27, 1999). See also Simplystocks.com (February 4, 199) and Andrew Jones and James Rutten (June 8, 1999). The SEC, in fact, has brought and settled enforcement actions against several companies who offered and issued unregistered free stock through their websites.

At least one issuer, YouNetwork Corporation, has registered an offering of free stock (Registration No. 333-71949). The offering includes some shares offered to the first 250,000 members of the issuer's consumer network, additional shares offered to members based upon referrals of other members to the issuer, and additional shares based upon rebates accumulated through purchases and purchases of referred members. The maximum offering price indicated on the cover page of the registration statement for the first two categories of shares is $0. This would indicate that a Regulation A or Regulation D offering of free stock should not run afoul of the maximum sale amount restrictions for Regulation A and Regulation D offerings.

Another issuer, USPages.net, Inc., has offered stock to website services customers and persons who visit the issuer website. Pursuant to a press release by the issuer (http://www.uspages.net/press_release.htm), the offering has been registered in 27 states but is exempt from federal registration pursuant to Rule 504 under Regulation D. Pursuant to Rule 504(b)(1)(i), Regulation D's restrictions on general solicitation and limitations on resale do not apply to offers and sales of securities that are made:

> "Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions."

XI. Suitability Obligations

A. NASD Rule 2310; Suitability Obligations

NASD Rule 2310 provides that,

> "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any disclosed by such customer as to his other security holdings and as to his financial situation and needs."

Under Rule 2310, a suitability obligation applies when a broker-dealer makes a recommendation to a customer. A broker-dealer's suitability obligation also arises under the common law "shingle" theory under which a broker-dealer, by holding itself out to the public, undertakes that it will not make a recommendation to a customer unless it has determined that the transaction is suitable for the customer.

B. Suitability Obligations for Public Offerings

There is some disagreement as to whether suitability obligations should apply to Internet broker-dealers that offer and sell shares in public offerings. Some Internet broker-dealers have argued that in making public offerings available to their customers they are not recommending the transaction to the customer and, in any event, are not recommending the transaction as suitable for any specific customer.

However, the NASD has taken the position that Internet broker-dealers do have a suitability obligation when they make public offerings available to their customers, at least in the situation where they send e-mail notices of a specific offering to their customers. The NASD's position is based, in part, upon its statement in NASD Notice to Members 96-60 that,

> ". . . a transaction will be considered to be recommended when the member . . . brings a specific security to the attention of the customer through any means, including . . . the transmission of electronic messages."

The NASD noted in a March 1997 letter that the foregoing statement,

> ". . . was not intended to suggest that every statement that includes mention of a security would be considered a recommendation."

However, the NASD did not provide further guidance. The NASD wrote in the March 1997 letter that,

> "Whether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances."

XII. Minimum Deposit Requirements

The SEC staff has expressed concern that it may constitute a violation of Section 5(a) of the Securities Act to require customers to have funds on deposit in their accounts prior to the effective time of a public offering, even though the funds are deposited into the customer's account and are within the customer's control. The staff has a particular concern when the amounts deposited by customers prior to effectiveness of an offering equal the ultimate purchase price for shares in the offering paid by the customers.

If a broker-dealer cannot require customers to have funds on deposit in their accounts, the broker-dealer is exposed to credit risk if its customers do not deposit sufficient funds by closing. This issue is of increased concern to the broker-dealer in affinity offerings where the broker-dealer is dealing with customers who have not previously opened accounts with the broker-dealer.

One approach that appears to be acceptable to the staff is to institute a minimum deposit requirement in connection with the opening of new accounts. The amount of the minimum deposit requirement should be uniform for all offerings. The following excerpt from the Andover.net prospectus sets forth procedures that are acceptable to the staff:

> "In order to open a brokerage account with WR Hambrecht & Co., potential investors must deposit $2,000 in their account. In addition, once the registration statement becomes effective and the auction closes, a prospective investor submitting a conditional offer to purchase through a WR Hambrecht & Co. brokerage account must have an account balance equal to or in excess of the amount of its conditional offer to purchase or its conditional offer will not be accepted by WR Hambrecht & Co. No funds will be transferred to the underwriters, however, until the acceptance of the conditional offer to purchase and the subsequent closing of this offering."

These procedures also should be acceptable in traditional offerings that do not involve an auction.

E-COMMERCE ISSUES

Electronic Delivery of Proxy Material
and
Electronic Proxy Voting

Terry L. Overbey
The Proctor & Gamble Company
Cincinnati, Ohio

SECTION I

E-COMMERCE ISSUES
ELECTRONIC DELIVERY OF PROXY MATERIAL AND ELECTRONIC PROXY VOTING

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ELECTRONIC DELIVERY OF PROXY MATERIALS AND ELECTRONIC PROXY VOTING

TERRY L. OVERBEY
THE PROCTER & GAMBLE COMPANY

I. INTRODUCTION

Procter & Gamble derives two benefits from the electronic distribution of proxy materials and annual reports and electronic proxy voting:

- For each shareholder converted to full electronic distribution and electronic voting, P&G saves approximately $4.00 in reduced postage, printing and handling costs.

- Many of P&G's shareholders want to receive proxy materials electronically and to vote electronically, so we are providing a service to these shareholders by offering electronic distribution and voting.

II. STREET SHAREHOLDERS

For shares held beneficially in street name, all companies should take advantage of electronic delivery and electronic voting to the fullest extent possible because there are no legal issues and the proxy tabulators have already done most of the work.

A. **Electronic Voting** - Because the shares are held in street name, the beneficial holder is merely providing voting instructions to the bank or broker, not a proxy, so there are no issues under state law regarding electronic proxies.

B. **Electronic Distribution** - If a beneficial holder consents to receive proxy materials electronically for a security, that consent is applicable to all other securities held beneficially in the same account at the bank or broker. Thus, even though P&G has never solicited consents from its beneficial holders, we distributed over 8,000 sets of proxy materials electronically in 1999 to our street shareholders who have otherwise provided a consent to their bank or broker. To take advantage of this, a company only needs to get in touch with Automatic Data Processing a few weeks before the record date, provide them with the website address for its annual report and proxy statement and make sure the website is active on the mailing date.

III. REGISTERED SHAREHOLDERS

For a company, the situation with registered shareholders is more complicated. Electronic votes must qualify as a legal proxy under the company's state of incorporation and the company must obtain its own consents to the electronic distribution of proxy materials.

A. **Electronic Voting** - A company must determine whether an electronic proxy is valid under its state of incorporation and, if so, what process it should use to ensure that the proxy has been properly authorized.

1. In 1998 when P&G first considered electronic voting, the law in Ohio was ambiguous. Ohio Revised Code 1701.48 required proxies to be "appointed by a writing signed by such person" and specified further that a writing included a "telegram or cablegram appearing to have been transmitted by such person, or a photographic, photostatic or equivalent reproduction of a writing."

2. While internet or telephonic proxies appeared to be within the spirit of the law, they were not clearly authorized. We, therefore, worked through our outside counsel, Dinsmore & Shohl, and the Attorney General issued an informal opinion to the Commissioner of Securities clarifying two issues:

   a. "Writing" includes computer transmitted documents such as e-mail.

   b. An e-mail "appearing to be transmitted by such person" would qualify as a "written" proxy.

3. Even though the Attorney General's opinion focused solely on e-mail transmissions, we received an opinion confirming that this reasoning would apply equally to telephonic transmissions.

4. Effective September 13, 1999, ORC 1701.48 was amended to explicitly authorize electronic proxies if there is a "verifiable communication."

B. **Electronic Notice of Annual Meeting** - Many states require companies to send a "written" notice for the annual meeting of shareholders. We relied upon the same Attorney General opinion to support the use of an electronic notice to satisfy the "written" notice requirement. Companies should also confirm that their bylaws or regulations do not require the notice to be "signed" or delivered by "mail."

C. **Electronic Distribution** - Two SEC releases (October, 1995 (#33-7233) and May, 1996 (#33-7288)) provide guidance regarding the electronic distribution of proxy materials. They set forth requirements as to notice, access and evidence of delivery to insure compliance with federal securities laws.

1. **Non-employee shareholders** - There are three requirements to deliver materials electronically to non-employee shareholders, with the key requirement being to obtain an informed consent from the shareholder:

   a. Provide evidence of delivery by obtaining consent from shareholder.

      - Method of electronic delivery that will be used (can't just post on a website)

      - Clarify any costs the shareholder may incur

      - Duration of the consent

      - Clarify the consent is revocable at any time

      - Confirm the documents covered by the consent

   b. Provide actual notice of availability of documents at about the same time paper copies are mailed

   c. Provide effective access - relatively easy access plus ability to retain a copy of the documents

2. **Employee Shareholders** - In Example 1 of the May, 1996 Release, the SEC provided an illustration that would allow an implied "consent" for employee-shareholders if three factors were present:

   a. The employees must have regular access to e-mail in the ordinary course of their duties.

   b. The employees must be given the option to request paper copies of the proxy materials.

c. An e-mail must be delivered to the employees with instructions for accessing the annual report and proxy statement.

IV. PROCTER & GAMBLE'S EXPERIENCE

A. 1998 Fiscal Year (June 30, 1998)

1. All street shareholders were provided the opportunity to provide voting instructions via telephone or internet and all consenting street shareholders received their proxy materials electronically.

2. P&G distributed its annual report and proxy statement electronically to 25,000 employees in the U.S.

   a. We did not distribute the annual report and proxy statement electronically to any international employees because we did not have time to determine which employees had regular e-mail access.

3. Except for the consenting street shareholders, all other shareholders (including employee-shareholders who received electronic copies of the annual report and proxy statement) received a paper copy of the proxy card in the mail, but all shareholders had the option to vote electronically.

B. 1999 Fiscal Year (June 30, 1999)

1. P&G expanded its electronic distribution in 1999.

   a. In addition to the 25,000 employees in the U.S., we identified 9,000 international employees who were eligible for electronic distribution.

   b. All 34,000 employees also received their proxy card electronically, thereby eliminating postage costs entirely and helping to increase the number of shareholders voting over the internet.

2. Procter & Gamble has about 350,000 registered shareholders and 500,000 street shareholders and in 1999, we had 350,000 shareholders who voted. The percentage of shareholders voting by each method was as follows with the costs of processing each vote indicated in parentheses:

	1998	1999	Index
Mail ($.34)	86.1%	82.2%	95
Telephone ($.18)	10.3%	9.5%	92
Internet ($.03)	3.6%	8.3%	230
Total electronic vote	13.9%	17.8%	128

3. The total number of P&G shareholders receiving proxy materials electronically was as follows:

	1998	1999	Index
Employee-Shareholders	24.5M	34.4M	140
Street shareholders	5.0M	8.4M	170
Total shareholders	29.5M	42.8M	145

4. P&G saved over $150,000 in 1999 by utilizing electronic distribution and voting and we expect this figure to increase to over $500,000 per year within a few years.

V. PRACTICAL CONSIDERATIONS

A. Electronic distribution and voting has been well-received by P&G shareholders. Favorable comments have far outnumbered negative comments, and only 1% of employees have elected to receive paper copies of their proxy materials.

B. Employee Communications

1. About one week prior to the mailing date of our proxy materials, each employee-shareholder with regular e-mail access received an e-mail from our CFO (see Exhibit I) announcing the electronic distribution of proxy materials and providing "opt out" instructions. This e-mail also included a PIN number for each employee – the last four digits of each U.S. employee's social security number or the P&G computer access number for each international employee.

2. On the mail date for our proxy materials, each employee-shareholder received a second e-mail (see Exhibit II) that contained hyperlinks to the annual report, proxy statement, proxy card and the proxyvote.com website.

3. Copies of the 1999 proxyvote.com website for P&G are included as Exhibit III.

4. A model letter to be used to solicit consents from registered and street shareholders is included as Exhibit IV and a model for registered shareholders only is included as Exhibit V. Procter & Gamble plans to include a letter like this as part of another mailing to our registered shareholders in 2000.

C. All companies should start offering electronic voting and the electronic distribution of proxy materials. These generate significant savings for relatively little effort and provide a benefit to shareholders. A company needs to appoint a project owner to coordinate the effort, which will require an IT resource who can identify eligible employees and assist with e-mail transmissions and the establishment of the hyperlinks.

EXHIBIT I

EMPLOYEE-SHAREHOLDER E-MAIL ANNOUNCEMENT REGARDING ELECTRONIC DISTRIBUTION OF PROXY MATERIALS

Dear Employee Shareholders,

PIN #

I'm pleased to announce that employee shareholders like you, who have Company provided Internet access, will be able to once again view shareholder materials online.

Consistent with last year's approach, as an alternative to receiving paper copies of your 1999 annual report and proxy statement in the mail, copies of these documents will be available via the Company's Investor Web site (www.pg.com/investor). Both documents can be accessed, viewed and printed 24 hours-a-day, 7 days-per-week.

In addition, all P&G shareholders will have the option of voting their proxy this year over the Internet or through a special telephone voting service. What's different this year is that your proxy ballot will also be accessible online. I encourage you to take advantage of this new, cost-effective service.

P&G is proud to be the first Ohio corporation to offer these services to its shareholders. We believe these options will make it more convenient for shareholders to cast their votes on issues that affect the Company. And just like votes cast using paper proxy cards, votes cast over the Internet and telephone are tabulated by an outside vendor. P&G does not have access to individual votes.

You will receive an e-mail message on or about August 27, describing how to access the annual report, proxy statement and proxy ballot on the P&G Investor Web site. At that time, employee shareholders will also be given the information required to vote your proxy ballot online or telephonically. **You will be need the PIN # listed above to access online voting**.

This improvement is consistent with the Company's objective of increasing shareholder value by decreasing unnecessary costs. We saved almost $100,000 last year and expect to save an additional $200,000 through these programs this year, as many of our international employees will receive their shareholder documents online for the first time. This amount should increase significantly in future years as more of our non-employee shareholders begin to take advantage of this capability.

Please consider using the electronic options to vote and receive shareholder materials. Whatever your choice, please remember to vote your proxy.

Sincerely,

Clayton C. Daley, Jr.
Chief Financial Officer and Shareholder

If you wish to receive paper copies of the 1999 annual report, proxy statement and/or proxy ballot, or if you don't have P&G provided Internet access, send an e-mail message to **shareholders-im**. Otherwise, you will receive an e-mail on or about August 27, 1999 notifying you that these documents have been posted on the Internet with instructions on how to access and print them.

Please send comments on this procedure to **shareholders-im**. Do not use the e-mail reply function to send back comments or request paper copies.

EMPLOYEE-SHAREHOLDER E-MAIL ANNOUNCEMENT REGARDING PROXY VOTING WITH HYPERLINKS TO OTHER SITES

Internet Mail Message

Received from host: [208.207.118.123] [208.207.118.123]

Click here for help on Internet Mail

From: proxymaster@proxyvote.com on 09/01/99 03:14 PM
To: Linda Rohrer-LD/PGI
cc:
Subject: Online Annual Report and Proxy Instructions %P01069 - V1868855499%

Your Control Number: 1868855499

Here are the instructions to access P&G's 1999 annual report, proxy statement and proxy ballot. In addition, you'll find directions on how to cast your proxy vote, as well as, an online link to your shareholder Swiffer sample.

As Mr. Daley announced previously, employee shareholders, such as yourself, will be given the ability to receive these documents online and vote your proxy electronically. We encourage you to take advantage of the online options, however, paper copies can be requested by sending an e-mail message to shareholders.im.

To Access the 1999 Online Annual Report, Proxy Statement and your shareholder Swiffer sample:

1. Click on this web site address: Http://www.pg.com/investor/ar_mstr_index.html
<u>Hyperlink</u>

To Access your 1999 Proxy Ballot and Vote your Proxy Online via the Internet:

1. Print out this page. You will need your 12-digit "Control Number" listed above. This control number is required to insure security of your vote.
2. Click on this Web site address: http://www.proxyvote.com
3. Go to "To submit your voting instructions over our secure site, click HERE", and click where asked.
4. Page down to enter your 12-digit "Control Number" listed above.
5. Next, enter your PIN number where requested (below the Control Number). Your PIN number is the last 4 digits of your social security number.
6. Click on "Click to Continue".
7. Follow the instructions to view your proxy ballot and cast your vote.

To Access your 1999 Proxy Ballot and Vote your Proxy via the Telephone:

1. Print out this page since you will need your 12-digit "Control Number" listed above.
   This control number is required for your security.
2. Click on this Web site address to print off a copy of the proxy ballot: http://www.pg.com/investor/ar_mstr_index.html
3. Dial 1-800-690-6903
4. Key in your 12-digit "Control Number" when requested.
   Note: Use the control number located on this page above.
   Ignore the reference to a control number on your proxy form, as indicated by the telephone instructions.
5. Follow the instructions to cast your vote.

WEBSITE FOR PROXY VOTING

PROXY Vote

WELCOME TO PROXYVOTE.COM

Please select one of the links below...

If you received your proxy material in the mail, please have your material and your control number ready.

If you received a notification via e-mail, please have your control number and Personal Identification Number ready.

To submit your voting instructions over our secure site, click HERE.

If your browser cannot support secure transactions via SSL encryption, click HERE.

Need to update to a security enabled browser? Click HERE.

You can submit your proxy voting instructions right over the Internet

It's fast, convenient, and your voting instructions are immediately posted.

If you received notification by postal mail:

1. Read the Proxy Statement. The accompanying Voting Instruction Form or Proxy Card contains your Control Number.
2. Enter the 12 digit Control Number to access an electronic ballot.
3. Complete the electronic ballot and submit your voting instructions.
4. Provide your E-Mail address if you want confirmation of your voting instructions.

If you received notification by E-Mail:

1. To access an electronic ballot, enter the 12 digit Control Number contained in your E-Mail message and the PIN you used when you enrolled for electronic delivery.
2. The ballot displayed contains Internet Links to the Proxy Statement and the Annual Report; read them carefully.
3. Complete the ballot and submit your voting instructions.

Enter your CONTROL NUMBER: [881030903006] (Please skip any spaces)

Enter your PIN NUMBER: [****] (last 4 digits of your SS#): (Required for the E-Mail option only)

[Click to Continue]

Need to update your browser or download the Adobe Acrobat® Reader? CLICK HERE
ProxyVote

PROXY Vote

PROCTER AND GAMBLE Annual Meeting

To be held on 10/12/1999 for holders as of 07/30/1999

CUSIP 742718- B02

Your Control Number: 8810 3090 3006

Management Recommendations:

Choose this if you would like to vote your shares following management's recommendations. See below for the detailed recommendations. Please read it carefully.

[Vote my shares per management's recommendations]

Proxy Ballot:

DIRECTORS:

Directors Recommend: A vote for election of the following nominees

○ For All Nominees ○ Withhold All Nominees

○ For All EXCEPT Those Selected Below:

☐ DONALD R. BEALL
☐ GRODON F. BRUNNER
☐ RICHARD B. CHENEY
☐ DURK I. JAGER
☐ CHARLES R. LEE

PROPOSALS:

Please indicate your proposal selections by clicking on the fields below.

02 . RATIFY APPOINTMENT AUDITORS
Directors Recommend: **FOR**
○ For ○ Against ○ Abstain

03 . RATIFY AND APPROVE CERTAIN GRANTS OF STOCK OPTIONS OR STOCK APPRECIATION RIGHTS
Directors Recommend: **FOR**
○ For ○ Against ○ Abstain

04 . BOARD OF DIRECTORS TERMS
Directors Recommend: **AGAINST**
○ For ○ Against ○ Abstain

[Vote my shares per the above selections]

Click to see: *"Letter to our clients regarding voting authority"*

PROXY Vote

Proxy Final Submission

Please check all of the information below for accuracy.
See instructions below and click on Final Submission

Your Control Number: 8810 3090 3006

PROCTER AND GAMBLE Annual Meeting

To be held on 10/12/1999 for holders as of 07/30/1999

CUSIP 742718 - B02

You elected to vote with management's recommendation

DIRECTORS:

DONALD R. BEALL , GRODON F. BRUNNER , RICHARD B. CHENEY , DURK I. JAGER , CHARLES R. LEE

Directors recommend and will vote for all directors.

PROPOSALS:

02 . RATIFY APPOINTMENT AUDITORS
Directors Recommend and will vote for this Proposal

03 . RATIFY AND APPROVE CERTAIN GRANTS OF STOCK OPTIONS OR STOCK APPRECIATION RIGHTS
Directors Recommend and will vote for this Proposal

04 . BOARD OF DIRECTORS TERMS
Directors Recommend and will vote against this Proposal

If any of the above information is incorrect, return to the proxy ballot form by using the Back feature of your Browser Program

---

If you would like to receive an electronic confirmation when this vote is recorded enter your E-Mail address here:

E-Mail:

You now have the option to receive future shareholder communications **(Annual Reports, Proxy Statements, Quarterly Reports, etc.)** electronically, instead of in print. This will save postage and mailing costs for the company(s) in which you have invested. It also means that you can vote future proxies electronically, without a trip to the Post Office.

Participation is completely your choice. To send future shareholder communications to you electronically, we require your permission. We also require you to choose a four digit personal identification number. Most people prefer to use the last four digits of their Social Security number. In the future, when, and if, material is available electronically, we will send you an e-mail which will contain information that will point you to an Internet location where the material is available.

You only have to enroll this investment account once. It will automatically apply to any other company that offers electronic distribution. We hope you will give this option your serious consideration.

ENROLLMENT

I wish to receive future shareholder communications electronically at the E-MAIL address supplied above. I have chosen as my four digit personal identification number [ ]

If all of the above information is correct then click on Final Submission below.

If any of the above information is incorrect, return to the proxy ballot form by using the Back feature of your Browser Program

[Final Submission]

Thank You For Voting

To enter your next Control Number Click Here

MODEL LETTER SOLICITING PROXY VOTING CONSENTS FROM REGISTERED AND STREET SHAREHOLDERS

Procter&Gamble

The Procter & Gamble Company
Executive Offices
1 Procter & Gamble Plaza, Cincinnati, Ohio 45202-3315

May __, 2000

Dear Procter & Gamble Shareholder:

We are pleased to offer you an opportunity to receive the Company's proxy statement and annual report electronically over the Internet. You will also be able to vote your proxy over the Internet instead of using the traditional paper proxy card. By choosing electronic access, you will also help Procter & Gamble reduce printing and postage costs.

These new online services are available for any Procter & Gamble shares you have deposited with a bank or brokerage firm that holds the shares on your behalf or for any shares you have in your own name. If you wish to take advantage of these services, you must have an electronic mail (e-mail) account and access to an Internet browser, and you will need to enroll by our record date of _________, 2000.

To enroll in the new online program, access the **www.InvestorDelivery.com** site and click "New Enrollment." You will be asked to enter the Enrollment Number displayed above. If you hold Procter & Gamble shares in more than one bank or brokerage account, you may receive additional copies of this letter with a separate Enrollment Number for each account. You must complete the process for each account, using the Enrollment Number assigned to that account. As part of the sign-up process, you will be asked to enter your e-mail address and create a four-digit personal identification number (PIN). We recommend that you choose the same PIN for all accounts that use the same e-mail address. When you have completed the enrollment, you will be sent an e-mail confirming your election to use the online services.

When Procter & Gamble's proxy statement and annual report are available, you will be sent an e-mail notification on how to access them electronically and how to vote your shares at the following Web site: **www.ProxyVote.com**. Please read both the proxy statement and the annual report before you cast your vote.

Please note that although there is no charge for this service, there may be costs associated with electronic access to the Procter & Gamble documents, such as usage charges from Internet access providers and telephone companies. These costs are your responsibility. We are not involved in the operation of the **www.InvestorDelivery.com** and **www.ProxyVote.com** Web sites and cannot take responsibility for any inaccurate information that may appear.

If you choose to use these new online services, your choice will apply not only to the Procter & Gamble shares held in your bank or brokerage account, but also the securities of any other companies in your account. Accordingly, as one or more of those companies make their shareholder communications available through electronic transmission over the Internet, you will no longer receive printed copies of their proxy statements or annual reports.

If you elect to access your Procter & Gamble materials via the Internet, you can still request paper copies of Procter & Gamble's proxy statement and annual report by contacting your bank, broker, or Procter & Gamble. You can also access all of our financial SEC filings through the Procter & Gamble Web site at: **www.pg.com**.

Your enrollment in the new online program will remain in effect as long as your account remains active or until you cancel your enrollment. You are free to cancel your enrollment at any time by accessing **www.InvestorDelivery.com** on the Internet.

If you have Internet access, we hope you will take advantage of these new online services.

Sincerely,

MODEL LETTER SOLICITING PROXY VOTING CONSENTS
FROM REGISTERED SHAREHOLDERS ONLY

Procter&Gamble

The Procter & Gamble Company
Executive Offices
1 Procter & Gamble Plaza, Cincinnati, Ohio 45202-3315

May __, 2000

Dear Procter & Gamble Shareholder:

We are pleased to offer you an opportunity to receive the Company's proxy statement and annual report electronically over the Internet. You will also be able to vote your proxy over the Internet instead of using the traditional paper proxy card. By choosing electronic access, you will also help Procter & Gamble reduce printing and postage costs.

These new online services are available for any Procter & Gamble shares you have in your own name. If you wish to take advantage of these services, you must have an electronic mail (e-mail) account and access to an Internet browser, and you will need to enroll by our record date of _________, 2000.

To enroll in the new online program, access the **www.InvestorDelivery.com** site and click "New Enrollment." You will be asked to enter the Enrollment Number displayed above. If you hold Procter & Gamble shares in more than one account, you may receive additional copies of this letter with a separate Enrollment Number for each account. You must complete the process for each account, using the Enrollment Number assigned to that account. As part of the sign-up process, you will be asked to enter your e-mail address and create a four-digit personal identification number (PIN). We recommend that you choose the same PIN for all accounts that use the same e-mail address. When you have completed the enrollment, you will be sent an e-mail confirming your election to use the online services.

When Procter & Gamble's proxy statement and annual report are available, you will be sent an e-mail notification on how to access them electronically and how to vote your shares at the following Web site: **www.ProxyVote.com**. Please read both the proxy statement and the annual report before you cast your vote.

Please note that although there is no charge for this service, there may be costs associated with electronic access to the Procter & Gamble documents, such as usage charges from Internet access providers and telephone companies. These costs are your responsibility. We are not involved in the operation of the **www.InvestorDelivery.com** and **www.ProxyVote.com** Web sites and cannot take responsibility for any inaccurate information that may appear.

If you elect to access your Procter & Gamble materials via the Internet, you can still request paper copies of Procter & Gamble's proxy statement and annual report by contacting Procter & Gamble. You can also access all of our financial SEC filings through the Procter & Gamble Web site at: **www.pg.com**.

Your enrollment in the new online program will remain in effect as long as your account remains active or until you cancel your enrollment. You are free to cancel your enrollment at any time by accessing **www.InvestorDelivery.com** on the Internet.

If you have Internet access, we hope you will take advantage of these new online services.

Sincerely,

STATE LAW ISSUES AFFECTING ELECTRONIC COMMUNICATIONS WITH SHAREHOLDERS

C. Craig Bradley, Jr.
Stites & Harbison
Louisville, Kentucky

SECTION J

STATE LAW ISSUES AFFECTING ELECTRONIC COMMUNICATIONS WITH SHAREHOLDERS

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State Law Issues Affecting Electronic Communications with Shareholders

C. Craig Bradley, Jr.
Stites & Harbison

Electronic technology offers corporations significant opportunities to enhance the means by which they communicate with their shareholders. A growing number of public companies are taking advantage of technological advances to offer shareholders the option of voting telephonically or through the internet as alternatives to the traditional paper proxy card.[1] In addition, issuers have begun to recognize the efficiencies and cost savings (and benefits to their shareholders) that can be achieved through direct electronic distribution of annual reports, proxy statements and other shareholder communications.[2] In addition to satisfying the information and delivery requirements of the federal securities laws,[3] issuers must focus on the substantive state laws governing communications between corporations and their shareholders.

The principal state law issues raised by electronic voting and distribution are the validity of electronic proxies and shareholder consents and the adequacy of electronic notice of shareholder meetings. The following discussion summarizes the applicable laws in the states of Kentucky and Delaware.

Electronic Proxies and Consents

The validity of a proxy is determined under the law of the state of the issuer's incorporation. Traditional state statutes, while not mandating a specific form, typically require that the grant of a proxy be evidenced by some form of written appointment signed by the shareholder.[4] To resolve legal uncertainties about the validity of electronic voting, nearly 30 states have enacted legislation in recent years to specifically authorize the use of electronic media to submit proxies.[5] These laws generally

[1] In 1998, 275 issuers provided electronic voting to registered shareholders. In 1999, over 400 companies offered electronic voting to their shareholders. American Society of Corporate Secretaries, "Technology and Other 1999 Proxy Trends," July 22, 1999 teleconference (remarks of Charles Pursar of Proxy Services Corporation).

[2] See Howard M. Friedman, "Proxy Solicitations and the Cyberspace Revolution," Insights, December 1997, p. 9; John C. Wilcox, "Electronic Communication and Proxy Voting: The Governance Implications of Shareholders in Cyberspace," Insights, March 1997, p. 8.

[3] The Securities and Exchange Commission has encouraged public companies to explore the use of electronic media for delivering disclosure documents under the Securities Act of 1933 and the Securities Exchange Act of 1934. To help facilitate the development and application of alternative electronic media systems, the Commission has also provided guidance regarding the principals of individual access, consent, notice and evidence of delivery as they relate to electronic disclosure practices and an issuer's responsibilities under the federal securities laws. See *Use of Electronic Media For Delivery Purposes*, Release No. 33-7233 (Oct. 6, 1995) and *Use Of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers For Delivery Of Information*, Release No. 33-7288 (May 9, 1996).

[4] E.g., Revised Model Business Corporation Act § 7.22(b) (1984).

[5] Arizona (A.R.S. § 10-722); California (Cal Corp Code § 178); Colorado (C.R.S. § 7-107-203); Connecticut (Conn. Gen. Stat. § 33-706); Delaware (D.G.L.C. § 212); Florida (Fla. Stat. § 607.0722); Georgia (O.C.G.A. § 14-2-722); Hawaii (HRS § 415-33); Indiana (Burns Ind. Code Ann. § 23-1-30-3); Louisiana (La. R.S. 12:75); Michigan (MSA § 21.200(421)); Minnesota (Minn. Stat. § 302A.449); Mississippi (Miss. Code Ann. § 79-4-7.22); Missouri (R.S.Mo. § 351.245); Montana (Mont. Code Anno. § 35-1-525); Nevada (Nev. Rev. Stat. Ann. § 78.355); New Jersey (N.J. Stat. § 14A:5-19); New York (NY CLS Bus Corp § 609); North Carolina (N.C. Gen. Stat. § 55-7-22); North Dakota (N.D. Cent. Code § 10-19.1-76.2); Ohio (O.G.C.L. § 1701.48); Oklahoma (O.G.C.A. § 1057); Puerto Rico (14 L.P.R.A § 2902); Rhode Island (R.I. Gen. Laws § 7-1.1-31); Tennessee (Tenn. Code Ann. § 48-17-203);

require that the electronic proxy be accompanied by some form of verification or authentication sufficient to identify the shareholder submitting the proxy.[6] In those states without express statutory authority, corporations and their counsel must resolve interpretative questions regarding whether a telephonic or internet vote meets the requirements under state law for a "written" proxy appointment "signed" by the shareholder.

All states permit shareholders to act by consent in lieu of a meeting. Applicable statutes generally specify that the consent action must be evidenced by one or more "written" consents "signed" by the shareholders entitled to vote on the matter and "delivered" to the corporation.[7] Corporations considering an electronic consent solicitation must determine whether consents transmitted electronically meet the applicable statutory requirements for form, signature and delivery.[8]

Electronic Distribution of Shareholder Notices

Issuers considering electronic distribution of proxy materials must also address whether form and delivery requirements for shareholder meeting notices are satisfied. For example, corporations choosing to utilize electronic delivery for an annual shareholder meeting will post their meeting notice, proxy statement and annual report on their web site and concurrently transmit an e-mail notice to all consenting shareholders containing details about the location of the web site and how shareholders can access the proxy materials on the internet. Many jurisdictions require that notices be in written form but authorize notice to be communicated through a wide range of distribution media.[9] On the other hand, would this practice qualify as acceptable notice under state statutes which may specify that notices of shareholder meetings be in writing and delivered by mail?[10]

Kentucky Law

The Kentucky Business Corporation Act does not specifically authorize the use of electronic proxies. KRS 271B.7-220(2) provides, in pertinent part:

> A shareholder may appoint a proxy to vote or otherwise act for him by signing an appointment form.... For purposes of this section . . . a telegram or cablegram appearing to have been transmitted by the proper person, or a photographic, photostatic, or equivalent reproduction of a writing appointing a proxy shall be deemed to be a sufficient, signed appointment form.

Utah (Utah Code Ann. § 16-10a-722); Virginia (Va. Code Ann. § 13.1-663); Wyoming (Wyo. Stat. § 17-16-722). Section 7.22 of the Model Business Corporation Act was amended in 1996 to specifically authorize the transmission of proxy appointments by electronic or other non-written means. 51 Bus. Law. 209 (Nov. 1995).

[6] E.g., California Corporations Code §178 (permits electronic transmissions generally, and specifically authorizes telephonic transmissions). Section 1.40(7A) of the Model Business Corporation Act, added in 1996, defines an electronic transmission as "any process of communication not directly involving the physical transfer of paper that is suitable for the retention, retrieval, and reproduction of information by the recipient." The Official Comment to Section 7.22 of the Model Business Corporation Act states: "An electronic transmission which appoints a proxy is deemed the equivalent of a signed appointment form if it contains or is accompanied by information from which it can be reasonably verified that the transmission was authorized by the shareholder or by the shareholder's agent or attorney-in-fact." The Official Comment to Section 7.22 of the Model Business Corporation Act further notes that the reference to electronic transmission is specifically intended to include telephonic voting procedures.

[7] See, e.g., Model Business Corporation Act § 7.04(a).

[8] The Model Act definitions of "deliver" (§ 1.40(5)) and "sign" (§ 1.40(22A)) were amended or added in 1997 to incorporate the concepts of electronic transmission and electronic signature.

[9] See, e.g., Revised Model Business Corporation Act § 1.41(b) (1984) (notice may be communicated by telephone, telegraph, teletype or other form of wire or wireless communication).

[10] See, e.g., Ohio General Corporation Law § 1701.41.

However, the Kentucky electronic records and signature law, KRS 369.010-.030, authorizes consenting parties to agree to accept electronic records and electronic signatures as substitutes for traditional signed written documents.[11] A qualifying electronic signature must possess the following characteristics: (a) it is unique to the person using it; (b) it is capable of verification; and (c) it is under the sole control of the person using it.[12] As a result, electronic proxies (including both telephonic and internet votes) which satisfy the requirements for an electronic signature under KRS 369.020 should be enforceable under the Business Corporation Act.[13] Similarly, an electronic shareholder consent which includes a legally enforceable electronic signature under Chapter 369 should be valid for purposes of Kentucky corporate law.

KRS 271B.1-410 requires notices to be in written form but doesn't limit delivery to mail. Transmission of shareholder notices electronically (such as e-mail and posting to a web site) should be an acceptable form of delivery under Kentucky law.

In addition to relevant statutory restrictions, corporations should review their articles of incorporation and bylaws for any provisions which would preclude or be inconsistent with electronic voting and distribution arrangements.

Delaware Law

The Delaware General Corporation Law ("DGCL") specifically provides for proxy solicitation by means of any authorized electronic transmission. Section 212 of the DGCL provides, in pertinent part:

> (b) Each stockholder . . . may authorize another person or persons to act for such stockholder by proxy. . . .
>
> (c) Without limiting the manner in which a stockholder may authorize another person or persons to act for such stockholder as proxy pursuant to subsection (b) of this section, the following shall constitute a valid means by which a stockholder may grant such authority. . . .
>
> (2) A stockholder may authorize another person or persons to act for such stockholder as proxy by transmitting or authorizing the transmission of a telegram, cablegram, or other means of electronic transmission to the person who will be the holder

[11] KRS 369.030(3) provides in pertinent part:

> If all parties to a private sector transaction agree to the use of an electronic record or an electronic signature . . .
>
> (a) Information, records, and electronic signatures shall not be denied legal effect, validity, or enforceability solely on the grounds that they are in electronic, duplicate, or imaged form.
>
> (b) Where a statute or administrative regulation requires a manual signature, or provides for certain consequences if a document is not manually signed, an electronic signature shall have the same force and effect as the use of a manual signature.
>
> (c) Where a statute or administrative regulation requires information to be "written," or "in writing," or provides for certain consequences if it is not, that statute or administrative regulation shall be satisfied by an electronic record.

[12] KRS 369.020(3). The current practice for corporations offering electronic voting options to its shareholders is to assign each shareholder a personal identification number which is used to authenticate the shareholder's voting instructions.

[13] For example, Ashland Inc.'s proxy statement for its January 2000 annual shareholder meeting states that the telephone and internet voting procedures offered for that meeting were designed to comply with Kentucky law regarding the use of electronic signatures.

of the proxy . . . provided that any such telegram, cablegram or other means of electronic transmission must either set forth or be submitted with information from which it can be determined that the telegram, cablegram or other electronic transmission was authorized by the stockholder. If it is determined that such telegrams, cablegrams or other electronic transmissions are valid, the inspectors, or if there are no inspectors, such other persons making that determination shall specify the information upon which they relied.

(d) Any copy, facsimile telecommunication or other reliable reproduction of the writing or transmission created pursuant to subsection (c) of this section may be substituted or used in lieu of the original writing or transmission for any and all purposes for which the original writing or transmission could be used, provided that such copy, facsimile telecommunication or other reproduction shall be a complete reproduction of the entire original writing or transmission.

Section 222(a) of the DGCL requires corporations to give written notice of shareholder meetings. Neither the exact form of the notice or an exclusive means of delivery are specified in the statute.

Conclusion

Much of the legal uncertainty over the validity of electronic proxies and shareholder notices has been clarified or eliminated as state corporate laws have been updated to accommodate modern technology practices. Issuers should nevertheless review the expanded state laws carefully to be certain that their electronic systems and procedures satisfy the applicable requirements for retrieval and retention of electronic corporate records and for authentication of electronic signatures and transmissions.

STATE LAW ISSUES AFFECTING ELECTRONIC COMMUNICATIONS WITH SHAREHOLDERS

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SECTION K

STATE LAW ISSUES AFFECTING ELECTRONIC COMMUNICATIONS WITH SHAREHOLDERS OF INDIANA AND TENNESSEE CORPORATIONS

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NOTE K-4

State Law Issues Regarding Electronic Communications with Shareholders of Indiana and Tennessee Corporations

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From a corporate law standpoint, required communications between a corporation and its shareholders are generally limited to notices (such as notices of meetings and certain actions taken without a meeting) and voting by proxies or written consents. Written when pen, paper and the United States mail were the means of commercial communication, many corporate statutes worded these requirements in terms of *written* notices or communications which were *signed* and *delivered* when mailed.

Increasingly, corporations and shareholders are preferring electronic communications to pen, paper and the mail. Electronic communications can be quicker, cheaper and, in some contexts, easier. Electronic communications are becoming an accepted practice from a securities law perspective. But for communications that must satisfy both corporate and securities law requirements, the question is: Are they permissible under the laws of the state in which the corporation is organized? The Securities and Exchange Commission has had a practice of requiring public companies to answer this question in their proxy materials, when they offer electronic voting.[1]

Various approaches have been taken by states to permit electronic communications under their corporate codes. The Model Business Corporation Act has updated its definitions, which are generally applicable to sections throughout the Act, to include concepts consistent with electronic communications, and then addressed permissible electronic communications in specific, operative sections. Indiana and Tennessee have, in general, followed a hybrid approach to authorize certain types of electronic communications with shareholders.

An Indiana or Tennessee corporation may send notice of shareholders' meetings by wire or wireless communication, though it is advisable for corporations using this method of communication to confirm receipt of the notice. In addition, shareholders may "vote" electronically, through the appointment of proxies.

There is currently no mechanism under either the Indiana or the Tennessee Business Corporation Act for "electronic" written consents by shareholders or directors.

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[1] Item 17 in the Division of Corporation Finance Manual of Publicly Available Telephone Interpretations (July 1997) (http://www.sec.gov/rules/othern/phin797r.txt) states

> When a company offers shareholders the option of submitting a proxy by Internet, the proxy statement should include a description of Internet voting procedures and the validity under applicable state law of proxies granted pursuant to this mechanism of electronic transmission. Rule 14a-9 requires similar disclosure on the proxy card.

Indiana

Electronic notice

While generally requiring that notice be "in writing",[2] IC 23-1-20-29 permits any notice under the Indiana Business Corporation Act to be communicated

> by telephone, telegraph, teletype, or other form of wire or wireless communication.

However, the corporation bears the risk if the notice to shareholders it communicates electronically is not received. Written notice mailed by an Indiana corporation to its shareholders is effective when mailed, if mailed and correctly addressed, as shown in the corporation's current record of shareholders. IC 23-1-20-29(c). In contrast, written notice communicated electronically is not effective until received. IC 23-1-20-29(e)(1).

Voting by proxy

IC 23-1-30-3 establishes three ways in which a shareholder may authorize a person to act for the shareholder as proxy

- The shareholder or the shareholder's designated officer, director, employee or agent may execute a writing by signing it or causing his signature to be affixed to the writing by any reasonable means, including by facsimile signature

- The shareholder may transmit or authorize the transmission of an electronic submission. The electronic transmission

    - may be transmitted by any electronic means, including data and voice telephonic communications and computer network

    - may be transmitted to the person who is the holder of the proxy, a proxy solicitation firm or a proxy support service organization or similar agency authorized by the person who will be the holder of the proxy to receive the electronic submission

    - must either contain or be accompanied by information from which it can be determined that the electronic submission was transmitted by or authorized by the shareholder.

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[2] Oral notice is permitted only if authorized by the corporation's articles of incorporation or bylaws.

A copy, facsimile telecommunication or other reliable reproduction of the writing or electronic submission created may be used instead of the original writing or electronic submission for all purposes for which the original writing or electronic transmission may be used if it is a complete copy of the entire original writing or electronic submission.

- In addition, the shareholder may authorize a person to act as the shareholder's proxy *by any other method authorized by law.*

Under IC 23-1-30-5, a corporation is entitled to reject a vote, consent, waiver, or proxy appointment if the secretary or other officer or agent authorized to tabulate votes, acting in good faith, has reasonable basis for doubt about: (1) the validity of the signature on a writing or about the signatory's authority to sign for the shareholder; or (2) the validity of an electronic submission or the submitter's authority to make the electronic transmission.

Actions without a meeting

The statutes permitting actions by shareholders or directors by written consent in lieu of a meeting require that the action be evidenced by a written consent signed by the shareholders or directors. IC 23-1-29-4; IC 23-1-34-2. Signed written consents by shareholders must be delivered to the corporation, and signed written consents by directors must be included in the corporation's records. Neither of these statutes contain any mechanism for a shareholder or director to "execute" a written consent in any manner other than signing it.

Tennessee

Electronic notice

While generally requiring that notice be "in writing",[3] T.C.A. Section 48-11-202 permits any notice under the Tennessee Business Corporation Act to be communicated electronically, as follows:

> (c) Notice may be communicated in person; by telephone, telegraph, teletype, facsimile transmission or other form of wire or wireless communication; or by mail or private carrier. . . .

However, the corporation bears the risk if the notice to shareholders it communicates electronically is not received. Written notice mailed by a Tennessee corporation to its shareholders is effective when mailed if mailed postage prepaid and correctly addressed, as

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[3] Oral notice is effective if it is reasonable under the circumstances and not prohibited by the charter or bylaws.

shown in the corporation's current record of shareholders. T.C.A. Section 48-11-202(c). In contrast, written notice communicated electronically is not effective until received. T.C.A. Section 48-11-202(e)(1).

Electronic voting

Under T.C.A. 48-17-203(b)(2),

> a shareholder may authorize another person to act for the shareholder as proxy by transmitting or authorizing the transmission of a telegram, cablegram, facsimile or other means of electronic transmission to the person who will be the holder of the proxy or to a proxy solicitation firm, proxy support service organization or like agent duly authorized by the person who will be the holder of the proxy to receive such transmission, provided that any such telegram, cablegram, facsimile or other electronic transmission was authorized by the shareholder. If it is determined that such telegrams, cablegrams, facsimiles or other electronic communications are valid, the inspectors or, if there are no inspectors, such other persons making such determination shall specify the information upon which they relied.

A copy, facsimile transmission or other reliable reproduction of the electronic submission created may be used instead of the original writing or electronic submission for all purposes for which the original writing or electronic transmission may be used if it is a complete copy of the entire original electronic transmission.

Actions without a meeting

The statutes permitting actions by shareholders or directors by written consent in lieu of a meeting require that the action be evidenced by a written consent signed by each shareholder. T.C.A. Section 48-17-104 and Section 48-18-202. Signed written consents by shareholders must be delivered to the corporation, and signed written consents by directors must be included in the corporation's records. Unlike the proxy statute [T.C.A. Section 48-17-203(b)], neither of these statutes contain any mechanism for a shareholder or director to "execute" a written consent in any manner other than signing it.

Note

The language in the Indiana and Tennessee statutes permitting delivery of notices by wire or wireless communications tracked the language in the corresponding section (§1.41) of the Revised Model Business Corporation Act as in effect prior to the amendments of the Model Act pertaining to electronic filings, which were adopted effective September 20, 1997. *See* Committee on Corporate Laws, A.B.A., *Changes in the Model Business Corporation Act–Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of*

Liability for Directors, 53 Bus. Law 157 (1997); Committee on Corporate Laws, A.B.A., *Changes in the Model Business Corporation Act-Amendments Pertaining to Electronic Filings*, 52 Bus. Law 991 (1997). The changes made to the Model Act pertaining to electronic filing included changing the notice section to expressly provide that

- Notice by electronic transmission is written notice.
- Notice may be communicated by telephone, voice mail or other electronic means[4].
- Notice is effective when electronically transmitted to the shareholder in the manner authorized by the shareholder.

These changes were accompanied by a change in the official comment to address specifically notice by electronic transmission.

The 1997 changes to the Model Act establish a workable framework under which a corporation may use electronic means to communicate notice to its shareholders. Still, language permitting the communication of notice by wire or wireless communication should be broad enough to permit delivery of notices by e-mail.

February 2000

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[4] This method of communication was substituted for telephone, telegraph, teletype, or other form of wire or wireless communication.

REVIEW OF EXEMPTIONS AND LIMITED OFFERINGS, THEIR STATUS, AND THEIR COMMON APPLICATIONS AFTER NSMIA

Private Placements and Changes as a Result of NSMIA

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SECTION L

REVIEW OF EXEMPTIONS AND LIMITED OFFERINGS, THEIR STATUS, AND THEIR COMMON APPLICATIONS AFTER NSMIA

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- Overview

One of the stated purposes of the National Securities Markets Improvement Act of 1996 was to amend the Federal securities laws in order to promote efficiency and capital formation in the financial markets. As explained in the statement by the Conference Committee which accompanied the final draft of the legislation:

> The development and growth of the nation's capital markets has prompted the Congress to examine the need for legislation modernizing and rationalizing our scheme of securities regulation to promote investment, decrease the cost of capital, and encourage competition. The Managers have sought to achieve these goals while also advancing the historic commitment of the securities laws to promoting the protection of investors. In particular, the system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation. Securities offerings and the brokers and dealers engaged in securities transactions are all currently subject to a dual system of regulation that, in many instances, is redundant, costly, and ineffective.
>
> During the course of consideration of this legislation, the Congress received testimony indicating that this duplicative regulation tends to raise the cost of capital to American issuers of securities without providing commensurate protection to investors or to our markets. Testimony also indicated that technological change has transformed the capital raising process, necessitating changes in the regulatory scheme to facilitate the flow of information to potential investors and reduce the marginal cost of capital to firms. The Managers have sought to eliminate duplicative and unnecessary regulatory burdens while preserving important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal government and the states.
>
> With respect to securities offerings, the Managers have allocated regulatory responsibility between the Federal and state governments based on the nature of the securities offering. Some securities offerings, such as those made by investment companies, and certain private placements are inherently national in nature, and are therefore subject to only Federal regulation. Smaller, regional, and intrastate securities offerings remain subject to state regulation. The Managers have preserved the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers. It does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents, whether prior to their use in a state or after such use. The Conference Report requires the SEC to conduct a study on the lack of uniformity in state regulation of non-covered securities. Such study shall focus on the effect of such uniformity or lack

thereof on the cost of capital, innovation and technological development in securities markets, and duplicative regulation with respect to securities issuers, including small business.

Overviews of the impact of NSMIA on securities offerings and the Kentucky legislative and regulatory initiatives spearheaded by the Kentucky Division of Securities in response to NSMIA's mandates were presented at the 9th Biennial Midwest/Midsouth Securities Conference. *See* The National Securities Markets Improvement Act of 1996: An Overview of Current Impact, by Rutheford B. Campbell, Jr., and Kentucky Department of Financial Institutions Division of Securities – An Overview of 1997 Initiatives, by Marion H. Lewis.

This paper provides a follow-up report, focusing on private placements, and their use by issuers after NSMIA.

- National Securities Markets Improvement Act of 1996

  - NSMIA changed the securities offering process for "covered securities" by preempting state law registration and qualification requirements. The extent of the preemption – and whether state notice filings and fees may still be required – depends on the type of covered securities being offered. NSMIA brought about this change by amending Section 18 to the Securities Act of 1933.

  - Four types of "covered securities" are defined in Section 18. They include

    - *Listed securities* – This category includes securities that are (or will be upon completion of the offering) listed (or authorized for listing) on

      - the New York Stock Exchange, the American Stock Exchange or the National Market System of Nasdaq, or

      - Tier 1 of the Pacific Exchange, Incorporation, Tier 1 of the Philadelphia Exchange, Incorporated, and the Chicago Board Options Exchange, Incorporation [*see* Rule 146 under the Securities Act of 1933],

      or are securities of the same issuer that are equal in seniority or senior to such listed securities.

      - States may not impose any filing requirement or fee in connection with offerings of these securities.

- *Investment company securities* -- This category includes securities issued by an investment company registered, or that has filed a registration statement under, the Investment Company Act of 1940

- *Exempt securities* – A third category includes securities when offered and sold pursuant to certain exemptions under Sections 3 and Section 4 of the Securities Act of 1933, or pursuant to rules adopted by the Securities and Exchange Commission under Section 4(2) of the Securities Act of 1933. These covered securities include

  - secondary trading in securities by non-affiliates of the issuer exempt under Sections 4(1) or 4(3), provided the issuer files reports with the Securities and Exchange Commission pursuant to Section 13 or 15(d) of the Securities Exchange Act

  - broker's transactions exempt under Section 4(4)

  - transactions in securities exempt under Section 3(a)(2) – except that municipal securities will not be a covered security in the state in which the issuer is located

  - commercial paper exempt under Section 3(a)(3)

  - securities issued by savings and loan associations or other entities exempt under Section 3(a)(5) or 3(a)(6)

  - securities issued in connection with certain Chapter 11 bankruptcy proceedings exempt under Section 3(a)(7)

  - insurance and endowment policies and annuity contracts exempt under Section 3(a)(8)

  - the exchange of securities by an issuer with its existing security holders exempt under Section 3(a)(9)

  - the issuance of equity securities in certain bank and savings and loan holding company formations exempt under Section 3(a)(12)

  - securities issued by certain church plans, companies or accounts exempt under Section 3(a)(13)

  - the issuance of securities pursuant to rules or regulations of the Securities and Exchange Commission under Section 4(2), although a state may impose notice filing requirements that are *substantially similar to* those required under rule or regulation as in effect on September 1, 1996.

* Currently, the only rule or regulation issued by the SEC under Section 4(2) is Rule 506 of Regulation D.

* Examples of exempt offerings that are **not** covered securities

  + limited offerings under Rule 504 or Rule 505 of Regulation D
  + offerings pursuant to compensatory plans under Rule 701

- *Qualified investors* – A final category covers securities when offered and sold to qualified investors, as defined by the Securities and Exchange Commission by rule. To date, the SEC has not defined the term "qualified investors".

o Advantages of offering a covered security

- Issuers are not required to comply with state securities law requirements to register or qualify the securities or the securities transaction

- State law requirements prohibiting, limiting or imposing conditions on the use of an offering document prepared by or on behalf of an issuer with respect to the covered security are preempted

- Avoid any state merit review of the offering or the issuer

o Some state law compliance is still required

- Except in connection with offerings of listed securities (see above), states may continue to require notice filings and assess fees in connection with offerings of covered securities.

  ■ A state securities commission may require the filing of documents filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933, together with annual or periodic reports of the value of securities offered or sold in the state (to the extent not included in the SEC filings), for notice purposes and the assessment of any fee, together with payment of any required fees and a consent to service of process.

  ■ Until a state, by law, rule, regulation, or order or administrative action, provides otherwise, filing and registration fees with respect to securities and securities transactions will continue to be collected in amounts determined pursuant to state law as in effect on the day before NSMIA was enacted. These fees must be paid, and supporting data reported, on the same schedule as would have been applicable absent preemption.

        - Listings of states that have adopted laws and/or regulations in response to NSMIA and containing filing requirements for covered securities offerings can be found at 1 CCH BLUE SKY L. RPTR. ¶ 6491.

    - Nothing in NSMIA prohibits a state securities commission from suspending the offer or sale of securities within that state for failure to submit any filing or fee required under law and permitted by NSMIA. In addition, during the first three years after the enactment of NSMIA (until October 1999), a state securities commission could require registration of securities if the issuer refused to pay the fee required.

    - State securities commissions retain jurisdiction to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful actions by brokers or dealers in connection with securities or securities transactions

    - While an offering of covered securities is, in effect, exempted from state registration and qualification requirements, this exemption does not extend to state broker-dealer and agent requirements.

        - State laws must still be examined to determine whether participants in the offering – or representatives of the issuer – will fall within the definition of a broker, dealer, agent or the like and will have to comply with state licensing requirements because of their role in the offering.

- Private placements and limited offerings– coordinating Federal and state exemptions

    - Under Section 4(2) of the Securities Act of 1933, transactions by an issuer not involving any public offering do not have to comply with the registration requirements imposed under Section 5 of that act.

        - The statute does not indicate what requirements must be met in order for a transaction by an issuer not to involve any public offering. One must look to the case law to determine the criteria considered important by courts when judging the availability of this exemption

        - Securities offered and sold in reliance on Section 4(2), and not pursuant to a rule adopted under Section 4(2) by the Securities and Exchange Commission, are not covered securities. The securities offering will have to be structured to meet an exemption from registration under applicable state securities laws, or be registered or qualified under those securities laws.

- The Securities and Exchange Commission adopted Rule 506 to provide a safe harbor as to what constitutes a transaction not involving a public offering, for purposes of Section 4(2).

  - A security issued in a non-public offering exempt from registration under Rule 506 will be a "covered security" with respect that offering, and will be exempt from state registration and qualification requirements, although a state may impose notice filing requirements that are "substantially similar" to those required under Regulation D, as in effect on September 1, 1996.

    - Under Regulation D, that notice, a Form D, is required to be filed with the SEC within 15 days after the first sale. The requirement to file notice of sales is contained in Rule 503. Failure to file the notice with respect to an offering will not affect the exempt status of the offering. However, if an issuer, or any of its predecessors or affiliates have been temporarily, preliminarily or permanently enjoined for failure to comply with this notice filing requirement, the issuer cannot use the exemptions under Rule 506 (or 504 or 505), unless the Securities and Exchange Commission, determines, upon a showing a good cause, that it is not necessary under the circumstances that the exemption be denied.

  - As noted in the SEC's Report on Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities", October 11, 1997 (http://www.sec.gov/news/studies/uniformy.htm), some states require advance notice of these offerings of covered securities, before sales are made, or require the filing of offering materials which are not required to be filed with the SEC.

  - Conditions that must be met for Rule 506 offerings:

    - no general advertising or general solicitation
    - no more than 35 purchasers, not counting accredited investors
    - each purchaser who is not an accredited investors must, alone or with his purchaser representative, have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the investment
    - all purchasers who are not accredited investors must receive information meeting minimum disclosure requirements a reasonable time before they make their investment decision
    - restrictions on transferability apply to securities acquired, and the issuer must exercise reasonable care to assure that investors are purchasing for investment and are not underwriters (*i.e.*, acquiring securities with a view to engaging in a distribution)

- Other exemptions for limited offerings of securities that do not constitute covered securities have been established by regulation of the Securities and Exchange Commission. Offerings of securities pursuant to these limited offering exemptions must be registered or qualified under applicable state securities laws absent a state exemption from registration. The limited offering exemptions created by the SEC include

  - the exemption for limited offerings and sales of securities not exceeding $1,000,000, pursuant to Rule 504 of Regulation D

    - This exemption cannot be used by an issuer that is subject to the reporting requirements of Section 13 or 15(d) under the Securities Exchange Act of 1934, that is an investment company, or that is a development stage company that either has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified person.

    - The maximum aggregate offering price cannot exceed $1,000,000 less the aggregate offering price of all securities sold during the 12 months before the start of and during the Rule 504 offering in reliance on any exemption under Section 3(b) or in violation of Section 5(a) of the Securities Act of 1933.

    - Effective April 7, 1999, the Securities and Exchange Commission modified Rule 504 to curb fraudulent transactions in securities of microcap companies. General advertising and general solicitation are now prohibited under Rule 504 and securities issued in reliance on the exemption will be restricted securities <u>unless</u> offers and sales of the securities are either

      + registered pursuant to state law requirements that require the public filing and delivery to investors of substantive disclosure documents before sale[1], or

      + made exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to accredited investors

        - A Model Accredited Investor Exemption for sales by an issuer to accredited investors was adopted by the North American Securities

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[1] So long as this requirement is met, offers and sales may also be made in other states that do not require registration or public filing or delivery of disclosure documents provided the disclosure document is delivered to <u>all</u> purchasers before sale.

Administrators Association (NASAA) in 1997. *See* CCH NASAA RPT. p. 361

- the exemption for limited offerings and sales of securities not exceeding $5,000,000, pursuant to Rule 505 of Regulation D

    * no general advertising or general solicitation
    * no more than 35 purchasers, not counting accredited investors
    * all purchasers who are not accredited investors must receive information meeting minimum disclosure requirements a reasonable time before they make their investment decision
    * restrictions on transferability apply to securities acquired, and the issuer must exercise reasonable care to assure that investors are purchasing for investment and are not underwriters (*i.e.*, acquiring securities with a view to engaging in a distribution)
    * the maximum aggregate offering price cannot exceed $5,000,000 less the aggregate offering price of all securities sold during the 12 months before the start of and during the Rule 505 offering in reliance on any exemption under Section 3(b) or in violation of Section 5(a) of the Securities Act of 1933.
    * the "bad boy" provisions of Regulation A apply

- the exemption for mini-public offerings not exceeding $5,000,000, pursuant to Regulation A

- the exemption for offers and sales pursuant to certain compensatory benefit plans and contracts, pursuant to Rule 701

    * This exemption is available to private companies – that is, an issuer that is not subject to the reporting requirements of Section 13 or 15(d) under the Securities Exchange Act of 1934, and that is not an investment company registered, or required to be registered, under the Investment Company Act of 1940.

    * The exemption covers offers and sales of securities under a written compensatory benefit plan (or written compensation contract) to employees, directors, general partners, officers or consultants and advisors.

    * Effective February 25, 1999, Rule 701 was amended to, among other things

+ remove the $5 million per year aggregate offering price ceiling. The aggregate amount of securities that can now be sold[2] pursuant to the exemption during a 12-month cannot exceed the greater of

  - 15% of the total assets of the issuer[3], or
  - 15% of the outstanding amount of the class of securities being offered[3], or
  - $1,000,000

+ require specific disclosure from issuers if the aggregate sales price of the amount of securities sold during a 12 month period exceeds $5 million

+ impose special requirements on the types of consultants and advisors to whom securities may be offered and sold in reliance on the rule

  - they must be natural persons
  - they must provide *bona fide* services
  - the services provided cannot be in connection with the offer or sale of securities in a capital raising transaction, and cannot directly or indirectly promote or maintain a market for the issuer's securities

+ extend the exemption to family members of employees, directors, general partners, officers and consultants and advisors who acquire such securities through gifts or domestic relations orders

- These limited offering exemptions were created by the Securities and Exchange Commission pursuant to Section 3(b) of the Securities Act of 1933. This statute authorizes the SEC to create additional exemptions from the Federal registration requirements for issues of securities that do not exceed $5,000,000, in the aggregate.

■ Section 3(c) of the Securities Act of 1933 also authorizes the Securities and Exchange Commission to create registration exemptions for securities issued by small business investment companies under the Small Business Investment Act of 1958. The SEC has adopted Regulation E which provides an exemption for securities of small business investment companies, subject to certain conditions.

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[2] Sales of securities underlying an option are counted as sales on the date the option is granted.

[3] Measured at the issuer's most recent balance sheet date (no later than its last fiscal year end).

- Standard state exemptions for private placements and limited offerings in Kentucky

  - Covered securities filing requirements, including filings for transactions exempt under Rule 506 of Regulation D, are contained in KRS 292.327

    - With respect to an offering exempt under Rule 506, the notice on Form D, together with a $250 filing fee and a consent to service of process, must be filed no later than 15 days after the first sale in Kentucky.

  - KRS 292.410(1)(i) provides an exemption from state registration requirements for certain types of limited offerings.

    - The types of limited offerings covered by this exemption are

      - *Organizer/manager:* each purchaser has access to all the material facts with respect to the securities by reason of the purchaser's active involvement in the organization or management of the issuer or the purchaser's family relationship with a person actively involved in the organization or management of the issuer

      - *Limited qualified purchasers:* there are no more than 15 purchasers in Kentucky and each Kentucky purchaser is an accredited investor or meets the active involvement test described above

      - *Limited amount:* the aggregate offering price of the securities (in and outside Kentucky) does not exceed $500,000, the total number of purchasers (in and outside Kentucky) does not exceed 35, and each purchaser either is an accredited investor or meets the active involvement test described above, or receives all of the material facts with respect to the investment decision

        - Upon request, the Commissioner of the Department of Financial Institutions may, by order, increase the maximum offering amount above $500,000 or the maximum number of purchasers above 35 if the Commissioner determines that the increase is necessary or appropriate in the public interest or for the protection of investors. The request must be made in advance of sales, and must be accompanied by

          - a statement of the reasons for requesting the increase

          - a copy of the offering circular or other disclosure materials being distributed to prospective purchasers

- a copy of the written representation and legend serving as the issuer's basis for reasonably believing each purchaser's investment intent and awareness of the transferability and resale restrictions on the securities being offered

- a $250 filing fee

■ The following conditions must be met:

* no general advertising or general solicitation

* the issuer must reasonably believe each purchaser is acquiring the securities for investment and is aware of the restrictions imposed on transferability and resale

- Kentucky's counterpart to Rules 504 and 505 is contained in Rule 808 KAR 10:210

  ■ Offerings exempt under Rule 504 (as in effect June 14, 1996) or Rule 505 (as in effect August 13, 1992) will be exempt if the following conditions are met

  * no general advertisement or general solicitation

  * the issuer must reasonably believe each purchaser is acquiring the securities for investment and is aware of the restrictions imposed on transferability and resale

  * notice is filed, together with a $250 filing fee

  + The required notice consists of notice on Form D, manually signed on behalf of the issuer, and information furnished by the issuer to an offeree (issuers must also provide notice of material changes to the offering materials during the course of the offering within 15 days, and file a copy of any subsequent filings with the Securities and Exchange Commission)

  + The notice must be filed no later than 15 days after the first sale from or into Kentucky, for Rule 505 transactions, or at least 10 *business* days *prior* to the first sale from or into Kentucky, for Rule 504 transactions

    - The Department of Financial Institutions can determine that the exemption is not available during this time period.

  * Disqualifying provisions, similar (but not identical) to the "bad boy" provisions contained in Regulation A, apply

- The exemption does not exempt any person who receives a commission, finder fee or other remuneration in connection with a sale of a security from state broker-dealer or agent registration requirements

- Kentucky's Rule 701

  - Offers and sales of securities that are exempt under Rule 701 are also exempt from registration in Kentucky, pursuant to Rule 808 KAR 10:300. However, this exemption cannot be used as part of a plan or scheme to circumvent the purpose of the exemption, including to raise capital.

- Limited offerings to accredited investors – Rule 808 KAR 10-340

  - Offers and sales by an issuer are exempt if sales are made exclusively to accredited investors

    * A general announcement of the offering may be made by any means, but its content generally must be limited to that set out in the rule

    * Information may be distributed to accredited investors (either through an electronic database restricted to prequalified accredited investors or to a prospective purchaser whom the issuer reasonably believes to be an accredited investor)

    * A notice filing is required within 15 days after the first sale in Kentucky, which must be accompanied by a copy of the general announcement, a consent to service of process and a $250 fee.

  - An issuer cannot rely on this exemption if the issuer issues interests in an oil, gas or mineral enterprise, or is in the development stage and has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified person.

  - An issuer may be disqualified from using this exemption as a result of certain stop orders, criminal convictions, administrative enforcement orders or judgments or restraining orders or injunctions.

- Other Kentucky exemptions that might be useful

  - securities issued in a statutory merger or reorganization (KRS 292.410(1)(n))

- offerings to existing security holders of the issuer if no commission or other remuneration is paid or given for soliciting any security holder in this state (KRS 292.410(1)(k))

- safe harbor for limited liability company membership interests – Rule 808 KAR 10:360

- Limited offering exemptions in Indiana

  - Federal covered securities are excepted from the state registration requirements [IC 23-2-1-3(3)], although the Securities Commissioner may, by rule or otherwise, require notice filings and a fee pursuant to IC 23-2-1-6.1.

  - For offerings made in compliance with Rule 506 of Regulation D, the Form D must be filed no later than 15 days after the date of first sale in Indiana. *See* Administrative Order of the Securities Commissioner, Indiana Division of Securities, dated November 22, 1996 [2 CCH BLUE SKY L. RPTR. ¶ 24,692]; Section 710 IAC 1-13-6(d)(2).

  - The Indiana uniform limited offering exemption is contained in Section 710 IAC 1-13-6. It exempts from state registration offers and sales exempt pursuant to Rule 504, 505 or 506 (as made effective by identified SEC releases). The exemption for offerings made in compliance with Rule 504 or 505 is subject to the following conditions:

    * No commission, fee or other remuneration is paid for soliciting prospective purchasers in Indiana to any broker-dealer who is not registered in Indiana

    * Notice on Form D is filed no later than *10 full business days prior to* the receipt of consideration or the delivery of a subscription agreement by an Indiana investor, together with a copy of offering materials and a consent to service of process

    * With respect to sales to nonaccredited investors in Indiana, either the issuer must reasonably believe (after inquiry) that the investment is a suitable investment[4] or the purchaser must either alone or with his purchaser representative have such knowledge and experience in financial and business matters that the purchaser is capable of evaluating the merits and risks of the investment

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[4] An investment that does not exceed 10% of the investor's net worth is presumed to be suitable.

The Indiana Securities Commissioner may, by order, increase the number of purchasers or waive any of the conditions of this exemption

- A statutory limited offering exemption is also contained in IC 23-2-1-2(b)(10).

    * Similar to Kentucky's statutory exemption, this section provides an exemption for limited offerings of restricted securities where there are a limited number of nonaccredited purchasers (either no more than 20 in Indiana or 35 anywhere), there is no general advertisement or general solicitation, and the issuer reasonably believes each purchaser is purchasing for investment and is aware of the transferability and resale restrictions on the securities being offered.[5] This exemption is self-executing if

        + each purchaser has access to all material facts by reason of his active involvement (or his family relationship with a person actively involved) in the organization or management of the issuer, or

        + there are no more than 15 purchasers in Indiana and each Indiana purchaser is an accredited investor or meets the active involvement test described above, or

        + the aggregate offering price of the securities (in and outside Indiana) does not exceed $500,000, the total number of purchasers (in and outside Indiana) does not exceed 25, and each purchaser either is an accredited investor or meets the active involvement test described above, or receives all of the material facts with respect to the security

    * Advance filings are required in connection with other types of transactions, and a $100 filing fee is required. Notices of sales are also required under Section 710 IAC 1-13-4. Based on the "tips" provided in the interpretive opinion of James Andrew Klimek, Chief Counsel to the Securities Commissioner, Indiana Securities Division, dated September 30, 1996, [2 CCH BLUE SKY L. RPTR. ¶ 24,693], issuers will want to rely on the Indiana limited offering exemption provided by regulation for a transaction that does not fit within the statute's self-executing exemption.

- Section 710 IAC 1-13-3 contains the "bad boy" provisions that can disqualify an issuer from using the limited offering exemptions established by the regulation and the statute.

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[5] See 710 IAC 1-13-2 for rules for calculating the number of purchasers and disclosure obligations.

- The Indiana model accredited investor exemption was adopted by Administrative Order of the Securities Commissioner, dated February 27, 1998. 2 CCH BLUE SKY L. RPTR. ¶ 24,698.

- Securities issued in connection with an employee stock purchase, savings, pension, profit-sharing or similar plan are exempt from state registration requirements pursuant to IC 23-2-1-2(a)(7). In addition, offers and sales to directors and executive officers are exempt under IC 23-2-1-2(b)(9).

○ Limited offering exemptions in Tennessee

- The notice filing requirements for covered securities are contained in Section 48-2-125 of the Tennessee Code, and Rule 0780-4-2-.12. Certain exemptions from the statutory notice filing and fee requirements have been added. *See* 3 CCH BLUE SKY L. RPTR. ¶54,180.

  - For Rule 506 transactions, the notice on Form D must be filed within 15 days after the first sale in Tennessee, together with a consent to service of process and a $500 fee.

  - Rule 0780-4-2-.12 also requires that each notice filing include "a copy of the issuer's prospectus and statement of additional information."

- Tennessee's uniform limited offering exemption, Rule 0780-4-2-.08, is limited to transactions exempt under Rule 505.

  - Notice filing and a $300 fee are required no later than 15 days after the earlier of the first payment of consideration or the delivery of a signed subscription agreement by a Tennessee investor

    * The notice filing must include the manually signed Form D, a consent to service of process, the date of the first sale in Tennessee (if any) and copies of offering materials (legends on offering documents are required). Additional information may be requested by the Division.

  - Suitability requirements apply to nonaccredited investors

  - No commissions, fees or other remuneration may be paid for soliciting prospective purchasers in Tennessee except to persons appropriately registered in Tennessee.

  - "Bad boy" provisions can disqualify a person from relying on this exemption

- Limited offerings are also exempt under Section 48-2-103(b)(4) of the Tennessee Code if

    - ■ The aggregate number of Tennessee purchasers of securities from the issuer and its affiliates pursuant to the exemption does not exceed 15 during a 12 month period

    - ■ The securities are not offered by means of publicly disseminated advertisements or sales literature

    - ■ All purchasers in Tennessee purchase for investment and not with an intent to participate in a distribution (investment intent is presumed if securities are held for 2 years after full payment)

- Section 48-2-103(b)(9) of the Tennessee Code Annotated contains an exemption of securities issued in connection with a stock bonus plan requiring payment of no consideration other than services or in connection with certain qualified stock bonus or retirement plans

- The March 7, 1995 Statement of Policy, Kenneth T. McClellan, Assistant Commissioner for Securities, addresses the status of limited liability company interests as securities. 3 CCH BLUE SKY L. RPTR. ¶54,521.

● Common questions

  ○ What disclosures are required

    - Rule 502(b)(2) of Regulation D describes the type of information that must be furnished to nonaccredited investors in a Rule 505 or 506 offering a reasonable time prior to the purchase. For U.S. issuers that are not subject to the reporting requirements under Section 13 or 15(d) of the Securities Exchange Act of 1934, these requirements include, to the extent material to an understanding of the issuer, its business and the securities being offered

      - ■ The same type of information that would be required in an offering circular pursuant to Regulation A (or, if the issuer is not eligible to use Regulation A, the same kind of information that would be required in a prospectus pursuant to a registration statement form the issuer would be entitled to use)

      - ■ The type of financial statements required depends on the amount of the offering

        - * Only the issuer's balance sheet (dated within 120 days of the start of the offering) is required to be audited for offerings up to $2,000,000 or for offerings over $2,000,000 if the issuer (other than a limited partnership) cannot obtain audited financial statements without unreasonable expense

    - The issuer must also provide purchasers the opportunity to ask questions and to receive answers and to obtain additional information to verify the information furnished.

    - In addition, the issuer must provide a brief description of any additional material written information concerning the offering that has been provided to an accredited investor.

    - For business combinations or exchange offers, in addition to the information required by a registration statement on Form S-4, the issuer is required to provide purchasers written information about any terms or arrangements of the proposed transactions that are materially different from those for all other security holders.

    - The issuer must advise the purchaser of the limitations on resale.

  - SEC Rule 701 requires the delivery to investors of a copy of the compensatory benefit plan or contract. In addition, if aggregate sales during a 12 month period exceed $5 million, investors must be given, a reasonable time before the date of sale (or, in the case of options, date of exercise)

    - a summary plan description for plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) or, if the plan is not subject to ERISA, a summary of the material terms of the plan

    - information about the risks associated with an investment in the securities being sold

    - financial statements that would be required to be delivered in a Regulation A offering, which are as of a date no more than 180 days before the date of sale

  - In any case, disclosure is required to the extent necessary to comply with Federal and state anti-fraud rules.

- Integration – when will offers and sales be treated as part of the same offering

  - Regulation D

    - Rule 502(a) of Regulation D creates a safe harbor for when offers and sales will <u>not</u> be "integrated" and treated as part of the same offering. Offers and sales that occur more than 6 months before the start of a Regulation D offering or are made more than 6 months after completion of a Regulation D offering will not be considered a part of the Regulation D offering so long as during those 6 month periods there are no other offers or sales of securities by the issuer of the same class as those offered in the Regulation D offering (other than offers and sales under an employee benefit plan).

- ■ When that safe harbor is unavailable, the following factors should be considered in determining whether offers should be integrated

  - * whether the sales are part of a single plan of financing
  - * whether the sales involve the issuance of the same class of securities
  - * whether the sales have been made at or about the same time
  - * whether the same type of consideration is being received
  - * whether the sales are made for the same general purpose

- Offers and sales exempt under Rule 701 will not be integrated with any other offers or sales.

- Some state exemptions also contain "no integration" provisions.

o What happens if something goes wrong, and the intended exemption is not available

- Insignificant deviations from the requirements of Rule 504, 505 or 506 of Regulation D or Kentucky's, Indiana's or Tennessee's counterpart will not result in the loss of the exemption. However, an enforcement action may still be brought.

  - ■ To qualify as an insignificant deviation under Rule 508 of Regulation D, the person relying on the exemption must show

    - * the term, condition or requirement not complied with was not directly intended to protect the particular individual or entity to whom the offer or sale was made

    - * the failure to comply was insignificant with respect to the offer as a whole

      - + the dollar limits in Rules 504 and 505 *are* significant
      - + limitations on the manner of sale *are* significant
      - + limitations on the number of purchasers *are* significant

    - * a good faith reasonable attempt was made to comply with all applicable terms, conditions and requirements

- Kentucky, Indiana and Tennessee provide similar treatment of insignificant deviations in 808 KAR 10:210, Section 710 IAC 1-13-6, and Rule 0780-4-2-.08.

o Broker-dealer compliance

- State securities laws frequently define an "agent" to include individuals representing an issuer in effecting purchasers or sales of securities, and impose licensing or registration requirements on them. Such definitions raise the potential problem that an officer or employee of an issuer could be characterized as an "agent" when the issuer offers securities directly, without the use of a broker-dealer. One approach states have taken that addresses this potential problem is to exclude from the definition of an "agent" individuals who represent issuers in connection with certain types of transactions exempt under state law. However, with the adoption of NSMIA, states may not have extended this approach to transactions in covered securities. As a result, an issuer may still be forced to find a state exemption in order to make an offering directly, by its officers or employees.

- Kentucky's definition of "agent" avoids this potential problem. In Kentucky, an individual is excluded from the definition of an "agent" if the individual primarily performs, or is intended primarily to perform upon completion of the offering of the issuer's securities, substantial duties for or on behalf of the issuer otherwise than in connection with transactions in the issuer's own securities and the individual's compensation is not based upon the amount of purchases or sales of the issuer's own securities effected for the issuer. KRS 292.310(1)(a)e.

- Indiana, in contrast, does not contain such an exclusion. IC 23-2-1-1(b). Whether an individual representing an issuer in connection with an offering will be required to register as an "agent" will depend on whether the transaction falls within certain exemptions, such as

  - transactions exempt under IC 23-2-1-2(b), or

  - transactions with existing employees, partners or directors of the issuer, if no commission or other remuneration is paid or given directly or indirectly for soliciting a person in Indiana

- In Tennessee, an "agent" refers to individuals representing broker-dealers in effecting or attempting to effect purchases or sales of securities from, in or into Tennessee. T.C.A. Section 48-2-102(2). Issuers are generally excluded from the definition of "broker-dealer", subject to an exception with respect to fractional undivided interests in oil, gas or other mineral rights. T.C.A. Section 48-2-102(3).

RULE 144 A OFFERINGS

Bob Ford Thompson
Bass, Berry & Sims PLC
Nashville, Tennessee

SECTION M

RULE 144A OFFERINGS

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RULE 144A OFFERINGS

Bob Thompson
Bass, Berry and Sims PLC
Nashville, Tennessee

1. Rule 144A. Adopted in April 1990, Rule 144A provides a safe harbor for resales of privately placed or other unregistered securities such as foreign debt and equity to "qualified institutional buyers" (popularly known as "QIBs"). Four conditions must be met:

a. Sales only to QIBs – the securities can only be sold to QIBs or persons reasonably believed to be QIBs for their own account or for the account of another QIB. QIBs are:

(i) Any corporation, partnership or other entity (not an individual) that owns and invests on a consolidated basis $100 million or more in the aggregate in non-affiliate securities;

(ii) Any investment company that is part of a family of investment companies that has the same investment adviser and together own $100 million of non-affiliate securities;

(iii) Registered dealers that own or invest on a discretionary basis at least $10 million of non-affiliate securities, or are acting in a "riskless principal transaction" on behalf of a QIB;

(iv) US or foreign banks or thrifts that not only own or invest more than $100 million in non-affiliate securities, but also have an audited net worth of at least $25 million;

(v) For purposes of above tests, non-affiliate securities cannot include bank deposits, loan participations, repurchase agreements and securities subject thereto, or interest rate, currency or commodity swaps;

(vi) For purposes of determining QIB status, sellers may rely on publicly available financial statements, securities manual information or certification from the chief financial officer or other executive officer of the purchasing QIB.

b. Notice from Seller – the seller must take reasonable steps to make sure purchaser is aware that the seller may rely on 144A. However, there is no requirement of a legend or other resale restriction.

c. Securities that can be sold under 144A – Debt or equity that, when issued, are not of the same class as securities listed as a national securities exchange or quoted through an automated interdealer quotation system ("Quoted Securities"). Convertible securities that are not immediately convertible or have a conversion premium of 10 percent or more are not considered to be of the same class as Quoted Securities. Warrants are treated as of the same class as the underlying security unless at the time of issuance they had a term of at least three years and an effective exercise premium of at least 10%. Open-end investment companies, unit investment trusts and face-amount certificate companies cannot utilize Rule 144A.

d. Disclosure Requirements – For issuers which are neither reporting companies under the Exchange Act or a foreign company exempt from reporting pursuant to Rule 12g3-2(b), the holder and an prospective purchaser must have the right to obtain from the issuer (and the purchaser must have obtained if requested) a "very brief statement" of the nature of the business of the issuer and the products and services it offers and the issuer's most recent balance sheet and profit and loss and retained earnings statement for the most recent period and the two preceding years (audited "to the extent reasonably available").

e. General Solicitation – Rule 144A does not contain any prohibition relating to "general solicitation." However, most 144A transactions are structured to avoid general solicitation, so that the resale might arguably qualify as a "4(1½)" exemption.

f. PORTAL ("Private Offering, Resale and Trading through Automated Linkages"). When Rule 144A was adopted, the SEC also approved rules establishing a NASD marketplace known as PORTAL, which is limited to Rule 144A securities, Rule 144(a)(3) restricted securities, or securities contractually required to be resold only pursuant to Regulation S, Rule 144A or Rule 144 or in "secondary private placements." Access to PORTAL is limited to QIBs, "PORTAL" dealers and "PORTAL brokers."

2. Rule 144A Private Placement Procedures – The procedures for Rule 144A offerings are similar to those for standard public offering. Typically there is a purchase agreement between the issuer and its investment bankers containing representations, warranties, covenants and conditions, including indemnification and contribution provisions. An offering memorandum containing prospectus-like information concerning the issuer and the securities offered is prepared and utilized by the purchasers for the resale of the securities pursuant to Rule 144A to QIBs.

3. Exxon Capital Exchange Offers.

a. Rule 144A offerings are often followed by SEC registered exchange offers (usually referred to as "AB exchange offers" or "Exxon Capital exchange offers") where the issuer offers to the holders of 144A securities to exchange them for similar securities that have been registered, and therefore are freely tradable. Usually the exchange offer is made pursuant to the terms of a registration rights agreement between the issuer and the 144A investment banks whereby the issuer agrees to register substantially identical securities on Form S-4, allowing exchanging QIB purchasers to acquire securities that can be resold without delivery of a prospectus. See Exxon Capital Holdings Corp., SEC No-Action Letter (May 13, 1988) and Morgan Stanley & Co. Incorporated, SEC No-Action Letter (June 5, 1991), among others. From the issuer's standpoint, the procedure permits the institutional purchasers to acquire registered securities without having to maintain a shelf registration.

b. These no-action letters generally are conditioned on:

(i) the holder not being an affiliate of the issuer;

(ii) the holder having acquired the new securities in the ordinary course of business;

(iii) the holder having no arrangement or understanding with any person to participate in a distribution of the new securities; and

(iv) the holder not having purchased the "old" securities directly from the issuer to resell pursuant to Rule 144A or any other available 33 Act exemption.

c. This procedure is available for non-convertible debt securities, non-convertible preferred stock, trust preferred securities and depository share representing common stock of non-reporting non-US companies.

d. Attached are selected portions of the documentation of a typical Exxon Capital exchange offer.

e. The SEC's Aircraft Carrier Release proposed to repeal the Exxon Capital line of interpretative letters, primarily because the flexibility and speed for public offerings by Form B and medium-sized Form A issuers purportedly provided under the proposal eliminates the need to facilitate these Exxon Capital offerings. The staff expressed concern in the Aircraft Carrier Release over Rule 144A/Exxon Capital offerings acting as conduits that allow securities to flow to public markets. However, a study by former SEC Commissioner Charles C. Cox found that retail trading after Exxon Capital exchange offers averaged less than 0.5% of the principal amount issued and slightly more than 1% of the aggregate trading volume.

f. The predominance of 144A offerings clearly was influential in the staff's undertaking the wholesale review which resulted in the Aircraft Carrier Release. The staff noted that in 1997 Rule 144A offerings comprised 17% of all offerings, including 21% of all equity and 16% of all debt. In that year 16% of the high-yield debt, 72% of the convertible investment grade debt, and 10% of the investment grade debt were issued in the Rule 144A market. It is with noting that Form S-3 is available for the last category, but not for high-yield or convertible debt offerings.

g. Recently, a group of 60 securities lawyers, including seven former SEC Commissioners and six of the last seven directors of the Division of Corporation Finance, have submitted an outline to the staff for how public and private offerings of securities should be regulated in the future. Among their proposals is to liberalize the definition of QIB so that it is consolidated with those of "accredited investor" under Reg D and "qualified purchaser" under the 40 Act. The group also recommends eliminating restrictions on offers for all private placements, including 144A, and confining Securities Act protection to purchasers as opposed to offerees.

SELECTED EXCERPTS FROM THE DOCUMENTATION OF A TYPICAL

"EXXON CAPITAL EXCHANGE OFFER"

-- Marsh Supermarkets Example --

MARSH SUPERMARKETS, INC.
(an Indiana corporation)

$150,000,000

PURCHASE AGREEMENT

July 29, 1997

MERRILL LYNCH & CO.
Merrill Lynch, Pierce, Fenner & Smith
Incorporated
McDonald & Company Securities, Inc.
c/o Merrill Lynch & Co.
Merrill Lynch, Pierce, Fenner & Smith
Incorporated
North Tower
World Financial Center
New York, New York 10281-1209

Ladies and Gentlemen:

Marsh Supermarkets, Inc., an Indiana corporation (the "Company"), and each of the Guarantors listed on Schedule B hereto (the "Guarantors") confirm their respective agreements with Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") and each of the other Initial Purchasers named in Schedule A hereto (collectively, the "Initial Purchasers", which term shall also include any initial purchaser substituted as hereinafter provided in Section 10 hereof), for whom Merrill Lynch is acting as representative (in such capacity, the "Representative"), with respect to (i) the issue and sale by the Company and the purchase by the Initial Purchasers, acting severally and not jointly, of the respective principal amounts set forth in said Schedule A of $150,000,000 aggregate principal amount of the Company's Senior Subordinated Notes due 2007 (the "Securities") and (ii) the issue and sale by the Guarantors and the purchase by the Initial Purchasers, acting severally and not jointly, of the senior subordinated guarantees (the "Guarantees") of the Company's obligations under the Securities. The Securities and the Guarantees are to be issued pursuant to an indenture dated as of August 5, 1997 (the "Indenture") among the Company, the Guarantors and State Street Bank and Trust Company, as trustee (the "Trustee"). Securities and Guarantees issued in book-entry form will be issued to Cede & Co. as nominee of The Depository Trust Company ("DTC") pursuant to a letter agreement, to be dated as of the Closing Time (as defined in Section 2(b)) (the "DTC Agreement"), among the Company, the Guarantors, the Trustee and DTC.

The Company and the Guarantors understand that the Initial Purchasers propose to make an offering of the Securities and the Guarantees on the terms and in the manner set forth herein and agree that the Initial Purchasers may resell, subject to the conditions set forth herein, all or a portion of the Securities and the Guarantees to purchasers ("Subsequent Purchasers") at any time after the date of this Agreement. The Securities and the Guarantees are to be offered and sold through the Initial Purchasers without being registered under the Securities Act of 1933, as amended (the "1933 Act"), in reliance upon exemptions therefrom. Pursuant to the terms of the Securities, the Guarantees and the Indenture, investors that acquire Securities and Guarantees may only resell or otherwise transfer such Securities and Guarantees if such Securities and Guarantees are hereafter registered under the 1933 Act or if an exemption from the registration requirements of the 1933 Act is available (including the exemption afforded by Rule 144A ("Rule 144A") or Regulation S ("Regulation S") of the rules and regulations promulgated under the 1933 Act by the Securities and Exchange Commission (the "Commission")).

The Company and the Guarantors have prepared and delivered to each Initial Purchaser copies of a preliminary offering memorandum dated July 16, 1997 (the "Preliminary Offering Memorandum") and have prepared and will deliver to each Initial Purchaser, on the date hereof or the next succeeding day, copies of a final offering memorandum dated July 29, 1997 (the "Final Offering Memorandum"), each to be used by such Initial Purchaser in connection with its solicitation of, purchases of, or offering of, the Securities and the Guarantees. "Offering Memorandum" means, with respect to any date or time referred to in this Agreement, the most recent offering memorandum (whether the Preliminary Offering Memorandum or the Final Offering Memorandum, or any amendment or supplement to either such document), including exhibits thereto and any documents incorporated therein by reference, which has been prepared and delivered by the Company and the Guarantors to the Initial Purchasers in connection with their solicitation of purchases of, or offering of, the Securities and the Guarantees.

All references in this Agreement to financial statements and schedules and other information which is “contained,” “included” or “stated” in the Offering Memorandum (or other references of like import) shall be deemed to mean and include all such financial statements and schedules and other information which is incorporated by reference in the

Offering Memorandum; and all references in this Agreement to amendments or supplements to the Offering Memorandum shall be deemed to mean and include the filing of any document under the Securities Exchange Act of 1934 (the "1934 Act") which is incorporated by reference in the Offering Memorandum.

The holders of the Securities and the Guarantees will be entitled to the benefits of the registration rights agreement to be dated as of the Closing Time (the "Registration Rights Agreement"), among the Company, the Guarantors and the Initial Purchasers, pursuant to which the Company will agree to file, as soon as practicable after the Closing Time but in any event within 30 days of the Closing Time, a registration statement with the Commission registering the Exchange Securities (as defined in the Registration Rights Agreement) under the 1933 Act.

SECTION 1. Representations and Warranties.

(a) *Representations and Warranties by the Company and the Guarantors.* The Company and each of the Guarantors, jointly and severally, represent and warrant to each Initial Purchaser as of the date hereof and as of the Closing Time referred to in Section 2(b) hereof, and agree with each Initial Purchaser as follows:

(i) Similar Offerings. The Company and the Guarantors have not, directly or indirectly, solicited any offer to buy or offered to sell, and will not, directly or indirectly, solicit any offer to buy or offer to sell, in the United States or to any United States citizen or resident, any security which is or would be integrated with the sale of the Securities and the Guarantees in a manner that would require the Securities or the Guarantees to be registered under the 1933 Act.

(ii) Offering Memorandum. The Offering Memorandum does not, and at the Closing Time will not, include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading; provided, that this representation, warranty and agreement shall not apply to statements in or omissions from the Offering Memorandum made in reliance upon and in conformity with information furnished to the Company and the Guarantors in writing by any Initial Purchaser through Merrill Lynch expressly for use in the Offering Memorandum.

(xxx) Rule 144A Eligibility. The Securities and the Guarantees are eligible for resale pursuant to Rule 144A and will not be, at the Closing Time, of the same class as securities listed on a national securities exchange registered under Section 6 of the 1934 Act, or quoted in a U.S. automated interdealer quotation system.

(xxxi) No General Solicitation. None of the Company, the Guarantors, any of their respective affiliates, as such term is defined in Rule 501(b) under the 1933 Act ("Affiliates"), or any person acting on any of their behalf (other than the Initial Purchasers, as to whom the Company and the Guarantors make no representation) has engaged or will engage, in connection with the offering of the Securities and the Guarantees, in any form of general solicitation or general advertising within the meaning of Rule 502(c) under the 1933 Act.

(xxxii) No Registration Required. Subject to compliance by the Initial Purchasers with the representations and warranties set forth in Section 2, it is not necessary in connection with the offer, sale and delivery of the Securities and the Guarantees to the Initial Purchasers and to each Subsequent Purchaser in the manner contemplated by this Agreement and the Offering Memorandum to register the Securities and the Guarantees under the 1933 Act or to qualify the Indenture under the Trust Indenture Act of 1939, as amended (the "1939 Act").

(xxxiii) No Directed Selling Efforts. With respect to those Securities and Guarantees sold in reliance on Regulation S, (A) none of the Company, the Guarantors, any of their respective Affiliates or any person acting on their behalf (other than the Initial Purchasers, as to whom the Company and the Guarantors make no representation) has engaged or will engage in any directed selling efforts within the meaning of Regulation S and (B) each of the Company, the Guarantors, any of their respective Affiliates and any person acting on their behalf (other than the Initial Purchasers, as to whom the Company and the Guarantors make no representation) has complied and will comply with the offering restrictions requirement of Regulation S.

(xxxiv) PORTAL. There are no securities of the Company or any of the Guarantors which are of the same class as the Securities or the Guarantees that are listed on a national securities exchange registered under Section 6 of the 1934 Act, or quoted in a United States automated inter dealer quotation system. The Company and the Guarantors have been advised by the National Association of Securities Dealers, Inc. PORTAL Market that the Securities and the Guarantees will be designated PORTAL eligible securities in accordance with the rules and regulations of the National Association of Securities Dealers, Inc.

(xxxv) Authorization of the Credit Agreement. The $30 million credit agreement among the Company, Marsh Supermarkets, LLC ("LLC"), the other guarantors named therein and Harris Bank, dated as of July 25, 1997 (the "Harris Credit Agreement"), has been duly authorized, executed and delivered by the Company and LLC and constitutes a valid and binding obligation of the Company and LLC, enforceable against the Company and LLC in accordance with its terms.

(b) *Officer's Certificates.* Any certificate signed by any officer of the Company or any of the Subsidiaries delivered to the Initial Purchasers or to counsel for the Initial Purchasers pursuant to the terms of this Agreement shall be deemed a representation and warranty by the Company or any of the Subsidiaries to each Initial Purchaser as to the matters covered thereby.

SECTION 2. Sale and Delivery to Initial Purchasers: Closing.

(a) *Securities and Guarantees.* On the basis of the representations and warranties herein contained and subject to the terms and conditions herein set forth, the Company and the Guarantors agree to sell to each Initial Purchaser, severally and not jointly, and each Initial Purchaser, severally and not jointly, agrees to purchase from the Company and the Guarantors, at the price set forth in Schedule C, the aggregate principal amount of Securities (including the Guarantees) set forth in Schedule A opposite the name of such Initial Purchaser, plus any additional principal amount of Securities (including the Guarantees) which such Initial Purchaser may become obligated to purchase pursuant to the provisions of Section 10 hereof.

(b) *Payment.* Payment of the purchase price for, and delivery of certificates for, the Securities and the Guarantees shall be made at the office of Fried, Frank, Harris, Shriver & Jacobson, or at such other place as shall be agreed upon by the Representative, the Company and the Guarantors at 9:00 A.M. (New York Time) on the fifth business day after the date hereof (unless postponed in accordance with the provisions of Section 10), or such other time not later than ten business days after such date as shall be agreed upon by the Representative, the Company and the Guarantors (such time and date of payment and delivery being herein called the "Closing Time").

Payment shall be made to the Company and the Guarantors by wire transfer of immediately available funds to a bank account designated by the Company and the Guarantors, against delivery to the respective accounts of the Initial Purchasers of certificates for the Securities and the Guarantees to be purchased by them. It is understood that each Initial Purchaser has authorized the Representative, for its account, to accept delivery of, receipt for, and make payment of the purchase price for, the Securities and the Guarantees which it has agreed to purchase. Merrill Lynch, individually and not as representative of the Initial Purchasers, may (but shall not be obligated to) make payment of the purchase price for the Securities and the Guarantees to be purchased by any Initial Purchaser whose funds have not been received by the Closing Time, but such payment shall not relieve such Initial Purchaser from its obligations hereunder. The certificates representing the Securities and the Guarantees shall be registered in the name of Cede & Co. pursuant to the DTC Agreement, or physical certificates representing the Securities and the Guarantees shall be registered in the names and denominations requested by the Initial Purchasers, and in either case shall be made available for examination and packaging by the Initial Purchasers in The City of New York not later than 9:00 A.M. on the last business day prior to the Closing Time.

(c) *Qualified Institutional Buyer.* Each Initial Purchaser severally and not jointly represents and warrants to, and agrees with, the Company and each of the Guarantors that it is a "qualified institutional buyer" within the meaning of Rule 144A under the 1933 Act (a "Qualified Institutional Buyer") and an "accredited investor" within the meaning of Rule 501(a) under the 1933 Act (an "Accredited Investor").

(d) *Denominations; Registration.* Certificates for the Securities (including the Guarantees) shall be in such denominations ($1,000 or integral multiples thereof) and registered in such names as the Representative may request in writing at least one full business day before the Closing Time.

SECTION 3. Covenants of the Company and the Guarantors. The Company and the Guarantors, jointly and severally, covenant with each Initial Purchaser as follows:

(a) *Offering Memorandum.* The Company and the Guarantors, as promptly as possible, will furnish to each Initial Purchaser, without charge, such number of copies of the Preliminary Offering Memorandum, the Final Offering Memorandum and any amendments and supplements thereto and documents incorporated by reference therein as such Initial Purchaser may reasonably request.

(b) *Notice and Effect of Material Events.* The Company and the Guarantors will immediately notify each Initial Purchaser, and confirm such notice in writing, of (x) any filing made by the Company or any Guarantor of information relating to the offering of the Securities and the Guarantees with any securities exchange or any other regulatory body in the United States or any other jurisdiction, and (y) prior to the completion of the placement of the Securities and the Guarantees by the Initial Purchasers as evidenced by a notice in writing from the Initial Purchasers to the Company, any material changes in or affecting the earnings, business affairs or business prospects of the Company and the Subsidiaries which (i) make any statement in the Offering Memorandum or any document incorporated by reference in the Offering Memorandum false or misleading or (ii) are not disclosed in the Offering Memorandum. In such event or if during such time any event shall occur or condition shall exist as a result of which it is necessary, in the opinion of the Company and the Guarantors, their counsel, the Initial Purchasers or counsel for the Initial Purchasers, to amend or supplement the Final Offering Memorandum in order that the Final Offering Memorandum not include any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein not misleading in the light of the circumstances then existing, the Company and the Guarantors will forthwith amend or supplement the Final Offering Memorandum by preparing and furnishing to each Initial Purchaser an amendment or amendments of, or a supplement or supplements to, the Final Offering Memorandum (in form and substance satisfactory in the reasonable opinion of counsel for the Initial Purchasers) so that, as so amended or supplemented, the Final Offering Memorandum will not include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements therein, in the light of the circumstances existing at the time it is delivered to a Subsequent Purchaser, not misleading.

(c) *Amendment to Offering Memorandum and Supplements.* The Company and the Guarantors will advise each Initial Purchaser promptly of any proposal to amend or supplement the Offering Memorandum and will not effect such amendment or supplement without the consent of the Initial Purchasers, which shall not be unreasonably withheld. Neither the consent of the Initial Purchasers to, nor the Initial Purchaser's delivery of, any such amendment or supplement, shall constitute a waiver of any of the conditions set forth in Section 5 hereof.

(d) *Qualification of Securities and Guarantees for Offer and Sale.* The Company and the Guarantors will use their best efforts to register or qualify the Securities and the Guarantees for offering and sale under the applicable securities laws of such jurisdictions as the Representative may designate and will maintain such qualifications in effect as long as required for the sale of the Securities and the Guarantees; provided, however, that the Company and the Guarantors shall not be obligated to file any general consent to service of process or to qualify as a foreign corporation or as a dealer in securities in any jurisdiction in which it is not so qualified or to subject itself to taxation in respect of doing business in any jurisdiction in which it is not otherwise so subject.

(e) *Integration.* The Company and the Guarantors agree that they will not and will cause their affiliates not to make any offer or sale of securities of the Company or any Guarantor of any class if, as a result of the doctrine of "integration" referred to in Rule 502 under the 1933 Act, such offer or sale could be deemed to render invalid (for the purpose of (i) the sale of the Securities and the Guarantees by the Company and the Guarantors to the Initial Purchasers, (ii) the resale of the Securities and the Guarantees by the Initial Purchasers to Subsequent Purchasers or (iii) the resale of the Securities and the Guarantees by such Subsequent Purchasers to others) the exemption from the registration requirements of the 1933 Act provided by Section 4(2) thereof or by Rule 144A or by Regulation S thereunder or otherwise.

(f) *Rating of Securities.* The Company and the Guarantors shall take all reasonable action necessary to enable Standard & Poor's Corporation ("S&P"), and Moody's Investors Service, Inc. ("Moody's"), to provide their respective credit ratings of the Securities and the Guarantees.

(g) *Rule 144A Information.* The Company and the Guarantors agree that, in order to render the Securities and the Guarantees eligible for resale pursuant to Rule 144A under the 1933 Act, while any of the Securities and the Guarantees remain outstanding, it will make available, upon request, to any holder of Securities and Guarantees or prospective purchasers of Securities and Guarantees the information specified in Rule 144A(d)(4), unless the Company and the Guarantors furnish information to the Commission pursuant to Section 13 or 15(d) of the 1934 Act (such information, whether made available to holders or prospective purchasers or furnished to the Commission, is hereinafter referred to as "Additional Information").

(h) *Restriction on Resales.* Until the expiration of two years after the original issuance of the Securities and the Guarantees, the Company and the Guarantors will not, and will cause their "affiliates" (as such term is defined in Rule 144(a)(1) under the 1933 Act) not to, resell any Securities and Guarantees which are "restricted securities" (as such term is defined under Rule 144(a)(3) under the 1933 Act) that have been reacquired by any of them and shall immediately upon any purchase of any such Securities and Guarantees submit such Securities and Guarantees to the Trustee for cancellation.

(i) *Use of Proceeds.* The Company and the Guarantors will use the net proceeds received by them from the sale of the Securities and the Guarantees in the manner specified in the Offering Memorandum under "Use of Proceeds." The Company will send a notice of redemption to Holders of the Senior Notes (as defined in the Offering Memorandum) no later than the Closing Time.

(j) *Restriction on Sale of Securities.* During a period of 90 days from the date of the Offering Memorandum, the Company and the Guarantors will not, without the prior written consent of Merrill Lynch, directly or indirectly, issue, sell, offer to sell, grant any option for the sale of, or otherwise dispose of, any debt securities or guarantees of debt securities of the Company (other than borrowings under the Company's bank credit agreements, the Securities, the Guarantees and the Exchange Securities).

(k) *DTC Clearance*. The Company and the Guarantors will use all reasonable efforts in cooperation with the Initial Purchasers to permit the Securities and the Guarantees to be eligible for clearance and settlement through DTC.

(l) *Legends*. Each certificate for a Security (including the Guarantee) will bear the legend contained in "Notice to Investors" in the Offering Memorandum for the time period and upon the other terms stated in the Offering Memorandum.

(m) *Interim Financial Statements*. Prior to the Closing Time, the Company shall furnish to the Initial Purchasers copies of any budgets or revised budgets for fiscal 1997 and any unaudited interim financial statements of the Company, promptly after they have been completed, for any periods subsequent to the periods covered by the financial statements appearing in the Offering Memorandum.

(n) *Periodic Reports*. For a period of three years after the Closing Time, the Company and the Guarantors will furnish to the Initial Purchasers copies of all annual reports, quarterly reports and current reports filed with the Commission on Forms 10-K, 10-Q and 8-K, or such other similar forms as may be designated by the Commission, and such other documents, reports and information as shall be furnished by the Company and the Guarantors generally to the holders of the Securities and the Guarantees or to security holders of its publicly issued securities generally.

SECTION 4. Payment of Expenses.

(a) *Expenses*. The Company and the Guarantors, jointly and severally, will pay all expenses incident to the performance of their respective obligations under this Agreement, including (i) the preparation, printing and any filing of the Offering Memorandum and the Registration Statement (including financial statements and any schedules or exhibits) and of each amendment or supplement thereto, including the preliminary prospectuses and the prospectus to be contained in the Registration Statement, (ii) the preparation, printing and delivery to the Initial Purchasers of this Agreement, the Registration Rights Agreement, the Indenture and such other documents as may be required in connection with the offering, purchase, sale and delivery of the Securities and the Guarantees, (iii) the preparation, issuance and delivery of the certificates for the Securities and the Guarantees to the Initial Purchasers, including any charges of DTC in connection therewith, (iv) the fees and disbursements of the Company's and the Guarantors' counsel, accountants and other advisors,

REGISTRATION RIGHTS AGREEMENT

This Registration Rights Agreement (the "Agreement") is made and entered into this 5th day of August, 1997, among Marsh Supermarkets, Inc., an Indiana corporation (the "Company"), Marsh Drugs, Inc., an Indiana corporation, Marsh Village Pantries, Inc., an Indiana corporation, Mundy Realty, Inc., an Indiana corporation, Marlease, Inc., an Indiana corporation, Marsh International, Inc., an Indiana corporation, Maraines Greenery, Inc., an Indiana corporation, Limited Holdings, Inc., an Indiana corporation, Convenience Store Distributing Company, an Ohio partnership, Marsh P.Q., Inc., an Indiana corporation, S.C.T., Inc., an Indiana corporation, North Marion Development Corporation., an Indiana corporation, Contract Transport, Inc., an Indiana corporation, Crystal Food Services, LLC, an Indiana limited liability company, Lobill Foods, LLC, an Indiana limited liability company, Contract Transport, LLC, an Indiana limited liability company, Marsh Supermarkets, LLC, an Indiana limited liability company, Village Pantry, LLC, an Indiana limited liability company, Marsh Drugs, LLC, an Indiana limited liability company, Trademark Holdings, Inc., a Delaware corporation, and Marsh Clearing House, LLC, an Indiana limited liability company (collectively, the "Guarantors") and Merrill Lynch, Pierce, Fenner & Smith Incorporated and McDonald & Company Securities, Inc. (collectively, the "Initial Purchasers").

This Agreement is made pursuant to the Purchase Agreement, dated July 29, 1997, among the Company, the Guarantors and the Initial Purchasers (the "Purchase Agreement"), which provides for (i) the sale by the Company to the Initial Purchasers of an aggregate of $150 million principal amount of the Company's 8 7/8% Senior Subordinated Notes due 2007, Series A (the "Securities") and (ii) the issue and sale by the Guarantors and the purchase by the Initial Purchasers of the guarantees (the "Guarantees") of the Company's obligations under the Securities. In order to induce the Initial Purchasers to enter into the Purchase Agreement, the Company and the Guarantors have agreed to provide to the Initial Purchasers and their direct and indirect transferees the registration rights set forth in this Agreement. The execution of this Agreement is a condition to the closing under the Purchase Agreement.

In consideration of the foregoing, the parties hereto agree as follows:

1. Definitions.

As used in this Agreement, the following capitalized defined terms shall have the following meanings:

"Registration Statement" shall mean any registration statement of the Company and the Guarantors which covers any of the Exchange Securities or Registrable Securities pursuant to the provisions of this Agreement, and all amendments and supplements to any such Registration Statement, including post-effective amendments, in each case including the Prospectus contained therein, all exhibits thereto and all material incorporated by reference therein.

"SEC" shall mean the Securities and Exchange Commission or any successor agency or government body performing the functions currently performed by the United States Securities and Exchange Commission.

"Shelf Registration" shall mean a registration effected pursuant to Section 2.2 hereof.

"Shelf Registration Statement" shall mean a "shelf" registration statement of the Company and the Guarantors pursuant to the provisions of Section 2.2 of this Agreement which covers all of the Registrable Securities on an appropriate form under Rule 415 under the 1933 Act, or any similar rule that may be adopted by the SEC, and all amendments and supplements to such registration statement, including post-effective amendments, in each case including the Prospectus contained therein, all exhibits thereto and all material incorporated by reference therein.

"Trustee" shall mean the trustee with respect to the Securities and the Guarantees under the Indenture.

2. Registration Under the 1933 Act.

2.1 Exchange Offer. The Company and the Guarantors shall (A) prepare and, as soon as practicable but not later than 30 days following the Closing Date, file with the SEC an Exchange Offer Registration Statement on an appropriate form under the 1933 Act with respect to a proposed Exchange Offer and the issuance and delivery to the Holders, in exchange for the Registrable Securities, a like principal amount of Exchange Securities, (B) use their reasonable best efforts to cause the Exchange Offer Registration Statement to be declared effective under the 1933 Act within 90 days of the Closing Date, (C) use their reasonable best efforts to keep the Exchange Offer Registration Statement effective until the closing of the Exchange Offer and (D) use their reasonable best efforts to cause the Exchange Offer to be consummated not later than 120 days following the Closing Date. The Exchange Securities will be issued under the Indenture. Upon the effectiveness of the Exchange Offer Registration Statement, the Company and the Guarantors shall promptly commence the Exchange Offer, it being the objective of such Exchange Offer to enable each Holder eligible and electing to exchange Registrable Securities for Exchange Securities (assuming that such Holder (a) is not an affiliate of the Company or any of the Guarantors within the meaning of Rule 405 under the 1933 Act, (b) is not a broker-dealer tendering Registrable Securities acquired directly from the Company or any of the Guarantors for its own account, (c) acquired the Exchange Securities in the ordinary course of such Holder's business and (d) has no arrangements or understandings with any person to participate in the Exchange Offer for the purpose of distributing the Exchange Securities) to transfer such Exchange Securities from and after their receipt without any limitations or restrictions under the 1933 Act and without material restrictions under the securities laws of a substantial proportion of the several states of the United States.

In connection with the Exchange Offer, the Company and the Guarantors shall:

(a) mail as promptly as practicable to each Holder a copy of the Prospectus forming part of the Exchange Offer Registration Statement, together with an appropriate letter of transmittal and related documents;

(b) keep the Exchange Offer open for acceptance for a period of not less than 30 calendar days after the date notice thereof is mailed to the Holders (or longer if required by applicable law) (such period referred to herein as the "Exchange Period");

(c) utilize the services of the Depositary for the Exchange Offer;

(d) permit Holders to withdraw tendered Registrable Securities at any time prior to 5:00 p.m. (Eastern Standard Time), on the last business day of the Exchange Period, by sending to the institution specified in the notice, a telegram, telex, facsimile transmission or letter setting forth the name of such Holder, the principal amount of Registrable Securities delivered for exchange, and a statement that such Holder is withdrawing his election to have such Securities and Guarantees exchanged;

(e) notify each Holder that any Registrable Security not tendered will remain outstanding and continue to accrue interest, but will not retain any rights under this Agreement (except in the case of the Initial Purchasers and Participating Broker-Dealers as provided herein); and

(f) otherwise comply in all respects with all applicable laws relating to the Exchange Offer.

As soon as practicable after the close of the Exchange Offer, the Company and the Guarantors shall:

(i) accept for exchange all Registrable Securities duly tendered and not validly withdrawn pursuant to the Exchange Offer in accordance with the terms of the Exchange Offer Registration Statement and the letter of transmittal which shall be an exhibit thereto;

(ii) deliver to the Trustee for cancellation all Registrable Securities so accepted for exchange; and

(iii) cause the Trustee promptly to authenticate and deliver Exchange Securities to each Holder of Registrable Securities so accepted for exchange in a principal amount equal to the principal amount of the Registrable Securities of such Holder so accepted for exchange.

Interest on each Exchange Security will accrue from the last date on which interest was paid on the Registrable Securities surrendered in exchange therefor or, if no interest has been paid on the Registrable Securities, from the date of original issuance. The Exchange Offer shall not be subject to any conditions, other than (i) that the Exchange Offer, or the making of any exchange by a Holder, does not violate applicable law or any applicable interpretation of the staff of the SEC, (ii) the due tendering of Registrable Securities in accordance with the Exchange Offer, (iii) that each Holder of Registrable Securities exchanged in the Exchange Offer shall have represented that all Exchange Securities to be received by it shall be acquired in the ordinary course of its business and that at the time of the consummation of the Exchange Offer it shall have no arrangement or understanding with any person to participate in the distribution (within the meaning of the 1933 Act) of the Exchange Securities and shall have made such other representations as may be reasonably necessary under applicable SEC rules, regulations or interpretations to render the use of Form S-4 or other appropriate form under the 1933

Act available and (iv) that no action or proceeding shall have been instituted or threatened in any court or by or before any governmental agency with respect to the Exchange Offer which, in the Company's and the Guarantors' judgment, would reasonably be expected to impair the ability of the Company and the Guarantors to proceed with the Exchange Offer. The Company and the Guarantors shall inform the Initial Purchasers of the names and addresses of the Holders to whom the Exchange Offer is made, and the Initial Purchasers shall have the right to contact such Holders and otherwise facilitate the tender of Registrable Securities in the Exchange Offer.

2.2 Shelf Registration. (i) If, because of any changes in law, SEC rules or regulations or applicable interpretations thereof by the staff of the SEC, the Company or the Guarantors are not permitted to effect the Exchange Offer as contemplated by Section 2.1 hereof, (ii) if for any other reason the Exchange Offer Registration Statement is not declared effective within 90 days following the original issue of the Registrable Securities or the Exchange Offer is not consummated within 120 days after the original issue of the Registrable Securities, (iii) upon the request of either of the Initial Purchasers or (iv) if a Holder is not permitted to participate in the Exchange Offer or does not receive fully tradable Exchange Securities pursuant to the Exchange Offer, then in case of each of clauses (i) through (iv) the Company and the Guarantors shall, at their cost:

(a) As promptly as practicable, file with the SEC, and thereafter shall use its reasonable best efforts to cause to be declared effective as promptly as practicable but no later than 120 days after the original issue of the Registrable Securities, a Shelf Registration Statement relating to the offer and sale of the Registrable Securities by the Holders from time to time in accordance with the methods of distribution elected by the Majority Holders participating in the Shelf Registration and set forth in such Shelf Registration Statement.

(b) Use their reasonable best efforts to keep the Shelf Registration Statement continuously effective in order to permit the Prospectus forming part thereof to be usable by Holders for a period of two years from the date the Shelf Registration Statement is declared effective by the SEC, or for such shorter period that will terminate when all Registrable Securities covered by the Shelf Registration Statement have been sold pursuant to the Shelf Registration Statement or cease to be outstanding or otherwise to be Registrable Securities.

(c) Notwithstanding any other provisions hereof, use their reasonable best efforts to ensure that (i) any Shelf Registration Statement and any amendment thereto and any Prospectus forming part thereof and any supplement thereto complies in all material respects with the 1933 Act and the rules and regulations thereunder, (ii) any Shelf Registration Statement and any amendment thereto does not, when it becomes effective, contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading and (iii) any Prospectus forming part of any Shelf Registration Statement, and any supplement to such Prospectus (as amended or supplemented from time to time), does not include an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.

The Company and the Guarantors further agree, if necessary, to supplement or amend the Shelf Registration Statement, as required by Section 3(b) below, and to furnish to the Holders of Registrable Securities copies of any such supplement or amendment promptly after its being used or filed with the SEC.

2.3 Expenses. The Company and the Guarantors shall pay all Registration Expenses in connection with the registration pursuant to Section 2.1 or 2.2. Each Holder shall pay all underwriting discounts and commissions and transfer taxes, if any, relating to the sale or disposition of such Holder's Registrable Securities pursuant to the Shelf Registration Statement.

2.4. Effectiveness. (a) The Company and the Guarantors will be deemed not to have used their best efforts to cause the Exchange Offer Registration Statement or the Shelf Registration Statement, as the case may be, to become, or to remain, effective during the requisite period if the Company or any Guarantor voluntarily takes any action that would, or omits to take any action which omission would, result in any such Registration Statement not being declared effective or in the holders of Registrable Securities covered thereby not being able to exchange or offer and sell such Registrable Securities during that period as and to the extent contemplated hereby, unless such action is required by applicable law.

(b) An Exchange Offer Registration Statement pursuant to Section 2.1 hereof or a Shelf Registration Statement pursuant to Section 2.2 hereof will not be deemed to have become effective unless it has been declared effective by the SEC; *provided, however*, that if, after it has been declared effective, the offering of Registrable Securities pursuant to a Shelf Registration Statement is interfered with by any stop order, injunction or other order or requirement of the SEC or any other governmental agency or court, such Registration Statement will be deemed not to have become effective during the period of such interference, until the offering of Registrable Securities pursuant to such Registration Statement may legally resume.

2.5 Interest. The Indenture executed in connection with the Securities and the Guarantees will provide that in the event that either (a) the Exchange Offer Registration Statement is not filed with the Commission on or prior to the 30th calendar day following the date of original issue of the Securities and the Guarantees, (b) the Exchange Offer Registration Statement has not been declared effective on or prior to the 90th calendar day following the date of original issue of the Securities and the Guarantees or (c) the Exchange Offer is not consummated or a Shelf Registration Statement is not declared effective, in either case, on or prior to the 120th calendar day following the date of original issue of the Securities and the Guarantees (each such event referred to in clauses (a) through (c) above, a "Registration Default"), the interest rate borne by the Securities shall be increased by one-quarter of one percent per annum upon the occurrence of each Registration Default, which rate will increase by one quarter of one percent each 90-day period that such additional interest continues to accrue under any such circumstance, with an aggregate maximum increase in the interest rate equal to one percent (1%) per annum. Following the cure of all Registration Defaults the accrual of additional interest will cease and the interest rate will revert to the original rate.

3. Registration Procedures.

In connection with the obligations of the Company and the Guarantors with respect to Registration Statements pursuant to Sections 2.1 and 2.2 hereof, the Company and the Guarantors shall:

(a) prepare and use their reasonable best efforts to file with the SEC a Registration Statement, within the relevant time period specified in Section 2, on the appropriate form under the 1933 Act, which form (i) shall be selected by the Company and the Guarantors, (ii) shall, in the case of a Shelf Registration, be available for the sale of the Registrable Securities by the selling Holders thereof, (iii) shall comply as to form in all material respects with the requirements of the applicable form and include or incorporate by reference all financial statements required by the SEC to be filed therewith or incorporated by reference therein, and (iv) shall comply in all respects with the requirements of Regulation S-T under the Securities Act, and use their best efforts to cause such Registration Statement to become effective and remain effective in accordance with Section 2 hereof;

(b) prepare and use their reasonable best efforts to file with the SEC such amendments and post-effective amendments to each Registration Statement as may be necessary under applicable law to keep such Registration Statement effective for the applicable period; and use their reasonable best efforts to cause each Prospectus to be supplemented by any required prospectus supplement, and as so supplemented to be filed pursuant to Rule 424 under the 1933 Act and comply with the provisions of the 1933 Act applicable to them with respect to the disposition of all securities covered by each Registration Statement during the applicable period in accordance with the intended method or methods of distribution by the selling Holders thereof;

(c) in the case of a Shelf Registration, (i) notify each Holder of Registrable Securities, at least five business days prior to filing, that a Shelf Registration Statement with respect to the Registrable Securities is being filed and advising such Holders that the distribution of Registrable Securities will be made in accordance with the method selected by the Majority Holders participating in the Shelf Registration; (ii) furnish to each Holder of Registrable Securities and to each underwriter of an underwritten offering of Registrable Securities, if any, without charge, as many copies of each Prospectus, including each preliminary Prospectus, and any amendment or supplement thereto and such other documents as such Holder or underwriter may reasonably request, including financial statements and schedules and, if the Holder so requests, all exhibits in order to facilitate the public sale or other disposition of the Registrable Securities; and (iii) hereby consent to the use of the Prospectus or any amendment or supplement thereto by each of the selling Holders of Registrable Securities in connection with the offering and sale of the Registrable Securities covered by the Prospectus or any amendment or supplement thereto;

(d) use their reasonable best efforts to register or qualify the Registrable Securities under all applicable state securities or "blue sky" laws of such jurisdictions as any Holder of Registrable Securities covered by a Registration Statement and each underwriter of an underwritten offering of Registrable Securities shall reasonably request by the time the applicable Registration Statement is declared effective by the SEC, and do any and all other acts and things which may be reasonably necessary or advisable to enable each such Holder and underwriter to consummate the disposition in each such jurisdiction of such Registrable Securities owned by such Holder; *provided, however*, that the Company and the Guarantors shall not be required to (i) qualify as a foreign corporation or as a dealer in securities in any jurisdiction where it would not otherwise be required to qualify but for this Section 3(d), or (ii) take any action which would subject it to general service of process or taxation in any such jurisdiction where it is not then so subject;

(e) notify promptly each Holder of Registrable Securities under a Shelf Registration or any Participating Broker-Dealer who has notified the Company and the Guarantors that it is utilizing the Exchange Offer Registration Statement as provided in paragraph (f) below and, if requested by such Holder or Participating Broker-Dealer, confirm such advice in writing promptly (i) when a Registration Statement has become effective and when any post-effective amendments and supplements thereto become effective, (ii) of any request by the SEC or any state securities authority for post-effective amendments and supplements to a Registration Statement and Prospectus or for additional information after the Registration Statement has become effective, (iii) of the issuance by the SEC or any state securities authority of any stop order suspending the effectiveness of a Registration Statement or the initiation of any proceedings for that purpose, (iv) in the case of a Shelf Registration, if, between the effective date of a Registration Statement and the closing of any sale of Registrable Securities covered thereby, the representations and warranties of the Company or any Guarantor contained in any underwriting agreement, securities sales agreement or other similar agreement, if any, relating to the offering cease to be true and correct in all material respects, (v) of the happening of any event or the discovery of any facts during the period a Shelf Registration Statement is effective which makes any statement made in such Registration Statement or the related Prospectus untrue in any material respect or which requires the making of any changes in such Registration Statement or Prospectus in order to make the statements therein not misleading and (vi) of the receipt by the Company or any Guarantor of any notification with respect to the suspension of the qualification of the Registrable Securities or the Exchange Securities, as the case may be, for sale in any jurisdiction or the initiation or threatening of any proceeding for such purpose;

(f) (A) in the case of the Exchange Offer Registration Statement (i) include in the Exchange Offer Registration Statement a section entitled "Plan of Distribution" which section shall be reasonably acceptable to the Initial Purchasers, and which shall contain a summary statement of the positions taken or policies made by the staff of the SEC with respect to the potential "underwriter" status of any broker-dealer that holds Registrable Securities acquired for its own account as a result of market-making activities or other trading activities and that will be the beneficial owner (as defined in Rule 13d-3 under the Exchange Act) of Exchange Securities to be received by such broker-dealer in the Exchange Offer, whether such positions or policies have been publicly disseminated by the staff of the SEC or such positions or policies represent the prevailing views of the staff of the SEC, including a statement that any such broker-dealer who receives Exchange Securities for Registrable Securities pursuant to the Exchange Offer may be deemed a statutory underwriter and must deliver a prospectus meeting the requirements of the 1933 Act in connection with any resale of such Exchange Securities, (ii) furnish to each Participating Broker-Dealer who has delivered to the Company and the Guarantors the notice referred to in Section 3(e), without charge, as many copies of each Prospectus included in the Exchange Offer Registration Statement, including any preliminary prospectus, and any amendment or supplement thereto, as such Participating Broker-Dealer may reasonably request,

(iii) hereby consent to the use of the Prospectus forming part of the Exchange Offer Registration Statement or any amendment or supplement thereto, by any person subject to the prospectus delivery requirements of the SEC, including all Participating Broker-Dealers, in connection with the sale or transfer of the Exchange Securities covered by the Prospectus or any amendment or supplement thereto, and (iv) include in the transmittal letter or similar documentation to be executed by an exchange offeree in order to participate in the Exchange Offer (x) the following provision:

> "If the exchange offeree is a broker-dealer holding Registrable Securities acquired for its own account as a result of market-making activities or other trading activities, it will deliver a prospectus meeting the requirements of the 1933 Act in connection with any resale of Exchange Securities received in respect of such Registrable Securities pursuant to the Exchange Offer;" and

(y) a statement to the effect that by a broker-dealer making the acknowledgment described in clause (x) and by delivering a Prospectus in connection with the exchange of Registrable Securities, the broker-dealer will not be deemed to admit that it is an underwriter within the meaning of the 1933 Act; and

(B) in the case of any Exchange Offer Registration Statement, the Company and the Guarantors agree to deliver to the Initial Purchasers on behalf of the Participating Broker-Dealers upon the effectiveness of the Exchange Offer Registration Statement (i) an opinion of counsel or opinions of counsel substantially in the form attached hereto as Exhibit A, (ii) an officers' certificate substantially in the form customarily delivered in a public offering of debt securities and (iii) a comfort letter or comfort letters in customary form if permitted by Statement on Auditing Standards No. 72 of the American Institute of Certified Public Accountants (or if such a comfort letter is not permitted, an agreed upon procedures letter in customary form) at least as broad in scope and coverage as the comfort letter or comfort letters delivered to the Initial Purchasers in connection with the initial sale of the Securities and the Guarantees to the Initial Purchasers;

(g) (i) in the case of an Exchange Offer, furnish counsel for the Initial Purchasers and (ii) in the case of a Shelf Registration, furnish counsel for the Holders of Registrable Securities copies of any comment letters received from the SEC or any other request by the SEC or any state securities authority for amendments or supplements to a Registration Statement and Prospectus or for additional information;

Notwithstanding the provisions of this Section 4, no Initial Purchaser shall be required to contribute any amount in excess of the amount by which the total price at which the Securities and Guarantees sold by it were offered exceeds the amount of any damages which such Initial Purchaser has otherwise been required to pay by reason of such untrue or alleged untrue statement or omission or alleged omission.

No person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the 1933 Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation.

For purposes of this Section 4, each person, if any, who controls an Initial Purchaser or Holder within the meaning of Section 15 of the 1933 Act or Section 20 of the 1934 Act shall have the same rights to contribution as such Initial Purchaser or Holder, and each director of the Company or any Guarantor, and each person, if any, who controls the Company or any Guarantor within the meaning of Section 15 of the 1933 Act or Section 20 of the 1934 Act shall have the same rights to contribution as the Company or any Guarantor. The Initial Purchasers' respective obligations to contribute pursuant to this Section 7 are several in proportion to the principal amount of Securities set forth opposite their respective names in Schedule A to the Purchase Agreement and not joint.

5. <u>Miscellaneous</u>.

5.1 <u>Rule 144 and Rule 144A</u>. For so long as the Company or any Guarantor is subject to the reporting requirements of Section 13 or 15 of the 1934 Act, the Company and each Guarantor covenants that they will file the reports required to be filed by them under the 1933 Act and Section 13(a) or 15(d) of the 1934 Act and the rules and regulations adopted by the SEC thereunder. If the Company and the Guarantors cease to be so required to file such reports, the Company and the Guarantors covenant that they will upon the request of any Holder of Registrable Securities (a) make available to such Holder such information as is necessary to permit sales pursuant to Rule 144 under the 1933 Act, (b) deliver such information to a prospective purchaser as is necessary to permit sales pursuant to Rule 144A under the 1933 Act and it will take such further action as any Holder of Registrable Securities may reasonably request, and (c) take such further action that is reasonable in the circumstances, in each case, to the extent required from time to time to enable such Holder to sell its Registrable Securities without registration under the 1933 Act within the limitation of the exemptions provided by (i) Rule 144 under the 1933 Act, as such Rule may be amended from time to time, (ii) Rule 144A under the 1933 Act, as such Rule may be amended from time to time, or (iii) any similar rules or regulations hereafter adopted by the SEC. Upon the request of any Holder of Registrable Securities, the Company and the Guarantors will deliver to such Holder a written statement as to whether they have complied with such requirements.

5.2 No Inconsistent Agreements. The Company and each Guarantor have not entered into and the Company and each Guarantor will not after the date of this Agreement enter into any agreement which is inconsistent with the rights granted to the Holders of Registrable Securities in this Agreement or otherwise conflicts with the provisions hereof. The rights granted to the Holders hereunder do not in any way conflict with the rights granted to the holders of the Company's and each Guarantor's other issued and outstanding securities under any such agreements.

5.3 Amendments and Waivers. The provisions of this Agreement, including the provisions of this sentence, may not be amended, modified or supplemented, and waivers or consents to departures from the provisions hereof may not be given unless the Company and the Guarantors have obtained the written consent of Holders of at least a majority in aggregate principal amount of the outstanding Registrable Securities affected by such amendment, modification, supplement, waiver or departure.

5.4 Notices. All notices and other communications provided for or permitted hereunder shall be made in writing by hand delivery, registered first-class mail, telex, telecopier, or any courier guaranteeing overnight delivery (a) if to a Holder, at the most current address given by such Holder to the Company and the Guarantors by means of a notice given in accordance with the provisions of this Section 5.4, which address initially is the address set forth in the Purchase Agreement with respect to the Initial Purchasers; and (b) if to the Company or any Guarantor, initially at the Company's or such Guarantor's address set forth in the Purchase Agreement, and thereafter at such other address of which notice is given in accordance with the provisions of this Section 5.4.

All such notices and communications shall be deemed to have been duly given: at the time delivered by hand, if personally delivered; two business days after being deposited in the mail, postage prepaid, if mailed; when answered back, if telexed;

when receipt is acknowledged, if telecopied; and on the next business day if timely delivered to an air courier guaranteeing overnight delivery.

Copies of all such notices, demands, or other communications shall be concurrently delivered by the person giving the same to the Trustee under the Indenture, at the address specified in such Indenture.

5.5 Successor and Assigns. This Agreement shall inure to the benefit of and be binding upon the successors, assigns and transferees of each of the parties, including, without limitation and without the need for an express assignment, subsequent Holders; provided that nothing herein shall be deemed to permit any assignment, transfer or other disposition of Registrable Securities in violation of the terms of the Purchase Agreement. If any transferee of any Holder shall acquire Registrable Securities, in any manner, whether by operation of law or otherwise, such Registrable Securities shall be held subject to all of the terms of this Agreement, and by taking and holding such Registrable Securities such person shall be conclusively deemed to have agreed to be bound by and to perform all of the terms and provisions of this Agreement, including the restrictions on resale set forth in this Agreement and, if applicable, the Purchase Agreement, and such person shall be entitled to receive the benefits hereof.

5.6 Third Party Beneficiaries. The Initial Purchasers (even if the Initial Purchasers are not Holders of Registrable Securities) shall be third party beneficiaries to the agreements made hereunder between the Company and the Guarantors, on the one hand, and the Holders, on the other hand, and shall have the right to enforce such agreements directly to the extent they deem such enforcement necessary or advisable to protect their rights or the rights of Holders hereunder. Each Holder of Registrable Securities shall be a third party beneficiary to the agreements made hereunder between the Company and the Guarantors, on the one hand, and the Initial Purchasers, on the other hand, and shall have the right to enforce such agreements directly to the extent it deems such enforcement necessary or advisable to protect its rights hereunder.

5.7 Counterparts. This Agreement may be executed in any number of counterparts and by the parties hereto in separate counterparts, each of which when so executed shall be deemed to be an original and all of which taken together shall constitute one and the same agreement.

5.8 Headings. The headings in this Agreement are for convenience of reference only and shall not limit or otherwise affect the meaning hereof.

OFFERING MEMORANDUM CONFIDENTIAL

$150,000,000

MARSH

Marsh Supermarkets, Inc.

8⅞% Senior Subordinated Notes due 2007

Interest on the 8⅞% Senior Subordinated Notes due 2007 (the "Notes") of Marsh Supermarkets, Inc. (the "Company") offered hereby (the "Offering") will be payable semi-annually in arrears on February 1 and August 1 of each year, commencing February 1, 1998. The Notes will mature on August 1, 2007. The Notes are redeemable at any time on or after August 1, 2002 at the option of the Company, in whole or in part, at the redemption prices set forth herein, together with accrued and unpaid interest, if any, to the date of redemption. Upon the occurrence of a Change of Control (as defined herein), each holder of Notes may require the Company to purchase all or a portion of such holder's Notes at a purchase price equal to 101% of the principal amount thereof, together with accrued and unpaid interest, if any, to the date of purchase. See "Description of the Notes."

The Notes will be unsecured senior subordinated obligations of the Company and, as such, will be subordinated in right of payment to all existing and future senior indebtedness of the Company. The Notes will rank *pari passu* in right of payment with all other existing and future senior subordinated indebtedness, if any, of the Company, and senior in right of payment to all existing and future subordinated indebtedness, if any, of the Company. The Notes will be guaranteed, jointly and severally, on a senior subordinated basis (the "Guarantees"), by all of the Company's subsidiaries (other than three immaterial subsidiaries) (the "Guarantors" and, together with the Company, the "Issuers"). The Guarantees will be unsecured senior subordinated obligations of the Guarantors and will be subordinated to all existing and future Guarantor Senior Indebtedness (as defined herein). See "Description of the Notes — Ranking." As of March 29, 1997, on a pro forma basis after giving effect to the Offering and the application of the estimated net proceeds therefrom, the Company and the Guarantors would have had approximately $219.1 million in aggregate principal amount of indebtedness outstanding, of which $49.2 million would have ranked senior in right of payment to the Notes and the Guarantees (all of which would have been secured) and approximately $19.9 million would have been subordinated in right of payment to the Notes and the Guarantees.

The Company's Class A and Class B Common Stock are traded on the Nasdaq National Market under the symbols "MARSA" and "MARSB," respectively.

See "Risk Factors" beginning on page 13 for a discussion of certain factors that should be considered by prospective investors in evaluating an investment in the Notes.

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR ANY STATE SECURITIES LAWS AND, UNLESS SO REGISTERED, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS. ACCORDINGLY, THE SECURITIES OFFERED HEREBY ARE BEING OFFERED AND SOLD ONLY (A) TO "QUALIFIED INSTITUTIONAL BUYERS" (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT ("RULE 144A")) IN COMPLIANCE WITH RULE 144A, AND (B) PURSUANT TO OFFERS AND SALES THAT OCCUR OUTSIDE THE UNITED STATES WITHIN THE MEANING OF REGULATION S UNDER THE SECURITIES ACT. SEE "NOTICES TO INVESTORS."

	Price to Investors(1)	Initial Purchasers' Discount(2)	Proceeds to Company(3)
Per Note	99.185%	2.625%	96.56%
Total	$148,777,500	$3,937,500	$144,840,000

(1) Plus accrued interest, if any, from August 5, 1997.
(2) The Issuers have agreed to indemnify the Initial Purchasers (as defined herein) against certain liabilities, including liabilities under the Securities Act. See "Plan of Distribution."
(3) Before deducting expenses payable by the Company, estimated at $700,000.

The Notes are offered by the Initial Purchasers, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of certain legal matters by counsel for the Initial Purchasers and certain other conditions. The Initial Purchasers reserve the right to withdraw, cancel or modify such offer and to reject orders in whole or in part. It is expected that delivery of the Notes will be made through the book-entry facilities of The Depository Trust Company in New York, New York on or about August 5, 1997 against payment in immediately available funds.

Merrill Lynch & Co. **McDonald & Company Securities, Inc.**

The date of this Offering Memorandum is July 29, 1997.

Information contained herein is subject to completion or amendment. This Offering Memorandum shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such jurisdiction.

SUBJECT TO COMPLETION DATED JULY 16, 1997

OFFERING MEMORANDUM CONFIDENTIAL

$150,000,000

MARSH

Marsh Supermarkets, Inc.

% Senior Subordinated Notes due 2007

Interest on the % Senior Subordinated Notes due 2007 (the "Notes") of Marsh Supermarkets, Inc. (the "Company") offered hereby (the "Offering") will be payable semi-annually in arrears on and of each year, commencing , 1998. The Notes will mature on , 2007. The Notes are redeemable at any time on or after , 2002 at the option of the Company, in whole or in part, at the redemption prices set forth herein, together with accrued and unpaid interest, if any, to the date of redemption. Upon the occurrence of a Change of Control (as defined herein), each holder of Notes may require the Company to purchase all or a portion of such holder's Notes at a purchase price equal to 101% of the principal amount thereof, together with accrued and unpaid interest, if any, to the date of purchase. See "Description of the Notes."

The Notes will be unsecured senior subordinated obligations of the Company and, as such, will be subordinated in right of payment to all existing and future senior indebtedness of the Company. The Notes will rank *pari passu* in right of payment with all other existing and future senior subordinated indebtedness, if any, of the Company, and senior in right of payment to all existing and future subordinated indebtedness, if any, of the Company. The Notes will be guaranteed, jointly and severally, on a senior subordinated basis (the "Guarantees"), by all of the Company's subsidiaries (the "Guarantors" and, together with the Company, the "Issuers"). The Guarantees will be unsecured senior subordinated obligations of the Guarantors and will be subordinated to all existing and future Guarantor Senior Indebtedness (as defined herein). See "Description of the Notes — Ranking." As of March 29, 1997, on a pro forma basis after giving effect to the Offering and the application of the estimated net proceeds therefrom, the Company and the Guarantors would have had approximately $219.1 million in aggregate principal amount of indebtedness outstanding, of which $49.2 million would have ranked senior in right of payment to the Notes and the Guarantees (all of which would have been secured) and approximately $19.9 million would have been subordinated in right of payment to the Notes and the Guarantees.

The Company's Class A and Class B Common Stock are traded on the Nasdaq National Market under the symbols "MARSA" and "MARSB," respectively.

See "Risk Factors" beginning on page 13 for a discussion of certain factors that should be considered by prospective investors in evaluating an investment in the Notes.

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR ANY STATE SECURITIES LAWS AND, UNLESS SO REGISTERED, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS. ACCORDINGLY, THE SECURITIES OFFERED HEREBY ARE BEING OFFERED AND SOLD ONLY (A) TO "QUALIFIED INSTITUTIONAL BUYERS" (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT ("RULE 144A")) IN COMPLIANCE WITH RULE 144A, AND (B) PURSUANT TO OFFERS AND SALES THAT OCCUR OUTSIDE THE UNITED STATES WITHIN THE MEANING OF REGULATION S UNDER THE SECURITIES ACT. SEE "NOTICES TO INVESTORS."

	Price to Investors(1)	Initial Purchasers' Discount(2)	Proceeds to Company(3)
Per Note	%	%	%
Total	$	$	$

(1) Plus accrued interest, if any, from , 1997.
(2) The Issuers have agreed to indemnify the Initial Purchasers (as defined herein) against certain liabilities, including liabilities under the Securities Act. See "Plan of Distribution."
(3) Before deducting expenses payable by the Company, estimated at $.

The Notes are offered by the Initial Purchasers, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of certain legal matters by counsel for the Initial Purchasers and certain other conditions. The Initial Purchasers reserve the right to withdraw, cancel or modify such offer and to reject orders in whole or in part. It is expected that delivery of the Notes will be made through the book-entry facilities of The Depository Trust Company in New York, New York on or about , 1997 against payment in immediately available funds.

Merrill Lynch & Co. **McDonald & Company Securities, Inc.**

The date of this Offering Memorandum is , 1997.

THE OFFERING IS BEING MADE IN RELIANCE UPON AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT FOR AN OFFER AND SALE OF SECURITIES THAT DOES NOT INVOLVE A PUBLIC OFFERING. EACH PURCHASER OF NOTES OFFERED HEREBY IN MAKING ITS PURCHASE WILL BE DEEMED TO HAVE MADE CERTAIN ACKNOWLEDGMENTS, REPRESENTATIONS AND AGREEMENTS AS SET FORTH HEREIN UNDER "NOTICES TO INVESTORS." THE NOTES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OR ANY STATE SECURITIES LAWS AND, UNLESS SO REGISTERED, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS. PURCHASERS OF THE NOTES SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THEIR INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

THIS OFFERING MEMORANDUM IS BEING SUBMITTED ON A CONFIDENTIAL BASIS TO A LIMITED NUMBER OF INSTITUTIONAL INVESTORS FOR INFORMATIONAL USE SOLELY IN CONNECTION WITH THEIR CONSIDERATION OF THE PURCHASE OF THE NOTES. USE OF THIS OFFERING MEMORANDUM FOR ANY OTHER PURPOSE IS NOT AUTHORIZED. THIS OFFERING MEMORANDUM MAY NOT BE COPIED OR REPRODUCED IN WHOLE OR IN PART NOR MAY IT BE DISTRIBUTED, NOR MAY ANY OF ITS CONTENTS BE DISCLOSED, TO ANYONE OTHER THAN THE PROSPECTIVE INVESTORS TO WHOM IT IS SUBMITTED. EACH OFFEREE OF THE NOTES, BY ACCEPTING DELIVERY OF THIS OFFERING MEMORANDUM, AGREES TO THE FOREGOING. SEE "NOTICES TO INVESTORS."

THE INFORMATION CONTAINED IN THIS OFFERING MEMORANDUM WAS OBTAINED FROM THE ISSUERS AND OTHER SOURCES BUT NO ASSURANCE CAN BE GIVEN AS TO THE ACCURACY OR COMPLETENESS OF SUCH INFORMATION. THIS OFFERING MEMORANDUM SUMMARIZES CERTAIN DOCUMENTS AND INFORMATION. SUCH SUMMARIES ARE QUALIFIED IN THEIR ENTIRETY BY REFERENCE TO SUCH DOCUMENTS AND INFORMATION. IN MAKING AN INVESTMENT DECISION, INVESTORS MUST RELY ON THEIR OWN EXAMINATION OF THE ISSUERS AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED. NO REPRESENTATION IS MADE TO ANY OFFEREE OR PURCHASER OF THE NOTES REGARDING THE LEGALITY OF AN INVESTMENT THEREIN BY SUCH OFFEREE OR PURCHASER UNDER ANY APPLICABLE LEGAL STANDARD. THE CONTENTS OF THIS OFFERING MEMORANDUM ARE NOT TO BE CONSTRUED AS LEGAL, BUSINESS OR TAX ADVICE. EACH PROSPECTIVE INVESTOR SHOULD CONSULT ITS OWN ATTORNEY, BUSINESS ADVISOR AND TAX ADVISOR AS TO LEGAL, BUSINESS OR TAX ADVICE.

NO REPRESENTATION OR WARRANTY, EXPRESS OR IMPLIED, IS MADE AS TO THE ACCURACY OR COMPLETENESS OF THE INFORMATION SET FORTH HEREIN, AND NOTHING CONTAINED IN THIS OFFERING MEMORANDUM IS, OR SHALL BE RELIED UPON AS, A PROMISE OR REPRESENTATION, WHETHER AS TO THE PAST OR THE FUTURE. THE INITIAL PURCHASERS HAVE NOT INDEPENDENTLY VERIFIED ANY SUCH INFORMATION AND ASSUME NO RESPONSIBILITY FOR THE ACCURACY OR COMPLETENESS THEREOF.

ALL INQUIRIES RELATING TO THIS OFFERING MEMORANDUM AND THE OFFERING CONTEMPLATED HEREIN SHOULD BE DIRECTED TO THE INITIAL PURCHASERS. PROSPECTIVE INVESTORS MAY OBTAIN ADDITIONAL INFORMATION FROM THE INITIAL PURCHASERS OR THE ISSUERS THAT THEY MAY REASONABLY REQUIRE IN CONNECTION WITH THE DECISION TO PURCHASE ANY OF THE NOTES.

THE NOTES HAVE NOT BEEN RECOMMENDED, APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION (THE "COMMISSION") OR ANY STATE SE-

Use of Proceeds	The Company intends to use net proceeds from the Offering to repay senior unsecured indebtedness and related prepayment penalties. The remaining net proceeds will be used to repay amounts outstanding under revolving credit facilities between the Company and Harris Trust and Savings Bank (the "Harris Revolving Credit Agreement") and, unless terminated and repaid prior to the closing of the Offering, each of KeyBank National Association (the "KeyBank Revolving Credit Agreement") and National City Bank, Indiana, a national banking association (the "National City Bank Revolving Credit Agreement") (collectively, the "Revolving Credit Agreements"), and notes payable to Bank One, Dayton NA (the "Bank One Note Payable") and First Merchants Bank of Muncie (the "First Merchants Note Payable") and for general corporate purposes, including capital expenditures. See "Use of Proceeds," "Capitalization" and "Description of Certain Indebtedness."
Exchange Offer; Registration Rights	Pursuant to a registration rights agreement relating to the Notes and the Guarantees (the "Registration Rights Agreement") by and among the Company, the Guarantors and the Initial Purchasers, the Company and the Guarantors have agreed to use their best efforts to (i) file within 30 days, and cause to become effective within 90 days, of the date of original issuance of the Notes, a registration statement (the "Exchange Offer Registration Statement") with respect to an offer to exchange the Notes (the "Exchange Offer") for notes of the Company with terms identical in all material respects to the Notes (the "Exchange Notes") (except that the Exchange Notes will not contain terms with respect to transfer restrictions or interest rate increases as described below) and (ii) cause the Exchange Offer to be consummated within 120 days of the original issuance of the Notes. In the event that any changes in law or the applicable interpretations of the staff of the Commission do not permit the Issuers to effect the Exchange Offer, or if the Exchange Offer Registration Statement is not declared effective within 90 days or consummated within 120 days following the original issue of the Notes, or upon the request of any of the Initial Purchasers, or if any holder of the Notes is not permitted by applicable law to participate in the Exchange Offer or elects to participate in the Exchange Offer but does not receive fully tradable Exchange Notes pursuant to the Exchange Offer, the Issuers will use their best efforts to cause a shelf registration statement with respect to the resale of the Notes (the "Shelf Registration Statement") to become effective within 120 days following the original issue of the Notes (or within 30 days of the request of any Initial Purchaser) and to keep the Shelf Registration Statement effective for up to two years from the date the Shelf Registration Statement is declared effective by the Commission. The interest rate on the Notes is subject to increase under certain circumstances if the Issuers are not in compliance with their obligations

	under the Registration Rights Agreement. See "Exchange Offer; Registration Rights."
Absence of Public Market for the Notes	There is no public trading market for the Notes and the Company does not intend to apply for listing of the Notes on any national securities exchange or for quotation of the Notes on any automated dealer quotation system. The Company has been advised by the Initial Purchasers that they presently intend to make a market in the Notes after the consummation of the Offering contemplated hereby, although they are under no obligation to do so and may discontinue any market-making activities at any time without notice. Although it is expected that the Notes will be eligible for trading in the Private Offering, Resales and Trading through Automated Linkages ("PORTAL") market, no assurance can be given as to the liquidity of the trading market for the Notes or that an active public market for the Notes will develop. If an active trading market for the Notes does not develop, the market price and liquidity of the Notes may be adversely affected. If the Notes are traded, they may trade at a discount from their initial offering price, depending on prevailing interest rates, the market for similar securities, the performance of the Company and certain other factors. See "Risk Factors — Absence of Public Market for the Notes."
Transfer Restrictions	The Notes have not been registered under the Securities Act and may not be offered or sold within the United States or to, or for the benefit of, U.S. persons except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. See "Notices to Investors."

Risk Factors

See "Risk Factors," beginning on page 13, for a discussion of certain factors that should be considered by prospective investors in evaluating an investment in the Notes.

PLAN OF DISTRIBUTION

Subject to the terms and conditions set forth in a purchase agreement (the "Purchase Agreement") among the Company, each of the Guarantors and each of Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") and McDonald & Company Securities, Inc., the Company has agreed to sell to each of the Initial Purchasers, and each of the Initial Purchasers severally and not jointly has agreed to purchase from the Company, the aggregate principal amount of the Notes set forth opposite its name below. The Initial Purchasers have agreed, subject to the terms and conditions set forth in the Purchase Agreement, to purchase all of the Notes if any of the Notes are purchased.

Initial Purchaser	Principal Amount
Merrill Lynch, Pierce, Fenner & Smith Incorporated	$120,000,000
McDonald & Company Securities, Inc.	30,000,000
Total	$150,000,000

The Initial Purchasers propose to offer the Notes for resale in transactions not requiring registration under the Securities Act or applicable state securities laws, including sales pursuant to Rule 144A under the Securities Act. The Initial Purchasers will not offer or sell the Notes except (i) to persons they reasonably believe to be QIBs (as defined herein) and (ii) pursuant to offers and sales to non-U.S. Persons that occur outside the United States within the meaning of Regulation S (as defined herein). Notes sold pursuant to Regulation S may not be offered or resold in the United States or to U.S. Persons (as defined in Regulation S), except pursuant to an exemption from the registration requirements of the Securities Act or pursuant to a registration statement declared effective under the Securities Act. Each purchaser of the Notes offered hereby in making its purchase will be deemed to have made certain acknowledgments, representations and agreements as set forth under "Notices to Investors." The Initial Purchasers have advised the Company that they propose initially to offer the Notes at the price set forth on the cover page hereof. After the initial offering of the Notes, the offering price and other selling terms of the Notes may from time to time vary based on market conditions.

There is no public trading market for the Notes and the Company does not intend to apply for listing of the Notes on any national securities exchange or for quotation of the Notes on any automated dealer quotation system. The Company has been advised by the Initial Purchasers that they presently intend to make a market in the Notes after the consummation of the Offering contemplated hereby, although they are under no obligation to do so and may discontinue any market-making activities at any time without any notice. Although the Notes are expected to be eligible for trading in the PORTAL market, the National Association of Securities Dealers' screenbased, automated market for trading of securities eligible for resale under Rule 144A, no assurance can be given as to the liquidity of the trading market for the Notes or that an active public market for the Notes will develop. If an active trading market for the Notes does not develop, the market price and liquidity of the Notes may be adversely affected. If the Notes are traded, they may trade at a discount from their initial offering price, depending on prevailing interest rates, the market for similar securities, the performance of the Company and certain other factors.

The Issuers have agreed, subject to certain exceptions (including borrowings under revolving credit agreements), not to directly or indirectly offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant for the sale of or otherwise dispose of or transfer any debt securities, or file a registration statement under the Securities Act with respect to the foregoing, without the prior written consent of Merrill Lynch on behalf of the Initial Purchasers, for a period of 90 days after the date of this Offering Memorandum.

The Issuers have agreed to indemnify the Initial Purchasers against certain liabilities, including certain liabilities under the Securities Act, or to contribute to payments the Initial Purchasers may be required to make in respect thereof.

Until the distribution of the Notes is completed, rules of the Securities and Exchange Commission may limit the ability of the Initial Purchasers and certain selling group members to bid for and purchase the Notes. As an exception to these rules, the Initial Purchasers are permitted to engage in certain transactions that stabilize the price of the Notes. Such transactions consist of bids or purchases for the purpose of pegging, fixing or maintaining the price of the Notes.

If the Initial Purchasers create a short position in connection with the offering, i.e., if they sell more Notes than are set forth on the cover page of this Offering Memorandum, the Initial Purchasers may reduce that short position by purchasing Notes in the open market. In general, purchases of a security for the purpose of stabilization or to reduce a short position could cause the price of the security to be higher than it might be in the absence of such purchases.

Neither the Issuers nor any of the Initial Purchasers makes any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of the Notes. In addition, neither the Issuers nor any of the Initial Purchasers makes any representation that the Initial Purchasers will engage in such transactions or that such transactions, once commenced, will not be discontinued without notice.

The Initial Purchasers have from time to time provided and may in the future provide investment banking and financial advisory services to the Company and its affiliates.

J.J.B. Hilliard, W.L. Lyons, Inc. and Nesbitt Burns Securities Inc. have acted as financial advisors to the Company in connection with the Offering and will receive fees of $100,000 and $20,000, respectively, as compensation for such services.

LEGAL MATTERS

Certain legal matters with respect to the legality of the issuance of the Notes offered hereby will be passed upon for the Company by Bass, Berry & Sims PLC, First American Center, Nashville, Tennessee 37238. Certain legal matters will be passed upon for the Initial Purchasers by Fried, Frank, Harris, Shriver & Jacobson (a partnership which includes professional corporations), One New York Plaza, New York, New York 10004. Bass, Berry & Sims PLC and Fried, Frank, Harris, Shriver & Jacobson will rely as to all matters of Indiana law upon the opinion of P. Lawrence Butt, Counsel of the Company. Bass, Berry & Sims PLC will rely as to all matters of New York law upon the opinion of Fried, Frank, Harris, Shriver & Jacobson.

INDEPENDENT AUDITORS

The consolidated financial statements of Marsh Supermarkets, Inc. and subsidiaries at March 29, 1997 and March 30, 1996, and for each of the three years in the period ended March 29, 1997, appearing in this Offering Memorandum have been audited by Ernst & Young LLP, independent auditors, as set forth in their report thereon appearing elsewhere herein.

As filed with the Securities and Exchange Commission on October 29, 1997

Registration No. 333-34855

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Amendment No. 2
to
FORM S-4

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

MARSH SUPERMARKETS, INC.
(Exact name of Registrant as specified in its charter)

Indiana	**5411**	**35-0918179**
(State or other jurisdiction of incorporation or organization)	*(Primary Standard Industrial Classification Code Number)*	*(I.R.S. Employer Identification No.)*

9800 Crosspoint Boulevard
Indianapolis, Indiana 46256-3350
(317) 594-2100
(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

SEE TABLE OF ADDITIONAL REGISTRANTS

P. Lawrence Butt
Senior Vice President, Counsel and Secretary
Marsh Supermarkets, Inc.
9800 Crosspoint Boulevard
Indianapolis, Indiana 46256-3350
(317) 594-2100
(Name, Address, including zip code, and telephone number, including area code, of agent for service)

Copies of all communications to:

James H. Cheek III
Bass, Berry & Sims PLC
2700 First American Center
Nashville, Tennessee 37238
(615) 742-6200

Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.

If the securities being registered on this form are being offered in connection with the formation of a holding company and there is compliance with General Instruction G, check the following box. ☐

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to such Section 8(a), may determine.

Subject to Completion, dated October 29, 1997

PRELIMINARY PROSPECTUS

MARSH

Offer to Exchange
up to $150,000,000 of
8⅞% Senior Subordinated Notes due 2007, Series B
for any and all of the outstanding
8⅞% Senior Subordinated Notes due 2007
of

Marsh Supermarkets, Inc.

The Exchange Offer will expire at 5:00 p.m., New York City time,
on , 1997, unless extended.

Marsh Supermarkets, Inc., an Indiana corporation (the "Company"), hereby offers, upon the terms and subject to the conditions set forth in this Prospectus and the accompanying letter of transmittal (the "Letter of Transmittal" and, together with this Prospectus, the "Exchange Offer"), to exchange an aggregate of up to $150,000,000 principal amount of 8⅞% Senior Subordinated Notes due 2007, Series B (the "Exchange Notes"), which have been registered under the Securities Act of 1933, as amended (the "Securities Act"), for an identical face amount of the issued and outstanding 8⅞% Senior Subordinated Notes due 2007 (the "144A Notes" and, together with the Exchange Notes, the "Notes") of the Company from the Holders (as defined herein) thereof in integral multiples of $1,000. As of the date of this Prospectus, there is $150,000,000 in aggregate principal amount of the 144A Notes outstanding. The terms of the Exchange Notes are identical in all material respects to the 144A Notes, except that the Exchange Notes have been registered under the Securities Act, and therefore will not bear legends restricting their transfer and will not contain certain provisions providing for an increase in the interest rate payable on the 144A Notes under certain circumstances relating to the Registration Rights Agreement (as defined herein), which provisions will terminate as to all of the Notes upon the consummation of the Exchange Offer. The Exchange Notes will be obligations of the Company evidencing the same indebtedness as the 144A Notes, and will be entitled to the benefits of the same Indenture (as defined herein). See "Exchange Offer."

Interest on the Exchange Notes will be payable semi-annually in arrears on February 1 and August 1 in each year, commencing February 1, 1998. The Exchange Notes will mature on August 1, 2007. The Exchange Notes are redeemable at any time on or after August 1, 2002 at the option of the Company, in whole or in part, at the redemption prices set forth herein, together with accrued and unpaid interest, if any, to the date of redemption. Upon the occurrence of a Change of Control (as defined herein), each holder of the Exchange Notes may require the Company to purchase all or a portion of such holder's Exchange Notes at a purchase price equal to 101% of the principal amount thereof, together with accrued and unpaid interest, if any, to the date of purchase. There can be no assurance that the Company will have sufficient funds necessary to repurchase the Exchange Notes. The provisions of the Indenture allow the Company to incur additional indebtedness, including Senior Indebtedness, subject to certain limitations. The provisions of the Indenture do not require the Company to repurchase the Exchange Notes in the event of highly leveraged or certain other transactions if such transaction is not a transaction defined as a Change of Control. See "Description of the Exchange Notes — Certain Covenants."

The Exchange Notes will be unsecured senior subordinated obligations of the Company and, as such, will be subordinated in right of payment to all existing and future senior indebtedness of the Company. The Exchange Notes will rank *pari passu* in right of payment with all other existing and future senior subordinated indebtedness, if any, of the Company, and senior in right of payment to all existing and future subordinated indebtedness, if any, of the Company. **The Company has not issued, and does not have any current arrangements to issue, any significant additional indebtedness to which the Notes would be senior, subordinate or rank *pari passu* in right of payment. The Notes will be effectively subordinate to essentially all of the currently outstanding indebtedness of the Company and its subsidiaries.** The Exchange Notes will be fully and unconditionally guaranteed, jointly and severally, on a senior subordinated basis (the "Guarantees") by all of the Company's subsidiaries (other than three inconsequential subsidiaries) (the "Guarantors" and, together with the Company, the "Issuers"). The Guarantees will be unsecured senior subordinated obligations of the Guarantors and will be subordinated to all existing and future Guarantor Senior Indebtedness (as defined herein). See "Description of the Exchange Notes — Ranking." The Company has $70.0 million in available credit, under its existing revolving credit agreements and notes payable to banks, which is senior in right of payment to the Notes. As of September 13, 1997, after giving effect to the offering of the 144A Notes and the application of the net proceeds therefrom, the Company and the Guarantors had outstanding $216.1 million of aggregate principal amount of indebtedness, of which $46.2 million ranked senior in right of payment to the Exchange Notes and the Guarantees (all of which was secured) and approximately $19.9 million was subordinated in right of payment to the Exchange Notes and the Guarantees. As of the date of this Prospectus, virtually all of the consolidated assets of the Company were held by the Guarantors and virtually all of the Company's cash flow and net income was generated by the Guarantors. Therefore, the Company's ability to make interest and principal payments when due to holders of the Exchange Notes is dependent, in part, upon the receipt of sufficient funds from its subsidiaries.

(cover page continued on next page)

See "Risk Factors," beginning on page 13, for a discussion of certain factors that should be considered by participants in the Exchange

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

UNTIL , 1997 (90 DAYS AFTER THE DATE OF THIS PROSPECTUS), ALL DEALERS EFFECTING TRANSACTIONS IN THE REGISTERED SECURITIES, WHETHER OR NOT PARTICIPATING IN THIS DISTRIBUTION, MAY BE REQUIRED TO DELIVER A PROSPECTUS.

The Date of this Prospectus is , 1997.

The Company will accept for exchange any and all validly tendered 144A Notes on or prior to the Expiration Date (as defined herein). Tenders of time, on the Expiration Date; otherwise such tenders are irrevocable. The Exchange Offer is not conditioned upon any minimum principal amount of 144A Notes being tendered for exchange. For certain conditions to the Exchange Offer, see "The Exchange Offer — Conditions."

The 144A Notes were offered and sold on August 5, 1997 at a price of $991.85 per $1,000 principal amount of Notes. For federal income tax purposes, the amount of original issue discount on the 144A Notes is considered to be de minimis and is treated as zero. See "Description of Certain Federal Income Tax Consequences of an Investment in the Notes."

The 144A Notes were offered and sold in a transaction not registered under the Securities Act in reliance upon an exemption from the registration requirements thereof. In general the 144A Notes may not be offered or sold unless registered under the Securities Act, except pursuant to an exemption from, or in a transaction not subject to, the Securities Act.

The Exchange Notes are being offered hereby in order to satisfy certain obligations of the Company contained in the Registration Rights Agreement. The Company has agreed to pay the expenses of the Exchange Offer. Based on interpretations by the staff of the Securities and Exchange Commission (the "Commission") set forth in no-action letters issued to third parties, the Company believes that the Exchange Notes issued pursuant to the Exchange Offer in exchange for 144A Notes may be offered for resale, resold or otherwise transferred by any Holder thereof (other than any such Holder that is an "affiliate" of the Company within the meaning of Rule 405 promulgated under the Securities Act) without compliance with the registration and prospectus delivery provisions of the Securities Act, *provided* that such Exchange Notes are acquired in the ordinary course of such Holder's business and such Holder is not engaged in and does not intend to engage in a distribution of such Exchange Notes. In some cases, certain broker-dealers may be required to deliver a prospectus in connection with the resale of such Exchange Notes.

This Prospectus, as it may be amended or supplemented from time to time, may be used by a broker-dealer in connection with any resale of Exchange Notes received in exchange for such 144A Notes where such 144A Notes were acquired by such broker-dealer for its own account as a result of market-making activities or other trading activities (other than 144A Notes acquired directly from the Company). The Company has agreed that it will make this Prospectus available to any broker-dealer for use in connection with any such resale.

Prior to this Exchange Offer, there has been no public market for the 144A Notes or Exchange Notes. If a market for the Exchange Notes should develop, the Exchange Notes could trade at a discount from their principal amount. The Company does not intend to list the Exchange Notes on any securities exchange nor does the Company intend to apply for quotation of the Exchange Notes on the NASDAQ National Market or other quotation system. The Initial Purchasers (as defined herein) have indicated to the Company that they intend to make a market in the Notes, but are not obligated to do so and such market-making activities may be discontinued at any time. As a result, no assurance can be given that an active trading market for the Exchange Notes will develop.

The Exchange Notes issued pursuant to this Exchange Offer will be issued in the form of Global Exchange Notes (as defined herein), which will be deposited with, or on behalf of, The Depository Trust Company (the "Depository" or "DTC") and registered in its name or in the name of Cede & Co., its nominee. Beneficial interests in the Global Exchange Notes representing the Exchange Notes will be shown on, and transfers thereof will be effected through, records maintained by the DTC and its participants. Notwithstanding the foregoing, 144A Notes held in certificated form will be exchanged solely for Certificated Exchange Notes (as defined herein). After the initial issuance of the Global Exchange Notes, Certificated Exchange Notes will be issued in exchange for the Global Exchange Notes only on the terms set forth in the Indenture. See "Description of the Exchange Notes — Book-Entry, Delivery and Form."

PROSPECTUS

MARSH.

Offer to Exchange
up to $150,000,000 of
8⅞% Senior Subordinated Notes due 2007, Series B
for any and all of the outstanding
8⅞% Senior Subordinated Notes due 2007
of

Marsh Supermarkets, Inc.

The Exchange Offer will expire at 5:00 p.m., New York City time, on December 3, 1997, unless extended.

Marsh Supermarkets, Inc., an Indiana corporation (the "Company"), hereby offers, upon the terms and subject to the conditions set forth in this Prospectus and the accompanying letter of transmittal (the "Letter of Transmittal" and, together with this Prospectus, the "Exchange Offer"), to exchange an aggregate of up to $150,000,000 principal amount of 8⅞% Senior Subordinated Notes due 2007, Series B (the "Exchange Notes"), which have been registered under the Securities Act of 1933, as amended (the "Securities Act"), for an identical face amount of the issued and outstanding 8⅞% Senior Subordinated Notes due 2007 (the "144A Notes" and, together with the Exchange Notes, the "Notes") of the Company from the Holders (as defined herein) thereof in integral multiples of $1,000. As of the date of this Prospectus, there is $150,000,000 in aggregate principal amount of the 144A Notes outstanding. The terms of the Exchange Notes are identical in all material respects to the 144A Notes, except that the Exchange Notes have been registered under the Securities Act, and therefore will not bear legends restricting their transfer and will not contain certain provisions providing for an increase in the interest rate payable on the 144A Notes under certain circumstances relating to the Registration Rights Agreement (as defined herein), which provisions will terminate as to all of the Notes upon the consummation of the Exchange Offer. The Exchange Notes will be obligations of the Company evidencing the same indebtedness as the 144A Notes, and will be entitled to the benefits of the same Indenture (as defined herein). See "Exchange Offer."

Interest on the Exchange Notes will be payable semi-annually in arrears on February 1 and August 1 in each year, commencing February 1, 1998. The Exchange Notes will mature on August 1, 2007. The Exchange Notes are redeemable at any time on or after August 1, 2002 at the option of the Company, in whole or in part, at the redemption prices set forth herein, together with accrued and unpaid interest, if any, to the date of redemption. Upon the occurrence of a Change of Control (as defined herein), each holder of the Exchange Notes may require the Company to purchase all or a portion of such holder's Exchange Notes at a purchase price equal to 101% of the principal amount thereof, together with accrued and unpaid interest, if any, to the date of purchase. There can be no assurance that the Company will have sufficient funds necessary to repurchase the Exchange Notes. The provisions of the Indenture allow the Company to incur additional indebtedness, including Senior Indebtedness, subject to certain limitations. The provisions of the Indenture do not require the Company to repurchase the Exchange Notes in the event of highly leveraged or certain other transactions if such transaction is not a transaction defined as a Change of Control. See "Description of the Exchange Notes — Certain Covenants."

The Exchange Notes will be unsecured senior subordinated obligations of the Company and, as such, will be subordinated in right of payment to all existing and future senior indebtedness of the Company. The Exchange Notes will rank *pari passu* in right of payment with all other existing and future senior subordinated indebtedness, if any, of the Company, and senior in right of payment to all existing and future subordinated indebtedness, if any, of the Company. **The Company has not issued, and does not have any current arrangements to issue, any significant additional indebtedness to which the Notes would be senior, subordinate or rank *pari passu* in right of payment. The Notes will be effectively subordinate to essentially all of the currently outstanding indebtedness of the Company and its subsidiaries.** The Exchange Notes will be fully and unconditionally guaranteed, jointly and severally, on a senior subordinated basis (the "Guarantees") by all of the Company's subsidiaries (other than three inconsequential subsidiaries) (the "Guarantors" and, together with the Company, the "Issuers"). The Guarantees will be unsecured senior subordinated obligations of the Guarantors and will be subordinated to all existing and future Guarantor Senior Indebtedness (as defined herein). See "Description of the Exchange Notes — Ranking." The Company has $70.0 million in available credit, under its existing revolving credit agreements and notes payable to banks, which is senior in right of payment to the Notes. As of September 13, 1997, after giving effect to the offering of the 144A Notes and the application of the net proceeds therefrom, the Company and the Guarantors had outstanding $216.1 million of aggregate principal amount of indebtedness, of which $46.2 million ranked senior in right of payment to the Exchange Notes and the Guarantees (all of which was secured) and approximately $19.9 million was subordinated in right of payment to the Exchange Notes and the Guarantees. As of the date of this Prospectus, virtually all of the consolidated assets of the Company were held by the Guarantors and virtually all of the Company's cash flow and net income was generated by the Guarantors. Therefore, the Company's ability to make interest and principal payments when due to holders of the Exchange Notes is dependent, in part, upon the receipt of sufficient funds from its subsidiaries.

(cover page continued on next page)

See "Risk Factors," beginning on page 13, for a discussion of certain factors that should be considered by participants in the Exchange

The Date of this Prospectus is October 31, 1997.

LETTER OF TRANSMITTAL

MARSH SUPERMARKETS, INC.

Offer to Exchange
8⅞% Senior Subordinated Notes due 2007, Series B
for any and all of the outstanding
8⅞% Senior Subordinated Notes due 2007

THE EXCHANGE OFFER AND WITHDRAWAL RIGHTS WILL EXPIRE AT 5:00 P.M., NEW YORK CITY TIME, ON DECEMBER 3, 1997, UNLESS THE OFFER IS EXTENDED

State Street Bank and Trust Company
(the "Exchange Agent")

By Mail
(registered or certified mail recommended):

State Street Bank and
Trust Company
Corporate Trust Department
P.O. Box 778
Boston, MA 02102-0078
Attention: Ms. Sandra
Szczsponik

By Facsimile Transmission:
(617) 664-5395

Confirm by Telephone
or for Information Call:
(617) 664-5587

By Hand or Overnight Courier:

State Street Bank and
Trust Company
Corporate Trust Department,
4th floor
Two International Place
Boston, MA 02110
Attention: Ms. Sandra
Szczsponik

Delivery of this instrument to an address other than as set forth above or transmission of instructions via a facsimile number other than the ones listed above will not constitute a valid delivery. The instructions accompanying this Letter of Transmittal should be read carefully before this Letter of Transmittal is completed.

The undersigned hereby acknowledges receipt of the Prospectus dated October 31, 1997 (the "Prospectus") of Marsh Supermarkets, Inc. (the "Company") and this Letter of Transmittal, which together constitute the Company's offer (the "Exchange Offer") to exchange $1,000 principal amount of its 8⅞% Senior Subordinated Notes due 2007, Series B (the "Exchange Notes"), which have been registered under the Securities Act of 1933, as amended (the "Securities Act"), pursuant to a Registration Statement of which the Prospectus is a part, for each $1,000 principal amount of its outstanding 8⅞% Senior Subordinated Notes due 2007 (the "144A Notes"). The term "Expiration Date" shall mean 5:00 p.m., New York City time, on December 3, 1997, unless the Exchange Offer is extended, in which case the term "Expiration Date" means the latest date and time to which the Exchange Offer is extended. Capitalized terms used but not defined herein have the meaning given to them in the Prospectus.

YOUR BANK OR BROKER CAN ASSIST YOU IN COMPLETING THIS FORM. THE INSTRUCTIONS INCLUDED WITH THIS LETTER OF TRANSMITTAL MUST BE FOLLOWED. QUESTIONS AND REQUESTS FOR ASSISTANCE OR FOR ADDITIONAL COPIES OF THE PROSPECTUS AND THIS LETTER OF TRANSMITTAL MAY BE DIRECTED TO THE EXCHANGE AGENT.

List on the next page the 144A Notes to which this Letter of Transmittal relates. If the space indicated is inadequate, the Certificate or Registration Numbers and the Principal Amounts should be listed on a separately signed schedule affixed hereto.

SALES OF SECURITIES IN THE AFTERMARKET

AND LIQUIDITY OF SHARES

Registration Rights, Lock-Ups and Rule 144

William G. Strench
Brown, Todd & Heyburn PLLC
Louisville, Kentucky

SECTION N

SALES OF SECURITIES IN THE AFTERMARKET AND LIQUIDITY OF SHARES: Registration Rights, Lock-Ups and Rule 144

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SALES OF SECURITIES IN THE AFTERMARKET AND LIQUIDITY OF SHARES: REGISTRATION RIGHTS, LOCK-UPS AND RULE 144

By: William G. Strench
Brown, Todd & Heyburn PLLC

I. LIQUIDITY OBJECTIVE

Investors in private companies typically seek liquidity as one of their principal objectives. Liquidity is generally achieved either through a sale of the private company or through an eventual public offering by the company. Although a public offering may create a market for the company's securities, a pre-IPO investor is not always free to sell into that market. The following describes the barriers to liquidity following a public offering and the means available to overcome those barriers.

II. BARRIERS TO LIQUIDITY

A. Securities Law Restrictions

Section 5 of the Securities Act of 1933 (the "1933 Act") provides for the registration of securities prior to sale unless an exemption is available. Section 4(1) exempts all transactions from the Section 5 requirements except those by "an issuer, underwriter, or dealer." The term "underwriter" is defined in Section 2(a)(11) of the 1933 Act as "any person who has purchased from an issuer with a view to ... the distribution of any security." Section 2(a)(11) further defines the term "issuer" for this purpose to include "... any person ... controlling ... the issuer..." As a result of these statutory provisions, any proposed resale of securities that either occurs relatively soon after they were purchased from the issuer or is made by an affiliate of an issuer may be deemed sold in connection with a distribution and therefore not exempt under the 1933 Act.

B. Lock-up Provisions.

Underwriters of securities in initial public offerings ("IPO") will generally require all directors, officers and significant shareholders to enter into lock-up agreements restricting the sale of their shares following the IPO. In some cases, underwriters will also impose lock-up restrictions on shares issued in the IPO that are directed to specific persons by the issuer's management (so-called "friends and family shares"). These agreements are designed to prevent such persons from selling shares in the market during the volatile period immediately following an IPO. During this period, the underwriters are often engaging in stabilizing transactions in the form of open market purchases to maintain the price of the issuer's stock. Insider sales during this period could undermine such efforts.

Typical lock-up provisions are very broad and not only apply to direct sales of stock but also to offers, pledges, contracts to sell, sales of options or contracts to purchase, purchases of options or contracts to sell, swaps or other arrangements that transfer to any of the economic consequences of ownership. In some cases exception to the lock-up restrictions are permitted for certain transactions that would not be expected to impact the market for the issuer's securities. These include gifts, transfers to a trust for the benefit of the restricted shareholder, and transfers to entities wholly owned by the restricted shareholder, provided in each such instance that such transfers do not require payment for the shares and that the transferee agrees to be bound by the restrictions of the lock-up agreement. A sample lock-up agreement is attached as Appendix A.

Transfer restrictions that contain lock-up agreements are generally enforceable under state law if they satisfy certain conditions. In particular, such restrictions must be either set forth in a written agreement entered into among shareholders or by the shareholder and the company or alternatively they must be included in the articles of incorporation or bylaws of the corporation. See KRS 271B.6-270 and § 202 of the Delaware General Corporation Law. However, if such restrictions are added to the articles of incorporation or bylaws pursuant to an amendment, they will only be effective with respect to shareholders who voted for the amendment or acquired their shares after the amendment went into effect.

Underwriters will often release shareholders from lock-up restrictions prior to expiration of the lock-up period if the stock is trading at a sufficiently high level and they do not believe that such sales will adversely affect the market for the shares. Sometimes the lifting of these lock-up restrictions is accomplished on a controlled basis whereby the restricted party will only be allowed to sell a portion of his shares through the underwriter and the underwriter will limit the aggregate number of shares sold pursuant to the lifted lock-up to a fixed amount per day.

III. PATHS TO LIQUIDITY

A. Rule 144

Rule 144 exempts from the registration prerequirements certain ordinary trading transactions of limited amounts of securities owned by (a) affiliates of the issuer or (b) persons who acquired securities from the issuer or an affiliate of an issuer in a private transaction. For a transaction to be exempt under Rule 144, a number of requirements must be met. These include the following:

- Rule 144(c) which requires that there be available current public information with respect to the issuer of the securities. This requirement can be met if the company is current with its filing obligations under the Securities Exchange Act of 1934.

- Rule 144(d) which requires that a person acquiring the securities from the issuer in a non-public transaction must hold them for at least one year before reselling them. Shares acquired by an affiliate in a non-private transaction are not subject to any holding period requirement.

- Rule 144(e) which provides that sales by any person of an issuer's securities under Rule 144 during any three month period may not exceed the greater of (a) one percent of the total number of shares of the security outstanding and (b) the average weekly trading volume for the preceding four weeks.

- Rule 144(f) which requires that the securities be sold in ordinary brokers' transactions.

If the securities have been held for at least two years after having been acquired from the issuer or an affiliate of the issuer, the volume limitations and manner of sale restrictions are no longer applicable for non-affiliates.

The following is a summary of some of the most significant issues under Rule 144 that relate to securities purchased in private equity transactions.

Commencement of Holding Period for Warrants. Rule 144(d) states that "[i]f the acquirer takes the securities by purchase, the one year period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer." The SEC takes the position that any consideration paid for the security, no matter how small, requires the commencement of a new holding period. Thus, the holding period for a person who acquires a warrant on January 1, 2000 and pays $0.01 per share to exercise the warrant on January 1, 2002 will not be deemed to commence until the exercise date. However, the SEC has permitted the holding period to commence as of the date of the issuance of the warrants if they are exercised pursuant to a "cashless" exercise procedure in the warrant. See Technology Funding Secured Investors II, SEC No-Action Letter (July 23, 1991). This is accomplished through an exercise whereby the holder surrenders the warrant and receives only the net share amount (i.e., the total number of shares subject to the warrant less that number of shares equal in value to the exercise price of the warrant). For these reasons, it is important to include a cashless exercise provision in all warrants even ones with a nominal exercise price.

Distributions by a Venture Capital Fund to its Partners. Often a partner of a venture capital firm will serve as a director of a portfolio company in which the firm's investment limited partnership has invested. As a result, both the partner and by attribution, the limited partnership, will be deemed to be affiliates of the portfolio company. Thus it would be anticipated that any securities distributed by the partnership to its limited partners would commence a new Rule 144 holding period. In such circumstances, however the SEC has taken the position that the limited partners can "tack" the period in which the partnership held the securities to the period that the limited partners hold the securities in determining whether the one and two year holding periods have been satisfied under Rule 144. Although such taking is permitted, the SEC otherwise applies the restrictions applicable to shares formerly held by affiliates. Accordingly, the unlimited resale provision in 144(k) will not be available to the limited partners until three months have elapsed from the date of distribution. During the period that the unlimited resale provision is unavailable, and for a maximum of two years after the distribution, the individual limited partners will also have to aggregate their sales under the volume limitation provisions of Rule 144. See Release No. 33-6099 at Q&A 34 and 45.

Capital Stock issued upon Conversion of a Limited Liability Company into a Corporation. Many business entities are initially organized as limited liability companies for tax and other reasons. When such companies decide to go public, they will convert to the corporate form. An issue arises under 144(d) whether shareholders of the new corporation may tack onto their holding period the time period in which they owned the LLC interests that were converted into such shares. Rule 144(d)(3)(i) states that "[s]ecurities acquired from the issuer ... pursuant to a ... recapitalization shall be deemed to have been acquired at the same time as ... the securities surrendered in connection with the recapitalization." In a number of no action letters, the SEC staff has expressly permitted tacking for a reorganization of a limited partnership into a corporation. See Hygeia Sciences, SEC No-Action Letter (March 13, 1986). Recently, the same result was reached with respect to limited liability companies. See Cravath, Swaine & Moore, SEC No-Action Letter (February 11, 2000). In order for tacking to apply, the following criteria must be present: (1) the partnership agreement or operating agreement or other organizational document must expressly contemplate reorganization as a corporation and the holder seeking to tack must not have veto or other voting rights with respect to the transaction; (2) there is no change in the business or operations of the company as a result of the reorganization; and (3) the equity interests of the stockholders of the successor corporation are based on their proportionate interests in the prior entity.

Thus, it is advisable to include a provision in the operating agreement of an LLC that clearly states the LLC may convert to a corporation at the discretion of the manager or an LLC board of directors, with no discretion given to a member to block the transaction. In addition, the operating agreement should specifically delineate the corporate securities that the members will receive in the reorganization in exchange for their LLC interests.

B. Registration Rights

Primarily because of the holding period and volume limitations set forth in Rule 144, it is often not possible for an investor to sell the full amount of shares that he would like to sell following an IPO even after any applicable lock-up period has expired. Even if it is permissible to sell such shares under the 1933 Act, the investor may not be able to sell such shares without negatively impacting the price of the stock and therefore resulting in a lower sales proceeds to the investor. Accordingly, it is common for an investor to negotiate "registration rights" for his shares. Such rights are commonly provided in venture capital transactions and are often included in other transactions where capital stock or warrants are issued including bank financings and strategic alliances.

There are two principal types of registration rights. Demand registration rights allow the holder to compel registration of the holder's shares either at his election or at the election of the holders of a fixed percentage of shares. Piggyback registration rights allow the holder to register his shares only if the company is otherwise registering shares of its stock either in an offering by the company or by another shareholder.

The following are certain issues that arise in connection with the negotiation of registration rights.

When may demand registration rights be exercised? Generally, demand registration rights may not be exercised until after a company becomes public. Otherwise, the holder of registration rights would have the ability to make the decision as to when the company is to go public rather than having that decision made by the company's board of directors and management. However, some investors require that demand rights be exercisable at any time after a specified number of years after the investment has been made regardless of whether the company is public at that time.

How long after the company has become public must the investor wait until it can first exercise its demand rights? Generally, a minimum of six months from the effective date of the company's initial public offering. This relates to the typical six month lock-up period during which the company does not wish to have additional shares enter the market. At times issuers will require a minimum 12 month period before demand registration rights may be exercised. This is to allow the issuer to utilize Form S-3 to register the shares. Form S-3 is only available if the issuer has been a public company for at least 12 months and is a greatly simplified filing compared to the Form S-1 that must be used in connection with initial public offerings and any offerings made within the first 12 months after an initial public offering.

Who may elect to exercise demand registration rights? Generally, the issuer will require that a specified percentage of the holders of a class of equity securities make the demand for registration (generally 25% to 50%). This ensures that the costs of registration are not incurred unless a significant number of holders desire to avail themselves of registration rights. For similar reasons, registration rights agreements will typically provide that a demand notice cannot be made unless the total amount of securities to be sold exceeds a certain minimum threshold (e.g., $5,000,000).

When may an issuer defer a registration pursuant to demand or piggyback registration rights? Often the registration rights agreement will provide that if the company's board of directors determines in good faith that a registration would be harmful to the company and/or its shareholders (e.g., the company would have to reveal a confidential transaction or unfavorable market conditions exist) the company may delay the registration. Since this provision undermines the rights of holders of registration rights, there are typically limits on these deferral rights by the company. First, the deferral may not be for more than a specified number of days (e.g., 180 days) and second, the company is not permitted to utilize this right more than a specified number of times during a particular period (e.g., more than once during any 12 month period).

How many demand registration rights are generally made available? Although this provision is negotiable, two to three demand rights are common. In addition, holders are often granted unlimited Form S-3 registrations. The only limitations on such registrations are that they must be for a minimum amount (generally $1,000,000 or more), the company's registration is not at the time seriously detrimental to the company under the same standards described above, or a prior S-3 registration was made within the last six months.

How many piggyback registration rights does a holder typically receive? Given the relatively low cost of allowing someone to exercise piggyback rights, these are generally unlimited.

In an underwritten offering, under what circumstances may a holder attempting to exercise registration rights be denied the right to have such shares included in the underwritten offering? Most registration rights agreements provide that if the managing underwriter determines in good faith that marketing factors require a limitation on the number of shares to be included in the offering, then the underwriter may exclude the shares. Cutbacks are generally made on a prorated basis based on the number of shares each person is entitled to register. In the context of a piggyback registration, the company will generally not be cut back in the number of shares that it can sell and only shareholders will be subject to cutbacks. Often the cutback provisions will provide that no shares of the investors will be cut back unless all management shares are excluded.

What expenses will the company generally bear in connection with a registered offering made pursuant to the exercise of registration rights? Generally, all costs of the offering other than commissions and underwriter's discounts will be paid by the issuer. Often, though not always, the issuer will pay the cost of at least one counsel for the selling shareholders. This amount is often limited to a specified dollar amount.

When do registration rights typically terminate? Generally, there is a time limit placed on the ability to use registration rights, typically three to seven years. In addition, registration rights as to a particular holder are often terminated when all of the holder's remaining registerable securities may be sold without registration under Rule 144(k) during a three month period.

SAMPLE LOCK-UP AGREEMENT

________, 2000

[Names and addresses
of Underwriters]

RE: LOCK-UP AGREEMENT ("*Agreement*")

Ladies and Gentlemen:

The undersigned is an owner of record or beneficially of certain shares of Common Stock, par value $________ (the "__________") of __________________, a Delaware corporation (the "*Company*"), or securities convertible into or exchangeable for or issuable upon the exercise of stock options and warrants to purchase shares of Common Stock. The undersigned understands that you, as representatives (the "*Representatives*"), propose to enter into an underwriting agreement (the "*Underwriting Agreement*") on behalf of the several Underwriters named therein (collectively, the "*Underwriters*"), with the Company providing for a public offering of shares of the Common Stock of the Company pursuant to a Registration Statement on Form S-1 to be filed with the Securities and Exchange Commission (the "*Public Offering*"). The undersigned recognizes that the Public Offering will benefit the undersigned and the Company by, among other things, raising additional capital for the operations of the Company. The undersigned acknowledges that you and the other Underwriters are relying on the representations and agreements of the undersigned contained in this Agreement in carrying out the Public Offering and in entering into underwriting arrangements with the Company with respect to the Public Offering.

To induce the Underwriters that may participate in the Public Offering to continue their efforts in connection with the Public Offering, the undersigned hereby agrees that, without the prior written consent of ____________________________ (which consent may be withheld in its sole discretion), it will not, and will not publicly announce its intention to, during the period commencing on the date hereof and ending 180 days after the date of the final prospectus relating to the Public Offering (the "*Prospectus*"), (1) offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend or otherwise transfer or dispose of, directly or indirectly, any shares of Common Stock or any securities convertible into or exercisable or exchangeable for Common Stock or (2) enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the Common Stock, whether any such transaction described in clause (1) or (2) above is to be settled by delivery of Common Stock or such other securities, in cash or otherwise. In addition, the undersigned agrees that, without the prior written consent of ____________________ (which consent may be withheld in its sole discretion), it will not, during the period commencing on the date hereof and ending 180 days after the date of the Prospectus, make any demand for or exercise any right with respect to, the registration, offering or sale of any shares of Common Stock or any security convertible into or exchangeable for or issuable upon the exercise of stock options and warrants to purchase shares of Common Stock. With respect to the Public Offering, the undersigned waives any registration rights relating to registration under the Securities Act of 1933, a amended, of any offering or sale of any Common Stock owned either of record or beneficially by the undersigned, including any rights to receive notice of the Public Offering.

The foregoing restrictions are expressly agreed to preclude the undersigned from engaging in any hedging or other transaction which is designed to or reasonably expected to lead to or result in a sale or disposition of the Common Stock even if such Common Stock would be disposed of by someone other than the undersigned. Such prohibited hedging or other transactions would include without limitation any short sale or any purchase, sale or grant of any right (including without limitation any put option or put equivalent position or call option or call equivalent position) with respect to any of the Common Stock or with respect to any security that includes, relates to, or derives any significant part of its value from such Common Stock.

Notwithstanding the foregoing, the undersigned may transfer shares of Common Stock or securities convertible into or exchangeable or exercisable for Common Stock (i) as a bona fide gift or gifts, provided that the donee or donees thereof agree to be bound by the restrictions set forth herein, (ii) to any trust for the direct or indirect benefit of the undersigned or the immediate family of the undersigned, provided that the trustee of the trust agrees to be bound by the restrictions set forth herein, and provided further that any such transfer shall not involve a disposition for value, (iii) to any corporation, partnership, limited liability company or other business entity that is wholly owned by the undersigned and/or its donees or assignees, provided that any such transfer shall not involve a disposition for value and any such transferee agrees to be bound by the restrictions set forth herein, or (iv) to the Underwriters pursuant to the Underwriting Agreement. For purposes of this Agreement, "immediate family" shall mean any relationship by blood, marriage or adoption, not more remote than first cousin.

The undersigned understands that whether the Public Offering actually occurs will depend on a number of factors, including stock market conditions. The Public Offering will only be made pursuant to an Underwriting Agreement, the terms of which are subject to negotiation among the Company and the Underwriters. The undersigned agrees and consents to the entry of stop transfer instructions with the Company's transfer agent and registrar against the transfer of shares of Common Stock or securities convertible into or exchangeable or exercisable for Common Stock held by the undersigned except in compliance with the foregoing restrictions.

This Agreement is irrevocable and shall be binding on the undersigned and the respective successors, heirs, personal representatives and assigns of the undersigned.

This Agreement shall terminate if the Underwriting Agreement (other than provisions that survive termination) shall terminate or be terminated prior to the payment for the delivery of the shares of the Common Stock thereunder or if such agreement is not executed by each party thereto on or prior to _____________, 2000.

Very truly yours,

____

Address:

____

____

____

AUDIT COMMITTEE REFORM

Solution or Panacea?

Charles M. Elson
Professor, Stetson University College of Law
St. Petersburg, Florida

SECTION O

AUDIT COMMITTEE REFORM
— Solution or Panacea? —

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How to Really Make Audit Committees More Effective

*By John F. Olson**

INTRODUCTION

On February 8, 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, chaired by Ira Millstein and John Whitehead (Millstein/Whitehead Committee) issued its report and recommendations (*Millstein/Whitehead Report*).[1] This effort is one of many chapters in a story that began more than twenty years ago with the enactment of the Foreign Corrupt Practices Act of 1977 (FCPA).[2] The FCPA requires that accurate financial books and records be kept, and that internal controls be reasonably designed to prevent and detect fraud and assure preservation of assets and adherence to corporate policies.[3] The adoption of the Federal Sentencing Guidelines in 1987 added impetus to the requirement of strong internal controls.[4] Also in 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) completed a comprehensive study of financial fraud and prescribed remedies, including specific recommendations as to the role of corporate audit committees.[5] In 1991 federal banking legislation mandated that audit committees for financial institutions with assets in excess of $150 million be composed entirely of independent directors.[6] In 1992 The American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* proposed guidelines for audit committee responsibility.[7] Following up on the work of the Treadway Commission, in 1992 the Committee of Sponsoring Organizations of the Treadway Commission published a four-part manual on effective internal controls which described a key role for audit committees.[8] In 1995 the Public Oversight Board, an autonomous group affiliated with the American Institute of Certified Public Accountants, published guidance with respect to the shared responsibilities of managers, directors (particularly audit committees), and auditors for accurate financial reporting.[9]

In short, the Millstein/Whitehead Committee was not writing on a blank slate. In fact, its report offers little that has not been said before, but it does serve as a useful summary and synthesis of the lore about the role and responsibilities of audit committees that has developed over the past two decades. The *Millstein/Whitehead Report* is not the last chapter. Already underway, under sponsorship of the Center for Board Leadership and the National Association of Corporate Directors (NACD), is a comprehensive study by a different Blue Ribbon Commission chaired by former U.S. Securities and Exchange Commission (SEC) Commissioner A. A. Sommer, Jr.[10] This study will emphasize audit committee "best practices" and provide further practical guidance for conscientious boards of directors.

The *Millstein/Whitehead Report* has been reprinted (without appendices) as part of this Symposium.[11] The major securities markets that sponsored the report, and the SEC, whose staff, led by Chairman Levitt, inspired and actively participated in the deliberations of the Millstein/Whitehead Committee, will presumably move forward over the next year or so with at least some of the recommendations for enhanced market-listing standards on audit committee qualifications and independence and on further disclosures to shareholders about the work of audit committees.

Without waiting for such regulatory action, well-informed public company managers and advisers will measure the practices of their own audit committees against the best practices recommendations in the *Millstein/Whitehead Report* and, where appropriate, adjust their practices. Assuming,

*Mr. Olson is a senior partner at Gibson, Dunn & Crutcher in Washington, D.C. and counsels a number of corporate audit committees as part of his practice. Corinne A. Lammers, an associate at Thorp Reed & Armstrong, LLP, assisted in preparation of this article.

1. REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES (1999) [hereinafter MILLSTEIN/WHITEHEAD REPORT], *reprinted (without appendices) in* 54 BUS. LAW. 1067 (1999) [hereinafter *Millstein/Whitehead Report*]. *Editor's note*: Any reference to the *Millstein/Whitehead Report's* appendices will be to the report as originally published by the committee and to the page numbers therein.

2. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended in scattered sections of 15 U.S.C.).

3. *See* 15 U.S.C. § 78m(b)(2) (1994).

4. *See* Sentencing Reform Act of 1984 § 217(a), 28 U.S.C. §§ 991-998 (establishing the duties of the U.S. Sentencing Commission); U.S. SENTENCING GUIDELINES MANUAL (1997).

5. REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING, app. I, at 179-81 (1987).

6. Federal Deposit Insurance Corporation Improvement Act of 1991 § 112, 12 U.S.C. § 1831m(g)(1)(A), (j)(1) (1994 & Supp. III 1997).

7. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.05 (Proposed Final Draft 1992).

8. COMMITTEE OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL—INTEGRATED FRAMEWORK (1992).

9. PUBLIC OVERSIGHT BD., DIRECTORS, MANAGEMENT, AND AUDITORS—ALLIES IN PROTECTING SHAREHOLDER INTERESTS (1995).

10. The author is a member of the Blue Ribbon Commission on Audit Committees which is conducting the Center for Board Leadership/NACD study. A report by this commission is expected to be issued by mid-summer 1999.

11. *See supra* note 1.

however, that this happens, the hard question remains as to whether implementation of the *Millstein/Whitehead Report*'s recommendations will in fact make a difference in improving the quality of financial reporting and preventing fraud.

LIMITATIONS OF THE MILLSTEIN/WHITEHEAD APPROACH

To approach an answer to this critical question, it is helpful to first note some limitations inherent in the Millstein/Whitehead approach.

The first problem arises from the wide range of public companies covered and the supposed impracticability of recruiting and operating a full-dress audit committee for many smaller companies that, under historic market-listing requirements, may have as few as two "independent" directors, who may or may not have financial or accounting experience.[12] The Millstein/Whitehead Committee has addressed this problem by recommending a two-tier structure with less stringent audit committee listing requirements for companies with less than $200 million in market capitalization.[13] The problem, of course, is that these often aggressive-growth, entrepreneurally managed businesses may be precisely the group most likely to push the edge of the envelope on financial reporting practices. Such companies often have minimal internal audit staff. For these companies and their shareholders, the Millstein/Whitehead Committee offers scant guidance as to what additional internal controls or external audit steps might be substituted for, or adequately supplement the work of, a less developed internal audit function and a potentially smaller, less experienced audit committee.

HOW WILL THE MARKETS ENFORCE THE NEW RULES?

Second, an inherent limitation in the Millstein/Whitehead approach is its reliance on market-listing standards as a primary enforcement mechanism for enhanced audit committee standards.[14] While the securities markets can certainly mandate that newly listed companies maintain audit committees and that those committees' members meet certain independence and experience requirements, the markets have little practical ability to monitor or enforce such standards once a company is listed. Court decisions have generally agreed that the listing agreement is a private contract between the listed company and the securities market, and have not recognized that shareholders or others have the right to enforce the agreement's provisions.[15]

The securities markets themselves have neither the personnel in place nor the enforcement tools to ensure compliance. None of the major markets currently monitor compliance with their corporate governance standards on a systematic basis; monitoring is focused on compliance with financial condition requirements, which can relatively easily be measured by review of 1934 Act reports filed with the SEC. Even if each market were to set up operations to review compliance with governance standards, the market's only remedy is to threaten delisting of the offending company's securities from the market. This "atomic bomb" sanction is unattractive to the markets that exist to promote, not discourage, the liquidity of public company securities and that survive on the fees derived from listing and trading. It has the perverse impact of punishing a company's public shareholders by depriving them of market liquidity, instead of focusing on the managers who might be responsible for governance lapses. Understandably, delisting occurs only in extraordinary cases and after significant advance notice and multiple opportunities for review and approval within the self-regulatory structure of the markets. Given the severity of the delisting sanction and its impact on innocent public shareholders, this process is entirely appropriate. It does, however, mean that using listing standards alone to prescribe governance norms is a blunt, imperfect, and uncertain weapon.

The author knows of at least half a dozen instances in recent years where companies listed on the major markets did not meet even today's more limited governance requirements and where, despite continued violations, the market in question took no action. Such instances included

12. *See, e.g.*, Am. Stock Ex. Guide (CCH) ¶ 10,021 (requiring that listed companies have at least two independent directors and that an audit committee be established, a majority of the members of which must be independent); Nat'l Ass'n of Sec. Dealers Manual (CCH) Rule 4460(c)-(d) (requiring that listed companies maintain a minimum of two independent directors on the board of directors and that an audit committee be maintained, a majority of the members of which must be independent directors); N.Y.S.E. Listed Company Manual § 303.00 (requiring that listed companies have at least a two-member audit committee composed solely of independent directors).

13. *Millstein/Whitehead Report*, *supra* note 1, at 1081, 1082 (Recommendations 2 and 3).

14. *See generally id.* at 1070-76 (containing recommendations for increasing the independence and effectiveness of the audit committee).

15. *See, e.g.*, State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 851-53 (2d Cir. 1981) (holding that the plaintiff did not have an implied right of action for violation of stock exchange listing agreement and company manual based on corporation's failure to notify exchange of construction contract); Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R., 509 F. Supp. 1002, 1015-17 (W.D. Pa. 1981) (holding that a listing agreement between a corporation and a stock exchange did not create third-party-beneficiary rights in investors), *aff'd in part, rev'd in part on other grounds*, 680 F.2d 933 (3d Cir. 1982). *Cf.* Sparta Surgical Corp. v. National Ass'n of Sec. Dealers, 159 F.3d 1209, 1213 (9th Cir. 1998) ("It is undisputed . . . that a party has no private right of action against an exchange for violating its own rules . . . .") (citation omitted); Spicer v. Chicago Bd. of Options Exch., Inc., 977 F.2d 255, 259-61 (7th Cir. 1992) (reenforcing the notion that § 6(b) of the Securities Exchange Act of 1934 (1934 Act) permits registration of a national securities exchange only if the exchange meets certain conditions and does not grant investors a private right of action against the exchange or exchange members for violating its own rules).

instances of listed companies that had only a single independent director for years even though all major markets require at least two; issuers whose chief executive officer was listed as a member of, and regularly attended and participated in, audit committee meetings; and companies that had never formally designated an audit committee or where the designated committee did not meet at any time during the year. Is it realistic to believe, as the Millstein/Whitehead Committee implicitly posits, that the New York Stock Exchange (with nearly 3000 listed companies) and the recently partnered NASDAQ Stock Market/American Stock Exchange (with even more listed companies) will be able to meaningfully monitor and enforce new, more elaborate audit committee standards that include much more specific independence and "financial literacy" qualifications for committee members and that require adoption and annual review of a detailed committee charter?

A PRACTICAL SOLUTION

It may be that the only practical solution—one that the *Millstein/Whitehead Report* commendably supports—will be for the SEC to adopt new disclosure requirements mandating that public issuers specifically represent in the annual proxy statement whether and how they comply with the enhanced exchange and NASDAQ listing standards.[16] If the SEC takes such action, concerned shareholders will at least be able to readily obtain the relevant information and, through the proxy process and informal pressure, move companies toward compliance.

Thus, when it comes to remedies, the Millstein/Whitehead Committee has implicitly recognized that listing standards alone cannot do the job without adding companion SEC disclosure requirements. Once disclosure occurs, shareholders can turn to the proxy process or, in egregious cases, to the courts for relief from boards that fail to adhere to the new governance norms. In its recent decisions administering Rule 14a-8, which governs shareholder access to management's proxy statement,[17] the SEC has taken a permissive view of mandatory bylaw amendments proposed by shareholders who wish to force governance changes.[18] Further, with the eloquent opinion of former Chancellor Allen in *Caremark* as precedent,[19] the Delaware Court of Chancery has recognized that the board of directors' duty of oversight includes the responsibility to see that the corporation has a reasonable system of internal controls in place.[20] The standards proposed by the Millstein/Whitehead Committee, particularly if they are endorsed by being made part of the listing standards of the major markets, may well become key elements in litigation that challenges directors on the point of whether the corporate audit committee has functioned adequately as part of the company's system of internal controls.

AUDIT COMMITTEE OVERLOAD

Another potential problem with the Millstein/Whitehead recommendations, as well as with other recent literature emphasizing the importance of a strong audit committee, is the risk of overloading committee members with too many responsibilities. This can have three adverse impacts: (i) committee effort and energy may be dissipated in so many directions that the committee becomes ever more busy but ever less effective; (ii) good directors may decline to take on the burden of audit committee service; and (iii) based on some unfortunate case law developments,[21] those who do serve may face increased risk of personal liability or at least a greater chance than other directors of being named as defendants in shareholder lawsuits.

Several recent examples of audit committee charters identify more than twenty separate "duties" frequently assigned to audit committees.[22] These duties include private meetings with both the external and internal auditors and a review of: (i) financial statements and accompanying notes; (ii) the 10-K Annual Report filed with the SEC; (iii) quarterly and other private reports filed with the SEC; (iv) financial press releases; (v) the external audit plan; (vi) the internal audit plan; (vii) staffing and quality of internal audit; (viii) audit fees; (ix) non-audit (consulting and other) work and fees of the external auditors; (x) codes of conduct; (xi) the system of internal controls; (xii) compliance with codes of conduct and internal controls; (xiii) litigation exposure; (xiv) risk identification and risk management; (xv) performance of the chief financial officer, chief accounting officer, and head of internal audit; (xvi) the annual "management letter" (with the outside auditors); (xvii) expense reports of senior management; (xviii) management "conflict of interest" transactions with the corporation; and (xix) alleged fraudulent actions or violations of law reported by internal compliance programs or, under the terms of the Private Securities Litigation Reform Act of 1995 (PSLRA),[23] by the outside auditor.[24] Of course, the audit committee is generally charged with selecting, or at least

16. *Cf. Millstein/Whitehead Report, supra* note 1, at 1083, 1087-88 (Recommendations 5 and 9).

17. 17 C.F.R. § 240.14a-8 (1998).

18. *See, e.g.,* General DataComm Indus., Inc., SEC No-Action Letter, 1998 WL 883796 (Dec. 9, 1998).

19. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

20. *See id.* at 970 ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists . . . .").

21. *See infra* note 35 (citing cases).

22. *See* MILLSTEIN/WHITEHEAD REPORT, *supra* note 1, app. C (presenting five sample audit committee charters).

23. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

24. *See* 15 U.S.C. § 78j-1 (Supp. III 1997) (setting forth the PSLRA's audit requirements). *See generally* Jonathan C. Dickey, *The New Auditor Responsibilities Under the Private Securities Litigation Reform Act*, CORP. GOVERNANCE ADVISOR, May-June 1996, at 4; Harvey L. Pitt et al., *More than "Classical GAAS": Audits and Corporate Illegality Under the Litigation Reform Act*, *in* 28TH ANN.

recommending, the external auditors, periodically reviewing their performance, approving their fees and, where the committee deems appropriate, recommending a change in auditors. To this list, the Millstein/Whitehead Committee would add still more work for the audit committee, including (i) adoption and *annual* review of a committee charter;[25] (ii) review of reports to government agencies other than the SEC;[26] (iii) review of the "quality" of accounting principles and judgments;[27] (iv) review of securities trading policies;[28] and (v) conducting various investigations.[29]

Such charters and charges of responsibility are daunting, particularly when a company is trying to recruit the type of strong, experienced outside director who can best meet these challenging duties. Women and men with relevant experience and ability, even if retired from active management of a business or professional organization, are likely to be busy people much in demand. Unless we want to create a mandarin class of "professional directors" beholden to corporate managers for their board sinecures, audit committee membership must not be made so burdensome that only the otherwise idle or ill-advised will accept.

LIABILITY CONCERNS

As did the SEC when it mandated compliance committee reports on executive compensation in 1992,[30] the Millstein/Whitehead Committee proposes that a partial safe harbor be adopted by the SEC as part of the proposal that each audit committee provide a formal report letter to shareholders in each corporate annual report.[31] In his introductory essay on the report, co-chair Millstein asserts that the committee "contemplates" a far broader safe harbor than the report specifically recommends,[32] but, based on the example of the compensation report safe harbor and the author's conversations with SEC staff members, it seems more likely that the safe harbor, if adopted, will protect only against federal securities law claims based on the report itself, not on claimed breaches of state law duties of care of audit committee members or federal class action claims generally. While even a limited safe harbor is helpful, it is only a small step in alleviating the liability concerns of audit committee members faced with increased monitoring and reporting duties. Corporate indemnification provisions and statutory protections against monetary liability for breaches of directors' duties of care give additional comfort.[33]

None of these defenses, however, offers effective protection against the embarrassment, potential damage to reputation, and just plain distraction and harassment that come when directors are sued and forced to defend themselves. The more duties well-meaning authoritative groups, such as the Millstein/Whitehead Committee, propose for audit committees, the more likely plaintiffs' lawyers are to name committee members as defendants, and the more likely courts are to refuse dismissal of such allegations. Courts have held inside directors—such as executive officers and lawyers for the corporation—to higher standards than other directors in meeting their duty of care.[34] Unfortunately, a number of courts have carried this perfectly valid principle over to outside directors who serve on the audit committee, arguing that such directors have access to "inside" knowledge of financial information and have agreed to assume the specialized role of financial "experts," or "supervisors" of the audit and reporting function on behalf of the rest of the directors and shareholders.[35]

INST. ON SEC. REG., at 269 (PLI Corp. Law & Practice Course Handbook Series No. B4-7141, 1996); Harvey L. Pitt & David B. Hardison, *New Reporting Obligations for Outside Auditors*, NAT'L L.J., Mar. 25, 1996, at B4.

25. *Millstein/Whitehead Report*, *supra* note 1, at 1083 (Recommendation 5).

26. MILLSTEIN/WHITEHEAD REPORT, *supra* note 1, app. C at 68. Although the committee did not "formally endorse" the sample audit committee charters set forth in Appendix C to the report, the sample charters were "advance[d] . . . as illustrations of charters that have been developed as models or employed in actual practice." *Id.*, app. C. at 55.

27. *Millstein/Whitehead Report*, *supra* note 1, at 1086 (Recommendation 8).

28. MILLSTEIN/WHITEHEAD REPORT, *supra* note 1, app. C at 69; *see supra* note 26 (discussing impact of sample charters).

29. MILLSTEIN/WHITEHEAD REPORT, *supra* note 1, app. C at 61, 66; *see supra* note 26 (discussing impact of sample charters).

30. Executive Compensation Disclosure, 57 Fed. Reg. 48,126, 48,138-39 (1992) (codified in part in 17 C.F.R. pts. 228, 229), *amended by* Executive Compensation Disclosure, 57 Fed. Reg. 53,985 (1992).

31. *Millstein/Whitehead Report*, *supra* note 1, at 1087-88 (Recommendation 9).

32. Ira M. Millstein, *Introduction to the* Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 BUS. LAW. 1057, 1065 (1999).

33. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145 (Supp. 1998).

34. *See, e.g.*, Blakely v. Lisac, 357 F. Supp. 255, 263-67 (D. Or. 1972) (requiring a standard of care of defendants in accordance with their degree of involvement as the company's officers, directors, underwriters, and financial and technical advisors); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 578 (E.D.N.Y. 1971) (holding inside directors, accountants, and underwriters to a higher duty of reasonable investigation than that of outside directors); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968) (rejecting the defendant-underwriters' argument that the standard of diligence for the reasonably prudent underwriter should be solely that of a reasonably prudent director).

35. *See, e.g.*, AUSA Life Ins. Co. v. Dwyer (*In re* JWP Inc. Sec. Litig.), 928 F. Supp. 1239, 1259-61 (S.D.N.Y. 1996) (denying summary judgment to a defendant audit committee accused of being "willfully blind" in its supervision of a fraudulent independent auditor); *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 980 (E.D.N.Y. 1995) (denying the dismissal motion of defendant audit committee members who "were charged with overseeing the conduct of MTC's accountants"), *vacated in part*, 993 F. Supp. 160 (E.D.N.Y. 1997); Tischler v. Baltimore Bancorp., 801 F. Supp. 1493, 1501-02 (D. Md. 1992) (finding possible validity in a negligence claim against outside directors by virtue of their "special knowledge" of the banking industry and real estate market); Greenfield v. Professional Care, Inc., 677 F. Supp. 110, 114-15 (E.D.N.Y. 1987) (denying dismissal motions of defendants assigned to monitor auditing and other company functions); Dubowski v. Ash (*In re* AM Int'l Inc. Sec. Litig.), 606 F. Supp. 600, 605 (S.D.N.Y. 1985) (finding a sufficient complaint against defendant audit committee members who were responsible for reviewing an independent auditor but who were not officers). *See also* Syracuse Television, Inc. v. Channel 9, Syracuse Inc., 273 N.Y.S.2d 16, 27 (Sup. Ct. 1966) (reasoning that the scope of directors' duties to the corporation is dependent upon their management roles).

While claiming to not endorse a higher duty of care for audit committee members,[36] the Millstein/Whitehead Committee makes no practical suggestion to address audit committee members' understandable fear of increased litigation risk. Rather, by lengthening the list of duties and processes that audit committees are urged to assume, the report may provide added fodder for differential liability standards for audit committee directors. In fact, if adopted, the *Millstein/Whitehead Report*'s recommendation that the SEC impose an annual certification-type report requirement on audit committees[37] will increase liability exposure for committee members. This is because the certification requirement will provide a reasonable basis for specific allegations of audit committee responsibility for financial reporting failures.[38]

INSURANCE IMPLICATIONS

Another disturbing recent trend has been the tendency of some insurance carriers to deny or take reservations to coverage when directors are sued for corporate financial fraud. Such denials and reservations are based on the theory that if the "fraud" in financial statements preceded an application for initial or renewal coverage, the application was itself infected by fraud, so the coverage is voided. Some carriers have taken the position that any restatement of financial results for periods reported on prior to the initial or renewal coverage period is prima facie proof of fraud in the inducement for the insurance contract. While such a position may make some sense when applied to corporate managers who are actual participants in fraudulent financial reporting decisions, its extension to audit committee members and other outside directors will present a real deterrent to board service.

In short, while the *Millstein/Whitehead Report* serves as a useful recapitulation of other literature and offers some helpful "best practices" suggestions by focusing heavily on listing standards, qualifications, and enumeration of additional duties and reporting requirements, it will increase the burdens of audit committee membership and raise liability concerns, thus possibly discouraging good directors from accepting audit committee service. Unfortunately, while the report devotes some thirty-six pages to introductory material and to its regulatory recommendations, only a short eight-page section discusses the best practices that truly effective audit

36. *Millstein/Whitehead Report*, *supra* note 1, at 1082-83.

37. *Id.* at 1087-88 (Recommendation 9).

38. Securities fraud claims must specify each statement alleged to have been misleading, the reasons why the statement was misleading, and, if the allegation is made on information and belief, must state with particularity all facts upon which that belief is based and which give rise to an inference that the defendant acted with the required state of mind. *See* 15 U.S.C. § 78u-4(b)(1)-(2) (Supp. III 1997).

committees follow. This is a missed opportunity that hopefully will be addressed by the Center for Board Leadership/NACD project.[39]

TEN RULES FOR REALLY EFFECTIVE AUDIT COMMITTEES

If the *Millstein/Whitehead Report* focuses too much on formal requirements, what are the conclusions and recommendations for "best practices" it might have made that do truly make a difference in committee effectiveness? The following suggests ten rules of the road for effective audit committee work. Note that *none* of these practical rules focuses on committee member credentials, adds to the catalog of formal committees tasks, or requires the preparation of formal certifications or reports.

1. RECOGNIZE PRACTICAL LIMITATIONS

Directors are not and should not try to be full-time corporate managers. Except in times of crisis, they should provide oversight and counsel to the managers of the corporation but they are not responsible for the day-to-day work of management or for setting the company's strategic course. Audit committee members, in ordinary times, meet three or four times a year for a few hours. Even if they meet more frequently, as a practical matter they can have only a general overview of financial statements and accounting issues. Effective audit committees recognize that they cannot micro-manage the enterprise and focus on what they can do well as overseers of financial integrity and risk management.

2. AUDIT COMMITTEES ARE NOT AUDITORS OR LAWYERS

While it may well be desirable that at least some audit committee members have financial management or accounting backgrounds, not all boards have or can recruit outside directors with such qualifications. As a practical matter, while one can expect all audit committee members to have, or take the time to learn, a basic knowledge of the essential principles of financial reporting—to be able to "read" financial statements, including the footnotes, with understanding—the audit committee will have neither the time nor the technical expertise to second-guess book entry decisions and selection of applicable or "appropriate" accounting principles, or to determine the "quality" of financial reporting decisions.

Effective audit committees understand that they are not and cannot be auditors. They focus on being comfortable with the integrity and skill of the auditors, internal and external, who report to them. While they should exercise constructive skepticism as they meet privately to question outside auditors about the quality of management's financial reporting and to

39. *See supra* note 10 and accompanying text.

question both external and internal auditors about the quality of controls, they must rely for the most part on the financial reporting judgments of the full-time managers and professionals. If the audit committee attempts to master the obscurities of generally accepted accounting principles, or the detailed line item requirements of periodic reports filed with the SEC, there is a real danger that it will not take enough time to focus on the big picture issues it is uniquely qualified to address.

As an example, several years ago, when derivative exposures became a concern, new SEC disclosure requirements were imposed.[40] Some audit committees spent hours in briefings on the new disclosure requirements and in reviewing the descriptions of derivative exposures in SEC filings. As one long experienced financial manager, who is also an effective audit committee member, observed to the author, "Our time would be better spent talking with management about what derivative positions they take, why they take them, and how they monitor them than by sitting through briefings by lawyers and accountants on all these disclosure requirements." In the case cited, that is exactly what that audit committee did, with the result that the company's managers made several changes in the way they monitor derivative exposures.

The greatest danger of recommendations, such as those in the *Millstein/Whitehead Report*, and in the SEC's recent "aircraft carrier" proposals[41] for more certifications and "read, review and sign" requirements,[42] is that audit committees will be pushed toward an unhelpful focus on disclosure and accounting details, spending more time being briefed and reassured by lawyers and auditors, and too little time in meaningful financial oversight discussions with corporate management.

3. *EFFECTIVE AUDIT COMMITTEES FOCUS ON THE BIG ISSUES*

The corollary of not getting miscast as technical disclosure or accounting experts is that good audit committees should do something that technical experts may not do. The audit committee should focus on identifying and reviewing with senior corporate management the key areas of business and financial risk to which the enterprise is exposed. The process of helping management identify, manage, and control such risks is the most important job for any audit committee. To that end, effective audit committees will often devote a substantial portion of each meeting to a briefing and dialogue with the corporate managers of a particular function (such as the treasury function) or a particular operating group, in order to understand the risks presented by, and the risk management techniques employed in, that function or business.

For this critical task, the best qualified audit committee members will often be those who have practical management experience, and industry knowledge, as opposed to those with a financial or accounting background.

4. *EFFECTIVE AUDIT COMMITTEES AVOID AUDIT OVERLOAD*

The best audit committees do not take on too many responsibilities. In order to be effective overseers of the financial function and focus on "big picture" risk issues, good audit committees do not become buried in reams of reports and detailed review of disclosure documents. They focus instead on the quality of systems and people who are responsible for financial management and reporting.

5. *AUDIT COMMITTEES SHOULD LOOK FORWARD, NOT BACK*

As is human nature, audit committees too often focus on problems of the past—horses already out of the proverbial barn—rather than the risks of the future. There is, of course, some value in understanding the pathology of past problems. It is also true that SEC disclosure requirements tend to trail the emergence of new problems by at least several years because of the time required for standard setting, and audit committees do need to have a general understanding of such new rules as they are adopted. Too much focus, however, on fact-finding—or fault-finding—for past problems or on the latest SEC disclosure rules can result in audit committee members focusing on critical issues too late in the oversight cycle. A recent example is the Year 2000 computer problem where, like the SEC, many corporate audit committees did not effectively focus on the issue until mid-1998, even though computer experts had identified the issue much earlier. This occurred in part because the issue did not receive much general press attention or comment until 1998 and because the SEC, and audit committees, were still spending a great deal of time focusing on "old" issues such as derivative exposures, which had given rise to surprise losses at several corporations a few years earlier. Today's effective audit committee should be looking beyond the identified issues of the past and the obvious, well-publicized issues of the present and asking itself, as well as the corporation's management and auditors: What are the loss exposures three, four, and five years from now?

40. *See* 17 C.F.R. § 229.305 (1998).

41. Regulation of Securities Offerings, 63 Fed. Reg. 67,174, 67,320-22 (1998) (to be codified at 17 C.F.R. pt. 240) (proposed Dec. 4, 1998).

42. One commentator has even suggested that the certification proposed in Recommendation 9 of the *Millstein/Whitehead Report* may require audit committees to undertake an activity that would be in violation of state laws that require the licensing of any person who certifies as to the reliability of financial information. Letter from B.W. Vick, Vick & Co. L.L.P., to John F. Olson, Gibson, Dunn & Crutcher, LLP (Feb. 15, 1999) (on file with *The Business Lawyer*, University of Maryland School of Law); *see* GA. CODE ANN. §§ 43-3-21, -23, -35 (Supp. 1998).

6. *EFFECTIVE AUDIT COMMITTEES FOCUS ON MANAGEMENT EFFECTIVENESS*

The best audit committees continually evaluate the quality and trustworthiness of senior corporate managers, particularly those responsible for financial accounting, internal controls, and financial reports. Good audit committees regularly meet with the chief executive, chief financial, and chief accounting officers, and the head of internal audit, not just to discuss issues but also to assess the quality and effectiveness of these officers. Where they do not have confidence in a person, they bring to the chief executive or to the full board their view that a change is needed. Note that for this critical function, once again technical accounting or financial knowledge is far less important than experience in judging people and performance.

7. *GOOD AUDIT COMMITTEES STRENGTHEN INTERNAL CONTROLS AND SUPPORT THE INTERNAL AUDIT FUNCTION*

The best audit committees spend more time on the quality of the company's internal controls, including "tone at the top" attitudes of senior management, and less time reading and revising reports and disclosure documents. Effective audit committees act as the "godfathers" for the head of internal audit, assuring themselves through regular private meetings that the internal audit staff is large enough and appropriately trained and that it has respect in the organization. Audit committees should have at least a ratification role in selecting the head of internal audit and in assuring adequate compensation and promotion and advancement opportunities for internal auditors. For example, in at least one very successful major corporation, the audit committee has established the principle that all candidates for the chief financial officer position will, at some time during their careers, have performed effectively as part of the internal audit staff. Thus, the committee has both emphasized the importance of the internal audit function and assured itself that future senior financial officers will have an internal control orientation.

Of course, any conscientious audit committee will also review the internal audit plan each year, to be sure that the scope of audit work and the cycle of review frequency for each operating unit and corporate function is reasonable, but this review is less important than being comfortable with the quality of the people responsible for internal audit. The internal audit and internal controls functions are a particular challenge at smaller public companies without enough dedicated internal audit staff. In such cases, the committee should focus with the chief financial officer and outside auditors on how best to provide effective internal audit functions. For example, it may be that the function can be wholly or partly outsourced to the external auditors or to another audit firm which has appropriate depth of staff and expertise.

In making their decisions it is critical that audit committees bear in mind the important differences between the jobs of external and internal auditors. External auditors review financial statements prepared by management and, based on their review of the overall adequacy of controls and on limited sampling and review techniques, express an opinion on whether the financial statements accord with generally accepted accounting principles. Internal auditors, on the other hand, examine operating and staff units of the corporation to determine whether internal controls are being adhered to, assets properly safeguarded, and management directions followed. Their review is thus more detailed, more focused, and directed to a different end—assuring effective management control.

8. *EFFECTIVE AUDIT COMMITTEES PLAN REALISTIC MEETING SCHEDULES AND AGENDAS*

Audit committees function best when they have careful advance planning of their schedules and agendas. A danger of requiring more director involvement in, and responsibility for, quarterly reports and earnings releases is that audit committees will become bogged down in meetings related to historical financial information and spend too little time on the identification and management of risks and the quality of financial controls and personnel. Meeting schedules and meeting agendas should be planned out in advance by the audit committee chair and corporate financial officers to be certain that these important "big picture" issues are not scanted as the number of formal and procedural duties increases.

9. *EFFECTIVE AUDIT COMMITTEE MEMBERS "LEARN THE COMPANY"*

As with other effective directors, the best audit committee members spend hours learning about the company and its business. They visit facilities, talk with employees, read (publications and analyst reports), and learn about the enterprise's major competitors. In the electronic age, they may even visit "chat rooms" devoted to the company or its industry to see what the "buzz" is about the company. With this base of knowledge, they are able to make better oversight judgments about risk management and financial reporting issues.

One of the best audit committee chairs the author has worked with is a retired retail marketing executive. While she had no formal training in accounting or finance, she has an inquiring mind, excellent judgment honed by years of experience in management and, of great importance, she did her homework and has learned a great deal about the business of the companies on whose boards she sits. She is thus equipped to assess risk and ask insightful questions and to prod management in the right direction.

10. THE BEST AUDIT COMMITTEES ARE CONSTRUCTIVE SKEPTICS

Good audit committee members approach both corporate managers and outside auditors with an attitude of healthy skepticism. They ask managers thought-provoking questions: What keeps you awake at night? What are our competitors doing? What happens if we enter a period of recession? What are your contingency plans if things do not go as you plan? Who is the back up if he/she becomes unavailable? They ask auditors: How comfortable are you with management? Is management pushing you on recording revenues or deferring expenses? How good is our internal audit function? Have you made any recommendations management has not followed?

It is neither necessary nor appropriate in most cases to be hostile or disruptive. Audit committee members can be tactful and generally supportive of management. Committee members must probe and challenge to identify potential areas of concern before they become significant problems. One wonders whether some of the highly visible financial reporting failures of recent months—for example, Cendant, Sunbeam, and Livent[43]—might have been prevented, or at least detected earlier, had audit committee members and other outside directors operated with a more skeptical view and been more willing to challenge managerial reports and assurances.

What is reasonably clear is that the way to get more effective work from audit committees is not to require more reports, impose more formal experience qualifications, or create a greater risk of committee members being named as defendants. The Millstein/Whitehead Committee itself recognizes that "a director's ability to ask and intelligently evaluate the answers to [probing] questions may not require 'expertise' but rather hinges on intelligence, diligence, a probing mind, and a certain basic 'financial literacy.' "[44] To the extent that the *Millstein/Whitehead Report* encourages public company boards to focus on selecting audit committee members with those personal characteristics, and encourages audit committees to use their time efficiently, with significant time devoted to risk identification and management and a constructive, forward-looking dialogue with management and the internal and external auditors, it will have served a valuable purpose. To the extent that it simply adds more lines to the litany of committee duties, and more reporting and liability burdens to the chores of committee membership, it will not have materially advanced the quality of corporate financial oversight.

43. *See generally* Michael Connor, *Regulators Target Bookkeeping Tricks*, WASH. POST, Dec. 25, 1998, at B10.

44. *Millstein/Whitehead Report*, *supra* note 1, at 1081.

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Introduction to the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*

By *Ira M. Millstein**

INTRODUCTION

When the chairman, general counsel, and chief accountant of the U.S. Securities and Exchange Commission (SEC) assert that something is awry in corporate financial reporting,[1] a skeptic could chalk it up to regulatory enthusiasm, or, simply, as a response to media attention and a flurry of recent and publicly reported accounting irregularities. Mindful of potential skepticism, the SEC encouraged the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) to form a private sector body to investigate the problems the SEC perceived. Accordingly, the Committee[2] took an objective look at U.S. corporate finan-

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1. *See* Chairman Arthur Levitt, The "Numbers Game," Remarks at the New York University Center for Law and Business (Sept. 28, 1998) <http://www.sec.gov/news/speeches/spch220.txt>; Chairman Arthur Levitt, A Partnership for the Public Trust, Remarks Before the American Institute of Certified Public Accountants (AICPA) (Dec. 8, 1998) <http://www.sec.gov/news/speeches/spch230.txt>; Chief Accountant Lynn E. Turner, Making Financial Statements Real: Recent Problems in the Accounting for Purchased In-Process Research and Development, Remarks at the the Software and Service Industry Analyst Group (Feb. 10, 1999) <http://www.sec.gov/news/speeches/spch251.htm>; Chief Accountant Lynn E. Turner, Current Projects of the Office of the Chief Accountant, Remarks at the Colorado State Society of Certified Public Accountants 1998 SEC Conference (Dec. 3, 1998) <http://www.sec.gov/news/speeches/spch243.htm>.

2. Ira M. Millstein and John C. Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co., co-chaired the Committee. The Committee was formed in October 1998 by the NYSE and the NASD, and its members

cial reporting, specifically assessing the current mechanisms for oversight and accountability among corporate audit committees, independent auditors, and financial and senior management.

In the course of its analysis the Committee canvassed its members, all of whom are active participants in the private sector. It also reached out to gain perspective from other knowledgeable and interested parties involved in the corporate financial reporting process.[3] Importantly, the Committee turned to seminal prior works and reports on the same topic.[4] Based on this diligence, the Committee independently concluded that the concern is real—improvements in financial reporting are needed.[5] Moreover, progressive change is overdue; calls for reform in this area have been echoed time and again over the last several decades, without sufficient response.[6]

In formulating the *Report*, the Committee took special note of the numerous prior suggestions for improvement in corporate financial reporting, many of which had languished in debate.[7] There was no need to retread ground well covered. Indeed, the *Report* relies on key provisions of prior studies and updates them with the Committee's own thoughts. The priority

were: John H. Biggs, Chairman, President, and CEO of TIAA-CREF; Frank J. Borelli, Senior Vice President and CFO of Marsh & McLennan Companies, Inc.; Charles A. Bowsher, former Comptroller General of the United States; Dennis D. Dammerman, Vice Chairman and Executive Officer of the General Electric Company; Richard A. Grasso, Chairman and CEO of the NYSE; Phillip Laskawy, Chairman and CEO of Ernst & Young LLP; James J. Schiro, CEO of PricewaterhouseCoopers LLP; William C. Steere, Jr., Chairman and CEO of Pfizer Inc.; and Frank G. Zarb, Chairman and CEO of the NASD. Paula Lowitt, an associate with Weil, Gotshal & Manges LLP, was a member of the Committee Staff.

3. Press Release, Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Nov. 4, 1998), *in* REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES app. A at 50 (1999). The press release describes the area of inquiry, requests public comment, and announces a public hearing on Dec. 9, 1998. *Id.*

Editor's note: The appendices to the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (*Report*) were not reprinted in this issue of *The Business Lawyer*. References to the appendices will therefore require a review of the original *Report*. All references to the body of the *Report* will be provided as references to the full text as reprinted herein. *See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1067 (1999) [hereinafter *Millstein/Whitehead Report*].

4. *See Millstein/Whitehead Report*, *supra* note 3, at 1067-68; *see also* NATIONAL ASS'N OF CORP. DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM (1996); REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987) [hereinafter TREADWAY REPORT]; PUBLIC OVERSIGHT BOARD ADVISORY PANEL ON AUDITOR INDEPENDENCE, STRENGTHENING THE PROFESSIONALISM OF THE INDEPENDENT AUDITOR (1994) [hereinafter POB REPORT].

5. *Millstein/Whitehead Report*, *supra* note 3, at 1068.

6. *Cf. id.*

7. *Cf. id.*

was to publish the Committee's conclusions promptly in an effort to precipitate action in short order.

While the Committee welcomes and expects vigorous discussion of the *Report*, the Committee structured the *Report* to advance very specific practical recommendations so that discussion, this time, would not be generalized or philosophic, but would be directed to the particulars. The Committee urges that the affected communities, private sector, and regulators will not allow the necessity for change to be buried by debate.

THE CURRENT PROBLEM

The integrity of our securities markets rides on the integrity of financial reporting by the corporations who have access to those markets. The U.S. securities markets are the most trusted, and hence the deepest and most fluid in the world. The goal of all the participants in and regulators of those markets is to keep them trusted and to improve their integrity and reliability.

The current concern with financial reporting is primarily fueled by a perceived need for corporations to constantly "make the numbers"—to match or exceed analysts' expectations and projections. That push, plus the fact that financial reporting is not an exact science (e.g., Generally Accepted Accounting Principles (GAAP) leave wide areas of discretion), allows managers to make choices in preparing a company's financial reports. While such reports may not violate GAAP, under certain circumstances they may obscure the true condition of the company. Earnings management crosses the line when it is abused to obscure the reality of the company's situation.

The question of when the line is crossed, i.e., when the financial report ceases to be fairly presented and becomes instead fogged, is not definable with an exact precision in all instances for all companies. Not surprisingly, many expert groups before the Committee, as noted above, have wrestled with this issue: in particular, the Treadway Commission in 1987,[8] and the Public Oversight Board of the AICPA in 1994.[9]

These and other groups developed the notion that the inquiry into the issue of accuracy should focus on "the quality, not just the acceptability" of a company's financial reporting. While the Committee does not define "quality," the term suggests an attempt to make appropriate and candid judgments on the accounting choices that fall within the large grey area of discretion allowed for by GAAP.

The *Report* is designed to advance awareness and implementation of measures to promote this concept of "quality" financial reporting among the audit committee, the outside auditor, and management. The Committee knew this could not be done by prescribing a list of precise accounting rules and strictures—the leeway GAAP affords is necessary and there will always be areas of discretion in financial reporting to which tight proscriptions will not apply. Consequently, the Committee chose to concentrate on process; specifically, the Committee wanted to improve the process by which that discretion is overseen and exercised. The goal was to try to ensure that independence, awareness, diligence, and care were the primary principles governing the unavoidable exercise of discretion.

Focusing on process leads directly to the board of directors. The board has ultimate responsibility for overseeing and monitoring all aspects of the corporation's performance, including its financial reporting.

CORPORATE GOVERNANCE

It is fitting that the *Report* frames the issue of improving corporate financial reporting in the corporate governance context, since the evolution of modern corporate governance that began in the 1970s was rooted in financial reporting issues.

Prior to the 1970s, boards of directors were management-dominated, passive, and generally inert.[10] Such passivity was largely overlooked; boards of directors were not expected to do much more than rubber-stamp management's decisions.[11] With the SEC's investigation of managerial misconduct and misreported earnings at the Penn Central Company (Penn Central), however, the dangers of little to no board oversight became readily apparent to regulators, the corporate community, and the public.[12] The SEC's 1972 official report on Penn Central, the nation's largest railroad company and (then) sixth largest industrial corporation, criticized, as never

8. *See* TREADWAY REPORT, *supra* note 4.

9. *See* POB REPORT, *supra* note 4.

10. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 130-31 (1996) (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933)).

11. Based on a study of boards of directors in the late 1960s, Myles L. Mace aptly described the disconnection between board responsibility and actual board activity: "[B]oards of directors of most large and medium-sized companies *do not* establish objectives, strategies, and policies, however defined," *do not* "ask[ ] discerning questions," and *do not* "select the [CEO]." MYLES L. MACE, DIRECTORS: MYTH & REALITY 185-90 (1971); *see also* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 7-8 (1989) (describing the passive culture of the traditional board, and the practices that have supported that culture). Thus boards were found *not* to perform the classical and generally accepted roles that are attributed to them. Note that only a decade ago, Peter Drucker was quoted as declaring that "[t]he board of directors is an impotent ceremonial and legal fiction." *See* CHARLES A. ANDERSON & ROBERT N. ANTHONY, THE NEW CORPORATE DIRECTORS: INSIGHTS FOR BOARD MEMBERS AND EXECUTIVES 1 (1986).

12. *See* SEC, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY: STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS (1972).

before, the failure of the board of a publicly traded company to provide effective oversight. Specifically, the SEC found that

(i) the outside directors did not have the acumen to deal with financial crisis;[13]
(ii) the outside directors were passive about the information they received from management;[14] and
(iii) board meetings were formalistic, with little discussion and practically no opportunity for outside directors to discuss affairs among themselves.[15]

In issuing its 1972 official report, the SEC emphasized the need for board independence, and placed outside directors in a special position of authority.[16]

Against the backdrop of Penn Central and with growing recognition that "the somnolent Penn Central board of directors was typical of most giant corporations' boards in the postwar period,"[17] the SEC probed further into inappropriate and fraudulent financial reporting, including widespread undisclosed use of slush funds for improper foreign and domestic payments. As a condition to settling enforcement actions against a number of large corporations for undisclosed improper payments, the SEC began to require that boards form special committees composed of a majority of independent directors to monitor compliance in the future.[18] Outside directors were instructed to monitor and oversee management and corporate conduct.[19]

13. *See generally id.* at 152-72.

14. *Id.* at 152-53.

15. *Id.* at 153.

16. *See id.* at 150-52.

17. Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 330 (1987).

18. *Id.* at 334.

19. *See e.g.,* SEC v. Mattel, Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807, at 96,693-95 (D.D.C. Oct. 1, 1974) (ordering corporate governance reforms in addition to permanent injunctions in response to the filing of defective financial statements, including: (i) the appointment of a board of directors comprised of a majority of directors unaffiliated with Mattel, Inc. (Mattel); (ii) the appointment of an executive committee comprised of a majority of the new, unaffiliated directors; and (iii) the appointment by the unaffiliated directors of a special counsel to conduct further investigation into the financial practices of Mattel and to prepare a report to be filed with the court); SEC v. Westgate-California Corp., Litig. Release No. 6142, 1973 SEC LEXIS 2364, at *1-*2 (S.D. Cal. Nov. 9, 1973) (requiring the creation of a seven member board, five of whom were appointed by the court in consultation with the SEC; and the establishment of an executive committee consisting of a majority of outside directors); SEC v. Coastal States Gas Corp., Litig. Release No. 6054, 1973 SEC LEXIS 2544, at *2-*3 (S.D. Tex. Sept. 12, 1973) (ordering the increase in the number of directors from 10 to 13, with six to be independent directors designated by the court, and the establishment of an executive committee of three directors, two of whom were to be appointed from among the six new independent directors).

By the mid-1970s, the SEC had solidified its view that some independent internal board mechanism was needed to ensure accountability of management.[20] In 1977, the SEC approved an NYSE rule requiring all listed domestic companies "to establish . . . and maintain thereafter, an audit committee comprised solely of directors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment as a committee member."[21] Scandal had brought independent director responsibility to the fore, particularly in respect of the audit committee.

The role and importance of the independent director has been further developed since the 1970s by the courts, particularly those of Delaware.[22] Additionally, in the 1990s, an evolution in thinking about board responsibilities led many high-profile U.S. boards to take voluntary action to

20. As a prologue to the era of questionable payments, the SEC continued to pursue actions against companies that it was beginning to investigate at the time the 1972 official report was first published. One of the most notorious cases involved Lockheed Aircraft Corp. (Lockheed). The SEC charged that from 1968 until at least 1975, Lockheed and certain of its officers made secret payments to foreign governmental officials of approximately $25 million to assist in procuring and maintaining contracts with foreign governments. The payments were disguised by false accounting, cash payments, and laundering funds through consultants or corporate entities. *See* SEC v. Lockheed Aircraft Corp., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,509, at 95,569 (D.D.C. Apr. 13, 1976). In addition, Lockheed officials were accused of paying out over $200 million in corporate funds, without adequate financial records, to various consultants, commission agents, and others. In the consent decree, the SEC required that Lockheed form a special committee, satisfactory to the SEC and composed solely of non-management directors or persons unaffiliated with Lockheed, to conduct extensive investigations into the allegations and all possible violative conduct and to prepare a report to be filed with the SEC. *Id.* at 95,570.

21. New York Stock Exchange, Inc., Exchange Act Release No. 13,346, 1977 SEC LEXIS 2252, at *1 (Mar. 9, 1977) (footnote omitted); *see* Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1800-01 (1976) (stating that an early SEC attempt to draft a position paper on outside directors was motivated in part by the SEC's inquiry into the Penn Central bankruptcy).

22. *See* Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (finding that the board was grossly negligent when it approved the sale of the company after just a few hours of deliberation, without seeking expert advice, and without informing itself of the chairman's role in selling the company for a low price); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). A board can defend against a hostile takeover if, after a good-faith reasonable investigation, the board has a reasonable belief that the takeover bid posed a danger to the corporation *and* the defensive tactics are reasonable in relationship to the threat posed. *Id.* at 958. The court emphasized that involvement by a majority of outside disinterested directors is a significant factor in showing good faith. *Id.* at 955; *see also* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990) (crediting a decision made by a well-informed, independent board); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (explaining that as part of its duty of care, the board of directors has an obligation to "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations").

improve their ability to monitor management actively.[23] This movement toward board "self-improvement" has primarily concerned structural modifications to promote director independence and improve the board's ability to objectively assess management and corporate performance.[24]

The movement to progressive corporate governance, which included regulatory, court-driven, and voluntary measures to improve overall board independence and oversight, was initiated by the SEC's early focus on financial reporting and then the audit committee's structure and role. It is totally consistent, therefore, that now good corporate governance practice points to the audit committee as the focal point for improvements in financial reporting.

The steps the *Report* outlines are what some of our best corporations, but not enough of them, are already doing in whole or in part. The Committee's suggestions describe more comprehensive practices which the audit committee by design is expected to perform. For example, today a majority of the board must sign the company's Form 10-K Annual Report (10-K), which includes the corporation's financial statements.[25] The report simply spells out how to make that signature mean what it was always supposed to mean—i.e., not just a rubber stamp, but an assurance of a responsible oversight process by the full board through the audit committee.

The *Report's* ten recommendations are grouped in three general categories to enhance the process through which the audit committee carries out its duties:

(i) strengthening the independence of the audit committee;
(ii) making the operation of the audit committee more effective; and
(iii) improving the mechanisms for discussion and accountability among the audit committee, the outside auditors, and the management.

The Committee believes the recommendations are straightforward and clear.

AREAS OF FOCUS

As stated at the outset, the Committee recognized that the *Report's* recommendations would generate discussion, and hopes that such discussion will be used constructively to devise the most appropriate measures for improvement. In this spirit, it may be helpful to briefly review the two most likely subjects for dialogue arising from the *Report*: (i) how to define "quality"; and (ii) the concern that the *Report* and its recommendations will lead to increased liability for audit committee members.

HOW TO DEFINE "QUALITY"

The *Report* puts the "quality" issue into the spotlight in two ways. First, it recommends that Generally Accepted Auditing Standards (GAAS) be modified to "require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting."[26] This discussion would include the auditor's view of the aggressiveness or conservatism of the accounting principles applied, the underlying estimates, and other significant judgments made by management. Next, as a natural extension of this GAAS requirement, the *Report* suggests that the audit committee disclose whether or not it conducted such discussions on quality with the outside auditor, financial management, and amongst the committee members themselves.[27]

If these two recommendations are to be implemented, the question of how to define "quality" will be unavoidable. The accounting profession will need to wrestle with that term and give it (and related ones, such as "aggressive" and "conservative") parameters if auditors, audit committees, and management are to give their discussions real meaning. The Committee recognized that this is a tall order, but if the goal is to heighten auditors' and audit committees' scrutiny and inquiry into this issue of quality, there must be a baseline definition, or at least some parameters that screen out what is and is not included in the ambit of "quality." Some members of the accounting community and other interested parties are skeptical about the feasibility of defining this term, while others are optimistic. At the very least, a narrowing of the broad area of discretion will suffice as a "definition"—as a start.

IMPACT ON LIABILITY

The argument has been raised that because the audit committee will be making disclosures as to its consideration of the auditing standards applied in the company's reporting as well as compliance with GAAP, audit committee members will be exposed to increased risk of class action and derivative lawsuits, if not increased liability. The Committee views this perception as unfounded. The opposite should be true. If audit committees adhere to the diligence and practices suggested in the *Report*, such behavior

23. These included the boards of American Express Co., General Motors Corp. (GM), International Business Machines Corp., Eastman Kodak Co., Westinghouse Electric Corp., and later, Kmart Corp., W.R. Grace & Co., and Morrison Knudsen Corp., among others.

24. *See, e.g., GM Board of Directors Corporate Governance Guidelines* (visited Feb. 24, 1999) <http://www.gm.com/about/investor/stockholder/guidelines.html>; *see also* California Public Employees' Retirement Sys., *U.S. Corporate Governance Principles* (Apr. 13, 1998) <http://www.calpersgovernance.org/principles/domestic/us/page01.asp>.

25. *See Millstein/Whitehead Report, supra* note 3, at 1087.

26. *See id.* at 1086 (Recommendation 8).

27. *See id.* at 1087-88 (Recommendation 9).

will protect audit committees against allegations of liability under state law. The *Report* also emphasizes the need for the SEC to create an appropriate "safe harbor" to avoid any question under federal law in this regard.[28]

As to common law claims, such as those based on an alleged breach of fiduciary duty and mismanagement, the law does not require directors and audit committees always to have made the "correct" decisions. The law only requires that directors engage in a reasonable, honest, and independently minded decisionmaking process to fulfill their responsibilities.[29] Consequently, an audit committee that follows the *Report*'s recommendations to conduct discussions with the auditors and management and to disclose the audit committee's belief—in reliance on its discussions with management and the auditors—that the company's financials conform with GAAP can only strengthen such committee's record of diligence. This, in turn, can only heighten the committee's protection under the business judgment rule, which after all is fundamentally premised on good faith process. Moreover, one would expect the courts to be particularly cognizant of the need to avoid imposing undue risk or enhanced standards on those who undertake audit committee service and adhere to good process as suggested in the *Report*.

This should suffice as protection for directors under state law, and the Committee has recommended a "safe harbor" under federal law. The Committee contemplates that such a federal safe harbor would apply not only to the audit committee's formal disclosure in the company's 10-K that the *Report* specifically recommends, but also to any actions taken by the directors serving on the audit committee. Specifically, the safe harbor should be designed to protect audit committee members from liability arising out of claims alleging that audit committee members should be held to a higher standard than other directors. This protection must be broad enough to cover any statements made in the 10-K, the "judgments" upon which the company's financial reports are based, and the reliance of the audit committee members on management and the outside auditors which the recommendations expressly contemplate.[30]

Finally, compare this protection for directors with the current mandate which requires, without further definition, a majority of directors to sign the 10-K.[31] Is the current situation, without explicit guidelines as to responsibility and liability, and without explicit justification for reliance on both management and the outside auditors, preferable to the concrete guidance on appropriate practices and the supplemental safe harbor protection proposed by the Committee's recommendations? The Committee thought not.

CONCLUSION

There is one last point to bear in mind as the discussion ensues over the precise form that the recommendations should take. While the Committee recommends changes to the listing requirements of the NYSE and the NASD, and disclosure requirements under the federal securities laws, the Committee contemplates these changes as only a part of the path to improvement. Enhancing audit committee performance is, and should be, a do-it-yourself kit. Although the Committee has reason to expect expedition, implementation by the regulators will probably take time. Meanwhile, audit committees, if they so desire, can implement every one of these suggestions without further regulation. Self-help has been a large component of the history of improved governance, and the Committee hopes that the *Report* will spur similar action.

28. *See id.* at 1083, 1088 (Recommendations 5 and 9).

29. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985); Smith v. Van Gorkum, 488 A.2d 858, 872 (Del. 1985).

30. *See Millstein/Whitehead Report*, *supra* note 3, at 1087-88 (Recommendation 9).

31. *See id.* at 1087.

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REPORT AND RECOMMENDATIONS

OF THE

BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES

Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

A few Committee members had varying degrees of comfort with a few of the recommendations advanced in this Report. Nevertheless, the Report reflects a fair consensus of Committee members' viewpoints.

Additional copies of this Report can be obtained by contacting Murray Teitelbaum at the New York Stock Exchange at (212) 656-2017, or Andrew MacMillan at the National Association of Securities Dealers at (202) 728-8340. The Report may also be found on-line at www.nyse.com or www.nasd.com.

Letter From the Chairmen

Since the end of September 1998, when you called upon us to chair this Blue Ribbon Committee, we have been honored to work with our fellow Committee members on what we believe to be a truly collaborative effort.

We are pleased to submit to you this Report and Recommendations, but wish to acknowledge that much of our work is based on the outstanding research and best practices documents previously drafted and disseminated by others. In particular, the Committee wishes to commend and thank those responsible for the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission (1987)) and Strengthening the Professionalization of the Independent Auditor, Report to the Public Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants (AICPA) from the Advisory Panel on Auditor Independence (1994) ("1994 POB Report") -- both resources the Committee used liberally.

This Report, however, is not intended to cover the breadth of financial reporting issues addressed by these and other prior reports. Nor does this Report focus on fraud per se, although many of our recommendations may reduce the possibility of fraud. The Committee's focus is on the large grey area where discretion and subjective judgments bear on the quality of financial reporting. It is not possible to lay down hard and fast rules where discretion is required. Accordingly, we emphasize the need for financial management to make sound financial judgments and the process by which the outside auditors and the audit committee evaluate those judgments.

Our Report is geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees, senior and financial management, the internal auditor, and the outside auditors regarding financial reporting and the oversight process. Underpinning our work is the recognition that quality financial accounting and reporting can only result from effective interrelationships among these relevant corporate participants.

Throughout our deliberations we have strived to produce recommendations that promote quality financial reporting, recognizing the benefits that inure from this practice: market confidence, a more efficient allocation of capital, and the resulting lower cost of capital. The strength of America's capital markets always has been their adherence to transparency and full disclosure.

Because so many groups within the corporate community are vested in some aspect of board oversight and the financial reporting process, you have assembled in this Committee representatives from the whole spectrum of the interested parties. In this spirit, the Committee gathered input from a wide range of constituencies through a public hearing and open request for formal written comments on the topic.

Overview and Recommendations

Recommendations for the performance of audit committees must be founded in the practices and attitudes of the entire board of directors. We, therefore, at the outset, urge boards of directors to understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation. Board membership is no longer just a reward for "making it" in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention.

The measure of the board, then, is not simply whether it fulfills its "legal" requirements but, more importantly, the board's attitude and how it puts into practice its awareness and understanding of its responsibilities. Is the board simply going through the motions, or has it demonstrated awareness of its important role by having some form of independent leadership that can act without relying only on management's initiative? Has the board established guidelines or operational procedures for its own functioning? Do the independent directors meet alone periodically to evaluate management and company performance and strategy? Does the board engage in individual director and full board evaluation? From self-generated measures such as these, one can infer that the board is aware, independent, professional and well-governing, or at least is endeavoring to be distinct from management. In essence, these signs show that a board is moving from being passive to active.

If a board is functioning properly, the audit committee can build on and relate to these very same board-wide principles. If the board is dysfunctional, the audit committee likely will not be much better. We cannot, however, suggest a single appropriate template for oversight by all audit committees. Just as "one size doesn't fit all" when it comes to board governance, "one size can't fit all" audit committees. Within broad parameters, each audit committee should evolve and develop its own guidelines suited to itself and its corporation.

A starting point for the development of audit committee guidelines is a recognition of the audit committee's position in the larger governance process as it relates to the oversight of financial reporting. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee's job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors. A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting -- the full board including the audit committee, financial management including the internal auditors, and the outside auditors -- form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight. However, in the view of the Committee, the audit committee must be "first among equals" in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process.

Turning from awareness and execution of responsibilities to another modern element of governance, we note that disclosure and transparency have become the first hallmark of good governance looked to by investors. The lack of disclosure and transparency no doubt contributed to the recent flight of capital from Asia. If a corporation is to be a viable attraction for capital, its board must ensure disclosure and transparency concerning the company's true financial performance as well as its governance practices. Accounting games may be short-term fixes, but they are not long-term bases for financial credibility.

Our recommendations, therefore, build on these two essentials: first, an audit committee with actual practices and overall performance that reflect the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulatory framework that emphasizes disclosure and transparency and accountability.

The Committee wishes to stress that while the recommendations in this Report appear separately, they together form a mosaic to enhance financial reporting and oversight of that process; in this light, the Committee views the recommendations as an integrated set of objectives that must be adopted in its entirety in order to accomplish the intended results. The need for such an integrated approach is of even greater importance given the fact that implementation will require action by a number of entities including the Securities and Exchange Commission (SEC), the securities markets through the self-regulatory organizations (SROs), the accounting profession, and, of course, boards and audit committees.

Notably, while several of the recommendations that apply to public companies contemplate an exemption for smaller entities due to the burdens involved, the Committee urges all companies regardless of size to make a good faith attempt to follow these recommendations. Similarly, while a number of the recommendations propose amendments to the listing standards applied by the NYSE and the NASD, the Committee hopes that these proposed amendments to listing standards be considered by any market that is a primary venue for U.S. equities.

It is with these perspectives the Committee advances the recommendations outlined in summary form below. The section of this Report, entitled "The Audit Committee as Catalyst for Effective Financial Reporting," more fully describes the rationale and intentions underlying each of these recommendations.

Summary

The first two recommendations are aimed at strengthening the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant* to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of

* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Our second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

The Case for Timely and Practical Action

The corporate governance debate has changed dramatically over the last three decades, moving from fundamental arguments over its relevance, to a practical discussion (which assumes relevance) of how to transform the concept from a good idea on paper to a reality in practice. One of the issues that has taken on increasing importance in the search for good governance is how best to harness the oversight process to achieve more fully the goal of quality corporate financial reporting. This important search leads immediately to the audit committee of the board of directors -- the entity at the core of the corporate financial reporting process.

In recent years, there has been an increasing sense of urgency surrounding the need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market. At the same time, the demands on the flexibility of our financial reporting have become increasingly intense -- with the growing sophistication of complex financial instruments to manage risks, the use of corporate restructurings to stay abreast of the latest business trends, and the emergence of new industries based on technology and information. The recent turmoil in foreign markets has further compounded pressures on financial reporting.

Navigating these uncharted waters requires great skill, and sometimes the temptation not to disappoint proves too great. The Chairman of the SEC, Arthur Levitt, at a recent address at New York University on the present state of financial reporting, expressed his "fear [that] we are witnessing a gradual, but noticeable erosion in the quality of financial reporting," and the emergence of a "grey area . . . where accounting practices are perverted; where managers cut corners; where earnings reports reflect the desires of management rather than underlying financial performance of the company."

There is little question, in the Committee's view, that some companies do respond to analysts and short-term market pressures by "managing" their earnings. While earnings management is not necessarily inappropriate, it can become abusive when it obscures the true financial performance of the company.

In that same address, SEC Chairman Levitt also referred to a number of highly publicized reports of companies practicing inappropriate earnings management in order to meet analysts' forecasts and to deliberately smooth earnings. Some of the specific practices referred to include:

- deliberately overstating one-time "big bath" restructuring charges in order to provide a cushion to satisfy future Wall Street earnings estimates;
- the misuse of acquisition accounting, particularly improper write-offs of acquired in-process research development, to inappropriately overstate future earnings;
- "cookie jar reserves" where companies over-accrue charges for such items as sales returns, loans losses or warranty costs in good times and use those reserves to smooth future earnings in bad times;
- premature revenue recognition, before a sale is complete, before a product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale;
- improper deferral of expenses to improve reported results; and
- misuse of the concept of materiality to mask inappropriate accounting treatment.

The Committee believes practices such as those described above can distort a company's true financial condition and results of operations, thus providing a compelling impetus for the Committee's task of improving oversight of the financial reporting system through the audit committee. Such practices, if left unchecked, have the potential to undermine investor confidence in the integrity of our securities markets.

Accordingly, the Committee calls for strengthening the role of the audit committee with pragmatic, progressive recommendations that can be quickly implemented. If these recommendations are implemented, the Committee believes audit committees will be more effective in helping to ensure the transparency and integrity of financial reporting and, thereby, maintain the investor confidence that makes our securities markets the deepest and most liquid in the world.

We leave it to other qualified bodies to debate and study thoroughly the proper technical accounting measures and the myriad other relevant issues that arise in this domain. In addition, the audit committee, if properly functioning and advised, can deal with the technical issues as they arise in a manner tailored to the individual company. Here, we focus on the broad oversight process, because even the finest set of rules will be no better than the oversight process designed to oversee them.

Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.

The Audit Committee as Catalyst for Effective Financial Reporting

Good governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance. It holds management accountable to the board and the board accountable to shareholders. In this paradigm, the board is in place to ensure that management is working in the best interests of the corporation and its shareholders -- by working to enhance corporate economic value. The audit committee's role flows directly from the board oversight function.

A key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.

This oversight function is typically delegated by the full board to the audit committee, pursuant to the board's general ability under state law to delegate certain of its duties to committees. While the listing standards of the primary U.S. securities exchanges mandate that companies have an audit committee, these listing standards do not stipulate with much specificity how an audit committee should be comprised and, moreover, how it should function. Similarly, neither state corporate law nor federal securities law lend much guidance on audit committee structure or role.

A significant body of literature concerning corporate governance has evolved over the past two decades guiding boards in their composition, structure, and responsibilities, as referenced in the Bibliography to this Report. The Committee believes that the same progressive governance standards applicable to the full board should be used to decide how the audit committee should carry out its job, and who should serve on the audit committee.

Audit Committee Membership

Good governance dictates that the board be comprised of individuals with certain personal characteristics, such as a recognition of the importance of the board's tasks, integrity, a sense of accountability, a history of achievement, and the ability to ask tough questions. Directors also should possess certain core competencies -- such as financial literacy, experience with organizations, leadership, and strategic thinking. Directors must have a significant degree of commitment to the company and its board -- such that they have adequate time for meeting preparation, near perfect meeting attendance, and ongoing education as to the company's business and environment and topical issues. As a whole, the board should have individual directors who contribute special expertise relevant to the company, such as manufacturing, marketing, financial, accounting, and international or other appropriate experience. Most importantly, the board overall should consist of a majority of independent directors.

It follows that as a member of the full board each member of the audit committee should possess most of the characteristics and core competencies enumerated above. The Committee views certain of these attributes as particularly important for audit committee membership -- namely, recognition of the significance of the audit committee's responsibilities, time commitment, financial literacy, and, above all, independence.

Independence

The rationale supporting the call for a majority of independent directors on a board of directors -- that independence is critical to ensuring that the board fulfills its objective oversight role and holds management accountable to shareholders -- is especially applicable to the audit committee. In fact, it is widely recognized that each member of the audit committee should be an independent director. Several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud. In addition, common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices.

The NYSE requires listed companies to have at least a two-member audit committee composed of all independent directors. The NYSE Listed Company Manual characterizes independent directors as those who are "free from any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment as a committee member." Section 303.00 specifies that directors who are "affiliates" of the company, or officers or employees of the company or of its subsidiaries, are not considered independent. Former officers of the company and its subsidiaries, however, may qualify for audit committee membership despite continued pension or deferred compensation from the company if "in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee." Former company officers, however, cannot comprise the majority of the committee.

Rule 4460 of the Marketplace Rules of the NASD requires that an issuer maintain an audit committee comprised of a majority of independent directors. Rule 4200(a)(13) defines an "independent" director as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The Committee believes that the current NYSE and NASD standards on independence allow for too much discretion and should be fortified. Certain relationships can impair a director's independent judgment and therefore should automatically disqualify a director from being considered "independent."

The Committee also recognizes, however, that smaller companies may have greater difficulties meeting any enhanced standard regarding independence; companies with smaller market capitalizations -- so-called "small-cap" companies -- may have relationships with large investors that may require greater flexibility as to board and audit committee membership and composition.

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NATIONAL ASSOCIATION — OF — CORPORATE DIRECTORS

Report of the NACD
Blue Ribbon Commission on

AUDIT COMMITTEES

A Practical Guide

O - 26

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EXECUTIVE COMPENSATION

Where Are We Going?

Charles M. Elson
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SECTION P

EXECUTIVE COMPENSATION
—Where Are We Going?—

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- October 1998 -
A Publication of the American Compensation Association

Executive Overcompensation and Board Independence

By Charles M. Elson
Stetson University College of Law

In far too many U.S. corporations, executives are paid much more than their performance seems to justify. The problem of overcompensation will not be solved, however, by the varied solutions currently being circulated, such as strict payment caps, fixed worker/manager salary multiples, taxation changes and even judicial intervention.

There is nothing inherently wrong with a large salary. The problem is overcompensation, not high compensation. Many executives who earn substantial salaries are worth every penny, considering their contribution to corporate profitability. Corporations will, and should, pay high-performing executives good salaries, not only to reward their performance but also to retain their services in a highly competitive labor marketplace. High compensation also can be a valuable incentive for future performance. To somehow limit arbitrarily the compensation that a corporation may offer limits the effectiveness of this important incentive.

Currently debated approaches to curb corporate overcompensation fail to adequately address its root causes. Overcompensation is usually the result of a failure in the bargaining process between a corporate board and management over salary. In many of America's leading corporations, management is supervised by a board still largely dominated by management.

Excessive compensation results when passive boards aligned with management agree to executive salary packages on demand – in the absence of engaged oversight or negotiation. It is not, however, the fact of management appointment that makes a board member passive in this regard – it is a lack of real independence from and, some may argue, dependence on company management. Many board members have the kinds of indirect and sometimes direct financial relationships with management that make active oversight difficult to exercise. Examples:

- Providing professional services to the corporation, either legal or financial.
- Existence of a significant consulting or employment relationship with the company.
- A substantial commercial relationship between the director's organization and the board's company.
- Reciprocal directorships between management and the board member.

Each of these relationships creates financial linkage with management that may interfere with objective oversight. And to compound the problem, when directors receive substantial fees for board service without meaningful, personal equity investment in the enterprise, their incentive to exercise effective compensation oversight is further reduced. So, what is the solution?

The answer to the overcompensation conundrum is simple – board equity and independence. Each director who sits on a company's compensation committee, which traditionally is charged with negotiating executive compensation arrangements, needs to be independent of company management in all respects and needs to be a meaningful equity holder in the enterprise. His or her financial relationship to the enterprise should be that of a stockholder. No other financial ties that may compromise objectivity should be permitted.

Independence frees a director from susceptibility to pressure, both direct and subtle, from management for pay packages unrelated to performance. Equity ownership, both through primarily equity-based director compensation schemes and affirmative stockholding requirements for each board member, creates a more proprietary attitude on the part of the director to take the company's interests, not management's, to heart when negotiating compensation arrangements.

Will equity and independence work to reign in executive overcompensation? An empirical study I conducted a few years ago suggested that bargaining between board and management would be more effective when outside directors have substantial stockholdings in the corporation. *Business Week*, in conjunction with Standard & Poor's Compustat Services, Inc., conducts an annual survey of executive compensation in 500 of the nation's largest publicly traded corporations. Compensation is then compared with executive performance as measured by corporate profitability and total return to the stockholders in stock appreciation and dividends. My own study reviewed the 158 businesses in the *Business Week* survey that received either the poorest possible rating for compensation in relation to performance or the best.

An intriguing fact emerged from my examination. Companies with what the *Business Week* survey called excessive levels of executive compensation tended to have corporate boards controlled by outside directors with insignificant equity holdings in the business. However, businesses with levels of executive pay the survey suggested were in line with services delivered, tended to be controlled by boards whose outside directors held substantial equity positions in the companies. There appeared to be a link between substantial stock ownership and more effective compensation oversight by outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession of large shareholding positions, would explain this phenomenon. And, in 1996, the National Association of Corporate Directors' Commission on Director Professionalism urged that corporate boards be composed of a substantial majority of independent directors. Independence essentially was defined as directors having no substantial financial relationship with the enterprise other than meaningful equity ownership.

Compensation committees composed only of independent, equity-holding directors, and full boards substantially dominated by such individuals are shareholders' best weapons against overcompensated management. As this phenomenon receives greater public attention, both courts and shareholders will come to expect nothing less from those who serve as stewards of the public corporation. □

A Board-Based Solution to Overpaid CEOs

In many U.S. corporations, executives are paid much more than their performance seems to justify. The problem of overcompensation will not be solved, however, by the Clinton administration's approach to the question.

Arguing on Feb. 11 that "the tax code should no longer subsidize excessive pay of chief executives," President Clinton requested in his budget, and Congress then mandated, that executive compensation over $1 million a year "unrelated to the productivity of the enterprise" no longer be deductible by the offending corporation as a legitimate business expense. The president apparently concluded that all executive salaries above $1 million were somehow inherently suspect. He has missed the point completely.

There is nothing inherently wrong with a large salary. The problem is overcompensation, not high compensation. Many executives who earn well over a million dollars are worth every penny, considering their contributions to corporate profitability. Corporations will gladly pay high-performing executives handsomely, not only to reward their performance but to retain their services in the competitive labor marketplace. High compensation can also be a valuable incentive for future performance. To limit arbitrarily the compensation that all corporations may offer limits the effectiveness of this important incentive.

Furthermore, the Clinton approach to corporate overcompensation fails to address its root cause. Overcompensation is usually the result of a failure in the bargaining process between a corporate board and management over salary.

In many of America's leading corporations, management is supervised by a board largely appointed by management. Excessive compensation results when passive boards beholden to management agree to salary packages on demand, in the absence of spirited negotiation.

Manager's Journal

By Charles M. Elson

An empirical study I recently conducted suggested that bargaining between board and management will be more effective when outside directors have substantial stockholdings in the corporation. Business Week, in conjunction with Standard & Poor's Compustat Services Inc., conducts an annual survey of executive compensation in 500 of the nation's largest publicly traded corporations. Compensation is then compared with executive performance as measured by corporate profitability and total return to the stockholders in stock appreciation and dividends. My own study reviewed the 158 businesses in the Business Week survey that received either the poorest possible rating for compensation in relation to performance or the best.

An intriguing fact emerged from my examination. Those companies with apparently excessive levels of executive compensation tended to have corporate boards controlled by outside directors with insignificant equity holdings in the business. On the other hand, those businesses with levels of executive pay considered in line with services delivered tended to be controlled by boards whose outside directors held substantial equity positions in the companies. There appeared to be a link between substantial stock ownership and more effective compensation oversight by the outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession of large shareholding positions, would explain this phenomenon.

Based on the findings of my study, I believe that some reform in board structure is warranted to create more effective board-level review of executive compensation and to promote more reasonable compensation schemes. The outside directors must be made to consider management compensation proposals not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Corporations should pay their directors their annual fees in company stock that is restricted as to resale during the director's term in office. In a few years, each outside director will have accumulated a reasonably substantial portfolio and will therefore possess a powerful financial incentive to act more independently of management.

Although some might argue that a stock-option grant to directors may serve the same purpose, such an approach would prove less effective than direct equity ownership, simply because of the highly tentative nature of an option prior to exercise. Stock ownership provides the director with a present tangible stake in an enterprise, not merely some speculative expectancy of a discounted future position.

Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decision making; by stretching out the time between elections, it would also make it harder for management to bully directors with a threat not to renominate them.

Director stock ownership may not prove the comprehensive cure to the overcompensation controversy—but it will have a strong salutary effect and is a much more positive approach than the Clinton administration's taxation-based plan.

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Charles M. Elson

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EXECUTIVE OVERCOMPENSATION—A BOARD-BASED SOLUTION†

CHARLES M. ELSON*

P-5

INTRODUCTION

Envy, for better or worse, is a fundamental part of the human condition. Whether we admit it or not, most of us take a keen interest in the financial status of our neighbors. Few aspects of existence in contemporary society create more anger, resentment and dissension than how much we are compensated for our daily toils in comparison to what our fellow workers earn. It is this simple fact, along with distributive justice concerns, that explain the cause of the extraordinary popular attention and fury directed at the seemingly innocuous issue of executive compensation. Within the last several months, both the popular and financial media have devoted much attention to the charge that the executives of America's largest and most respected public corporations are being grossly overpaid for their services, at the expense of their shareholders, employees and the general public.[1] Comparisons are made with historic U.S. compensation levels and the

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[1] *See, e.g., Debate; Readers and Authors Face Off Over HBR's Last Issue; CEO Pay: How Much is Enough?*, HARV. BUS. REV., July-Aug. 1992, at 130 [hereinafter *Debate*]; Amanda Bennett, *A Little Pain and a Lot to Gain*, WALL ST. J., Apr. 22, 1992, at R1; Amanda Bennett, *Voices of Protest*, WALL ST. J., Apr. 22, 1992, at R6; Tommy Denton, *Where is the Justice in Bloated Executive Bonuses?*, L.A. DAILY J., May 14, 1991, at 6.

amounts executives of foreign competitors receive, particularly in relation to the spread between the salaries of the highest and lowest paid employees.[2] It is argued that U.S. executives are being compensated at an alarmingly high and dramatically escalating rate, despite the fact that domestic corporations may be performing less efficiently and less profitably than similarly situated foreign enterprises.[3] What are the legal ramifications of this executive compensation issue and is there a need for some sort of legal response?

The controversy is not a new one. In the mid-1930s, a similar public debate emerged over what was then considered to be the extraordinarily high compensation levels of certain corporate executives. While acknowledging that a corporate board may be responsible for salaries paid to executives that exceeded compensation for services rendered and thus became actionable "waste" or improper gifts of corporate assets, the courts generally declined to intervene.[4] It was believed that a court was no better at valuing an executive's worth than a properly functioning board, and therefore judicial review would be fruitless.[5] With the judiciary a reluctant venue for compensation reform, Congress attempted to resolve the issue by dramatically raising

[2] In 1991, the average chief executive of a large corporation was paid approximately 104 times the average factory employee's wage. In 1980, the average chief executive earned only 42 times the average factory worker's wage. John A. Byrne, *What, Me Overpaid? CEOs Fight Back*, BUS. WK., May 4, 1992, at 142, 143. *See also* ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 170 (1991) (observing that executive overcompensation has a negative effect on employee morale); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 69–71 (1992); Jonathan Rowe, *CEO Pay Affects Company Morale*, CHRISTIAN SCI. MONITOR, Mar. 12, 1992, at 13.

[3] Roberto Goizueta, Chairman of Coca Cola, recently received over $80,000,000 in restricted stock for his services to the company. Anthony O'Reilly, the retiring chief executive officer of H.J. Heinz, was paid $75,085,000 in compensation for 1991. And for the same year, Leon Hirsch, chairman of U.S. Surgical Corp., received $23,281,000. *See* Byrne, *supra* note 2, at 142. Can any one executive's services be worth that much to the corporation? The tenor of the varied articles discussing the phenomenon suggests not. *See supra* note 1.

[4] *See, e.g.*, Rogers v. Hill, 289 U.S. 582, 591–92 (1933) (ruling that bonus payments to executives which have no relation to the value of services rendered are gifts of corporate property, and remanding to the trial court to determine whether payments constituted a waste of corporate assets); Seitz v. Union Brass & Metal Mfg. Co., 189 N.W. 586, 587–88 (Minn. 1922) (explaining that courts should proceed with caution when determining whether salaries are excessive and unreasonable; courts are not called upon to make a yearly audit and adjust salaries); Gallin v. National City Bank, 281 N.Y.S. 795, 802–03 (Sup. Ct. 1935) (ruling that the magnitude of the total compensation received by officers does not, by itself, entitle plaintiffs to recover, but merely requires an investigation by court as to whether a cause of action exists and leaves the burden of proof on the plaintiffs); Barris, *supra* note 2, at 81–83; Detlev Vagts, *Challenges to Executive Over Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–55 (1983).

[5] Heller v. Boylan, 29 N.Y.S.2d 653, 679–80 (Sup. Ct. 1941) ("Courts are ill-equipped to solve or even to grapple with these entangled economic problems."), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941).

the income taxation rates imposed on those receiving the greatest compensation.[6] No legal changes, however, in internal corporate governance procedures were enacted. Following this taxation-based response, the issue basically lay dormant until the perceived salary excesses of the late 1980s revived public interest and debate.

Although some may argue that through efficient market function, either few executives are overcompensated or that market-based forces will act to limit salary excesses,[7] there is a compensation problem today that, for various reasons to be discussed below, is not responsive to a market-based solution. The best way to encourage reasonable compensation without discouraging effective executive performance centers on better internal corporate oversight. Such oversight may come only from an unfettered, unbiased, *independent* board of directors. This article proposes two reforms in corporate board structure to encourage such independence of judgment that will result in the proper review of executive compensation procedures. First, the outside directors should be compensated solely in company stock. Second, directors' term lengths should be significantly expanded. These internal structural changes will result in a more effective board-level review of executive compensation and should lead to more reasonable compensation schemes.

Unfortunately, as this article will discuss, most commentators examining the compensation issue have not focused on reform of the internal corporate governance procedures that created the problem. Rather, they have proposed externally-based solutions that will either prove ineffective or hinder effective corporate management. Indeed, the regulatory and legislative communities have been quickest to respond, offering varying responses to the overcompensation problem. The Securities and Exchange Commission, probably seeking to stimu-

[6] 1 GEORGE T. WASHINGTON & V. HENRY ROTHSCHILD, 2ND, COMPENSATING THE CORPORATE EXECUTIVE 9 & n.32, 10–11 (1951).

[7] *See, e.g.*, Robert Thomas, *Is Corporate Executive Compensation Excessive?*, *in* THE ATTACK ON CORPORATE AMERICA 276, 278 (M. Bruce Johnson ed., 1978) ("Competition among corporations . . . sets the level of executive compensation."); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1263, 1283 (1982) ("[M]arket constraints . . . may be more effective in setting salaries than a committee of uninformed independent directors."); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975–78 (1980) ("excessive" compensation is eliminated by market forces, including competition for executive positions); Alisa J. Baker, *Stock Options—A Perk that Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20; Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28 (arguing that executives are paid in line with performance and their pay should not be cut); Kevin J. Murphy, *Top Executives are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125 (arguing that current compensation policies encourage managers to act in the best interests of company shareholders).

late a shareholder response to the issue, has taken a two-flanked approach. The first, adopted in early 1992 during the height of the proxy season, loosened the restrictions on placing shareholder-initiated proposals on compensation issues on corporate ballots.[8] The second, initially released as proposed amendments to the proxy rules and later adopted with some revisions, expanded the amount of disclosure companies must provide to their shareholders on the amounts their top executives are paid.[9] The Congress, on the recommendation of President Clinton, chose an historic tax-based response to the problem. In the Revenue Reconciliation Act of 1993, Congress mandated that corporations may no longer deduct, as a business expense, any compensation to an executive in excess of $1 million per annum that is not related to performance.[10] Additionally, a new "millionaires" surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year.[11]

[8] Shareholder Communications Rules, Exchange Act Release No. 34-29562, 56 Fed. Reg. 41,635 (SEC 1991). The SEC revised the proposal in 1992. Regulation of Communications Among Securityholders, Exchange Act Release No. 34-30849, 57 Fed. Reg. 29,564 (SEC 1992).

[9] One of the elements of the SEC proposal, and later adopted in rule form, required companies to compare, in graphic form, the company's performance with the amount of compensation its executives received. Executive Compensation Disclosure, Exchange Act Release Nos. 33-6940 & 34-30851, 57 Fed. Reg. 29,582 (SEC 1992); Executive Compensation Disclosure, Exchange Act Release No. 6962, 57 Fed. Reg. 48,126 (SEC 1992).

[10] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). This bill prohibits publicly held corporations from deducting executive compensation in excess of one million dollars per annum. *Id.* However, corporations that tie compensation to performance may be able to continue to deduct the entire amount of compensation. In order to qualify for this performance-based compensation exception, corporations must meet five basic requirements: 1) executive compensation must be made according to a previously established performance based goal; 2) the performance goal may not be altered following its establishment; 3) such a plan must be approved by a board committee that is comprised of at least two outside directors; 4) the material terms of the plan must be disclosed to and ratified by stockholders prior to the payment of compensation; and 5) the committee must certify satisfaction of the performance goals prior to the payment of compensation. *Id.* Thus, corporations may avoid the deduction limitation by either following these guidelines, shifting a portion of compensation into stock options, "which are generally considered 'performance based'" or making payments to a qualified retirement plan. Kathryn Jones, *Tax Law Expected to Bring Little Shift in Executive Pay*, N.Y. TIMES, Aug. 24, 1993, at C1, C2. Consequently, some commentators and corporate executives have suggested that these new deduction limitations will in actuality have only a limited impact upon most corporate executive compensation schemes. *Id.*

[11] H.R. 2264. The bill, which both the House and Senate passed by the narrowest of margins, imposes a ten percent surtax upon individuals with taxable income in excess of the applicable threshold of two hundred fifty thousand dollars. *Id.* *See also* Jackie Calmes, *With Signature, President Will Erase Reagan's Legacy*, WALL ST. J., Aug. 9, 1993, at A4. During the presidential campaign, President Clinton proposed implementing a "millionaires" surtax upon individuals with incomes in excess of one million dollars. *See President-Elect Clinton Foresees Change in Plan for Middle-Class Tax Break*, 10 DAILY TAX REP. (BNA) D-4 (Jan. 15, 1993). However, President Clinton subsequently lowered this ceiling and proposed imposing a ten percent surtax upon

A debate is also occurring within the academic community. Despite the traditional reluctance of courts to involve themselves in compensation disputes, a few commentators have called for increasing judicial activism in reviewing questionable compensation schemes.[12] Given the present interest in both the legal and financial communities in the emerging power of institutional investors, some academics have suggested an institutional investor-based solution to the problem. Should the institutions eschew their traditional passivity and take a greater interest in the management of the companies in which they invest, they may act as a powerful force in preventing executive overcompensation.[13]

Although each of these approaches is not without some merit, this article will argue that they are "solutions" that will either cause more harm than good, or effect little change in the present state of affairs which, given the level of public discontent, cannot be ignored. The problem of executive overcompensation is best dealt with not at the regulatory or even shareholder level, but by focusing on that body traditionally charged with responsibility for corporate oversight—the board of directors. It is the board which must approve all executive compensation. Thus, it is the board which must act to rein in overzealous and overcompensated management. Some commentators have suggested that only by strengthening the power and independence of the board's compensation committee will the issue be successfully resolved.[14] Such tampering, however, is not the solution. In large publicly-traded companies, where the compensation crisis is most manifest, no major shareholder or group of shareholders controls the activities

individuals with incomes in excess of two hundred fifty thousand dollars per annum. Under the new tax code, the effective tax rate for individuals with incomes in excess of two hundred fifty thousand dollars per year has risen to 39.6 percent. H.R. 2264.

[12] Vagts, *supra* note 4, at 275–76; Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 79–83 (1993); Richard L. Shorten, Jr., Note, *An Overview of the Revolt Against Executive Compensation*, 45 RUTGERS L.J. 121, 159–61 (1992).

[13] *See, e.g.*, Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 915–17 (1992) [hereinafter Black, *Empirical Evidence*]; Kevin G. Salwen & Joann S. Lublin, *Activist Holders: Giant Investors Flex Their Muscles More at U.S. Corporations*, WALL ST. J., Apr. 27, 1992, at A1.

[14] *See* Lance Berger, *New Initiatives for the Compensation Committee*, DIRECTORS & BOARDS, Winter 1985, at 33; James W. Fisher, Jr., *Crafting Policy for Performance and Rewards*, DIRECTORS & BOARDS, Winter 1986, at 26. *See also* Alison L. Cowan, *Board Room Back-Scratching?*, N.Y. TIMES, June 2, 1992, at C1 (noting that the leaders of various companies often sit on each others' compensation committees and, as such, set pay for one another). Some large institutional investors are proposing that shareholders be allowed to vote on the selection of compensation consultants used by boards to set executive compensation. Gilbert Fuchsberg, *Investors May Seek Vote on Executive Pay Consultants*, WALL ST. J., Aug. 27, 1992, at B1.

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of the enterprise because of the sheer size of the operation and atomistic shareholding patterns. Rather, corporate management controls the business. The board is not representative of any one shareholder or shareholder group, but is picked by and responsive to the leading officers of the corporation. This phenomenon may be described as the "captured board" syndrome.[15] In a captured board, the directors, responsible for oversight, are generally either the officers themselves (inside directors); participants in enterprises retained by management, such as law firms, and investment banks (inside "outside" directors); or social or business acquaintances of the top executives, most likely the top officers of other corporations, on whose boards the chief executive officers may sit ("outside" directors).[16] Although such board composition may lead to affable board gatherings, the oversight function may be severely compromised. Even if the compensation committee (which determines compensation levels) itself is composed exclusively of "outside" directors, both economic and psychological ties to management exist that preclude exercise of truly independent judgment. Theoretically, the threat of legal liability should ensure unencumbered judgment, but, as a matter of practice, the protection afforded by the business judgment rule and concomitant reliance on "captured" outside consultants counters any potential prophylactic effect. A compensation committee is only as effective as its members. If the outside directors comprising it are beholden in any respect to management, whether by economic or psychic ties, the committee will not function as the panacea.

The solution lies in loosening the outside directors' ties to management and recreating a vital and independent board, which will engage in active oversight, not passive agreement. A way must be found to reinvigorate the outside director who traditionally acted in the shareholders' interests by directing management. Some commentators have argued that this may be accomplished by placing representatives of the corporation's major institutional shareholders on the board.[17]

[15] *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 139–48 (1976). *See generally* MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1986).

[16] *See* Avery S. Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, 837 (1977) (classifying directors as "inside directors, non-independent outside directors, and independent outside directors"); *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1619–20 (1978) (describing directors as management and non-management directors); *but see* PRINCIPLES OF CORPORATE GOVERNANCE § 1.29 (A.L.I.) (Tentative Draft No. 11, 1991) (abandoning the use of labels, but defining when a director has a "significant relationship" with a company's senior executives).

[17] *See* Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37 (1990) (arguing that the proxy rules should be modified so that it is easier for shareholders to elect

They reason that because these individuals attained their board positions as a result of their relationship to the shareholding institutions and not to management, they will act in the shareholders' best interests, independent of management.[18] This approach is problematic in one major respect. It assumes that the institutions will bond together to elect their representatives and that the institutions possess sufficient voting power to place enough directors in office to gain control over the board.

There is, however, a much simpler and more effective way to reposition the board to act as a counter-force to management, and resolve the perceived compensation crisis. The outside directors must be made to consider management proposals from the perspective of the equity-holders to whom they are legally responsible, and not from the viewpoint of one engaged by and beholden to management. After all, they were elected to their positions as the representatives of the shareholders, not the officers. The best way to create this perspective may be to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Frequently, however, outside directors do own stock in the corporations on whose boards they sit. Yet, they are still subject to management capture. Why? It is because their equity positions in the companies are insubstantial compared with the monetary and reputational compensation they receive for serving on the board. Financially, it is far better to side with management and not risk failing to be renominated and receiving the compensation and prestige a board seat brings, than to act independently and face removal. If, however, one's personal financial interest in the corporation's stock exceeded the annual compensation and prestige value of board membership, one would be less willing to side automatically with management. Self-interest is obviously tied to board behavior, and if a director's self-interest is aligned with the equity-holders, as opposed to management, then the compensation problem, and maybe even the whole issue of management capture, might be solved. But how do we place significant equity positions in the hands of the outside directors?

outside directors); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992) [hereinafter Black, *Agents*] (arguing that regulations should be relaxed so that particular institutions may be permitted to own 5–10% of certain companies). *See also* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991) (calling for institutional investors to organize a core of professional directors).

[18] Black, *Agents*, *supra* note 17, at 842–44.

This article proposes that corporations should pay their directors their annual fees in restricted company stock. In a few years, each outside director will have accumulated a reasonably substantial portfolio and, therefore, will possess a powerful financial incentive to act more independently of management. Additionally, directors' term lengths must be significantly expanded both to ensure that their equity positions (or potential positions) will reach the levels necessary to influence their decision-making and to mitigate the chilling effect of a management threat not to renominate that frequent elections create.

Of course, the linchpin to the effectiveness of this approach is the assumption that stock ownership has a salutary impact on individual behavior—that significant stock ownership does make for a director less susceptible to management capture. An empirical examination of the voting behavior of boards comprised of outside directors with substantial stockholdings, compared with boards with outside members who do not, should confirm the validity of the approach. This article undertakes such an examination. In the realm of executive compensation, it appears that companies with boards composed of outside directors with significant shareholdings are less susceptible to the charge of executive overcompensation than companies without such boards. In fact, an apparent relationship exists between the way companies are regarded by the financial community in terms of the fairness of executive compensation, and the levels of outside director stock ownership. Those companies that are viewed as having high levels of executive compensation tend to have fewer outside directors with significant holdings in the business. On the other hand, those businesses with levels of executive pay considered to be in line with services rendered tend to have a greater number of outside directors with significant equity holdings. An alignment of the directors' interests with those of the shareholders, rather than with management, through the development of substantial equity holdings which results in more effective oversight, would explain this phenomenon. Director stock ownership may not prove the comprehensive cure to the overcompensation controversy and related captured board syndrome—but it may have a strong salutary effect and certainly would be a good beginning.

Part I of this article examines the question of overcompensation. Are U.S. executives overpaid, and, if so, can the market itself act to correct any imbalances? For reasons to be discussed, I think the market cannot. Part II considers the various solutions proffered, including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation committees. These approaches are critiqued as either ineffective or causing more harm than good to ultimate shareholder and national interests. Part III focuses on stock ownership and lengthened board terms as the preferred response to the problem of overcompensation. Finally, this article examines the link between substantial equity holdings and better oversight and proposes that companies create such holdings in their outside directors. This proposal should eventually result in more effective board oversight, reasonable market-based compensation schemes, and healthier, more competitive corporations.

I. The Overcompensation Problem

A. *Is There Overcompensation?*

Before embarking on a quest to determine an appropriate solution to a perceived inequity, it must first be determined that a problem exists which requires an active response. In other words, are U.S. executives overcompensated and, if so, is extraordinary action necessary to remedy the situation? The problem with examining compensation is that the entire inquiry begs the question—for what is the true value of the deployment of human capital? Unlike determining the cost of providing a physical good based upon known variables, there is really no mechanistic process for quantifying the value of human labor. If it were merely the cost of the basic human needs of food, clothing and shelter, we would all be compensated similarly.[19] However, we are not. Although human effort is in one sense easily quantifiable by being limited to the physical capacities of the human being and the time limitations of the twenty-four-hour day, human capital is highly differentiated. The tasks required to maintain an advanced economy are extraordinarily varied and require vastly different skills. Some skills are seemingly more valuable to society than others and, as a result, are compensated at higher levels. What those levels may be are determined through the routine function of the market.

How much individuals are compensated for their labors is the

[19] As Karl Marx and Fredrich Engels stated:

> The average price of wage labor is the minimum wage, i.e., that quantum of the means of subsistence which is absolutely requisite to keep the laborer in bare existence as a laborer . . . . We by no means intend to abolish this personal appropriation of the products of labor. . . . All that we want to do away with is the miserable character of this appropriation . . . .

Manifesto of the Communist Party, *in* Marx & Engels, Basic Writings on Politics & Philosophy 22 (Lewis S. Feuer ed., 1959).

result of an implicit or explicit bargaining process. One party has labor to offer and another has a need for the skill. The resulting compensation is the product of the matching of expectations—what one expects to receive and what the other is willing to give. These expectations, created through routine market function, determine compensation levels. What others are giving or receiving for similar tasks produces the expectations that determine particular compensation levels for particular skills. The "value" of a particular skill is not implicit in the skill itself but, rather, is simply the result of this bargaining process. In this regard, there is really no such thing as an implicitly "fair" salary—only one that is acceptable to both parties.

This is the real problem with discussions concerning "overcompensation," for if a salary is the result of an active bargaining process can such compensation ever be considered excessive? Because there is no truly objective standard for valuing human capital other than through the operation of the market driven by active bargaining, the reasonableness of a particular compensation arrangement is objectively indeterminable. Reasonableness is the product of the bargain. For example, who can say that an employee is overcompensated if two willing parties agree that the efforts of one of them are worth one million dollars? If one is voluntarily willing to part with capital to obtain a particular service, that is the value of the service. The compensation is thus reasonable. Compensation becomes unreasonable when it is not the product of balanced bargaining. Where one party to a bargain, due to external pressures, is unable or unwilling to bargain effectively to maximize self-interest, then the resulting agreement may be unreasonable.

In the corporate setting, the executive bargains with the corporation for compensation. The executive possesses managerial skills that the corporation desires. The corporation possesses capital that the executive desires in exchange for services rendered. How much capital will be parted with for these services is the result of bargaining. The resulting salary may be problematic where effective bargaining does not take place because one party does not attempt to maximize its own self-interest. This is the crux of the overcompensation dispute. Executive salary arrangements are the products of negotiation between the executive and the company's board of directors who represent the interests of the company and its owners, the shareholders. If the board is reluctant to bargain effectively with management because, despite its fiduciary obligations, it believes itself to be more closely allied with management than the shareholders, then the product of such a "bargain" may be no bargain at all to the corporation and its owners.

Alliances between bargaining parties may result in acquiescence rather than bargained-for agreement. Salary arrangements that result from such a one-sided bargaining process may be susceptible to charges of excess.

Although the popular media focuses simply on the large executive salaries themselves as proof of the existence of an overcompensation problem, the problem actually involves the process by which these salaries were determined and not the dollar amount. A lucrative salary, either standing on its own or in comparison with other salaries paid within the organization, is not in and of itself proof that the recipient has been overcompensated. As long as the compensation was the product of an active, good-faith bargaining process between the board and the executive, the salary cannot be characterized as unreasonable. Negotiation, motivated by self-interest on both sides, assures proper compensation. There is really nothing improper about an executive's compensation if a board determines that the services rendered are highly valuable to the corporation and offering a high salary is the only way to retain that executive.

Compensation amounts do become problematic, however, when a board, beholden to a particular executive, agrees to a salary package upon demand, in the absence of self-interested bargaining. The failure to actively negotiate an executive's compensation request is most likely to occur in corporations where the directors are not obligated to any particular shareholder or shareholder block, but gain and maintain their board seats because of executive largesse. This situation generally exists in companies that, due to their large size and consequent atomistic shareholding patterns, are controlled by incumbent management and not by one shareholder or group of shareholders.[20] In such businesses, the boards of directors generally consist of management and those appointed by management. In these situations, it is unwise for the outside directors to actively challenge the executives who have placed them in office.[21] Such directors have little incentive, other than fiduciary duty (which for reasons to be discussed has proven ineffective

[20] As of December 31, 1974, management controlled 165 of the 200 largest, publicly-owned, nonfinancial corporations in the United States. EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 58 (1981) (Table 3.2). "[W]ide diffusion [of stock] does not increase the power of holders of small blocks of stock; it enhances the power of whoever controls the proxy machinery." *Id.* at 53. *See also* MACE, *supra* note 15, at 83–84. *See generally* ADOLF A. BERLE, JR., & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 47–118 (1933).

[21] EISENBERG, *supra* note 15, at 147.

> [I]n life as in law the power to hire implies the power to fire. A director who has been brought on the board by a chief executive—as outside directors typically are—is therefore likely to regard himself as serving at the latter's sufferance.

in creating incentive), to bargain actively with management over compensation.

Many of the largest U.S. public corporations have shareholding ownership patterns that dispose them to such potential management capture and attendant compensation problems.[22] It is these companies which have traditionally paid their executives the largest salaries and are currently the target of popular scrutiny.[23] A large salary is not in and of itself malignant. However, a significant executive compensation package paid by a large public corporation subject to management capture, may be indicative, because of its size, of a failure by the directors to have bargained effectively. Such compensation may thus be overcompensation. Because of the rapid escalation in executive compensation scales in the U.S. and in the large number of companies whose boards do not report to a controlling shareholder group, it is clear that a strong potential for overcompensation may exist.[24]

The difficulty with attempting to measure the adequacy of compensation is the highly subjective nature of the entire matter. This is why the courts have traditionally been reluctant to open their dockets to salary disputes. There are too many ways of measuring compensation and related performance.[25] What by one standard is excessive, may

Id.; *see also* HERMAN, *supra* note 20, at 30–48; MONKS & MINOW, *supra* note 2, at 73–79; Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 607–39 (1982); Gilson & Kraakman, *supra* note 17, at 873–76 ("All too often . . . outside directors . . . turn out to be more independent of shareholders than they are of management."). This situation may be changing. In October 1992, the outside directors of General Motors fired their CEO in response to the company's lackluster performance. *See* Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14. *See also* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17–31 (1989) (noting that while the CEO still controls the director nomination process, boards are beginning to have greater participation in the process); Thomas A. Stewart, *The King is Dead*, FORTUNE, Jan. 11, 1993, at 34 (discussing recent firings and forced resignations of company CEOs); Stuart Mieher, *Firms Restrict CEOs in Picking Board Members*, WALL ST. J., Mar. 15, 1993, at B1 (reporting survey which indicates that many companies now prohibit corporate insiders from nominating new directors).

[22] *See* HERMAN, *supra* note 20, at 70–85.

[23] *See, e.g.*, MONKS & MINOW, *supra* note 2, at 166 (explaining that in 1989, the average CEO at top 200 companies received $2.8 million in salary and bonuses); Arch Patton, *Those Million-Dollar-a-Year Executives*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 43, 44 (Fred K. Foulkes ed., 1991) (noting that executive pay in the 100 largest publicly-owned corporations increased by an average of 13.7% in 1983); *Executive Compensation Scoreboard*, BUS. WK., May 4, 1992, at 148–62 (rating executive pay among 300 largest U.S. companies).

[24] *See supra* note 2. *See also* MONKS & MINOW, *supra* note 2, at 166–67 (noting that U.S. executive pay significantly outpaced inflation, wage, and profits rates from 1977 to 1987 and that American CEOs in billion-dollar companies receive two to three times the pay of comparable executives in Europe and Japan).

[25] Statistics describing compensation levels do not give a complete picture of an executive's compensation package. In addition to salary and incentive awards, executive compensation often

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be by another perfectly reasonable. This is what accounts for the tremendous division within the financial community over who is being overpaid and who is not.[26] The only way to judge a compensation package objectively is through the same process by which businesses themselves are assigned value—through the operation of routine market forces, characterized by active bargaining. Given the potential for subdued bargaining and coincident overcompensation in the largest corporations, coupled with rapidly accelerating salary scales in the face of a national economic recession, it is not surprising that the popular media have sounded an alarm. Although it is very difficult to look at a specific salary and immediately reach an informed conclusion as to its excessiveness, the great potential for abuse mandates the formulation of a prophylactic response.

B. *The Inadequacy of a Market-Based Response*

Some argue that even if an overcompensation problem does exist, no external response need be forthcoming. The ordinary operation of the markets themselves will provide the solution. If the compensation scheme in a particular company is unreasonable, then market forces will punish that enterprise in the form of a lower stock price. The lessened equity value will, in turn, force the board to bargain more effectively for reduced salary levels to avoid revolt and replacement by enraged shareholders. Under this model, a market-induced decline in share values will encourage shareholder rebellion sufficient to compel a traditionally management-allied board to reconsider its compensation bargaining strategy. As a result, no externally-based approach to the compensation problem is necessary. The situation will take care of itself.

This approach may be seriously flawed despite its strong logical appeal. It is based entirely on the problematic assumption that unreasonable executive salary levels will result in lower equity prices. Although high salaries may indicate a lax bargaining environment between the board and the company's top executives regarding compensation practices, the harm to the company itself may appear insignificant in a macro view. To a multibillion dollar corporation, a few million more dollars paid to its top management than may actually be necessary to retain their services has little bearing on that business's overall profitability. In this sense, the alleged overcompensation may be statistically insignificant. To a business earning $250,000,000, a million dollar overpayment to an executive, while a spectacular windfall to that individual, is insignificant in evaluating the company's earnings.[27]

Many techniques are used to value a business. Analysts consider such factors as price/earnings ratios, debt to equity computations, projected earnings streams, resale value, and break-up potential, among others, to determine the going equity value of an enterprise.[28] While an executive's compensation is of major concern to that individual, in a large organization it has little impact on any of the common valuation methods because of its small relative scale. The actual effect of an excessive salary on the company's earnings or even its total asset base is likely to be minimal, if not minuscule.[29] Therefore, even if an executive has been grossly overpaid, the impact on the company's stock price will be negligible because the market places its heaviest emphasis in valuation on "the bottom line," whether that may involve earnings, assets or liabilities.[30] For a "market-based" solution to the compensation

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includes executive stock plans with company-arranged financing, use of company aircraft and automobiles, financial, tax, and estate counselling, retirement benefits, life insurance, and intangibles, such as the power to designate firms with which the company does business, that increase the executive's prestige and power. V. HENRY ROTHSCHILD, 2ND & ARTHUR D. SPORN, EXECUTIVE COMPENSATION 1–2 (1984).

Most executive compensation plans attempt to align an executive's rate of compensation with the company's performance in various areas, most predominantly stock prices and profits. *See* Seymour Burchman, *Choosing Appropriate Performance Measures*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 189 (Fred K. Foulkes ed., 1991); Stephen F. O'Byrne, *Linking Management Performance Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91; S. Prakash Sethi & Nobuaki Namiki, *Factoring Innovation Into Top Management's Compensation*, DIRECTORS & BOARDS, Winter 1986, at 21.

[26] *See supra* notes 1 and 7.

[27] *But see Debate*, *supra* note 1, at 133 (Michael S. Kesner, National Director on Compensation and Benefits at the accounting firm of Arthur Andersen, states that "[A] $5 million CEO pay package on the bottom line of a $2 billion sales company is clearly not the issue."). As former Illinois Senator Everett M. Dirksen remarked, "A billion here, a billion there, and pretty soon you're talking about real money." RESPECTFULLY QUOTED 155 (Suzy Platt ed., 1989).

[28] Analysts use four main methods to value companies. Discounted cash flow analysis ("DCF") essentially states that the value of a company is reflected in the profits the company will earn over a projected period of time. With the comparable company method, analysts compare the business to be valued with companies possessing similar financial and operational profiles. With the comparable acquisitions method, the value of a business is based on the cost of acquiring similar businesses. Liquidation analysis determines the company's value based on the prices the company's assets could be sold for in an orderly manner. Analysts apply combinations and variations of these methods when valuing a company. ROBERT L. KUHN, INVESTMENT BANKING 97–123 (1990). *See also* Brian H. Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42 (analyzing the strengths and weaknesses of the four methods).

[29] Most valuation analyses do not separately address the executive's compensation. *See supra* note 28.

[30] *See* Brownstein & Panner, *supra* note 7, at 29 ("The question is not 'Are executives paid too much?' The real question is 'Are shareholders getting their money's worth from their executives?'").

problem to be effective, overcompensation must have a reasonably significant impact on the equity value of a company to force a board response.

The market functioning alone will provide no certain remedy, because the problem seems to merit little market attention.[31] Still, a response is warranted. Even if an executive is overpaid only a single dollar, that dollar rightfully belongs to the shareholders, not the executive. In our system of criminal justice, the amount that an individual takes wrongfully is unimportant in adjudging potential criminal responsibility. The mere fact that an unlawful gain occurred is the basis for action. So must a response in the corporate arena be similarly forthcoming? While an unreasonable compensation scheme may, in and of itself, have little impact on overall corporate performance, it may also indicate a much broader problem that should demand an immediate response. An overcompensated executive is indicative of an inattentive board whose neglect may result in far more dire consequences for corporate profitability than a simple excessive salary scheme.[32] Inattention to this problem will ultimately result in a runaway management which may lead to corporate disaster. By the time company profits have decreased to such a level as to warrant a market-based response, the damage to the business and shareholder wealth will have already been done. If the loss to the corporation of its market share and reputation are severe enough, the damage may be irreversibly crippling and perhaps even fatal to the enterprise. An active, non-market-based response is therefore required.

II. A CRITIQUE OF CURRENTLY PROPOSED SOLUTIONS

As the controversy over compensation has grown, proposals to solve the problem have proliferated as well. The governmental and legal communities have offered several dramatically differing solutions. These well-intentioned approaches miss the mark. They appear to

[31] Compensation commentator Graef Crystal concedes that a CEO's pay package does not significantly influence stock values, but argues that investors should consider both the amount of an executive's pay as well as the mechanisms by which he is paid in order to make an intelligent investment decision. GRAEF S. CRYSTAL, IN SEARCH OF EXCESS 253–64 (1991).

[32] The consequences of an inattentive board and the resulting benefits of an activist board are best illustrated by the recent turmoil at General Motors. Throughout its history, the GM board was typically beholden to GM management, with board meetings being little more than social gatherings in which the CEO's agenda was approved. After a long, steady decline during which GM's share of the American car market dropped from 52% to 35%, the GM board finally took affirmative steps to improve the company's performance, steps which included firing GM's CEO, Robert Stempel. *See* John Greenwald, *What Went Wrong?*, TIME, Nov. 9, 1992, at 42, 44.

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attack the manifestation of the problem without targeting its root cause—passive bargaining resulting from inactive boards. These proposals will either prove ineffective or may even act to compound the damage to corporate health that overcompensation creates.

A. Heightened Disclosure

The Securities and Exchange Commission (the "SEC") has developed a two-tiered approach to the issue. This approach involves a reexamination of the way the proxy rules deal with executive compensation questions and it will have about as much effect on the problem as aspirin provides for the common cold. It may make us feel a bit better, but the offending virus remains. First, the SEC has liberalized its stance on permitting shareholders' resolutions regarding executive compensation onto the annual meeting ballot. Traditionally, such proposals were excluded as a matter of policy. Under Rule 14a-8(C)(7) of the Securities and Exchange Act of 1934, resolutions that dealt "with a matter relating to the conduct of the ordinary business operations of the registrant" were excludable.[33] Resolutions relating to compensation were said to fall within this category. In early 1992, however, the SEC amended its policy and announced that it would no longer permit the wholesale exclusion of such proposals, as long as they targeted top executive compensation and not ordinary managerial compensation policy.[34] At least ten shareholder proposals calling for compensation

Recently, a number of formerly passive boards have become increasingly active and have removed from office managers who were previously untouchable. For example, Paul E. Lego, the Chairman and CEO of Westinghouse, resigned his post in response to mounting charges of inadequate corporate financial performance and growing concern about management effectiveness amongst the company's directors. Stuart Mieher, *Westinghouse's Paul E. Lego Resigns as Chief*, WALL ST. J., Jan. 28, 1993, at A3, A6. IBM's CEO and Chairman John F. Akers was forced into retirement as the company saw its stock price lose half of its value within a six-month time frame: the corporation was forced to make a 55% cut in its quarterly dividend, and recorded a $4.97 billion loss in 1992. Michael W. Miller & Laurence Hooper, *Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed*, WALL ST. J., Jan. 27, 1993, at A1, A6.

In the past 18 months, 13 Fortune 500 corporate CEOs have either resigned, been fired, or been asked by their directors to prepare for departure. Prominent among Lego's and Aker's colleagues: Nicholas J. Nicholas, Jr., Time Warner; Tom H. Barrett, Goodyear; James D. Robinson III, American Express; Kenneth H. Olsen, Digital Equipment; Joseph R. Canion, Compaq Computer; and James L. Ketelsen, Tenneco. Stewart, *supra* note 21, at 34, 35–36, 40.

[33] 17 C.F.R. § 240.14a-8(c)(7) (1992). Rule 14a-8(c)(7) states:

> (c) The registrant may omit a proposal and any statement in support thereof from its proxy statement and form of proxy under any of the following circumstances:
>
> . . . .
>
> (7) If the proposal deals with a matter relating to the conduct of the ordinary business operations of the registrant.

[34] Kevin G. Salwen, *Shareholder Proposals On Pay Must be Aired, SEC to Tell 10 Firms*, WALL ST. J., Feb. 13, 1992, at A1.

limitations were allowed onto proxy ballots. None, however, was ultimately successful.[35]

The second tier of the SEC's response to the compensation issue involves increased public disclosure of executive salary arrangements. In June, 1992, the SEC proposed sweeping changes in the type and amount of disclosure that must be made to the public by reporting corporations in the executive pay area. The reasoning behind the proposals was ostensibly "to improve shareholders' understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance."[36] Three new disclosure requirements were proposed. First, all compensation paid to certain senior executives was to be reported to the public in the form of a "Summary Compensation Table" which would "show both annual and long-term compensation in a single, comprehensive overview."[37] Second, the board's Compensation Committee would be directed to prepare a report "on the corporate performance factors that it relied on in making specific compensation awards for reporting executives, as well as describe the general policies of the committee in determining senior executive compensation."[38] Third, the reporting corporation would be required to prepare an annual "Performance Graph"[39] to aid in shareholder evaluation of the effectiveness of corporate performance in relationship to compensation practices. This graph would set forth the cumulative total return to shareholders of the registrant over a period of at least the previous five years, together with the comparable return to

[35] The ten proposals and the percentage of shares voted in favor of each motion are: IBM: improved disclosure of officer pay, 16.7% shares; Baltimore Gas & Electric: cap executive pay at 20x average worker's salary, 12.2% shares; Eastman Kodak: disclose executive severance packages, 15.9% shares; Equimark: tie executive severance pay to company performance, 16.5% shares; Bell Atlantic: end management short-term bonus plan, 10.9% shares; Black Hills Corp.: eliminate director's retirement plan, 36.9% shares; Chrysler: disallow revaluing of stock options, 5.6% shares; Aetna: cut director's pay for failure to attend board meetings, 7.5% shares; Battle Mountain Gold: cut executive pay 30% and end stock options until profit recovers, not on ballot; Reebok: establish compensation committee of independent directors, 19.2% shares. Executive Compensation Disclosure, Exchange Act Release No. 6940, 57 Fed. Reg. 29,582, 29,583 (July 2, 1992); REEBOK INT'L LTD., MAR. 30, 1992, PROXY STATEMENT (1992); *Battle Mountain Gold Sees Possible Loss*, REUTERS, Apr. 21, 1992, *available in* LEXIS, Nexis Library, Reuters File; Salwen, *supra* note 34, at A12. *See also* Judith H. Dobrzynski, *A Ground Swell Builds for 'None of the Above'*, BUS. WK., May 11, 1992, at 34 (observing that many shareholders are withholding proxy votes in an effort to remove directors from company boards).

[36] Executive Compensation Disclosure, Exchange Act Release No. 6962, 57 Fed. Reg. 48,126, 48,126 (Oct. 21, 1992).

[37] *Id.* at 48,126–27.

[38] *Id.* at 48,127.

[39] *Id.*

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shareholders for the stocks included in (i) the Standard and Poor's 500 Composite Stock Price Index ("S & P 500"); and (ii) any recognized industry index (e.g., the Dow Jones Transportation Average) or a group of peer companies selected by the registrant.[40] Following substantial public comment and debate,[41] the SEC adopted the proposals with some changes made in the amount of information to be disclosed. A number of the proposed tables were either revised or dropped "to eliminate redundant information and to improve the clarity of information presented."[42] Despite these changes, the increase in the amount and type of information to be reported under the new rules as compared with the material disclosed under the old regime was substantial.

It is clear from these changes that the SEC has settled on a disclosure-based approach to the compensation controversy. In the SEC's view, the solution to overcompensation lies with an informed and empowered shareholdership, informed as to exactly how much the executives are earning and how that figure relates to performance, and empowered to vote both on compensation resolutions and, if thoroughly dissatisfied, on ultimate board replacement. SEC Chairman Richard C. Breeden has summarized the Commission's theory behind its actions by stating that:

> The proposals would give the shareholders more information and then make it reasonably possible for them to do something about that information . . . . The philosophy that underlies the proposals is that the people in the best position, if a company is deteriorating or stagnating, to do something about it are the people who own it. For too long, the Wall Street rule has been that if you don't like what's going on, sell out. That has made it difficult and expensive for shareholders. These proposals make sure the information is out in the open and remove the restraints so shareholders can do something.[43]

This approach, although not without some visceral appeal (for who can argue with a better-informed public), is basically ineffectual. Indeed, in its very premise can be found the source of its primary

[40] *Id.*

[41] 57 Fed. Reg. at 48127. The SEC received more than 900 letters of comment concerning the proposal. *Id.*

[42] *Id.*

[43] Stephen Labaton, *SEC Will Require Fuller Disclosure of Executive Pay*, N.Y. TIMES, Oct. 15, 1992, at A1, C22.

weakness. The whole concept relies on the idea that an outraged and invigorated shareholding public will provide the solution to the perceived corporate malaise. Shareholder activism will result in more accountable and productive management. The best way to create this necessary activism is through the prodding effect of heightened disclosure. Additionally, the more excessive a salary structure appears, the more likely that full disclosure will embarrass management into correcting the situation.

Although it is certainly true that as the owners of the enterprise, shareholders have the power to engage effective and accountable managers, it is equally clear that this ability does not always translate into results. Indeed, it was the same shareholders who permitted the creation of that management capture that has led to the entire controversy. Shareholder passivity created the problem, and it is unlikely that disclosure will provide the solution. This irksome passivity is not the result of a lack of information, but, rather, a growth in the size of the typical public corporate entity. The larger the corporation became, the more likely its ownership took on an atomistic quality, with no one shareholder or shareholding group exercising control.[44] Moreover, as the size of proportionate shareholding fell, individual shareholders, who no longer held controlling or particularly significant amounts of stock, lacked the incentive to take an active role in the corporation's affairs. Management then filled the vacuum.[45] Increased disclosure will have no effect on this situation. As Professor Bainbridge has observed:

> Basic financial economics tells us that most shareholders prefer to be passive investors. A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs. Given the length and complexity of SEC disclosure documents, the opportunity costs are quite high and very apparent. In contrast, the benefits aren't at all clear because most shareholders' holdings are too small to have any significant effect on the vote's outcome. For most shareholders, therefore, the investment of time and effort necessary to make informed voting decisions remains a game not worth playing. . . . What then will shareholders do with the enhanced disclosure required by the commission's present proposals? They will do what they always do

[44] *See* William L. Cary & Melvin A. Eisenberg, Cases and Materials on Corporations 142–43 (concise 6th ed. 1988).

[45] *Id.* at 141.

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> with corporate disclosure: ignore it and simply vote for management's director slate and management compensation proposals.[46]

What about the institutional investors whose growing ownership presence in the largest public corporation presents, according to many scholars, so much potential for effecting positive change in corporate governance? Will increased disclosure motivate this group to pursue more reasonable compensation practices? Probably not. First, for reasons to be developed later in this section,[47] it is unlikely that institutional investors, even if awakened from their current economic slumber, will ever achieve the substantial control position in a corporation necessary to direct the affairs of the business. Second, it is unclear that the compensation disclosure now mandated by the SEC will inform institutional investors (or individual investors, for that matter) of anything that they do not already know. As a result of the heightened media attention to the issue, much information on compensation programs in a dizzying variety of corporations (based on past disclosure requirements) has flooded the market-place. Various popular financial publications feature annual performance profiles of numerous public companies detailing compensation practices and how they relate to overall performance.[48] There is no shortage of information available to the individual investor on corporate compensation. Moreover, the performance comparisons the SEC has now required reporting companies to make are well within the analytical capabilities of even the most inexperienced financial analyst and may be available to all investors through periodic brokerage house reports. Indeed, the SEC's new disclosure regime will only serve to create more fodder for potential Rule 10b-5 mis-disclosure actions.[49] The end result may be an

[46] Stephen M. Bainbridge, *Executive Pay: Who Listens?*, Legal Times, Aug. 10, 1992, at 23. *See also* Michael P. Dooley, *Two Models of Corporate Governance*, 47 Bus. Law. 461, 525 (1992) (observing that shareholders are not effective monitors of a company's board of directors and that prominent features of corporate law actually make it difficult for shareholders to hold the board and managers legally responsible).

[47] *See infra* notes 90–100 and accompanying text.

[48] *See, e.g.*, *The Boss's Pay*, Wall St. J., Apr. 22, 1992, at R9; *Executive Compensation Scoreboard*, Bus. Wk., May 4, 1992, at 149; *What 800 Companies Paid Their Bosses*, Forbes, May 25, 1992, at 182.

[49] *See* Bainbridge, *supra* note 46, at 22 (commenting that disclosure rules only benefit plaintiffs' lawyers who will bring lawsuits and defense lawyers who will defend them). To avoid this potential liability, companies have started to hire a variety of different advisors, including law firms, compensation consultants, public relations firms, accountants, investment banks, computer software makers, and publishers of electronic data. Thus, company shareholders must pay for increased disclosure in the form of fees the company pays to these advisors. Joann S. Lublin &

increase in official information available, but with little corresponding benefit.[50] Increased required disclosure will do little to arrest the traditional cause of shareholder passivity and will have an insignificant impact on overcompensation.

B. *Increased Taxation*

The second major response to the compensation controversy has come from the legislature. In early August, 1993, the Congress, upon the recommendation of the President, enacted legislation that placed a one million dollar limit on the deductibility of executive compensation. Under a provision contained within the Revenue Reconciliation Act of 1993, corporations are no longer able to deduct, as a business expense, compensation payments to executives that exceed one million dollars per annum that are not performance-based.[51] Additionally, a special surtax has been imposed on incomes in excess of two hundred fifty thousand dollars per year.[52] The theory seems to be that by removing the deductibility of high salaries, and increasing the taxes due by the recipients of sizeable compensation, corporations and the individual recipients will find it too costly to negotiate excessive compensation packages. The benefits of high compensation to the recipient will be taxed out of existence and the corporation itself will find it twice as expensive to pay such large salaries. Moreover, by setting the taxation tripwire at one million dollars, Congress seems to have concluded that salaries over this level are per se excessive.

Although this approach will certainly "solve" the compensation problem and simultaneously produce heightened revenues for a tax-

Julie A. Lopez, *Executive-Pay Disclosure Rules Pay Off—For Advisors*, WALL ST. J., Jan. 15, 1993, at B1.

[50] Indeed, the new disclosure requirements may even have the deleterious effect of deluging the investor in "data-overkill." Joann Lublin, *Executives Grumble About SEC Plan to Require More Pay Data*, WALL ST. J., Sept. 21, 1992, at B1. The new disclosure requirements, however, appear to have increased institutional investor scrutiny of the compensation practices of at least one company. The Wisconsin public pension fund is seeking to remove the outside directors of Paramount Communications who approved the company's executive compensation plan. The fund is basing its action on charts, required by the SEC, which show that, although Paramount's stock has underperformed both the Standard & Poors 500 stock index as well as peer group stocks, Paramount executives continued to receive bonuses. Susan Pulliam, *Paramount Is Targeted by Pension Fund Due to Weak Stock Price, Executive Pay*, WALL ST. J., Mar. 4, 1993, at A4.

[51] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). See *supra* note 10 and accompanying text for a discussion of the new limitations placed upon corporate deductions for executive compensation.

[52] Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). See *supra* note 11 and accompanying text for an examination of the surtax placed on individual incomes in excess of two hundred fifty thousand dollars.

starved treasury, it will have no favorable impact on corporate health in general. This response is akin to removing a splinter by amputating the limb. The splinter is gone, but at enormous cost. Similarly, this tax-based "cure" may result in more harm to the patient than the initial problem.

First, there is nothing inherently wrong with a salary over one million dollars. An executive who produces substantial increases in corporate profitability that results in large profits for the shareholders, may be worth paying more to retain in the competitive labor market place.[53] The salary is only problematic when it has not been fairly bargained for. Second, a salary not only provides compensation for an individual's efforts, but also acts as an incentive for future activity. Companies compensate both to reward past activities and to encourage greater productivity in the future. The idea emanates from the classic carrot-stick parable. It is not the stick that compels productive labor, but the carrot as incentive. The larger the carrot, the greater incentive to increase productivity.[54] While a large salary may certainly be viewed as a wasteful expenditure of corporate assets if one assumes that wages were simply created to compensate solely for work produced, from a different perspective, heavy compensation may be beneficial to the corporate enterprise as a powerful incentive for heightened management creativity and effort. The larger the proffered salary, the greater effort potentially to be expended. To limit arbitrarily the amount of compensation will effectively eliminate any incentive for the kind of executive productivity necessary to keep our large corporations competitive.

The term compensation itself is a bit of a misnomer, for compensation is not merely a reward for past services, but also acts as an incentive for future efforts. As pointed out earlier, a large salary is not in and of itself pernicious; it is only when it has not been bargained for and is a simple toll paid to the ineffective that it becomes troublesome.[55] To solve the perceived problem of overcompensation by summarily taxing out of existence salaries over one million dollars per year

[53] *See* CRYSTAL, *supra* note 31, at 159–73 (arguing that high-paid CEOs of Reebok, Walt Disney, and H.J. Heinz are properly compensated due to the risk they take and the returns they generate for their shareholders).

[54] *See* LLOYD G. REYNOLDS ET AL., LABOR ECONOMICS AND LABOR RELATIONS 183–84 (1986). *See also* Burchman, *supra* note 25, at 189–211 (discussing ways to create proper incentives through executive compensation). This "carrot" theory of compensation is evidently in operation as IBM searches for a new CEO. Despite IBM's well-publicized problems, it has had little difficulty finding accomplished candidates for the lucrative position. Michael W. Miller, *IBM's Search for New Leader Appears Ahead of Schedule*, WALL ST. J., Feb. 24, 1993, at B1.

[55] *See infra* notes 113–16 and accompanying text.

would stifle the crucial incentives created by the prospect of high, and perhaps seemingly excessive, salary levels.

C. *Judicial Activism*

While some have sought to curtail compensation through heightened disclosure or tax-based legislative limits, one group of commentators has focused on a judicially-based approach.[56] They maintain that active judicial review of executive compensation structures may serve to limit executive salaries. Professor Vagts has argued that while judicial evaluations of "the excessiveness of compensation are not easy to make, they are not impossible. . . . [C]ourts can and should carefully scrutinize compensation that is substantially out of line and prune off the abnormal amount when not justified by special risks run by the executive recipients or special contributions made by them."[57] This approach to the compensation issue is not without some appeal but it may prove to be as ineffective today as it was when the problem first emerged in the mid-1930s.

Board compensation decisions are generally protected by the business judgment rule.[58] Provided that there has been an informed deci-

[56] *See* Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 252–61. Both authors point out the willingness of several courts to grapple with the overcompensation issue by applying comparative data in judging the appropriateness of compensation in close corporation, tax and partnership cases. Although the authors note that there are salient differences between public corporations and close corporations, and between tax cases and derivative actions, they each conclude that courts should be willing to apply the same type of analysis in the context of public corporation overcompensation cases. Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 252–61. *See also* Bogus, *supra* note 12, at 79–83.

[57] Vagts, *supra* note 4, at 276. *See also* Barris, *supra* note 2, at 87. *But see* Geoffrey S. Rehnert, Comment, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1154 n.38 (1985) (observing that courts have not applied reasoning employed in close corporation and tax cases to public corporation cases).

[58] Compensation decisions are in essence "self dealing" transactions because they may be voted on by those inside directors who have an obvious stake in the decision and theoretically should be reviewed under the rules governing self-interested transactions, which require that such transactions must (1) be fully disclosed to the corporate decision-makers and (2) be fair to the corporation in order to pass muster. Because "compensation differs from other self-interested transactions," these rules are applied somewhat differently. Section 5.03 of the [ALI's] *Principles of Corporate Governance*, following the case law, therefore breaks off compensation transactions for separate treatment by adopting the rule that if full disclosure has been made, and the compensation has been approved by disinterested directors, it will be reviewed only under a business judgment standard. Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1006 (1988). Therefore, provided that an executive who is also a director does not vote on his compensation arrangement, the disinterested directors' decision to approve that arrangement will be protected by the business judgment rule. *See* Barris, *supra* note 2, at 81–83.

In Aronson v. Lewis, 473 A.2d 805 (Del. 1983), the Delaware Supreme Court described the business judgment rule as:

> [A] presumption that in making a business decision the directors of a corporation

sion-making process and no self-dealing, a board's compensation award will be judicially unassailable, with one exception. Where compensation to an executive simply bears no relation to the services that individual has rendered, it will be considered a waste of corporate assets and thus actionable.[59] This standard was initially promulgated by

> acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest . . . of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Id. at 812 (citations omitted). The American Law Institute—in its *Principles of Corporate Governance* has defined the rule in the following manner:

> (c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:
> (1) he is not interested . . . in the subject of his business judgment;
> (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
> (3) he rationally believes that his business judgment is in the best interest of the corporation.

PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). *See also* Teren v. Howard, 322 F.2d 949 (9th Cir. 1963); Wall & Beaver Street Corp. v. Munson Line, Inc., 58 F. Supp. 109 (D. Md. 1944); Richardson v. Blue Grass Mining Co., 29 F. Supp. 658 (E.D. Ky. 1939), *aff'd*, 127 F.2d 291 (6th Cir. 1942); Haber v. Bell, 465 A.2d 353 (Del. Ch. 1983).

The Delaware Supreme Court, in *Beard v. Elster*, explained the rationale behind the application of the business judgment rule to compensation decisions:

> We have before us a [stock option] plan which, in the judgment of a disinterested Board, is adequately designed to further the corporate purpose of securing the retention of key employees' services. It is theoretically possible, we suppose, that some businessmen could be found who would hold the opinion that options exercisable at once were improvidently granted, but, on the other hand, there are businessmen who would hold a favorable view, as this board of independent businessmen in fact did. At most, therefore, we find ourselves in the twilight zone where reasonable businessmen, fully informed, might differ. We think, therefore, we are precluded from substituting our uninformed opinion for that of experienced business managers of a corporation who have no personal interest in the outcome, and, whose sole interest is the furtherance of the corporate enterprise.

160 A.2d 731, 738 (Del. 1960), *aff'd sub nom.* Elster v. American Airlines, 167 A.2d 231 (1961).

Section 5.03 of the ALI *Principles of Corporate Governance* provides in part that a court may not invalidate a compensation arrangement if it is "authorized in advance or ratified by disinterested directors . . . in a manner that satisfies the standards of the business judgment rule." PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 5.03(a)(2). Where directors have a personal interest in the fixing of executive compensation, the business judgment rule does not apply and the directors must prove that the transactions were fair to the corporation. Cohen v. Ayers, 596 F.2d 733, 739–40 (7th Cir. 1979) (citing Kerbs v. California Eastern Airways, 90 A.2d 652 (Del. 1952), *reh'g denied*, 90 A.2d 652 (1952); Gottlieb v. Heyden Chemical Corp., 90 A.2d 660 (Del. 1952)).

[59] Even disinterested directors and shareholders cannot ratify waste. Rogers v. Hill, 289 U.S. 582, 591–92 (1933) ("If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority."). Courts usually define "waste" in terms of the adequacy of consideration the corporation receives from the employee in return for the

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the Supreme Court in 1933 in *Rogers v. Hill*,[60] which remains the seminal compensation case.[61] Following disclosures made in the 1930s of substantial compensation paid to executives immediately prior to and during the Great Depression, a number of shareholder actions were brought challenging these compensation practices.[62] The *Rogers* decision determined the approach for judicial review of these claims.

While the "waste" standard articulated by the *Rogers* Court was seemingly simple to comprehend, problems arose in its actual application. The difficulty was, of course, in determining when exactly compensation was unrelated to services rendered. The oft-cited language of a New York State Supreme Court Judge in the legendary *Heller v. Boylan*[63] decision highlights the difficulty of determining what constituted actionable waste:

> Assuming arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring-rod? The conscience of equity? Equity is but another name of human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing this

compensation paid by the corporation. *See, e.g.*, Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984) (holding that stock option plans must contain conditions or surrounding circumstances must be such that the corporation may reasonably expect to receive the contemplated benefit from the grant of options); Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (ruling that the court's examination is limited to discovering whether what the corporation has received from the employee is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation paid). Courts have held that boards have not wasted corporate assets when the boards canceled existing stock option plans and reissued new options to executives at a lower exercise price when the company's stock price declined. *See Cohen*, 596 F.2d at 741–43.

The United States Court of Appeals for the Eighth Circuit, in *International Ins. Co. v. Johns*, ruled that in determining whether a corporation receives "adequate" consideration for payments to an executive, a court must inquire into whether the compensation an executive receives bears a "reasonable relationship" to the services rendered. 874 F.2d 1447 (1989) (citations omitted). The court further stated that to find a reasonable relationship, a court must answer three questions. First, did the corporation benefit from the services rendered? If the corporation received no benefits in exchange for the payments, the compensation plan is waste. Second, was the compensation so disproportionate to the benefits received that a reasonable person would think that the corporation received no quid pro quo? If no quid pro quo resulted, the payments would constitute corporate gifts. Finally, did the services rendered trigger the payments? If some other occurrence triggered the payments, the plan is invalid because it cannot assure performance. *Id.* at 1461–62 (citations omitted).

[60] 289 U.S. 582 (1933).

[61] Barris, *supra* note 2, at 84.

[62] Vagts, *supra* note 4, at 252–53.

[63] Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941), *aff'd mem.*, 32 N.Y.S.2d 131 (App. Div. 1941), *reh'g denied*, 32 N.Y.S.2d 1011 (1942).

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> corporation than its stockholders?
>
> Yes, the Court possesses the *power* to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is no reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.
>
> If comparisons are to be made, with whose compensation are they to be made—executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province.[64]

For these reasons, courts have been highly reluctant to involve themselves in compensation disputes. A compensation decision is not really capable of mechanistic review. It is essentially a business judgment and the same rationale that mandated the creation of the business judgment rule lies behind judicial reluctance to characterize certain payments as "waste." A court is hardly in a better position than an informed, impartial board to determine an executive's worth.[65] Furthermore, the liability that would result from such judicial second-guessing would seriously compromise a board's effectiveness and its ability to recruit prospective members. Thus, since the *Heller* ruling, there have been few reported cases dealing with the compensation levels of executives of large publicly-traded corporations. In those cases, the courts have reached similar results, "either appl[ying] the business judgment rule and endors[ing] the compensation practice, or simply throw[ing] in the towel and refus[ing] to deal with the problem."[66]

Despite judicial reluctance to decide compensation questions in-

[64] 29 N.Y.S.2d at 679–80.

[65] Barris, *supra* note 2, at 82. *See also* Vagts, *supra* note 4, at 254–55.

[66] Barris, *supra* note 2, at 82. *See infra* notes 67–69 and accompanying text. *See also* Barris, *supra* note 2, at 86–88; Vagts, *supra* note 4, at 255–57.

volving large, public corporations, the same reticence is not evident in numerous cases regarding compensation disputes in smaller close corporations. Courts regularly pass on salary fairness, or lack thereof, in this area.[67] In addition, in the tax arena, both tax court and U.S. District Court judges frequently review executive compensation packages to determine the appropriateness of specific corporate deductions for "reasonable" compensation expenditures under § 162 of the Internal Revenue Code.[68] Commentators argue that if the courts have no problem determining the reasonableness of compensation in the close corporation and tax settings, they should extend the same "judicial aggressiveness" to the large corporation compensation cases.[69]

This call for judicial activism, in the face of escalating compensation packages, will remain as unheeded by the courts in the future as it was when initially issued by Professor Vagts more than ten years ago. Although courts have indeed manifested a willingness to review compensation in certain limited contexts, Professor Vagts' call to action underestimates the critical differences between compensation disputes in the close corporation or tax cases and those involving large corporations. The close corporation compensation cases are not disputes about compensation at all. Rather, they are grounded in the attempted oppression of minority shareholders by a controlling shareholder or group of shareholders.[70] In actuality, these cases involve attempts by

[67] *See, e.g.*, Roged, Inc. v. Paglee, 372 A.2d 1059 (Md. 1977); Galler v. Galler, 316 N.E.2d 114 (Ill. 1974), *aff'd*, 336 N.E.2d 886 (1975); Baker v. Cohn, 42 N.Y.S.2d 159 (Sup. Ct. 1942), *modified and aff'd*, 40 N.Y.S.2d 623 (1943), *aff'd as modified*, 54 N.E.2d 689 (1944). *See also* Barris, *supra* note 2, at 87; Vagts, *supra* note 4, at 256.

[68] The Internal Revenue Code states generally that a trade or business deduction shall be allowed for all ordinary and necessary expenses, a provision which includes a "reasonable" allowance for salaries and compensation for services actually rendered. I.R.C. § 162(a)(1) (1988). Factors used by the courts include: the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexity of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable position in comparable concerns; the salary policy of the taxpayer as to all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in recent years. Mayson Mfg. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949). *See generally* WILLIAM E. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 215–20 (2d ed. 1981); David E. Hoffman, *Heeding Significant Factors Improves the Odds for Reasonable Compensation*, 50 J. TAX'N 155 (1979).

[69] Barris, *supra* note 2, at 87; Vagts, *supra* note 4, at 276. *See also* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1896–1906 (1992) (reviewing GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991)) (suggesting that easing the legal standard from "waste" to "reasonable in relation to the corporate benefits expected" will create the possibility of litigation with attendant uncertainty which will result in incentive for restraint by CEOs seeking substantially above-average compensation).

[70] All of the close corporation cases Professor Vagts cites to support his proposition that courts

the controlling shareholders to steer large portions of the corporate profits selfward rather than sharing the fruits of corporate success proportionately with their fellow equity-holders. Instead of dividing the profits evenly through dividends, the controlling individuals enrich only themselves through large compensation packages, leaving fellow shareholders out in the cold, deprived of the benefits of equity ownership.[71]

Whether effected through simple greed or as part of some nefarious "freeze-out" scheme,[72] this manifestly unfair sharing is the type of self-dealing that courts, from an equity standpoint, are eager to remedy. It is not the size of the compensation that provokes a judicial response, but the attempt to divert profits from the minority holders. These shareholders really have no other remedy besides judicial intervention. Because of their minority status, they cannot win a board or shareholder vote on the practice, nor is there any market for their shares. The only potential purchaser is the oppressing majority. In such circumstances, it is a relatively appealing task for a court to intervene and find the compensation unjustified, either forcing a proper sharing of corporate profits with the minority, or a majority buy-out of their shares at an acceptable price. This explains judicial willingness to engage in compensation review in this area. Such judicial involvement is not really about compensation; rather, it involves clear and remedi-

can determine reasonable compensation involved some kind of self-dealing or bad faith conduct. Vagts, *supra* note 4, at 256 nn.114–15 (citing Ruetz v. Topping, 453 S.W.2d 624, 631 (Mo. Ct. App. 1970) (defendant, president of company, raised his own salary; suit brought by defendant's ex-wife who owned half of the company's stock); Fendelman v. Fenco Handbag Co., 482 S.W.2d 461 (Mo. 1972) (majority shareholder directors forced minority shareholder director who founded company out of office and paid no dividends to non-director shareholders; founder returned to former job of cutting linings for purses); Goldman v. Jameson, 275 So. 2d 108 (Ala. 1973) (directors owning 80% of company stock removed minority shareholder from board and did not pay dividends); Binz v. St. Louis Hide & Tallow Co., 378 S.W.2d 228 (Mo. Ct. App. 1964) (after minority shareholder/director sold stock to son, other directors brought in additional directors in violation of stock agreement and raised their salaries)).

In one study, courts found compensation to be excessive in 23 out of 67 close corporation overcompensation cases. Of these 23 cases, all but one involved self-help or self-dealing on the part of the defendant executive. 2 WASHINGTON & ROTHSCHILD, *supra* note 6, at 865–67.

Most courts, before they will substitute their judgment for that of the directors, seem to require that unreasonable compensation be coupled with a clear showing of dishonest, oppressive or improvident corporate management that they can label "fraud," "bad faith," "breach of fiduciary duty," "waste," or "spoliation."

1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 3.08, at 59–60 (2d ed. 1991).

[71] *See, e.g.*, Sugarman v. Sugarman, 797 F.2d 3 (1st Cir. 1986); Bessette v. Bessette, 434 N.E.2d 206 (Mass. 1982); Shelstad v. Cook, 253 N.W.2d 517 (Wis. 1977).

[72] *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513–15 (Mass. 1975) (describing various freeze-out techniques). *See generally* O'NEAL & THOMPSON, *supra* note 70, § 3.07.

able self-dealing. Without the protection of the courts, few investors would be willing to accept minority status in a small corporation, and such enterprises would be deprived of necessary investment capital.

This is not the case in the large public corporation setting where excessive executive compensation deprives shareholders of a relatively small portion of profits and is effected by a group without the kind of absolute control possible in the close corporation arena. In small businesses, it is not uncommon for a control group to possess over 50% of the corporation's stock and effectively block any kind of minority response to unwelcome actions.[73] In the large public corporation, management controls a relatively small amount of stock and can always be outvoted by an outraged shareholdership. This is obviously not an easy task but it is not a numerical impossibility, as is often the case in the close corporation setting. Thus, judicial involvement seems less necessary, as the problem appears less drastic and other remedies are available. Concerns about judicial competence to review compensation reemerge and stifle intervention.[74]

Judicial activism in the taxation cases is also easily distinguished from the ordinary compensation dispute. The general object of any kind of tax litigation is not the punishment of some overreaching executive, but the production of additional revenue for a tax-starved federal treasury.[75] The objective is revenue generation and any judicial

[73] *See Donahue*, 328 N.E.2d at 511 (defining a close corporation as a corporation typified by "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in management"). Holders of a majority of a company's stock have the ability to elect and control a majority of the company's directors and thus have the power to employ a variety of techniques to deprive minority shareholders of the value of their interests in the company. Some examples of these techniques include a refusal to declare dividends, payment of exorbitant salaries to majority shareholder officers, refusal to employ minority shareholders, and sale of corporate assets to majority shareholders at inadequate prices. O'NEAL & THOMPSON, *supra* note 70, § 3.02.

[74] Due to the disparity in size of earnings between a small close corporation and a large public corporation, it is usually easier for a court to determine whether an executive's salary is excessive in the close corporation. For example, a $1 million salary for an executive in a Fortune 500 company is insignificant in relation to the company's bottom line, whereas in a small close corporation, the same salary could constitute a significant percentage of the company's earnings for a given year and thus substantially reduce dividend payments to the company's shareholders. *See* Vagts, *supra* note 4, at 255–56.

[75] The executive compensation cases in this area generally deal with close corporations in which company executives are also controlling shareholders. Section 162 of the Internal Revenue Code is designed to prevent these owner-managers from distributing sums in the guise of salaries (which are deductible by the corporation) that are actually non-deductible dividends and thus subject to corporate-level taxation. *Id.* at 257. Thus, in this area, courts do not focus solely on the reasonableness of an executive's compensation. They are equally, if not more, concerned with a company's dividend policy. *See, e.g.*, McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970) (finding compensation reasonable, yet disallowing deduction because the corporation

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concern about second-guessing a board is secondary to the process. With this in mind, courts review compensation in this arena not with the objective of limiting unreasonable salaries, but to determine the legitimacy of income deductions that reduce tax revenues.[76] The business judgment concerns that accompany judicial review of ordinary compensation actions are simply not present in this area and thus do not create the same judicial reluctance to become involved.

The problem of judicial involvement in large corporation compensation disputes, like that raised in *Heller*,[77] is as valid today as it was fifty years ago. Courts neither feel comfortable nor particularly well-qualified to substitute their business judgment for that of an informed board of directors. Nothing has changed in the past five decades to enable courts to determine with any better precision what part of a salary has been earned and what part constitutes "waste." The Judiciary's discomfort and consequent reticence remain and will continue. There simply is no mechanistic procedure available to compute with precision an executive's worth and any judicial resolution of the matter involves a judgment call of the type courts have typically avoided. Unless a plaintiff can introduce some kind of evidence of fraudulent or collusive behavior on the part of a board in its compensation decision-making process, misconduct which would provide for easy judicial resolution, it is highly unlikely that the courts will abandon their traditional passivity in compensation cases. Judicial activism is simply not a realistic solution to the overcompensation dilemma.

D. *Institutional Shareholder Activism*

Another proffered solution to the compensation problem involves institutional shareholder activism. It is argued that institutional inves-

did not pay dividends the previous five years). *See also* Geoffrey S. Rehnert, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1155 n.38 (1985).

[76] The legal standard in the tax cases is different from the standard in shareholder suits. While shareholders must show that compensation amounts to "waste," the test in the tax cases is merely one of "reasonableness." *See supra* notes 59 and 68.

Professor Vagts observes that very few tax cases involve public corporations. Vagts, *supra* note 4, at 258. This fact is not surprising given that, in most public corporations, compensation is approved by a majority of disinterested directors and has no relation to the company's dividend policy. If a public company does not pay dividends, it usually reinvests the sums into the company for new capital or debt service. *But see* R.J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889, 896–97 (Ct. Cl. 1957) (finding that distributions of profits to employees of a public corporation in proportion to the employees' stockholdings constituted a dividend distribution and not compensation).

[77] Heller v. Boylan, 29 N.Y.S.2d 653 (Sup. Ct. 1941).

tors, who increasingly constitute the largest shareholders in many of the largest public corporations,[78] possess tremendous potential to effect positive change in the operation of these businesses by becoming more active "monitors" of corporate management. The size and financial sophistication of institutional investors make them uniquely positioned to take the lead in promoting corporate productivity. Increased institutional investor activism will result in more effective shareholder oversight of both boards and managers and may prove a solution to corporate inefficiency by stimulating more productive and responsive management. Indeed, much scholarly attention has been devoted to the "promise of institutional investor voice."[79]

The positive potential of active monitoring may also carry over to the compensation area. Professor Black has suggested that despite "systemic shortfalls in corporate performance . . . institutional oversight, either directly or through stronger boards of directors, could correct these shortfalls. . . . Institutional investors could add value by . . . establishing a more arm's-length process for setting CEO pay."[80] As a corporation's largest shareholders, institutions may have the clout to force a board to bargain impartially and effectively with senior management to produce reasoned compensation arrangements. Failure to so act could result in a board's ultimate replacement by a coalition of shareholders spearheaded by the agitated institutional investors. The prospect, or even the actual or perceived threat, of such action would

[78] By the end of 1990, institutions owned 53% of the equity in U.S. companies. In addition, institutions have begun to concentrate their assets in specific companies. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1140 (1991) (observing that the top twenty pension funds plus the ten largest U.S. money managers hold more than 16% of the shares in the 10 largest U.S. corporations) (citing William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70); Black, *Agents*, *supra* note 17, at 827. *See also* Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets*, *in* INSTITUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3–33 (Arnold W. Sametz & James L. Bicksler eds., 1991); Barris, *supra* note 2, at 89.

[79] Black, *Agents*, *supra* note 17. *See also* MONKS & MINOW, *supra* note 2; Barnard, *supra* note 78; Black, *Empirical Evidence*, *supra* note 13; Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (1989); Gilson & Kraakman, *supra* note 17; Louis Lowenstein, *Why Managements Should (And Should Not) Have Respect for Their Shareholders*, 17 J. CORP. L. 1 (1991); Thomas C. Paefgen, *Institutional Investors* Ante Portas: *A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327 (1992); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

[80] Black, *Empirical Evidence*, *supra* note 13, at 899, 915–17.

be strong enough to convince otherwise passive directors to act more effectively.

To encourage this seemingly positive form of monitoring, a number of commentators have proposed various reforms in the legal rules regulating institutional conduct in order to give institutional investors more freedom and incentive to engage in active oversight of corporate activities.[81] In addition, they have formulated numerous techniques for institutional investors to use in their attempts to exercise corporate control.[82] These proposals include: amending various SEC regulations to permit more communication and coordination between institutions;[83] altering regulations governing institutional investment strategy to restrict portfolio diversification to discourage investor "exit" and encourage investor "voice;"[84] creating activist shareholders' advisory committees to make management more aware of institutional concerns;[85] placing representatives of the institutional investors on the corporate boards themselves;[86] or even creating a cadre of professional directors who would serve on corporate boards to demand effective management.[87]

[81] *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (describing the complex web of legal rules and cultural factors that prevent institutional shareholders from becoming more active monitors); Coffee, *supra* note 79 (suggesting that an incentive for institutional monitoring be created by restricting portfolio diversification, requiring fund managers to price investment and monitoring services separately, and authorizing incentive compensation for fund managers); Conard, *supra* note 79, at 176–78 (calling for, among other things, greater access to company proxy statements and the removal of the threat of "controlling person" liability); Dent, *supra* note 79, at 907 (proposing that a committee of a firm's 10 or 20 largest shareholders be given authority to use corporate funds to solicit proxies). *Cf.* Rosenbaum, *supra* note 79 (contending that changes in the proxy rules are unnecessary). *See also* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (observing that U.S. financial institutions cannot reach their full potential as monitors due to a variety of legal prohibitions designed to prevent them from gaining too much power).

[82] See Black, *Agents*, *supra* note 17, at 830–49, for a discussion of the variety of methods institutional investors could employ to affect corporate performance.

[83] *See* Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1991) [hereinafter Black, *Disclosure*]; Conard, *supra* note 79, at 161–62, 177–78; Dent, *supra* note 79, at 907–23.

[84] Coffee, *supra* note 79, at 1351–66.

[85] Participation in a "shareholders' advisory committee" is the most commonly proposed role for the institutional investor. In general, these committees would be composed of representatives of a company's largest shareholders and would be appointed by the board of directors for one-year terms. The committee would advise the board on matters of concern to the company's shareholders and submit proposals from time to time. *See* Barnard, *supra* note 79; Rock, *supra* note 79, at 49. Professor Barnard argues that shareholders' advisory committees will be ineffective monitors of corporate performance and suggests that institutions should place representatives on the board itself, rather than on some "shadow committee." Barnard, *supra* note 79, at 1168–73.

[86] *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209–10 (1988); Barnard, *supra* note 79, at 1168–73; Dent, *supra* note 79, at 907.

[87] Gilson & Kraakman, *supra* note 17, at 883–92.

It is unquestionable that institutional investors have begun to exercise more power over corporate affairs than they did even a few years ago. In a number of large corporations, they have been active agitators for change in corporate policy and personnel. Most recently, a number of the large institutions have played a major role in forcing changes in management and policy at such prominent corporations as IBM, Sears Roebuck, American Express, and even General Motors.[88] Despite this activity, it is unclear whether these groups will either be able, or even desire to be a primary force in effecting change in executive compensation practices.[89] There are a number of reasons why sole reliance on institutions to resolve the compensation controversy would be a mistake.

The first set of problems with institutional action is general in nature. There are several fundamental reasons why institutional investors, as currently constituted, may never be able to monitor corporate activities in the manner envisioned by their supporters. The first concern has to do with investment strategy. Professor Coffee has argued that there is an inherent preference among many institutions to structure their investment portfolios in such a manner as to provide maximum liquidity. Investments are arranged by type and size to provide for quick and easy disposition in the event that conditions warrant. Thus, investments that are not readily saleable are avoided. Such liquidity, the ability to easily exit an investment, effectively eliminates

[88] As its financial outlook has deteriorated, IBM has faced increased shareholder agitation from groups such as the United Shareholders Association (USA). USA plans to press at IBM's annual meeting for the passage of four proxy proposals which deal with management performance, oversight, and compensation. Catherine Arnst & Joseph Weber, *IBM After Akers*, BUS. WK., Feb. 8, 1993, at 22. Sears Roebuck's Edward Brennan relinquished several leadership roles and the company agreed to divest itself of certain business lines in the face of growing shareholder threats. Stewart, *supra* note 21, at 35. Despite the fact that American Express Chairman James C. Robinson III initially persuaded his board to keep him in power in the face of disappointing results, institutional shareholder agitation eventually led to his resignation. J. P. Morgan, joined by Alliance Capital and Putnam Management, was highly influential in forcing Robinson's removal. Leslie Wayne, *Shareholders Exercise New Power with Nation's Biggest Companies*, N.Y. TIMES, Feb. 1, 1993, at A1. It was institutional shareholder pressure that was instrumental in convincing the board of General Motors to demand the resignation of its chief executive, Robert C. Stempel. *Id.* See Stewart, *supra* note 21, for a list of companies that have responded to investor pressure by changing leadership. *See also* Black, *Agents*, *supra* note 17, at 828–29.

In addition, investors such as the Council of Institutional Investors, USA, and several state employee pension funds have all gained the attention of corporate management by creating publicized "hit lists" of poorly-performing corporations. Kevin G. Salwen, *Institutions Are Poised to Increase Clout in Boardroom*, WALL ST. J., Sept. 21, 1992, at B1. A prime example is ITT Corp. which held several meetings with shareholders and agreed to demands that certain management policies be changed, in order to be removed from USA's "hit list." Salwen & Lublin, *supra* note 13.

[89] *See infra* note 100.

any incentive to exercise a meaningful voice in corporate affairs. The institutions

> have considerable reason to remain 'rationally apathetic' about corporate governance and little reason to become active participants. Why? [A] tradeoff exists and must be recognized between liquidity and control. Investors that want liquidity may hesitate to accept control . . . . [A] preference for liquidity chills the willingness of institutional investors to participate in the control of major corporations . . . .[90]

Coffee suggests several structural reforms to lessen the bias towards "exit" and encourage the exercise of "voice"—such as "a restricted diversification strategy which would discourage institutional investors from diversifying beyond the limits of their monitoring capacity."[91] Unless such reforms are implemented, however, the continued predilection towards liquidity lessens the incentive to monitor, which suggests a continuing passivity among the institutions.

The second concern involves size and communication. Although institutional holdings are substantial, particularly in dollar terms, each institution's ownership interest in the various corporations in which it invests is likely to be proportionately quite small.[92] This reflects a preference for liquidity and portfolio diversification as well as legal restraints.[93] As a result, even if a company's stock is held primarily by institutions, these holders, individually, control very little of that company's overall equity. To exercise "control," therefore, a number of institutions would have to agree to form a coalition. This may be problematic. First, each institution may have varying goals regarding its investment in a particular company and its own general investment strategy. No two institutions are precisely alike insofar as participant composition and investment goals are concerned.[94] Consequently, each

[90] Coffee, *supra* note 79, at 1281.

[91] *Id.* at 1338.

[92] For example, even the nation's largest state employee pension fund, Calpers (California Public Employees' Retirement System), only owns .6% of Westinghouse's outstanding shares. Mieher, *supra* note 32, at A3, A6. Indeed, despite its stock portfolio totalling $25 billion, Calpers has limited its holdings to just under a 1% ownership interest in more than 1,000 large U.S. corporations. George Anders, *Restless Natives: While Head of Calpers Lectures Other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at A1, A9.

[93] *See* Coffee, *supra* note 79. *See supra* notes 90–92 and accompanying text.

[94] *See* Brancato, *supra* note 78, at 7–13 ("Institutional investors are not a 'monolithic' group and have widely divergent investment and risk objectives, as well as varying attitudes on their appropriate role in corporate governance."). One commentator argues that public pension funds, which have the greatest power to influence management, are not well-equipped to do so effec-

would likely respond to varying control issues with differing levels of concern. Where interests diverge, coalitions and consequent power may disappear. Second, as some commentators have observed, to act as a group, the varying shareholding institutions must be able to communicate with one another freely. Under present SEC regulations, including the proxy rules, however, such communication may be restricted.[95] Although changes have been suggested and some, in fact, promulgated,[96] it remains to be seen how easily institutional investors may be able to solicit each other's votes or consent so as to act as a group without running afoul of various SEC requirements.

While these problems generally act to restrict institutional activity, another set of difficulties exists that may also limit institutional investor effectiveness in the compensation area. The first concern involves the benefits to be achieved by active compensation review. As discussed earlier, the actual impact on corporate earnings that an excessive salary represents is not likely to be particularly significant.[97] Given the costs in terms of reputational capital expended in a compensation challenge[98] and time required for organization of opposition among the

tively because of their politically-minded leadership. In contrast, private institutions, such as mutual funds, are run by individuals with greater financial expertise, but who have little inclination to influence management. Taylor, *supra* note 78, at 72. *See infra* notes 98–99 and accompanying text. *See also* Anders, *supra* note 92, at A1 (reporting that the head of Calpers is facing pressure from his board, which is composed mostly of state officials, to limit his efforts in influencing poorly performing companies and to concentrate instead on the management of the pension fund itself).

[95] SEC regulations define "proxy" and "solicitation" very broadly so that virtually any statement of opinion to security holders is subject to costly and time-consuming filing requirements. Rules 14a-1(f), 14a-1(l), 14a-6, 17 C.F.R. §§ 240.14a-1(f), 240.14a-1(l), 240.14a-3(a), 240.14a-6 (1992). In addition, all solicitations are subject to antifraud rules which may chill communications in a hotly-contested proxy fight. Rule 14a-9a, 17 C.F.R. § 240.14a-9(a) (1992). Black, *Disclosure*, *supra* note 83, at 53–57. See *infra* note 96 for a discussion of recent changes to these rules. *See also* Black, *Agents*, *supra* note 17, at 820 n.9; Coffee, *supra* note 79, at 1342–45; Conard, *supra* note 79, at 161–62.

[96] The SEC recently eased the rules governing communications among shareholders. The changes include: An exemption from the proxy rules for communications with shareholders where the person soliciting is not seeking proxy authority and does not have a substantial interest in the subject matter of the vote. 17 C.F.R. § 240.14a-2(b) (1992) (amendment to Rule 14a-2(b)). The definition of "solicitation" has been changed so that shareholders can publicly announce how they intend to vote and provide reasons for that decision without having to comply with the proxy rules. 17 C.F.R. § 240.14a-1(l) (1992) (amendment to Rule 14a-1). Solicitations conveyed through the public media are not subject to the proxy rules so long as a definitive proxy statement is filed with the SEC. 17 C.F.R. § 240.14a-3(f) (1992) (amendment to Rule 14a-3). In certain transactions, companies must furnish shareholders with lists of all company shareholders. 17 C.F.R. § 240.14a-7 (1992) (amendment to Rule 14a-7). Regulation of Communications Among Shareholders, Exchange Act Release No. 31326, 57 Fed. Reg. 48,275, 48,276 (Oct. 22, 1992).

[97] *See supra* notes 27–30 and accompanying text.

[98] *See* Yablon, *supra* note 69, at 1893.

various stockholders, it may be that the potential benefit of slightly increased earnings due to lower compensation costs, particularly when diluted among many holders, may not appear worth the effort. Indeed, it would seem more expedient to expend one's energies challenging management on the issues that have a more substantial and fundamental impact on the company's business prospects, such as expansion, asset disposition or even general labor policy, than championing an issue with limited impact on the company's "bottom line."

The second concern involves the interests of those managing the large institutions. As Professor Yablon has pointed out:

> Financial institutions are also run by corporate executives who may be receiving, or be interested in receiving, compensation at levels or in forms not very different from those that are under attack from the various shareholder groups. Such executives are unlikely to mount or join challenges to executive compensation plans because they may feel . . . that the compensation offered to their fellow executives is perfectly appropriate.[99]

Thus, the management structure of some of the institutional investors, may itself serve to limit active compensation oversight.

There is no doubt that institutions are becoming more restless shareholders and have begun to demand a more active role in corporate governance. For the various reasons discussed, however, they may never prove as effective in providing either compensation oversight or even a more general monitoring role. This does not mean that efforts to encourage institutional voice should cease, but this "voice" may not bring as much positive change as earlier envisioned, particularly in the compensation arena.[100]

E. Strengthened Compensation Committees

A final approach that has been offered to resolve the compensation controversy involves a change in the internal functioning of the corporation's board of directors. It has been suggested that there be a reformation of the way in which the board's compensation committee,

[99] *Id.*

[100] Recently, the head of Calpers, Dale Hansen, has received pressure from his board to limit his shareholder activism and direct more of his energy to the pension fund's day-to-day operations. Hansen is viewed as the leader of the shareholder rights movement and his retreat could create uncertainty as to the future activism of other large institutional investors. Anders, *supra* note 92, at A1.

appointed to "review, analyze, and approve or revise compensation proposals,"[101] operates to assure independent and effective oversight. If this committee could be strengthened and made more independent of management, then excessive compensation programs could be defeated before they even reach the full board for consideration. This approach is laudable but ultimately unworkable. The problem lies not in the functioning of this committee, but in the composition of the board itself.

Compensation decisions by a board are generally protected by the business judgment rule.[102] As noted earlier, such decisions are immune from attack if made by disinterested directors following an "informed" decision-making process.[103] As one way of satisfying this requirement, most publicly-held corporations have formed compensation committees, traditionally comprised of several outside directors (those who are not employees of the business) to examine and consider proposals for executive compensation.[104] These committees theoretically evaluate the performance of senior management and make recommendations on compensation formulas to the full board. Frequently, a company's management engages compensation consultants to study the subject company's executive salary scheme and to advise its committee on its appropriateness. These outside advisors examine compensation scales at companies of similar size, similar profitability and in similar industries to determine the reasonableness of each proposed plan.[105] The

[101] Barris, *supra* note 2, at 75. *See also* CRYSTAL, *supra* note 31, at 242–45 (arguing that compensation committees hire their own independent compensation consultants and establish more formal procedures for determining compensation); James W. Fisher, Jr., *The Role of the Compensation Committee*, *in* EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE 1990s 366, 369–71 (Fred K. Foulkes ed., 1991) (suggesting that compensation committees should, among other things, establish a charter which clearly designates the committee's responsibilities and its relationship to management); Lance Berger, *New Initiatives for the Compensation Committee*, DIRECTORS & BOARDS, Winter 1985, at 33 (detailing how compensation committees can become more proactive and link payment strategy and performance of the company). *Cf.* Frederick W. Cook, *Executive Pay and the Board*, DIRECTORS & BOARDS, Spring 1992, at 43 (arguing that compensation committees should not hire their own consultants).

[102] *See supra* notes 58–62 and accompanying text.

[103] *Id.*

[104] Recent studies indicate that between 84 and 99 percent of large publicly-held corporations have compensation committees. *See* Fisher, *supra* note 101, at 366 (citing J.E. Richard, *Compensation Committee Issues, 1989*, DIRECTOR'S MONTHLY, June 1989, at 3); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, at § 3A.05. Compensation committees should be composed entirely of outside directors. *Id.*

[105] The American Law Institute recommends that large publicly-held corporations establish compensation committees to provide oversight on compensation issues. The committees should actively review existing compensation programs and recommend methods that ensure that payments are reasonably related to executive performance. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 3A.05. Traditionally, however, compensation committees have been relatively

presence of only outside directors on such committees and the abstention of interested officers from compensation voting removes any self-dealing taint from such decisions and eliminates any challenge on self-dealing grounds. Moreover, the retention of independent consultants to advise the compensation committee and the committee's recommendations to the full board following extensive discussion with the consultants assure that the informed decision-making process required by the business judgment rule has been met and that the board's compensation decisions will thus be protected.

If compensation committees functioned in the truly independent fashion envisioned in their origination, then there would be little controversy over excessive compensation. The outside directors comprising the committees, bolstered by the efforts of independent compensation consultants, would bargain effectively with management to produce compensation packages that were the result of serious negotiation and not simple acquiescence on demand. Unfortunately, for reasons inherent in present board composition and structure, this is unlikely to occur. As noted earlier, many larger public corporations, due to atomistic shareholding patterns and ineffective communication among shareholders, are subject to management capture.[106] No one

passive. Critics argue that most compensation committees simply rubber-stamp compensation plans submitted to them by consultants hired by management. CRYSTAL, *supra* note 31, at 42–50; Berger, *supra* note 101, at 33–34; Joann S. Lublin, *Compensation Panels Get More Assertive, Hiring Consultants and Sparking Clashes*, WALL ST. J., July 15, 1992, at B1. This passivity may be changing. Twenty percent of major corporations' compensation committees have hired their own compensation consultants to get a second opinion on executive pay plans. *Id.*

According to Professor Crystal, a former compensation consultant, executives use such consultants to justify their salaries to the compensation committee. The compensation consultant has a variety of techniques at his disposal to accomplish this task. First, the consultant will compare the executive's compensation plan with the plans at similar companies to determine whether the executive is being paid competitively. The executive and the consultant can manipulate this process by including in the survey companies which are not obviously similar to the subject company, but which have executives which are paid excessively. In addition, the executive may ask the compensation consultant to limit his company comparisons to certain categories of pay. For example, if the executive has a substantial salary, but does not receive options, he can ask the consultant to survey the option grants of similar companies and not their salary policies, explaining that he will hire the consultant to do a salary comparison next year. Inevitably, the comparisons will reveal that the executive must be given more stock options, even if the executive's base salary dwarfs the salaries of executives in comparable companies. Not only must the executive's pay be competitive, but it must provide the proper incentives. Thus, after determining a competitive level of pay based on comparisons with other companies, the consultant will structure an incentive payment package based on a variety of market and qualitative measures so that the executive will be paid additional amounts for any improvements in the company's performance. CRYSTAL, *supra* note 31, at 42–60. *See also* Burchman, *supra* note 25, at 189; Yablon, *supra* note 69, at 1877–81.

[106] *See supra* note 20 and accompanying text.

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shareholder or shareholding group possesses enough shares to exercise control of the corporation through the election of a majority of the board. Instead, incumbent management, through control of the proxy process, fills the power vacuum and nominates its own candidates for board membership.[107] The board of directors, theoretically composed of representatives of various shareholding groups, is instead peopled by individuals selected by management.

Serving on such boards are the officers themselves, individuals performing various professional services for the corporation, such as lawyers and investment bankers, and, finally, those with no real professional attachment to the enterprise other than board membership.[108] The first two groups, because of their employment or financial relationship to management, may find it difficult to exercise independent oversight. The third group (from which the membership of the compensation committee is recruited) will rarely challenge management prerogative either, although there have been recent exceptions.[109] Such board members are usually selected either by the chairman or other senior management and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors.[110] These directors are often officers of other public corporations[111] and frequently ask their counterparts, whom they oversee, to serve as members of their own boards. Cross-directorships are not uncommon.[112]

There are three problems with such arrangements that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult

[107] *See id.*

[108] See *supra* notes 15–16 and accompanying text for a discussion of the distinction between "inside" and "outside" directors.

[109] *See supra* notes 21 and 32.

[110] *See supra* note 21 and accompanying text. *See also* CRYSTAL, *supra* note 31, at 224–30; Gilson & Kraakman, *supra* note 17, at 884. *But see* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 247 (arguing that directors need not have an adversarial relationship with management to be effective).

[111] Barris, *supra* note 2, at 76.

[112] *Id.* at 76, 78 n.113. A recent study of 788 of the nation's largest public companies conducted by Directorship, a consulting firm located in Westport, Connecticut, found that in 39 of the companies surveyed, the leaders of those businesses served on one another's boards in a "cross-directorship" phenomenon. The study further detailed that in five of those companies, the cross-directorships involved the boards' compensation committees. Cowan, *supra* note 14, at C1. The five compensation committee cross-directorships were B.F. Goodrich Co. and Kroger Co.; Conagra, Inc. and Valmont Industries, Inc.; Kellogg Co. and Upjohn Co.; Sonoco Products Co. and NationsBank Corp.; and Allergan, Inc. and Beckman Instruments, Inc. *Id.*

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to engage in necessary confrontation. It is always tough to challenge a friend—particularly where the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, where one owes one's board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which, given the large fees paid to directors[113] and great reputational advantage to board membership, may function as an effective club to stifle dissension. Such realities hinder effective oversight by a corporation's outside directors. Because the compensation committees are peopled by such outside directors, it is highly questionable whether, on compensation matters, these individuals possess the kind of independence from management necessary to function as effective bargainers for the corporate interest.[114]

Indeed, because of these relational realities, compensation matters are particularly susceptible to management influence. The single most sensitive issue to an employee relating to his employment is compensation. Few issues cause as much excitement or resentment as how much one is to be paid. A confrontation with a manager over compensation has the potential to breed more ill-will towards a complaining director than any other kind of policy dispute. Given the outside director's personal ties to management and the lucrative nature of a board seat, there is very little incentive to engage in a dispute with an executive over salary. Such a confrontation will breed tremendous resentment and may result in that director's failure to be renominated at the next board election.[115] Furthermore, considering that

[113] For example, non-employee directors receive annual compensation in the amount of $33,000 at Exxon, $55,000 at IBM, $48,000 at American Express, and $35,000 at General Electric. Moreover, these non-employee directors usually receive a fee of between $1,000 and $2,000 for each meeting attended. In addition, committee chairmen usually receive a supplemental retainer of between $3,000 and $5,000 per annum. AMERICAN EXPRESS CO., Mar. 14, 1991 PROXY STATEMENT, at 7 (1991); EXXON CORP., Mar. 6, 1992 PROXY STATEMENT, at 5 (1992); INTERNATIONAL BUSINESS MACHINES CORP., Mar. 16, 1992 PROXY STATEMENT, at 10 (1992); GENERAL ELECTRIC CO., Mar. 3, 1992 PROXY STATEMENT, at 13 (1992). *See also* Barris, *supra* note 2, at 78 n.114, 79.

[114] In addition, most compensation committee members do not have the expertise to evaluate compensation packages proposed by consultants properly.

> They are, for the most part, not very adept at statistics and corporate finance, and they may not be able to follow the consultant's sophisticated reasoning. Further, they have no counsel of their own to tell them that what the consultant is saying is or is not true. So they may either fall asleep or look repeatedly at their watches in such a way that the consultant will not fail to notice. CRYSTAL, *supra* note 31, at 50.

[115] *Id.* at 226–27; Barris, *supra* note 2, at 79.

executive compensation has little bearing on a large company's overall profits, why would an individual risk a lucrative board seat on an issue sure to inflame passions but also certain to have minimal impact on corporate performance? Finally, because many outside directors are also officers of other large corporations, it is not in their own self-interest to object too strenuously to generous compensation, for the higher their peers' compensation tends to be, the richer their own packages may become.[116]

This reality makes it extraordinarily difficult for an outside director in a management-dominated enterprise to engage in the sort of active bargaining with executives over compensation that will result in reasonable salary arrangements. Despite the existence of a compensation committee theoretically comprised of "independent" outsiders to monitor compensation, the very composition of most boards in the large public corporation setting limits the effectiveness of that supposedly independent body. A compensation committee is only as independent as its members, and in the typical management-captured corporation, given the predilections of most outside directors, that independence is likely to be minimal.

Despite these problems that may lead to the ineffectiveness of a compensation committee and the full board for that matter, in issues relating to executive compensation, each director is still subject to legal requirements as to conduct that should theoretically compel effective action. Unfortunately, the threat of legal liability has little impact on director behavior or effectiveness. Ideally, a director should carry out his or her responsibilities "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[117] This would seem to compel circumspect and diligent conduct in executive salary negotiations. Under the business judgment rule, however, a director may be found to have met this duty of care, if in making a specific business decision, he or she has acted without self-interest, in an informed manner and with a rational belief that the decision is in the best interests of the corpora-

[116] Barris, *supra* note 2, at 78. *See also* CRYSTAL, *supra* note 31, at 227–28 (observing that a CEO can ensure high compensation by placing other company CEOs with pay packages rivaling his own on the compensation committee).

[117] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(a). Approximately 37 states have adopted statutory duty of care provisions; the rest have a common law duty of care. *Id.* at 200. Most states have adopted a reasonable care standard. *Id.* at n.15. *See also* 2 MODEL BUSINESS CORP. ACT ANN. 3d § 8.30, at 934 (1990); CAL. CORP. CODE § 309(a) (West 1990); N.Y. BUS. CORP. LAW § 717 (McKinney 1986); Graham v. Allis Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *but see, e.g.*, KY. REV. STAT. ANN. § 271B.8-300(1) (Baldwin 1989) ("A director shall discharge his duties . . . [i]n a manner he honestly believes to be in the best interests of the corporation.").

tion.[118] A director who so acts in reaching a business decision is then protected from any legal liability to his or her shareholders.

This standard of care is not very difficult to satisfy, particularly in the compensation area. Provided that the directors are to receive none of the compensation they are voting on and the decision is not "so removed from the realm of reason" as to appear absolutely irrational (few decisions could ever be so characterized), two of the business judgment rule's three elements have been met.[119] Most challenges to a particular board decision involve the third requirement, that an *informed* decision was made. How exactly does one demonstrate that a decision was informed? The Delaware Supreme Court's landmark ruling in *Smith v. Van Gorkom*[120] created a number of important guideposts to informed decisionmaking. In addition to requiring that a board spend a proper amount of time making a particular decision,[121] the court also suggested that the retention of some independent third-party advisor might assist a board in meeting the "informed" requirement.[122] Consequently, a compensation committee's decisions may be labeled "informed" and, thus, protected, upon a showing that the committee has no actual interest in the salary recommendations it is considering, has spent a significant amount of time discussing compensation proposals, and has relied on the advice of a third-party advisor as to the appropriateness of a particular salary package. And, in due course, the full board itself is entitled to rely upon the recommendation of its compensation committee when approving a salary proposal in order to meet its own obligations under the business judgment rule and, thus, reduce any threat of shareholder liability.[123]

The retention of an independent compensation consultant insu-

[118] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(c). Where a director has not made a business decision, such as in cases of omission, the business judgment rule does not apply and the director should be judged under the reasonable care standard. *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

[119] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 16, § 4.01(c) cmt. f.

[120] 488 A.2d 858 (Del. 1985).

[121] *Id.* at 874 (holding that the board of directors was grossly negligent when it approved the sale of the company with only two hours of deliberation).

[122] *Id.* at 876–88. *See generally* Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L. REV. 951 (1992).

[123] *See, e.g.*, International Ins. Co. v. Johns, 874 F.2d 1447, 1460 (11th Cir. 1989) ("[W]hen a board's enactment of a course of action merely effectuates the plans of a disinterested directors' committee, the board's action is *prima facie* subject to the protections of the business judgment rule."). *See supra* notes 58–59 and accompanying text. When a compensation plan is not approved by a majority of disinterested directors, the burden of proof shifts from the shareholder challenging the plan to the directors, who must prove that the plan was fair to the corporation. Cohen v. Ayers, 596 F.2d 733, 739–40 (7th Cir. 1979).

lates both the compensation committee and the full board from liability. Theoretically, the use of a third-party advisor would help to ensure director probity in compensation decisionmaking. This, of course, assumes that the consultant acts in an objective and independent manner when advising the directors. Unfortunately, this is rarely the case. There are two fundamental problems in the structure of the consultant/corporation relationship that undercut objectivity. First, these advisors are generally hired by management and frequently perform multiple tasks for the corporation.[124] Thus, there is a powerful disincentive for recommending a salary structure that management would consider inadequate. It is difficult to cross the party who has engaged you, particularly if the promise of future dealings with that party or friends of that party lie in the offing.[125]

Second, compensation structuring is not a precise art or science. It is based on comparisons with what other business are paying. There is tremendous subjectivity involved in deciding with what businesses the client's compensation structure will be compared. The consultant may look at companies in the same industry, differing types of businesses of similar size, or even companies with a similar profitability picture—the universe is practically infinite, limited only by the number of businesses in existence. Moreover, the relative weight given to each element is also completely up to the advisor.[126] The high level of subjectivity inherent in compensation analysis and the reengagement concerns discussed above, have left consultants prone to management capture in the same way that investment bankers who render corporate fairness opinions lack independence from the corporation that has retained them.[127] As a result, the advice given by a compensation consultant potentially lacks the objectivity and independence neces-

[124] For example, Towers Perrin, the largest compensation consulting firm also designs employee pension and health plans for companies. CRYSTAL, *supra* note 31, at 219–20.

[125] *Id.* at 218–19.

[126] *Id.* at 42–50. *See supra* note 103.

[127] *See, e.g.*, Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (1989); William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523 (1992); Elson, *supra* note 122. *See supra* notes 120–23 and accompanying text.

See also Suein L. Hwang, *Ties That Bind, Fired Tambrands CEO Was Unusually Close to a Consulting Firm*, WALL ST. J., Aug 23, 1993, at A1. Immediately following the ouster of Tambrands Chairman and Chief Executive Martin C. Emmett, the corporation terminated all contracts with Personnel Corporation of America (PCA). PCA, a corporation with which Emmett had close personal ties, is a human resources firm that had been retained to advise the board of directors concerning, among other matters, executive compensation. As a result of PCA's efforts, Emmett received a lucrative benefit package and options to purchase close to 600,000 Tambrands shares. Judith Fischer, publisher of Executive Compensation Reports, says that "it is, or can be, an

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sary to assure a compensation package reasonably related to an executive's professional contributions. This compensation consultant "for hire" phenomenon, particularly when combined with compensation committees comprised of outside directors who may be unwilling to challenge management results in compensation arrangements that are acquiesced to and not bargained for, and, thus, are potentially unreasonable.[128] Unfortunately, these arrangements enjoy legal protection through the operation of the business judgment rule, administered by a judiciary reluctant to involve itself in compensation disputes.[129]

Although a board's use of a compensation committee comprised exclusively of outside directors has the theoretical potential to create reasoned compensation schemes, this solution is entirely predicated on finding outside directors who are unwilling to compromise their objectivity in the face of management capture. This potential may never be realized given the current state of the outside directorship in the typical large public corporation and the ready availability of possibly corruptible outside compensation consultants. How, then, can a compensation committee be made more effective? The solution does not lie in making the consultants more independent of management—their desire for future retention and the subjectivity inherent in the analytic process have rendered this a most difficult goal. Rather, an approach must be found to promote independent and responsible behavior on the part of the outside directors. Simply mandating that compensation decisions be made exclusively by outside directors will accomplish little; only if these directors are truly independent in motivation, will the dispassionate bargaining requisite to reasonable compensation ever occur.[130] Strengthening the compensation committees will have negligible impact, unless those who comprise these bodies are given sufficient motivation to act effectively. This seems unlikely to occur under the current scheme of director appointment and retention.

F. *Summary*

The various proposals for attacking the problem of executive overcompensation, whether involving heightened disclosure, tax-based

incestuous relationship," when a chief hires a compensation consultant to advise the board concerning executive compensation. *Id.*

[128] *See* CRYSTAL, *supra* note 31, at 214–40; *but see* Cook, *supra* note 101, at 43, 45 (observing that the best compensation consultants are not advocates for the CEO, but merely provide independent, objective advice).

[129] *See supra* notes 58–66 and accompanying text.

[130] CRYSTAL, *supra* note 31, at 224–28; Barris, *supra* note 2, at 77–78. *See supra* notes 112–16 and accompanying text.

remedies, judicial involvement, institutional shareholder activism or strengthened board compensation committees will ultimately prove ineffective and, worse still, may even jeopardize corporate well-being. Although they may attack the problem from various angles, these proposals fail to strike at the heart of the issue. The real solution to overcompensation lies with stimulating effective board oversight. This must take place from within the boardroom itself. Solutions that attempt to change board behavior through external pressure may effect some positive results, but they do not tackle the problem that created the overcompensation issue in the first place. The board must act as its own motivational force. External pressure will have an impact only so long as it continues to be applied. Once the pressure is reduced due to public apathy, the problem will resurface. The only long-term solution is to create a corporate regime based on board self-motivation. Only then will the board function as the effective monitoring force both as to compensation and general corporate affairs for which it was originally created.

III. The Equity-Based Approach

The overcompensation controversy is the result of unchecked self-interest on the part of management and passive indifference by the corporation's board of directors. Because personal greed created the problem, a similar appeal to individual interest may resolve it. Externally-based pressure on a board to bargain effectively with management overcompensation, as noted earlier, is an ineffective approach. There is a much simpler and efficacious method to reposition the board as a counter-force to management in the compensation area.

A. *Stock Ownership*

The outside directors must be made to consider executive compensation proposals from the viewpoint of the company's stockholders to whom they are legally obligated instead of from the perspective of ones beholden to management. It is the stockholders who stand to lose the most from unreasonable compensation arrangements. Thus, it is crucial that the company's outside directors re-align their interests and thinking with those of the shareholders. The most effective way of creating such perspective is to appeal directly to these directors' personal pecuniary interests. The outside directors must not remain mere observers of the corporate enterprise, but must become active equity participants. If a director's personal capital is potentially affected by an excessive compensation package, that director is much less likely to acquiesce to such a proposal. It is easy to spend other people's money

freely; it is always much more difficult to be inattentively lavish with what one considers to be one's own funds.

By becoming equity-holders, the outside directors would assume a personal stake in the success or failure of the enterprise.[131] Decisions that had a negative impact upon the business would be collaterally harmful to their own personal financial interests. Thus, director demand for effective management would no longer be the result of compliance with distant legal requirements, or vaguely understood pressures from outside institutions, but would emanate from within. Directors would have a substantial personal interest in creating an efficient and competitive management structure. To demand less would be disadvantageous to their own financial well-being.

Equity ownership would act to counter the pressures placed on the outside directors as a result of management capture. It is very hard to resist the demands of individuals to whom you owe your position when your involvement in the venture is limited to the fee you receive for your services and the continuance of that fee is subject to the will of management. Possessing an actual stake in the venture itself alters the nature of this relationship considerably. In addition to the consideration that the active monitoring of management may lead to eventual replacement, an outside director must also consider that the failure to exercise effective oversight may also result in the diminution of that individual's personal wealth. Under such an arrangement, it would not be quite so easy to simply acquiesce to the demands of management.

Nowhere would the positive effect of a personally-motivated outside directorship be more evident than in the area of executive compensation. Overcompensation is the result of ineffective bargaining.

[131] The benefits of outside director stock ownership have been well-documented. *See, e.g.*, MACE, *supra* note 15, at 61–65 (outside directors who own substantial amounts of stock in their company are more likely to ask discerning questions than non-stockholding outside directors); Louis Fernandez, *Tax Deferral, Capital Gains*, DIRECTORS & BOARDS, Spring 1985, at 51 (discussing tax advantages of stock payments); James J. Fitzsimmons, *A Better Approach to Director Pay*, DIRECTORS & BOARDS, Spring 1992, at 48, 49–50 (directors paid in stock are more closely aligned with shareholders and are in a better position to ensure that top management is paid based on its performance); Edmund W. Littlefield, *A Stake with Restricted Stock*, DIRECTORS & BOARDS, Spring 1985, at 51, 52 ("Paying directors in meaningful amounts of restricted stock gives them a common stake with the shareholders."). *See also* Pearl Meyer, *The Rise of the Outside Director As an Equity Owner*, DIRECTORS & BOARDS, Spring 1986, at 41 (observing that, historically, directors owned large amounts of stock and that companies may be returning to this compensation strategy).

Brown Brothers Harriman's Lawrence Tucker, who served as a director on one particular corporate board that had an average director investment of nearly one million dollars, described that group as a "board that pays attention, . . . I've never seen pocket calculators come out so quickly in my life." *Finance*, INVESTOR'S BUSINESS DAILY, July 7, 1993 at 4.

People without great incentive to press for position rarely do. Equity ownership would align the position of the outside director with that of the group most disadvantaged by unreasonable compensation, the shareholders. It would provide an incentive to bargain not out of a sense of duty to some indistinguishable mass of stockholders, but duty to one's own interest. Given the fundamental fact of human nature that all are susceptible to the vice of envy, no one delights in providing a financial windfall to another, most especially when it comes out of one's own pocket. It is galling enough to see someone overpaid for their efforts; it is all the more galling to be the vehicle for such overpayment, particularly when the ill-gotten gain results in the perceived diminution of one's own wealth. This dynamic would set an appropriate tone for compensation negotiations between management and equity-holding outside directors, and, in turn, create the sort of active bargaining that would lead to more reasoned compensation.

B. *Lengthened Director Terms*

Very often, though, outside directors do in fact hold stock in the companies they serve. If equity ownership has any motivational impact or potential, why then are these directors still so susceptible to management capture? It is not that the possession of an equity position in a venture has no impact on director motivation, but the fact that these directors' stockholdings in their companies are insubstantial compared with the monetary and reputational compensation they receive for board service. In the typical large public corporation, many of the outside directors own relatively small amounts of company stock.[132]

[132] For example, the holdings of a few noted outside directors at several larger public corporations are as follows:

	Director	Shares		Director	Shares
Bank of Boston	Donald Monan	0	Philip Morris	Rupert Murdoch	400
	Thomas B. Wheeler	236		Richard Parsons	500
	Alfred M. Zeien	500	Sears Roebuck	Mandell de Windt	450
IBM	Harold Brown	321		Norma Pace	400
	Nannerl Keohane	321		Nancy C. Reynolds	454
	Richard Munro	421	Ralston Purina	David Banks	200
Mobil	Donald Fites	200		Francis Ferguson	536
Disney	Robert Stern	0			
	Stanley Gold	250			
	Samuel Williams	480			
	Gary Wilson	0			

Bank of Boston Corp., February 26, 1992 Proxy Statement, at 6 (1992); International Business Machine Corp., Mar. 16, 1992 Proxy Statement, at 11 (1992); Mobil Corp., Mar. 18, 1991 Proxy Statement, at 7, 10 (1991); Philip Morris Companies Inc., Mar. 7, 1991 Proxy

Their major stake in the venture is the fee they receive each year for board service. Such fees, particularly in the larger corporations, may well exceed $40,000 per annum—no small reward for a position involving the attendance of only a few meetings a year.[133] In addition, the social and reputational advantages for board service are obvious. The more prestigious the company on whose board an individual sits, the more influential one is considered in the business community, leading to other opportunities for financial benefit.[134] Outside directors may sometimes supplement their fees with lucrative consulting contracts provided by solicitous management. The most glaring example of this phenomenon occurred during the leadership of F. Ross Johnson, the legendary CEO of RJR/Nabisco, who had placed several outside directors on the company payroll prior to the leveraged buy-out that eventually cost Johnson his job.[135]

Generally, the cumulative annual fees paid to each outside director, particularly when considered over the multi-year terms of typical board membership, involve considerably more money than the usual value of that director's stockholdings in the business. Most business decisions involve a consideration of both the costs and benefits of the contemplated strategy. When an outside director makes a decision that challenges management prerogative, that director, in a management-controlled enterprise, risks retribution from the dominant executives that might involve the failure to be renominated to the board at the next election. Obviously, before making such a decision, the director

Statement, at 12 (1991); Ralston Purina Co., December 10, 1991 Proxy Statement, at 8–9 (1991); Sears Roebuck & Co., Mar. 21, 1991 Proxy Statement, at 6 (1991); Walt Disney Corp., Dec. 27, 1991 Proxy Statement, at 2 (1991).

[133] Remuneration for non-employee directors often exceeds $40,000 including their annual retainer, the fee received for attending meetings, and any additional compensation they may receive for chairing committees. *See supra* note 113. Often remuneration goes beyond annual compensation and payments for meetings attended. For example, each non-employee director at Eastman Kodak is covered by group term life insurance in the amount of $100,000. Non-employee directors at American Express, who have served at least five years, are eligible to receive $30,000 per annum upon their retirement from the board. These payments continue for a number of years equal to the time served on the board or until death. Similarly, General Electric's non-employee directors, who have served at least five years, are over 65 years of age, and retire directly from the board, are eligible to receive either an annual payment for life equal to the amount of the last retainer received or a $450,000 life insurance policy. American Express, Mar. 14, 1991 Proxy Statement, at 7 (1991); Eastman Kodak Co., Mar. 18, 1991 Proxy statement, at 8 (1991); General Electric Co., Mar. 3, 1992 Proxy Statement, at 13 (1992). *See* Bruce Overton, *Remuneration of Outside Directors*, *in* Executive Compensation: A Strategic Guide for the 1990s 383 (Fred K. Foulkes ed., 1991).

[134] *See* Mace, *supra* note 15, at 87–91; Overton, *supra* note 133, at 383.

[135] *See* Bryan Burrough & John Helyar, Barbarians at the Gate 97–98 (Harper Perennial 1991). At the time of the LBO, RJR Nabisco's outside directors were among the highest paid directors in American industry. Overton, *supra* note 133, at 388.

will, consciously or not, weigh the various benefits such a decision entails, with any attendant costs. Where a director's stockholdings in a given corporation are substantially less than the income that a director receives in fees, the potential loss of such fees may weigh more heavily in that director's mind than any beneficial increase in stock value that might result from the corporate efficiencies created. This would explain management "capture" even in situations where the outside directors have equity positions in their companies. The key, then, is not merely stock ownership but *substantial* ownership.

At what threshold do holdings become "substantial"? To have a salutary impact on director behavior, equity ownership by outside directors must be significant enough to affect a director's decision-making process. An outside director's shareholding position must be large enough that, in deciding a particular course of action, concern about how that decision will positively affect equity value will subsume traditional desires to placate fee-paying management. A director's personal shareholdings must weigh more heavily in that individual's decision-making process than fee maintenance concerns. The value of that individual's equity interest in the business must exceed the amount to be obtained through continued fee income. If a director's personal interest in the company's stock were to exceed the annual compensation and prestige value of board membership, perhaps that individual would be less willing to side continually and complacently with management when such behavior could have a negative impact on the company's market value and, thus, on his or her personal holdings. We must make it in the director's own self-interest to challenge and monitor management. A large equity position in the business would go far toward accomplishing this goal. But how can we create a stake large enough to induce favored behavior?

To create the appropriate equity incentive, the corporation should simply pay the directors their annual fee in company common stock. As compensation for the exercise of oversight as a board member, it seems only natural that each director should be rewarded with an interest in the business itself. In addition, the company should make a limited cash payment to each equity-compensated director to cover any income taxes that may be imposed as the result of such stock grants. To prevent the quick liquidation of these stock payments and consequent loss of equity-based incentive, the stock awarded must be restricted as to resale during the individual's directorship.[156]

[156] To alleviate any potential liquidity concerns that a director may have as the result of such restriction, the corporation may allow the individual to pledge the restricted stock as collateral for either a company-sponsored or third-party loan.

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Although such a compensation system will create substantial stockholdings in the hands of the previously complacent outside directors, a few problems remain. As noted earlier, to have any sort of favorable impact on director behavior, the amount of stock that each director holds must be reasonably substantial. The key is to provide each individual with a block large enough to induce active monitoring. Although a director's yearly fee may purchase a large amount of stock, it may not be enough to create the kind of stake that will counterbalance the fear of replacement that management challenge may bring. Therefore, a director's term of office must be expanded significantly. Instead of being elected to a term of one to three years, directors should instead serve for five-year terms. In addition to minimizing the immediacy of any management replacement threat, such a term will create in each director both an immediate equity stake and, without yearly re-election concerns, the promise of a fixed number of future stock grants. Five years' worth of fees paid in company stock should result in the accumulation of a reasonably substantial equity position for each director.[157] Moreover, because of the fixed five-year term, the beneficial impact of equity ownership will manifest itself throughout the period of board service. A director will either possess the stock itself or the expectancy of a certain five-year accumulation that will provide similar incentive.

The quinquennial election of directors is not a new proposal. Martin Lipton and Steven Rosenblum, two prominent corporate practitioners, have recently advocated such a change in board structure, along with a host of other major governance reforms.[158] They suggest that the creation of a five-year fixed term of office will create a corporate "long-term view" highly beneficial to corporate "vitality."[159] The main goal of their proposal, however, involves the creation of a corporate governance model "that will lead managers and stockholders to work cooperatively towards the corporation's long-term business suc-

[157] For example, if a director is paid $35,000 per annum, at the conclusion of his term, he should own $175,000 in company stock. If he receives $50,000 per year, he would complete his term with $250,000 worth of stock.

[158] Lipton & Rosenblum, *supra* note 110, at 187. The quinquennial election of directors is one part of Lipton and Rosenblum's proposal for comprehensive reform of the present corporate governance system. Their proposal would also bar nonconsensual changes in control between elections; provide major shareholders with access to corporate proxy materials relating to elections of directors; require a detailed five-year report on the company's performance and a prospective five-year plan; and tie management compensation awards and penalties to the corporation's performance against the plan. *Id.* at 190.

[159] *Id.* at 216.

cess."[140] Their arguments advocating term expansion focus primarily on creating a management/shareholder "long term" cooperation relationship, rather than corporate productivity through active director oversight.[141] Despite this goal, their call for a longer range perspective on company affairs, an obvious by-product of five-year director terms, is a laudable and desirable result. Who can really argue with management and boards of directors making decisions with the long-term health of the enterprise in mind? Some of Lipton's and Rosenblum's other proposals, especially those promoting the hindrance of changes of corporate control, are more problematic. They should not detract, however, from the potential benefits of quinquennial director terms. If five-year terms can be combined with equity grants, an effective incentive for active director monitoring will be created, resulting in greater productivity and responsibility to the equity-holders in the executive compensation area.

There are two potential drawbacks, however, to lengthened director terms. First, such terms may make corporate changes of control much more difficult to accomplish, and second, they could lead to the possible entrenchment of ineffective or even disloyal directors. These problems are not as dramatic as they would appear at initial glance. First, shareholders always have the right to remove a director for cause,[142] a power which should resolve the problem of the disloyal or inattentive director. Second, provision could be made to allow shareholder removal of directors without cause, which should ease any potential chilling effect of the proposal on changes of corporate control. However, given the more active director behavior this proposal should entail, changes of control would not appear so necessary to compel effective management. Moreover, the "long view" perspective such a lengthened term may provide to the outside directors, no longer subject to the pressures of annual election, also weighs heavily in its favor. Directors, now possessing a five-year time horizon, will find it easier to make decisions that offer the promise of strong returns over the long term, even though they may have a negative impact on profitability in the short-run. The five-year term has, thus, great potential.

[140] *Id.* at 189.

[141] *Id.* at 224–52.

[142] *See, e.g.*, Campbell v. Loew's Inc., 134 A.2d 852 (Del. Ch. 1957); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954). Some state statutes have modified the common law rule and allow shareholders to remove directors without cause. *See, e.g.*, CAL. CORP. CODE § 303(a) (West 1990); REV. MODEL BUSINESS CORP. ACT § 8.08 (1984); N.Y. BUS. CORP. LAW § 706 (McKinney 1986). *See also* CARY & EISENBERG, *supra* note 44, at 153–54.

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C. *Potential Costs*

Of course, as no approach to resolving a particular corporate problem comes without its costs, we must consider the negative impact an equity-based approach may entail. One difficulty that increased equity-ownership may create involves the possible chilling of positive risk-taking behavior by the outside directors. A business will only prosper by the amount of risk management is willing to take. The greater the risk taken, the greater the potential return to the shareholders. It may be argued that outside directors who own large amounts of company stock, particularly those with limited outside assets, will have such a significant portion of their personal wealth tied to company stock that they will have an incentive to demand that management adopt a more conservative risk-taking posture. While such an approach may preserve the value of these individual's personal holdings through the steady maintenance of corporate assets, it will concurrently deter the sort of aggressive behavior that brings the potential of significant profit and asset growth. Unfortunately, these individuals would have no opportunity to increase their personal tolerance to risk through the portfolio diversification techniques other investors utilize, because they would be forced to hold unsalable restricted stock.

This problem, although not insignificant, is not as troubling as it would initially appear. It assumes that the commitment of a large portion of one's assets to a single enterprise inevitably leads to conservative behavior. This is not always the case. Many successful entrepreneurs have most of their personal wealth invested in their businesses. This does not discourage, but rather acts to encourage risk, for the ultimate goal of wealth accumulation that motivates these individuals cannot be met without risk. They achieved success through risk and their stockholdings encouraged still greater risk because of the potential to share in the larger returns such risk brings. What about those in business who are not entrepreneurial in spirit, but who possess a more restrained, managerial bent? For such individuals, unless they possess significant holdings in other ventures, the commitment of a large portion of their personal wealth to the company on whose board they sit may discourage risk-taking. On the other hand, can it be said that a fee-based compensation program will act conversely to stimulate risk-taking behavior? Not necessarily. In fact, this is why there has been a shift in recent years to creating compensation programs for corporate management that result in executive equity accumulation rather than simple cash payments. One goal is to encourage risk-taking, rather than position preservation.[143] Creating equity positions in outside directors may have the same impact.

Although some individuals are risk-averse by nature (and, indeed, the presence on a board of such persons may even be a welcome counterbalance to those with excessive dare), it is not at all clear that the payment of directors' fees in cash encourages risk-positive behavior. As noted earlier, in the typical management-captured corporation, the expectation of continued fee income leads to passive conduct ultimately harmful to corporate productivity. Risk averse individuals are particularly susceptible to such pressure. Creation of an equity-based incentive as an antidote to director passivity may produce the positive impact on behavior that will far outweigh any potential danger of elevated risk aversion among a few individuals. In fact, the impact may be risk neutral (for some may be inherently risk-averse) or even risk-positive.

A second disadvantage of equity-based director compensation may be the exclusion from the pool of potential directors of those who would rather be compensated for their activities with cash. It could be argued that by refusing to compensate in cash, a corporation could deprive itself of the services of a large group of talented individuals. No such loss would occur by paying cash fees, for a company could attract the involvement of both those who desire cash and those who would prefer equity (these individuals could easily convert their cash payments into company stock). This argument misses the point. It was the payment of fees in cash that, in the management-captured enterprise, created the passivity that led to oversight-driven productivity problems in the first place. A director who would demand only cash and refuse to take an equity position in the enterprise might be just the sort of individual who should not serve as a monitor of management behavior.[144] Of course, a director is not giving up the right to

[143] *See, e.g.*, Michael C. Jenson & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 141 ("By controlling a meaningful percentage of total corporate equity, senior managers experience a direct and powerful 'feedback effect' from changes in market value."); Stephen F. O'Byrne, *Linking Management Incentives to Shareholder Wealth*, J. CORP. ACCT. & FIN., Autumn 1991, at 91, 97; Alisa J. Baker, *Stock Options—A Perk That Built Silicon Valley*, WALL ST. J., June 23, 1992, at A20; Gilbert Fuchsberg, *Former Critic of Big Stock Plans For CEOs Now Supports Them*, WALL ST. J., Dec. 16, 1992, at B1; *but see* Amanda Bennett, *Taking Stock: Big Firms Rely More on Options but Fail to End Pay Criticism*, WALL ST. J., Mar. 11, 1992, at A1.

[144] One commentator states that he will not serve on public company boards unless he can make a substantial cash investment in the company. This large investment allows him to get involved in nearly every facet of the business, which in turn creates a chance to earn a substantial

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compensation by being paid in stock. The form of compensation is simply being varied. Indeed, to decline to serve simply because of a non-cash form of payment suggests the sort of purely mercenary mentality that has led to the entire problem of management capture. A board made up of individuals willing to demonstrate a real commitment to the shareholders they were elected to serve by taking an equity position in the enterprise is a corporation's best hope. An equity-based director compensation system will lead to the type of board composition that will maximize management productivity. And reasoned executive compensation will be a beneficial by-product of this approach.

D. *The Empirical Evidence*

Central, of course, to the effectiveness of an equity-based solution to the compensation dilemma is the assumption that stock ownership has a positive impact on director behavior. For this approach to succeed, there must be a link between equity ownership and more motivated director behavior. An empirical examination of the executive compensation voting behavior of boards composed of outside directors with substantial stockholdings, compared with boards whose outside members do not possess large equity stakes, may act to demonstrate the potentially positive impact of an equity-based approach.

Business Week magazine, in conjunction with Standard & Poor's Compustat Services, Inc., conducts an annual survey of 500 of the nation's largest publicly-traded corporations in an attempt "to measure how closely" executive compensation by those companies "matches performance."[145] The study uses two separate approaches to rate performance. The first compares an executive's compensation package with the business's total return to shareholders in stock appreciation and dividends over a three-year period. The second measures compensation against corporate profitability for the same time period. The survey is conducted by assigning each company examined to one of nine industry groups. A comparison is made among those companies in each group based on how their individual compensation programs compared with shareholder return and company profit. A "performance rating" is then assigned to each company surveyed for each of the two categories examined. Each business is thus rated on a scale of 1 (indicating the best performance) to 5 (indicating the poorest). "The

return as well as decreases the chance of lawsuits from other shareholders. William A. Sahlman, *Why Sane People Shouldn't Serve on Public Boards*, HARV. BUS. REV., May-June 1990, at 28.

[145] Byrne, *supra* note 2, at 148.

top 15% of the sample receives a 1, 25% a 2, 30% a 3, 20% a 4, and 10% a 5."[146]

Assuming that this survey, conducted by two independent organizations, possesses even minimal validity in its assessment of the relationship between pay and performance, it provides an excellent starting point for an empirical examination of the link, if any, between "reasoned" compensation and outside director stock ownership. Of the 500 companies examined in the *Business Week* study, approximately 158[147] were selected that possessed, in either one of the two categories examined, either the poorest possible rating ("5") for compensation in relation to performance, or the best ("1"). The proxy statements of

[146] *Id.*

[147] Allied Signal, Inc.; Alltel Corp.; Amerada Hess Corp.; American Express Co.; American Home Products Corp.; American International Group, Inc.; Amgen, Inc.; AMP, Inc.; Apple Computer, Inc.; Arco Chemical Co., Atlantic Richfield Co., Automatic Data Processing, Inc.; Avon Products, Inc.; Baker Hughes, Inc.; Baltimore Gas & Electric Co; Banc One Corp.; Bear Stearns Companies, Inc.; Beckton Dickinson & Co.; Berkshire Hathaway, Inc.; Betz Laboratories, Inc.; Biomet, Inc.; Bristol-Myers Squibb Co.; Burlington Northern, Inc.; Burlington Resources, Inc.; Capital Cities/ABC, Inc.; Carolina Power & Light Co.; Caterpillar, Inc.; CBS, Inc.; Centerior Energy Corp.; Central & South West Corp.; Chase Manhattan Corp.; Chemical Banking Corp.; Chrysler Corp.; Citicorp; Coca-Cola Enterprises, Inc.; Commonwealth Edison Co.; Compaq Computer Corp.; Consolidated Rail Corp.; Cooper Tire & Rubber Co.; Costco Wholesale Corporation; CPC International, Inc.; CSX Corp.; Deluxe Corporation; Detroit Edison Co.; Digital Equipment Corp.; Dominion Resources, Inc.; Dow Chemical Co.; Duke Power Co.; Eastman Kodak Co.; Ethyl Corp.; Exxon Corp.; Federal Express Corp.; Fifth Third Bancorp, First Chicago Corp.; First Interstate Bancorp, Fleet/Norstar Financial Group,Inc.; Ford Motor Co.; FPL Group, Inc.; Franklin Resources, Inc.; Freeport-McMoran, Inc.; General Electric Co.; General Motors Corp.; Genuine Parts Co.; Golden West Financial Corp.; Great Lakes Chemical Corp.; Hewlett-Packard Co.; Hillenbrand Industries, Inc.; H.J. Heinz Co.; Home Depot, Inc.; Honeywell, Inc.; H & R Block, Inc.; Intel Corp.; International Business Machines Corp.; International Flavors & Fragrances, Inc.; ITT Corp.; Keycorp; Kimberly Clark Corp.; Liz Claiborne, Inc.; Long Island Lighting Co.; Lyondell Petrochemical Co.; Maytag Corp.; MBIA, Inc.; McCormick & Co., Inc.; MCI Communications Corp.; Mead Corp.; Medco Containment Services, Inc.; Mellon Bank Corp.; Merrill Lynch & Co., Inc.; Microsoft Corp.; Mobil Corp.; Molex, Inc.; Morgan Stanley Group, Inc.; Nalco Chemical Co.; National Medical Enterprises, Inc.; Newmont Gold Co.; New York Times Co.; Nike, Inc.; Novell, Inc.; Nucor Corp.; Nynex Corp.; Occidental Petroleum Corp.; Oracle Systems Corp.; Pacificorp; Pall Corp.; Paramount Communications, Inc.; Pennsylvania Power & Light Co.; Pennzoil Co.; Phelps Dodge Corp.; Philip Morris Companies, Inc.; Pioneer Hi-Bred International, Inc.; Premier Industrial Corp.; Primerica Corp.; Ralston Purina Co.; Reebok International, Ltd.; Roadway Services, Inc.; Rubbermaid, Inc.; Safeco Corp.; Salomon, Inc.; San Diego Gas & Electric Co.; Schlumberger, Ltd.; Scott Paper Co.; Sears Roebuck & Co.; Southern Co.; Southern New England Telecommunications; Stanley Works; St. Jude Medical, Inc.; Stone Container Corp.; Stryker Corp.; Suntrust Banks, Inc.; Syntex Corp.; Tambrands, Inc.; TECO Energy, Inc.; Telecommunications, Inc.; Tribune Co.; Tenneco, Inc.; Texaco, Inc.; Texas Instruments, Inc.; Texas Utilities Co.; Torchmark Corp.; TRW, Inc.; T2 Medical Incorporated; Tyco Laboratories, Inc.; Union Camp Corp.; Union Carbide Corp.; Union Pacific Corp.; UAL Corporation; United Technologies Corp.; Unocal Corp.; Upjohn Co.; U.S. Bancorp; Walt Disney; Waste Management, Inc.; Wells Fargo & Co.; Westinghouse Electric Corp.; Willamette Industries, Inc.; Winn-Dixie Stores, Inc.; Wisconsin Energy Corp.; Wm. Wrigley Jr. Co.

each of these selected corporations were then reviewed to ascertain how much company stock was held by each of the companies' outside directors. This study then compared the stockholdings of outside directors serving on the boards with the worst ratings (indicating overpaid executives) with the holdings of outside directors on the boards of companies with the best ratings (indicating reasonably paid executives). This comparison was an attempt to test the hypothesis that outside directors on the boards of companies that pay their executives in a "reasoned" manner are more likely to have substantial equity holdings in those companies than outside directors on the boards of companies with "overpaid" executives. It was then determined how many companies in the two groups were run by boards in which outside directors with individual holdings valued in excess of $10,000[148] constituted a majority of the full board and thus theoretically controlled that institution. This procedure was repeated for holdings valued in excess of $25,000, $50,000, $100,000, $125,000, $150,000 and $200,000.

The results, presented in Table I, tend to confirm the initial hypothesis on the relationship between equity holdings and effective compensation oversight. The greater the value of outside director holdings, the more likely it was that the corporation surveyed would be managed by "reasonably" compensated executives. In the group of companies with overcompensated executives, as the value of the stockholdings of the outside directors increased, the number of companies with directors holding such equity positions decreased dramatically. At the $10,000 level, 83.1% of the companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped substantially to 42.2%, and at the $100,000 level, the percentage fell to 18.2%. Finally, in the $200,000 category, the highest level surveyed, only 6.5% of the companies in the overcompensation grouping had outside director equity holdings at that value level.

The results for those companies in the "reasonable" compensation category differed significantly. To be sure, there was, as the dollar criteria grew, a decline in the numbers of companies meeting the standards at each level. The decline, however, was not nearly as steep or dramatic as in the overcompensation model and bottomed out at a significantly higher base percentage. At the $10,000 level, 75.3% of the

[148] The stock prices used to calculate the dollar value of the outside directors' stockholdings reflected the closing market values of the various stocks as of July 9, 1992. WALL ST. J., July 9, 1992, at C3–5.

TABLE I

Total Number of Companies in Survey: 158

Number of Companies with overcompensated executives: 77

Number of Companies with reasonably compensated executives: 81

Number of Boards controlled by directors who own substantial amounts of company stock:

	Overcompensated	Percentage of total companies in overcompensated grouping	Reasonably compensated	Percentage of total companies in reasonably compensated grouping	Deviation Factor
>$10,000	64	83.1%	61	75.3%	.906
>$25,000	50	64.9%	45	55.6%	.857
>$50,000	33	42.9%	39	48.1%	1.121
>$100,000	14	18.2%	26	32.1%	1.764
>$125,000	11	14.3%	22	27.2%	1.902
>$150,000	9	11.7%	19	23.5%	2.009
>$200,000	5	6.5%	15	18.5%	2.846

companies surveyed had outside director stockholdings meeting the relevant criteria. At the $50,000 level, the percentage dropped to 48.1%, and at the $100,000 level, the percentage stood at 32.1%. Finally, in the $200,000 category, 18.5% of the companies in the "reasonable" compensation grouping had outside director equity holdings at that value level.

While at the lower levels of stockholdings, $10,000-$50,000, the results in both groups were rather similar, it was when the base holdings reached the $100,000 level that the two groups diverged significantly and the effect of equity ownership on compensation patterns appeared to have the greatest impact. At the $100,000 level, only 18.2% of the companies in the overcompensation grouping met the equity-holding criteria; at $150,000, only 11.7%, and at $200,000, just 6.5%. This differed significantly from those companies in the "reasonable" compensation grouping where, at the $100,000 level, 32.1% met the criteria, at the $150,000, 23.5%, and at the $200,000 level, 18.5%. As the stockholding levels grew, the spread between the two groups increased significantly. At the $100,000 level, there were almost twice as many companies with "reasoned" compensation schemes than those overcompensating their executives. And at the highest level, the spread between the two grew to almost three times in number.

What, then, do these numbers demonstrate and how do they relate to an equity-based solution to the overcompensation problem? The results of this survey suggest that at lower levels of outside director equity ownership—that is, less than $50,000—the impact of equity ownership on director behavior seems inconsequential. But as the value of director holdings increases, the two groups experience substantial divergence in result. Substantially fewer of the corporations that are overpaying their executives, at least by the standards of the *Business Week* study, are run by boards numerically dominated by outside directors with substantial equity holdings in those businesses—that is, greater than $100,000 per director. Many more of the companies that are reasonably compensating their directors have boards numerically controlled by outside directors with large stockholding positions. At the $200,000 level, there are almost three times as many companies that "reasonably" compensate their executives as those in the overcompensation category. Although this is obviously not a survey of great scientific precision, it does suggest that there may be some connection between heightened equity-ownership and more effective compensation oversight. The more substantial the holdings become, the greater the appearance of a link between stock ownership and the kind of effective monitoring that leads to reasoned compensation. This fact gives support to the theory that the creation of substantial equity positions in the outside directors may lead to more effective compensation oversight.

Missing, of course, from an interpretation of the results of the study, is any indication of the effect of a five-year board term on director behavior. None of the 158 companies surveyed had such a term structure. What does appear from the results, however, is an indication of the positive impact not simply of stock ownership, but of substantial stock ownership. The key to more effective compensation monitoring, then, is to create in each outside director a substantial equity position in the business itself. The payment of director fees in stock, in combination with five-year terms of office, will create such holdings. As noted earlier,[149] implementation of this plan will result in outside director stakes in the larger corporations of at least $175,000, or even higher, which, as indicated in the survey, is well above the level at which positive benefit appears to begin.

The empirical evidence yielded by this study, does suggest that in the realm of executive compensation, companies with boards composed of outside directors with significant shareholdings, are less susceptible to the charge of executive overcompensation than those companies that do not. Fewer of those companies that are believed to overcompensate their executives, have outside directors with significant holdings in the business than those enterprises with levels of executive pay that are viewed as proportionate to services delivered. An alignment of the directors' interests with those of the shareholders, rather than with management, through the development of large shareholding positions resulting in more effective oversight, would explain this phenomenon. Thus, an equity-based approach to the compensation controversy seems potentially helpful and warranted.

IV. Conclusion

Executive overcompensation is a serious problem that weakens the corporate enterprise and undermines public confidence in the management of our largest institutions. It is primarily the result of ineffective monitoring and bargaining on the part of corporate boards of directors. Unlike a number of governance issues, it is not susceptible to effective solution through the normal operation of market forces. Overcompensation is not merely a problem in and of itself. Rather, it is symptomatic of a more serious problem within the corporation—that

[149] *See supra* note 137 and accompanying text.

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of a management unresponsive to shareholder welfare because it is unchecked by appropriate monitoring and oversight by an active and involved board. Such self-interested management, motivated primarily by personal gain, may create the kind of ineffective corporate enterprise that will result both in diminished shareholder profit and lessened overall societal wealth. Eventually, when corporate productivity declines sufficiently to provoke a market-based response to the situation—the wholesale replacement of management—the problem of overcompensation will be remedied. But by the time this occurs, the damage to the enterprise that ineffective management brings will already have taken place and, in the highly competitive world market, may prove fatal to the enterprise. Thus, in practice, a market-based solution may come along too late to save the enterprise, and is an ineffective remedy to the problem.

This destructive result need not occur. The key is to prevent the problem from ever developing, not to "solve" it once it has manifested itself and lessened shareholder value. A number of solutions to executive overcompensation have been proffered including heightened disclosure, tax-based remedies, judicial involvement, institutional shareholder activism, and strengthened board compensation committees. Several of these approaches attempt to eliminate the problem without attacking the root causes, thus creating the potential for its eventual reemergence. All, unfortunately, will ultimately prove ineffective, and some even potentially harmful to corporate well-being.

The most effective solution lies in stimulating effective board oversight. We must reinvigorate the board from within; each director must function as his or her own motivational force. The only real long-term solution to the compensation controversy is to create effective management monitoring based on board self-motivation. Such internal motivation will result from substantial equity-ownership on the part of the outside directors. To create the sizeable shareholdings that may achieve such positive monitoring, directors should be paid their annual fee in company stock. To ensure that the holdings grow large enough to induce the desired behavior, this equity-compensation proposal must be combined with a quinquennial term of office for each board member. Director stock ownership may not prove the comprehensive cure to the overcompensation problem, but the costs of this approach are minimal and it is a good beginning. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most importantly, a healthier, more competitive corporation.

OBLIGATIONS OF "FAIR PRICE" AND "FAIR VALUE" IN CORPORATE ACQUISITIONS

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SECTION Q

OBLIGATIONS OF "FAIR PRICE" AND "FAIR VALUE" IN CORPORATE ACQUISITIONS

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I. Introductory Note.

This "outline" consists of: (a) In Section II, brief description of examples of settings in which lawyers involved acquisitions must deal with present value concepts; (b) In Section III, an in-depth analysis of "fair price" (a concept from the jurisprudence of corporate fiduciary duties) and "fair value" (a concept from appraisal statutes) by the author in his law review article, Rutheford B Campbell, Jr., *Fair Value and Fair Price in Corporate Acquisitions*, 78 N. Car. L. Rev. 101 (1999); and (c) In Section IV, a couple of important Kentucky cases, which will demonstrate, hopefully, the kinds of problems lawyers will face as they attempt to deal with complicated valuation problems in the face of older decisions that may not reflect properly modern finance theory and modern developments from other jurisdictions.

II. Examples of settings in which lawyers must deal with "fair value" and/or "fair price" questions.

A. Transactional lawyer representing a special negotiation committee in an affiliated acquisition.

E.g., Majority shareholders (70% owners) of Corporation cause a freezeout of the minority shareholders through merger of Corporation into NewCo,. Majority shareholder of Corporation own 100% of NewCo. The purpose of the freezeout is to eliminate sufficient numbers of shareholders to qualify for S Corporation status. Prior to the transaction, Corporation was earning, after taxes, $1 million. Because of the elimination of the income tax at the corporate level following the freezeout, NewCo will earn approximately $1.3 million. Prior to the freezeout, Corporation has 200 shareholders and thus is very thinly traded.

B. Transactional lawyers representing the board of a target company in a friendly all cash acquisition.

E.g., In a friendly, negotiated deal, Aggressor offers to acquire Target in a transaction structured as a statutory merger for $10 per share. In determining whether to approve this offer and recommend the merger to its shareholders, Target's board must measure Aggressor's $10 offer against some measure of the "fair" value for Target. Thus, if the "fair" value for Target is more than $10 per share, the board's fiduciary duty requires that it reject the offer. Legal rules determine how "fair" value is to be measured.

C. Litigator representing shareholders of a target company in a suit alleging breach of fiduciary duty or exercising appraisal rights (or both).

In order, for example, to determine whether the litigator should accept a settlement offer, obviously the litigator must understand the legal rules applicable to the calculation of fair value and fair price.

III. Rutheford B Campbell, Jr., *Fair Value and Fair Price in Corporate Acquisitions*, 78 N. Car. L. Rev. 101 (1999).

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FAIR VALUE AND FAIR PRICE IN CORPORATE ACQUISITIONS

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In statutory corporate acquisitions, dissenters' rights entitle shareholders of acquired corporations to obtain a "fair value" for their consideration, while common-law fiduciary duties ensure that such shareholders receive a "fair price" in the transaction. Courts, however, have had difficulty defining and measuring fair value and fair price, leaving this area of the law in disarray. This Article reviews the current framework of appraisal rights and fiduciary duties and proposes refined definitions of fair value and fair price that are based on attractive moral and economic values widely shared by society. The proposal respects the expectations of shareholders and provides guidance for the proper measure of valuations in acquisitions.

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INTRODUCTION

In a statutory corporate acquisition,[1] the stockholders of the acquired corporation are entitled to receive adequate consideration for their stock.[2] This right is protected by state appraisal statutes, pursuant to which stockholders who are unhappy with the terms of the acquisition can exercise their dissenters' rights[3] and thereby receive cash equal to the "fair value" of their shares.[4]

Stockholders of the acquired corporation also are protected by common-law fiduciary duties, which ensure that they receive a "fair price" for their shares. The term "fair price" grew out of the common law of corporate fiduciary duties as applied in affiliated acquisitions, in which a court is required to consider fair price as a part of its evaluation of the acquisition under the intrinsic fairness test.[5] Even

1. Most corporate statutes provide expressly for acquisition through merger, share exchange, and sale of assets. *See, e.g.*, MODEL BUS. CORP. ACT §§ 11.01–12.01 (1998). Today, approximately 24 states have adopted some form of the Model Business Corporation Act (MBCA or "Model Act"), and seven states have corporate acts based on an earlier version of the MBCA. *See* MODEL BUS. CORP. ACT ANN. at xxvii (Supp. 1997).

2. Stockholders on the acquiring side of the transaction also may be entitled to receive fair value through appraisal in certain instances. *See, e.g.*, MODEL BUS. CORP. ACT § 13.02(a)(1).

3. *See, e.g.*, *id.* § 13.02(a)(1)–(3).

4. *See, e.g.*, *id.* § 13.01(3) (defining "fair value"); *id.* § 13.02(a) ("[S]hareholder[s] . . . [are] entitled to . . . fair value.").

5. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710–15 (Del. 1983); *see also infra*

non-affiliated, arm's length acquisitions, however, generate a fair price requirement,[6] as the directors of Trans Union Corporation learned in *Smith v. Van Gorkom*.[7] Fundamentally, the Trans Union directors in *Van Gorkom* failed their common-law fiduciary duty because they did not take reasonable steps to ensure that the stockholders of Trans Union received a fair price for their stock in an arm's length transaction.[8]

Resolving matters of fair value and fair price is difficult for courts.[9] For example, cases involving the resolution of what constitutes fair value and fair price require courts to make financial calculations involving complex judgmental[10] and theoretical[11] issues

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note 32 and accompanying text (describing the intrinsic fairness test).

6. *See infra* note 33 and accompanying text (explaining a manager's obligation to ensure a fair price for the shareholders).

7. 488 A.2d 858, 893 (Del. 1985).

8. In *Van Gorkom*, the board of Trans Union approved, subject to a shareholder vote, the acquisition of Trans Union by the Pritzker interests at $55 per share. The court noted that the "high and low range [for the trading price of Trans Union's stock] for 1980 through September 19 (the last trading day before announcement of the merger) was $38 1/4 to $29 1/2." *Id.* at 866 n.5. The Delaware Supreme Court held that, even though the sales price was well above the trading price the day before the merger, the board's approval of that acquisition violated the business judgment standard because the board had not used reasonable care to investigate the proposed acquisition. *See id.* at 874; *see also infra* note 30 (providing a concise statement of the business judgment standard). Subsequently, the Trans Union director-defendants became parties to a $23.5 million settlement of the Trans Union stockholders' claims. *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 627 (7th ed. 1995).

9. Commentators also try to define and explain fair price and fair value. Predictably, those who are devotees of the law and economics movement ("Contractarians") are driven by their fundamental assessment of the dominating importance of economic efficiency and the need to get assets into the hands of the most efficient users. *See, e.g.*, Benjamin Hermalin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEGAL STUD. 351, 370 (1996) (arguing against protection for minority shareholders in buyout transactions because such protection prevents optimal asset investment). Contractarians, accordingly, are less concerned about a "fair" sharing of value than about providing sufficient economic incentives for, and removing all impediments to, the flow of assets into the hands of the most efficient users. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700–15 (1982) (arguing in favor of, and defending as fair, an unequal sharing of gains from corporate control transactions).

Other commentators opposed to, or at least strongly suspicious of, the Contractarians' views and factual assumptions ("Regulators") consider major corporate restructuring as a transaction rich in opportunities to treat certain stockholders unfairly. Regulators, therefore, as compared with Contractarians, typically have an expansive view of fair price and fair value and define those terms in ways designed to ensure some "fair" sharing of the benefits of transactions with all stockholders. *See, e.g.*, Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 345 (1974) (arguing fairness requires that gains from mergers be shared among all interested parties).

10. Present value calculations require many factual predictions or guesses about future events. The Securities and Exchange Commission (SEC) opinion in the *Atlas*

that can be puzzling for courts unaccustomed to the world of corporate finance. Nevertheless, courts in recent years have done much better in dealing with such issues, especially in states such as Delaware, where much of this litigation takes place.[12] With some facility, courts now often deal with financial concepts as complicated as the Capital Asset Pricing Model,[13] a circumstance that is a far cry from the primitive analyses utilized by courts in earlier periods.[14]

Notwithstanding such progress by courts in the area of financial calculations, fair value and fair price cases continue to be perplexing, and some of the most difficult issues for courts involve the allocation

Pipeline case, although not involving an acquisition, provides a classic example of such guesswork. *See In re* Atlas Pipeline Corp., 9 S.E.C. 416, 421–40 (1941). In *Atlas Pipeline*, the SEC significantly underestimated the value of Atlas apparently because the SEC judged inaccurately the probability that the United States would enter into World War II. *See* VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY AND CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 31–32 (4th ed. 1993) (providing information regarding the unpredicted commercial success of Atlas during the wartime economy).

11. "Theoretical" matters are not always distinct from "judgmental" matters. The intent here, however, is to establish a "theoretical" rubric that includes, for example: (1) whether present value should be determined by utilizing earnings calculated under generally accepted accounting principles or, alternatively, whether cash flows should be used to establish present value, *see* Walter J. Blum & Wilber G. Katz, *Depreciation and Enterprise Valuation*, 32 U. CHI. L. REV. 236, 238–42 (1965); and (2) whether an appropriate capitalization rate for a company should include unsystematic or unique risk, this latter issue arising when valuation of a company is measured by some form of the Capital Asset Pricing Model, *see* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 183–88 (5th ed. 1996).

12. Professors Macey and Miller reported some years ago that 40% of all New York Stock Exchange Companies were incorporated in Delaware and that 82% of all reincorporations went to Delaware. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 483 (1987). Various theories are offered for the preeminence of Delaware in corporate charters. For a description of these theories, see *id*, *passim*, and Roberta Romano, *The State of Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 720–25 (1987).

13. *See, e.g.*, Cede & Co. v. Technicolor, Inc., No. Civ. A. 7129, 1990 WL 161084, at *23–24 (Del. Ch. Oct. 19, 1990) (mem.), *rev'd on other grounds*, Cede & Co. v. Technicolor, Inc. ("Technicolor IV"), 684 A.2d 289 (Del. 1996). For an explanation of the Capital Asset Pricing Model, see BREALEY & MYERS, *supra* note 11, at 183–88, 990.

14. Earlier cases in which courts provided inadequate analyses for their valuations of corporations or ownership interests in corporations include *Hottenstein v. York Ice Machinery Corp.*, 136 F.2d 944, 952–53 (3d Cir. 1943), *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418, 422–25 (D. Del. 1944), *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198, 205 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944), *Goldman v. Postal Telegraph, Inc.*, 52 F. Supp. 763, 771 (D. Del. 1943), *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 151–52 (Del. Ch. 1943), *State v. Bechtel*, 31 N.W.2d 853, 864 (Iowa 1948), *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341, 347–50 (Mich. 1949), *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215, 216–17 (N.J. Ch. 1944), *aff'd*, 39 A.2d 431 (N.J. 1944), *Kamena v. Janssen Dairy Corp.*, 31 A.2d 200, 202 (N.J. Ch. 1943), *Zobel v. American Locomotive Co.*, 44 N.Y.S.2d 33, 37 (N.Y. Sup. Ct. 1943), *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89, 99–100 (R.I. 1969), *Matteson v. Ziebarth*, 242 P.2d 1025, 1033–36 (Wash. 1952) (en banc).

of the significant financial gains often generated by acquisitions.[15] In such instances, courts must resolve the matter of how much, if any, of the value created by an acquisition is included in fair value and fair price and accordingly shared with the shareholders of the acquired corporation.

To a significant extent, courts' difficulties in dealing with such matters are the result of their inability or unwillingness to articulate fundamental underlying principles for fair value and fair price determinations. Without such principles, outcomes lack consistency and predictability and also may lack sound moral or economic footing.

The impact of unprincipled decision-making falls in the first instance on the parties involved in corporate acquisitions. Consider, for example, a simple affiliated transaction in which a subsidiary corporation is to be merged into its parent, and, under the terms of the definitive merger agreement, the minority public shareholders of the subsidiary are to receive $10 per share in cash for their stock. The board of directors of the subsidiary typically is required to evaluate the offer and, if the deal is to go forward, must recommend the merger to the subsidiary's shareholders.[16] If the offer of $10 per share is less than a fair price for the stock of the subsidiary, the board is in danger of violating its fiduciary duty to the subsidiary's shareholders if it recommends the transaction. The board, therefore, must measure its conduct against the criterion of fair price. As a corollary, shareholders of the subsidiary, in voting on the acquisition, also will evaluate whether the offer of $10 per share amounts to fair value and fair price. If the offer falls short of fair value or fair price, then the shareholders are not limited to the proffered exchange and may have valuable claims against the corporation and its managers.

The definitions of fair value and fair price, however, have significance beyond the particular parties to the transaction. Because the meanings assigned to fair value and fair price impact both the allocative efficiency[17] of society's assets and the fairness of the

15. *See infra notes* 72–96, 107–28 and accompanying text.

16. For example, under the Model Act, the board of the acquired corporation is required to "adopt" the plan of merger and "recommend" the plan to the corporation's shareholders. *See* MODEL BUS. CORP. ACT §§ 11.01, .03.

17. In this piece, economic efficiency is used to mean an allocation of assets or rights to those who are willing and able to pay most for them. This definition is widely used. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12–16 (5th ed. 1998). I do not mean to imply that Judge Posner believes that the pursuit of economic efficiency is necessarily morally attractive. Other definitions of economic efficiency are discussed in Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509,

distribution of those assets among its citizens, society also has a strong interest in the proper definition of those terms.

Using the simple example above, the parent is encouraged to undertake the merger if it is able to freeze out the public minority shareholders at a low price, because the lower the price is the more the parent nets from the transaction. If one assumes that the parent is the most efficient user of the subsidiary's assets (an assumption, of course, that is not legitimate in all cases), the low price encourages the movement of assets into the hands of the most efficient user.[18] The low price under those factual assumptions, therefore, promotes an efficient allocation of assets.

At the same time, however, the distributive impact on the parties involved in a freeze-out of the minority shareholders at a very low price may be morally unacceptable to some. Assume an extreme case in which the market value of the subsidiary stock prior to the affiliated merger is $10 per share and the parent undertakes the freeze-out at $1 per share. The distributive impact of that transaction, even if it leads to an economically efficient allocation, may be morally unacceptable to many.[19] Setting fair value and fair price at an amount well above $1 per share in such a transaction is one way society can eliminate such distributive inequality.

The purpose of this Article is to articulate fair value and fair price in a manner that is intelligible, as well as morally and economically attractive. The principles underlying this analysis are

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512 (1980).

18. This type of analysis also is proffered as support for an argument against management's deployment of antitakeover tactics in the face of a hostile bid for a company. Because such takeovers are viewed as a situation in which assets (the target) flow into the hands of more efficient users, and because defensive tactics can increase the price that the bidder will have to pay for the target, some commentators argue that defensive tactics will reduce the economic incentive for more efficient users to attempt to acquire underutilized assets. Much of the thinking and debate on these matters can be found in Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981), Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978), and Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

19. In *Economic Analysis of Law*, Judge Posner specifically disavows an opinion on the morality or desirability of pursuing economic efficiency (i.e., pursuing an allocation of assets in which assets are in the hands of those willing to pay most for the assets). He views his book as a positive work and admits, or at least suggests, that a state of economic efficiency may or may not be morally attractive. *See* POSNER, *supra* note 17, at 15, 30. In another work, however, he defends the moral attractiveness of economic efficiency as a goal of society. *See* Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 488–502 (1980).

based on a reasonably strong version of consent. If one is able to find that the corporate constituencies, shareholders in this case, consent to a particular measure of fair value and fair price, then holding the shareholders to their bargain is morally attractive and economically sound. Morally, permitting shareholders voluntarily to allocate rights to share in wealth in the event of an acquisition of their company is consistent with principles of both utilitarianism[20] and Kantianism.[21] Similarly, permitting shareholders to trade with regard to such rights is the very essence of the creation of economic wealth.[22]

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20. To use a simple example, assume initially that Shareholder A has the right to receive all the corporate synergy generated by an acquisition. If Shareholder *A* prefers cash to the synergy right and Shareholder *B* prefers the synergy right to cash, a purchase of Shareholder *A*'s synergy right by Shareholder *B* must make each happier, otherwise they would not trade. Total utility, therefore, is increased by the trade, assuming that the trade generates no disutility for third parties. Uiilitarianism in a modern setting is discussed in J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANSM, FOR AND AGAINST (1973), and H.L.A. Hart, *Between Utility and Rights*, 79 COLUM. L. REV. 828, 829–31 (1979). It is worth noting, however, that utilitarianism has been subjected to intense criticism from various quarters. *See, e.g.*, POSNER, *supra* note 17, at 13 ("The fact that one person has a greater capacity for pleasure than another is not a very good reason for a forced transfer of wealth from the second to the first."); Coleman, *supra* note 17, at 511 (summarizing popular criticism of utilitarianism); Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 216 (1980) ("[U]tilitarianism, as a general theory of either value or justice, is false and its present unpopularity is well-deserved.").

21. See JEFFRIE G. MURPHY & JULES L. COLEMAN, PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE 70–82 (rev. ed. 1990), in which the authors present a compact and thoughtful discussion of Kantianism as a basis for legal rules. Broadly, Kantianism refers to analyses based on the work of Immanuel Kant, although Murphy and Coleman warn that what they present as "Kantianism" "is in no sense attempted to be a literal presentation of the views of Immanuel Kant." Instead, they present "a kind of moral view that is highly Kantian in spirit." *Id.* at 99 n.6.

The following quotations from Murphy and Coleman are helpful to illuminate the meaning of Kantianism, as it is used in this Article: "Kantianism . . . is the view that the rational choice in ethics is always the choice that respects the rights of autonomous persons freely to determine their own destinies, even if respect is bought at the cost of a loss of happiness or well being." *Id.* at 71. Kantianism is respect for individual autonomy, based on "our status as free and autonomous creatures with the capacity to make choices that are rational in a special sense." *Id.* at 77. If, therefore, individuals consent to a particular allocation of rights in the event of acquisitions, and society respects their bargain or trading on the matter, then society is acting in a manner that is respectful of individuals and their autonomy and, thus, in a manner that broadly is consistent with Kantianism.

Judge Posner has used a somewhat similar argument to link consent with Kantianism and ultimately with his view of the moral attractiveness of the pursuit of wealth maximization. *See* Posner, *supra* note 19, at 488–502.

On Kant more generally, see JEFFRIE G. MURPHY, KANT: THE PHILOSOPHY OF RIGHT (1970) (presenting a critical discussion of Kant's philosophy).

22. Judge Posner, for example, describes trading as a "basic economic principle" necessary to achieve economic efficiency and to create wealth. *See* POSNER, *supra* note 17, at 12–17. This is easily explained. If one defines economic efficiency as an allocative

Part I of this article is a brief overview of appraisal rights and corporate fiduciary duties applicable in acquisitions. Part II highlights the confusion and uncertainty of present definitions of fair value and fair price and provides a foundation for later discussions by parsing the corporate value that is available for division among stockholders in acquisitions. Part III then describes the present state of the law regarding stockholders' rights to fair value in appraisal proceedings and fair price in fiduciary duty cases. The Part, to a large extent, explains today's rules by reference to the corporate value parsed in Part II. Part IV offers refined definitions of fair value and fair price. These refined definitions also are described by reference to the parsed value of Part II and, hopefully, are founded on attractive moral and economic values that are widely shared by society.

I. APPRAISAL RIGHTS AND FIDUCIARY DUTIES IN ACQUISITIONS

Both appraisal statutes and fiduciary duty rules protect the right of an acquired corporation's shareholders to receive some fair measure of corporate value in a statutory acquisition. Accordingly, a brief overview of appraisal rights and fiduciary duties as they apply to corporate acquisitions is a helpful way to begin.

A. *Appraisal Rights*

Corporate statutes provide appraisal rights for stockholders whose companies are acquired in statutory acquisitions.[23] Appraisal rights are predicated solely on the nature of the particular transaction and are available without regard to any wrongdoing or conflict of interest on the part of persons or entities involved in the particular covered transaction.[24] Accordingly, a dissatisfied stockholder of a

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state in which resources or rights are in the hands of those willing to pay the most for them, then economic value or wealth is created by moving resources or rights from the hands of those who are not willing to pay most into the hands of those who are willing to do so. Rules that facilitate such trades, therefore, lead to economic efficiency and the creation of economic wealth or value.

23. *See* 2 AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 291–99 (1994) [hereinafter ALI CORP. GOV.] (describing the history of appraisal proceedings, the breadth of the remedies available in various states, and the actual use of appraisal proceedings in acquisitions).

24. The Model Act, for example, permits stockholders to exercise appraisal rights in several transactions, including mergers, share exchanges, sales of substantially all assets other than in the regular course of business, and certain amendments to the company's articles of incorporation that significantly affect the rights of stockholders. *See* MODEL BUS. CORP. ACT § 13.02.

All states provide for statutory appraisal rights. *See* ALI CORP. GOV., *supra* note 23, at 292. Not unexpectedly, variations appear among states. *See* Hideki Kanda & Saul corporation acquired, for example, in a statutory merger is entitled to have the acquiring company pay her or him cash for the securities that are exchanged in the acquisition,[25] provided, of course, that the dissatisfied stockholder follows the complex procedures that typically are part of the state's appraisal regime.[26]

Shareholders of an acquired corporation who perfect their appraisal rights are entitled to receive cash equal to the "fair value" of their shares.[27]

B. Fiduciary Duties

Shareholders of acquired corporations are also protected by fiduciary duty principles. Fiduciary duty claims by disgruntled shareholders of corporations that are acquired in arm's length acquisitions typically are evaluated under the business judgment standard.[28] The standard requires corporate managers to perform their tasks, including the facilitation of acquisitions, in good faith and without any significant conflict and reasonably to investigate the proposed action.[29] If these criteria are met, the ultimate decision of an acquired corporation's managers to pursue a particular acquisition of their company under particular terms violates their fiduciary duty

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Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 445–61 (1985) (examining the variety in various appraisal statutes by contrasting appraisals in Delaware, New Jersey, and New York). The Reporter's Notes to the American Law Institute *Principles of Corporate Governance* observe generally that "[a]ll jurisdictions grant dissenters' rights in at least some mergers" and specifically that "[f]orty-four jurisdictions expressly grant an appraisal remedy in connection with certain sales amounting to all or substantially all the firm's assets," while "[t]wenty-five jurisdictions expressly grant an appraisal remedy for certain amendments to the certificate of incorporation." ALI CORP. GOV., *supra* note 23, at 296–97. For an outstanding description of the evolution of the appraisal remedy, see Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 11–23 (1995).

25. The Commentary to the *Principles of Corporate Governance* states that the "better justification" for the right to appraisal is "that it can curtail unfair conduct by those controlling the corporation through an ex ante provision that does not involve high monitoring costs." ALI CORP. GOV., *supra* note 23, at 293.

26. *See, e.g.*, MODEL BUS. CORP. ACT. §§ 13.20–.31.

27. *See id.* § 13.02(a). Recently, proposed amendments to the appraisal provisions of the Model Act were promulgated. These amendments, if adopted by the states, would change both the scope of the appraisal proceedings availability and the definition of "fair value." *See* MODEL BUS. CORP. ACT. §§ 13.01–.31 (Proposed Changes 1998), *available in Proposed Changes in the Model Business Corporation Act—Appraisal Rights*, 54 BUS. LAW. 209, 251–67 (1998).

28. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), is probably the most famous case applying the business judgment test to acquisitions. *See supra* note 8.

29. *See infra* note 30.

only if that judgment is so bad as to amount to something similar to gross negligence.[30]

On the other hand, an acquisition undertaken in a conflict of interest setting, such as a corporate parent's acquisition through a statutory merger of a public minority's interest in its subsidiary, is evaluated under the intrinsic fairness test.[31] Under the intrinsic fairness test, the decisions of the acquired (subsidiary) corporation's managers and its controlling stockholder (parent) to facilitate or undertake the acquisition are evaluated against a more general concept of fairness. In considering whether the acquisition is fair, courts look at two elements, fair price and fair dealing. In the final analysis, however, fairness is considered as a whole and not as a function of its individual elements.[32]

In all cases, whether or not a conflict is present, managers' conduct in acquisitions is measured against some fair price criterion. In cases without a conflict, corporate managers' facilitation of an acquisition of their company at an unfair price will violate their fiduciary duty under the business judgment standard, unless the managers are able to defend the loss flowing from their malfeasance by establishing some level of due diligence. This defense, of course, does not detract from the primary obligation of managers to garner a

30. The *Principles of Corporate Governance* state that a director or officer meets his duties under a business judgment test if the director or officer "makes a business judgment in good faith" and:

> (1) is not interested . . . in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.

ALI CORP. GOV., *supra* note 23, § 4.01(c).

The standard under the *Principles of Corporate Governance* by which the actual judgment of the director or officer is evaluated is described in section (3), above, as "rationally believes." The Delaware Supreme Court defines that standard as one of "gross negligence." This Article uses the Delaware Supreme Court's definition. *See, e.g.*, *Van Gorkom*, 488 A.2d at 873. The difference between "rationally believes" and "gross negligence" is uncertain.

31. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

32. *See id.* Later language, however, clouds the applicability of this approach. In *Cede & Co. v. Technicolor, Inc.* ("*Technicolor II*"), 634 A.2d 345 (Del. 1993), the court stated that, under an intrinsic fairness analysis, the defendants "must establish . . . that the transaction was the product of *both* fair dealing *and* fair price." *Id.* at 361 (emphasis added). The language was repeated in *Cinerama, Inc. v. Technicolor, Inc.* ("*Technicolor III*"), 663 A.2d 1156, 1162 (Del. 1995). Later in the *Technicolor III* opinion, however, the court referred to the "unified approach to entire fairness mandated by established Delaware law" and, still later, to the "non-bifurcated components of entire fairness." *Id.* at 1172.

fair price for the acquired corporation, but instead merely protects directors if their fault level is low. Cases involving a conflict apply the intrinsic fairness doctrine, and the fair price obligation is even more direct. In these cases, unless managers of the acquired corporation obtain a fair price for the stock of the acquired corporation, the managers risk a determination that the transaction was not intrinsically fair.[33]

C. *The Relationship Between Appraisal Rights (Fair Value) and Fiduciary Duties (Fair Price)*

Courts generally have determined that the measure of fair price is different from the measure of fair value.[34] With the possibility of two different measures of recovery, depending upon the path a disgruntled shareholder takes, cases inevitably arise addressing whether a disgruntled stockholder subjected to an acquisition may obtain one remedy or the other.[35]

Stated succinctly, courts usually hold that appraisal with its fair value remedy is the exclusive remedy for disgruntled stockholders in an acquisition, unless the transaction involves some measure of unfair dealing.[36] Accordingly, when the controversy is only about price and

33. Although the fiduciary standard by which managers' conduct is evaluated appropriately changes, depending on whether such managers are acting in a conflict or a non-conflict setting, the constancy of the fair price requirement across all such decisions makes sense. Fundamentally, the fair price requirement is based on the managers' broad obligation to maximize shareholder wealth, and that obligation of managers is ubiquitous. Thus, managers' approval of any acquisition of their company, irrespective of the existence of conflict, always must maximize shareholder wealth in order to meet the managers' fiduciary obligation. In other words, managers must always ensure that shareholders receive a fair price for their shares.

The discussion in the balance of this Article relies primarily on affiliated acquisitions, which typically involve managers in conflict decisions and thus subject them to the intrinsic fairness test. No attempt is made to distinguish or discuss separately conflict and non-conflict cases. Notwithstanding this emphasis in the discussion, the analyses and this Article's ultimate proposal respecting the appropriate measure of fair price are intended to be applicable to both conflict and non-conflict situations.

34. *See infra* notes 45–132 and accompanying text.

35. In *Cede & Co. v. Technicolor, Inc.* ("*Technicolor I*"), 542 A.2d 1182, 1188–89 (1988), the court held that a disgruntled shareholder may pursue both appraisal and a breach of fiduciary claim in one lawsuit, although double recovery is not permitted.

36. *See* Rabkin v. Phillip A. Hunt Chem. Corp., 498 A.2d 1099, 1104–05 (Del. 1985); *Weinberger*, 457 A.2d at 714; Seagraves v. Urstadt Property Co., No. Civ. A. 10307, 1996 WL 159626, at *8 (Del. Ch. Apr. 1, 1996) (mem.); Cooper v. Pabst Brewing Co., No. Civ. A. 7244, 1933 WL 208763, at *2 (Del. Ch. June 8, 1993) (mem.). Statutes also typically deal with the exclusivity of appraisal proceedings. *See, e.g.*, MODEL BUS. CORP. ACT § 13.02(b) (stating that the appraisal is exclusive, unless "the action is unlawful or fraudulent"). Professor Thompson argues that "[a]ppraisal should not be exclusive until there is a comprehensive legislative treatment of the remedy." Thompson, *supra* note 24,

not about process, unhappy stockholders are entitled only to pursue their appraisal remedies and receive fair value.[37] Apparently this outcome holds even if the price offered in the acquisition is extremely unfair.

II. PARSING SYNERGY

This Part of the Article parses the additional economic value, or synergy,[38] created by corporate acquisitions that move assets into more efficient hands.[39] This parsing is undertaken through the use of the following factual pattern, which, although hypothetical, is meant to be representative of recurring reality.[40] This analysis is later used in Part III as a framework to consider the present definitions of fair value and fair price, and Part IV uses the analysis to propose an appropriate definition of fair value and fair price.

Assume that an acquiring corporation ("Acquiring Corporation") merges an acquired corporation ("Acquired Corporation") into itself through a statutory merger for a cash price equal to $10 for each of Acquired Corporation's outstanding shares of common stock. Prior to the merger, Acquired Corporation has one million shares of common stock outstanding. Acquiring Corporation owns 51% of the Acquired Corporation's outstanding shares of common stock, and the remaining 49% of Acquired Corporation's common stock is publicly owned. An Acquired Corporation stockholder, Ms. C, is unhappy with the terms of the acquisition and believes her one share of Acquired Corporation is worth considerably more than $10.

As to the value of Acquired Corporation, assume the following facts exist immediately before the acquisition:

(1) Acquired Corporation's common stock is selling in an

at 54.

37. On the other hand, when the case involves unfair dealings, courts are willing to allow disgruntled shareholders to pursue fiduciary remedies. *See* Thompson, *supra* note 24, at 24 n.102 (acknowledging and listing "[a]t least eleven Delaware cases in the last decade [that] apply the fair dealing/fiduciary duty standard from *Weinberger* without relegating the plaintiff to appraisal").

38. "Synergy," as used in this article, means total additional value created by moving assets into new hands.

39. *See supra* note 22.

40. The parsing in this section is similar in structure to the approach Professors Gilson and Black take in their fine teaching materials. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, 253–638 (2d ed. 1995). Their book provides an excellent discussion of the economic and legal aspects of most of the Additives discussed in this Article. Their materials are rich in legal and economic analyses and citations.

efficient market[41] for $10 per share.

(2) Acquired Corporation has not disclosed the material fact that it just signed a lucrative government contract to supply the parts for a new jet fighter. If disclosed, this fact would increase the market price of Acquired Corporation's common stock by $1 per share. The increase in value of Acquired Corporation's stock that would be generated by the disclosure of the information is referred to herein as the "Information Additive."

(3) During the last year, the managers of Acquired Corporation made an unwise, discrete decision that violated the managers' fiduciary duties to Acquired Corporation. Assume, for example, that the company's board of directors caused Acquired Corporation to invest in a project that was a total loss and that the decision to invest was so unwise as to violate the business judgment standard applicable to the decision. No move has been made to pursue legal recourse against the legally culpable managers. As a result of this breach of duty, the company suffered damages that, if reasonably pursued through legal means, would increase the market price of Acquired Corporation's common stock by $1 per share. The increase in value in Acquired Corporation's stock that would be generated by pursuing a legal remedy is referred to herein as the "Discrete Mismanagement Additive."

(4) Acquired Corporation owns an expensive machine used in its operations and currently uses only fifty percent of the machine's capacity. Managers of Acquired Corporation could reduce this overcapacity inefficiency through a number of means, including selling the machine and outsourcing the particular function, renting the excess capacity to other manufacturing companies that need the function, entering into strategic alliances with other companies, or merging with a company, such as Acquiring Corporation, that can use the excess capacity. These steps, if reasonably pursued by Acquired Corporation's managers, would create an operational savings that would increase the market price of Acquired Corporation's stock by $1 per share. This increase in value in Acquired Corporation's stock is referred to herein as the "Operational Savings Additive."

41. "Efficient market," as used in this Article and unless otherwise indicated, means only that the market for the particular stock is sufficiently active to absorb information effectively into the price of stock and to reflect the preferences of traders. The term does not mean that necessarily all information about the stock and the company is available to the market. For instance, some information may be unknown and thus not impounded in price. Scholars have developed various measures and descriptions of market efficiency. *See, e.g.*, BREALEY & MYERS, *supra* note 11, at 321–27.

(5) In addition to the foregoing, Acquired Corporation is significantly and broadly mismanaged or undermanaged. Assume, for example, that the board fails to monitor senior management, thereby enabling senior managers to divert too much corporate value to themselves, fails to make efficient investments in technology, fails to capitalize on expansion opportunities, permits bickering among top employees that significantly and adversely affects production levels, and fails to uncover significant theft and diversion of assets by top employees. As a result, the efficient market reduces the price it is willing to pay for the stock of Acquired Corporation. If the company were managed at a reasonable level of skill and integrity—that is, at a level that approximates the minimum level required by fiduciary standards—the market price of Acquired Corporation's common stock would increase by $1 per share. The increase in value in Acquired Corporation's stock that would be generated by such better management is referred to herein as the "Reasonable Management Additive."

(6) If Acquired Corporation were broadly managed at a super-reasonable level—that is, at a level that approximates the finest available management—the market would increase the value of Acquired Corporation's common stock by an additional $1 per share. The increase in value in Acquired Corporation's stock that would be generated by the finest available management is referred to herein as the "Super-Reasonable Management Additive."

(7) By moving Acquired Corporation's assets into the hands of different managers, 500 of Acquired Corporation's present employees could be eliminated. One way, but not the only way, to accomplish this cost saving is through Acquired Corporation's merger into Acquiring Corporation. Terminating the 500 employees without cause is legal, although some may feel morally troubled by such a firing of workers without cause.[42] The total savings from the elimination of such jobs would result in an increase in value equal to $1 per share for each share of Acquired Corporation common stock outstanding and is referred to herein as the "Labor Reduction Additive."

(8) To effect the acquisition, Acquiring Corporation, or other acquirers of Acquired Corporation's assets, will borrow heavily. As a result of the additional leverage, the existing creditors of Acquired

42. For example, an interesting body of scholarship argues that such conduct on the part of the corporation may violate an implied contract with workers. *See infra* note 167 and accompanying text.

Corporation will lose significant value, which will be captured by the equity holders of Acquired Corporation and Acquiring Corporation.[43] The total value that will be transferred from creditors to equity owners as a result of this additional leverage amounts to $1 for each outstanding share of Acquired Corporation's stock and is referred to herein as the "Creditor Value Reduction Additive."

While all of this hypothetical background is admittedly tedious and somewhat complex, parsing the total value, or synergy, created by moving the assets of Acquired Corporation into new hands advances the analysis offered in this Article in a number of ways. First, it demonstrates that acquisition synergy does not spring from any single source, but is instead generated by various economic considerations. The parsing also illuminates the principal bases for the synergy generated by corporate acquisitions.[44]

More broadly, the parsing facilitates an examination of the allocative and distributive implications of rules governing the sharing of synergy and further assists the evaluation of the moral and economic force of the arguments various claimants may make for that synergy. One is able to anticipate, for example, that Ms. C will lay claim to her proportionate share of the synergy, arguing, perhaps as a matter of distributive equality or "fairness," that she has a legitimate

43. The highly leveraged transactions of the 1980s attracted much attention in the legal and financial literature. Authors report both the loss to creditors that resulted from such transactions, *see, e.g.*, Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 933 n.2 (reporting that between 1984 and 1988, the bonds of 183 companies "lost value as a result of mergers, acquisitions or leveraged buyouts"), and the gains to shareholders resulting from such transactions, *see, e.g.*, Bernard Black & Joseph A. Grundfest, *Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: $162 Billion Is a Lot of Money*, J. APPLIED CORP. FIN., Spring 1988, at 5 (estimating that the wealth of stockholders increased $162 million during the period between 1981 and 1986 as a result of takeovers).

44. The parsing in this section does not necessarily exhaust the sources of gain or synergy generated by acquisitions. For example, Professors Gilson and Black state that tax benefits are a "common explanation" for the incentive to acquire. GILSON & BLACK, *supra* note 40, at 454. Gilson and Black go on to say, however, that "the accuracy of the claim that a significant number of acquisitions are tax-motivated . . . has remained hard to assess." *Id.*; *see also* ALAN J. AUERBACK & DAVID REISHUS, *The Impact of Taxation on Mergers and Acquisitions*, *in* MERGERS AND ACQUISITIONS 69, 70 (Alan J. Auerback ed. 1988) (claiming that although tax incentives may play a role in acquisitions, convincing evidence is limited). In another article, Professor Black opines that "[t]ax effects are most important in [leveraged buyouts], where they may explain perhaps a third of the observed premiums, although estimates vary." Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 611 (1989).

In any event, the elements of value separated by the parsing in this section are sufficient for the purposes of this Article, because any additional sources of value, such as tax savings, can be allocated by reference to the analysis this Article provides.

claim to a payment amounting to $17 for her one share of Acquired Corporation stock. Parsing facilitates the evaluation of the legitimacy of her claim.

III. THE MEASURE OF FAIR VALUE AND FAIR PRICE UNDER TODAY'S LAWS

This section describes and analyzes today's laws regarding the calculation of fair value and fair price, with attention paid to the obligation to share synergy. What emerges from this discussion is a series of discrete rules that cannot be explained by reference to any unifying principle.

A. *Appraisal Rights and the Right to "Fair Value"*

1. The Model Business Corporation Act

Under the Model Business Corporation Act (MBCA), shareholders of an acquired corporation who dissent normally are entitled to receive, in lieu of the consideration offered in the acquisition, cash equal to the "fair value" of their stock. Fair value is stated to be "the value of the shares immediately before the effectuation of the [acquisition] ..., excluding any appreciation or depreciation in anticipation of the [acquisition] ... unless exclusion would be inequitable."[45]

The ambiguities in the critical terms of this definition of fair value are apparent.[46] "Value" is undefined,[47] leaving unanswered, for

45. MODEL BUS. CORP. ACT § 13.01(3). Recently a proposal was made to amend this definition of fair value as follows:

> "Fair Value" means the value of the corporation's shares determined:
> (i) immediately before the effectuation of the corporate action to which the shareholder objects;
> (ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
> (iii) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).

MODEL BUS. CORP. ACT § 13.01(4) (Proposed Changes 1998), *supra* note 27, at 251.

46. *See* Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 627 (1998) (discussing the limited guidance available in the language of appraisal statutes with respect to the determination of fair value).

47. California defines appraisal value as "fair market value." CAL. CORP. CODE § 1300(a) (West 1990 & Supp. 1998). The act goes on to define further the timing and method of calculation: "The fair market value shall be determined as of the day before the first announcement of the terms of the proposed reorganization or short-form merger,

example, the fundamental question of whether "value" should be computed as liquidation value or going concern value. "Appreciation," which normally is excluded from fair value under the terms of the definition,[48] is also an undefined term. Thus, returning to the parsing of synergy described in Part II of this Article, an issue exists as to whether the statute intends that all of the Additives be considered "appreciation" and accordingly beyond the reach of dissenting stockholders. Finally, the term "inequitable" is undefined, once more leaving uncertain the matter of whether it is "inequitable" to exclude dissenting shareholders from sharing in some or all of the Additives described in Part II.

The Official Comment to the MBCA provides some guidance for dealing with these ambiguities, stating that the statute "leaves to the . . . courts . . . the details by which 'fair value' is to be determined."[49] Regarding the impact of pre-existing common law on the calculation of fair value, the Comment states that the MBCA leaves "untouched the accumulated case law."[50]

The drafters of the MBCA, therefore, purposefully left critical terms in the appraisal statute ambiguous. The intent apparently was to delegate to courts the task of determining the essential components of, and methodologies for, calculating fair value and to reaffirm, or at least leave unchanged, the existing jurisprudence on these matters.

2. Cases Interpreting Fair Value

Courts faced with interpreting ambiguous appraisal statutes have articulated a number of rules regarding the calculation of fair value.[51]

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excluding any appreciation or depreciation in consequence of the proposed action . . . ." *Id.*

48. New York law, however, allows sharing of such appreciation with dissenters. *See* N.Y. BUS. CORP. LAW § 623(h)(4) (McKinney 1986); *see also* Cawley v. SCM Corp., 530 N.E.2d 1264, 1267 (N.Y. 1988) (interpreting New York law as including in appraisal value elements of future value derived from the merger); Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 27 (N.Y. 1984) (same).

49. MODEL BUS. CORP. ACT § 13.01, official cmt. 3.

50. *Id.* Recent proposed changes in the Model Act also change the Official Comment on fair value. *See* MODEL BUS. CORP. ACT § 13.01(4), official cmt. 2 (Proposed Changes 1998), *supra* note 27, at 255. The Comments to the Proposed Changes state, for example, that the new definition of fair value "permits consideration of changes in the market price of the corporation's shares in anticipation of the transaction, to the extent such changes are relevant." *Id.* The Comment goes on to approve valuation techniques for fair value that include "assigning a higher valuation to corporate assets that would be more productive if acquired in a comparable transaction, but excluding any element of value attributable to the unique synergies of the actual purchaser of the corporation." *Id.* at 256.

51. For an outstanding discussion of how courts have dealt with fair value cases, see Wertheimer, *supra* note 46, at 626–702.

These rules, however, generally are limited in scope and appear to have no unifying principles. Predictably, such rules lead to problematic and inconsistent outcomes.[52]

a. Going Concern Value

One rule that seems well settled in case law is that fair value is based on going concern value and not on the liquidation value of the corporation.[53] Intuitively, this rule seems correct. Stockholders

52. One problem for courts is the nearly dizzying array of valuation techniques that may be offered by the parties in a single case. For example, in *Cooper v. Pabst Brewing Co.*, No. Civ. A. 7244, 1993 WL 208763 (Del. Ch. June 8, 1993) (mem.), the dissenters' experts offered three separate methods of valuation to the court. *See id.* at *3–7. In another example, *In re Appraisal of Shell Oil Co.*, 607 A.2d 1213 (Del. 1992), the expert for the dissenting stockholders offered three separate valuations of Shell, each based on a different valuation methodology, and the company's expert also offered three additional valuation methods for calculating the fair value of Shell. *See id.* at 1216–17.

When faced with an offering of multiple methodologies for the determination of fair value, a court must either select from the methodological offerings of the litigants or, perhaps, reject all such offerings and utilize the court's own methodology. Thus, for example, from the six analyses offered by the parties in *Shell Oil*, the Vice Chancellor selected one methodology, referred to in the case as the "present value of equity analysis," and determined that analysis to be "entitled to the greatest weight." *Id.* at 1218. The Vice Chancellor, however, finally arrived at fair value by discounting the "present value of equity analysis" by 20%. *See id.* In *Cooper*, also mentioned above, the court found none of the proffered valuation methods persuasive and thus used its own, different fair value methodology, which was "based upon an estimate of the actual market value of the stock as determined from . . . [the] successful tender offer price" for the company. *Cooper*, 1993 WL 208763, at *8. Although the courts in both *Shell Oil* and *Cooper* attempted to explain the selection of their particular fair value methodology, neither was successful. Neither court provided any meaningful principle for the selection of one methodology over the other.

To some extent, the opinion in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), explains the parties' proffering of multiple valuation methodologies. *Weinberger* eliminated the Delaware block method as the "exclusive" method for determining present value in Delaware and practically solicited future parties to offer any method of valuation that was reasonable. *See id.* at 703–04. For a description of the Delaware block method and the valuation computation under that method, see the authorities cited in *infra* notes 55–56. More fundamentally, however, the proffer of multiple methodologies by litigants and the difficulty courts have in articulating criteria for selection from among the various offerings may best be explained by the absence of principles. Unconstrained by clear and sensible principles, litigants naturally offer differing valuation methodologies that suit their particular preferences. Without a theoretical anchor, courts, especially when faced with such multiple methodologies, are likely to make inconsistent selections over time and, thus, provide no guidance for future litigants. The cycle, therefore, repeats itself, as future litigants are able to select their preferred methodologies from prior unprincipled decisions.

Surveying all this, Professor Wertheimer nevertheless concludes that "the most prominent method of valuation in Delaware has been the discounted cash flow . . . method." Wertheimer, *supra* note 46, at 627.

53. In Delaware, this rule goes back many years, *see, e.g.*, Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950), and continues to be applied uniformly today. *See, e.g.*, Cede & Co. v. Technicolor, Inc. ("Technicolor IV"), 684 A.2d 289, 298 (Del. 1996) (stating

invest in anticipation of participating in the value that a corporation generates as a going concern. Thus, to the extent that appraisal is designed to compensate stockholders for what is taken from them, going concern value, and not liquidation value, seems the appropriate measure of fair value.[54]

Even this most fundamental idea, however, is applied unevenly. For example, some courts allow liquidation value to seep into going concern value calculations by considering liquidation value as a component of going concern value. Such is the case with the Delaware block approach,[55] under which liquidation value or, as it is called, "asset value," is typically accorded significant weight in the present value calculation.[56]

that liquidation value is not appropriate as the sole measure); *Shell Oil*, 607 A.2d at 1218–19 (same); Rapid-American Corp. v. Harris, 603 A.2d 796, 803 (Del. 1992) (same).

54. Liquidation value, however, should be considered a part of going concern value if there is some probability that liquidation may in fact occur. In such a case, the anticipated proceeds from liquidation comprise a part of the company's cash flows that are discounted to a present value. To use a simple example, assume it is anticipated that Acquired Corporation will generate cash flows of $100 in each of years one and two, will generate no cash flows in year three, and will be liquidated for net value of $100 at the end of year three. The going concern value of Acquired Corporation should be the discounted value of $100 per year in each of the next three years. The liquidation value of $100, therefore, merely becomes a part of the anticipated cash flows of Acquired Corporation. The approach that the SEC used to value Atlas in *In re Atlas Pipeline Corp.*, 9 S.E.C. 416, 437–38 (1941), provides an example of the use of this methodology.

Similarly, liquidation value is relevant to going concern value because a high liquidation value may reduce the risk of the investment. Financial economists generally view risk as the range of the dispersion of probable outcomes. *See* WILBUR G. LEWELLEN, THE COST OF CAPITAL 8–18 (1969) (providing a utilitarian explanation for risk aversion and an explanation why investors, therefore, accept risk only if paid to do so); *see also* BREALEY & MYERS, *supra* note 11, at 143–66 (explaining risk in terms of variance or standard deviations). A high liquidation value may compress the lower range of outcomes from an investment, thus reducing the variance in possible outcomes and accordingly reducing risk and increasing the present value of a company or its stock.

55. Prior to *Weinberger*, 457 A.2d at 701, the Delaware block method (or, as it also was called, the weighted average method) of valuation was the exclusive method for valuation in Delaware. *See, e.g.*, Francis I. DuPont 7 Co. v. Universal City Studios, Inc., 312 A.2d 344, 349–50 (Del. Ch. 1973), *aff'd*, 334 A.2d 216 (Del. 1975); *In re* Delaware Racing Ass'n, 206 A.2d 664, 670 (Del. Ch.), *aff'd*, 213 A.2d 203 (Del. 1965). Writing in 1984, Dean Joel Seligman observed that "in the post-World War II period, virtually all states followed the Delaware block-valuation approach." Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 841 (1984). Delaware courts have correctly noted that *Weinberger* did not prohibit the use of the Delaware block approach, but instead only eliminated the methodology's exclusivity. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 940 (Del. 1985). Other jurisdictions apparently continue to rely on the Delaware block approach. *See, e.g.*, Walter S. Cheesman Realty Co. v. Moore, 770 P.2d 1308, 1311 (Colo. Ct. App. 1988).

56. For an outstanding discussion of the Delaware block approach and the way courts handled this valuation methodology around the time *Weinberger* was decided, see

In other instances, courts have reached an improper measure of going concern value by applying too literally the rule that fair value is determined by going concern value. In *Bell v. Kirby Lumber Corp.*,[57] for example, minority stockholders were frozen out of Kirby Corporation in a short-form merger at a price of $125 per share.[58] Applying the Delaware block approach, the Chancellor found that the earnings value of Kirby was $120 per share but that the asset value of Kirby was $456 per share.[59] The Chancellor weighted earnings at 60% and assets at 40% and thus arrived at a weighted average value of $254.40 per share, which the Delaware Supreme Court affirmed.[60]

Kirby's assets should have received 100% of the weight, and thus the going concern value of Kirby for appraisal purposes should have been at least $456. This result follows from the principle that corporate managers owe a duty to stockholders to maximize stockholder wealth. Kirby's managers should have sold the assets of Kirby and divided the proceeds among stockholders.[61] It is nearly too simple to observe that corporate managers who can manage the company only to a value of $120 per share should sell the company's assets to other managers who can manage at $456 (or more) per share.[62] Corporate stockholders benefit from the sale, and society profits from the moving of assets into the hands of more efficient users. In this instance, going concern value should have been based on an assumption of appropriate management of the assets by Kirby's managers, an assumption which leads to a going concern value of $456 per share.

Even the simplest of the discrete rules of fair value, therefore, is

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Seligman, *supra* note 55, at 841–56; *see also* J. Steven Rogers, Note, *The Dissenting Shareholder's Appraisal Remedy*, 30 OKLA. L. REV. 629, 641–42 (1977) (presenting a chart to illustrate the percentage weight applied by various courts during valuation proceedings); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1468–71 (1966) (discussing the weight allocation applied by Delaware courts in valuation cases).

57. 413 A.2d 137 (Del. 1980).

58. *See id.* at 139.

59. *See id.* at 147 n.3.

60. *See id.* at 145–46.

61. For a different opinion on such cases, see Seligman, *supra* note 55, at 850 (arguing that asset values have no necessary significance in calculations of the value of a minority shareholder's interest, because minority shareholders have no power to compel liquidation).

62. In *Rapid-American Corp. v. Harris*, 603 A.2d 796, 802–03 (Del. 1992), the Delaware Supreme Court reaffirmed *Bell*. *See also* Cede & Co. v. Technicolor, Inc. ("Technicolor IV"), 684 A.2d 289, 298 (Del. 1996) (relying on *Bell* in its valuation analysis).

often misunderstood and misapplied by courts.

b. Proportionate Share of the Entity

Another broad issue facing courts in appraisal proceedings is the question of whether fair value should be measured by the value of a dissenting shareholder's proportionate interest in the entire company or by the value of the dissenting shareholder's individual shares. One way this issue may arise is in relation to minority interests in a publicly traded company that has an identifiable majority stockholder.[63] An efficient market may discount such minority shares,[64] in part because the market fears that the majority shareholder will forcibly acquire the minority interest at an unfairly low price.[65] The question that courts face in such a case is whether fair value should impound the so-called minority discount or, alternatively, whether dissenting stockholders are entitled to some part of the control premium.

A similar issue comes up in the context of appraisals involving closely held corporations. In these cases, the company may argue that the fair value of the stock should be discounted because there is no active market for the sale of the securities.[66]

Courts differ as to whether fair value should be reduced to reflect a minority discount or a nonmarketability discount, although most appear to conclude that such discounts should not be considered in fair value calculations.[67] Thus, in broadly mechanical terms, courts

63. An example of this is *In re Appraisal of Shell Oil Co.*, 607 A.2d 1213 (Del. 1992), in which Royal Dutch Petroleum Company owned 94.6% of Shell at the time of the freeze-out merger. *See id.* at 1216.

64. *See* Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact on Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 478 (1990); *see also* J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 5 (1977) (arguing that an outside buyer will discount the value of the shares to account for the risk that the majority will reduce the rate of return).

65. *See* Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1073, 1099 (1983); Theodore N. Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 489 (1983); Carole B. Silver, *Fair Dealing Comes of Age in the Regulation of Going Private Transactions*, 9 J. CORP. L. 385, 396 (1984).

66. *See, e.g.*, Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144–45 (Del. 1989) (rejecting the company's argument that nonmarketability discounts should be applied); *In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1003 (Me. 1989) (same).

67. The following are examples of cases that measure fair value by the dissenter's proportionate share of the entity as a whole: *Shell Oil*, 607 A.2d at 1218; *Rapid-American*, 603 A.2d at 802; *Cavalier Oil*, 564 A.2d at 1144; *McLoon Oil*, 565 A.2d at 1004. In *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. 1982), however, the Kentucky court used a "marketability discount" of 25% in arriving at fair value for a closely held

calculate the going concern value for the corporation as a whole and then award a dissenting shareholder value equal to his or her proportionate ownership interest in the company.[68]

In determining whether or not to include a minority or nonmarketability discount in fair value, courts typically fail to articulate meaningful principles, offering instead only the most general explanations as to why they exclude or include such discounts in their fair value calculation. Courts, for example, often support the exclusion of such discounts as a way to promote "fairness,"[69] avoid a result that "unfairly enriches the majority shareholders who may reap a windfall from the appraisal process,"[70] or avoid a "transfer of wealth from the minority shareholders to shareholders in control."[71]

Once again, one may have a sense that courts are essentially on sound ground in not allowing minority or nonmarketability discounts, even though the extremely general reasoning supporting such outcomes may be less than satisfying. One may, for example, conclude that disallowing a minority discount is consistent with corporate fiduciary obligations. As described above, the minority discount, at least to a large degree, is thought to be the result of the pricing by the efficient market of the expropriation risk, which includes, for example, the risk that the minority shareholders will be frozen out at an unfairly low price. Such a freeze-out is inconsistent with the fiduciary duties the majority shareholder and the acquired corporation's managers owe to minority shareholders. Accordingly, disallowing the minority discount removes the incentive to exploit this potentially unfair advantage and promotes conduct consistent with corporate fiduciary obligations.

c. Sharing Synergy

Today's law regarding the obligation to share synergy in appraisal proceedings can best be explained by reference to the parsing analysis offered in Part II of this Article. As described earlier, the MBCA excludes from fair value "any appreciation . . . [in

corporation. *See id.* at 556–57. Recently promulgated proposed amendments to the MBCA reject minority and nonmarketability discounts in appraisal proceedings. *See* MODEL BUS. CORP. ACT § 13.01(4)(iii) (Proposed Changes 1998), *supra* note 27, at 251.

68. One court explained that it has an obligation to establish "the best price a single buyer could reasonably be expected to pay for the firm as an entirety[.] The court then prorates that value for the whole firm equally among all shares of its common stock. The result is that all of those shares have the same fair value." *McLoon Oil*, 565 A.2d at 1004.

69. *Id.*

70. *Cavalier Oil*, 564 A.2d at 1145.

71. *McLoon Oil*, 565 A.2d at 1004.

the value of the dissenter's stock] in anticipation of the [acquisition] ... unless exclusion would be inequitable."[72] Delaware statutes exclude from fair value[73] "any element of value arising from the accomplishment ... of the merger."[74] Under such statutory language, however, the obligation to share synergy with dissenters is poorly defined. It is unclear which of the Additives described in Part II's parsing discussion qualify as, in the words of the statutes, appreciation in value that is "in anticipation of" or "arising from" the amalgamation of the companies.

Cases provide some help, indicating that the Information Additive (the value added by correcting misinformation about the Acquired Corporation) and the Discrete Mismanagement Additive (the additional value created by pursuing a breach of fiduciary duty claim against Acquired Corporation's managers) should be included in fair value. Stated alternatively and in the language of the appraisal statutes, the cases hold that the value represented by those two Additives should not be excluded from fair value as being in "anticipation of" or "arising from" the acquisition.

Regarding the Information Additive, the court in *Cede & Co. v. Technicolor, Inc.* ("*Technicolor I*"),[75] for example, stated directly that fair value must reflect "all relevant information regarding the

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72. MODEL BUS. CORP. ACT. § 13.01(3). Proposed amendments to the MBCA would change this language. Specifically, the language of the proposed amendments requires that fair value be "determined ... immediately before the effectuation of the corporate action to which the shareholder objects." MODEL BUS. CORP. ACT § 13.01(4)(i) (Proposed Changes 1998), *supra* note 27, at 251. Obviously, this language provides no explicit exclusion of appreciation. The Official Comments state that "section 13.01(4) permits consideration of changes in the market price of the corporation's shares in anticipation of the transaction, to the extent such changes are relevant." *Id.* § 13.01(4), official cmt. 2.

73. Recently, the Delaware court was required to determine the point at which fair value is calculated in a second step, clean up merger. The case, *Cede & Co. v. Technicolor, Inc.* ("*Technicolor IV*"), 684 A.2d 289 (Del. 1996), involved a two-step, friendly acquisition in which MacAndrews & Forbes Group Inc. (MAF) acquired 82% of Technicolor in the first step and then froze out the minority stockholders in a second-step merger. *See id.* at 293. Between the completion of the tender offer and the second-step merger, MAF took control of Technicolor and began to implement a plan of operation that improved the value of Technicolor. *See id.* The question for the court was whether the exclusion of "value arising from the ... merger" from fair value excluded the new value generated by MAF's business plan. *Id.* at 294 (quoting DEL. CODE ANN. tit. 8, § 262(h)). The court took a literal reading of the statute and held that fair value was determined on the day of the merger, which, as a result, impounded in fair value the value of the improvements made between the tender and the second step merger. *See id.* at 298–99.

74. DEL. CODE ANN. tit. 8, § 262(h) (1991 & Supp. 1998).

75. 542 A.2d 1182 (Del. 1988).

company and its shares."[76] The court explained that if the value added by the Information Additive were not included in the fair value calculation, dissenting shareholders might "be deprived of part of the true investment value of their shares."[77]

Similarly, cases provide support for including the Discrete Mismanagement Additive in fair value.[78] In *Cavalier Oil Corp. v. Harnett*,[79] for example, the Delaware Supreme Court held that the value of a usurped corporate opportunity must be considered in arriving at fair value. Fair value, the court concluded, must include the present value of the earnings lost as a result of the usurpation of the opportunity.[80] A related rule comes from *Porter v. Texas Commerce Bankshares, Inc.*,[81] in which the Chancellor stated that "[i]f the company has substantial and valuable derivative claims, they, like any asset of the company, may be valued in an appraisal."[82]

76. *Id.* at 1187 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983)). The court expanded the scope of the information that would be impounded in fair value beyond the materiality standard. The court stated that fair value includes "bits and pieces of *nonmaterial* information that have value as a totality." *Id.* at 1187 n.8.

77. *Id.* Both *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1143–44 (Del. 1989), and *Porter v. Texas Commerce Bankshares, Inc.*, No. Civ. A. 9114, 1989 WL 120358, at *6 (Del. Ch. Oct. 12, 1989) (mem.), which are discussed in *infra* notes 78–82 and accompanying text, provide support for including the Information Additive in fair value.

Disclosure of material information generally is considered a part of the fiduciary duty of corporate managers. *See, e.g.*, Kahn v. United States Sugar Corp., No. Civ. A. 7313, 1985 WL 4449, at *4–6 (Del. Ch. Dec. 10, 1985) (finding a breach of duty by corporate fiduciaries because of a disclosure failure in connection with a self-tender). As a result, allowing minority shareholders of Acquired Corporation to participate in the value generated by correcting managers' nondisclosures seems similar to allowing minority shareholders to participate in the value generated by correcting prior discrete acts of mismanagement.

78. An interesting question faced by courts is whether excessive salaries paid to top executives can be considered in determining fair value. The argument is that the difference between the actual, excessive salary and the fair market value of executive services should be considered as part of the earnings of the corporation and thus a part of fair value. Often, this matter has arisen in valuation of smaller corporations, in which control persons attempt to take large salaries in order to acquire a tax benefit for the corporation. *See, e.g.*, Gonsalves v. Straight Arrow Publishers, Inc., No. Civ. A. 8474, 1996 WL 483093 (Del. Ch. Aug. 22, 1996) (mem.) (asserting that capitalizing excessive compensation is no different than capitalizing future cash flows), *rev'd on other grounds*, 701 A.2d 357 (Del. 1997); Raskin v. Walter Karl, Inc. 514 N.Y.S.2d 120, 121 (N.Y. App. Div. 1987) (stating that, to reflect true earning power, excess capitalization should be eliminated from corporate expenses).

79. 564 A.2d 1137 (Del. 1989).

80. *Id.* at 1144. The court accepted the lower court's determination that, but for the usurpation, the corporation's earnings "would have increased resulting in a higher per share valuation at the time of the merger." *Id.*

81. No. Civ. A. 9114, 1989 WL 120358 (Del. Ch. Oct. 12, 1989) (mem.).

82. *Id.* at *5.

Referencing the parsing analysis of Part II, one is able to conclude that fair value in the hypothetical transaction would probably be at least $12 per share, because fair value would include the Information Additive and the Discrete Mismanagement Additive. What is much more difficult to establish under current law, however, is whether additional Additives would be included in fair value or would be excluded under the terms of the appraisal statute as appreciation arising from the acquisition. In quantified terms, the issue is whether a court faced with facts similar to those in the parsing hypothetical would be willing to establish fair value at an amount in excess of $12 per share and perhaps as much as $17 per share.[83]

The case law bearing on this question is both conflicting and imprecise.[84] In one case, *Bell v. Kirby Lumber Corp.*,[85] the evidence was that, if liquidated, Kirby had a net asset value of around $456 per share.[86] The court nonetheless determined fair value to be only $254 per share.[87] Obviously excluded from the court's measure of fair value was most of the synergy that could have been generated by moving Kirby's assets into more efficient hands. Thus, although not discussed in terms of the various components of synergy described through the parsing in Part II, most of the Additives that may have been in play in that acquisition were excluded from fair value.[88]

In contrast to *Bell*, the outcome in *Cooper v. Pabst Brewing Co.*[89] appears to include in fair value most of the synergy generated by that

83. *See supra* notes 41–44 and accompanying text.

84. In addition to *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980), and *Cooper v. Pabst Brewing Co.*, No. Civ. A. 7244, 1993 WL 208763 (Del. Ch. June 8, 1993) (mem.), which are discussed in the text, a third case deserves mention, although the court's disposition of the case does not materially advance this discussion. In *David J. Greene & Co. v. Dunhill International, Inc.*, 249 A.2d 427 (Del. Ch. 1968), the court in an appraisal proceeding refused to increase earnings for valuation purposes based on the prospective elimination of losses from an unprofitable operation. *See id.* at 432–33. The court seemed to base its decision on the uncertainty that the loss elimination would actually materialize. *See id.*

85. 413 A.2d 137 (Del. 1980). This case is discussed elsewhere in this Article. *See supra* text accompanying notes 57–62; *infra* notes 164–65 and accompanying text.

86. *See Bell*, 413 A.2d. at 139–40, 147–48.

87. *See id.* at 145–48.

88. Based on a literal interpretation of the Delaware appraisal statute, the outcome in *Bell* may appear correct. As described previously, the Delaware statute excludes from fair value "any element of value arising from the accomplishment or expectation of the merger." DEL. CODE ANN. tit. 8, § 262(h) (1991 & Supp. 1998). Because apparently the only way a value for Kirby of $456 per share could be achieved was by moving Kirby's assets out of the hands of present managers and into the hands of new managers, the higher value of $456 per share arguably was possible only "from the accomplishment or expectation of the merger." *See Bell*, 413 A.2d at 139–40.

89. No. Civ. A. 7244, 1993 WL 208763 (Del. Ch. June 8, 1993) (mem.).

acquisition.[90] Pabst was selling at around $14 per share when it became the subject of a bidding contest for control. Ultimately, Heileman won the bidding contest, paying a blended value of $29.50 per share.[91] In an appraisal proceeding, the Chancellor rejected the $14 pre-bidding market price as an appropriate measure of fair value because that price had prevailed more than a year before the merger and for other "various reasons" that the court never explained.[92] The court also rejected Heileman's winning bid of $29.50 per share as the measure of fair value because that price most likely contained "a control premium unrelated to the value of [Pabst] ... as a going concern."[93] The court, essentially without further explanation, concluded that fair value of the Pabst stock was $27 per share.[94]

As a result, the dissenting Pabst shareholders were permitted to share in most of the value created when the Pabst assets were moved into more efficient hands. Specifically, of the $15.50 per share difference between the pre-bidding price for Pabst ($14 per share) and the fully bid price for Pabst ($29.50 per share), dissenters participated in synergy amounting to $13 per share and were denied participation in synergy equaling only $2.50 per share.[95]

Cooper, therefore, cannot be reconciled with *Bell*. The *Bell* court excluded from fair value nearly all the gains that could be recognized by moving assets into more efficient hands, while the *Cooper* court included nearly all of these gains in fair value.

Attempting to fit the *Cooper* outcome into the language of the applicable Delaware appraisal statute also is an interesting exercise, because the statute excludes from fair value "any element of value arising from the accomplishment ... of the merger."[96] Interpreting this language literally, one might conclude that the entire $15.50 per share in synergy generated by the transaction in *Cooper* falls within that exclusionary language and that, accordingly, fair value of the Pabst stock should have been set at $14 per share (the pre-bidding price). On the other hand, such a literal approach to the meaning of

90. *See id.* at *10.

91. The bids were all front-end loaded. Heileman's successful bid was $32 in cash on the front end and $24 in debentures on the back end, which amounted to a blended value of $29.50 per share. *See id.* at *8.

92. *See id.* at *9.

93. *Id.* at *8–9. The Delaware court in other cases uses the term "control premium" interchangeably with synergy. *See, e.g.*, Cede & Co. v. Technicolor, Inc. ("Technicolor IV"), 684 A.2d 289, 298 (Del. 1996).

94. *See Cooper*, 1993 WL 208763, at *8.

95. *See id.* at *9.

96. DEL. CODE ANN. tit. 8, § 262(h) (1991 & Supp. 1998).

the language of appraisal statutes may also lead to the exclusion of the Information Additive and the Discrete Mismanagement Additive from fair value, and we saw previously that courts are unwilling to accede to such exclusions.[97]

The right of dissenting shareholders to share in the synergy generated by acquisitions, therefore, is uncertain. Although the cases do indicate that fair value includes both the Information Additive and the Discrete Mismanagement Additive, and thus fair value within the parsing hypothetical in Part II would be at least $12 per share,[98] the inclusion of other Additives in fair value is uncertain and subject to apparently conflicting rules. Within the parsing hypothetical, one is unable to determine whether fair value for Acquired Corporation's shares under current law should be $12 per share, $17 per share, or some value between these two figures.

3. Summary

Appraisal statutes are designed to be vague and to rely on courts to establish their critical terms, including the definition of fair value. Courts, however, have been unable to articulate meaningful principles to guide them in fair value cases. As a result, the few discrete common-law rules defining fair value are confusing and, in some instances, irreconcilable.

B. *Fiduciary Duties and the Right to "Fair Price"*

While the fair value obligation in appraisal proceedings is rooted in statute, the obligation of fair price has developed through the common law. Notwithstanding these differing origins, the discrete common-law rules respecting the determination of fair price are in many respects similar to the discrete rules respecting fair value. In at least one way, however, rules of fair price and fair value appear to differ significantly. Specifically, the rhetoric in fair price cases, unlike the rhetoric in fair value cases, seems to require the inclusion of some measure of synergy generated by the challenged transaction.[99]

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97. *See supra* notes 75–83 and accompanying text.

98. The $12 per share is comprised of the $10 initial price, plus $1 for the Information Additive, and $1 for the Discrete Mismanagement Additive.

99. Already, though, we have seen that some (but not all) fair value cases may award a significant portion of the synergy to dissenting shareholders. *See supra* notes 79–98 and accompanying text.

1. Specific Rules of Fair Price

a. Going Concern Value

As in the fair value cases, courts determine fair price as going concern value and not as liquidation value,[100] and some courts indicate a willingness to apply this rule even in situations in which liquidation value exceeds the going concern value for the entity.[101] This latter outcome, refusing to consider liquidation value as fair price when liquidation value exceeds the market or going concern value, is subject to the same criticism described in the fair value section of this Article,[102] in that such a result is inconsistent with managers' duty to maximize shareholder wealth and provides a disincentive to move assets into the hands of most efficient users.[103]

b. Proportionate Share of the Entity

In calculating the fair price of a stockholder's shares in an acquired company, courts generally start with the plaintiff's "pro rata value of the entire firm as a going enterprise."[104] This calculation means that fair price, like fair value, normally does not impound any minority or nonmarketability discount in the event the shares are closely held or thinly traded.[105] While the refusal to reduce fair price by any minority or nonmarketability discount may seem attractive and, indeed, may be the better rule, courts typically arrive at this outcome in fair price cases, as they do in fair value cases, without the

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100. *See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 942 (Del. 1985). Courts also have held that book value is not a proper measure of fair price. *See* Seagraves v. Urstadt Property Co., No. Civ. A. 10307, 1996 WL 159626, at *7 (Del. Ch. Apr. 1, 1996) (mem.); Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc., 532 A.2d 1324, 1334–35 (Del. Ch. 1987).

101. In *Rosenblatt*, the complaining shareholder attempted to have fair price measured by liquidation value, under the theory that the real worth of an oil company is in its assets, principally in its reserves. *See id.* at 941. Obviously, the plaintiff was convinced that liquidation value was higher than going concern value. *See id.* at 941–92. The court rejected the shareholder's argument, stating that for fair price purposes, "a company is valued as a going concern, not on what can be obtained by its liquidation." *Id.* at 942.

102. *See supra* notes 61–63 and accompanying text.

103. *See id.*

104. Kahn v. Tremont Corp., No. Civ. A. 12339, 1996 WL 145452, at *9 (Del. Ch. Mar. 21, 1996) (mem.), *rev'd on other grounds*, 694 A.2d 422 (1997).

105. *See, e.g.*, Ryan v. Tad's Enters., Inc., 709 A.2d 682, 693 n.14 (Del. Ch. 1996). The *Ryan* court also determined that market value was an inappropriate measure of fair value of the complaining shareholders' stock, given that the market price was depressed because of the "illiquidity [of the stock] due to the relatively small number of outstanding minority shares being traded." *Id.* at 693.

benefit of articulated principles.[106]

c. Sharing Synergy

Although the product of a convoluted pedigree, the generally accepted rule is that fair price includes some portion of synergy.[107] To explain this apparently broad rule, reference again is made to the parsing of value described in Part II of this Article.[108] The discussion, therefore, is framed in terms of identifying those Additives or components of synergy that are a part of the fair price and that, accordingly, must be shared with the shareholders of Acquired Corporation.

Not surprisingly, cases provide support for including the gains represented by the Information Additive (the value added by correcting misinformation about Acquired Corporation) and the Discrete Mismanagement Additive (the additional value created by pursuing a breach of fiduciary duty claim against Acquired Corporation's managers) in the calculation of fair price. Accordingly, the court in *Kahn v. Tremont Corp.*[109] addressed the inclusion of the Information Additive by stating that "fair price is a price that is

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106. *Kahn*, 1996 WL 145452, at *10, does, however, provide an interesting and economically sound explanation for the reason that the market, even if active, will discount minority shares when there is an identifiable majority block of stock. *Kahn* involved the parent's sale to a subsidiary of stock in a second subsidiary corporation. A stockholder of the purchasing subsidiary claimed that the price of the sister's stock was too high. Because the transaction involved a conflict on the part of the parent, the court analyzed the claim under the intrinsic fairness test and thus inquired whether the price of the sister's stock to the subsidiary was a "fair price." *See id.* at *9–15. The *Kahn* court stated that

> the market may deeply discount or ignore possible future cash flows not reflected in established dividend patterns because the controlling shareholder may have other ways of getting increased corporate cash flows out of the enterprise. While fiduciary duties are designed to protect against that eventuality, that protection is expensive to invoke, slow and quite imperfect. Thus it is not at all irrational for markets to discount deeply potential non-dividend cash flows in some situations where a controlling shareholder exists.

Id. at *9 n.14.

107. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the court articulated the meaning of fair price, but it did so in an indirect manner by indicating that in certain instances the measure of damages for an intrinsic fairness violation includes rescissory damages. *See id.* at 714. For its definition of rescissory damages, the *Weinberger* court relied on *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 505 (Del. 1981), which essentially defined the term rescissory damages to include the synergy from the transaction. Putting these together, and because damages are co-extensive with the wrong, the measure of the obligation to offer a fair price to minority stockholders in affiliated acquisitions necessarily includes a portion of the synergy generated by the transaction.

108. *See supra* text accompanying notes 38–44.

109. No. Civ. A. 12339, 1996 WL 145452 (Del. Ch. Mar. 21, 1996) (mem.).

within a range that reasonable men and women *with access to relevant information* might accept."[110]

Regarding the obligation to include the Discrete Mismanagement Additive in fair price, a number of cases reject the idea that fair price can be discounted by the negative value of serious, past mismanagement.[111] In *David J. Greene & Co. v. Dunhill International, Inc.*,[112] the court held that fair price must include the recapture of the value lost through the usurpation of a corporate opportunity. In *Coggins v. New England Patriots Football Club, Inc.*,[113] the court held that fair price included the value of wrongfully wasted corporate assets.[114]

In evaluating whether the other Additives are included in fair price under current law, one is required to look to more general rules from cases such as *Cinerama, Inc. v. Technicolor, Inc.*[115] Technicolor became the subject of a friendly acquisition by MacAndrews & Forbes Group, Inc. (MAF). Immediately before MAF manifested its interest, Technicolor stock was selling at around $11 per share.[116] Ultimately, the Technicolor board of directors agreed that their company would be acquired by MAF at $23 per share.[117] In a prior

110. *Id.* at *1 (emphasis added).

111. In addition to the cases described in *infra* notes 112–14 and accompanying text, in *Berkowitz v. Power/Mate Corp.*, 342 A.2d 566 (N. J. 1975), the court indicated that fair price should not be reduced as a result of the excessive salaries the majority stockholders paid to themselves. *See id.* at 571. Also, in *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682 (Del. Ch. 1996), fair price included the recapture of the value of consulting and non-competition agreements, which the court viewed as a mechanism that controlling stockholders used to divert corporate value to themselves. *See id.* at 694–95. The *Ryan* court held that the defendants, who had the burden on the matter, had not proven that the contracts were worth what the majority stockholders individually were paid for them. Thus, the presumption became that the contract price represented a diversion of corporate value to the majority stockholders. *See id.* at 690.

112. 249 A.2d 427 (Del. Ch. 1968).

113. 492 N.E.2d 1112 (Mass. 1986). In *Coggins*, the court determined that a freeze-out violated fiduciary duties, because it served no legitimate corporate purpose. The court ordered rescissory damages as a remedy, and thus dealt with fair price in that context. *See id.* at 1120.

114. *See id.* at 1120. The court noted that "[t]he present value of the Patriots . . . should include the amount wrongfully removed or diverted from the corporate coffers by the individual defendants." *Id.* More technically, *Coggins* held that rescissory damages must include a recapture of value lost through corporate waste. *See id.* As described above, the measure of rescissory damages and fair price should be considered co-extensive. *See supra* note 107.

115. 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, Cinerama, Inc. v. Technicolor, Inc. ("Technicolor III"), 663 A.2d 1156 (Del. 1995).

116. *See* Cede & Co. v. Technicolor, Inc. ("Technicolor II"), 634 A.2d 345, 352 (Del. 1993).

117. *See id.* at 357.

decision, *Cede & Co. v. Technicolor, Inc.* ("*Technicolor II*"),[118] the Delaware Supreme Court concluded, however, that Technicolor's board had not informed itself fully about the acquisition. Accordingly, the court held that the board's decision to approve the acquisition at $23 per share did not get business judgment protection, but instead was to be evaluated under the intrinsic fairness test.[119] On remand from *Technicolor II*, therefore, the Chancery Court in *Cinerama* considered whether the action of the board of Technicolor in approving the acquisition at $23 per share met the intrinsic fairness test, which, in turn, required the *Cinerama* court to consider whether $23 per share amounted to a fair price.[120]

Consistent with other Delaware cases,[121] the court in *Cinerama* defined fair price as "the highest value reasonably achievable" for the Technicolor stock.[122] The court recognized that, in a competitive market for corporate control of Technicolor, a successful bidder would "be driven to pay a substantial part of the expected synergy value" over to the target's shareholders.[123] The court's reckoning on that matter is based on the simple economic fact that, in such circumstances, surrendering a substantial part of the synergistic gain to the seller is necessary in order for the successful buyer to out-bid its rivals.

The court then applied this criterion by assuming that a bidder other than MAF would have been willing to pay $25 per share for Technicolor. Even under that assumption, however, the court concluded that the acquisition price of $23 per share "was certainly fair," given that the Technicolor stockholders, as the result of the sale to MAF at $23 per share, garnered 86% of the total synergy that might be generated by selling Technicolor to the very highest possible

118. 634 A.2d 345 (Del. 1993).

119. *See id.* at 368–69.

120. *See Cinerama*, 663 A.2d at 1138–39.

121. *See* Cinerama, Inc. v. Technicolor, Inc. ("Technicolor III"), 663 A.2d 1156, 1162, 1177 (Del. 1995); Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 48 (Del. 1994); *Technicolor II*, 634 A.2d at 361.

122. *Cinerama*, 663 A.2d at 1143. At other points, the *Cinerama* court articulated its standard of fair price differently, stating, for example, that "fair price does not mean the highest price financeable or the highest price that fiduciary [sic] could afford." *Id.* Later, the court stated that fair price was one a "reasonable seller . . . would regard as within a range of fair" and, still later, described fair price as "one that such a seller could reasonably accept." *Id.* All of these definitions seem to be either alternate ways of stating, or at least not inconsistent with, what apparently is the basic criterion of fair price, which is that it be the highest value reasonably available under the circumstances.

123. *Id.*

bidder.[124]

Initially, it is hard to understand how the fair price criterion articulated in *Cinerama*, which requires managers to get "the highest value reasonably achievable," is satisfied by an acquisition price that is $2 (or 8%) less than the price the court assumes to be available from the highest bidder.[125] One possibility could be that the *Cinerama* court concluded without articulation that the search costs for additional bidders, including the costs associated with the risk that MAF would abandon its interest in Technicolor, exceeded $2 per share.

Alternatively, one may reconcile the outcome in *Cinerama* to the broad rule from the case if the court determined, again, without articulation, that $23 per share, although less than the maximum value available for the Technicolor stock, did not amount to a performance by managers that was so bad as to rise to the level of culpability necessary to support a finding that the managers had breached their fiduciary duty. Thus, for example, assuming that negligence were the standard by which we judge managers in this case, the failure to maximize shareholder wealth did not amount to a deviation from ordinary care.

A final explanation for the outcome may be the court's unarticulated assumption that competition in the market for corporate control of Technicolor was insufficient to drive the price to $25 per share, even though the most efficient user actually could pay that price. For example, assume that a number of Technicolor competitors, including MAF, could develop sufficient efficiencies to make money by paying $23 per share for Technicolor, but could not make money at any higher price. One super efficient competitor, however, could make money by paying up to, but not beyond, $25 per share. The price under these assumptions respecting the market for corporate control would settle somewhere between $23 per share and

124. *See id.* In *Cinerama*, as described in *supra* notes 115–23 and accompanying text, the pre-bidding market price of Technicolor was around $11 per share, the merger price was $23 per share, and the highest price the court supposed to be possible for Technicolor was $25 per share. *See id.* "Synergy," therefore, was apparently considered to be the $14 difference between the pre-bidding market price and the highest possible price. The old Technicolor shareholders received $23 per share for their stock, which amounted to $12 in synergy ($23 merger price minus the $11 pre-bidding market price), or 86% (12/14ths) of the synergy. *See id.*

Cinerama was affirmed by the Delaware Supreme Court in *Technicolor III*, 663 A.2d at 1156. The supreme court specifically affirmed both the lower court's standard of fair price and its application to the facts of the case. *See id.* at 1176–77, 1180.

125. *See Cinerama*, 663 A.2d at 1143.

$25 per share. Thus, $23 per share would be within the range, although on the low end, of the "highest value reasonably achievable."[126]

Notwithstanding these possible explanations, the *Cinerama* opinion remains ambiguous concerning the meaning of fair price, even though the essence of the broad *Cinerama* formula may be attractive.[127] This confusion is due at least in part to the fact that it is impossible to determine which, if any, of the foregoing explanations is the basis for the decision. As a result, the value of *Cinerama* is limited, for example, when one attempts to apply *Cinerama* to a case such as the hypothetical situation in Part II.[128] Within the facts of that hypothetical, one is able to suppose only that fair price is somewhere between $12 and $17 per share and is perhaps closer to the latter amount.[129]

2. Summary

The uncertainty regarding the proper measure of fair price is made significantly worse by the common-law rules limiting the broad availability of the fair price protection. Recall from the discussion in Part II.C of this Article that *Weinberger* and its progeny hold that the fair price obligation of the intrinsic fairness standard is inapplicable if the corporate fiduciaries have acted with procedural fairness.[130] In instances of fair dealing, *Weinberger* holds that complaining shareholders' exclusive remedy is appraisal, a remedy that seemingly denies shareholders full participation in synergy.[131]

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126. *Id.* In order for the outcome under this analysis to be consistent with the broad rule of the case, one must assume that MAF is the second highest bidder and that the normal results of competition would mean that the super-competitor could acquire Technicolor without sharing any of the unique synergy (the $2 between $23 and $25 per share) it would generate by the acquisition. The case contains no factual bases for such assumptions, however.

127. In fact, the *Cinerama* formula for fair price ("the highest value reasonable achievable") is quite close to the formula for fair value and fair price proposed in this Article. *See infra* text accompanying note 177.

128. *See supra* text accompanying notes 38–44.

129. The raw numbers of *Cinerama* would indicate that fair price in the hypothetical should be around $16 per share. In the hypothetical, the synergy generated by the acquisition amounts to $7 (this assumes, perhaps incorrectly, that all the Additives would be considered synergy within *Cinerama*); if *Cinerama* holds that the fair price obligation requires that at least 86% of such synergy be shared proportionately by the shareholders of the Acquired Corporation, shareholders of the Acquired Corporation would be entitled to approximately $16 per share ($10 market value plus 86% of $7 in synergy).

130. *See supra* text accompanying note 36.

131. Recall, however, that this rule is uncertain. Some appraisal cases seem to permit shareholders to share in synergy. *See supra* notes 79–98 and accompanying text.

Consider the implications of the *Weinberger* rule for the hypothetical situation in Part II and the principal parties involved in that transaction. Acquiring Corporation, which controls Acquired Corporation, must first determine what price it is required by its fiduciary duties to pay for this acquisition. Similarly, Acquired Corporation's independent negotiating committee, which, in light of the *Weinberger* opinion, the Acquired Corporation's board will undoubtedly appoint in order to evaluate Acquiring Corporation's offer,[132] must also determine the price it is able to approve consistent with its fiduciary duties.

The most difficult problem for both Acquiring Corporation and Acquired Corporation's independent negotiating committee is the matter of whether fair price, which apparently includes some measure of synergy, or, alternatively, fair value, which may not include synergy, is the standard by which the fiduciary obligations of Acquiring Corporation and the independent negotiating committee are to be judged. If fair price is the measure of the principal parties' fiduciary obligation, perhaps something close to $17 per share may be required; if fair value is the measure of the principal parties' fiduciary obligation, perhaps something around $12 per share may be sufficient. The uncertainty in all this is obviously troubling, not only to the parties, who may not be able to figure out what to do, but also to society, as such ambiguities may provide an incentive for resource allocations that are economically inefficient or otherwise morally unattractive.

IV. THE APPROPRIATE MEASURE OF FAIR VALUE AND FAIR PRICE

As described in the preceding parts, today's rules respecting fair value and fair price generally are confusing and appear to lack moral or economic foundations. The purpose of this part, therefore, is to propose rules of fair value and fair price that are founded on attractive moral and economic values widely shared by society, rules that also are sufficiently intelligible to enable parties to engage in ex ante planning with predictable outcomes.

A. *True Consent*

In developing principles to guide courts in fair value and fair price cases, one attractive analysis is founded on consent and thus focuses on the expectations of the parties.[133] Accordingly, when

132. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983).

133. Judge Posner proposes that consent provides moral support for the pursuit of

presented with the matter of whether a minority stockholder is permitted to share in any or all of the Additives described in Part II, a court utilizing this analysis attempts to reach an outcome that respects the ex ante expectations of the parties. If parties in the particular situation strike an ex ante bargain with regard to the sharing of the Additives and the bargain generates no third party effects, the consent to the transaction by those who are affected may go a long way in satisfying both moral and economic concerns that result from a particular outcome.

Assume, for example, that within the facts of the hypothetical in Part II, Ms. C purchases a share of common stock in Acquired Company believing that, in the event of an affiliated merger, she has the right to the market value of her stock ($10 per share), plus the value of the Information Additive (which adds $1 per share), the Discrete Mismanagement Additive (which adds another $1 per share), and the Operational Savings Additive (which adds another $1 per share). One may be content in that instance to hold Ms. C to the bargain she made and thus to award Ms. C $13 as fair price or fair value in the case of an acquisition, because Ms. C consented to and priced the outcome through her willingness to purchase Acquired Corporation stock at, assume, $10 per share. Morally, one may be satisfied with such an outcome, given that Ms. C ex ante voluntarily entered into a transaction that maximized her happiness and that was in furtherance of her personal autonomy.[134] Expressed in economic terms, such voluntary trades are the very essence of economic efficiency. Such trades, assuming no third party effects, by definition create economic wealth.[135]

While clearly demonstrable consent to transactions is a powerful factor providing moral and economic legitimacy for particular outcomes, the difficulty with this criterion is that such true consent is rarely clearly demonstrable in these types of transactions. To state

economic efficiency. *See* Posner, *supra* note 19, at 488–502. He finds consent congenial to both a utilitarian regime and a Kantian regime. *See id.* at 489–90. Simplified, a voluntary (consensual), wealth-creating trade between two parties generates an increase in total utility (assuming no third party effects), *see id.* at 488; similarly, permitting such voluntary (consensual) trades also respects the autonomy of the trading parties as rational beings. *See id.* at 490. Thus, by permitting such pursuit of economic efficiency, Posner says that society "will produce an ethically attractive combination of happiness, of rights (to liberty and property), and of sharing with the less fortunate." *Id.* at 487. Posner does not explain this last point in his article.

134. See *supra* notes 20–21 for a brief discussion of utilitarianism and Kantianism.

135. For the meaning of economic efficiency and the creation of economic wealth as used in this Article, see *supra* notes 17, 22.

the apparent, it is impossible to demonstrate that all the shareholders involved in a freeze-out merger of a publicly held company consented ex ante to a particular payout formula that includes none, part, or all of the elements of value described in Part II. More likely, most, and probably all, shareholders at the time they purchased their shares in Acquired Corporation were ignorant about that particular term in their investment contract. Without any such true consent respecting the matter of fair value and fair price, enforcing a particular outcome becomes more troubling, both morally and economically.

B. *Contractarians' Version of Consent*

Some scholars who follow the traditions of neoclassical economics ("Contractarians") are not slowed by the inability to demonstrate the true consent of the parties to a particular term. Instead, Contractarians generally are morally and economically satisfied with enforcing terms (i.e., allocating rights) that coincide with the terms to which the parties would agree, assuming transaction costs were zero.[136] Pursuing this line of reasoning, Contractarians propose that the parties, if able to bargain freely and without costs, would agree to terms that lead to allocative efficiency. In other words, absent transaction costs, the Contractarians propose that the parties through bargaining will agree to terms allocating a particular right to the party that is willing to pay most for the right.[137]

Easterbrook and Fischel turn this line of thinking into an argument in favor of allowing Acquiring Corporation to grab all the synergy generated by the transaction.[138] They argue that all shareholders, including minority shareholders of Acquired Corporation, like Ms. C, would agree ex ante for Acquiring Corporation to get all the synergy generated by the acquisition.[139] Their reasoning is that such an outcome generates broadly

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136. *See, e.g.*, Easterbrook & Fischel, *supra* note 9, at 700 ("[T]he legal system *should* supply rules that mimic the *ex ante* agreements shareholders would reach if they could bargain for and enforce their agreements costlessly." (emphasis added)); Posner, *supra* note 19, at 491–97.

137. This form of analysis is used repeatedly and in various factual settings by law and economics scholars. For example, Judge Posner, in addition to using this analysis to interpret contracts, as I am doing here, *see* POSNER, *supra* note 17, at 105, also uses this analysis to discuss the economics involved in the incompatible uses of property rights. *See id.* at 55.

138. *See* Easterbrook & Fischel, *supra* note 9, at 708–10. Professor Cox critiques Easterbrook and Fischel's theories in connection with his article on derivative suits. *See* James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 749–52 (1984).

139. *See* Easterbrook & Fischel, *supra* note 9, at 711.

throughout society the maximum incentive to create economic value by moving assets into more efficient hands, as the more profit Acquiring Corporation is able to garner from the transaction, the more likely the transaction is to occur.[140]

Easterbrook and Fischel argue that by holding a diversified portfolio, investors such as Ms. C are able to share broadly in the value created by such moves and to insulate themselves from any unfair treatment stemming from unequal sharing of gain in any one instance.[141] With a diversified portfolio, investors like Ms. C sometimes will benefit from unequal sharing (by being shareholders in the acquiring corporation) and sometimes lose from the unequal sharing (by being shareholders in the acquired corporation), but over a diversified portfolio, these gains and losses should balance out.[142] Consequently, the total additional gain from a rule of unequal sharing will enrich such diversified investors, because through diversification they will participate in the additional economic value created by the incentive to undertake the transactions.[143] From all this, Easterbrook and Fischel are willing to infer that shareholders such as Ms. C would consent to an unequal sharing of gains.[144]

Easterbrook and Fischel's line of argument is problematic on a number of grounds. Perhaps the most apparent basis for criticism is the fact that not all investors hold portfolios that are sufficiently diversified to ensure that they will be losers and winners equally over time.[145]

An even more difficult problem for this line of reasoning results from the failure to distinguish the various sources of synergy,[146] a

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140. *See id.*

141. *See id.* at 712–13.

142. *See id.*

143. *See id.*

144. *See id.* at 713–14.

145. Easterbrook and Fischel, in response to this criticism, state that their argument is supported by "[t]he existence of diversification—not its employment." *Id.* at 713. Diversification is, in their view, cheap ("available at a remarkably low cost"), and, thus, anyone choosing not to diversify has no moral basis for complaint ("have little claim that they were treated inequitably"). *Id.* In all events, Easterbrook and Fischel place a high value on encouraging value-maximizing transactions. *See id.* Not all would agree with such factual assumptions and moral reckonings, however. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 29–30 (1982).

146. My disagreement with Easterbrook and Fischel's conclusion that Acquiring Corporation should be able to seize all the synergy may be less dramatic than first appears. In their piece, they set "market value" as a "rule-of-thumb" for the minimum amount that shareholders, such as Ms. C, should receive. Easterbrook & Fischel, *supra* note 9, at 714–15. The balance of the value generated by an acquisition may, under their regime, be

matter that is best understood by reference to the parsing in Part II. Assume now that Ms. C is fully diversified and is frozen out in a merger of Acquired Corporation into Acquiring Corporation at $10 per share.[147] To infer Ms. C's consent to this outcome, one must conclude that she (and all shareholders), in order to provide fuel for value maximizing transactions, consented ex ante to a freeze-out value that impounds disinformation, mismanagement, and non-value maximizing conduct on the part of their corporate managers. Relating this to the parsing in Part II, one must infer that Ms. C consented to forego the value of the Additives that could be attained by good management and full disclosure.

Obviously, an inference of consent on the part of investors to such conduct by managers is difficult to draw. In the first place, such an inference is inconsistent with society's mandatory corporate fiduciary duties, which require managers to pursue shareholder wealth maximization with some reasonable degree of care and vigor.[148] To restate slightly differently, such an inference of consent would also create a perverse incentive for Acquiring Corporation (the majority shareholder) to act through its agents (the managers of Acquired Corporation) to undermanage, mismanage, and fail to disclose facts about Acquired Corporation in order to maximize Acquiring Corporation's gain on the transaction. Indeed, the worse the management of Acquired Corporation, the greater the gain of Acquiring Corporation. This incentive may lead to conduct that is not only economically inefficient but also inconsistent with broadly shared societal values as manifested through our corporate fiduciary principles.

To relate this to the Additives described in Part II, it is most difficult to conclude that Ms. C consented ex ante to, or that society benefits from, Acquired Corporation's managers' failure, for example, to make complete disclosure (the Information Additive) or to pursue the reasonably attainable operational efficiencies (the Operational Savings Additive).

One, therefore, may be inclined to search for a regime based on a

shared unequally. If they were willing to accept my proposed definition of fair value and fair price as their definition of "market value" (i.e., they were willing to define "market value" as the value that an efficient market would put on the stock, assuming that the market had all material information and that the company were managed as required by fiduciary laws, *see infra* text accompanying note 155), then, obviously, I would have no quarrel with their analysis.

147. This amount, as described in Part II, equals the market price for Acquired Corporation's common stock.

148. *See supra* notes 28–32 and accompanying text.

version of consent that is more satisfying than that offered by the Contractarians.

C. Consent Through Corporate Fiduciary Principles

1. The Bases for the Theory

By considering the fiduciary obligations imposed on corporate managers, one generally is able to identify and respect the expectations of investors with regard to the allocation of value in the event of an acquisition. This approach facilitates an articulation of fair value and fair price based on a version of consent that is closer to true consent than the version offered by the Contractarians.

Pursuant to corporate fiduciary duties, corporate managers are obliged to make all moves that increase total stockholder wealth and to refrain from making moves that diminish stockholder wealth.[149] Under the duty of due care, managers avoid liability for any act or omission that does not so maximize stockholder wealth only if they act consistent with some level of due diligence, such as acting in a manner that is not negligent or not reckless.[150]

Similarly, under the duty of loyalty, managers are forbidden to transfer wealth away from any stockholder or group of stockholders to another corporate constituency or to other stockholders.[151] This principle explains why an unfair contract between a corporate officer and the corporation violates the officer's fiduciary duty[152] and why an

149. *See generally* Rutheford B Campbell, Jr., *A Positive Analysis of the Common Law of Corporate Fiduciary Duties*, 84 KY. L.J. 455 (1995–96) [hereinafter Campbell, *A Positive Analysis*] (arguing that the fiduciary duties of corporate managers are best understood as obligations to make all moves that enhance total shareholder wealth and to refrain from making any move that diminishes the wealth of any shareholder, rules that the author characterizes and describes as the obligation to pursue Pareto efficiency on behalf of corporate shareholders).

150. Today corporate managers may be subject to a negligence standard respecting their monitoring duties. *See, e.g.*, MODEL BUS. CORP. ACT § 8.30(a)(2); Francis v. United Jersey Bank, 432 A.2d 814, 817 (N.J. 1981) (holding corporate directors personally liable in negligence for the failure to prevent misappropriation of trust funds by other directors). For discrete decisions under the business judgment test, corporate managers may be required to act without negligence in investigating the action and without gross negligence at the decisionmaking stage. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

151. *See* Campbell, *A Positive Analysis*, *supra* note 149, at 474–78 (describing by reference to Pareto criteria the impact of the duty of loyalty on single company recapitalizations and affiliated mergers).

152. An example of this is the classic case, *Globe Woolen Co. v. Utica Gas & Electric Co.*, 121 N.E. 378 (N.Y. 1918). The Model Act now has significant provisions dealing with such conflict transactions. *See* MODEL BUS. CORP. ACT §§ 8.60–.63.

unfair corporate freeze-out of minority stockholders by a majority stockholder also violates fiduciary duties owed to the minority stockholders.[153] Each represents a detrimental wealth transfer away from a stockholder or a group of stockholders to either the corporate officer in the first case or majority stockholder in the second case and, thus, violates the obligation to avoid moves that harm stockholders.

One can infer that investors, at least in a general sense, understand these fiduciary duties and, thus, price their stock purchases in light of their expectations about managers' fiduciary duties. After all, such general duties are longstanding and often are applied in highly visible situations in the business world—hostile takeovers, for example. If asked, nearly all stockholders likely would affirm their understanding that corporate managers are legally bound to look out for the stockholders' interests, that corporate mangers must try to increase the value of the corporation, and that corporate managers are not permitted to give away any part of the stockholders' pro rata interests in the corporation to themselves, other stockholders, or other corporate constituencies.

One way to animate this is to assume that a hypothetical company, Alpha Co., is able to and does eliminate all of its fiduciary duties, that this change is widely published, and that no other company is able or willing to follow Alpha's lead in that matter. One would certainly anticipate that such a change would decrease the market value of Alpha's stock, as investors migrate to companies whose managers are subject to the basic fiduciary obligations to maximize wealth and avoid detrimental wealth transfers. Investors would likely be willing to remain invested in Alpha Co. only if paid a significant premium for the risk generated by rules permitting managers with complete legal impunity to undermanage the corporation and expropriate shareholder wealth for themselves and other favored constituencies.[154]

153. Examples of affiliated merger cases include *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), *Schreiber v. Bryan*, No. 4250, 1979 WL 2706 (Del. Ch. Oct. 29, 1979), *Tanzer v. International General Industries, Inc.*, 402 A.2d 382 (Del. Ch. 1979), *Walter J. Schloss Associates. v. Chesapeake & Ohio Railway*, 536 A.2d 147 (Md. Ct. Spec. App. 1988), and *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co.*, 496 N.E.2d 959 (Ohio 1986).

154. Not surprisingly, others have made similar observations in other settings. For example, in a piece on insider trading, Professor James D. Cox concludes that any harm to a corporation as a result of society's changing legal rules to permit insider trading would cause the market to "discount the value of . . . [the] firm." James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 637–39. In another piece dealing with international securities regulation, Professor Cox observes that investors trading in markets with high instances of "fraud, manipulation,

Thus, although conclusive proof is difficult to find, logic and analysis point strongly to the conclusion that investors, at least as a general matter, expect and price the basic fiduciary protections that managers are required by law to accord them. To measure fair value and fair price in a manner that is consistent with the fiduciary duties of corporate managers, therefore, can be legitimized by an attractive version of consent.

2. The Articulation and Application of the Theory

At this point, a more definite articulation of fair value and fair price is possible.

Shareholders subjected to an acquisition of their company should be entitled to fair value and fair price in an amount equal to the value that an efficient market would place on their proportionate interest in the company, assuming that the company is operated in a manner consistent with corporate managers' fiduciary duties and that the market has available all material information about the company. This broad principle for determining fair value and fair price amounts to an acceptable approximation of the parties' bargain and accordingly leads to outcomes that can be legitimized by a reasonably strong and, thus, attractive version of consent. The principle is also consistent with society's moral and economic values as reflected through our laws, specifically in the rules respecting the conduct of corporate fiduciaries.

To understand both the attractiveness of the formula and the likely outcomes from its application,[155] consider its application to the hypothetical situation described in Part II. Start, for example, with a consideration of the Information Additive (the value created by

unfairness . . . will discount the price of each security in that market by a greater amount than a comparable security in a market where they believe there is a lower incidence of such abuses." James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1201 (1999).

155. Two previously discussed matters deserve mention at this point. In Part III of this Article, we saw that, under today's laws, fair value and fair price usually do not include any nonmarketability discount or minority discount. *See supra* notes 63–71, 104–06 and accompanying text. These rules would continue under the author's proposed formula. Investors should anticipate that corporate managers, in furtherance of their obligations to maximize shareholder wealth, will move ownership configurations away from disadvantageous circumstances. A contrary rule of allowing minority discounts and nonmarketability discounts in fair value and fair price would create perverse incentives for a controlling shareholder to establish or maintain a non-maximizing ownership configuration in order to acquire the subsidiary at a bargain price. Creating such incentives is inconsistent with corporate fiduciaries' duties to maximize shareholder wealth.

correcting material misinformation) and the Discrete Mismanagement Additive (the value created by pursuing a recovery against corporate managers for a breach of their fiduciary duties).

Because legal rules prevent managers from exploiting undisclosed information[156] and require that managers adhere to standards of due care,[157] shareholders purchasing stock in a corporation can be considered reasonably to anticipate and, thus, price their investment based upon the assumptions of disclosure and reasonable management.[158] Fiduciary duties, supplemented by state and federal securities antifraud rules, therefore, provide acceptable bases for inferring an attractive version of consent to the right of shareholders to share in those two Additives. Quantified within the assumptions of the hypothetical situation described in Part II, consent comfortably underpins a value of at least $12 per share for the corporation's stock, which amounts to the pre-bidding market value of the stock of Acquired Corporation ($10 per share), plus $1 each for the Information Additive and the Discrete Mismanagement Additive.[159]

Additionally, including these two Additives in fair value and fair price is consistent with society's manifested moral and economic values. Perhaps the best way to demonstrate this is to consider the perverse incentives generated by a rule that excludes these Additives from fair value and fair price. In an affiliated acquisition, for example, such an exclusion would give majority stockholders and their surrogates—corporate managers—the incentive to withhold material positive information from the other shareholders and the market and the incentive to mismanage the corporation in order to

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156. The most obvious source of this principle is Rule 10b-5 under the Securities Exchange Act of 1934. *See* 17 C.F.R. § 240.10b-5 (1998). A disclosure obligation is also part of managers' fiduciary duty. See, for example, *Weinberger*, 457 A.2d at 709, in which disclosure failures by fiduciaries was a part of the basis for finding a breach of fiduciary duty in connection with an affiliated acquisition. *See id.* at 709. Another example is *Kahn v. United States Sugar Corp.*, No. Civ. A. 7313, 1985 WL 4449 (Del. Ch. Dec. 10, 1985), in which the Chancellor found that, in connection with a self-tender, managers breached their fiduciary duty to selling shareholders by failing to disclose certain material facts to them. *See id.* at *1.

157. *See supra* notes 28–29 and accompanying text.

158. This sentence initially appears to refer to minority shareholders who are, for example, at risk of being frozen out of a corporation at an unfair price. This idea, however, applies both to minority and majority stockholders. Thus, majority shareholders should have no legitimate expectation that managers will undermanage or fail to disclose material information as a way to facilitate the majority shareholders' acquisition of the minority's portion of the Additives.

159. As described earlier, courts today seem inclined to include these Additives in fair value and fair price. *See supra* notes 75–82, 109–14 and accompanying text.

drive down the fair value or fair price of the stock. As noted earlier, the legal requirements of corporate fiduciary and antifraud principles manifest society's distaste for such nondisclosure and mismanagement.[160]

Consider now whether fair value and fair price should include the Operational Savings Additive (the value created in our example by eliminating, perhaps through a merger with Acquiring Corporation, the overcapacity inefficiency of a major machine owned by Acquired Corporation) and the Reasonable Management Additive (the value created by increased efficiency in generalized management and monitoring of the corporation). The assumption in Part II for each of those Additives is that the value is created by moving the management of Acquired Corporation's assets out of the hands of poor managers and into the hands of managers who perform at the minimum level required by corporate fiduciary laws.

Formulated in this manner, the answer to the question of whether to include those two Additives in fair value and fair price once again can be based on the logic of the consent analysis used to include the Information Additive and the Discrete Mismanagement Additive in value.[161] Shareholders, when purchasing stock in a corporation, can be considered reasonably to anticipate and, thus, to price their investment based upon the assumption that managers will comply with their fiduciary obligations to eliminate operational inefficiencies and generally to manage and monitor the corporation reasonably. Once again, therefore, fiduciary duties provide an acceptable basis for inferring an attractive version of consent for the right of shareholders to share in the Operational Savings Additive and the Reasonable Management Additive.

For the same reason, society's manifested moral and economic values support including these two Additives in fair value and fair price.[162] Indeed, perverse incentives to undermanage or mismanage

160. Excluding the two Additives from fair value and fair price may be distasteful both to those concerned with distributive equality and those concerned with allocative efficiency. Persons who have a taste for distributive equality may feel that excluding minority shareholders from participating in the two Additives results in majority shareholders' receiving an unfairly large portion of the corporate value. Perhaps, although this is less certain, persons concerned with allocative efficiency may also object to excluding the Additives, because the assets of the company are, for a period of time, undermanaged and may be misallocated as a result of misinformation. A contrary argument, however, can be based on the discussion in *supra* text accompanying notes 138–45.

161. *See supra* notes 156–59 and accompanying text.

162. *See supra* note 160 and accompanying text.

the corporation are created by excluding these Additives from fair value and fair price. Exclusion of these Additives, therefore, would be inconsistent with societal values reflected in corporate fiduciary laws.

What becomes clear from this discussion is that fair value and fair price should include all of the so-called "synergies" that managerial conduct consistent with fiduciary obligations can garner. Quantified within the hypothetical situation of Part II, fair value and fair price should be at least $14 per share, which includes the original market price of the Acquired Corporation's stock, plus the Information Additive, the Discrete Mismanagement Additive, the Operational Savings Additive, and the Reasonable Management Additive.

The Super-Reasonable Management Additive was defined in Part II as the value added by moving the assets of Acquired Corporation into the hands of the finest available management. The question of whether this particular type of synergy should be included in fair value and fair price, however, may appear not susceptible to a consent analysis and accordingly more problematic in its resolution. The argument against including the Super-Reasonable Management Additive in fair value and fair price relies on the fact that such a superior level of management exceeds the level required by law, which, in turn, appears to negate any assumption that shareholders of Acquired Corporation anticipate or price such fine management. As investors arguably do not invest with any expectation of such superior management, consent appears to be lacking.

Such an analysis, however, may be incomplete. While investors may not expect their corporate managers *themselves* to manage at the highest level, investors do expect managers to take reasonable steps to maximize the value of the corporation. Thus, if third party super-managers are better able than present management to manage the corporation's assets, the obligation of the present managers to engage in reasonable conduct may dictate that they sell the assets to the super-managers, who presumably will pay a price for the assets that exceeds the value of the assets in the hands of existing corporate managers.

Although incorrectly decided, the facts of *Bell v. Kirby Lumber Corp.*[163] can be used to illustrate this point. In *Bell*, the common stock of Kirby appears to have had a market price in the area of $125 per

163. 413 A.2d 137 (Del. 1980).

share.[164] The court found, however, that the asset value of Kirby was $456 per share.[165] It seems difficult to argue that, in such a situation, the Kirby shareholders consented to the managers' failure to sell the assets, even if one assumes that the old managers were managing the company at a level consistent with legally imposed fiduciary standards. The more likely assumption regarding shareholders' expectations, and certainly the assumption that creates incentives to move assets into more productive hands, is that the Kirby shareholders expected their fiduciaries, consistent with their obligation to maximize shareholder wealth, to sell the assets of Kirby to the more efficient user, who was willing to pay an amount equal to $456 per share for the assets.

Perhaps if one attempts to refine the foregoing, the analysis does not lead to the inclusion of all of the Super-Reasonable Management Additive in fair value and fair price, given that the allocation of that Additive is the subject of bargaining between Acquired Corporation and Acquiring Corporation and accordingly is determined to a large degree by the strength of competition in the market for corporate control of Acquired Corporation. Nonetheless, shareholders of Acquired Corporation would reasonably anticipate that their managers would sell to the highest bidder, would exploit fully on their behalf the competitive strength of the market for corporate control of Acquired Corporation, and would bargain hard respecting the allocation of that part of the Super-Reasonable Management Additive that only can be achieved by Acquiring Corporation. In short, the managers' overarching obligation to maximize shareholder wealth would lead shareholders to expect reasonable managers to garner most of the Super-Reasonable Management Additive on their behalf.[166]

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164. *See id.* at 139. The market value of Kirby is somewhat difficult to glean from the various cases that were generated by the acquisition. It is apparent, however, that the market for Kirby stock was thin, as only 25,000 shares of Kirby were held by the minority, public stockholders. *See id.* Kirby, in its calculations of fair value, used $125 as "market value." *See id.* In the Section 10(b) action resulting from this transaction, the Supreme Court reported that, between 1968 and 1973 (the actual transaction occurred in 1974), Santa Fe Industries had been purchasing shares of Kirby at prices between $65 and $92.50 per share. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 465 (1977). Nonetheless, while the exact market price is uncertain, it was obviously substantially below the value that could be recognized by liquidating the company.

165. *See Kirby*, 413 A.2d at 151.

166. Economic studies regarding the allocation of synergy between shareholders of the acquired corporation and the acquiring corporation support this resolution. Those studies indicate that, in fully negotiated deals, the shareholders of the acquired corporation are able to appropriate most of the gains generated by acquisitions.

The questions of whether the Labor Reduction Additive (value generated by the elimination of employees' jobs) and the Creditor Value Reduction Additive (value generated for shareholders at the expense of creditors by increasing leverage) are to be included in fair value and fair price generate additional complexities. In recent years, a portion of shareholders' gains in acquisitions has been, at least in the view of some commentators, at the expense of workers and creditors. For example, following an acquisition, the new owners of an acquired corporation may generate gains for themselves by eliminating workers and replacing them with less expensive machines or new, cheaper workers.[167] Similarly, through the use of highly leveraged acquisitions, shareholders are able to expropriate a portion of the value of creditors' investments in the acquired corporation. Commentators cite the numerous highly leveraged acquisitions that occurred during the 1980s as transactions involving transfers of corporate wealth from creditors to stockholders.[168] Even more than a

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Regarding the appropriation of value by shareholders of the acquired corporation, Gilson and Black report on, and provide citations to, "many studies that find that takeovers are very, very good for target shareholders." GILSON & BLACK, *supra* note 40, at 258; *see also* Black & Grundfest, *supra* note 43, at 5 ("There is no shortage of research demonstrating takeover premiums averaging 30–50%."). Regarding the appropriation of synergy by the acquiring corporation and its shareholders, Gilson and Black also report numerous studies indicating that the acquiring corporation and its shareholders typically gain little if any from such acquisitions. *See* GILSON & BLACK, *supra* note 40, at 300–04. Gilson and Black then pose the question: "If there is synergy from combining acquirer and target, *why don't acquirers earn a share of the gains . . .* ?" *Id.* at 302. The explanations they offer are that the market for corporate control drives bidder returns to zero, that the managers may be able to grab part of the synergy, and that some transactions are just bad deals for the acquirer. *See id.* at 302–04.

167. A significant scholarly attack has been mounted against this and similar practices. One line of this scholarship argues that employees invest in their firms by underpricing their services in the early years of their employment in return for an implied promise that they will be repaid in the later years of their services, when their productivity may diminish. The fear is that the corporation has the economic incentive to expropriate workers' human capital investment by breaching the implied contract, firing the workers later in their careers, and replacing the fired workers with younger, less expensive workers. For explanations of these theories, see Maureen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1205–07 (1991), Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 48–53 (1991), Katherine Van Wezel Stone, *Policing Employment Contracts Within the Nexus-of-Contracts Firm*, 43 U. TORONTO L.J. 353, 363–69 (1993).

168. *See supra* note 43; *see also* Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187, 190 nn.14–15 (1991) (finding 230 companies that, between 1984 and 1989, were involved in "event risk" transactions, which were defined as corporate activities that "result[] in a downgrading of the credit rating of corporate debt obligations"); Kahan & Klausner, *supra* note 43, at 933 n.2 (reporting that, from 1984 through 1988, the bonds of 183 companies "lost value as a

decade later, the most famous such case probably is the RJR Nabisco acquisition, in which estimates are that creditors lost forty million dollars following the announcement of the highly leveraged acquisition of that company.[169]

The imperative to include the Labor Reduction Additive and the Creditor Value Reduction Additive in fair value and fair price can once again be based on the obligation of corporate managers to make all moves that enhance the wealth of stockholders. When they invest in corporations, stockholders count on managers to enhance the wealth of the stockholders to the extent possible from whatever legal sources may be available. Thus, to the same extent that stockholders expect managers to increase stockholder wealth by making profitable investments, stockholders also expect managers to increase stockholder wealth by expropriating value from other corporate constituencies, such as workers and creditors, so long as the expropriation is legal. Under such an analysis, the inclusion of the Labor Reduction Additive and the Creditor Value Reduction Additive in fair value and fair price, therefore, once more can be based on a consent notion.

The weakness of this position, of course, is that some observers consider expropriation of value from other corporate constituencies to be an immoral act.[170] Thus a number of commentators view harshly what they consider to be the expropriation through acquisitions of the workers' human capital investment in their corporations.[171] Similarly, the expropriation of creditor value during the highly leveraged takeovers of the 1980s resulted in much unfavorable scholarly opinion.[172]

Notwithstanding such concerns, courts for the most part have refused to extend the protection of broad fiduciary duties to workers[173] and creditors.[174] Instead, courts have defined the fiduciary

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result of mergers, acquisitions or leveraged buyouts").

169. *See* Deborah A. DeMott, *Introduction—The Biggest Deal Ever*, 1989 DUKE L.J. 1, 1. It is reported that the announcement in 1992 by Marriott Corp. that it intended to effect a spin-off by splitting its business into two separate corporations may have cost creditors, at least in the view of one investment banking firm, as much as $11 billion in lost value. BRUDNEY & BRATTON, *supra* note 10, at 220.

170. *See supra* notes 167–68 and accompanying text.

171. *See* Rutheford B Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 608–10 (1996) [hereinafter Campbell, *Corporate Fiduciary Principles*].

172. One writer referred to this as "possibly the largest expropriation of investors in American business history." Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206 (1988).

173. *See generally* Campbell, *Corporate Fiduciary Principles*, *supra* note 171, at 607–15

obligation of corporate managers as the requirement to promote only the interests of stockholders.[175] As a result, expropriative moves

(discussing further the implied contract theory under which managers should owe employees fiduciary duties).

174. Over the years, creditors have attempted to enforce fiduciary duty claims in both direct and derivative actions. Generally, both have been unsuccessful. Cases rejecting any direct claim include *Nuclear Corp. of America v. Hale*, 355 F. Supp. 193, 199 (N.D. Tex. 1973), *Skinner v. Hulsey*, 138 So. 769, 773 (Fla. 1931) ("Directors are not liable to the creditors on the theory of their being fiduciaries."), *Conrick v. Houston Civic Opera Ass'n* 99 S.W.2d 382, 385 (Tex. 1936) ("Directors are not personally liable to creditors for mismanagement, or for waste of assets except upon proof of the commission of such fraud."), *Equitable Life & Casualty Insurance Co. v. Inland Printing Co.*, 484 P.2d 162, 163 (Utah 1971), *Anderson v. Bundy*, 171 S.E. 501, 508 (Va. 1933), and *Wheeling Kitchen Equipment Co. v. R & R Sewing Center., Inc.*, 179 S.E.2d 587, 590 (W. Va. 1971). Statutes generally preclude creditors from suing derivatively to enforce fiduciary claims against management. *See, e.g.*, MODEL BUS. CORP. ACT § 7.41(1) (predicating the right to institute a derivative suit on one's having been a "shareholder of the corporation at the time of the act or omission complained of"). The rules denying creditors direct or derivative recovery for managers' breaches of fiduciary duties are longstanding general rules. *See* HENRY W. BALLANTINE, CORPORATIONS § 72a, at 184–86, § 148, at 351 (rev. ed. 1946). Nevertheless, a few cases over the years have indicated that corporate managers do owe creditors fiduciary duties. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 307 (1939); Ford Motor Credit Co. v. Minges, 473 F.2d 918, 920–22 (4th Cir. 1973) (applying North Carolina law); W. H. Elliott & Sons Co. v. Gotthardt, 305 F.2d 544, 545 (1st Cir. 1962); United States v. AT&T, 552 F. Supp. 131, 205 (D.D.C. 1982), *aff'd mem. sub. nom.* Maryland v. United States, 460 U.S. 1001 (1983); Johnson v. Coleman, 20 S.W.2d 186, 188 (Ark. 1929); Sternberg v. Blaine, 17 S.W.2d 286, 288 (Ark. 1929); Great W. Producers Coop. v. Great W. United Corp., 613 P.2d 873, 878 (Colo. 1980) (en banc); Francis v. United Jersey Bank, 432 A.2d 814, 825 (N.J. 1981); Underwood v. Stafford, 270 N.C. 700, 702, 155 S.E.2d 211, 212–13 (1967); Goodwin v. Whitener, 262 N.C. 582, 583–84, 138 S.E.2d 232, 233 (1964); Anthony v. Jeffress, 172 N.C. 378, 379–80, 90 S.E. 414, 415 (1916). The overwhelming majority rule, however, is that creditors are owed no fiduciary duties. *See, e.g.*, Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. 680 F.2d 933, 941 (3d Cir. 1982); Harff v. Kerkorian, 324 A.2d 215, 221–22 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1975) (per curiam). Professor Mitchell correctly states that "scholars supporting expanded bondholder rights do not have a great deal of law supporting them." Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1168 n.11 (1990).

175. While this statement essentially is accurate, it is worth noting that so-called constituency statutes permit directors to consider the interest of other constituencies in takeover situations. For a discussion and evaluation of constituency statutes, see Alexander C. Gavis, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 *passim* (1990), James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1227–30 (1988), James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 103 (1991). Also, in certain takeover cases, courts have indicated that directors, in determining whether to deploy takeover defenses, may consider the interests of other constituencies. *See, e.g.*, Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) ("[D]irectors may consider, when evaluating the threat posed by a takeover bid, the 'inadequacy of the price offered, nature and timing of the offer, questions of illegality, [and] *the impact on "constituencies" other than shareholders . . .*' " (emphasis added) (citation omitted)).

against workers and creditors on behalf of stockholders are not only legally permissible, but also may be legally required of corporate managers in order for them to fulfill their obligation to maximize shareholder wealth.[176] One is able, therefore, to find a compelling version of consent respecting the sharing of such expropriative "gains," given that shareholders, when they invest in corporations, reasonably anticipate that managers will garner such expropriative "gains" on their behalf.

In sum, fair value and fair price should include a pro rata portion of all of the Additives, except, perhaps, some portion of the Super-Reasonable Management Additive in instances when the strength of the market for corporate control is less vigorous. Procedurally, this could be implemented by a presumption of a pro rata sharing of all synergy, unless the Acquiring Corporation were able to demonstrate that, in light of the vigor of the market for corporate control and through unfettered bargaining, it would be able to retain some disproportionate share of the Super-Reasonable Management Additive. The resulting outcome is consistent with the conclusion that corporate managers, in pursuit of maximizing shareholder wealth and acting consistent with fiduciary mandates, could capture nearly all the Additives, or synergy, for their shareholders. A rule requiring such a pro rata sharing of synergies, therefore, is supported by the consent of the parties and, thus, founded on attractive moral and economic values.

CONCLUSION

Although the courts' sophistication in evaluating fair value and fair price cases has increased dramatically over the years, many of the outcomes in these cases continue to be unsatisfactory, due in large part to the lack of any consistently applied principle. The purpose of this Article, therefore, is to propose a principle that will render a proper measure of fair value and fair price.

Fair value and fair price should be the price that an efficient market would place on the shareholders' proportionate interest in their company, assuming that the shareholders' company is operated in a manner consistent with corporate fiduciary duties and that the market has available all material information about the company.[177]

176. *See* Campbell, *A Positive Analysis*, *supra* note 149, at 502–03.

177. Delaware courts at times have articulated a fair price formula that is similar to the one proposed in this Article. For example, in *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995), which is discussed at *supra* notes

This principle is based on a reasonably strong version of consent and, thus, is supported by both sound economics and moral theory. Investors and managers can be considered to anticipate and, thus, to consent to a measure of fair value and fair price that is consistent with the corporate fiduciary obligations society imposes on corporate managers and controlling shareholders. Establishing a measure of fair value and fair price that is consistent with such fiduciary duties, therefore, respects the ex ante bargain of the parties and is, thus, congenial to the creation of economic wealth and to the concepts of utilitarianism and Kantianism. Such a measure of fair value and fair price also is consistent with society's widely shared values, as reflected in society's rules respecting corporate fiduciary duties.

One result of the application of this principle is that shareholders of an acquired corporation essentially share pro rata in the synergy generated by acquisition transactions. Courts should be reluctant to allow less than full, pro rata sharing of synergy by such shareholders, because their reasonable expectations are that managers will garner for the shareholders nearly all of the value created by moving their corporate assets into new hands.

An application of the principle also leads to the elimination of a different measure for fair value, as compared to the measure for fair price. The premise of this Article is that shareholders, when they

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115–28 and accompanying text, the court at one point defined fair price as "the highest value reasonably achievable" for an acquired corporation. *Id.* at 1143 (citing Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993)). This formulation is nearly identical to the one proposed in this Article and in certain transactions may provide workable criteria for courts to reach the outcomes sought in this Article. For example, to restate this Article's principle in the fashion of the *Cinerama* articulation may be especially helpful to a court in a case such as *Cooper v. Pabst Brewing Co.*, No. Civ. A. 7244, 1993 WL 208763 (Del. Ch. June 8, 1993) (mem.), which is discussed at *supra* notes 89–96. *Cooper* involved a heated contest for Pabst in what appeared to be an efficient market for corporate control. Although fundamentally my articulation of this principle still expresses the essence of the fair value and fair price obligation, courts may feel more comfortable with the *Cinerama* articulation in such a case, because the "highest value reasonably attainable" may be apparent as a result of the bidding in the contest for control. In any event, the same outcome will be reached in such a factual setting under either the *Cinerama* articulation or my articulation.

In *Cinerama*, however, the court's articulation and use of its fair price formula is made less forceful by two facts. First, and less significantly, the particular articulation, "the highest value reasonably achievable," was only one of the multiple articulations of fair price from the court's decision. *See supra* note 122. So long as these various articulations are only different ways of saying the same thing, as they seem to have been in *Cinerama*, such articulations are not overly troublesome. Second, and more troublesome, is the fact that the outcome reached by the court in *Cinerama* seems inconsistent with the court's own, otherwise attractive formula for fair price. *See supra* notes 124–29 and accompanying text.

purchase stock in a corporation, consent to a measure of payment in the event of acquisition that impounds assumptions of sound management and full disclosure. It is impossible, without stretching the notion beyond acceptable limits, to find that shareholders consent to different levels of payment, depending upon the path plaintiffs are able to access during any ex post settlement that might occur. Disparate measures of fair value and fair price based on some ex ante consent are, therefore, unsupportable under the analysis offered by this Article.

Although presently cases generally seem to distinguish between the measure of fair value and the measure of fair price, society already may be moving in the direction of eliminating such differences. This Article, for example, describes cases in which outcomes in fair value cases and fair price cases seem to be nearly identical.[178] Thus in *Cooper*, a fair value case, and in *Cinerama*, a fair price case, the two courts reached nearly identical outcomes, essentially requiring a sharing of a significant part of the synergy generated by the transactions.[179] Recently proposed changes in the Revised Model Business Corporations Act also may be consistent with limiting disparate outcomes.[180]

Finally, the principle also is meant to provide the underpinnings for sensible and intelligible fair value and fair price criteria that are amenable to modern finance theory. Investment bankers, special negotiating committees, shareholders, and ultimately courts involved in disputes over fair value and fair price are required to establish a present value for the company involved in the particular acquisition. Only by comparing the consideration offered for the acquired corporation with some measure of the present value of the acquired corporation are those parties able to determine whether the consideration amounts to fair value or fair price.

Fundamentally, under modern finance theory, the present value for any company (or any portion of a company) is determined by discounting the expected cash flows to be derived from the company in the future.[181] This Article's principle provides meaningful guidance

178. *See supra* notes 89–96, 115–28 and accompanying text.

179. *See Cinerama*, 663 A.2d at 1176–77; *Cooper*, 1993 WL 208763, at *7–12.

180. *See* MODEL BUS. CORP. ACT § 13.01(4) & official cmt. 2 (Proposed Changes 1998), *supra* note 27, at 254–57.

181. Brealey and Myers state the matter succinctly: "Value . . . always equals future cash flow discounted . . . ." BREALEY & MYERS, *supra* note 11, at 73. The authors provide an extensive discussion of present value calculations as applied to corporations, shares in corporations, particular investments, etc. Always, the foundation of such discussion is reducing future cash flows through discounting to a present value. *See id.* at

for defining the cash flows appropriately considered in arriving at the present value of the acquired corporation and for defining the discount rates appropriately applied to those cash flows. Stated broadly, the principle presented in this Article defines the cash flows as all cash flows reasonably anticipated, assuming good management and full disclosure of material information about the company,[182] and defines the appropriate discount rate as the rate the efficient market applies to the cash flows of companies similar in risk to the acquired corporation.[183]

11–84.

182. To elaborate, return one final time to the parsing of Part II, *see supra* notes 41–44, and indulge the following assumptions about the cash flows of Acquired Corporation. Assume that the present cash flow of Acquired Corporation is $1,000,000 annually, or $1 per share, and that amount represents the reasonably foreseeable cash flows if Acquired Corporation continues on as it is and without the disclosure of information concerning the jet fighter parts contract. As each of the Additives materializes, however, assume that the cash flow of Acquired Corporation increases by $100,000, or $0.10 per share. Thus, for example, disclosure of the jet parts contract (the Information Additive) will increase the reasonably foreseeable cash flow of Acquired Corporation by $100,000, or $0.10 per share, aggressively pursuing the remedy for past mismanagement (the Discrete Mismanagement Additive) will result in a similar increase in Acquired Corporation's cash flows, and so forth. Under those facts, the principle presented in this Article identifies the cash flow to be discounted in fair value and fair price calculations as $1.7 million, or $1.70 per share. *See supra* notes 155–76 and accompanying text.

183. For a simplified explanation of the discount rate, see BREALEY & MYERS, *supra* note 11, at 12–14 (calculating present value in a simple example by discounting cash flows "by the rate of return offered by comparable investment alternatives"). In the first nine chapters in their book, Brealey and Myers provide a lucid and sophisticated discussion of modern present value theory, including a thorough discussion of the theoretical underpinnings and calculation methodologies for discount rates. *See id.* at 1–235.

IV. Two Important Kentucky Cases

FORD V. COURIER-JOURNAL JOB PRINTING COMPANY, 639 S.W.2d 553 (Ky. 1982)

The case involved a sale of assets otherwise than in the regular course of business. This triggered shareholder appraisal rights under Kentucky law, which at the time was the Model Business Corporation Act. Thus, dissenting shareholders had the right to "fair value" for their shares.

The court appointed two appraisers, who, the court stated, had "impeccable credentials". Appraisers put a value of $124 per share on the stock. The lower court adopted the report in its entirety. Court of Appeals affirmed.

Some observations concerning and holdings from the case:

1. The date of the case is important. The date of the appraisal was December 20, 1978; the opinion of the Court of Appeals was 1982. This was before *Weinberger v. UOP*, 457 A. 2d 701 (Del. 1983).

2. Relatedly, the age of the case is important -- it is nearly 20 years old. The whole approach of the case is reminiscent of valuation cases from the 1940s through the 1960s, where outcomes were usually determined by burdens of proof and political predilections (i.e., whether the court, deep in its judicial heart, thought that shareholders were a bunch of whining ingrates, or, alternatively, thought shareholders were decent and unfortunate individuals who were at the mercy of unscrupulous managers). Cases today, frankly because of better lawyering and increased business sophistication of the courts, show much improved analyses and outcomes.

3. This is a Court of Appeals case, not a Supreme Court case.

4. This is a "fair value" case, not a "fair price case".

5. The Court states as its "holding" that in valuations for appraisal purposes "the three elements to be considered . . are market value, investment or earnings value, and net asset value." Id., at 555. This is the old Delaware block method, which Delaware in the *Weinberger* case abandoned as the exclusive method for valuation.

6. Ultimately, the methodology applied in the case appears to be: The Court calculated the "net asset value" of the company (which it

determined to be $165 per share) and then discounted that by a 25% "marketability discount" (because the company was closely held, making its stock "considerably less attractive to an investor than a similar stock with access to the public marketplace").

7. As a transactional lawyer advising the board of an acquired company or a special negotiations committee in a conflicted acquisition, I would completely disregard the case. It provides no meaningful guidance regarding the fiduciary obligations of fiduciaries (i.e., boards and special negotiation committees) and, in my judgment, very little guidance regarding the probable outcome of an appraisal proceedings (unless you get caught in a lower court by stare decisis).

8. In an appraisal proceeding, I would expect that the "law" from this case would not be followed, provided: (a) The appraisal litigation is well-lawyered; and (b) the case is fully appealed.

<u>YEAGER V. PAUL SEMONIN COMPANY</u>, 691 S.W. 2d 227 (Ky. 1985)

Paul Semonin Company ("PSC") merged into Paul Semonin Associates, Inc. ("PSA"). It was a freezeout transaction in which the shareholders of PSC received cash of $1.20 per share for their PSC stock. Plaintiff owned 100 of the nearly 700,000 shares of the outstanding stock of PSC.

Plaintiff sought to enjoin the merger, alleging (in the words of the Court) "that the plan of merger was unlawful, that it was unfair and inequitable to minority stockholders, and that its whole purpose was to eliminate the appellant and other minority stockholders from any ownership in the PSC."

The trial court held that the appellant's exclusive remedy was appraisal. The Court of Appeals affirmed the decision of the trial court.

Statements or holdings of the Court, and observations by the author:

1. The Court rejected the "business purpose doctrine". That doctrine provides that an acquisition solely for the purpose of freezing out minority shareholders (i.e., with no valid business purpose) is illegal.

2. The Court stated that appraisal is not the only remedy available for a shareholder complaining about a merger: ". . . we do not construe a legislative purpose to deny judicial relief in a merger situation where illegality or fraud are involved." At, 228

3. The Court seems to conclude that the case before it was only a business purpose case (i.e., that the nub of the plaintiff's claim is his exclusion from ownership). As a result, the Court affirms the lower court's decision that the plaintiff had no claim.

4. I would expect that the rejection of the business purpose doctrine would be accepted by all courts in Kentucky. Clearly that is the trend today and probably makes a lot of sense.

5. Regarding the non-exclusivity of appraisal.

(a) KRS 271B.13-020(2) makes appraisal the exclusive remedy, "unless the action is unlawful or fraudulent with respect to the shareholder or the corporation."

(b) I would expect Kentucky to adopt the widely held position that appraisal is exclusive unless the transaction involves "unfair dealing". *See*, Campbell, at 108-112.