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11th Biennial Midwest/Midsouth Securities Law Conference

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SECURITIES
LAW CONFERENCE

February 2002
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BUSINESS COMBINATIONS:
DEVELOPMENTS AND COMING QUESTIONS

James C. Woolery
Cravath Swaine & Moore
New York, New York

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SECTION A
BUSINESS COMBINATIONS:
DEVELOPMENTS AND COMING QUESTIONS

James C. Woolery

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A. SECURITIES AND EXCHANGE COMMISSION RULE 14d-10
I. INTRODUCTION

This article addresses the impact of various judicial interpretations of Securities and Exchange Commission (the "Commission") Rule 14d-10, commonly known as the "best-price rule," on the structuring of M&A transactions. Rule 14d-10 provides in pertinent part:

"(a) No bidder shall make a tender offer unless:

(1) . . .

(2) The consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."

The recent judicial interpretations, particularly the decision of the U.S. Court of Appeals for the Ninth Circuit in Epstein v. MCA, Inc.,2 have created significant risks that the Rule will be breached by various arrangements customarily entered into in connection with acquisition transactions, which breach could have severe financial consequences. As a direct result, M&A practitioners and their clients are avoiding tender offers as a component of acquisition structures in most transactions. This includes instances where using a tender offer would be beneficial to all parties involved.

The purpose of this article is to analyze the adoption, interpretation and application of Rule 14d-10, and its effects on acquisition transactions. In addition, this article will critique the Ninth Circuit's holding in Epstein and discuss its potential ramifications on M&A activity.

II. LEGISLATIVE AND ADMINISTRATIVE HISTORY OF RULE 14d-10

Section 14(d)(7) ("Section 14(d)(7)") of the Securities Exchange Act of 1934 (the "Exchange Act"), which was adopted in 1968 as part of a substantial revision of the law regarding tender offers, provides:

"Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to the tender offer or request or invitation for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation."

Following its adoption, the Commission consistently interpreted Section 14(d)(7) as imposing a "best-price" rule in favor of holders of the securities that were

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1 17 C.F.R. § 240.14d.10.

2 50 F.3d 644 (9th Cir. 1995), rev'd on other grounds, 516 U.S. 367 (1996).
subject to a tender offer, requiring that "all such holders must be paid the highest consideration offered under the tender offer."3

Notwithstanding that the Commission’s interpretation of Section 14(d)(7) as imposing a best-price requirement was widely known and was generally accepted tender offer practice, certain Court decisions cast doubt on the application of the best-price rule in the context of issuer tender offers and, accordingly, the Commission proposed in 1985 that its interpretation of Section 14(d)(7) be codified.4 The result was Rule 14d-10, which was adopted by the Commission in 1986 as part of a package of changes to the tender offer rules.5

A key part of the Commission’s focus in adopting that package was the elimination of "abusive" or "discriminatory" tender offer practices, such as those inherent in "Saturday Night Specials," "First-Come First-Served" offers and other "abuses presented by unconventional tender offers."6

In proposing and adopting Rule 14d-10, the Commission emphasized the "need to provide clarity and certainty in the regulatory scheme applicable to tender offers with respect to equal treatment of security holders."7 In doing so, the Commission was recognizing, as a matter of policy, that the tender offer rules needed to be unambiguously defined, and it expressly stated that it was intending its proposals to remove any ambiguity over its existing interpretation of Section 14(d)(7), while at the same time ensuring "equal treatment of all holders of a class of securities for which a tender offer is made while facilitating transactions consistent with investor protection."8

III. RULE 14d-10 JURISPRUDENCE

Although the intent of the Commission seemed clear in adopting Rule 14d-10, the cases that have interpreted it have given rise to greater uncertainty and ambiguity over the best-price rule than existed before the adoption of the Rule.

The focus in these cases has principally and most importantly centered on whether the phrase "during such tender offer" in Rule 14d-10 set a temporal limit, such that only transactions entered into during the formal tender offer period could be


4 Id., *2.

5 SEC Release Nos. 33-6653; 34-23 421; IC-15199; 1986 SEC LEXIS 1179 (July 11, 1986) ("SEC Adopting Release"), *47. At the same time, the Commission effected changes to the rules regarding minimum offering periods and withdrawal rights.


8 Id.

9 Id., *6.
considered in determining whether Rule 14d-10 had been complied with, or whether such phrase did not limit the application of the Rule to the formal tender offer period on the basis that the concept of "tender offer" could be construed to encompass transactions entered into and/or consummated outside such period.

(a) Pre-Epstein Decisions

Prior to Epstein, which was decided in 1995, three cases considered Rule 14d-10.

In the first of these, *Field v Trump*,\(^{10}\) the bidder in a tender offer was encountering difficulty with certain key stockholders, who would not support the tender offer. In order to resolve this issue, the bidder purported to terminate its tender offer and negotiate separately with the dissident stockholders. One day after such purported termination, having successfully agreed on the purchase of the dissident stockholder's stock for a price in excess of the first tender offer price, the bidder purported to commence a second tender offer, at a new price that was lower than that agreed with the dissident stockholders. The essential issue for the U.S. Court of Appeals for the Second Circuit was whether the bidder's tender offers were two separate tender offers, or whether they were a single offer. The Court concluded that "where the goal [of the tender offer] has not been abandoned, a purported withdrawal followed by a 'new' offer must be treated as a single continuing offer for the purposes of the 'best-price rule.'"\(^{11}\) As there was a single offer, the higher price paid to the dissident stockholders, which was agreed during the formal tender offer period, breached Rule 14d-10.

In the second case, *Kramer v. Time Warner, Inc.*,\(^{12}\) the U.S. Court of Appeals for the Second Circuit considered whether the "cashing-out" of certain executives' equity units and stock options by the target following expiration of a tender offer and upon consummation of a back-end merger breached the best-price rule in Rule 14d-10. The Court held that it did not, for reasons that included that such cash-out occurred "well after the expiration of the tender offer"\(^{13}\) (in this case five months after such expiration).

Although the U.S. Court of Appeals for the Second Circuit did not directly address the meaning of "during such tender offer" in either *Field* or *Kramer*, each opinion of the Court effectively treated that expression as meaning "after commencement and before expiration of the tender offer."

The same treatment is evident in the third pre-Epstein case, *Kahn v. Virginia Retirement System*,\(^{14}\) a decision of the U.S. Court of Appeals for the Fourth Circuit. In this case the Court had to determine whether certain private purchases of shares, undertaken in advance of the commencement of a tender offer, breached the best-

\(^{10}\) 850 F.2d 938.

\(^{11}\) *Id.*, *945*.

\(^{12}\) 937 F.2d 767.

\(^{13}\) *Id.*, *779*.

\(^{14}\) 13 F.3d 110.
price rule. In holding that such purchases did not, the Court focused on the fact that, at the time of the purchases, the tender offer had not commenced in terms of Rule 14d-2 under the Exchange Act.\footnote{The key issue in the case was whether a particular press release had commenced the tender offer, such that Section 14(d)(7) and Rule 14d-10 would actually apply.} As such, the share purchases did not occur "during" the tender offer and thus did not, and could not, violate Section 14(d)(7) or Rule 14d-10.

(b) Epstein v. MCA, Inc.

In Epstein, the U.S. Court of Appeals for the Ninth Circuit considered the acquisition of MCA, Inc. ("MCA") by Matsushita Electric Industrial Co., Ltd. ("Matsushita"). The acquisition was structured as a tender offer for MCA common stock followed by a back-end merger of MCA into Matsushita. Shortly before the tender offer commenced, Matsushita entered into a separate arrangement with MCA's chairman and chief executive officer whereby he would not tender his MCA common stock in the tender offer, but shortly after the tender offer expired he would exchange such shares for preferred shares in a Matsushita subsidiary that was capitalized at 106% of the value of the CEO's MCA common stock, with such value determined on the basis of the highest price paid in the tender offer. Such preferred shares would be redeemed for such highest tender offer price in certain specified circumstances, provided an annual dividend and were secured by letters of credit. In addition, the CEO's exchange of common stock for preferred shares would take place on a tax free basis (unlike the tender offer/merger), which provided a substantial tax benefit to the CEO.

MCA's CEO, who was a significant stockholder in MCA, had clearly received preferential treatment relative to other stockholders in MCA, and the question (among others) for the Court was whether this seemingly private purchase of shares from the CEO, which was agreed to before formal commencement of the tender offer, was conditioned upon consummation of the tender offer and was consummated after expiration of the tender offer, violated Rule 14d-10.

The Court stated that the answer to this question "depended on whether [the CEO] received greater consideration than other MCA shareholders "during such tender offer.""\footnote{Id., *654, quoting the language of Rule 14d-10.} In interpreting Rule 14d-10, the Court rejected MCA's arguments that the determination of whether this was the case was simply a function of the timing of entry into the arrangements with the CEO and that Rule 14d-10 had no application as such arrangements were effected in all respects outside the formal tender offer period.

Instead, the Court focused on the investor protection purposes of the Exchange Act and Rule 14d-10 and held that "an inquiry more in keeping with the language and purposes of Rule 14d-10" focuses on whether the transaction in question was an "integral part" of the tender offer. In reaching this conclusion, and in considering whether the seemingly separate arrangements with the CEO were really a part of the tender offer, the Court adopted the "functional test" that had been articulated in Field that "[c]ourts faced with the question of whether purchases of a corporation's shares are privately negotiated or are part of a tender offer have applied a functional test that
scrutinizes such purchases in the context of various salient characteristics of tender offers and the purposes of the Williams Act."\(^7\)

Applying these standards, the Court held the transaction with the CEO to be integral to the tender offer, for the principal reasons that the redemption price for the preferred stock was based on the tender offer price and that such transaction was conditional on completion of the tender offer in a number of material respects.\(^8\)

The Court also considered a second transaction, whereby the employment agreement of MCA's chief operating officer was amended, with Matsushita's approval, shortly before announcement of the tender offer to provide for the payment of $21 million to the COO if the tender offer succeeded. MCA advised the Court that this was undertaken to compensate the COO for the value of certain options he had expected to receive, but would not receive because of the impending Matsushita acquisition transaction. The Court held that the central issue in relation to this payment was "whether it constitutes incentive compensation that MCA wanted to give [the COO] independently of the [Matsushita/MCA] deal, or a premium that Matsushita wanted to give [the COO] as an inducement to support the tender offer and tender his own shares."\(^9\) If that were the case, then such payment would be integral to the tender offer and would constitute "consideration" paid, in terms of Rule 14d-10, for shares tendered, and Rule 14d-10 would be violated.\(^10\) The Court held that there were material issues of fact as to whether such an inducement existed in respect of the payment to the COO.

The Court did recognize in reaching its decision that not all transactions entered into in the context of a tender offer would be integrated with the tender offer, noting that "Rule 14d-10 does not prohibit transactions entered into or effected before, or after, a tender offer--provided that all material terms of the transaction stand independent of the tender offer."\(^11\)

(c) \textit{Lerro v Quaker Oats Co.}

\textit{Lerro v. Quaker Oats Co.}\(^\text{22}\) concerned the acquisition of the Snapple Beverage Corporation ("Snapple") by Quaker Oats Co. ("Quaker Oats") pursuant to a merger agreement that provided for a tender offer followed by a back-end merger. Prior to the formal commencement of the tender offer, Snapple and a subsidiary of Quaker Oats entered into a distribution agreement with a company ("Select") controlled by one of the...

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\(^7\) \textit{Id.}, *656, quoting \textit{Field}, \textit{Id.}, 943-44. As discussed in Section 5 of this letter, the Court was in fact quoting \textit{Field} out of context.

\(^8\) \textit{Id.}, *656.

\(^9\) \textit{Id.}, *659.

\(^10\) This analysis is not explicit in the opinion of Epstein, but this is how the U.S. District Court for the Northern District of California in \textit{Perera v. Chiron Corporation}, 1996 WL 251936 (N.D. Cal.) reconciled the "integration" test and "inducement" test in \textit{Epstein}.

\(^11\) \textit{Id.}, *656.

\(^22\) 84 F.3d 239 (May 17, 1996).
major stockholders of Snapple, which provided for the distribution of Snapple and Quaker products after the merger, and which replaced an existing agreement between Snapple and Select for the distribution of Snapple products. The effectiveness of the distribution agreement was conditioned on the consummation of the merger.

As the distribution agreement was signed on November 3, 1994, and the tender offer formally commenced at 12.01 a.m. on November 4, 1994 (such time being determined by the Court in accordance with Rule 14d-2 under the Exchange Act\textsuperscript{23}), the U.S. Court of Appeals for the Seventh Circuit held that the agreement was not entered into "during such tender offer" in terms of Rule 14d-10. Rather, it was entered into before such offer and, accordingly, as "before the offer is not 'during' the offer,\textsuperscript{24} there could not, as a matter of law, be a breach of Rule 14d-10. It was irrelevant to the Court whether or not the distribution agreement was "integral" to the tender offer.\textsuperscript{25}

In reaching this conclusion, the Court adopted an entirely different test from that in \textit{Epstein},\textsuperscript{26} and held that only transactions entered into during the formal tender offer period, \textit{i.e.}, after the formal commencement of the tender offer under Rule 14d-2 and prior to the expiration of the offer in accordance with its terms, could as a matter of law result in a breach of Rule 14d-10.

\textbf{(d) The Progeny of \textit{Epstein} and \textit{Lerro}}

The difference in approach between \textit{Epstein} and \textit{Lerro} is succinctly captured in a statement at the end of the \textit{Lerro} opinion: "our case is about 'when' rather than 'what'.\textsuperscript{27} \textit{Lerro} provides a clear temporal limitation on the application of Rule 14d-10—whether the Rule applies is solely a function of "when" the transaction in question occurred relative to the formal tender offer period. On the other hand, \textit{Epstein} focuses on "what" a tender offer is and "what" is part of that tender offer—\textit{if} a transaction is integral to the tender offer then, irrespective of when it occurs, it is part of the tender offer and, therefore, occurs "during such tender offer" for the purposes of Rule 14d-10.

In the U.S. District Court cases decided since each of \textit{Epstein} and \textit{Lerro}, there has been an inconsistent application of Rule 14d-10, depending principally on which of the two approaches the particular District Court has followed. Overall, and despite the fact that \textit{Epstein} is of questionable precedential value (having been overruled on grounds unrelated to Rule 14d-10), the \textit{Epstein} approach appears to be prevailing over the \textit{Lerro} approach, as plaintiffs use the uncertainty of the "integral part" test, and the

\textsuperscript{23}17 \textsc{C.F.R.} § 240.14d.2.

\textsuperscript{24}Id., 243.

\textsuperscript{25}Id., 244.

\textsuperscript{26}Id., 246. Although the approach in \textit{Lerro} is clearly at odds with the approach in \textit{Epstein}, the Court stopped short of holding that \textit{Epstein} was incorrectly decided (although it did state that it lacked precedential value). Rather, it preferred to distinguish both \textit{Epstein} (as not involving a merger, such that arrangements were conditional on a tender offer) and \textit{Field} (as involving a single tender offer and purchases clearly in the formal tender offer period for that single offer) on their facts, and indeed went so far as to say that the Ninth and Second Circuits would have reached the same conclusion on the facts in \textit{Lerro}.

\textsuperscript{27}Id.
factual determinations that must be made in connection therewith, to survive motions to dismiss and applications for summary judgment.\textsuperscript{28}

As a result, a wide range of arrangements customarily entered into in connection with acquisition transactions have been held to give rise to material issues as to whether they breach Rule 14d-10. The following cases illustrate different types of such arrangements, all of which were entered into and consummated outside the formal tender offer period, that may now be problematic under Rule 14d-10:

- In \textit{Perera v. Chiron Corporation},\textsuperscript{29} the U.S. District Court for the Northern District of California considered whether the enhancement of certain options held by the target's employees was integral to the tender offer and constituted a premium intended to encourage employee optionholders that were also stockholders to support the tender offer. The Court found that material issues of fact existed on these issues, and denied defendant's motion to dismiss.

- In \textit{Padilla v. Medpartners, Inc.},\textsuperscript{30} the U.S. District Court for the Central District of California considered whether the amendment of certain employment agreements with key target employees to provide a tax gross up on golden parachute payments, and the acquiror's agreement to honor such amended agreements, constituted extra consideration that was paid pursuant to the tender offer in return for the employees' support of the tender offer. The Court found that material issues of fact existed as to whether that was the case, and denied defendant's motion to dismiss.

- In \textit{Million Errors Investment Club v. General Electric Co. Plc},\textsuperscript{31} the U.S. District Court for the Western District of Pennsylvania considered whether the issuance of new options to certain of target's employees prior to commencement of the tender offer, that were subsequently to be cancelled and cashed-out in connection with a back-end merger, were granted and to be cashed-out in order to secure such employees' support for and approval of the tender offer and constituted greater compensation than was provided to other stockholders in the tender offer. The Court found that material issues of fact existed on these matters, and denied defendant's motion to dismiss.

- In \textit{Maxick v. Cadence Design Systems, Inc.},\textsuperscript{32} the U.S. District Court for the Northern District of California considered whether certain retention bonuses paid to target employees were paid pursuant to the tender offer and/or for the support

\textsuperscript{28} In broad terms, in each of a motion to dismiss and an application for summary judgment, factual issues must be presumed in favor of the party not making the motion or application, as applicable. Accordingly, such motions and applications can only be dismissed where it is beyond doubt that no set of facts could support the plaintiffs claim for relief or if the complaint lacks a cognizable legal theory or alleges insufficient facts to support such a cognizable legal theory. See \textit{Perera v. Chiron Corporation}, 1996 WL 251936, *2.

\textsuperscript{29} 1996 WL 251936 (N.D. Cal., May 8, 1996). This case was decided before \textit{Lerro}.


\textsuperscript{31} 2000 WL 1288333 (W.D. Pa., March 21, 2000).

\textsuperscript{32} 2000 WL 33174386 (N.D. Cal., Sept. 21, 2000).
of the tender offer. The Court found that material issues of fact existed, and
denied defendant’s motion to dismiss.

- In *Katt v. Titan Acquisitions, Ltd.*, the U.S. District Court for the Middle District
  of Tennessee, Nashville Division, considered whether certain financial incentive
  agreements with target’s officers (providing for golden parachutes, accelerated
  incentive awards and performance unit awards in connection with certain change
  of control transactions) entered into several months before the formal
  commencement of the tender offer, but which acquiror had agreed to honor, were
  integral to the tender offer and induced such officers to participate in that tender
  offer. The Court found that the agreements were integral to the tender offer, and
  thus subject to Section 14(d)(7) and Rule 14d-10, and that material issues of fact
  existed as to whether the arrangements had in fact induced the officers to support
  the tender offer. As such, defendant’s motion to dismiss was denied.

- In *Karlin v. Alcatel S.A.*, the U.S. District Court for the Central District of
  California considered whether certain new options granted to officers of target
  prior to the formal commencement of a tender offer, as well as the enhancement of
  certain existing options of such officers, were integral to the tender offer and an
  inducement to such officers to participate therein. The Court found that material
  issues of fact existed as to the question of inducement, and denied defendant’s
  application for summary judgment.

Each of these cases illustrates one of the principal difficulties of the *Epstein*
approach to Rule 14d-10. In each case, in order for the defendant to have been
successful, they would have had to establish as a matter of law that Rule 14d-10 did not
apply or that there were no facts that supported plaintiff’s allegations. Given the nature of
the *Epstein* integration/inducement test and particularly the factual determinations that
must be made in connection therewith, this standard is virtually impossible to satisfy as all
disputed factual matters are, in the context of a motion to dismiss or application for
summary judgment, required to be construed in a manner that is most favorable to the
non-moving/non-applying party. Almost inevitably, therefore, the motions and
applications will be dismissed.

One exception to that result, and a case that provides a contrast to the other cases described above that applied *Epstein*, is *McMichael v. United States Filter Corporation*.* In that case, the U.S. District Court for the Central District of California considered whether the modification of certain employment agreements, principally in respect of golden parachute payments, immediately before a tender offer was integral to the tender offer, and resulted in a breach of Rule 14d-10. The Court granted the defendant’s motion to dismiss, holding that the modifications did not change the substance of the agreements, only the form. Therefore, the payments in question were merely the discharge of a pre-existing contractual duty and, as a matter of law, the payments were not integral to the tender offer and hence could not constitute additional consideration that violated Rule 14d-10. It is difficult to reconcile this finding with the earlier decisions that

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33 133 F. Supp. 2d 632 (M.D. Tn., Nashville Division, November 17, 2000).


have followed Epstein, a number of which also involved the amendment of existing arrangements, and the case adds uncertainty to the law on Rule 14d-10.

Such uncertainty is also created by a case following that followed Lerro. In Walker v. Shield Acquisition Corp., the U.S. District Court for the Northern District of Georgia, Atlanta Division, granted defendant's motion to dismiss plaintiff's allegations that certain retention and transition payments entered into with target officers in the month before the commencement of a formal tender offer breached Section 14(d)(7) and Rule 14d-10. The Court rejected Epstein's integration test, and followed the bright line test in Lerro. Accordingly, as all arrangements with respect to the retention and transition payments were entered into and consummated outside the formal tender offer period, the court held that such arrangements could not, as a matter of law, breach either Section 14(d)(7) or Rule 14d-10. There is no distinction in principle between the type of arrangements considered in Walker and those considered in the six cases described above that followed the Epstein approach in which similar types of arrangements were held to be problematic—the different result is simply a product of the application of a different legal test.

Each of the cases described in this section considered arrangements with employees that are very common in the context of acquisition transactions and are very different from the type of egregious arrangements entered into with the CEO in Epstein. Unlike the CEO's arrangement in Epstein, none of the arrangements considered in the cases following Epstein and Lerro (or indeed in Lerro itself) presented facts that in any way looked like abusive or discriminatory takeover practices presenting issues of inequality between shareholders that are of a nature that the Commission was seeking to regulate in promulgating Rule 14d-10.

Nevertheless, the current state of the law on Rule 14d-10 suggests that such arrangements may breach Rule 14d-10, and the answer to whether they do is dependent upon the approach that the Court addressing the issue wishes to adopt, how the selected approach is actually applied and, ultimately, a complicated and confusing factual analysis.

(e) The Financial Cost of a Breach of Rule 14d-10

None of the cases described above have resulted in a substantive trial on the facts, or an award of damages.


37 The Court also noted that the instant case, where the payments were conditioned on a merger, could be distinguished from Epstein where the arrangements in question were conditioned on successful completion of a tender offer. Id., *1371.

38 The Court also cited Kramer, Id., in support of its conclusion trial transactions conditional on the merger could not be said to be a part of the tender offer. A second case, Gerber v. Computer Associates International Inc., (2000 WL 307379 (E.D.N.Y., March 14, 2000), a decision of the US District Court for the Eastern District of New York), also appears to favor the approach in Lerro, although it distinguished Lerro on the facts and did not expressly discuss the law in Epstein or Lerro. In Gerber, a payment in exchange for a non-compete agreement was made after commencement of the tender offer under Rule 14d-2, and during the formal tender offer period. Accordingly, defendant's motion to dismiss was denied.

39 Id., *1375.
However, in Epstein, the Court appeared to indicate that the assessment of damages would be mechanistic—the aggregate extra value received by the favored stockholder would be calculated, and such aggregate value would be divided by the number of shares owned by such favored stockholder. Each other stockholder would then be entitled to the resulting amount for each share that they own.

The amounts that could be at issue in these cases could be very significant, running into the billions (as in Epstein) and even trillions (as in Millionerrors) of dollars of potential damages. For example, the $21 million payment to the COO in Epstein would have equated to $17.80 per share that the COO owned, a 25% increase in the tender offer price of $71.00. The result would be that a $6.1 billion tender offer would effectively be $7.6 billion tender offer.

IV. THE IMPACT OF EPSTEIN AND ITS PROGENY

Traditionally, the question of whether stockholders (including employees) of a target have been treated appropriately in an acquisition has been a matter of state law. In particular, employee and other collateral arrangements entered into in connection with an acquisition are subject to scrutiny according to state law fiduciary duty concepts and, in the context of employee arrangements, suitability and reasonableness concepts. Furthermore, in the context of mergers (including a back-end merger after a tender offer), various state statutes provide appraisal rights to stockholders who believe the merger consideration is unfair, pursuant to which stockholders can seek and receive fair value for their stock in specified circumstances. Transaction parties manage their risks in these regards with expert advice from legal and financial advisors, and through "due process" mechanisms such as Special Committees and Compensation Committees. Even though the risk of challenge to such employee and other collateral arrangements always exists in the state law context, and indeed strike suits are common, those risks are well understood and, importantly, the financial consequences are typically directly linked to the value of the arrangements. As such, the risks are both manageable and measurable by competent M&A practitioners.

The situation is, however, currently very different in the context of tender offers. Following Epstein and its progeny it appears that a very wide range of employee and possibly other arrangements are now problematic in the context of tender offers, irrespective of facts such as that:

• the arrangements are entered into for legitimate commercial purposes (principally employment incentive arrangements to ensure continued employment after the change of control transaction);

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40 Epstein, Id., *657.

41 For a discussion on the applicable law in the Delaware context, see Balotti and Finkelstein, The Delaware Law of Corporations and Business Organizations, Chapter 4.

42 See, for example, Katt, Id., *636; Walker, Id., *1362.
the arrangements are not contingent on the tender of shares by the beneficiary of the arrangement and are not a *quid pro quo* for the tendering of shares;\(^{43}\)

- the tendering of the shares of the beneficiary is immaterial to the success or failure of the tender offer;\(^{44}\)

- the arrangements are consistent with state law reasonableness standards and fiduciary limitations on compensation, and have been approved by the target's board of directors following "due process" under state law;\(^{45}\)

- the arrangements are entered into by persons in their capacity as employees, not stockholders, and the arrangements are entered into with employees who are not stockholders as well as with employees who are stockholders;\(^{46}\)

- disclosure of the arrangements is made to stockholders in the tender offer documents, so that such stockholders are aware of them prior to tendering their stock and can choose not to do so;\(^{47}\) and

- the arrangements are entered into with the target rather than the acquiror.\(^{48}\)

Furthermore, the fact-based standard articulated by *Epstein* has, given the legal tests governing motions to dismiss and applications for summary judgment, made it highly unlikely that such motions or applications will be dismissed, leading to the prospect of lengthy and costly litigation that would not exist if a tender offer were not part of the transaction structure.

Moreover, the potential damages from losing a Rule 14d-10 action, and hence the likely cost of settling an action (if such a settlement was desirable), is likely to affect significantly the strategic and economic logic and viability of a transaction, such that transactions that are otherwise strategically and economically beneficial to the parties and their stockholders may no longer be worth pursuing.

The practical result of the *Epstein* interpretation of Rule 14d-10 as encompassing customary arrangements, as requiring complex factual determinations and of creating significant financial exposures for a breach is that unacceptable transactional and financial risks have been introduced into acquisitions that involve a tender offer. Those risks cannot be effectively managed by M&A practitioners in the tender offer context, other than by not entering into any employee or other collateral arrangements in connection with a particular acquisition. However, such arrangements are necessary in the vast majority of M&A transactions, principally in order to manage effectively the "social

\(^{43}\) See, for example, *Perera, Id.*, \#2-4.

\(^{44}\) See, for example, *Perera, Id.*, \#1, 4; *Katt, Id.*, \#645.

\(^{45}\) See, for example, *Walker, Id.*, \#1363-1364.

\(^{46}\) See, for example, *Perera, Id.*, \#3-4.

\(^{47}\) See, for example, *Walker, Id.*, \#1363-1364.

\(^{48}\) See, for example, *McMichael, Id.*, \#5-6.
issues" arising out of an acquisition and change of control, so an approach of simply eliminating such arrangements is problematic.

As a result of these risks, it is likely that M&A practitioners and their law firms may be forced to advise their clients that tender offers should not be incorporated in transaction structures, except in the most exceptional cases where the necessity for speed of execution justifies the significant risks that must be taken.

Rather, bidders are favoring one-step mergers to effect acquisitions. Such a structure may lead to the slower consummation of transactions, but it does not pose the risks of a two-step deal incorporating a tender offer.

Accordingly, and importantly, stockholders are having to wait three or more months after the launch of a deal, even in cash deals, to receive their transaction consideration, whereas they could generally be paid within four weeks of announcement of a deal if a tender offer had been used. Also, acquirers are having to wait longer to secure control of targets, thus exposing themselves to transaction risks, and delaying their ability to achieve the strategic benefits and synergies that made the acquisition attractive in the first place. These timing disadvantages are even more apparent in respect of transactions in which the consideration is stock, where the difference in execution time between an exchange offer and a stock-for-stock merger can be even more significant. The 14d-10 risks discourage the use of exchange offers and, therefore, eliminate the possibility that stockholders will receive the merger consideration very quickly in stock deals.

The foregoing impacts of the Epstein interpretation of Rule 14d-10 are highly undesirable. Transactions consistent with investor protection are not being facilitated and an important structuring option has effectively been eliminated from the alternatives available to M&A practitioners and transaction parties, which disadvantages such parties and their stockholders alike.

V. LEGAL DIFFICULTIES WITH THE EPSTEIN INTERPRETATION

In addition to the risks and the resulting consequences for transaction structuring caused by Epstein that justify reform of Rule 14d-10, it appears that the interpretation of Rule 14d-10 by the Ninth Circuit in Epstein is wrong, and that the interpretation in Lerro is right, as a matter of law. The decision in Epstein ignores the plain words of Rule 14d-10, the statutory context in which the Rule is found and the intent of the SEC in promulgating the Rule. Furthermore, strong policy justifications exist for preferring the approach in Lerro.

Rule 14d-10 on its face limits its application to "the highest consideration paid to any other security holder during such tender offer" (emphasis added). This language, despite what the Court said in Epstein, clearly denotes a specified time frame--to hold otherwise would be to contradict the plain meaning of "during" and, in fact, attribute no real meaning at all to that word.

Furthermore, the Court in Epstein effectively ignored Rule 14d-2 in formulating its approach to Rule 14d-10. Rule 14d-2 sets out the precise time at which a tender offer commences, and explicitly states that its definition of commencement applies "for the purposes of Section 14(d) and the rules thereunder." (Emphasis added.) Accordingly, if there is a tender offer that is subject to the Exchange Act and the Rules thereunder, under Rule 14d-2 such tender offer (irrespective of what transactions are part of that tender offer) does not commence as a matter of law until the time determined by
that Rule. Therefore, an arrangement entered into prior to such commencement cannot as a matter of law occur "during" such tender offer. It is exactly this conclusion that the Court reached in Lerro.49

On this basis, cases such as those described earlier where the employee option, retention, golden parachute and other arrangements were, on their facts, entered into prior to formal commencement of the tender offer pursuant to Rule 14d-2 and consummated after expiration of the offer cannot, as a matter of law, have breached Rule 14d-10 as nothing occurred "during" the tender offer. Epstein has caused such cases to be wrongly decided on this point.

It is somewhat ironic that the Ninth Circuit in Epstein, noted that Rule 14d-2 defined when a tender offer began for the purposes of Section 14(d)(7) and stated that:

"Rule 14d-10 was promulgated to codify the all-holders and best-price requirements in § 14(d)(7), and the SEC stated when proposing the Rule that the §14(d)(7) time frame would carry over to the Rule."50

The Epstein Court then ignored Rule 14d-2 and its timing requirement reaching its decision and thereby ignored the Commission's intent to carry §14(d)(7)'s time requirement, as established by Rule 14d-2, over into Rule 14d-10. Rather, as noted above, the Court in Epstein attempted to define "during such tender offer" by focusing on "what" constituted or formed part of a tender offer, and held that anything that was a part of the tender offer must occur "during" it. The analysis of Rule 14d-2 above shows that this cannot be correct, as it would suggest that arrangements entered into before the commencement of the tender offer that were part of it occurred "during" it, which is directly contradictory to Rule 14d-2's statement that its commencement tests applied for "Section 14(d) and the rules thereunder." (Emphasis added.).

In formulating its approach to Rule 14d-10, the Epstein court relied on Field v. Trump, and the functional test espoused thereunder, for determining whether the arrangements in Epstein with the CEO were part of the tender offer. However, Field is not at all concerned, as is suggested by the Epstein Court, with the question of whether a private purchase of stock like that in Epstein should be integrated with a tender offer for the purposes of interpreting Rule 14d-10. Rather, it was concerned with whether a single tender offer had been engaged in or whether there were two offers. Having determined that there was a single offer, the stock purchases in question clearly took place during that offer as they occurred after commencement, in terms of Rule 14d-2, of the formal tender offer that was purported to be terminated. The Court was not in fact examining the meaning of "during such tender offer" and, accordingly, Field did not actually provide authority for the interpretation of Rule 14d-10 adopted in Epstein.

It appears that the phrase "during such tender offer" is intended to be interpreted as imposing a timing limitation on the application of the Rule 14d-10. This view is supported by the administrative history of both Section 14(d)(7) and Rule 14d-10, which histories the Court in Epstein misinterpreted. While the Court in Epstein correctly emphasized the Commission's intent to ensure "equality of treatment among all

49 Id., *242.

50 Epstein, Id., *655 (footnote 18).
shareholders who tender their shares," the Court was incorrect in stating that the administrative history of Rule 14d-10 "suggests anything but the notion that the SEC intended the Rule to be a mechanical provision concerned not with discriminatory tender offers, but with the timing of payment to favored shareholders." In fact, the Commission was concerned with both the concept of equality and the concept of timing. For example, in discussing the "best-price rule" under Section 14(d)(7) that the Commission was intending to codify, it stated:

"Application of the best-price rule raises certain interpretive issues. The best-price rule extends to all tendering holders of the class of securities subject to the offer. The consideration to be paid must be equal to the highest amount offered at any time during the tender offer period. Consistent with the Williams Act, the Commission's position has been that the highest consideration offered is determined from the earlier of the date the offer is first published or sent or given to security holders as defined by Rule 14d-2(a) or the date of public announcement as specified in Rule 14d-2(b)." (Emphasis added.)

This emphasis on the formal tender offer period is also evident from the Report of the House of Representatives on the adoption of Section 14(d)(7) of the Exchange Act, pursuant to which Rule 14d-10 was promulgated:

"Proposed section 14(d)(7) would provide that where a person making a tender offer increases the consideration offered to shareholders before the expiration of the tender offer, he must pay the increased consideration to those who tendered their securities prior to the increase in the price, whether or not he had taken up any of the securities before the increase in the consideration was announced. The purpose of this provision is to assure fair treatment of those persons who tender their shares at the beginning of the tender period, and to assure equality of treatment among all shareholders who tender their shares." (Emphasis added.)

The Commission's focus on the formal tender offer period was most clearly demonstrated by the text the Commission proposed in 1985 for Rule 14d-10, which referred to consideration offered "at any time during such tender offer, determined from the earlier of the date of public announcement as specified in Rule 14d-2(b) or the date of commencement pursuant to Rule 14d-2(a)." The language regarding Rule 14d-2 was dropped from the Commission's revised proposed text for the Rule as released in January 1986, although the reference to "at any time" was retained in that proposal. There was no explanation given for the change in language between proposals. The text "at any time" was not included in Rule 14d-10 as finally promulgated, and again no explanation.

51 Epstein, Id., *655.
52 Id., *654.
56 SEC Proposing Release, #2, Id., *

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was given for the change. Thus, these changes in language do not evidence any intent by the Commission to eliminate the temporal limitations on the application of Rule 14d-10 that the Commission had specified explicitly in its proposals, particularly since the Commission emphasized many times that it was simply intending to codify its existing interpretation of Section 14(d)(7) as containing a best-price rule, which rule Congress and the Commission clearly intended (as such intention is described above) to apply only during the formal tender offer period. Furthermore, if the Commission was intending to eliminate entirely the temporal limitations on the Rule, and thus change its prior interpretation of Section 14(d)(7), we believe that the Commission would have said so explicitly in its proposing and adopting releases on Rule 14d-10. It did not do so.

Accordingly, it appears clear to that the Congressional intent in adopting Section 14(d)(7), and the Commission's intent in adopting Rule 14d-10, was to regulate the consideration paid to security holders during the formal tender offer period, being the period from commencement of the tender offer, determined in accordance with Rule 14d-2, until the expiration thereof in accordance with the terms of the tender offer.

In sum, the Court in Epstein erred in interpreting both the plain words of Rule 14d-10 and the intent of the Commission in promulgating the Rule.

In addition to the interpretive and intent based reasons for believing that the Court in Epstein adopted the wrong approach in respect of Rule 14d-10, there are very strong policy reasons for interpreting the scope of Rule 14d-10 as limited to the clear time frame indicated by the phrase "during such tender offer," as the Courts did in both Lerro and Walker. As the Commission itself noted in proposing and adopting Rule 14d-10 there is "a need to provide clarity and certainty in the regulatory scheme applicable to tender offers," and a need to facilitate transactions while protecting investors. Without clarity over the scope and temporal aspects of the best-price rule, as the Court in Lerro stated it would "wreak havoc to say that the operation of all of the clocks cannot be known until, years after the events, a judge declares when negotiations became sufficiently serious to mark the commencement of the offer. Everything depends on making the times start from a public announcement--and on making that time as clear as humanly possible. That is the function of Rule 14d-2." And as the Court stated in Walker: "In a business setting, it is impractical to leave the validity of such agreements and the legality of ensuing tender offers subject to endless litigation." It is exactly these undesirable results that Epstein causes.

There are strong grounds to support the policy justifications for a narrow application of Rule 14d-10 offered by the Court in Lerro.

57 SEC Adopting Release, Id., *56.

58 *19. See also SEC Adopting Release, Id., *47.


60 Id., 246.

61 Walker, Id., *1377.

62 Lerro, Id., *243.
"Purchases near in time to a tender offer, but outside it, may be essential to transactions that all investors find beneficial. Controlling shareholders often receive indirect or non-monetary benefits and are unwilling to part with their stock (and hence with control) for a price that outside investors find attractive. At the same time, potential bidders may be unable to profit by paying everyone the price essential to separate the insiders from their shares. [...] Treating the Williams Act as a mandate for an identical price across the board—as opposed to an identical price for all shares acquired in the offer—would make all investors worse off."

VI. CONCLUSION

The current state of the law on Rule 14d-10, as interpreted by Epstein and its progeny, does not permit M&A practitioners and their clients to structure transactions to include a tender offer component without being exposed to significant risks. That fact is precluding the use of tender offers, a situation that needs to be remedied by reform of Rule 14d-10 to create clearly and certainly in respect of its scope and application.
OUTLINE OF ARTICLE ON SEC RULE 14d-10

I. INTRODUCTION

- Article addresses the impact of the recent judicial interpretations of Rule 14d-10
- Recent interpretations are problematic and are having a significant impact on how M&A deals are being structured and executed
- Purpose of article is to analyze the adoption, interpretation, and application of Rule 14d-10, and its effects on acquisition transactions
- The SEC should restore certainty and clarity to Rule 14d-10

II. LEGISLATIVE AND ADMINISTRATIVE HISTORY OF RULE 14d-10

- SEC's stated intent in adopting Rule 14d-10 for the formal tender offer period
- Rule codified existing SEC interpretation of Section 14(d)(7) of the Williams Act as imposing a "best price" rule
- Adoption of Rule 14d-10 designed to remove ambiguity over SEC's interpretation of Section 14(d)(7)
- Rule avoids discriminatory tender offers and avoids favoring either management or the takeover bidder; Rule regulates "Saturday Night Specials" and "First-Come First-Served" offers
- Rule intended to be focused on pendency of the tender offer (fixed period)
- Clarity and certainty are required and need to be restored

III. RULE 14d-10 JURISPRUDENCE

(a) Early cases

- *Field v. Trump* (1988; Second Circuit)
- *Kramer v. Time Warner* (1991; Second Circuit)
- *Kahn v. Virginia Retirement System* (1993; Fourth Circuit)
- Each effectively treated the expression "during the tender offer" in Rule 14d-10 as meaning "after commencement" and "before expiration" of the tender offer
(b) *Epstein v. MCA* (1996; Ninth Circuit)

(c) Seminal case creating uncertainty about Rule 14d-10

- Legal Tests
  - "integral part" (CEO)
  - "inducement" (COO)

- Rejection of rigid "temporal" test

- Focus on investor protection purposes of the Williams Act

- Damages calculated using multiplier of highest per share amount paid

(d) *Lerro v. Quaker Oats* (1996; Seventh Circuit)

- Preferred interpretation of 14d-10

- Rejected/Distinguished *Epstein*

- Adopted a "Brightline" test - focused on temporal aspects of Rule 14d-10: "during the tender offer"

- Recognized that Brightline test could lead to manipulation, but understood need for certainty

(e) Recent Decisions and Trends

- Inconsistent application of the Rule by the courts, aligned with either *Epstein* or *Lerro*.

- *Epstein* view appears to be prevailing, as plaintiffs use the factual uncertainty of the "integral part" test to survive motions to dismiss and summary judgment:

  - *Chiron* (1996) - enhanced options; followed *Epstein*; Summary Judgment for Defendants denied

  - *Padilla* (1998) - pre-existing equity incentive plan; followed *Epstein*; Motion to Dismiss by Defendants denied


  - *Maxick* (2000) - retention bonuses; followed *Epstein*; Summary Judgment for Defendants denied

- Gerber (2000) - non-Competition Agreement; followed Quaker Oats; Summary Judgment for Defendants denied as arrangement was entered into in formal tender offer period

- McMichael (2001) - golden parachutes; followed Epstein (but no inducement found); Summary Judgment for Defendants granted

- Walker (2001) - existing management compensation arrangements; followed Quaker Oats; Summary Judgment for Defendants granted

- Karlin (2001) - Acceleration of options; followed Epstein; Summary Judgment for Defendants denied

  • Cases are all very different from Epstein (they involved standard employment arrangements; no obligation to tender; not enough stock to matter in the tender offer; do not look like abusive practices) - yet all have presented problems for Defendants based on Epstein

  • Fact based analysis required -- result is that motions to dismiss and applications for summary judgment are almost inevitably denied

(f) Financial Cost of a Breach

  • Epstein's multiplier effect

  • Damages can be in the trillions/billions

IV. THE IMPACT OF EPSTEIN AND ITS PROGENY

  • Ambiguous, confusing standards have created risk in structuring M&A deals

  • Problem of "integral part" test - fact based analysis makes it almost impossible to have complaints dismissed given the legal standards for summary judgments/motions to dismiss

  • Transactions that may be more beneficially structured to include tender offers being structured as one step mergers [anecdotal--not in article]

  • Problems arise notwithstanding that:

    - arrangements have legitimate commercial purposes separate from the tender offer and are not a quid pro quo for the tender of shares

    - tender of shares by recipient immaterial to the offer

    - arrangements not conditioned on the tender of shares
- arrangements are consistent with state law on fiduciary duties and on compensation and have been approved by Boards following "due process" under state law
- arrangements entered into with target rather than acquirer
- full disclosure is made to stockholders
- arrangements entered into outside the formal offer period

- Delay in shareholders receiving merger consideration
- Exchange offers unlikely to be used other than in hostile context
- Certainty and clarity required for practitioners and their clients to use tender offers again

V. LEGAL DIFFICULTIES WITH THE EPSTEIN INTERPRETATION

- Epstein ignores the clear words of Rule 14d-10
- Epstein ignores the clear intent of Rule 14d-10
- Epstein misinterprets Field v Trump
- Epstein is wrong from a policy (certainty) perspective

VI. CONCLUSION

- Epstein is wrong as a matter of law and does not reflect the intent of the SEC in adopting Rule 14d-10
- Epstein's interpretation of Rule 14d-10 will have a significant impact on how M&A deals are being structured and implemented
- The SEC may need to address Epstein so that the Rule provides certainty and clarity, consistent with the Commission's original intent for the Rule.
B. RECENT DEVELOPMENTS IN THE LAW MATERIALITY QUALIFICATIONS AND MATERIAL ADVERSE CHANGE ("MAC") CLAUSES
Where MAC’s and Materiality Qualifiers are found in a Merger Agreement:

- Within the representations and warranties:
  - Stand-alone representation: There is often a representation by the seller stating that no MAC has occurred since a specified date in the past (most often the date of the most recent audited balance sheet provided to buyer by the seller).
  - Qualifiers to representations and warranties: Throughout the reps and warranties section of the merger agreement (and occasionally in other sections, such as certain covenants), many of the representations are limited or qualified by use of the MAC concept (e.g., “no defaults exist except such defaults as would not cause a material adverse effect”). In addition, the concept of materiality is used throughout the representations and warranties to limit their reach (e.g., “the financial statements of the Company fairly present, in all material respects, the financial position of the Company.”)

- Within the closing conditions:
  - Stand-alone closing condition: It is often a simple condition to buyer’s obligation to close the transaction that no MAC have occurred prior to closing.
  - Condition that reps and warranties be true: It is often required as a condition to closing that seller’s reps and warranties be true as of the closing date. To the extent that there is a MAC rep that is required to be true as of the closing date, this makes the MAC rep into a closing condition. Furthermore, the closing condition bringing down the representations and warranties to closing is itself usually qualified by materiality, except to the extent that such a qualifier is already embedded in the relevant representation (e.g., “the representations and warranties of the Company contained herein that are qualified as to materiality shall be true and correct and the representations and warranties of the Company contained herein that are not so qualified shall be true and correct in all material respects.”)
Functions of MAC’s and Materiality Qualifiers in a Merger Agreement:

- **Escape valve**: A MAC gives the buyer (and sometimes the seller as well) a “walk-away” right in the event that something bad happens to the business being acquired between the particular point in time set forth in the MAC and the time of closing.

- **Shorthand drafting tool**: The MAC language and the phrases introducing a materiality qualifier summarize in relatively short phrases or definitions a host of concepts that the parties to a complex agreement would otherwise have to spend endless effort hashing out between themselves in negotiations. The number of factual possibilities that could constitute a MAC or that could give rise to something “material” are literally infinite. To the extent that the parties rely on a relatively short MAC definition (or choose not to define the phrase “material adverse change” at all) or just use a phrase like “materially correct” as a qualifier, they are making a risk allocation decision balancing the possibility that a judge or other regulatory agent will be required to interpret the meaning of the definition or phrase against the time gained by not negotiating more explicit language.
**Standard MAC Language:**

- The following is an example of a relatively standard MAC definition, less any exceptions:

  "material adverse effect" means any state of facts, change, development, effect, condition or occurrence that [is][would][could][reasonably be expected to be] material and adverse to the business, assets, properties, condition (financial or otherwise) [prospects] or results of operations of the Company and its subsidiaries, taken as a whole, except...

- Some of the important elements of the MAC language that are often negotiated include:
  
  o **temporal basis:** the "[is][would][could][reasonably be expected to be]" sequence in the definition above sets forth a continuum of ways to deal with the certainty of the MAC event(s) being claimed. If "is" is used, then the MAC would presumably have to have already occurred to count. Conversely, the "could reasonably expected to" formulation implies a much lower degree of possibility being necessary to trigger the clause. The Tyson court commented on the ambiguous nature of the temporal language in that merger agreement but largely ignored its significance.
  
  o **characteristic of the company affected to trigger the clause:** the "business, assets,..." sequence in the paragraph above is an attempt by the buyer to describe all the aspects of the business that could change that could decrease its value to the buyer. The less concrete the aspect being described, the more latitude the buyer will have to claim that the clause has been triggered. Buyers sometimes attempt to include the term "prospects" in the sequence; this is often viewed as an attempt to force the company to meet financial projections supplied to the buyer by the seller. Sellers usually resist inclusion of "prospects", and the term makes it into a relative minority of agreements.
• The following is an example of some fairly standard exceptions to a MAC clause:

"except for any state of facts, change, development, effect, condition or occurrence (i) relating to the economy in general, (ii) relating to the [insert relevant industry] industry generally and not specifically relating to the Company or its subsidiaries or (iii) resulting from the announcement or existence of this Agreement."

- **General vs. specific:** In negotiating exceptions to the MAC clause, sellers focus on carving out adverse events that impact a large part of the economy, the industry, etc. rather than just the acquired business. The reasoning is that once the buyer decides to assume the risk of making the investment, the seller shouldn’t be penalized by events that impact a broader part of the market as opposed to things that are wrong with the acquired business itself. For example, the buyer shouldn’t get to walk away from the deal just because the U.S. economy went into a recession or because the entire construction industry entered a cyclical downturn.

- **Impact of signing the transaction:** Sellers are often wary of assuming the risk for events that occur because the transaction is signed up. For example, employees may begin leaving if they believe lay-offs will result from the deal, or large customers may cease doing business with the seller because they don’t like the buyer. This exception is often hotly debated because causation is very difficult to prove.

- **Events previously disclosed to buyer:** Sellers often try to exclude events of which the buyer already has knowledge, for example through the due diligence process or because the events are described in the seller’s publicly-filed documents. The reasoning is that the buyer is entering into the deal with full knowledge of the event, so the event shouldn’t be the basis for a right to walk away. Otherwise, the agreement would be more like an option.
Unusual/Highly Negotiated Exceptions to MAC Clauses:

- Sellers often attempt to negotiate more customized exceptions to the MAC clause, particularly when they have identified something unique to their business or industry for which they believe that the buyer should assume the risk at the time of signing. Some examples of different exceptions are:
  
  o changes in the capital markets, or even a particular exchange or market index (e.g., Dow Jones, S&P 500);
  
  o changes in the company’s stock price;
  
  o changes in foreign-exchange rates (particularly relevant in cross-border deals or when a substantial portion of a seller’s revenues are in a foreign currency);
  
  o changes in a particular commodity price (e.g., airplane fuel);
  
  o loss of material customers, suppliers, employees or executives;
  
  o judgments from particular lawsuits or a particular type of litigation;
  
  o changes general to the geographic region where the seller operates;
  
  o failures to meet analysts’ earnings estimates; and
  
  o events resulting from actions taken at the buyer’s request.
TSC v. Northway

TSC, which was decided in 1976, is the seminal U.S. Supreme Court case interpreting the concept of materiality as applied to corporate transactions. The TSC case specifically dealt with a claim by a shareholder that two companies that had issued a joint proxy statement had omitted material facts from the proxy statement. In its holding, the court resolved a dispute among the lower courts as to the correct standard to be applied for what constitutes “material” information.

The court’s basic holding can be summarized as follows:

- “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” The standard “contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the reasonable shareholder’s deliberations.”

The court also offered an alternate (and possibly easier to apply) formulation of the materiality standard:

- “There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”
Tyson v. IBP: The Delaware Chancery Court Interprets a MAC Clause

- **Background:** Tyson (chicken processor) agreed to buy IBP (beef processor) at the conclusion of an auction process begun by IBP management's attempt to do a management buy-out of IBP. Shortly before the scheduled closing of the acquisition, Tyson terminated the merger agreement on the basis of the claim (among other claims) that IBP had breached the MAC representation in the merger agreement, therefore leaving one of Tyson’s conditions to closing unfulfilled. Specifically, Tyson claimed that 1) IBP’s financial performance in the last quarter of 2000 and first quarter of 2001 and 2) an impairment charge of $60 million taken to fix some accounting problems with an acquisition, taken together, constituted a MAC under the definition. The MAC definition in the Tyson-IBP agreement contained standard language but no exceptions for general economic or industry effects. After Tyson terminated, IBP sued seeking specific performance of the merger agreement. The primary question at issue in the “MAE” portion of the case was the proper viewpoint from which to analyze the concept of materiality.

- **The Chancery Court focused on the following facts in its analysis:**
  
  - The Tyson/IBP agreement used the following “MAE” definition: “any event, occurrence or development of a state of circumstances of facts which has had or reasonably could be expected to have a Material Adverse Effect ... on the condition (financial or otherwise), business, assets, liabilities or results of operations of IBP and its Subsidiaries taken as whole.”

  - The financial statement representation in the Tyson/IBP agreement used the following language: “the audited consolidated financial statements of the Company included in the Company 10-K and unaudited consolidated financial statements of the Company included in the Company 10-Q’s each fairly present, in all material respects (emphasis added), in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in the notes thereto), the consolidated financial position of the Company and its consolidated subsidiaries as of the dates thereof and their consolidated results of operations and changes in financial position for the periods then ended (subject to normal year-end adjustments in the case of any unaudited interim financial statements).”

  - IBP’s historical financial statements showed a consistently profitable company subject to strong swings in earnings from year to year, and Tyson was aware of those swings.

  - Just before Tyson terminated the agreement, Tyson’s investment bank had prepared a fairness opinion stating that it believed that the deal price in the merger agreement was still within the range of fairness (after the occurrence of the “MAC” events).
Tyson was unable to produce (or didn’t produce) expert testimony showing that IBP’s long-term value or earnings potential was diminished by its poor first quarter performance.

Despite its poor first quarter performance, IBP management believed that IBP was on track to meet or exceed the projections provided to Tyson for full-year 2001.

When terminating the merger, Tyson did not assert that a MAC had occurred. The court took this to mean that Tyson did not itself believe that a short-term drop in earnings constituted a MAC.

The main points of the Chancery Court’s analysis were:

- The court imposed a heavy burden of proof on Tyson as buyer. The court admitted that it was unusual whether it was applying the correct burden of proof, so this issue may be litigated again in the future.

- The materiality of a development should be analyzed from the “long-term” perspective of a reasonable investor rather than the perspective of a short-term speculator.

- An event that could constitute a MAC is likely to have an effect that can be measured over a period of years (a “durationally significant” period), rather than a period of months. In particular, an adverse impact on financial results for one or two quarters is not dispositive evidence of the occurrence of a MAC.

- In analyzing whether a MAC occurred, the court should take into account the total mix of information available to the buyer, including 1) information within the agreement, including the schedules, and 2) information the buyer learned in due diligence.

- The court should analyze whether a buyer would have acted differently if it knew that a representation by the seller was untrue or misleading at the time it signed the agreement. That analysis should also be undertaken in the context of all the information available to the buyer.

- The information supplied by a buyer’s outside advisors and third parties are relevant in determining whether a MAC has occurred. The Chancery Court relied both on earnings estimates prepared by third party analysts and on a value analysis prepared by the buyer’s investment bank.

Chancery Court’s holding: The court found that the MAC representation in the Tyson/IBP merger agreement had not been breached, and that IBP was therefore entitled to specific performance of the merger agreement (i.e., Tyson had to complete the acquisition).
Sample MAE Language Disclaiming Tyson

"Material Adverse Effect" shall mean any state of facts, change, development, effect, condition or occurrence (including other than any state of facts, change, development, effect, condition or occurrence (i) relating to the economy in general or (ii) relating to the [industry] industry generally [even if not] [and not] specifically relating to the Company) that could reasonably be expected to be material and adverse to the (a) business, (b) assets, (c) properties, (d) condition (financial or otherwise), (e) value or (f) results of operations of the Company. For purposes of analyzing whether any state of facts, change, development, effect, condition or occurrence constitutes a "Material Adverse Effect" under this definition, the parties agree that (A) materiality shall be analyzed from the viewpoint of whether there is a significant likelihood that the disclosure of such state of facts, change, development, effect, condition or occurrence would be viewed by a reasonable investor (and not Buyer or any other particular investor) as having significantly altered the total mix of information available to such investor if the total mix of information had consisted solely of the representations and warranties of the Seller contained in this Agreement (other than ["No MAE" clause of "absence of adverse changes" rep]), the [Filed SEC Documents] and the Disclosure Schedule, (B) the analysis of materiality shall not be limited to the viewpoint of a long-term investor, (C) each of the terms contained in (a) through (f) above are intended to be separate and distinct and (D) the words of the definition of "Material Adverse Effect" are intended to be read literally without any regard to the holding or reasoning of IBP, Inc. v. Tyson Foods, Inc., No. 18373, 2001 Del. Ch. LEXIS 81 (Del. Ch. June 18, 2001).
9-11: Impact of the World Trade Center disaster

- **WPP and Tempus:** In early October 2001, WPP, a large advertising firm, won a takeover battle to acquire Tempus, a smaller British media-buying firm. The agreement came after a months-long competition between WPP and another rival, Havas, over who would acquire Tempus. In the press release announcing that 93.9% of Tempus’ shareholders had accepted its tender offer, WPP noted that its offer was subject to conditions, including a material adverse change condition. The tender offer had been launched in August 2001.

  - Approximately three weeks later, WPP applied to the U.K.’s Takeover Panel (the regulatory body that governs acquisitions in the U.K.) to withdraw from the acquisition based on the occurrence of a MAC (which have historically have rarely been invoked in the U.K.). WPP claimed that the downturn in the Tempus media-buying business resulting from the events of 9-11 constituted a MAC.

  - The Takeover Panel initially rejected WPP’s application without comment. After WPP appealed, the Panel issued a sweeping decision rejecting WPP’s application and setting a very high bar for the exercise of a MAC clause in an acquisition agreement under U.K. law.

  - The decision held that in order to justify use of a MAC clause, the change would have to be “of very considerable significance striking at the heart of the purpose of the transaction in question, analogous...to something that would justify frustration of a legal contract” and that “exceptional circumstances must have arisen affecting the offeree company which could not have reasonably been foreseen at the time of the announcement of the offer...judged not in terms of short term profitability but on their effect on the longer term prospects of the offeree company.”
USA Networks and NLG: In November 2001, USA Networks filed an action with the Delaware Chancery Court seeking the court’s approval of USA’s termination of its acquisition agreement with National Leisure Group (NLG). USA based its claim for the right to terminate the agreement on the MAC clause in the agreement.

- USA’s MAC claim was based on a combination of two separate events: 1) the 9-11 terrorist attacks and 2) NLG’s loss of a major customer contract after the signing of the merger agreement. The MAC clause in the USA/NLG merger agreement (like the MAC clause in the Tyson case) did NOT contain “standard” exceptions for events affecting the economy or the industry generally. NLG is a travel company whose business would at least arguably have been significantly impacted by the downturn in the travel industry after 9-11.

- USA and NLG settled the case shortly before it was scheduled to go to trial. Under the terms of the settlement, USA invested $20 million for an approximately 20% stake in NLG. The purchase price for the acquisition of 100% of NLG in the original agreement was approximately $150 million.
Enron: Post - Tyson exercise of a MAC clause

- On December 3, 2001, Enron Corp. sued its former merger partner Dynegy Inc. for $10 billion claiming wrongful termination of their merger agreement. Dynegy had earlier terminated the agreement claiming a breach of the MAC clause in the merger agreement. Dynegy cited Enron’s deteriorating cash position, its mounting long-term liabilities and unspecified misrepresentations of Enron’s financial position in terminating the merger agreement.

  - The Enron/Dynegy agreement is governed by Texas law, so different legal rules will govern the litigation than governed the Tyson case (NY law).

  - The facts of the Enron case are similar to the facts of the Tyson case in that the buyer (Dynegy) was aware of significant problems with the seller’s business while merger negotiations were taking place.

  - Under the facts as currently known, it appears possible that Dynegy may have known that Enron was in breach of the agreement at the time that Enron signed it. Texas law is not clear on whether a party that knew of a breach at the time it signed an agreement may void the agreement based on that breach.
C. RECENT DEVELOPMENTS IN DELAWARE CASE LAW
I. ENTIRE FAIRNESS CLAIMS IN SHORT-FORM MERGERS
A. Glassman v. Unocal Exploration Corporation, 777 A.2d 242 (Del.Supr. 2001)

ISSUE:

- Whether a minority stockholder may challenge a "short-form" merger by seeking equitable relief through an entire fairness claim?

- In resolving that issue, the Delaware Supreme Court must determine what fiduciary duties are owed by a parent corporation to the subsidiary's minority stockholders in the context of a "short-form" merger.

  • Fiduciary has a seemingly absolute duty to establish the entire fairness of any self-dealing transaction.

  • In contrast, the Delaware "short-form" merger statute authorizes the elimination of minority stockholders by a process that does not involve the "fair dealing" component of entire fairness.

FACTS:

• Unocal Corporation ("Unocal") owns 96% of the stock of Unocal Exploration Corporation ("UXC"). Both corporations appoint special committees to consider a possible merger.

• UXC's committee consisted of three directors who, although also directors of Unocal, were not officers or employees of the parent.

• Merger was effected pursuant to 8 Del. C. § 253, the "short-form" merger statute.

• Plaintiffs filed this class action on behalf of UXC's minority stockholders, asserting that Unocal's directors breached their duties of entire fairness and full disclosure.

ANALYSIS:

• The Delaware Supreme Court notes that "a parent corporation and its directors undertaking a short-form merger are self-dealing fiduciaries who should be required to establish entire fairness, including fair dealing and fair price."

February 5, 2002

D. Y. Abebe
However, the Court recognizes that § 253 authorizes a summary procedure that is inconsistent with fair dealing.

Court notes that if a fiduciary follows the procedure in the "short-form" merger statute it cannot establish the fair dealing prong of entire fairness. If the fiduciary sets up negotiating committees and hires independent experts, etc., it loses the benefit of an efficient merger provided by the statute.

HOLDING:

Court holds that:

1. § 253 must be construed to obviate the requirement to establish entire fairness.

2. Although entire fairness in not necessary, the duty of full disclosure remains for stockholder actions.

3. Absent illegality, appraisal is the only remedy for a minority stockholder who objects to a "short-form" merger.


ISSUE:

Whether alleged breaches of fiduciary duties and the oppressive structure of a merger require a tender offer to be judged by the entire fairness standard.

FACTS:

Siliconix Inc., shareholder challenges stock-for-stock tender offer by Vishay Intertechnology, Inc. ("Vishay"), through its wholly-owned subsidiary, for the 19.6% equity interest in Siliconix that its subsidiary does not already own.

In 2/01, Vishay proposed an all-cash tender offer for Siliconix at $28.82 a share and stated that if it obtained over 90% of the stock, it would consider a "short-form" merger of Siliconix into a subsidiary at the same price.

In its offer, Vishay requested to meet with a special committee of independent Siliconix directors. Siliconix named two directors with extensive relationships with Vishay to the special committee and paid them for their services.

In 5/01, Vishay informed the special committee that it was considering going forward with a stock-for-stock exchange offer without the committee's approval. The special committee decided to stay neutral and declined to make a recommendation.

Plaintiff alleges that Vishay and the directors of Siliconix breached their fiduciary duties to the by issuing disclosures that omitted material facts and by structuring the tender in an coercive manner.
ANALYSIS:

- The Delaware Supreme Court establishes that Vishay was under no duty to offer a particular price to the Siliconix minority shareholders because as long as the tender offer was properly pursued, the minority's right to reject the tender provides sufficient protection.

- As to entire fairness claims, plaintiff alleges that the Siliconix Board breached the duty of care and the duty of loyalty by failing to properly evaluate the transaction and because the board was conflicted.

- Court notes that in the context of a merger of a subsidiary with a third party where the controlling shareholder wants the merger and the minority shareholders are powerless to prevent it, there are certain duties for a subsidiary's directors:
  1. They must protect the minority shareholders' interests;
  2. They cannot abdicate their duty by letting the shareholders respond on their own; and
  3. They must assist the minority shareholders by determining the subsidiary's value as a going concern.

- However, Court establishes that those duties are "context specific" and that in this case, minority stockholders had the power to prevent the tender and that the Siliconix transaction was in the context of a tender offer rather than a merger.

- Plaintiff alleges (1) that Vishay misled Siliconix stockholders in its Registration Statement ("RS") by providing negative projections about Siliconix; (2) that the RS incorrectly states that Siliconix management prepared the projections; and (3) that the RS did not describe new Siliconix products.63

- Court states that the projections are "soft-information" which are inherently speculative and uncertain, that the RS stated that Vishay participates in Siliconix' forecasts, and that the RS described Siliconix' recent successes in product development.

- The RS disclosed that members of the Special Committee "had prior business relationships with Vishay."

- Court concludes that the timing of the announcement of the tender offer could not have had a coercive effect on shareholders' decision to tender over three months later.

- Moreover, there was no coercive effect from the alleged threat to delist because the RS states that the de-listing would occur after the tender offer and the "short-form" merger, at which time there would be no publicly traded

63 Plaintiff also alleges that the special committee failed to disclose additional financial projections, pro formas, valuation methodologies, and the basis for Vishay's tender offer. The Court addresses these allegations in a summary manner and concludes that there were no disclosure violations. As such, the specifics of these allegations are not included in the case summary.
Siliconix stock.

- Court concludes that plaintiff has not demonstrated a reasonable probability of success on the merits of his claim.

HOLDING:

In sum, the Court concludes that the entire fairness standard is not implicated in the context of a parent company's tender offer for a subsidiary that it already controls.

- Since this specific transaction does not require the action of the target's board of directors, the entire fairness standard is not applicable.

- Court denies plaintiff's motion for a preliminary injunction to enjoin the tender.

DISCUSSION:

The Glassman and Siliconix cases represent a shift by both the Delaware Supreme Court and Court of Chancery to allowing the parent corporation in a short-form merger to avoid the entire fairness doctrine in situations where the parent already controls over ninety percent of the target company. The parent may adjust its negotiating posture because it has increased leverage over the special committee, which would be functioning without the protection of the entire fairness standard and would be unable to unilaterally block a transaction. In practice, Glassman and Siliconix allow a parent corporation bidder to have greater flexibility in setting its price. The decision also determines the role of special committees in tender offers that are dependent on the parent obtaining a ninety percent or greater interest of the target because, the parent would not need the special committee's recommendation to close the merger.

Although the Delaware courts may have opened the door to the "intransigent" majority shareholder, who could simply ignore the special committee and deal directly with the minority shareholders, both Glassman and Siliconix still require the duty of full disclosure. In Siliconix, the Delaware Chancery Court expressly assumes that the parent corporation or majority shareholder would accurately disclose pertinent information to the minority shareholders. The implication of such a requirement is that the Court may invalidate an otherwise legitimate short-form merger on inadequate disclosure grounds alone.

While entire fairness may not be required in short-form mergers, thereby weakening the position of the special committees and the minority shareholders relative to a majority shareholder, the Delaware courts may nonetheless rigorously examine disclosures to guarantee some protection for minority shareholders in short-form mergers.

II. DISCLOSURE REQUIREMENTS IN THIRD PARTY BID SITUATIONS


ISSUE:

Plaintiff stockholders challenge merger alleging: (1) breaches of the target board's duty of loyalty or its disclosure duties; and (2) aiding and abetting or
tortuous interference by the acquiring corporation.

FACTS:

- Frederick's of Hollywood ("Frederick's") plans merger with Knightsbridge Capital Corporation.

- Two trusts (the "Trusts") hold about 41% of the Class A voting shares and 51% of the outstanding class B non-voting shares of Frederick's.

- Frederick's board (the "Board") approves an offer from Knightsbridge and signs a merger agreement that prohibits the Board from soliciting bids from third parties, but allows the Board to negotiate with third-party bidders.

- Veritas Capital Fund ("Veritas") offers Frederick's a higher unsolicited bid. Knightsbridge matches the Veritas offer with conditions limiting Frederick's from pursuing higher offers.

- In the meantime, Knightsbridge agrees to purchase the Trusts' shares, informs the Board of the purchase, and states that it will vote the shares against any third-party bidder.

- The Board rejects the revised Veritas bid, citing the "no-talk" provision in the merger agreement and Knightsbridge's plan to vote against third-party bids.

- Plaintiff shareholders alleged that the Board breached its fiduciary duties in selling the company and by omitting material information from the Consent Solicitation Statement ("CSS").

ANALYSIS:

- The Delaware Supreme Court states that the salient issue is whether the sale of Frederick's constitutes a breach of the Board's fiduciary obligation to maximize shareholder value by its failure to conduct an auction.

- Court states that the Board must perform its fiduciary duties to maximize the sale price of the enterprise.

- Court rejects plaintiffs' initial allegation that the directors' individual interests in avoiding personal liability to Knightsbridge influenced the decision to approve the merger.

- Court concludes that the Board's disclosure of the second, higher Veritas offer in the CSS renders immaterial any alleged misstatement about the Board's rationale for rejecting the bid.

- Court concludes that the simple allegation that the CSS did not include the reasons for the resignation of two directors did not demonstrate that the Board knew of the reasons for the resignations. Thus, the Board had no duty to disclose.

- Court evaluates whether the board should pay damages for its alleged breach of the duty of due care but does not reach the issue because Frederick's charter exempts directors from personal liability in damages adopted pursuant to 8 Del. C. § 102(b)(7).
Court addresses claims that Knightsbridge aided and abetted the Board's breach of its fiduciary duty to obtain the highest price available and concludes that the merger agreement was the product of arm's-length negotiations.\(^4\)

**HOLDING:**

The Court concludes that the amended complaint does not allege a breach of loyalty or disclosure duty, does not support a claim for aiding and abetting a breach of fiduciary duty, and does not support a claim for tortuous interference with a business opportunity.

**III. CALCULATION OF SHELF REGISTRATION DAMAGES**

*Duncan v. Theratx, Inc.*, 775 A.2d 1019 (Del.Supr. 2001)

**ISSUE:**

The appropriate method of calculating contract damages where an issuer's temporary suspension of a shelf registration prevents trading by stockholders in violation of the terms of a merger agreement.

**FACTS:**

- In the merger agreement between Theratx, Inc. and PersonaCare, Inc., PersonaCare shareholders received restricted, unregistered shares in Theratx. Theratx filed a shelf registration that would permit the holders to trade the shares in the event of a public offering.
- Soon after the trading began, Theratx acquired another company. Since the acquisition was a material change requiring an amendment to the shelf registration, Theratx suspended the shelf registration and re-imposed trading restrictions on the PersonaCare stockholders' shares.
- The PersonaCare stockholders sued for breach of the merger agreement.\(^5\)

**ANALYSIS:**

- The Delaware Supreme Court must identify the damages rule that provides the stockholders with adequate compensation for a breach and provides both parties with the incentive to minimize joint losses from the breach.
- Court states that the stockholders' lost expectation interest is the reduction in their presumptive capital gains attributable to the trading restrictions.

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\(^4\) The Court also disposes of a tortuous interference claim against Knightsbridge, stating that Knightsbridge's alleged misrepresentation was remedied well before the board of Frederick's acted and that the allegations were insufficient to support the inference that the alleged misrepresentation caused the board to accept the Knightsbridge offer and reject the higher Veritas offer.

\(^5\) The case originated in the United States District Court for the Northern District of Georgia. The district court held that Theratx breached the merger agreement. On appeal to the United States Court of Appeals for the Eleventh Circuit, the Court affirmed but certified the question of damages to the Delaware Supreme Court.
Thus, the Court must determine: (1) the best estimate of what the sale price would have been absent the restrictions, and (2) at what point the Court should measure the value of the shares after the restrictions were lifted.

Court estimates the hypothetical sale price by identifying a reasonable period after the restriction was imposed during which the stockholders could have sold the shares and then by selecting the "highest intermediate sale price" during that period as the presumed sale price.

Court then determines the amount that the hypothetical "highest intermediate sale price" must be reduced to reflect the remaining value of the shares after the breach. The Court uses the average price of the shares immediately after reinstatement, or the "hypothetical immediate sale price."

HOLDING:

Court concludes that contract damages caused by the suspension of a shelf registration in violation of a contract are measured by calculating the difference between (1) the highest intermediate price of the shares during a reasonable time at the beginning of the restricted period and (2) the average market price of the shares during a reasonable period after the restrictions were lifted.

DISCUSSION:

The Duncan holding is important as the Delaware Supreme Court, in a case of first impression, decides the appropriate method for calculating contract damages where an issuer violates a merger agreement by preventing trading by stockholders through the suspension of a shelf registration. While this is not an area that is traditionally heavily litigated, the Court has outlined its method for calculating damages and has provided an incentive to both parties to minimize the effects of a breach.

IV. DISCLOSURES TO "CASHED-OUT" MINORITY STOCKHOLDERS


ISSUE:

The adequacy of corporate disclosures to minority stockholders who were "cashed out" in a merger approved by the majority stockholder.

• Minority stockholders suggest that more than the traditional disclosure requirements must be disclosed where a merger decision has been made and the only decision for the minority stockholders is whether to seek appraisal.

• Directors argue that traditional disclosure requirements are adequate and that there should not be a different standard for appraisals.

FACTS:

• House of Fabrics, Inc. ("HF"), agreed to be acquired by Fabric-Centers of America, Inc. ("FCA") in a two step transaction--tender offer for a majority of HF shares followed by a merger.

• Three weeks after the tender offer closed, HF announced the second step of the merger and sent the minority stockholders a Notice of Special Meeting of
Stockholders ("Notice") and an Information Statement ("IS"), but no proxy.

- HF explained that FCA owned enough shares of HF, approximately 77%, to approve the merger without the vote of any other stockholder. Thus, minority stockholders were not asked to vote on the merger.

- Plaintiffs allege that FCA's and HF's directors breached their fiduciary duties by failing to disclose certain financial projections, financial reports, the range of HF's fair value, and the board's reason to sell the company.

ANALYSIS:

- The Delaware Supreme Court states that the duty of disclosure requires directors to "disclose fully and fairly all material information within the board's control."

- For a disclosure claim, a party must identify the missing facts, state why they meet the materiality standard, and demonstrate how the omission of the alleged fact caused injury.

- Court states that the minority stockholders failed to show that the omitted data would be material to the their decision to support the merger.

HOLDING:

While agreeing that a stockholder deciding whether to seek appraisal should be given financial information that is material to the decision, the Court rejects the contention that there should be a new disclosure standard in cases where appraisal is an option.

- The Court rejects the argument that stockholders should be given all the financial data that they would need if they were making an independent determination of the company's value.

DISCUSSION:

The Delaware Supreme Court clearly rejects any argument that "cashed-out" minority stockholders in a merger approved by the majority stockholder have the right to a new, more stringent disclosure standard simply because appraisal is an option. Although the Court establishes that minority stockholders should receive all material information within the target board's control, it refuses to require any additional disclosure in the appraisal context.
D. PURCHASE ACCOUNTING & GOODWILL
MEMORANDUM FOR J. WOOLERY

Purchase Accounting & Goodwill

D. Y. Abebe

February 5, 2002

The Financial Accounting Standards Board's ("FASB") decision to eliminate the pooling of interests accounting method and to allow an "impairment" test to determine whether to amortize goodwill assets has changed the traditional accounting treatment for business combinations.

This memorandum briefly outlines the previous accounting regime and discusses the steps for applying the "impairment" test to new business combinations. It is not intended to be a comprehensive description or analysis of the new FASB statements.66

I. POOLING V. PURCHASE ACCOUNTING

Under the pooling of interests accounting method, an acquirer assumes the assets, liabilities, and net worth of the target company at the value present on the target's financial statements. With this treatment, there is no accounting goodwill because the value of the target's capital and inventory transfer to the acquirer without adjustment.

In purchase accounting, if an acquirer's cost for the target is greater than the value of the target's assets, the excess in cost creates amortizable goodwill. Acquirers could amortize the goodwill assets as charges against earnings for a period not exceeding forty years. Although the acquirer's assets are increased using this method, it must still write down the newly created goodwill over time, thereby affecting the acquirer's stock price and future earnings.

II. NEW TREATMENT OF GOODWILL

Under FASB Rule No. 141, "Business Combinations" and Rule No. 142, "Goodwill and Other Intangible Assets," acquirers using the purchase accounting method will not have to amortize the goodwill assets over time. In addition, the FASB eliminated the pooling of interests method for business combinations. The new accounting treatment allows acquirers to subject the goodwill assets to an "impairment" test, in which the acquirer must determine whether there has been a decline in value of the goodwill. If there is an "impairment" of the goodwill's value, the acquirer must then amortize the goodwill asset to its fair value.

III. GOODWILL IMPAIRMENT TEST

The are several steps involved in determining whether the goodwill assets have been impaired:

1. A company must determine fair value of each reporting unit. The "fair

66 Please refer to the full text of the FASB's statements for the official description of the rules.
value" of a reporting unit is the amount at which it could be purchased or sold in a current transaction between willing parties.

- Once the company determines the fair value, proceed to the next step of the impairment test only if the fair value is less than the carrying value.

2. If the fair value is less than the carrying value, then the company must determine the fair value of all tangible and intangible net assets of each reporting unit in order to arrive at the "implied fair value" of that reporting unit's goodwill.

3. The implied fair value of the goodwill is equal to the fair value of the reporting unit, as determined in step one, subtracted by the fair value of that reporting unit's tangible and intangible net assets.

4. If the implied fair value of the goodwill of a reporting unit is less than its carrying value, the goodwill is written down to the implied fair value.

IV. INTERIM TESTING

In addition to the annual impairment test required by FASB No. 142, interim tests are mandatory when an event occurs or circumstances change between annual tests that would more likely than not reduce the fair value of the reporting unit below its carrying value. Such events include:

1. Significant adverse changes in legal factors or business climate;
2. Adverse actions or assessments by a regulator;
3. Unanticipated competition;
4. Loss of key personnel; and
5. "A more likely than not" expectation that a reporting unit or significant portion of a reporting unit will be sold or otherwise disposed of; and

V. EXEMPTION FROM ANNUAL IMPAIRMENT TESTING

There are also exemptions from the annual impairment test. If the following three conditions are satisfied with respect to a reporting unit, a company does not have to engage in the annual impairment test for that reporting unit:

1. The assets and liabilities of the reporting unit have not changed significantly since the last fair value determination.
2. The amount of the most recent fair value determination exceeded the carrying amount of the reporting unit by a substantial margin.
3. Based on an analysis of events and changed circumstances since the most recent valuation, the likelihood that a current fair value determination would be lower than the carrying value of the reporting unit is remote.
IN RE IBP SHAREHOLDERS LITIGATION
(IBP, INC. V. TYSON FOODS, INC.)

A CASE STUDY

Stewart E. Conner
Wyatt, Tarrant & Combs, LLP
Louisville, Kentucky

Bob Ford Thompson
Bass Berry & Sims PLC
Nashville, Tennessee

and

Cynthia W. Young
Wyatt, Tarrant & Combs, LLP
Louisville, Kentucky

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SECTION B
IN RE IBP, INC. SHAREHOLDERS LITIGATION
(IBP, Inc. v. Tyson Foods, Inc. (Court of Chancery of Delaware))

Stewart E. Conner
Bob Ford Thompson
and
Cynthia W. Young

The IBP/Tyson case was chosen as a subject for this seminar because of the enlightening view it give practitioners of how their highly negotiated, masterfully word-smithed, artfully arcane contractual provisions are viewed by a knowledgeable judge with considerable business knowledge. The case should help us all in descending from our ivory towers and wallowing in the trenches of real issues in real deals with real people.

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OPINION

STRINE, Vice Chancellor.

*1 This post-trial opinion addresses a demand for specific performance of a "Merger Agreement" by IBP, Inc., the nation's number one beef and number two pork distributor. By this action, IBP seeks to compel the "Merger" between itself and Tyson Foods, Inc., the nation's leading chicken distributor, in a transaction in which IBP stockholders will receive their choice of $30 a share in cash or Tyson stock, or a combination of the two.

The IBP-Tyson Merger Agreement resulted from a vigorous auction process that pitted Tyson against the nation's number one pork producer, Smithfield Foods. To say that Tyson was eager to win the auction is to slight its ardent desire to possess IBP. During the bidding process, Tyson was anxious to ensure that it would acquire IBP, and to make sure Smithfield did not. By succeeding, Tyson hoped to create the world's preeminent meat products company—a company that would dominate the meat cases of supermarkets in the United States and eventually throughout the globe.

During the auction process, Tyson was given a great deal of information that suggested that IBP was heading into a trough in the beef business. Even more, Tyson was alerted to serious problems at an IBP subsidiary, DFG, which had been victimized by accounting fraud to the tune of over $30 million in charges to earnings and which was the active subject of an asset impairment study. Not only that, Tyson knew that IBP was projected to fall seriously short of the fiscal year 2000 earnings predicted in projections prepared by IBP's Chief Financial Officer in August, 2000.

By the end of the auction process, Tyson had come to have great doubts about IBP's ability to project its future earnings, the credibility of IBP's management, and thought that the important business unit in which DFG was located—Foodbrands—was broken.

Yet, Tyson's ardor for IBP was such that Tyson raised its bid by a total of $4.00 a share after learning of these problems. Tyson also signed the Merger Agreement, which permitted IBP to recognize unlimited additional liabilities on account of the accounting improprieties at DFG. It did so without
demanding any representation that IBP meet its projections for future earnings, or any escrow tied to those projections.

After the Merger Agreement was signed on January 1, 2001, Tyson trumpeted the value of the merger to its stockholders and the financial community, and indicated that it was fully aware of the risks that attended the cyclical nature of IBP's business. In early January, Tyson's stockholders ratified the merger agreement and authorized its management to take whatever action was needed to effectuate it.

During the winter and spring of 2001, Tyson's own business performance was dismal. Meanwhile, IBP was struggling through a poor first quarter. Both companies' problems were due in large measure to a severe winter, which adversely affected livestock supplies and vitality. As these struggles deepened, Tyson's desire to buy IBP weakened.

*2 This cooling of affections first resulted in a slow-down by Tyson in the process of consummating a transaction, a slow-down that was attributed to IBP's on-going efforts to resolve issues that had been raised about its financial statements by the Securities and Exchange Commission ("SEC"). The most important of these issues was how to report the problems at DFG, which Tyson had been aware of at the time it signed the Merger Agreement. Indeed, all the key issues that the SEC raised with IBP were known by Tyson at the time it signed the Merger Agreement. The SEC first raised these issues in a faxed letter on December 29, 2000 to IBP's outside counsel. Neither IBP management nor Tyson learned of the letter until the second week of January, 2001. After learning of the letter, Tyson management put the Merger Agreement to a successful board and stockholder vote. But the most important reason that Tyson slowed down the Merger process was different: it was having buyer's regret. Tyson wished it had paid less especially in view of its own compromised 2001 performance and IBP's slow 2001 results.

By March, Tyson's founder and controlling stockholder, Don Tyson, no longer wanted to go through with the Merger Agreement. He made the decision to abandon the Merger. His son, John Tyson, Tyson's Chief Executive Officer, and the other Tyson managers followed his instructions. Don Tyson abandoned the Merger because of IBP's and Tyson's poor results in 2001, and not because of DFG or the SEC issues IBP was dealing with. Indeed, Don Tyson told IBP management that he would blow DFG up if he were them.

After the business decision was made to terminate, Tyson's legal team swung into action. They fired off a letter terminating the Agreement at the same time as they filed suit accusing IBP of fraudulently inducing the Merger that Tyson had once so desperately desired.

This expedited litigation ensued, which involved massive amounts of discovery and two weeks of trial. [FN1]

In this opinion, I address IBP's claim that Tyson had no legal basis to avoid its obligation to consummate the Merger Agreement, as well as Tyson's contrary arguments. The parties' extensive claims are too numerous to summarize adequately, as are the court's rulings.

At bottom, however, I conclude as follows:

- The Merger Agreement and related contracts were valid and enforceable contracts that were not induced by any material misrepresentation or omission;
- The Merger Agreement specifically allocated certain risks to Tyson, including the risk of any losses or financial effects from the accounting improprieties at DFG, and these risks cannot serve as a basis for Tyson to terminate the Agreement;
- None of the non-DFG related issues that the SEC raised constitute a contractually permissible basis for Tyson to walk away from the Merger;
- IBP has not suffered a Material Adverse Effect within the meaning of the Agreement that excused Tyson's failure to close the Merger; and

*3 · Specific performance is the decisively preferable remedy for Tyson's breach, as it is the only method by which to adequately redress the harm threatened to IBP and its stockholders.

I. Factual Background
IBP's Key Managers

IBP was first incorporated in 1960. Its current Chairman of the Board and Chief Executive Officer, Robert Peterson, has been with the company from the beginning. Having started in the cattle business as a cattle driver, Peterson learned the business from the ground up and has been the strategic catalyst behind IBP's growth from a relatively small fresh beef business to a diversified food company with sales of over $15 billion annually.

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Peterson is a strong and committed CEO, who loves the business he has helped build and the people who work for it. By the late 1990s, however, Peterson was in his late sixties and cognizant that it would soon be time to turn the reins over to a new CEO. Peterson's heir apparent was IBP's President and Chief Operating Officer, Richard "Dick" Bond. By 2000, Peterson had also installed one of his top aides, Larry Shipley, as IBP's Chief Financial Officer. Sheila Hagen was IBP's General Counsel, having joined the company from one of its beef industry rivals.

Although this quartet all have important roles in the company, it is clear that Peterson remains the dominant manager at IBP, and that Bond is the next most important. Shipley and Hagen, however, each have important duties regarding financial and legal functions at issue in this case. As in any organization, the roles of the four overlapped, but imperfectly so. Put less obliquely, it is common for "big picture" executives to view and speak about issues from a larger strategic perspective that is less specific and technically precise than executives like CFOs and General Counsels who are charged with getting the details precisely right.

IBP's Business

The traditional business of IBP is being a meat processor that acts as the middleman between ranchers and retail supermarkets and food processors. This is the so-called "fresh meats" business of IBP. Over the years, that business has evolved in sophistication so that just about every inch of the animals eventually can be processed by IBP or a later purchaser into something useful. The fresh meats business has also gotten more and more precise in terms of slaughtering. Whereas very large sections of animals used to be shipped to end-users, the industry trend is for middlemen like IBP to do more of the cutting.

As of 2000, IBP was on the verge of taking that strategy to its next level. Instead of shipping large sections of meat to stores for further butchering, IBP was preparing to butcher meat itself, which would be shipped "case ready"—that is, ready to be put into the supermarket case. This was a new endeavor that was hoped to yield higher margins and reduce the overall cyclicalty of IBP's business.

Likewise, IBP was endeavoring to build up its food processing businesses. These are the businesses that take raw food products and turn them into something canned or packaged for supermarket or restaurant sale. Because these processing activities "add value," they tend to have higher profit margins and generate more stable earnings than middleman meat slaughtering.

*4 To carry out this strategy, IBP had recently made a series of acquisitions, including the purchase of Corporate Food Brands America, Inc. ("CFBA") in February 2000. These purchased entities were being put together within IBP under the larger heading of Foodbrands. The companies make a variety of products, such as pizza toppings and crusts, side dishes, sauces, condiments, and portion-controlled meat products. IBP was also intent on promoting a branded line of lunch meat and similar products under the name "Thomas E. Wilson."

IBP hoped that these processed food investments would provide a vehicle for growth and reduce the year-to-year volatility of IBP's earnings. Given that most of the acquired companies within Foodbrands had been purchased no earlier than 1998, IBP was obviously quite early in executing this yet-to-be fully proven strategy.

Moreover, while Foodbrands was a central part of IBP's strategy for the future, it remained at that time a much smaller contributor to the bottom line than IBP's fresh meats business. As originally reported, for example, fiscal year ("FY") 1999 sales for IBP's fresh meats business were $12.4 billion as opposed to $1.7 billion for Foodbrands. [FN2] Similarly, FY 1999 operating earnings in the fresh meats business were $438 million as opposed to $90 million for Foodbrands. [FN3] Thus, while Foodbrands had a higher profit margin, fresh meats remained by far the most substantial part of IBP's business.

IBP Management Proposes An LBO

During 1999 and early 2000, IBP's management was frustrated by the stock market's valuation of the company's stock. As earnings-less dot.coms traded at huge multiples to eyeball hits, IBP's stock traded at a relatively small multiple to actual earnings. In response to this problem, Peterson, Bond, and Shipley were receptive when the investment bank of Donaldson, Lufkin & Jenrette, Inc. ("DLJ") expressed interest in a leveraged-buy out ("LBO") of the company.

In July, management informed the IBP board that it would like to pursue an LBO seriously. With the help of DLJ, a syndicate of investors who called themselves "Rawhide" was prepared to take the
company private if a deal could be negotiated with the IBP board. The board formed a special committee comprised of outside directors, who then selected Wachtell, Lipton, Rosen & Katz as its legal advisor and J.P. Morgan Securities, Inc. as its financial advisor.

To facilitate their work, the special committee and J.P. Morgan asked IBP management to develop a set of five-year projections for the performance of IBP, which I will call the "Rawhide Projections" or the "Projections." This request put the IBP management in the position of performing a task that was relatively novel to them. While IBP had periodically prepared two to three-year projections for rating agencies, it was not accustomed to making five-year projections. Even more important, it did not utilize such long-term projections in its own business operations.

*5 To the contrary, IBP generally created plans for the coming year. In the fresh beef part of the business, these plans were quite ambitious and designed to motivate excellent performance, rather than to be predictive of actual results. The plans for the processed foods part of the business were designed to be more predictive, but these plans also dealt with the part of the business that was newest, and that included several units that had been recently purchased by IBP.

Several other factors made it difficult to project IBP's performance accurately. Although IBP was executing a strategy to diversify its business so as to be less dependent on its fresh meats business, the reality was that fresh meats was still the core of the company, constituting well over 80% of its sales and earnings in 1999. Not only that, IBP's processed foods division used fresh meats heavily.

As a middleman processor of fresh meats, IBP purchases cows and hogs at market prices, slaughters them, and sells them to food retailers and food processors. IBP's profit margins are quite tight. When live stock supplies are low, these margins shrink further. When livestock supplies are plentiful, IBP is more profitable.

Cattle and hog supplies go through cycles that can be tracked with some general precision using information from the United States Department of Agriculture. These cycles are affected by actual demand and ranchers' expectations of market demand, as well as the need at various points to hold animals back to build up herds. Livestock supply is also heavily weather-driven. Ranchers are paid more money for large animals, from which more meat can be butchered. Cold weather makes it difficult for ranchers to grow the animals to the point where they will sell for the optimal price. When a severe winter hits, ranchers may hold animals back, so that they can be sold later after having been grown to more profitable sizes.

IBP's Foodbrands business was also affected by fluctuations in livestock pricing, because it uses fresh meats as raw material. While Foodbrands has a relatively greater ability to make up for any shortage in livestock than the fresh meats part of IBP, Foodbrands also suffers when livestock supplies are tight and is unable to pass on its increased costs immediately. Instead, it hopes to regain its reduced margins within a reasonable time. [FN4]

For all these reasons, IBP's management was wary of preparing a five-year projection, but did so. The task fell largely to Shipley as CFO. His methodology was sound and reasonable, if not scientific. In sum, Shipley's August, 2000 Rawhide Projections assumed as follows:

- **Fresh Meats:**
  
  Beef: Shipley estimates for FY 2000 profitability ("EBIT [FN5] per head") and volume were based on first-half results and projected to continue through the rest of the year. Thus, he projected EBIT per head of $27.50. But Shipley assumed a sharp decline in EBIT per head in 2001 to $16.50 per head, and a further decline in 2002 to $15.00, and a modest increase from 2003 to 2005. Profitability during this period was expected to remain fairly flat. Shipley's August, 2000 Rawhide Projections assumed an expected trough in the cattle cycle, in view of historical trends.

- **Pork:** Shipley used the same per-head EBIT figure for all five years, derived from IBP's historical average, with a slight upward adjustment for industry rationalization. Overall EBIT fluctuated, but was fairly steady throughout.

- **Logistics/Other:** This category deals with IBP's trucking and freezer businesses. Shipley simply assumed that FY 2000 estimated profits would be repeated in each of the projected years because it was a stable business.

- **Case Ready:** Shipley used management's existing assumptions. These projected losses for 2000 and 2001, and profitability in years 2002-2005.

- **Foodbrands:** Shipley divided Foodbrands into three basic categories as follows:

  .(500) Thomas E. Wilson—Shipley assumed that IBP's venture into branded ready-to-eat or cooked...
meat products would lose money until 2003, when it would begin to be profitable.

**SYM**> **IBP Foods**—This was a unit comprised of businesses that IBP had purchased out of bankruptcy. Shipley projected losses in 2000 and 2001, and profitability in the remaining years.

**SYM**> **Other Foodbrands**—This was the heart of Foodbrands' business. Shipley assumed 2000 EBIT of $157 million with a steady growth rate of 8% for the remaining years.

The overall picture for Foodbrands therefore was a composite of these assumptions that had Foodbrands producing $125 million in EBIT in 2000, $137 million in 2001, and growing to nearly $300 million by 2005. The $125 million EBIT number excluded $42.5 million in one-time costs associated with IBP's acquisition of CFBA and the write-off of bad debt relating to a customer (together, the "CFBA Charges"). Shipley excluded the CFBA Charges because they were a non-recurring cost that was not expected to affect Foodbrands going forward. All users of the Rawhide Projections relevant to this opinion were made aware of this feature of Shipley's analysis.

Shipley's assumptions were reasonable given the inherent imprecision of the task he was given. In reaching this conclusion, I also find that the Rawhide Projections were prepared with particular users in mind: a sophisticated special committee and investment bank that would understand that projections of this kind are at best a useful roadmap to where a business may go if the assumptions used in the model pan out and if the company's business plan is executed well. Shipley reasonably assumed that the users of the Projections would approach them with the sort of intrinsic skepticism and caution that one expects from seasoned professionals, rather than with the unquestioning attitude of a believer at the foot of a prophet.

The IBP Board Accepts A Bid From The Rawhide Group

After several months of negotiations, the Rawhide Group and the special committee struck a deal on October 1, 2000 whereby the Rawhide Group would purchase all of IBP's shares at $22.25 per IBP share. At a special committee meeting in connection with approval of the transaction, Peterson expressed his view that IBP's performance for the second half of the year was softening, and that overall EBIT for FY 2000 might be $500 to $525 million, a range that was lower than the Rawhide Projection estimate that had been performed in August.

*7 The Rawhide deal was publicly announced the next day. By this time, rumors had been circulating within the financial community about the possibility of such a deal.

The announcement of the transaction inspired class action lawsuits in this court, alleging that the transaction was unfair. These suits were filed irrespective of the minimal barriers that existed to a higher transaction.

Problems At DFG Foods Begin To Surface

In 1998, as part of its strategy to grow IBP's higher-margin food processing business, IBP management purchased a specialty hors d'oeuvres, kosher foods, and "airline food" business for $91 million, including assumed debt. IBP bought this business from its managers, including its President, Andrew Zahn. Within IBP, the business became known as DFG Foods, Inc. or "DFG." In late 1999, IBP purchased a competitor of DFG named Wilton Foods, and combined its operations with DFG. Zahn stayed on board after the purchase of Wilton Foods and continued to run the business, with a right to certain earn-out payments upon his departure that were tied to the unit's performance.

Although IBP hoped that DFG would become a useful part of its overall strategy to move into higher-margin businesses, as of the year 2000, DFG was an insignificant portion of IBP's overall business. Before the drastic adjustments that I will discuss later, DFG's 1999 sales had been around $75 million and its pre-tax earnings were $8.2 million. At these levels, DFG constituted less than 1% of IBP's sales and less than 2% of its pre-tax earnings. While IBP employed around 50,000 people at over 60 production facilities, DFG employed approximately 300 workers at its two facilities.

On September 30, 2000, Andrew Zahn left DFG and took a sizable earn-out payment with him. On October 16, 2000, IBP issued a press release announcing earnings for the third quarter of FY 2000 of $83.9 million and year-to-date earnings of $203 million. Soon after this announcement, Dick Bond learned that there were problems with the integrity of DFG's books and records, and that it was possible that DFG's inventory value was overstated.

The evidence reveals that audit staff within the Foodbrands unit had harbored concerns about DFG's
accounting procedures for some time. Dan Hughes, the director of internal audit at Foodbrands, had been questioning issues. His boss, Bill Brady, who was Foodbrands' CFO, had not taken these concerns as seriously, and had resisted Hughes's suggestion to inform IBP's audit committee about possible overstatements. Despite Tyson's arguments to the contrary, there is no credible evidence that suggests that anyone in IBP top management were on notice about irregularities at DFG until mid-October 2000.

When IBP top management learned of the problems at DFG, a full inventory audit was ordered. The audit concluded that DFG's inventory was overvalued by $9 million. On November 7, 2000, IBP therefore announced that it would take a $9 million reduction over pre-tax earnings from the amounts previously reported for third quarter of FY 2000. These amounts were reported to the SEC in IBP's third quarter 10-Q. As of that time, Peterson and Bond were led to believe that the $9 million overstatement was the extent of the problem at DFG, although efforts to get control of DFG's financials continued.

The Auction For IBP Begins

*8 The rumors about IBP's possible sale had not gone unnoticed among meat industry leaders. Two industry participants had toyed with the idea of making a play for IBP for years.

One was Smithfield Foods, the nation's number one pork processing firm. When combined with IBP, Smithfield would be the number one producer of beef and pork products. The strength of the Smithfield-IBP combination was also its weakness. Because of IBP's own strength in pork, anti-trust and political concerns were bound to be raised about a merger. Nonetheless, those concerns did not impede Smithfield from making an unsolicited bid for IBP on November 12, 2000. The Smithfield bid offered $25 in Smithfield stock for each share of IBP stock. This was not the best of news for IBP management, whose relationship with Smithfield management was not warm.

Meanwhile, Tyson Foods had been pondering a deal with IBP for several years. Bob Peterson and Tyson founder and controlling stockholder, Don Tyson, were old industry friends with great respect for one another. In the preceding year or so, Peterson had bantered with Don Tyson about the idea of putting Tyson and IBP together. This would create a company that was number one in beef and chicken, number two in pork, and that would have a diverse processed food business. Put mildly, Peterson's ardor for a combination with Tyson was much stronger than for a deal with Smithfield.

When Peterson spoke with him earlier, Don Tyson saw the potential of the combination, but had recently stepped aside as CEO to make way for a new management team, destined to be led by his son John Tyson. Don Tyson felt that the new team needed to settle in before undertaking such a big deal.

By November 2000, the new Tyson team had been putatively in charge for some time, and was led by John Tyson, the company's CEO. As a part of its active consideration of corporate strategy, Tyson management periodically ran numbers on the feasibility of a merger with IBP. By mid-November, Tyson was seriously considering making a play for IBP. Shortly before Thanksgiving, John Tyson received a call from George Gillett, a major IBP stockholder who was a participant in the Rawhide group. Gillett called to encourage Tyson to bid for IBP. By the time Gillett got to John Tyson, John Tyson was already quite receptive.

Soon after the call with Gillett, John Tyson called Dick Bond to set up a meeting to discuss a possible combination. The meeting was arranged for November 24, 2000 at an airport in Tampa due to the various Thanksgiving itineraries of the expected participants. The primary participants were to be Peterson and Bond for IBP, and Don and John Tyson for Tyson.

The November 24 Meeting

The November 24 meeting was a lovefest. Tyson came ready to buy, and IBP came ready to be bought. The meeting was dominated by the two elder statesmen, Peterson and Don Tyson. Each was excited about the possibility of combining the companies, under the day-to-day leadership of John Tyson and Dick Bond. Don Tyson had even been dreaming about the companies' combined balanced sheets at bedtime.

*9 The two discussed the combination in general, big picture terms with great enthusiasm. Peterson told the two Tysons that the Rawhide Projections would soon be published. He expressed confidence that performance of the kind indicated in the Projections could be achieved by IBP and that his own internal operating plans for IBP were more ambitious. But at no time did Peterson promise that IBP could be guaranteed to perform as the Projections predicted.
Indeed, Peterson discussed many of the risk factors that affected IBP and that would naturally lead a reasonable listener to conclude that future results could not be projected with certainty. These risk factors included the cattle cycle, which Peterson explained was likely to be on the downside in the ensuing years.

The testimony suggests that the conversation was largely focused on the future and the synergistic benefits of the combination, and not as much on year 2000. While I have little doubt that Peterson expressed confidence in his company, I also conclude that he did not promise Tyson that IBP's FY 2000 results would be exactly as set forth in the Rawhide Projections. I do think Peterson felt that IBP would have a good year and projected that confidence. That is, I conclude that his subjective belief was fully in accord with the views he expressed to the Tysons.

I also conclude that Peterson felt that he was having a big picture conversation with savvy businessmen, who would be careful to absorb his larger thoughts against a backdrop informed by careful reading and examination of all the information usually considered by a corporation considering a mega-transaction. In this regard, I specifically conclude that a reasonable participant in the meeting would have assumed that the statements of all participants were general and in keeping with the informal and preliminary nature of the meeting. In talking about the Rawhide Projections that were to be released soon, the IBP participants would have naturally assumed that the Tysons would read them carefully and the information that qualified them. This assumption that Tyson Foods was proceeding cautiously and not heedlessly is borne out by record evidence that shows that Tyson was running its own assumptions about a combination, with downside cases.

As a result, I conclude that John and Don Tyson did not form a belief at the November 24 meeting that the Rawhide Projections were in the bank and would be met with ease. Instead, they took away the view that Peterson and Bond believed that IBP would meet those Projections, but that there were no guarantees of that and that there were known risks that could compromise IBP's ability to deliver.

At a later point in the meeting, enthusiasm for the deal had run so high that the participants called in Tyson General Counsel Les Baledge, who had flown down with John Tyson, to discuss generally how the parties would proceed if Tyson made a bid. [FN7] By the end of the meeting, the Tysons were enthusiastic.

Don Tyson ended the meeting by saying that the companies ought to be put together as quickly as possible.

The Rawhide Projections Are Published

*10 On November 28, 2000, the preliminary proxy statement for the Rawhide deal was filed with the SEC. The preliminary statement included a description of the Rawhide Projections. The statement included the Projections "solely because of the disclosures [of them] that were made to J.P. Morgan " during the negotiation process. [FN8] The preliminary proxy statement included a large amount of highlighted language that was intended to signal the caution with which those Projections should be used. A careful reader of the preliminary proxy would have noted, among other things, that: (i) the Projections had been prepared in August 2000; (ii) that the Projections had not been updated; (iii) that IBP Management does not ordinarily make such Projections; (iv) that the Projections should be read in light of IBP's most recent financial statements; (v) that there were a large number of risks that could affect whether the Projections would be met, particularly supply cycles in the livestock markets; and (vi) that the Projections were not guarantees of particular results.

By November 28, 2000, IBP had already issued its third quarter 10-Q. The preliminary proxy statement expressly informed readers that the Rawhide Projections—which had been made as of August 2000 and had not been updated—should be read in light of the third quarter 10-Q. The third quarter 10-Q contained information that suggested that IBP would have difficulty meeting the $542 million in EBIT predicted for the year 2000. By the end of the third quarter, IBP's total reported EBIT was $340 million, a result that trailed third quarter results for FY 1999 by $67 million. [FN9] Whereas the Rawhide Projections had assumed that Foodbrands would deliver EBIT of $125 million for full year 2000, Foodbrands had only delivered around $50 million as of the end of third quarter 2000 on a normalized basis. [FN10] It thus needed to generate more EBIT in the fourth quarter than the whole of the preceding year to meet the Rawhide Projections' estimate.

Tyson Makes Its Opening Bid

In early December, the Tyson board of directors met to consider making a bid for IBP. John Tyson's vision for the deal was fundamental: he wanted to dominate the meat case of America's supermarkets and be the
"premier protein center-of-the-plate provider" in the world. [FN11] Tyson/IBP would be number one in beef and chicken, and number two in pork. It would therefore be able to provide supermarkets with nearly all the meat they needed.

Not only that, John Tyson saw the potential to bring Tyson Foods' own experience and unique expertise to bear outside of the poultry realm. As all parties agree, Tyson was an innovator in the meat industry, which had been the leader in demonstrating that a meat processor could produce value-added meat products of a ready-to-eat and ready-to-heat nature. In the past, meat processors sold large portions of meat to supermarkets and other processors, who butchered them and cooked them into higher priced serving sizes. Tyson began to do much of that work itself, thus preserving more of the profit for itself.

*11 IBP was acknowledged to have a great fresh beefs business with an excellent, long-term track record. While it was beginning to embark on value-added strategies in the beef and pork industry, IBP was by all accounts not as far along in that corporate strategy and could most benefit from Tyson's expertise in that particular area. John Tyson saw the potential for Tyson's expertise to help IBP do in beef and pork what Tyson had done in poultry. His vision of the companies, however, had little to do with DFG and pork what Tyson had done in poultry. His vision of the companies, however, had little to do with DFG specifically, a small subpart of Foodbrands that he knew little, if anything, about.

Tyson's board supported management's recommendation to make a bid. On December 4, 2000, Tyson proposed to acquire IBP in a two-step transaction valued at $26 (half cash, half stock) per share. Tyson trumpeted the fact that its offer was preferable to Smithfield's, in no small measure because Tyson did not face the same degree of anti-trust complications that Smithfield did and could thus deliver on its offer more quickly. To emphasize this point, Tyson said that its offer was "subject to completion of a quick, confirmatory due diligence review and negotiation of a definitive merger agreement." [FN12]

To that end, Tyson sent IBP an executed "Confidentiality Agreement," modeled on one signed by Smithfield, which would permit it to have access to non-public, due diligence information about IBP. That Agreement contains a broad definition of "Evaluation Material" that states:

For purposes of this Agreement, Evaluation Material shall mean all information, data, reports, analyses, compilations, studies, interpretations, projections, forecasts, records, and other materials (whether prepared by the Company, its agent or advisors or otherwise), regardless of the form of communication, that contain or otherwise reflect information concerning the Company that we or our Representatives may be provided by or on behalf of the Company or its agents or advisors in the course of our evaluation of a possible Transaction. [FN13]

The agreement carves out from the definition the following:

This Agreement shall be inoperative as to those particular portions of the Evaluation Material that (i) become available to the public other than as a result of a disclosure by us or any of our Representatives, (ii) were available to us on a non-confidential basis prior to the disclosure of such Evaluation Material to us pursuant to this Agreement, or (iii) becomes available to us or our Representatives on a non-confidential basis from a source other than the Company or its agents or advisors provided that the source of such information was not known by us to be contractually prohibited from making such disclosure to us or such Representative. [FN14]

As plainly written, the Confidentiality Agreement thus defines Evaluation Material to include essentially all non-public information in IBP's possession, regardless of whether the company's employees or agents prepared it. The terms of the Confidentiality Agreement also emphasize to an objective reader that the merger negotiation process would not be one during which Tyson could reasonably rely on oral assurances. Instead, if Tyson wished to protect itself, it would have to ensure that any oral promises were converted into contractual representations and warranties. The Confidentiality Agreement does so by providing:

*12 We understand and agree that none of the Company, its advisors or any of their affiliates, agents, advisors or representatives (i) have made or may make any representation or warranty, expressed or implied, as to the accuracy or completeness of the Evaluation Material or (ii) shall have any liability whatsoever to us or our Representatives relating to or resulting from the use of the Evaluation Material or any errors therein or omissions therefrom, except in the case of (i) and (ii), to the extent provided in any definitive agreement relating to a Transaction. [FN15]

The Due Diligence Process Begins

Tyson did not enter into the due diligence process
alone. It retained Millbank, Tweed, Hadley & McCoy as its primary legal advisor, Merrill Lynch & Co. as its primary financial advisor, and Ernst & Young as its accountants.

The bidding process was being run by IBP's special committee. As members of the Rawhide group, Peterson, Bond, and their subordinates were considered "interested" participants. Thus, while IBP management played a key informational role, the special committee had the final say.

On December 5 and 6, 2000, Tyson's due diligence team reviewed information in the data room at Wachtell, Lipton. Tyson soon learned that the data room did not contain certain information about Foodbrands and the reason why that was so: IBP was reluctant to share competitively sensitive information with Smithfield. The special committee's approach to this sales process was to treat the bidders with parity. As a result, Tyson was told that any information it wanted that was not in the data room could be provided, but that if Tyson received that information, so would Smithfield.

As a result of its due diligence, Tyson flagged certain items including:

- Possible asset impairments at DFG and certain other Foodbrands companies. [FN16]
- Discrepancies in the way that IBP reported its business segments. [FN17]
- Concerns regarding whether the CFBA acquisition qualified as a pooling. [FN18]
- IBP's policy of recognizing revenue upon invoicing, which was going to have to change on a going-forward basis because of new SEC guidance. [FN19]
- IBP's possible over-confidence about the outcome of certain environmental cases. [FN20]
- IBP's decision to treat its stock option plan as involving the issuance of "fixed" rather than "variable" options, and whether the accounting treatment for the plan, which was disclosed in the company's financial statements, was proper. [FN21]

**13 Tyson came to the meeting expecting the now *de rigeur* Power-Point presentation. IBP came expecting to answer Tyson's questions. As a result, the meeting became a question and answer session that covered IBP's business, segment by segment.**

At least two important issues were discussed at the meeting. I will start with the DFG issue. Going into the December 8, 2000 meeting, the chairwoman of the IBP special committee, Joann Smith, specifically told John Tyson to ask about DFG at the meeting.

According to IBP witnesses, the DFG situation had gotten more serious by December 8. IBP's top management was concerned that the accounting problems at DFG were deeper than they had recognized and that additional charges to earnings might be necessary. The IBP employee-witnesses all remember Peterson saying that the DFG problem had gotten worse by at least $20 million. Peterson himself remembers speaking in angry and vehement terms about Andy Zahn, labeling him as a "thief in the hen house," and the progeny of a female dog who should be hanged on main street in front of a crowd. [FN22] He also recalls saying that DFG was a "black hole." His colleagues at IBP have far less specific recollections, but do recall Peterson being quite upset.

The Tyson witnesses have a different recollection. They recall being told that DFG was a $9 million problem. Leatherby's notes of the meeting note that there had been a "$9 mm writedown here (guy fired) fudged earnout," that DFG was "not doing well," but that IBP believe[d] in bus. [FN23] Hankins's notes about DFG tersely state: "DFG--At bottom of problem." [FN24] None of the Tyson witnesses heard Peterson describe Zahn—at that meeting—in such unforgettable terms. They do admit, however, that Peterson appeared agitated and upset by the issue, that the problem was attributed to fraud by Zahn, that Zahn had been the head of the business, that Zahn was now gone, and that IBP was looking into his activities.

Tyson CEO John Tyson testified at his deposition that he was told at the December 8, 2000 meeting that the problem had reached $20 million, which accords with the account of the IBP witnesses. [FN25] At
The participants seem to have placed little focus on FY 2000. IBP's representatives never clearly indicated that the company would not meet the Rawhide target for the year. For their part, the Tyson participants appear to have been oblivious to the obvious warnings in the IBP third quarter 10-Q that IBP was well behind the run-rate needed to meet the Projections, particularly as to Foodbrands. Therefore, the Tyson and IBP representatives did not get "granular"--as the current lexicon goes--regarding IBP's 2000 performance-to-date. Indeed, at no time in December did Tyson ever ask IBP for updated profit and loss information for the year.

Tyson Asks For Additional Due Diligence Regarding Foodbrands

After the December 8, 2000 meeting, Tyson quickly commenced its tender offer. As due diligence continued, Tyson requested access to additional accounting information involving Foodbrands. IBP management responded with this basic and consistent theme: "if you want to look at it, we have to show it to Smithfield, too. But if you want Smithfield to see it, you can have it."

This line of reasoning was frustrating to certain members of Tyson's due diligence team. Nonetheless, Tyson was never denied access to documents, it was simply told to make a tactical decision. Because Tyson wanted to buy IBP and wanted to compete with Smithfield after doing so, Tyson did not wish Smithfield to see the information. Nor did IBP management, who preferred that Tyson come out on top in the bidding.

Tyson also never chose to narrow its due diligence requests to deal only with the fraud at DFG. It did so even though its own accountants were concerned about the issue and whether IBP had really gotten to the bottom of the problem. [FN29] While Tyson says it did not dig deeper because IBP management told it there was nothing bad at Foodbrands and Tyson relied upon those assurances, I do not find that testimony credible. While IBP management may have said that there were no problems at Foodbrands other than DFG, there is no credible evidence that any such statements were untrue when made, or, as we shall see, that Tyson placed any trust in those statements. Most important, IBP never denied Tyson access and had already told Tyson that there had been fraud at DFG. As a result, it is more probable that Tyson simply wanted to keep Smithfield from having knowledge about a business unit Tyson hoped to soon own. What is certain is that Tyson never
demanded access to additional due diligence as a condition to going forward with a merger.

The Problems At DFG Grow Deeper

*15 During this same period, IBP management was wrestling with the DFG situation. On December 11, 2000, Foodbrands' CFO Brady had sent a memorandum to Foodbrands President Randy Devening. The memorandum signaled that additional write-offs would be necessary, and that DFG would suffer serious losses for the year in proportion to the size of its business. The memorandum concluded by stating:

[It] is clear that the business as it is clearly configured is not economically viable. We need to move rapidly and decisively to eliminate costs, improve sales realization and stem losses. DFG's management is in the process of preparing a detailed plan to turn the business around. [FN30]

Soon thereafter, IBP deepened its examination of DFG by assigning a team from Price Waterhouse Coopers ("PWC") to do a full investigation. Brady's memo was never turned over to Tyson (or to Smithfield) in due diligence. Peterson's trial testimony made clear that he had little regard for Brady's views of the matter, an attitude that is explicable given that Brady had stifled Hughes' earlier efforts to explore the DFG issues more deeply and to apprise IBP's audit committee about his concerns.

According to Tyson, IBP's failure to turn over the Brady memorandum was inconsistent with Hagen's representation to Hudson that she had turned over all audit reports for the "company" to Tyson. According to Hagen, she interpreted this as requesting all audit reports for IBP (i.e., the "company") itself, not all of its various business units, and responded accordingly. [FN31] Hudson never asked Hagen for audit reports specific to DFG.

Shipley Prepares New FY 2000 Numbers For Use In An Auction

By mid to late December, the IBP special committee was preparing to conduct an auction between Tyson and Smithfield. By this point, the Rawhide group was out of the running and happy to receive a termination fee courtesy of the winning bidder.

J.P. Morgan asked Shipley to update his Rawhide Projections for use in this final bidding stage. On December 20, 2000 Shipley provided an update to J.P. Morgan. The update reduced IBP's expected EBIT for FY 2000 by $70 million-- from $542 to $472 million. [FN32]

On December 21, J.P. Morgan sent Tyson and Smithfield bid instructions which called for them to submit best and final bids, along with proposed merger contracts, by 5:00 p.m. on December 29, 2000. The instructions informed the bidders that the special committee was free to change the rules of the process and that no agreement would be binding until reduced to a signed contract.

Tyson Receives Comment Letters From The SEC And Does Not Share Them With IBP

During this period, Tyson's lawyers at Millbank, Tweed had been in communication with the SEC about its tender offer. The communications addressed, among other things, whether Tyson had to exercise good faith in determining whether a condition to the tender offer closing had failed.

Millbank, Tweed did not send the SEC correspondence to IBP.

Tyson Raises Its Bid After Learning That IBP's FY 2000 Earnings Would Be Lower Than The Rawhide Projections Had Anticipated

*16 In the middle of the day on December 28, 2000, Tyson received Shipley's updated numbers from J.P. Morgan, which showed a $70 million decrease in FY 2000 IBP earnings. After learning of that reduction, Tyson raised its tender offer bid $1.00 a share to $27.00 per share in cash.

Tyson Is Informed Of Additional Problems At DFG

On December 29, 2000, IBP and Tyson representatives held two due diligence calls. In the first, Peterson and IBP's controller, Craig Hart, spoke with Tyson CFO Hanks and General Counsel Baledge. Peterson told Hanks and Baledge that the DFG charges to earnings had grown to $30 to $32 million, inclusive of the original $9 million charge and a $3 million charge to a reserve. Because he was not a numbers man, Peterson also told them that his CFO Shipley would go over all the numbers with them later in the morning.

On the second call, Shipley addressed the DFG issue, as well as the larger issue of reconciling his December 20 projection for FY 2000 with the Rawhide Projections. As to DFG, Shipley indicated
that their best estimate was that the problem had grown to $30 to $35 million, and that there could be more charges to come. [FN33] Shipley told Tyson that PWC and IBP were fairly far along in their work, but that they had not yet finished working on the accounting issues at DFG. Shipley indicated that DFG would not be contributing at all to earnings in FY 2000.

Tyson representatives questioned the size of these charges in relation to the size of DFG and the fact that IBP had paid less than $100 million to buy the business. They asked how much goodwill IBP carried on its books for DFG because the amount of the charges seemed very large for a business of DFG's size. Shipley told Tyson that IBP had not yet finished accounting for the problems and that examining the issue of goodwill was necessary to complete that process. [FN34] He also told Tyson that IBP had not figured out yet how it would account for the DFG issues, and that the problems had arisen from past conduct that took place for over a year. [FN35]

During the call, Shipley also reconciled his revised FY 2000 estimate with the Rawhide Projections. He informed Tyson that the beef business was off by around $20 million because of tighter margins in the fourth quarter of 2000. This $20 million decrease was offset almost exactly by improved performance in the logistics sectors. As a result, the entirety of the discrepancy related to Foodbrands. Much of that came from the charges from DFG and DFG's failure to reach $10 million in EBIT. The rest came from under-performance in the rest of Foodbrands. Shipley's recitation of IBP's likely FY 2000 performance was reasonable, given the information he knew and the fact that he told Tyson that the DFG accounting was not yet concluded. [FN36]

Shipley also discussed the Rawhide Projections for future years, particularly as to Foodbrands. Shipley indicated that he had not changed them, and that the numbers were attainable. He explained certain strategies IBP expected to implement that would help reach that number. Shipley did not lead Tyson to believe that meeting the Projections would be easy or a sure thing, but that IBP had the capability to do so. As to DFG, Shipley indicated that it would not deliver EBIT of $10 million in FY 2001, but could perhaps make $2 to $5 million. [FN37]

Tyson's Lack Of Faith In IBP's Management

By this point, Tyson's representatives harbored more than a healthy skepticism regarding IBP's representations. The evidence reveals, for example, that Tyson had "BIG QUESTIONS" about Foodbrands' ability to meet its projected performance for FY 2001. [FN38] Hankins scribbled down a note that said "How can $80 m sales company hit you for $30 + million." [FN39] Tyson's investment banker doubted that DFG had ever made a real profit. [FN40]

Tyson also placed little faith in Shipley. Hankins did not believe that Shipley had addressed the financial issues between the companies in the manner expected of a public company CFO. Hankins knew that he, rather than Shipley, was likely to be the CFO of the combined companies when all was said and done.

By their own admission, Tyson's representatives had had "red flags" waved at them. [FN41] They found it "alarming" that there was such a sharp drop-off between IBP's expected FY 2000 performance and the Rawhide Projections, and were angry that the likely shortfall had not been highlighted at the December 8 due diligence meeting. [FN42]

Tyson CEO John Tyson thought he had been "misled or lied to." [FN43] By December 29, John Tyson's level of confidence in Shipley was simple, he had "none." [FN44] He had been told by Bond that Shipley was likely to be replaced as CFO of IBP. John Tyson believed that Foodbrands was "broken." [FN45] In sum, John Tyson did not trust IBP management going into the final stages of the bidding process.

Tyson Proceeds To Raise Its Bid In The Face of Waving Red Flags

In keeping with its skepticism about IBP's assurances, Tyson was receiving advice from its investment bankers that allowed it to examine whether an acquisition of IBP would make sense if Foodbrands performed at much lower levels than were projected in the Rawhide Projections. For example, Merrill Lynch ran a downside case in which Foodbrands EBIT would be only $85 million FY 2001 and 2002, and stay at a flat $95 million in FY 2003-2005. [FN46] Merrill Lynch also ran downside cases for IBP's performance as a whole that used assumptions more pessimistic than the Rawhide Projections.

During the evening of December 29, Smithfield put in an all stock bid it valued at $30 per share. On or about that same date, a member of Tyson management and Ernst & Young discussed the
possibility that the DFG problem could require IBP to restate its previously reported financials and to accept an impairment charge. [FN47]

Tyson Wins The Auction--Twice

On December 30, 2000, Smithfield advised the special committee that $30 was its best and final offer. Special committee chair Smith called John Tyson and told him that if Tyson bid $28.50 in cash it would have a deal. John Tyson agreed and Smith said they had a deal. Later, the IBP special committee met to consider the Tyson and Smithfield bids. With the advice of J.P. Morgan, the special committee considered Tyson's $28.50 cash and stock bid to exceed the value of Smithfield's all stock $30 bid. The special committee decided to accept Tyson's bid, subject to negotiation of a definitive merger agreement.

* 18 As a courtesy, the special committee and its counsel informed Smithfield that it had lost the auction. On December 31, Tyson increased its all stock bid to $32.00. With deep chagrin, Smith went back to John Tyson and explained what had happened and the committee's duty to consider the higher bid. John Tyson was justifiably angry, but understood the realities of the situation.

Tyson Foods went to the well again and drew out another $1.50 a share, increasing its bid to $30 per share. IBP agreed and this time the price stuck.

The Merger Agreement Negotiations

While the auction was on, the lawyers for IBP's special committee had been negotiating possible merger agreements with Tyson and Smithfield. By December 30, the IBP lawyers were mostly focused on Tyson because it appeared they had prevailed in the auction.

The document that was used as a template for what became the final Merger Agreement was initially prepared by Millbank Tweed, whose team was led by Lawrence Lederman. Lederman used the Rawhide merger agreement as his starting point because he believed it was a good agreement for a buyer with strong representations and warranties on the part of the seller.

Late on December 30, IBP sent Tyson's negotiators the disclosure schedules to the Merger Agreement, which had been drafted by IBP's General Counsel Hagen. These schedules included a Schedule 5.11 that expressly qualified Section 5.11 of the Merger Agreement, which reads as follows:

Section 5.11. No Undisclosed Material Liabilities. Except as set forth in Schedule 5.11 the Company 10-K or the Company 10-Qs, there are no liabilities of the Company of any Subsidiary of any kind whatsoever, whether accrued, contingent, absolute, determined, determinable or otherwise, and there is no existing condition, situation or set of circumstances which could reasonably be expected to result in such a liability, other than:
(a) liabilities disclosed or provided for in the Balance Sheet;
(b) liabilities incurred in the ordinary course of business consistent with past practice since the Balance Sheet Date or as otherwise specifically contemplated by this Agreement;
(c) liabilities under this agreement;
(d) other liabilities which individually or in the aggregate do not and could not reasonably be expected to have a Material Adverse Effect.

Schedule 5.11 itself states:

No Undisclosed Material Liabilities

Except as to those potential liabilities disclosed in Schedule 5.12, 5.13, 5.16 and 5.19, the Injunction against IBP in the Department of Labor Wage and Hour litigation (requiring compliance with the Wage and Hour laws), and any further liabilities (in addition to IBP's restatement of earnings in its 3rd Quarter 2000) associated with certain improper accounting practices at DFG Foods, a subsidiary of IBP, there are none. [FN48]

On a later conference call between Tyson and IBP negotiators, Hagen told the Tyson participants that Schedule 5.11 was intended to cover the DFG issues discussed by Shipley in the December 29 conference call. The Tyson negotiators accepted the Schedule, based on prior discussions between Tyson in-house counsel Hudson and Tyson Finance Vice President Leatherby.

* 19 Tyson's lead outside lawyer, Lederman, did not participate in the call in which Schedule 5.11 was accepted. It appears that neither he, Baledge or Hankins learned about the Schedule until well after the Merger Agreement was signed on January 1, 2001.

The Merger Agreement's Basic Terms And Structure

The Merger Agreement contemplated that:

* Tyson would amend its existing cash tender offer (the "Cash Offer") to increase the price to $30 per
share.

- Tyson would couple the cash tender offer with an "Exchange Offer" in which it would offer $30 of Tyson stock (subject to a collar) for each share of IBP stock. This would permit IBP stockholders who wished to participate in the potential benefits of the Tyson/IBP combination to do so.
- The Cash Offer would close no later than February 28, 2001 unless the closing conditions set forth in Annex I of the Merger Agreement were not satisfied.
- If the conditions to the Cash Offer were not met by February 28, 2001, Tyson would proceed with a "Cash Election Merger" to close on or before May 15, 2001 unless the closing conditions set forth in Annex III of the Merger Agreement were not satisfied. In the cash election merger, IBP stockholders would be able to receive $30 in cash, $30 in Tyson stock (subject to a collar), or a combination of the two.

The Annexes to the Agreement contain certain language that is substantively identical regarding Tyson's duty to close the transactions. That language provides:

Except as affected by actions specifically permitted by this Agreement, the representations and warranties of the Company contained in this Agreement (x) that are qualified by materiality or Material Adverse Effect shall not be true at and as of the scheduled expiration of the Offer as if made at and as of such time (except in respect of representations and warranties made as of a specified date which shall not be true as of such specified date), and (y) that are not qualified by materiality or Material Adverse Effect shall not be true in all material respects at and as of the scheduled expiration date of the Offer as if made at and as of such time (except in respect of representations and warranties made as of a specific date which shall not be true in all material respects as of such specified date). [FN49]

The previously described Section 5.11 is one of the representations and warranties referenced above. Primarily implicated in this case are the following representations and warranties:

Section 5.07. SEC Filings. (a) The Company has delivered or made available to Parent (i) the Company's annual report on Form 10-K for the year ended December 25, 1999 (the "Company 10-K"), (ii) its quarterly report on Form 10-Q for its fiscal quarter ended September 23, 2000, its quarterly report on Form 10-Q for its fiscal quarter ended June 24, 2000 (as amended) and its quarterly report on Form 10-Q for its fiscal quarter ended March 25, 2000 (together, the "Company 10-Qs"), (iii) its proxy or information statements relating to meetings of, or actions taken without a meeting by, the stockholders of the Company held since January 1, 1998, and (iv) all of its other reports, statements, schedules and registration statements filed with the SEC since January 1, 1998.

(b) As of its filing date, each such report or statement filed pursuant to the Exchange Act did not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading.

(c) Each such registration statement, as amended or supplemented, if applicable, filed pursuant to the Securities Act of 1933, as amended (the "Securities Act"), as of the date such statement or amendment became effective did not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading.

Section 5.08. Financial Statements. The audited consolidated financial statements of the Company included in the Company 10-K and unaudited consolidated financial statements of the Company included in the Company 10-Qs each fairly present, in all material respects, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in the notes thereto), the consolidated financial position of the Company and its consolidated subsidiaries as of the dates thereof and their consolidated results of operations and changes in financial position for the periods then ended (subject to normal year-end adjustments in the case of any unaudited interim financial statements). For purposes of this Agreement, "Balance Sheet" means the consolidated balance sheet of the Company as of December 25, 1999 set forth in the Company 10-K and "Balance Sheet Date" means December 25, 1999.

Section 5.09. Disclosure Documents. (a) Each document required to be filed by the Company with the SEC in connection with the transactions contemplated by this Agreement (the "Company Disclosure Documents"), including, without limitation, (i) the Exchange Schedule 14D-9 (including information required by Rule 14f-1 under the Exchange Act), the Schedule 14D-9/A (including information required by Rule 14f-1 under the Exchange Act) and (iii) the proxy or information statement of the Company containing...
information required by Regulation 14A under the Exchange Act (the "Company Proxy Statement"), if any, to be filed with the SEC in connection with the Offer or the Merger and any amendments or supplements thereto will, when filed, comply as to form in all material respects with the applicable requirements of the Exchange Act except that no representation or warranty is made hereby with respect to any information furnished to the Company by Parent in writing specifically for inclusion in the Company Disclosure Documents.

(b) At the time the Schedule 14D-9/A, the Exchange Schedule 14D-9 and the Company Proxy Statement or any amendment or supplement thereto is first mailed to stockholders of the Company, and, with respect to the Company Proxy Statement only, at the time such stockholders vote on adoption of this Agreement and at the Effective Time, the Schedule 14D-9/A, the Exchange Schedule 14D-9 and the Company Proxy Statement, as supplemented or amended, if applicable, will not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. At the time of the filing of any Company Disclosure Document other than the Company Proxy Statement and at the time of any distribution thereof, such Company Disclosure Document will not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. The representations and warranties contained in this Section 5.09(b) will not apply to statements or omissions included in the Company Disclosure Documents based upon information furnished to the Company in writing by Parent specifically for use therein.

*21 (c) Neither the information with respect to the Company or any Subsidiary that the Company furnishes in writing to Parent specifically for use in the Parent Disclosure Documents (as defined in Section 6.09(a)) nor the information incorporated (sic) by reference from documents filed by the Company with the SEC will, at the time of the provision thereof to Parent or at the time of the filing thereof by the Company with the SEC, as the case may be, at the time of the meeting of the Company's stockholders, if any, contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading.

Section 5.10. Absence of Certain Changes. Except as set forth in Schedule 5.10 hereto, the Company 10-K or the Company 10-Qs, since the Balance Sheet Date, the Company and the Subsidiaries have conducted their business in the ordinary course consistent with past practice and there has not been:

(a) any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect .... [FN50]

Sections 5.07-5.09 therefore warrant the material accuracy of IBP's 1999 10-K and its 10-Qs for the first three quarters of 2000 (the "Warranted Financials"). Viewed literally and in isolation, these representations can be read as providing Tyson with a right not to close if IBP had to restate the Warranted Financials on account of the earnings charges at DFG that clearly related to past conduct that occurred during the periods covered by the Warranted Financials. Meanwhile, § 5.10 protected Tyson in the event IBP suffered a Material Adverse Effect, as defined in the Agreement.

The Agreement also required Tyson to correct promptly any information contained in its SEC filings regarding its Cash Tender and Exchange Offers (the "Offer Documents") that had become false and misleading. [FN51] Tyson was also required to provide IBP promptly with any correspondence between itself and the SEC regarding the Offer Documents. [FN52] For its part, IBP agreed to correct promptly any information it had given to Tyson for inclusion in the Offer Documents. [FN53]

The December 29 SEC Comment Letter

On December 29, the SEC sent an e-mail to IBP special committee counsel Seth Kaplan at the firm of Wachtell, Lipton. The e-mail contained a fifteen-page letter from the SEC's Division of Corporate Finance to IBP CEO Peterson commenting on the preliminary Rawhide Proxy as well as the Warranted Financials (the "Comment Letter").

At the time Kaplan received this e-mail, he was swamped with numerous pressing tasks. He quickly scanned the document on screen and concluded that it largely related to the by-then moribund Rawhide transaction. Kaplan had been expecting comments on the Rawhide proxy before year's end. And in fact, the letter's initial 42 comments were focused on the Rawhide preliminary proxy. What Kaplan failed to
notice is that the latter half of the document contained 45 comments regarding the Warranted Financials, which had been incorporated by reference into the Rawhide proxy. Kaplan also failed to notice that the letter had been e-mailed only to him, and not to Peterson.

*22 Instead, Kaplan simply sent a copy of the Comment Letter on to his associate, Ante Vucic, to handle. He did not send a copy to Tyson, Smithfield, or to IBP.

The Comment Letter addressed a number of items that Tyson had already identified in its due diligence process. For example, the Comment Letter:
• Asked IBP to identify how it had discovered the $9 million inventory problem at DFG and a synopsis of the events that caused the problem.
• Asked IBP to disclose its revenue recognition policies to comply with recent SEC accounting guidelines.
• Requested information regarding pooling of interest accounting for the CFBA acquisition;
• Asked IBP to revisit its reporting of its business segments, in view of certain inconsistencies in its prior approach. [FN54]

In January, Kaplan learned that the SEC had not faxed a copy of the Comment Letter to Peterson. Instead, the SEC staffers responsible for the Comment Letter had mailed Peterson's copy sometime after the New Year's holiday, most likely January 3, 2001. The Comment Letter arrived by mail at IBP on January 8, 2001, and IBP sent it to Tyson by facsimile on January 10, 2001.

IBP's General Counsel Hagen spoke with the SEC about why IBP had not received an earlier copy. She was led to believe that the SEC had received instructions from Wachtell, Lipton to fax to it and mail to IBP. Hagen blew her top. During the auction process, Hagen had found it difficult to be on the sidelines while the Wachtell, Lipton firm acted in the lead role. While Hagen understood that the Rawhide LBO made this the wiser course, tensions had arisen between her and Kaplan.

She unleashed her anger at Kaplan in a series of e-mails. Kaplan denied that he had instructed the SEC to fax to him and mail to IBP. I believe him. After she cooled off, so did Hagen.

In a letter to the IBP special committee, Tyson's General Counsel Baledge also expressed his concern about receiving the letter twelve days after its mailing date. He pointed out that IBP had received this letter during the final negotiation and bidding round. He claimed that the SEC's comments should have been disclosed and that "no exception was taken to IBP's representations relating to the issues raised in the SEC comment letter." [FN55]

Baledge also claimed that the Comment Letter would cause Tyson delay in commencing its Exchange Offer, which it had been prepared to launch that very day. Because the Exchange Offer Documents incorporated IBP's financial statements, Tyson had to hold off until PWC resolved the issues the SEC raised. Baledge also complained that progress could have been made on the issues, had Tyson received the letter earlier.

Baledge closed by indicating that Tyson was "assessing the materiality and impact of the SEC's comments and the SEC's requirement that IBP revise its financial statements." [FN56]

Tyson's Board and Shareholders Vote For The Merger Agreement

On January 12, 2001, Tyson's board of directors met and ratified management's decision to enter into the Merger Agreement. Peterson and Bond attended as guests of Tyson. At that point, Tyson expected to invite both of them onto its board, and for Bond to run the IBP unit of the combined entity.

*23 At the board meeting, Baledge did not discuss the Comment Letter with the Tyson board.

The same day the Tyson shareholders meeting was held. The Merger Agreement was put to a vote of the Tyson stockholders. Baledge made the motion. He did not inform the shareholders of the Comment Letter. The Tyson stockholders approved the Merger Agreement and authorized management to consummate the transactions it contemplated. [FN57]

The fact that the Tyson board and stockholders were not told about the Comment Letter is made more understandable by the fact that Tyson's accountants believed that the Comment Letter did not contain "any comment that [Ernst & Young] thought was significant to Tyson as an acquiror that Ernst & Young had missed prior to January 1, 2001." [FN58]

John Tyson Trumpets The Deal's Benefits

During January, Tyson and its CEO John Tyson told the world how wonderful the Tyson/IBP combination
was going to be. "By combining the number one poultry company with the leader in beef and pork we are creating a unique company...." [FN59] John Tyson emphasized that Tyson had seized a unique "point in time" opportunity to put together two companies who were industry leaders and thus become the world's "premier protein provider." [FN60] Together, the companies would dominate the meat cases of America's supermarkets.

John Tyson's public statements also acknowledged that there were no sure things in life. Thus, he indicated that Tyson was purchasing IBP "fully aware of the cyclical factors that affect commodity meat products." [FN61] John Tyson also evinced his acknowledgement that IBP was not as far along in the processed foods side of their business as Tyson Foods was and that Tyson Foods' expertise would help IBP achieve success in this area:

When you look at IBP, they look like Tyson Foods twenty years ago. They have put in place the foundation, the assets, but most of all, the people to do to the beef and pork industry what our great company has done in the last fifteen or twenty years to the poultry industry. When you see that, you understand why we get excited.

In our experiences [sic] in branding case ready packaging and fully cooked value-added products mirrors the path that they have created for themselves. It is our belief that our experience and market access in both foodservice and retail can help them achieve their goals quicker and more efficiently. [FN62]

None of Tyson's public statements or internal documents specifically reference DFG as important to the fulfillment of John Tyson's vision for the combined companies.

IBP Addresses Its Issues With The SEC While Tyson Positions Itself To Negotiate A Lower Price

On January 16, 2001, Shipley informed Hankins that the DFG earnings charges might reach $50 million, including the $9 million already taken. Shipley indicated that some of the charges related to 1999, and that it was unclear if a restatement to 1999 earnings would be necessary. He also told Hankins that the impairment study was underway but not complete. Hankins concluded "without a doubt" from what he was told that IBP would have to restate the Warranted Financials. [FN63]

*24 The next day Tyson extended its Cash Offer. The only reason it gave was that the waiting period under the Hart-Scott-Rodino anti-trust law had not expired. On January 19, 2001, IBP met with Tyson's financial and accounting team and discussed the DFG issues in more depth. No one at Tyson told IBP that IBP would breach the Merger Agreement if it restated the Warranted Financials.

On January 24, 2001, Baledge wrote the IBP special committee and told it that Tyson would issue a press release the following day extending its Cash Offer again. His letter again reiterated his view that Tyson should have received the Comment Letter before the Merger Agreement was signed. Baledge said that Tyson would publicly indicate that the reason for extending the Cash Offer would be that the Cash Offer Documents contained information prepared in reliance on the Warranted Financials. As a result, Tyson viewed it as prudent to delay closing until IBP satisfied the SEC. For the same reason, Tyson was not going to commence its Exchange Offer until the SEC issues were settled. Once that was done, Tyson would "assess the impact and materiality of any changes to your financial statements and business." [FN64]

In reaction to Tyson's January 25 disclosure, IBP issued a letter from Peterson to Tyson. The letter disclosed that the DFG charges to earnings would be $47 million, inclusive of the $9 million, and that the charge related to prior periods. It said that IBP was still considering whether a restatement was necessary and the extent of any asset impairment at DFG. Peterson's letter also stated that IBP had sent a letter to the SEC that day with IBP's response to the Comment Letter and that IBP was scheduled to meet with the SEC on January 29, 2001 to discuss its concerns.

At the January 29, 2001 meeting, IBP hoped to get some helpful guidance from the SEC regarding how it should account for the DFG issue. [FN65] This expectation was disabused at the meeting. Instead, the SEC told IBP that it had to figure out how to account for DFG and that it should do so promptly. Members of the SEC's Division of Enforcement also attended the meeting, to the surprise and chagrin of IBP.

On February 5, 2001, IBP delivered to the SEC a large submission of materials to address issues raised by the SEC. In those materials, IBP stated that the DFG adjustments were "material to previously reported quarterly 2000 data as well as to 1999." [FN66] Hagen promptly sent this submission to Baledge. Baledge never informed her that if IBP restated the Warranted Financials, it would...
automatically breach the Merger Agreement. The next day, Tyson issued a press release extending the Cash Offer yet again for the same reasons expressed in its January 25, 2001 extension.

On February 7, 2001, the SEC wrote to IBP and indicated that it would "not decline to accelerate the effectiveness of a registration statement" for the Exchange Offer so long as IBP had fully and fairly restated the Warranted Financials to address the DFG issue and the registration statement adequately described the restatements. [FN67] Hagen discussed this letter with Baledge.

*25 By mid-February, the SEC's correspondence with IBP took on a quite brusque and directive tone. The SEC's message was that IBP ought to get on with the business of filing restated financial statements. [FN68] The SEC had identified several technical issues in the Warranted Financials that were not reported in accordance with the SEC's view of GAAP. In view of the serious DFG issues, the SEC wanted all the issues addressed in very prompt restatements to the Warranted Financials.

During this period, Hagen and Baledge talked about the need for a restatement. Baledge expressed Tyson's preference that there be only one restatement rather than a series of them. He did not tell Hagen that a restatement by IBP would breach the Merger Agreement. [FN69] Baledge did not do so because he believed that Tyson would have to determine whether any restatement was material to Tyson. [FN70]

On February 22, 2001, IBP publicly announced that it would have to restate the Warranted Financials to take an additional DFG charge of $32.9 million. DFG took an additional $12 million DFG charge for the fourth quarter of FY 2000. IBP also indicated that it would be taking an impairment charge at DFG of up to $108 million. And the company announced that it would be restating the Warranted Financials to account for the company's stock option plan as a "variable" rather than a "fixed" plan. This issue had arisen during the back- and-forth between the SEC and IBP in 2001, and was not mentioned in the December 29 Comment Letter. Tyson had flagged this issue much earlier in due diligence, and IBP's previous accounting decision was openly stated in its 1999 10-K.

As the February 28 deadline for the Cash Offer loomed, Hagen approached Tyson about extending the deadline. Tyson never responded. On February 28, Tyson instead terminated the Cash Offer. John Tyson was quoting as stating: "Unfortunately, it will be impossible to complete the cash tender offer by the 28th. IBP continues to work with the SEC to resolve their accounting issues. After that work is complete, we will determine what effect these matters will have on our deal." [FN71] As of that date, Tyson had not made a determination that IBP had breached a contractual warranty, as Baledge admitted at trial. [FN72]

IBP responded publicly to the termination of the Cash Offer by indicating that Tyson's decision was in "complete accordance" with the Merger Agreement. [FN73] Throughout this period, it had continued to note to the public the risk that IBP would not resolve the SEC issues to Tyson's satisfaction.

Tyson Gets Nervous And Wants To Reprice The Deal

During February, Tyson Foods became increasingly nervous about the IBP deal and began to stall for time. While Tyson still believed that the deal made strategic sense, it was keen on finding a way to consummate the deal at a lower price. The negotiations with the SEC were a pressure point that Tyson could use for that purpose and it did.

*26 Tyson's anxiety was heightened by problems it and IBP were experiencing in the first part of 2001. A severe winter had hurt both beef and chicken supplies, with chickens suffering more than cows.

Tyson's first quarter 2001 ended on December 30, 2000. During that period, Tyson earned $.12 a share, down from $.25 during the same period in its FY 2000. Tyson's second quarter 2001 was shaping up even worse. Tyson's performance was way down from previous levels. Eventually, Tyson would have to reduce its earnings estimate for this period, only to find out its reduction was not sufficient. Eventually, Tyson reported a loss of $6 million for the pertinent quarter, compared to a profit of $35.7 million for the prior year's period. [FN74] It described the period as involving the "most difficult operating environment" Tyson had seen since 1981, and admitted that Tyson had suffered from the "on-going effect of the severe winter weather." [FN75]

Meanwhile, IBP was experiencing similar problems. At the end of January, IBP had begun sending weekly profit & loss ("P & L") statements to Tyson. These showed very slow results that appeared to leave IBP in a compromised position from which to meet the Rawhide Projection of $446 million in EBIT for
2001. Both the beef fresh meats and Foodbrands businesses were performing at below-par levels. When the quarter ended on March 31, 2001, IBP had earned only $.19 a share, meaning that it would have to produce $1.74 a share in earnings over the succeeding three quarters to meet the Rawhide Projection of $1.93 per share for FY 2001.

By mid-February, these factors led the Tyson and IBP factions to approach each other warily. IBP sensed that Tyson wanted to renegotiate. Hagen prepared for an even worse possibility: that Tyson would walk away and IBP would have to enforce the deal. Bond tried to deal with the problem by being responsive to John Tyson's calls for help in reassuring his father, Don Tyson, that the deal still made sense.

On the Tyson side, its key managers began to slow down the merger implementation process to buy time for John and Don Tyson. While Tyson and IBP continued to do all the merger integration planning that precedes a large combination, Tyson was also bent on using its leverage to extract concessions from IBP. To the extent that Tyson Foods had wiggle room not to close the Cash Offer, Don and John Tyson wanted to use that to give them more time to see numbers from IBP and to assess the transaction in light of Tyson's own strategic situation. Their subordinates did as instructed and stalled for time by not agreeing to extend the Cash Offer deadline, as IBP had offered.

By February, Don Tyson had brought in Leland Tollet and Buddy Wray to counsel with him on the transaction. Tollet and Wray were Don Tyson's key executives when he was Tyson's CEO and the three were known as the "old guard." Since Don Tyson controlled 90% of Tyson's stock, his word was still the key one at Tyson, and he was worried.

*27 On March 5, 2001, Dick Bond met with Don Tyson to help alleviate some of those worries. Don Tyson was quite concerned that IBP was not on course to meet its projected earnings for the year. Bond tried to convince him otherwise. As to DFG, Don Tyson said that if he were running IBP, he would "blow that whole thing up and write the whole thing off and move on." [FN76] Don Tyson never mentioned the SEC Comment Letter issues during the entire meeting.

During a later phone conversation, Bond again talked with Don Tyson. Don Tyson raised fears about mad cow disease and hoof-and-mouth disease. Bond addressed these issues and Don Tyson's continued concern about IBP's year-to-date performance. Don Tyson did not voice concerns about DFG or the SEC accounting matters. At the end of the conversation, Don Tyson said he was satisfied and was going fishing. Bond relayed this to John Tyson, who was pleased. [FN77]

On March 7, 2001, John Tyson sent all the Tyson employees a memorandum stating that Tyson Foods was still committed to the transaction. But on March 13, 2001, he expressed concern to Bond about IBP's first quarter performance and wanted Bond's best estimates for the rest of the year. Bond sent him estimates that had a low estimate of $1.80 per share in earnings and a high side of $2.47, with a best estimate of $2.12. John Tyson's advisor Hankins believed these estimates to be much too optimistic in view of IBP's slow start.

On March 13, 2001, IBP also formally filed its restatements to the Warranted Financials. The formal restatements were in line with the previous release regarding DFG, as was the $60.4 million DFG "Impairment Charge" took in its year 2000 10-K. None of the other issues covered had any impact on IBP's prospects. Tyson reacted in print in a March 14 press release that indicated that Tyson was pleased IBP had resolved most of its issues with the SEC. The press release also indicated that Tyson was continuing to look at IBP's business and noted its weak first quarter results. Behind the scenes, Tyson's investor relations officer, Louis Gottsponer, was turning up the heat on IBP through comments to analysts.

In an internal e-mail, Gottsponer explained Tyson's renegotiation strategy:

To document this point in the process. We've billed this as the next significant event (we're waiting until they file), so now people want to know what the new timeline looks like....
To keep the pressure on their stock price. Based on the voice mails that have been left for me (those seven) the street views these restatements as insignificant. We know these accounting issues aren't the biggest reason to renegotiate (i.e. beef margins). Let's remind people of that (softly). To set the stage for other points that may help us to renegotiate. [FN78]

Sure enough, the next day analysts began reporting...
that IBP's earnings outlook would possibly lead to a renegotiation of the deal. [FN79]

*28 On March 15, 2001, Tyson in-house counsel Read Hudson sent a letter to Hagen at Baledge's instruction. The letter reads:

Congratulations on getting your restated SEC filings behind you. I know they involved a lot of hard work on your part.

Now that all you have left to file is the 2000 10-K, it seems that we should begin preparation of documentation, filings, etc. as we move forward with the cash election merger.... [FN80]

Tyson Terminates And Sues IBP

By late March, Don Tyson did not support an acquisition of IBP at $30 per share. On March 26, 2001, Tyson and IBP's merger integration teams had a scheduled meeting. John Tyson used that occasion to raise the possibility of repricing the deal with Bond to $27 to $28 per share. Bond told John Tyson that he did not see how the DFG issue could warrant a reduction of more than $5.00 or so. Although he did not tell this to John Tyson, Bond had already come to the pragmatic conclusion that IBP might have to reprice to $28.50 or so in order to get a deal done without a fight. The price discussion went no further.

At the merger integration meeting, the companies' consultant McKinsey & Co. reported that $250 million in synergies could be achieved in the Merger. John Tyson instructed the merger integration team to move full speed ahead. [FN81] During the meeting, John Tyson had been called out a couple of times. When the meeting concluded, he pulled Bond aside and told Bond that his father, Don Tyson, was coming back to Arkansas. Don Tyson was still nervous about the deal and John Tyson needed Peterson and Bond to help "get him back in the boat." [FN82]

On March 27, 2001, Merrill Lynch presented Tyson with a revised IBP valuation analysis, using pessimistic assumptions generated by Tyson CFO Hankins. The analysis concluded that $30.00 per share was still within the " 'fairness' range," that the "transaction still makes tremendous strategic sense," and that "[e]ven at $30 per share, tremendous long-term value accrues to TSN." [FN83] But the document also contained analyses that Tyson could use to renegotiate a lower price.

On March 28, 2001, Don Tyson called a meeting of the "old guard" and Tyson's current top management.

The agenda's first two items were the state of the economy in general, and the state of Tyson's business. As of that day, Tyson's own performance for the year was very disappointing and it had been forced to admit so publicly only days earlier. Only after discussing the first two items on the agenda did the participants discuss the IBP deal. Don Tyson expressed continued concerns about IBP's current year performance and about mad cow disease. When it came time to make the decision how to proceed, Don Tyson left to caucus with the old guard. The new guard was excluded, including John Tyson. Don Tyson returned to the meeting and announced that Tyson should find a way to withdraw. The problems at DFG apparently played no part in his decision, nor did the comments from the SEC. [FN84] Indeed, DFG was so unimportant that neither John nor Don Tyson knew about Schedule 5.11 of the Agreement until this litigation was underway. [FN85]

*29 After the old guard had decided that the Merger should not proceed, Tyson's legal team swung into action. Late on March 29, 2001, Baledge sent a letter stating:

Tyson Foods ... will issue a press release today announcing discontinuation of the transactions contemplated by the Agreement and Plan of Merger dated as of January 1, 2001 among IBP, Inc. ("IBP") and Tyson (the "Merger Agreement"). We intend to include this letter with our press release.

On December 29, 2000, the Friday before final competitive negotiations resulting in the Merger Agreement, your counsel received comments from the Securities and Exchange Commission ("SEC") raising important issues concerning IBP's financial statements and reports filed with the SEC. As you know, we learned of the undisclosed SEC comments on January 10, 2001. Ultimately, IBP restated its financials and filings to address the SEC's issues and correct earlier misstatements. Unfortunately, we relied on that misleading information in determining to enter into the Merger Agreement. In addition, the delays and restatements resulting from these matters have created numerous breaches by IBP of representations, warranties, covenants and agreements contained in the Merger Agreement which cannot be cured. Consequently, whether intended or not, we believe Tyson Foods, Inc. was inappropriately induced to enter into the Merger Agreement. Further, we believe IBP cannot perform under the Merger Agreement. Under these facts, Tyson has a right to rescind or terminate the Merger Agreement and to
receive compensation from IBP. We have commenced legal action in Arkansas seeking such relief. We hope to resolve these matters outside litigation in an expeditious and business-like manner. However, our duties dictate that we preserve Tyson's rights and protect the interests of our shareholders.

If our belief is proven wrong and the Merger Agreement is not rescinded, this letter will serve as Tyson's notice, pursuant to sections 11.01(f) and 12.01 of the Merger Agreement, of termination.

Notably, the letter does not indicate that IBP had suffered a Material Adverse Effect as a result of its first-quarter performance.

But as indicated in the letter, Tyson had sued IBP in Arkansas that evening, shortly before the close of the business day. The next day IBP filed this suit to enforce the Merger Agreement.

II. The Basic Contentions Of The Parties

The parties have each made numerous arguments that bear on the central question of whether Tyson properly terminated the Merger Agreement, which is understandable in view of the high stakes. The plethora of theories and nuanced arguments is somewhat daunting and difficult to summarize. But the fundamental contentions are as follows.

IBP argues that Tyson had no valid reason to terminate the contract on March 29, 2001 and that the Merger Agreement should be specifically enforced. In support of that position, IBP argues that it has not breached any of the contractual representations and warranties. In addition, IBP contends that Tyson improperly terminated the Cash Offer on February 28, 2001 because all closing conditions were met as of that date. In this regard, IBP says that Tyson did not need IBP to formally file its Restated Financials in order for Tyson to proceed with the Cash Offer. As a result, IBP says that § 2.01(e) and (h) of the Agreement do not provide Tyson with a contractual safe harbor.

*30 Tyson argues that its decision to terminate was proper for several reasons. First, Tyson contends that IBP breached its contractual representations regarding the Warranted Financials, as evidenced by the Restatements. Second, Tyson contends that the DFG Impairment Charge as well as IBP's disappointing first quarter 2001 performance are evidence of a Material Adverse Effect, which gave Tyson the right to terminate.

Finally, Tyson argues that the Merger Agreement should be rescinded because that Agreement (and related contracts) were fraudulently induced. In this respect, Tyson contends that IBP's failure to disclose the Comment Letter and certain DFG-related documents before January 1, 2001 constitutes ground for rescission. Tyson says that the Agreement should also be rescinded because IBP management made oral statements regarding the Rawhide Projections that they knew to be false, on which Tyson reasonably relied to its detriment. For identical reasons, Tyson says that a letter agreement it signed in connection with the Merger Agreement should also be rescinded, thus entitling Tyson to a refund of a $66 million termination fee it paid to the Rawhide group on behalf of IBP.

The parties have chosen to accompany their basic contentions with a variety of subsidiary theories, all of which derive from the same factual issues.

Before turning to the resolution of the parties' various arguments, it is necessary to pause to discuss certain choice of law issues. The parties are in accord that New York law governs the substantive aspects of the contractual and misrepresentation claims before the court. This accord is in keeping with the parties' choice to have New York contract law govern the interpretation of the Merger Agreement. [FN87] But they part company on certain issues with respect to the precise burden of proof governing these claims. [FN88] For the sake of clarity, I will outline the approach I take up front.

Under either New York or Delaware law, IBP bears the burden of persuasion to justify its entitlement to specific performance. Under New York law, IBP must show that: (1) the Merger Agreement is a valid contract between the parties; (2) IBP has substantially performed under the contract and is willing and able to perform its remaining obligations; (3) Tyson is able to perform its obligations; and (4) IBP has no adequate remedy at law. [FN89] These elements must be proved by a preponderance of the evidence under New York law. Delaware law, by contrast, requires that a plaintiff demonstrate its entitlement to specific performance by clear and convincing evidence. The reasons for this are not entirely clear, but seem to rest in the policy concern that a compulsory remedy is not typical and should not be lightly issued, especially given the availability of the more usual legal remedy of money damages. [FN90]

Although the conflict of law principles by no means
provide clear guidance, the better reading of them suggests that New York law should apply. The relevant principles indicate that the law of Delaware should be applied "unless the primary purpose of the relevant rule of the otherwise applicable law is to affect decision of the issue rather than to regulate the conduct of the trial. In that event, the rule of the state of the otherwise applicable law will be applied." [FN97] IBP has the better of the argument, in my view. The question of which party has the burden of proof may be seen as purely procedural. But the question of what the burden of proof is typically constitutes a policy judgment designed to affect the outcome of the court's decision on the merits. [FN92] For example, Delaware's choice of the clear and convincing evidence standard appears to have been made for substantive policy reasons that do not affect the trial process. The parties have not provided me with authority suggesting why New York selected the preponderance standard, which is not the prevalent rule in the United States for specific performance. [FN93] Because the New York approach is a minority approach, I infer that New York public policy as expressed by its common law of long-standing is in favor of a standard that makes it easier, rather than more difficult, to hold a party to its specific promise. For that reason, I conclude that it is most appropriate to apply the law of New York to IBP's claim for specific performance, especially because the application of New York law is in keeping with the parties' own choice of the law governing the Merger.

*31 In this case, IBP's and Tyson's respective abilities to perform the Merger Agreement are not disputed. Nor is there any doubt that the Merger Agreement, on its face, is a binding contract setting forth specific rights and duties. What is most at issue is whether Tyson had a right to terminate what appears to be a valid and binding contract, or to rescind that contract because of misrepresentations or material omissions of fact in the negotiating process.

Under both New York and Delaware law, a defendant seeking to avoid performance of a contract because of the plaintiff's breach of warranty must assert that breach as an affirmative defense. [FN94] Indeed, Tyson has plead breach of warranty as an affirmative claim, and not simply as a defense. Therefore, Tyson bears the burden to show that a breach of warranty excused its non-performance.

Under either Delaware or New York law, Tyson also bears the burden to prove its rescission claim. The parties agree that New York law generally governs these claims, but dispute what state's law governs the precise burden of proof. Under New York law, the plaintiff must prove fraud by clear and convincing evidence. [FN95] Under Delaware law, by contrast, the standard is a preponderance. [FN96] Tyson claims that the issue of burden of proof is a purely procedural issue that ought to be decided by the law of Delaware. IBP contends that the issue is a matter of substantive policy that ought to be governed by the law of the state whose law is relevant to the determination of Tyson's claim, the law of New York. For the same reasons discussed above, New York's choice of the clear and convincing standard is best viewed as a policy decision that affects the court's decision, rather than a matter of trial procedure. [FN97] Given the parties' choice to use New York law as the law governing the Merger Agreement, it makes sense that the merits of any claim for rescission of that contract be decided using the evidentiary burden established by New York law.

Candor requires acknowledgement of the fact that the parties did not provide me with detailed briefing about the choice of law and burden issues discussed above. These questions may be thought to raise many subtle concerns that I do not pretend to have addressed in any sophisticated way. [FN98] As a result, I will indicate clearly whether there is any issue in the case that would be decided differently were the evidentiary burden different than I have just outlined.

III. Resolution Of The Parties' Merits Arguments

In the pages that follow, I first address whether IBP breached a representation and warranty that justified Tyson's termination of the Merger Agreement. I then analyze the merits of Tyson's rescission claims. I conclude with the question of whether Tyson was entitled to terminate its Cash Offer on February 28, 2001.

A. General Principles Of New York Contract Law

The Merger Agreement's terms are to be interpreted under New York law. Like Delaware, New York follows traditional contract law principles that give great weight to the parties' objective manifestations of their intent in the written language of their agreement. [FN99] If a contract's meaning is plain and unambiguous, it will be given effect. [FN100] Parol evidence may not be used to create a contractual ambiguity; rather, such ambiguity must be discerned by the court from its consideration of the contract as an entire text. [FN101]
*32 In reading a contract, "the [court's] aim is a practical interpretation of the expressions of the parties to the end that there be a realization of [their] reasonable expectations." [FN102] "In a written document [a] word obtains its meaning from the sentence, the sentence from the paragraph, and the latter from the whole document, all based upon the situation and circumstances existing at its creation." [FN103] "Particular words should be considered ... in the light of the obligation as a whole and "not as if isolated from the context." [FN104]

When, however, the contract is susceptible to more than one reasonable interpretation, the court may consider extrinsic evidence to resolve the ambiguity. [FN105] The court's examination of the parol evidence is merely a continuation of an effort to discern the parties' intentions. Therefore, the subjective beliefs of the parties about the meaning of the contractual language are generally irrelevant. [FN106] Where one of the parties, however, expresses its beliefs to the other side during the negotiation process or in the course of dealing after consummation, such expressions may be probative of the meaning that the parties attached to the contractual language in dispute. [FN107]

B. Do The DFG Charges To Earnings Evidence A Breach Of Warranty?
1. The Merger Agreement Does Not Unambiguously Assign The DFG-Related Risks

The first question I address is whether the DFG-related problems of IBP were a risk that was contractually accepted by Tyson, through the inclusion of Schedule 5.11. The parties have starkly different views of whether the reference to DFG in Schedule 5.11 operates to qualify all of the representations and warranties in the Agreement. Tyson contends that Schedule 5.11 has no effect on any representation and warranty other than that contained in § 5.11 of the Agreement. There are no Schedules 5.07-5.09 attached to the Agreement that operate to qualify §§ 5.07-5.09 explicitly. And §§ 5.07, 5.08, and 5.09 are, by their own terms, unqualified by reference to Schedule 5.11, and generally stand for the proposition that IBP warranted that the Warranted Financial Statements were accurate in all material respects and complied with GAAP. Tyson thus claims that these "flat" representations were plainly breached when IBP restated the Warranted Financial Statements to record the additional losses at DFG.

In support of this argument, Tyson points out that the parties knew how to qualify representations and warranties when they wished to do so. For example, § 5.16 in the Agreement is a representation regarding IBP's compliance with its legal obligations. The Agreement contains no Schedule 5.16, but §§ 5.16 expressly references Schedules 5.11, 5.12, and 5.19. Likewise, the Agreement's disclosure schedule states that "[i]tems disclosed for any one section of this Disclosure Schedule are deemed to be disclosed for all other sections of this Disclosure Schedule to the extent that it is reasonably apparent that such disclosure is applicable to other such section(s)." Had the drafters wished to provide that each Schedule would qualify each representation and warranty, this language could have been easily altered to accomplish that purpose plainly. [FN108] Furthermore, the parties agreed that the disclosure schedule was "qualified by its entirety by reference to specific provisions of the Agreement..." As a result, Tyson argues that the scope of Schedule 5.11 is qualified by the flat warranties in §§ 5.07-5.09. In sum, Tyson contends that a written deal is a written deal. Having plainly warranted the material accuracy of the Warranted Financial Statement as a closing condition, IBP is stuck.

*33 For reasons I now explain, my reading of the Agreement suggests that Tyson's reading is not the only reasonable one and that it is therefore appropriate to consider parol evidence in determining the meaning of the Agreement. As a general matter, the strength of Tyson's interpretation--its simplicity and laser beam focus on the language of §§ 5.07-5.09--is also its weakness. When these sections are considered in light of the overall Agreement and the undisputed factual context in which the parties were contracting, the Tyson reading becomes far less than compulsory.

I begin at § 5.11 itself. That section says that "[e]xcept as set forth in Schedule 5.11 [or the Warranted Financials], there are no liabilities of the Company or any Subsidiary of any kind whether accrued, contingent, absolute, determinable or otherwise ...." Schedule 5.11 itself states that in addition to what was disclosed in the Warranted Financials, there may be "further liabilities (in addition to IBP's restatement of earnings in its 3rd Quarter 2000) associated with certain improper accounting practices at DFG Foods." [FN109] Taken together, § 5.11 and Schedule 5.11 use the term "liabilities" in a broad and imprecise manner that would not be used by an accountant. Certainly, Schedule 5.11 can reasonably be read to include
additional charges to earnings associated with improper accounting practices at DFG within the term, along with any other liabilities—such as litigation risks—associated with those practices.

Section 5.11 expressly contemplates that scheduled liabilities of this nature are not reflected in the Warranted Financials, but will be in addition to those contained in the Warranted Financials, regardless of when the events giving rise to the liabilities arose. Tyson largely acknowledges that this is the most reasonable reading of §§ 5.11 and Schedule 5.11.

But it argues that the fact that IBP could recognize potentially unlimited liabilities because of past accounting improprieties at DFG does not mean that DFG was free to restate the Warranted Financials without breaching the Agreement. That is, what was contractually important to the parties was the particular document in which such liabilities were publicly disclosed, rather than the magnitude of such liabilities. To be specific, under Tyson's reading, IBP was free to take a charge to earnings of $45 million in its fourth quarter 2000 10-Q, even if that charge related to accounting improprieties that had taken place in prior periods. [FN110] What IBP was not permitted to do was to disclose an identical charge as a restatement to the Warranted Financials because that would violate the "flat" warranties in §§ 5.07-5.09.

The record reveals that this sort of hair-splitting has no rational commercial purpose. At trial, Tyson's CFO Hankins was asked directly to explain what difference it made whether the DFG charges were disclosed in a restatement to the Warranted Financials as opposed to a later filing. Hankins at first could not even understand the issue, which alone is telling given its significance in this case and Hankins' active role in it. Once he understood the question, Hankins paused for a very lengthy period of time, until basically admitting that he could not come up with a reason why the filing in which the liabilities were recognized was consequential. Subsequent Tyson witnesses—who were all on notice that this question would likely be asked—had no better answer. [FN111] In fact, Tyson's General Counsel Baledge admitted that it made no economic difference whether the Warranted Financials were restated to record the liabilities or whether those liabilities were recorded in a filing for a later period. [FN112]

*34 Tyson's interpretation is one that would be "unreal to men of business and practical affairs."

[FN113] New York law disfavors a reading of a contract that produces capricious and absurd results, in favor of a reading that is reasonable in the commercial context in which the parties were contracting. [FN114]

To rebut this conclusion, Tyson has argued that §§ 5.07-5.09 "look to the past" and "do not identify future risks." [FN115] Meanwhile, Schedule 5.11 is supposedly forward-looking and only "warrants that there are no contingencies that may result in IBP obligations in the future to a third party (such as litigation against the company) other than those disclosed in the [Warranted Financials] and Schedule 5.11." [FN116]

There are several reasons why this construction is not mandated. First, as noted, the term "liabilities" in Schedule 5.11 seems to clearly encompass charges to earnings of the kind taken in the third quarter 2000 10-Q so long as those charges resulted from the same kind of past accounting irregularities that produced the initial charges. Second is Tyson's past and future reading of the Agreement. Tyson contends that its past/future construction makes sense because a restatement of past financial statements adversely affects market perception and subjects the company to fraud suits by investors, as it did here. [FN117] Supposedly, Tyson did not want to accept this sort of risk. Yet, by its own argument, Tyson admits that Schedule 5.11 allocates to Tyson the risk of any liability that arose from "improper accounting practices" at DFG, including liability from lawsuits based on the practices. Tyson's logic is simply sliced too thin to sustain a finding that its construction is the only reasonable one.

Perhaps most importantly, Tyson's argument fails to address Schedule 5.11's reference to Schedule 5.13. Schedule 5.13 discloses that IBP is engaged in an "inventory accounting method dispute" with the Internal Revenue Service, and that the "issue of past years has yet to be formally resolved" and "[t]ax years 1992 to date are still open." Sections 5.07-5.09 do not cross-reference Schedule 5.13. Under Tyson's argument, it could walk away from the contract if the IRS determines that IBP's inventory accounting methods used in the Warranted Financials was improper and that a restatement of them is required. That reading of the Agreement therefore produces a silly result, which supports IBP's contention that §§ 5.07-5.09 cannot be read woodenly in isolation from the other provisions of the Agreement. [FN118]

As IBP notes, Schedule 5.11's reference to Schedule...
5.13 is of interpretative significance for another reason. By including a reference to Schedule 5.13 and this "inventory" dispute, Schedule 5.11 again signals that the word "liabilities" was being used as a loose term for balance sheet adjustments that might affect prior warranted periods. This cuts against the view that Tyson's reading is the only reasonable construction.

*35 So too does language in the Annexes to the Agreement. These Annexes are of great significance because they govern the circumstances under which Tyson was free to abandon its Cash and Exchange Offers, as well as the Merger. Each of the applicable Annexes provides that Tyson may refuse to close if the representations and warranties in the Agreement are not true "except as affected by actions specifically permitted by" the Merger Agreement. IBP argues that this proviso is essentially a contract-specific articulation of the New York law principle that more specific sections of a contract govern over more general ones, when there is an inconsistency between the two. [FN120]

According to IBP, Schedule 5.11 specifically permits IBP to recognize further liabilities on account of the accounting improprieties at DFG. Thus, according to IBP, the Annexes protect IBP by ensuring that its specific contractual right to do so does not result in a technical breach of a more general representation and warranty that permits Tyson to walk. IBP supports this contention by pointing to the Model Stock Purchase Agreement produced by the American Bar Association's Committee on Negotiated Acquisitions. The Committee Commentary states:

The Sellers may also request that the 'bring down' clause [i.e., the Annexes] be modified to clarify that the Buyer will not have a 'walk right' if any of the Sellers' representations is rendered inaccurate as a result of an occurrence specifically contemplated by the acquisition agreement. The requested modification entails inserting the words 'except as contemplated or permitted by this Agreement' (or some similar qualification). [FN121]

Tyson's response to this line of argument is again quite literalistic and technical, rather than commonsensical. At most, Tyson says, Schedule 5.11 operates solely to prevent IBP's recognition of additional liabilities for accounting improprieties from causing a breach of § 5.11; it does not specifically permit IBP "to incur liabilities related to DFG." [FN122] And if it did, IBP would be in breach of its covenant not to take any action that would make a representation or warranty untrue. [FN123] Rejection of Tyson's first contention in this regard, largely disposes of its second. It makes little sense to say that Schedule 5.11 does not specifically permit IBP to recognize additional liabilities at DFG on account of the improper accounting there. That appears to be its plain purpose, and to clearly extend to liabilities that were caused by improper past activities. [FN124] And if IBP is "specifically permitted to" take such action, it is implausible to think that the Agreement would construe that same action as a breach of covenant. Rather, it seems more commercially reasonable to read the proviso in the Annexes, as IBP does, as a safe-guard that ensures that more specific aspects of the representations and warranties in the Agreement will govern over the more general, when giving literal effect to both the general and specific provisions produces an unreasonable result.

*36 For all these reasons, I conclude that Tyson's reading of the language of the contract is not the only reasonable one. Indeed, if forced to choose, I would find that IBP's reading of the Agreement is the one that is most reasonable in view of the overall language and structure of the Agreement, and commercial setting within which the parties were operating. The Tyson interpretation in essence reads the DFG disclosure in Schedule 5.11 out of the Agreement because it gives IBP no reasonable room to address additional charges to earnings on account of past accounting improprieties. Put differently, Tyson argues that it came out of a hotly contested auction with an option, rather than an obligation, to purchase IBP, having silently pocketed an almost sure walk-away right. By contrast, the IBP reading continues to give wide scope to §§ 5.07-5.09, but merely qualifies their application when necessary to give effect to a more specific provision of the contract.

2. The Parol Evidence Demonstrates That IBP's Reading Of The Agreement Is In Large Measure The Correct One

The parol evidence supports IBP's position. The representations and warranties in the Agreement were lifted for the most part from the pre-existing Rawhide merger agreement. Tyson's lawyers created the first draft of the Agreement using the Rawhide agreement because it was one that contained representations and warranties favorable to a buyer.

By contrast, Schedule 5.11 was created specifically to address the DFG issues that had been discussed by
representatives of Tyson and IBP during the December 29 call in which Shipley provided Tyson with updated information regarding IBP's year 2000 results. [FN125] During that conversation, Shipley had informed Tyson that there would be more large charges to earnings because of improprieties at DFG, that an asset impairment study was beginning, and that IBP was not done with its accounting for the problems.

Hagen drafted Schedule 5.11 to address the DFG issues dealt with during the December 29 call and told the Tyson negotiators that this was her intention. She did so during a conference call with Tyson's in-house counsel Read Hudson and outside counsel Millbank Tweed that had been set up to permit Tyson to ask any questions it wanted regarding the disclosure schedules. During that call, Hagen specifically noted that the Schedule was to cover a subject addressed during the December 29 call with Shipley. [FN126] The evidence also reveals that Hudson had reviewed Schedule 5.11 with Tyson Senior Finance Vice President Dennis Leatherby, who had participated in the December 29 call. Hudson testified at his deposition that "Based on the knowledge [Leatherby] had and based on the representation and the exception from the representation contained in there, I think he was satisfied that, you know, he was willing to go forward with that disclosure." [FN127] Tyson elected not to have any of its witnesses who participated in the December 29 conference call about the disclosure schedules testify, even though several of its participants in that call were present throughout the trial.

*37 The record therefore reveals that Tyson's negotiators knew that Hagen believed that Schedule 5.11 covered the DFG items discussed at the December 29 call. Reasonable and forthright negotiators for Tyson would--and I find did--understand Hagen as expressing her view that the Schedule ensured that Tyson was accepting the fully disclosed risk that IBP would recognize additional charges because of the accounting improprieties at DFG and that such additional charges would not give Tyson a right to walk away. [FN128]

To the extent that the Tyson negotiators had a question whether Hagen's carve-out was intended to permit IBP to recognize these additional charges resulting from past accounting practices by way of a restatement of the Warranted Financials, they should have spoken up. The current, hairsplitting interpretation that Tyson advances was never voiced to Hagen at the time, and I do not think that the Tyson negotiators embraced that interpretation at the time. Rather, the Tyson negotiators' attitude reflected the relative unimportance that Tyson's top executives placed on DFG. The decisionmakers at Tyson were comfortable with accepting the risk of further charges to earnings from DFG because of past accounting practices, without focus on the filing in which such charges were taken. This conclusion is buttressed by the fact that Tyson's top inside lawyer, Baledge, and its top outside lawyer, Lederman, were unaware of the DFG Schedule until after the Agreement was signed, as was Tyson's CEO John Tyson.

The later behavior of Tyson also supports this inference. From at latest January 16, 2001 onward, Tyson knew that IBP would almost certainly have to restate the Warranted Financials to record additional charges to earnings because of the DFG accounting problems. [FN129] At no time did it express the view that such a restatement would, in itself, give rise to a right on Tyson's part to walk away. To the contrary, Tyson simply urged IBP to get the issue worked out with the SEC promptly. Indeed, Hudson, the Tyson in-house lawyer who participated in approving Schedule 5.11 congratulated Hagen when the restatements were filed. John Tyson did not care about the filing in which IBP disclosed the DFG problem; he just wanted IBP to "get it right." [FN130] This course of dealing under the Agreement is at odds with Tyson's construction. [FN131]

The reason for this later course of dealing is obvious: none of the Tyson negotiators harbored the belief that the particular filing in which IBP recognized the charges had any relationship to whether the Agreement was breached. [FN132] After all, they knew that the accounting problems at DFG were likely caused by the fraudulent acts of Andrew Zahn, who had left DFG during the period covered by the Warranted Financials. Before the Merger Agreement was signed, Tyson representatives suspected that a restatement of the Warranted Financials might be necessary [FN133] for just this reason. The problems that gave rise to the need for additional charges had occurred in the past, and the additional charges were far larger than the previously disclosed $9 million problem, and had to be recognized sometime. Therefore, it is reasonable to infer that Tyson's negotiators believed that these charges had been carved out entirely by Schedule 5.11.

*38 I reach a different conclusion, however, regarding the Impairment Charge. While I have found that the issue of a possible impairment was
touched upon in the December 29 meeting, it was not as clearly a focal point as the issue of additional earnings charges. Most important, Hagen's draft of Schedule 5.11 is not without boundaries as applied to DFG. While Tyson's negotiators could not have reasonably understood Schedule 5.11 as anything other than a total carve-out for the earnings charges, that is not the case with the Impairment Charge. The reason why is fundamental. Schedule 5.11 only addresses additional liabilities—expansively defined—"associated with certain improper accounting practices at DFG Foods." Hagen did not give Tyson any reason to believe that she intended Schedule 5.11 to cover any problem lacking this "association." IBP told the SEC that the impairment study was not triggered by the mismanagement and accounting improprieties at DFG, but by an unexpected and severe drop in sales in the fourth quarter. [FN134] Therefore, Schedule 5.11 does not cover that Charge.

3. Schedule 5.10 Does Not Cover The Impairment Charge

IBP argues alternatively that the Impairment Charge was covered by Schedule 5.10 of the Agreement, which states that "IBP may, as part of normal year-end adjustments consistent with past practices, revalue assets ...." [FN135] According to IBP, its impairment review of DFG's assets falls within this clause, especially because IBP had taken what it considers to be a similar $35 million non-cash charge in FY 1999, when it wrote down assets associated with its decision to exit the cow boning business.

IBP's position that it wrote down the DFG asset values by 75% as part of "normal year-end adjustments" is not borne out by the evidence. As previously noted, IBP itself told the SEC that the DFG asset impairment review was triggered by "an unprecedented and precipitous decline in Q4 2000 sales ...." [FN136] There was nothing "normal" about the DFG review, it was quite unusual, and the language of Schedule 5.10 is not easily read as covering a large write down resulting from an extraordinary impairment review.

C. The Other Aspects Of The Restated Financials Do Not Evidence A Breach Of Warranty

The Restated Financials dealt with three other issues in addition to DFG, which have at times become points of contention in this case.

In its opening post-trial brief, Tyson did not argue that these issues would in themselves be sufficient to give it a reason not to close in the event that the DFG-related issues in the Restated Financials were carved out by Schedule 5.11. As a result, I consider Tyson to have waived any arguments about these issues.

Because I may be found wrong on that point, I will address these three issues briefly. Under Tyson's literal approach, §§ 5.07-5.09 of the Agreement embrace the view of the world that any error in applying the often-technical rules of GAAP constitutes a breach of warranty, regardless of whether the error would be material to a person using the financial statements to make real world economic decisions.

*39 In their briefs, the parties do battle regarding whether §§ 5.07-5.09 embrace a particular materiality standard. Tyson argues that those sections are written in the language of the federal securities laws and accountant opinion letters, and must be interpreted as written. [FN137] IBP argues that those sections are contained in a merger-agreement between sophisticated parties, and that materiality must be defined by reference to an objectively reasonable acquiror in Tyson's position who has the same mix of information as Tyson had. [FN138]

As an initial matter, I am not sure that the parties' fight about whether a reasonable acquiror or reasonable investor standard is, in itself, material. The more important question is whether the restatements would be influential in the decision-making process of either a reasonable investor or acquiror, having the same total mix of information that Tyson possessed. The Agreement is silent and thus ambiguous on the question of whether materiality of the Restated Financials is to be viewed in isolation, or in relation to the total mix of information. In this regard, I reject Tyson's notion that it is utterly irrelevant whether it possessed full knowledge of material facts that might have been technically misrepresented in the Restated Financials. Certainly, the plaintiff's knowledge of the underlying facts may render an omission immaterial under the federal securities law, because that law considers materiality in light of the total mix of information that the plaintiff had available. That is, even if Tyson is correct that the contractual language is taken from a federal securities context, that context is one that deals with materiality in view of the total mix of information available to the user. [FN139]

The only reason one would take a different approach
here is if one has confidence that Tyson bargained for the right to walk away if IBP's Warranted Financials were technically imperfect in any manner. This would have been an odd bargaining position for a reasonable investor or acquiror to take, and there is no evidence that Tyson contracted with this idiosyncratic approach in mind. Indeed, if this approach were the governing one under the Agreement, it is hard to explain the presence of subsections (e) and (h) of § 2.01 in the Agreement, since those subsections contemplate the correction of financial statements that have become false.

The course of dealing by the parties under the Agreement reveals that Tyson had a different understanding than it advocates now. Tyson did not believe that a mere restatement of the Warranted Financials would trigger a breach of warranty; rather, it believed that a breach would occur if the restatement was material. Tyson's pre-litigation understanding comports with the commercial context in which the parties were operating. Its present hair-trigger approach does not.

In any event, while this duel might have had great importance if the DFG-related issues were not cut off, it has little importance regarding the remaining issues. As a distinguished expert testified at trial, past financial reports are not restated merely because the preparer had made a technical error under GAAP. Such technical errors can be fixed on a prospective basis, so long as the errors did not have a material impact on prior periods. The three remaining issues that were contained in IBP's restatements were not material, when viewed from the perspective of a reasonable "public" user of its financial statements who was making a decision whether to invest in IBP at the end of 2000.

*40 The first issue was the issue of accounting for IBP's stock option plan as a "variable" rather than "fixed plan." IBP had not hidden its prior accounting from any user of its financial statements. It had clearly told users of its financial statements that it was treating the plan as a fixed one, and indicated that another treatment was possible. The actual economic consequences of the plan were identical under either approach, but for accounting reasons the "variable" plan has an income statement effect. The Restated Financials contained this income effect, which in totality was basically a wash over all the periods it affected. A reasonable user of the financial statements would not view these effects as material given what had already been disclosed about this issue because the problem, if any, that this change in treatment caused could be fixed as to future periods. In the absence of the DFG problem, IBP most likely could have made this accounting change on a prospective basis only. Indeed, Tyson executives had "discussed [this issue] on several occasions" before the Merger Agreement was signed. Moreover, IBP had already come up with a fix to the problem on a going-forward basis, which Tyson had approved.

The second issue is that IBP provided new segment reporting in the Restated Financials. Segment reporting is an SEC "hot topic." Absent the DFG problem, IBP could have dealt with this problem on a going-forward basis. No reasonable user of IBP financial statements would have found any problems with IBP's segment reporting material to prior periods. Segment reporting in no manner affects IBP's bottom line. And Tyson, of course, had access to segmented results from IBP.

The third issue is that IBP also agreed to change its revenue recognition policies retroactively. This was another SEC hot topic that was the subject of recent SEC guidance requiring companies to comply with new revenue recognition guidelines. IBP voluntarily decided to adopt these guidelines retroactively because it was already restating the Warranted Financials. IBP had in fact announced its intent to implement the new approach required by the SEC in its original third quarter 10-Q for FY 2000. IBP correctly indicated then that the adoption of that new approach would not have a material effect on the company's earnings. In March 2001, Tyson itself indicated that it would be adopting the new SEC standard in the near future and that the standard would have no material effect. Absent the need to restate because of the DFG issues, IBP would not have had to restate the Warranted Financials to deal with this minor issue and no reasonable public investor would have cared if it had not.

D. Was Tyson's Termination Justified Because IBP Has Suffered A Material Adverse Effect?

Tyson argues that it was also permitted to terminate because IBP had breached § 5.10 of the Agreement, which is a representation and warranty that IBP had not suffered a material adverse effect since the "Balance Sheet Date" of December 25, 1999, except as set forth in the Warranted Financials or Schedule 5.10 of the Agreement. Under the contract, a material adverse effect (or "MAE") is defined as "any event,
occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect" ... "on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as whole ...."

[FN146]

*41 Tyson asserts that the decline in IBP's performance in the last quarter of 2000 and the first quarter of 2001 evidences the existence of a Material Adverse Effect. It also contends that the DFG Impairment Charge constitutes a Material Adverse Effect. And taken together, Tyson claims that it is virtually indisputable that the combination of these factors amounts to a Material Adverse Effect.

In addressing these arguments, it is useful to be mindful that Tyson's publicly expressed reasons for terminating the Merger did not include an assertion that IBP had suffered a Material Adverse Effect. The post-hoc nature of Tyson's arguments bear on what it felt the contract meant when contracting, and suggests that a short-term drop in IBP's performance would not be sufficient to cause a MAE. To the extent the facts matter, it is also relevant that Tyson gave no weight to DFG in contracting.

The resolution of Tyson's Material Adverse Effect argument requires the court to engage in an exercise that is quite imprecise. The simplicity of § 5.10's words is deceptive, because the application of those words is dauntingly complex. On its face, § 5.10 is a capacious clause that puts IBP at risk for a variety of uncontrollable factors that might materially affect its overall business or results of operation as a whole. Although many merger contracts contain specific exclusions from MAE clauses that cover declines in the overall economy or the relevant industry sector, or adverse weather or market conditions, [FN147] § 5.10 is unqualified by such express exclusions.

IBP argues, however, that statements in the Warranted Financials that emphasize the risks IBP faces from swings in livestock supply act as an implicit carve-out, because a Material Adverse Effect under that section cannot include an Effect that is set forth in the Warranted Financials. I agree with Tyson, however, that these disclaimers were far too general to preclude industry-wide or general factors from constituting a Material Adverse Effect. Had IBP wished such an exclusion from the broad language of § 5.10, IBP should have bargained for it. At the same time, the notion that § 5.10 gave Tyson a right to walk away simply because of a downturn in cattle supply is equally untenable. Instead, Tyson would have to show that the event had the required materiality of effect.[FN148]

The difficulty of addressing that question is considerable, however, because § 5.10 is fraught with temporal ambiguity. By its own terms, it refers to any Material Adverse Effect that has occurred to IBP since December 25, 1999 unless that Effect is covered by the Warranted Financials or Schedule 5.10. Moreover, Tyson's right to refuse to close because a Material Adverse Effect has occurred is also qualified by the other express disclosures in the Schedule, by virtue of (i) the language of the Annexes that permits Tyson to refuse to close for breach of a warranty unless that breach results from "actions specifically permitted" by the Agreement; and (ii) the language of the Agreement that makes all disclosure schedules apply to Schedule 5.10 where that is the reasonably apparent intent of the drafters. Taken together, these provisions can be read to require the court to examine whether a MAE has occurred against the December 25, 1999 condition of IBP as adjusted by the specific disclosures of the Warranted Financials and the Agreement itself. This approach makes commercial sense because it establishes a baseline that roughly reflects the status of IBP as Tyson indisputably knew it at the time of signing the Merger Agreement.

*42 But describing this basic contractual approach is somewhat easier than applying it. For example, the original IBP 10-K for FY1999 revealed the following five-year earnings from operations and earnings per share before extraordinary items:

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<td>Earnings from Operations (in thousands)</td>
<td>$ 528,473</td>
<td>373,735</td>
<td>226,716</td>
<td>322,908</td>
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The picture that is revealed from this data is of a company that is consistently profitable, but subject to strong swings in annual EBIT and net earnings. The averages that emerge from this data are of EBIT of approximately $386 million per year and net earnings of $2.38 per share. If this average is seen as weighting the past too much, a three-year average generates EBIT of $376 million and net earnings of $2.29 per share.

The original Warranted Financials in FY 2000 also emphasize that swings in IBP's performance were a part of its business reality. For example, the trailing last twelve month's earnings from operations as of the end of third quarter of FY 2000 were $462 million, as compared to $528 million for full year 1999, as originally reported. [FN149] In addition, the third quarter 10-Q showed that IBP's earnings from operations for the first 39 weeks of 2000 were lagging earnings from operations for the comparable period in 1999 by $40 million, after adjusting for the CFBA Charges. [FN150]

The financial statements also indicate that Foodbrands was hardly a stable source of earnings, and was still much smaller in importance than IBP's fresh meat operations. Not only that, FY 2000 Foodbrands performance was lagging 1999, even accounting for the unusual, disclosed items.

The Rawhide Projections add another dimension to the meaning of § .5.10. These Projections indicated that IBP would not reach the same level of profitability as originally reported until FY 2004. In FY 2001, IBP was expected to have earnings from operations of $446 and net profits of $1.93 a share, down from what was expected in FY 2000. This diminishment in expectations resulted from concern over an anticipated trough in the cattle cycle that would occur during years 2001 to 2003. Moreover, the performance projected for FY 2001 was a drop even from the reduced FY 2000 earnings that Tyson expected as of the time it signed the Merger Agreement.

These negotiating realities bear on the interpretation of § .5.10 and suggest that the contractual language must be read in the larger context in which the parties were transacting. To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. [FN151] To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause. [FN152]

"43 In large measure, the resolution of the parties' arguments turns on a difficult policy question. In what direction does the burden of this sort of uncertainty fall: on an acquiror or on the seller? What little New York authority exists is not particularly helpful, and cuts in both directions. One New York case held a buyer to its bargain even when the seller suffered a very severe shock from an extraordinary event, reasoning that the seller realized that it was buying the stock of a sound company that was, however, susceptible to market swings. [FN153] Another case held that a Material Adverse Effect was evidenced by a short-term drop in sales, but in a commercial context where such a drop was arguably quite critical. [FN154] The non-New York authorities cited by the parties provide no firmer guidance.

Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close. Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. [FN155] A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror. In this regard, it is worth noting that IBP never provided Tyson with quarterly projections.
When examined from this seller-friendly perspective, the question of whether IBP has suffered a Material Adverse Effect remains a close one. IBP had a very sub-par first quarter. The earnings per share of $1.19 it reported exaggerate IBP's success, because part of those earnings were generated from a windfall generated by accounting for its stock option plan, a type of gain that is not likely to recur. On a normalized basis, IBP's first quarter of 2001 earnings from operations ran 64% behind the comparable period in 2000. If IBP had continued to perform on a straight-line basis using its first quarter 2001 performance, it would generate earnings from operations of around $200 million. This sort of annual performance would be consequential to a reasonable acquiror and would deviate materially from the range in which IBP had performed during the recent past. [FN156]

Tyson says that this impact must also be coupled with the DFG Impairment Charge of $60.4 million. That Charge represents an indication that DFG is likely to generate far less cash flow than IBP had previously anticipated. [FN157] At the very least, the Charge is worth between $.50 and $.60 cents per IBP share, which is not trivial. It is worth even more, says Tyson, if one realizes that the Rawhide Projections portrayed Foodbrands as the driver of increased profitability in an era of flat fresh meats prices. This deficiency must be considered in view of the overall poor performance of Foodbrands so far in FY 2001. The Rawhide Projections had targeted Foodbrands to earn $137 million in 2001. In a January 30, 2001 presentation to Tyson, Bond had presented an operating plan that hoped to achieve $145 million from Foodbrands. As of the end of the first quarter, Foodbrands had earned only $2 million, and thus needed another $135 million in the succeeding three quarters to reach its Rawhide Projection. IBP's overall trailing last twelve month's earnings had declined from $488 million as of the end of the third quarter of 2000 to $330 million. [FN158]

*44 As a result of these problems, analysts following IBP issued sharply reduced earnings estimates for FY 2001. Originally, analysts were predicting that IBP would exceed the Rawhide Projections in 2001 by a wide margin. After IBP's poor first quarter, some analysts had reduced their estimate from $2.38 per share to $1.44 a share. [FN159] Even accounting for Tyson's attempts to manipulate the analyst community's perception of IBP, this was a sharp drop.

Tyson contends that the logical inference to be drawn from the record evidence that is available is that IBP will likely have its worst year since 1997, a year which will be well below the company's average performance for all relevant periods. As important, the company's principal driver of growth is performing at markedly diminished levels, thus compromising the company's future results as it enters what is expected to be a tough few years in the fresh meats business.

IBP has several responses to Tyson's evidence. IBP initially notes that Tyson's arguments are unaccompanied by expert evidence that identifies the diminution in IBP's value or earnings potential as a result of its first quarter performance. [FN160] The absence of such proof is significant. Even after Hankins generated extremely pessimistic projections for IBP in order to justify a lower deal price, Merrill Lynch still concluded that a purchase of IBP at $30 per share was still within the range of fairness and a great long-term value for Tyson. The Merrill Lynch analysis casts great doubt on Tyson's assertion that IBP has suffered a Material Adverse Effect. [FN161]

IBP also emphasizes the cyclical nature of its businesses. It attributes its poor first quarter to an unexpectedly severe winter. This led ranchers to hold livestock back from market, causing a sharp increase in prices that hurt both the fresh meats business and Foodbrands. Once April was concluded, IBP began to perform more in line with its recent year results, because supplies were increasing and Foodbrands was able to begin to make up its winter margins. Bond testified at trial that he expects IBP to meet or exceed the Rawhide Projection of $1.93 a share in 2001, and the company has publicly indicated that it expects earnings of $1.80 to $2.20 a share. Peterson expressed the same view.

IBP also notes that any cyclical fall is subject to cure by the Agreement's termination date, which was May 15, 2001. By May 15, IBP had two weeks of strong earnings that signaled a strong quarter ahead. Moreover, by that time, cattle that had been held back from market were being sold, leading to plentiful supplies that were expected to last for most of the year.

Not only that, IBP notes that not all analyst reporting services had been as pessimistic as Tyson portrays. [FN162] In March, Morningstar was reporting a mean analyst prediction of $1.70 per share for IBP in 2001. [FN163] By May, this had grown to a mean of $1.74 a share. [FN164] Throughout the same period, Morningstar's consensus prediction was an FY 2002
performance of $2.33 range in March, and $2.38 in May. [FN165] Therefore, according to Morningstar, the analyst community was predicting that IBP would return to historically healthy earnings next year, and that earnings for this year would fall short of the Rawhide Projections by less than $.20 per share.

*45 IBP also argues that the Impairment Charge does not approach materiality as a big picture item. That Charge is a one-time, non-cash charge, and IBP has taken large charges of that kind as recently as 1999. While IBP does not deny that its decision to buy DFG turned out disastrously, it reminds me that DFG is but a tiny fraction of IBP's overall business and that a total shut-down of DFG would likely have little effect on the future results of a combined Tyson/IBP. And as a narrow asset issue, the charge is insignificant to IBP as a whole.

I am confessedly torn about the correct outcome. As Tyson points out, IBP has only pointed to two weeks of truly healthy results in 2001 before the contract termination date of May 15. Even these results are suspect, Tyson contends, due to the fact that IBP expected markedly better results for the second week just days before the actual results come out. In view of IBP's demonstrated incapacity to accurately predict near-term results, Tyson says with some justification that I should be hesitant to give much weight to IBP's assurances that it will perform well for the rest of the year.

In the end, however, Tyson has not persuaded me that IBP has suffered a Material Adverse Effect. By its own arguments, Tyson has evinced more confidence in stock market analysts than I personally harbor. But its embrace of the analysts is illustrative of why I conclude that Tyson has not met its burden.

As of May 2001, analysts were predicting that IBP would earn between $1.50 [FN166] to around $1.74 [FN167] per share in 2001. The analysts were also predicting that IBP would earn between $2.33 [FN168] and $2.42 [FN169] per share in 2002. These members are based on reported "mean" or "consensus" analyst numbers. Even at the low end of this consensus range, IBP's earnings for the next two years would not be out of line with its historical performance during troughs in the beef cycle. As recently as years 1996-1998, IBP went through a period with a three year average earnings of $1.85 per share. At the high end of the analysts' consensus range, IBP's results would exceed this figure by $.21 per year.

This predicted range of performance from the source that Tyson vouches for suggests that no Material Adverse Effect has occurred. [FN170] Rather, the analyst views support the conclusion that IBP remains what the baseline evidence suggests it was—a consistently but erratically profitable company struggling to implement a strategy that will reduce the cyclicity of its earnings. Although IBP may not be performing as well as it and Tyson had hoped, IBP's business appears to be in sound enough shape to deliver results of operations in line with the company's recent historical performance. Tyson's own investment banker still believes IBP is fairly priced at $30 per share. The fact that Foodbrands is not yet delivering on the promise of even better performance for IBP during beef troughs is unavailing to Tyson, since § 5.10 focuses on IBP as a whole and IBP's performance as an entire company is in keeping with its baseline condition.

*46 Therefore, I conclude that Tyson has not demonstrated a breach of § 5.10. I admit to reaching this conclusion with less than the optimal amount of confidence. [FN171] The record evidence is not of the type that permits certainty. [FN172]

E. Tyson Was Not Fraudulently Induced To Enter Into The Confidentiality Agreement Or The Merger Agreement

Tyson argues that it was fraudulently induced to enter into the Confidentiality Agreement and the Merger Agreement. As a result, it contends that those contracts should be rescinded, along with the contract under which Tyson paid the Rawhide termination fee on IBP's behalf.

The basic elements Tyson must prove are well-established:

Under New York law, the essential elements of a claim for fraudulent inducement are: (1) misrepresentation of amaterial existing fact; (2) falsity; (3) scienter; (4) deception; and (5) injury. Plaintiff must demonstrate that defendant knowingly uttered a falsehood intending to deprive the plaintiff of a benefit and that the plaintiff was thereby deceived and damaged. [FN173]

Tyson also contends that it was victimized by negligent or innocent misrepresentations. New York law permits rescission if IBP made a negligent or innocent misrepresentation of material fact, so long as Tyson reasonably relied upon that misrepresentation to its detriment. [FN174]

"However, the alleged misrepresentation must be factual in nature and not promissory or relating to
future events that might never come to fruition."  
[FN175]

Tyson also claims that it was injured by material omissions of fact made by IBP during the Merger negotiations. This claim is subject to somewhat different requirements and requires Tyson to "prove the existence of a fiduciary or confidential relationship warranting the trusting party to repose his confidence in the defendant and, therefore, to relax the care and vigilance he would ordinarily exercise in the circumstances."  
[FN176]

Tyson bases its rescission claims on alleged misrepresentations or omissions of material fact related to three areas: (1) the Rawhide Projections; (2) audit reports relating to DFG and Foodbrands; and (3) the Comment Letter. I will address each in turn.

Before doing that, it is important to place my more specific analysis in some context. The negotiations between IBP and Tyson did not take place between a world-wise, globe-trotting capitalist with an army of advisors on one side, and Jethro Bodine, on the other. Instead, two equally sophisticated parties dealt with each other at arms' length with the aid of expensive and highly skilled advisors. Caveat emptor is still the basic law of New York, [FN] 771 and it applies with full force in these circumstances.

Not only that, a contextually-specific factor—the Confidentiality Agreement—contributes to the caution with which Tyson should have taken any oral assurances or representations from IBP during the Merger negotiation process. Tyson had agreed that it could not use any oral or written due diligence information (or omissions therefrom) as a basis for a lawsuit unless that issue was covered by a specific provision of a subsequent, written contract. As a result, Tyson could not have assumed that it could place reasonable reliance on assurances of IBP that were not reduced to a specific written promise in the Merger Agreement.  
[FN178]

*47 While Tyson argues that the Confidentiality Agreement itself should be rescinded, I find otherwise as outlined below. Alternatively, Tyson contends that the Confidentiality Agreement does not cover the Warranted Financials or the Rawhide Projections because those documents were publicly filed. As such, Tyson argues convincingly that those documents were not Evaluation Material for purposes of that Agreement. What Tyson has not shown is that oral statements about those documents that IBP made during the due diligence process would not fall within the expansively defined "Evaluation Material" category. Likewise, Tyson has not convinced me that the Confidentiality Agreement does not cover information that was in IBP's possession that constituted Evaluation Material, regardless of whether that information was created by IBP or one of its agents. The contractual definition is much broader.  
[FN179] Given these factors, Tyson should have been very cautious, indeed.  
[FN180]

Finally, the nature of the Merger Agreement itself demonstrates the parties' attentiveness to the need to cover material issues in writing, if they were a concern. The Agreement contains numerous representations and warranties, with lengthy schedules of carve-outs. To the extent that a contracting party chose not to negotiate for specific language regarding an issue, the most plausible inference is that the issue was simply not fundamental enough to buttress a rescission claim.

1. Tyson Cannot Base Rescission On The Rawhide Projections

Tyson's first argument is that it was assured that the Rawhide Projections were conservative, that IBP believed in them, and that IBP would meet them. It further contends that IBP representatives made statements about the Projections that they knew to be false at the time they were made. I conclude otherwise.

First, I do not believe that IBP ever made a misrepresentation of material fact regarding the Rawhide Projections. When first prepared, the Rawhide Projections were based on reasonable assumptions. When the Projections were discussed with Tyson, IBP informed Tyson of those assumptions. IBP also told Tyson about the factors that bore on whether IBP would achieve the anticipated numbers. More fundamentally, Tyson was on notice that it was to read the Rawhide Projections in light of other information that was available to it, including IBP's most recent 10-Q. It was also on notice about when the Projections had been prepared, and that they had not been updated. These factors should have indicated to Tyson in late November and early December 2000 that IBP would likely fall short of the EBIT target for FY 2000.

Most important, when Tyson signed the Merger Agreement, Tyson had been told that the Rawhide Projections for FY 2000 would not be met by a wide margin. It was also told that IBP's CFO, Shipley,
thought IBP could meet the Projections for FY 2001 but that there was no guarantee and that doing so would depend on certain strategies working out. Therefore, before it signed the contract, Tyson knew that the Rawhide Projections were a prediction of future events that had already been proven less than accurate.

*48 Under New York law, the fact that IBP management said that the Projections were based on reasonable assumptions and that IBP expected to meet the Projections does not constitute a material misrepresentation of fact. [FN181] Expressing confidence about a projection of future results will not support a claim for material misrepresentation. [FN182]

Nor am I persuaded that IBP management intended to mislead Tyson in any way. The circumstances simply do not support that inference. IBP told Tyson too much information that placed Tyson on notice of the uncertainty of predictions of IBP's future performance. Whatever confidence Peterson and Bond expressed in their company was, I conclude, heart-felt. Likewise, I find that Shipley lacked any intent to deceive. While the IBP side of the negotiation may not have been as promptly forthcoming as was ideal, its failures in that respect were, if anything, likely to lead a reasonable acquirer to place less reliance on the Rawhide Projections, rather than more. Put simply, it is odd to posit a stranger scheme to mislead than the one IBP supposedly carried out. The scheme involved behaving in a manner that would naturally lead IBP’s negotiating adversary to be skeptical and on notice of possible problems. In any event, by the critical point in time IBP had given Tyson all the information it needed to assess the Rawhide Projections and their inherent unreliability.

Finally, I conclude that Tyson did not reasonably rely to its detriment on the Rawhide Projections. By the time it signed the Merger Agreement, Tyson had come to the conclusion that IBP management could not be trusted, particularly Shipley, who they knew prepared the Projections. To make sure that they were making a sound deal, Tyson had its investment banker run downside cases using numbers much lower than were contained in the Projections. By the time it signed the Merger Agreement, Tyson’s investment banker doubted whether DFG had ever made money, and its CFO, Hankins, was openly skeptical of IBP’s ability to meet the Projections. John Tyson believed that Foodbrands was broken. Despite all these risk factors, Tyson proceeded without securing any written representation and warranty giving Tyson the right to walk away if IBP did not perform in the first quarter of FY 2001 on a pace to meet the Rawhide Projection for that year. Nor did Tyson seek to escrow a portion of the Merger consideration, pending IBP’s performance in 2001.

Notably, in January 2001, Tyson’s Cash Offer documents reprinted the Rawhide Projections, revised as of December 20, 2000. In so doing, Tyson warned as follows: The Company has advised us that it does not as a matter of course make public forecasts as to future revenues, earnings or other financial information, and the Projections were not prepared with a view to public disclosure.

The Projections were not prepared with a view to public disclosure or compliance with published guidelines of the SEC or the American Institute of Certified Public Accountants regarding prospective financial information. In addition, the Projections were not prepared with the assistance of or reviewed, compiled or examined by, independent auditors. The Projections reflect numerous assumptions, all made by the Company management, with respect to industry performance, general business, economic, market and financial conditions and other matters, all of which are difficult to predict and many of which are beyond the Company's control. Accordingly, there can be no assurance that the assumptions made in preparing the Projections will prove accurate, and actual results may be materially greater or less than those contained in the Projections.

*49 The inclusion of the Projections in this Supplement to the Offer should not be regarded as an indication that the Company, Tyson or Purchaser or any of the Company’s, Tyson’s or Purchaser's respective representatives, or respective officers and directors, consider such information to be an accurate prediction of future events or necessarily achievable. In light of the uncertainties inherent in forward looking information of any kind, we caution against reliance on such information. The Company has advised us that it does not intend to update or revise the Projections to reflect circumstances existing after the date when prepared or to reflect the occurrence of future events, unless required by law. [FN183]

For all these reasons, the Rawhide Projections provide IBP with no basis to rescind the Merger Agreement or the Confidentiality Agreement.
Tyson's next argument is that it was misled by IBP about the health of Foodbrands, and that it was denied access to full due diligence regarding that part of IBP. This argument is unavailing for several reasons.

First, the assertion is barred by the Confidentiality Agreement, which prohibits a claim based on a due diligence omission. No representation or warranty in the Merger Agreement specifically covers this contention.

Second, IBP did not deny Tyson access to due diligence about Foodbrands. It told Tyson that the cost of access was permitting Smithfield to see the same information. Tyson has not proven that IBP management thought there were problems outside of DFG as of December 2000 and decided to deny Tyson access to information so as to conceal them.

Third, I conclude that Hagen did not intentionally mislead Tyson about whether it had received audit reports about all units of IBP. Tyson's request was directed to the "company" and was never more specific. Tyson never asked for audit reports specific to DFG or Foodbrands after being told that it had received all audit reports for the company. The type of misunderstanding that emerged between Hudson and Hagen is typical of those that are common in discovery disputes. Given the large volume of information Hagen turned over, I cannot infer that she purposely hid any particular audit reports from Tyson. Hudson could have followed up if he wanted Foodbrand-specific audit reports and had not received any. Persistence by the requesting party is expected when huge volumes of information are being produced in a hurry.

Lastly, any failure on Hagen's part did not cause Tyson to sign the Merger Agreement under a misapprehension of material fact. The Brady memorandum regarding DFG is the only potentially material audit report that Tyson complains Hagen failed to provide. But that memorandum contains no information that, in words or substance, was not communicated to Tyson before it signed the Merger Agreement. By the time it signed on the dotted line, Tyson doubted that DFG would contribute in FY 2001, and knew that a company with only $70 million in sales had caused an over $30 million loss, that IBP still had not figured out how to account for the problem, and was still studying whether an impairment was necessary. Tyson also knew that this problem had been caused by fraud that had gone on for a lengthy period, without detection by IBP's top management. In part because of these events, Tyson lacked confidence in IBP's CFO at the time it signed the Merger Agreement.

*50 In view of what Tyson knew, anything in the Brady memorandum would have been merely cumulative. The key is that IBP told Tyson about the problems identified in that memorandum. And given Tyson's decision to increase its bid after learning of the deepening problems at DFG and its acceptance of Schedule 5.11, Tyson's argument that it would not have signed the Merger Agreement if it had seen the Brady memorandum is meritless.

3. Tyson Cannot Base Rescission On The Comment Letter

Tyson argues that it was misled into signing the Merger Agreement because of IBP's failure to disclose the Comment Letter. Earlier in this litigation, Tyson argued that IBP's failure to turn over the Comment Letter was intentional. Tyson has dropped that claim and contends that the failure was an actionable innocent omission of a material fact. For reasons discussed, this argument is barred by the Confidentiality Agreement. Even if not barred by that Agreement, this argument is without merit.

As is obvious, Tyson's Comment Letter claim is not based on any statement that IBP made to Tyson. It is based on IBP's failure to disclose the Letter. IBP was not Tyson's fiduciary during the contractual negotiations. It had no special duty to provide Tyson with the Comment Letter, even assuming it had focused on the Letter before the Agreement was executed--which neither it nor its attorneys had.

The fact that IBP had no duty to disclose the Comment Letter to Tyson is perhaps best illustrated by Tyson's own behavior. In the weeks preceding the Merger Agreement's execution, Tyson had corresponded with the SEC about issues that IBP would have found interesting. Tyson never turned this correspondence over to IBP. In fact, after the Merger Agreement was signed, Tyson breached its obligation to turn over SEC correspondence to IBP at the same time as it was complaining about the Comment Letter. Tyson's own behavior demonstrates that the parties were dealing with each

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other at arms' length, and that no special duty of disclosure had arisen. For this reason alone, Tyson's rescission claim fails. [FN187]

As important, there is no basis to infer that Tyson would not have signed the Merger Agreement if it had seen the Comment Letter. [FN188] The Comment Letter flagged no issues that Tyson had not already identified and concluded were not obstacles to going forward with the Merger Agreement. [FN189] As of December 29, 2000, Tyson had far more knowledge than the SEC had about the issues raised in the Letter—especially DFG.

In the face of a grandstand full of waving red flags, Tyson sped into the final round of the negotiation process. The Comment Letter would not have slowed it down. This conclusion is best demonstrated by the fact that Tyson's board and stockholders voted to approve the Merger Agreement after Tyson had received the Comment Letter. [FN190] Tyson's top management deemed the Letter too insignificant—i.e., immaterial [FN191]—to share with the board or the stockholders. [FN192]

F. IBP Has Not Proven That Tyson's Termination Of Its Cash Offer Breached The Agreement

*51 The final merits issue I must examine is IBP's contention that Tyson's first breach of contract occurred no later than February 28, 2001, when Tyson did not close on its Cash Offer. [FN193] As of that time, the minimum tender condition of 50.1% of the IBP shares had been easily met and Tyson had obtained Hart-Scott-Rodino clearance. For the reasons discussed, Tyson did not have a basis to terminate as of that date in reliance on the Agreement's representations and warranties, because none of them were breached. Even more important, Tyson was required by Annex I of the Agreement to make a reasonable good faith judgment that a representation and warranty was breached as of the time it decided not to close the Cash Offer. As Baledge testified, Tyson had not made any such good faith determination.

Therefore, Tyson must rely on some other basis to excuse its failure to close the Cash Offer. The basis that Tyson asserts is that IBP's failure to formally file the Restated Financials in time for Tyson to amend its Cash Offer Documents made it impossible for Tyson to comply with the relevant SEC regulations and thus to close. In support of this argument, Tyson cites to SEC regulations and guidance, which state that "[p]ro forma financial information is required in a negotiated third-party cash tender offer when securities are intended to be offered in a subsequent merger or other transaction in which remaining target securities are acquired and the acquisition of the subject company is significant to the offeror ...." [FN194] Tyson was subject to this requirement because IBP stockholders who did not elect to tender into the Cash Offer would receive Tyson stock in the Exchange Offer or ultimate Merger. Therefore, Tyson's Cash Offer documents contained pro forma information that was based on the original Warranted Financials. As a result, Tyson contends that it had no choice but to refuse to close, because IBP did not formally file the Restated Financials until after the contractual expiration of the Cash Offer on February 28, 2001. To the extent that any party is at fault, Tyson says, it is IBP, which failed to provide corrected financial information pursuant to § 2.01(e) in sufficient time to allow Tyson to update its Cash Offer documents and close on February 28.

In January and February, Tyson put IBP on notice that it was awaiting the outcome of IBP's SEC discussions before updating its Cash Offer documents. In this regard, Tyson notes that IBP never demanded that Tyson update those documents on the basis of interim information that was not contained in formally Restated Financials. Indeed, once Tyson terminated, IBP issued a press release stating that Tyson's termination of the Cash Offer was "in complete accordance with the" Merger Agreement. [FN195]

IBP's response hinges largely on § 9.02 of the Agreement, which imposed on Tyson the duty to use its "reasonable best efforts" to close the Cash Offer. According to IBP, Tyson breached this duty because it took no steps to use the information that it possessed before February 28, 2001 to construct pro forma information that, with the inclusion of appropriate qualifications, would pass muster under the SEC regulations. For example, IBP says that Tyson possessed drafts of the Restated Financials in early February. [FN196] Not only that, Tyson had received a copy of a February 7, 2001 SEC letter to IBP, which indicated that the SEC would not decline to accelerate the effectiveness of a registration statement for Tyson's Exchange Offer, so long as the statement included the restated financial statements. [FN197] Even if that earlier information was not sufficient, IBP notes that it publicly disclosed the substantive aspects of the Restated Financials on February 22, 2001, including the quarters to which the DFG charges would be allocated. [FN198] This...
disclosure also indicated that an asset impairment of up to $108 million could be taken, and discussed the effect that variable option plan accounting would have.

*52 IBP therefore argues that if Tyson had used "reasonable best efforts" it could have constructed pro forma information that met the requirements of the SEC Regulations, and disclosed that information in time for it to close the Cash Offer on February 28, 2001. In early February, Hagen had called Baledge to discuss moving forward with the Cash Offer on the basis of this information. Baledge never responded to her request.

IBP contends that the reason that Baledge never responded has now become clear, and evidences a breach of § 9.02: Tyson was trying to stall for time so that Don Tyson could see more IBP results from 2001 before deciding whether to proceed, renegotiate, or terminate. The evidence does support the conclusion that Tyson's principal motivation was delay for reasons that had to do with Tyson's own weakened financial condition and IBP's weak first quarter, rather than any of the issues pending before the SEC.

Yet, during February 2001, Tyson did not tell IBP that its most important reason for not proceeding with the Cash Offer had nothing to do with the SEC issues. Instead, it issued public statements indicating that it was committed to the transaction's prompt consummation, but wished to assess the materiality of any restatements resulting from the SEC process. Indeed, on February 21, 2001, John Tyson publicly reiterated that Tyson was "going to buy IBP," that it was "a unique point in time and opportunity to create the world's largest marketer of these proteins," and that "IBP is a strong company." [FN199] As a result, IBP says it was lulled into a sense of false security that led it to refrain from demanding that Tyson speed up its efforts to close the Cash Offer. Had Tyson disclosed its real motives, IBP would have acted differently. IBP's public indication that Tyson's termination of the Cash Offer comported with the Agreement must be understood in context: IBP was expressing its reliance on the good faith of a merger partner who it thought was exercising best efforts. Therefore, its press release cannot be regarded as an enforceable waiver of any breach on Tyson's part.

My ability to resolve the competing arguments of Tyson and IBP is compromised by the murky nature of the governing administrative law that has been cited to me. As a general matter, there seems to be no dispute that Tyson had a duty to present pro forma financial information, and no question that its presentation should be as accurate as possible. Beyond that, the parties basically give me opinion testimony about how the SEC would treat this kind of question. Tyson says that the SEC wants tender offerors to get it right, and that it is not adequate to simply set forth pro forma information and indicate that there could be deviations based on unaudited numbers in the target's press releases. IBP contends that the SEC is more flexible than that, and that if Tyson had constructed pro formas that factored in the information in the draft restatements provided to Tyson in early February, this would have sufficed to meet any fair disclosure obligation. IBP also adds that it was ludicrous for Tyson to fear litigation, because it is difficult to conceive how IBP shareholders could have been injured by a disclosure of a pro forma balance sheet, adjusted by the information in the draft restatements and coupled with an indication that an asset impairment of up to $108 million could be taken at a later time.

*53 My suspicion is that a motivated tender offeror, working with a cooperative target and the target's accountants, could have put together Cash Offer documents that would have satisfied SEC standards and presented no likelihood of serious litigation risk based on the information that Tyson had in its possession in early to mid-February. This would have required a collaborative effort with the target and discussions with the SEC, but it probably could have been done. That's my guess.

And that's my problem. IBP is hinging its present argument on several "could have been" scenarios that I am not well-positioned to evaluate with the certainty that is required to sustain a finding of contractual breach. Under the Agreement, IBP had the primary duty here, to provide Tyson with corrected information that would allow the Cash Offer to close. Although IBP hinted that Tyson could proceed with interim information in advance of the final Restated Financials, it never demanded that Tyson do so, and it never asked Tyson to request the SEC's permission to go forward on that basis. Thus, IBP asks me to speculate that it was commercially unreasonable for Tyson to wait until it had certified restatements before proceeding.

While it is troubling that Tyson used IBP's troubles with the SEC to prospect for more time, I am not sufficiently persuaded that it was unreasonable for Tyson to await the formally Restated Financials before proceeding. Indeed, the SEC's February 7,
2001 letter to Hagen is at best ambiguous about whether the SEC was willing to permit a registration statement based on draft restatements, rather than filed restatements. And although more complete information was publicly released by IBP on February 22, 2001, that was a very short time before the Cash Offer deadline and IBP has not convinced me that it was practical for Tyson to amend its pro forma information, and disclose that information in time for IBP stockholders to consider it in their decision-making process by the deadline. Therefore, I conclude that Tyson did not breach the Agreement, or any duty to the IBP stockholders, by failing to close the Cash Offer on February 28, 2001.

As a result of this conclusion, my merits determination is that Tyson is in breach of the Merger Agreement because it improperly terminated in late March, 2001. That is, it is in breach of its obligation to close the Cash Election Merger on or before May 15, 2001. [FN200]

IV. IBP Is Entitled To An Award Of Specific Performance

Having determined that the Merger Agreement is a valid and enforceable contract that Tyson had no right to terminate, I now turn to the question of whether the Merger Agreement should be enforced by an order of specific performance. Although Tyson's voluminous post-trial briefs argue the merits fully, its briefs fail to argue that a remedy of specific performance is unwarranted in the event that its position on the merits is rejected.

This gap in the briefing is troubling. A compulsory order will require a merger of two public companies with thousands of employees working at facilities that are important to the communities in which they operate. The impact of a forced merger on constituencies beyond the stockholders and top managers of IBP and Tyson weighs heavily on my mind. The prosperity of IBP and Tyson means a great deal to these constituencies. I therefore approach this remedial issue quite cautiously and mindful of the interests of those who will be affected by my decision.

*54 I start with a fundamental question: is this a truly unique opportunity that cannot be adequately monetized? If the tables were turned and Tyson was seeking to enforce the contract, a great deal of precedent would indicate that the contract should be specifically enforced. [FN201] In the more typical situation, an acquiror argues that it cannot be made whole unless it can specifically enforce the acquisition agreement, because the target company is unique and will yield value of an unquantifiable nature, once combined with the acquiring company. [FN202] In this case, the sell-side of the transaction is able to make the same argument, because the Merger Agreement provides the IBP stockholders with a choice of cash or Tyson stock, or a combination of both. Through this choice, the IBP stockholders were offered a chance to share in the upside of what was touted by Tyson as a unique, synergistic combination. This court has not found, and Tyson has not advanced, any compelling reason why sellers in mergers and acquisitions transactions should have less of a right to demand specific performance than buyers, and none has independently come to my mind.

In addition, the determination of a cash damages award will be very difficult in this case. And the amount of any award could be staggeringly large. No doubt the parties would haggle over huge valuation questions, which (Tyson no doubt would argue) must take into account the possibility of a further auction for IBP or other business developments. A damages award can, of course, be shaped; it simply will lack any pretense to precision. An award of specific performance will, I anticipate, entirely eliminate the need for a speculative determination of damages. [FN203]

Finally, there is no doubt that a remedy of specific performance is practicable. Tyson itself admits that the combination still makes strategic sense. At trial, John Tyson was asked by his own counsel to testify about whether it was fair that Tyson should enter any later auction for IBP hampered by its payment of the Rawhide Termination Fee. This testimony indicates that Tyson Foods is still interested in purchasing IBP, but wants to get its original purchase price back and then buy IBP off the day-old goods table. I consider John Tyson's testimony an admission of the feasibility of specific performance. [FN204]

Probably the concern that weighs heaviest on my mind is whether specific performance is the right remedy in view of the harsh words that have been said in the course of this litigation. Can these management teams work together? The answer is that I do not know. Peterson and Bond say they can. I am not convinced, although Tyson's top executives continue to respect the managerial acumen of Peterson and Bond, if not that of their financial subordinates.
What persuades me that specific performance is a workable remedy is that Tyson will have the power to decide all the key management questions itself. It can therefore hand-pick its own management team. While this may be unpleasant for the top level IBP managers who might be replaced, it was a possible risk of the Merger from the get-go and a reality of today's M&A market.

*55 The impact on other constituencies of this ruling also seems tolerable. Tyson's own investment banker thinks the transaction makes sense for Tyson, and is still fairly priced at $30 per share. One would think the Tyson constituencies would be better served on the whole by a specific performance remedy, rather than a large damages award that did nothing but cost Tyson a large amount of money.

In view of these factors, I am persuaded that an award of specific performance is appropriate, regardless of what level of showing was required by IBP. That is, there is clear and convincing evidence to support this award. Such an award is decisively preferable to a vague and imprecise damages remedy that cannot adequately remedy the injury to IBP's stockholders.

V. Conclusion

For all the foregoing reasons, IBP's claim for specific performance is granted. Tyson's claims for relief are dismissed. The parties shall collaborate and present a conforming partial final order no later than June 27. In addition, the parties shall schedule an office conference with the court to occur later that same week.

FN1. This lawsuit started as a challenge by stockholder plaintiffs to an earlier leveraged buyout of IBP. The plaintiffs then drew fire on the Tyson Merger, contending it was unfair, too. When the Tyson Merger went away, IBP quickly moved for specific performance. The stockholder plaintiffs had the "flexibility" to adapt to these events and have decided that the Tyson Merger is the best deal and should be enforced. The stockholder plaintiffs thus join in the arguments made by IBP, but have let IBP take the lead on behalf of the company and its stockholders. The stockholder plaintiffs were present at trial, but allowed IBP's counsel to present their case.

The parties agreed to expedite the trial on the merits and the question of whether specific performance was appropriate, and to defer any issues of damages. This approach was designed to ensure that the passage of time would not preclude IBP's chance at specific performance. For reasons that the opinion suggests, it may be that any damages issue has largely been obviated, depending on the parties' cooperation and the outcome on appeal.

FN2. PX 27, at IBP2000184.

FN3. Id.

FN4. This is a simplification of a very complex issue that involves the timing of Foodbrands' purchase of livestock at certain costs and the timing of its sale of finished product, and the pricing of those respective transactions, among other factors. The simplicity of this rendering also applies to the overall discussion of IBP's susceptibility to changes in livestock supply.

FN5. Typically, this is defined as Earnings Before Interest and Taxes, but has been used more loosely by the parties in this case. In this opinion, earnings from operations and EBIT are used interchangeably. They are the terms the companies have used to describe IBP's earnings.

FN6. PX 531, at T41054.

FN7. Earlier in the litigation, Tyson leveled serious fraud allegation at IBP based on assertions by Baledge relating to the November 24 meeting. Baledge claimed to have been given access to a copy of the Rawhide Projections before the November 24 meeting as a fraudulent inducement by IBP to enter the bidding. The Arkansas court was told that this document would be a key one in this case. So flimsy did this...
accusation turn out to be that it was not even made in Tyson's post-trial brief. Although Baledge sticks to his story, Tyson did not and Baledge's management colleagues have not. I do not credit Baledge's version of events, which is at best mistaken.

FN8. PX 531, at T41053 (emphasis added).

FN9. PX 40, at T40977.

FN10. Id. at T40988.

FN11. Tr. 41.

FN12. PX 63.

FN13. Id. (emphasis added).

FN14. Id.

FN15. Id.


FN17. Id. at 139.

FN18. Id. at 45-46; PX 442.


FN20. PX 561.

FN21. PX 74.

FN22. Peterson Dep. at 85; Tr. 1210-11.

FN23. DX 383, at T53527.

FN24. DX 306, at T53134.

FN25. Tyson Dep. at 74.


FN27. DX 306, at 53132; DX 383, at T53522.

FN28. Tr.2059-60; DX 383, at T53529.

FN29. McCabe Dep. at 45.

FN30. DX 30.

FN31. At trial, Hagen admitted she did not review IBP's internal audit database in compiling her response. Tr. 1569-70. Nonetheless, Tyson has not argued that it did not receive "IBP" audit reports, nor has it produced any specific request by Hudson for Foodbrands or DFG audit reports after Hagen's assertion that she had sent all company audit reports. In due diligence, as in discovery, recipients of information often review what they receive in order to identify possible gaps.

FN32. PX 108.

FN33. PX 438; Tr. 2609-10; Tr. 833.

FN34. Tr. 835-36.

FN35. Tr. 834-35.

FN36. Tyson attempted to show that Shipley had under-stated Foodbrands' performance, by attempting to show that his December 20 estimates were rosier than were the company's own weekly profit and loss statements as of that time. Those statements,
however, backed out the CFBA Charges previously discussed, as the record evidence demonstrates. DX 528; DX 529. As a result, Tyson’s contention is without merit.

FN37. Tr. 2605-06.

FN38. DX 306, at 53162.

FN39. PX 116, at T23655.

FN40. Tr. 2592-93.

FN41. Tr.2075-78.

FN42. Id.

FN43. Tyson Dep. at 47; Tr. 2309.

FN44. Tr. 2309-2310.

FN45. Tr.2094-95.

FN46. Tr.2096-2098; Tr.2063.

FN47. McCaleb Dep. at 57-58, 91-96.

FN48. Emphasis added.

FN49. Agreement, Annex I(d), Annex III § (14)(e) (emphasis added).

FN50. Agreement § § 5.07-5.10.

FN51. Id. § 2.01(e), (h).

FN52. Id.

FN53. Id.

FN54. PX 122.

FN55. PX 177.

FN56. Id.

FN57. PX 189.

FN58. McCaleb Dep. at 166, 187.

FN59. PX 156.

FN60. PX 178.

FN61. PX 156.

FN62. Id.

FN63. Tr.1961.

FN64. PX 208. These words were massaged by Baledge at the request of Bond. The original language indicated that Tyson would assess the materiality of any of these questions to the “transaction.” Tr. 327.

FN65. Tyson’s expert says that IBP was naïve to think that the SEC would give such counsel, and that IBP was in general less than adroit in its dealings with the SEC. This strategic issue does not bear on the outcome of the case. Tyson’s SEC expert essentially believed that IBP should have simply agreed to all of the SEC’s concerns straight-away and filed a large restatement. While this would have, of course, shortened the process, under Tyson’s theory IBP would still have been in breach. In addition, I note that the SEC itself purports to encourage registrants to discuss difficult issues like IBP faced with it. SEC Staff Accounting...

FN66. DX 330, at T4414.

FN67. PX 237.

FN68. DX 164; DX 173.

FN69. Tr. 2496-97.

FN70. Id.

FN71. PX 277.

FN72. Tr. 2485-86.

FN73. PX 274.

FN74. PX 370.

FN75. PX 326.

FN76. Tr. 109-115.

FN77. Tr. 122-25.

FN78. PX 297. Another March 13, 2001 document that evidences Tyson's desire to retrade the deal is PX 310.

FN79. PX 573.

FN80. PX 317.

FN81. Tr. 164-66.

FN82. Tr. 166-67.

FN83. PX 347.

FN84. D. Tyson Dep. at 100-02, 180-82.

FN85. Tr. 2280-2282; D. Tyson Dep. at 100-102.

FN86. Hudson Dep. Ex. 5.

FN87. I have not quibbled with this rare area of agreement, although I note that the Confidentiality Agreement and the agreement giving rise to Tyson's payment of the Rawhide termination fee are governed by the contract law of Delaware.

FN88. It is fair to say that this is one of the more tersely argued disputes in the briefs.


FN90. In re Estate of Getchell, Del. Ch., C.A. No. 101037, 1994 WL 469153. *4 n. 3, Jacobs, V.C. (Aug. 4, 1994) ("[c]ourts have, in certain cases, required a party seeking an order of specific performance to meet a higher evidentiary burden, "for fear of doing greater wrong than by leaving the parties to their legal remedy") (quoting 71 Am Jur. 2d Spec. Perf. § 208, at 266 (1973)).

FN91. Restatement (Second) of Conflicts § 133 (1971).

FN92. Id.; see also id. § 133..

FN93. 71 Am Jur. 2d Spec. Perf. § 208 (1973) (the "established rule" is that more than a "mere preponderance" is necessary to support an award of specific performance).


FN97, Restatement (Second) of Conflicts § 133, 135.

FN98, For example, Tyson asserts that Delaware law requires a party seeking specific performance to demonstrate its entitlement by clear and convincing evidence. It does not dilate on whether that burden applies to the court's determination that the party resisting specific performance is in breach of a written contract, or whether that burden applies solely to the question of whether the court is sufficiently persuaded that an award of specific performance is warranted. Given that one can recover contractual damages simply by proving a contractual breach by a preponderance, it is somewhat inefficient to have the breach determination be governed by a different evidentiary burden solely because the plaintiff seeks specific performance. But that higher merits burden may be thought important to advance the public policy of Delaware. It is because these level-of-proof issues are so bound up with public policy concerns--rather than trial procedure--that I believe that New York law is applicable.


FN107. See, e.g., Alland v. Consumers Credit Corp., 476 F.2d 951, 956 (2d Cir.1973) (subjective understanding expressed during negotiations may be probative of meaning that the parties placed on language); Restatement (Second) of Contracts § 201(2) (1979) (same); Federal Insur. Co. v. Americas Insurance Co., 258 A.D.2d 39, 691 N.Y.S.2d 508, 512 (N.Y.App.Div.1999) (course of performance is persuasive evidence of intent); Restatement (Second) of Contracts § 202 cmt. g ("The parties to an agreement know best what they meant, and their action under it is often the strongest evidence of their meaning.").

FN108. Tyson cites to another merger agreement in which the Wachtell, Lipton firm used this technique. DX 1207.


FN110. Tyson is not always consistent, however. In its brief, Tyson argues that the Restated Financials were evidence of a breach, not the breach itself. But if the breach itself was the DFG earnings charges that resulted from accounting improprieties during the periods covered by the Warranted Financials, IBP was in breach from the date of signing the Agreement and Tyson knew it, thus turning the contract into a pure option on Tyson's part.

FN111. Tr. 2270-72, 2617-19.

FN112. Tr. 2522.


FN116. Id.

FN117. Securities lawsuits were filed based on the DFG-related issues in the Restated Financials. The record does not support the conclusion that IBP faces material risk from the suits, because its top management and board were victimized by Zahn and did not act with scienter.

FN118. Section 2.01(e) & (h) of the Agreement also casts doubt on Tyson's rigid reading. That provision requires IBP to "correct promptly" any information (e.g., the Warranted Financials) provided to Tyson for use in its offer documents "which shall have become false or misleading" so that Tyson could file corrected offer documents with the SEC. Section 2.01 thus appears to contemplate the possibility that there would be a need to correct historical--i.e., past--financial information IBP had previously reported to the SEC and that this eventuality in itself would not be fatal to IBP's right to have the Merger consummated.

FN119. Agreement, Annex I(d), Annex III § 14(d).


FN122. Tyson Post Tr. Ans. Br. at 11.
FN123. Agreement § 7.01(i).

FN124. In a similar vein, it is plausible that IBP would be specifically permitted to restate its inventory based on the inventory dispute with the IRS disclosed in Schedules 5.11 and 5.13.

FN125. *Trans Pacific Leasing Corp. v. Aero Micronesia, Inc.*, 26 F.Supp.2d 698, 709 (S.D.N.Y.1998) ("separately negotiated or added terms are given greater weight than standardized terms or other terms not separately negotiated"); see also Restatement (Second) of Contracts § 203(d) (1979) (same).

FN126. Hlawaty Dep. at 95-98.


FN128. Restatement (Second) of Contracts § 201(2) (1979).

FN129. PX 197.

FN130. Tr. 2270-2272.


FN133. McCaleb Dep. at 91-95.

FN134. DX 168.

FN135. Emphasis added.

FN136. DX 168.


FN138. IBP cites cases including *Recupito v. Prudential Securities, Inc.*, 112 F.Supp.2d 449, 459-60 (D.Md.2000) (where financial statement was not prepared in conformance with GAAP, that problem was immaterial where the relevant information was disclosed elsewhere in the filing); *Wollins v. Antman*, 638 F.Supp. 989, 994-95 (E.D.N.Y.1986) (where defendants had disclosed to the buyer of a business information about the company's value, a lost account, and information from which to calculate the value of that loss, the defendants' failure to disclose the total percentage of the company's sales represented by the lost account was not material in view of the total mix of information).

FN139. *TSC Indus.*, 426 U.S. at 449 (materiality viewed in context of total information mix); SEC Staff Accounting Bulletin: No. 99-- Materiality, 17 CFR Part 211 [Release No. SAB 99] (Aug. 12, 1999) ("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 ...."); Statement of Financial Accounting Concepts No. 2, ("The better informed decision makers are, the less likely it is that any new information can add materially to what they already know.").

FN140. Tr. 962 (testimony of Roman Weil citing APB Opinion No. 20- Accounting Changes).

FN141. PX 276.

FN142. Id.

FN143. S.E.C. Staff Accounting Bulletin Number 101.

FN144. PX 40.

FN145. PX 370, at 5-6.

FN146. Agreement § 5.10(a) (specific warranty dealing generally with MAE); § 5.01 (defining MAE for entire agreement).


FN148. But see Pittsburgh Coke & Chem. Co. v. Bollo, 421 F.Supp. 908, 930 (E.D.N.Y.1976) (where Material Adverse Condition ("MAC") clause applied to a company's "financial condition", "business", or "operations," court read that clause narrowly to exclude "technological and economic changes in the aviation industry which undoubtedly affected the business of all who had dealings with that industry.").

FN149. See PX 27, at 13; PX 40, at 3.

FN150. PX 40, at 3, 14.

FN151. James C. Freund, Anatomy Of A Merger: Strategies and Techniques for Negotiating Corporate Acquisitions 246 (Law Journals Seminars-Press 1975) ("[W]hatever the concept of materiality may mean, at the very least it is always relative to the situation.").

FN152. Pine State Creamery Co. v. Land-O-Sun Dairies, Inc., 201 F.3d 437, 1999 WL 1082539, at*6 (4th Cir.1999) (per curiam) (whether severe losses during a two month period evidenced a MAC was a jury question where there was evidence that the business was seasonal and that such downturns were expected as part of the earnings cycle of the business).


FN154. In Pan Am Corp. v. Delta Airlines, 175 B.R. 438, 492-493 (S.D.N.Y.1994), Pan Am airlines suffered sharp decline in bookings over a three-month period that was shocking to its management. The court held that a MAC had occurred. It did so, however, in a context where the party relying on the MAC clause was providing funding in a work-out situation, making any further deterioration of Pan Am's already compromised condition quite important. In another New York case, Katz v. NVF Co., 473 S.2d 786 (N.Y.App.Div.1984), two merger partners agreed that one partner has suffered a material adverse change when its
full year results showed a net loss of over $6.3 million, compared to a $2.1 million profit a year before, and steep operating losses due to plant closure. \textit{Id.} at 788. The \textit{Katz} case thus presents a negative change of much greater magnitude and duration than exists in this case.

\textbf{FN155.} A contrary rule will encourage the negotiation of extremely detailed "MAC" clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a reasonable acquiror eliminates the need for drafting of that sort.

\textbf{FN156.} \textit{See Raskin v. Birmingham Steel Corp.,} Del. Ch., 1999 WL 193326, at *5, Allen, C. (Dec. 4, 1990) (while "a reported 50% decline in earnings over two consecutive quarters might not be held to be a material adverse development, it is, I believe unlikely to think that might happen").

\textbf{FN157.} The Impairment Charge was, of course, signaled by Shipley's reduced estimate for DFG in FY 2001, and his indication that an impairment study was underway.

\textbf{FN158.} \textit{Tr.} 693-94.

\textbf{FN159.} \textit{Tr.} 2791-92.

\textbf{FN160.} It has admittedly taken its own payment multiples based on the Rawhide Projections and simply "valued" the effect that way. But IBP never warranted that it would meet those Projections.

\textbf{FN161.} Tyson's only expert on this subject testified that a MAE would have occurred in his view even if IBP met the Rawhide Projections, because those Projections were more bearish than the analysts. This academic theory is of somewhat dubious practical utility, as it leaves the enforceability of contracts dependent on whether predictions by third-parties come true.

\textbf{FN162.} I take judicial notice of these publicly available estimates, \textit{D.R.E.} 201, and consider it important to do so given Tyson's heavy reliance on analyst opinion to prove that a Material Adverse Effect has occurred.

\textbf{FN163.} Morningstar, Inc. estimate for ninety days prior as of June 12, 2001.

\textbf{FN164.} \textit{Id.}, for thirty days prior as of June 12, 2001.

\textbf{FN165.} \textit{Id.}, for thirty and ninety days prior as of June 12, 2001.

\textbf{FN166.} First Call Earnings Estimate-IBP, Inc. for thirty days prior as of June 12, 2001.

\textbf{FN167.} Morningstar, Inc. estimate for thirty days prior as of June 12, 2001.

\textbf{FN168.} Morningstar, Inc. estimate for thirty days prior as of June 12, 2001.

\textbf{FN169.} \textit{Id.}

\textbf{FN170.} Again, I emphasize that my conclusion is heavily influenced by my temporal perspective, which recognizes that even good businesses do not invariably perform at consistent levels of profitability. If a different policy decision is the correct one, a contrary conclusion could be reached. That different, more short-term approach will, I fear, make merger agreements more difficult to negotiate and lead to Material Adverse Effect clauses of great prolixity.

\textbf{FN171.} Tyson has tried to suggest that other
factors exist that contribute to the conclusion that IBP has suffered a Material Adverse Effect. These include unsubstantiated charges that other Foodbrands units suffer the same type of serious accounting problems as DFG and that other IBP assets are impaired, as well as the effects of DFG-related lawsuits that Tyson admits were covered by Schedule 5.11. I find none of Tyson's other Material Adverse Effect arguments meritorious.

FN172. If I am incorrect and IBP bore the burden to prove the absence of a Material Adverse Effect by clear and convincing evidence in order to obtain an order of specific performance, it would not have met that burden. It would prevail under a preponderance standard, regardless of whether it bore the burden of persuasion.


FN178. Citibank, N.A. v. Plapinger, 66 N.Y.2d 90, 495 N.Y.S.2d 309, 485 N.E.2d 974, 975 (N.Y.1985) (specific contractual agreement that representations outside of contract were not relied upon foreclosed fraud in inducement claim); Danann Realty Corp. v. Harris, 5 N.Y.2d 317, 184 N.Y.S.2d 599, 157 N.E.2d 597, 599 (N.Y.1959) ("[P]laintiff has in the plainest language announced and stipulated that it is not relying on any representations as to the very matter as to which it now claims it was defrauded. Such a specific disclaimer destroys the allegations in plaintiff's complaint that the agreement was executed in reliance upon these contrary oral representations."); see also Harsco Corp. v. Segui, 91 F.3d 337, 345-48 (2d Cir.1996) (fraud and negligent misrepresentation claims barred by provision that "specifically disclaims representations that are not in the agreement").

FN179. Tyson's skillful advocacy swayed IBP General Counsel Hagen to testify otherwise. Her hurried answer contradicts the text of the Confidentiality Agreement, and the evident intent of the Agreement. Under Tyson's approach, it could sue IBP for damages if IBP's due diligence responses did not provide a copy of a complaint filed against IBP, which could be a common subject of due diligence. The intent of the Confidentiality Agreement is clear: it was designed to require Tyson to waive any deficiencies in due diligence as a basis for suit, unless that deficiency constituted a breach of a representation or warranty in the resulting merger agreement.

FN180. Tyson tries to compare the Confidentiality Agreement's liability limitation to a boilerplate integration clause. But the Confidentiality Agreement is a short and important contract knowingly entered into by Tyson to govern its relationship with IBP. Tyson thus seeks to have this court relieve it of a risk that it assumed with full knowledge and to deprive IBP of its legitimate contractual expectations. Under New York or Delaware law, the Confidentiality Agreement is a clear and enforceable contract that precludes Tyson's plea to be excused from its own commitment.
FN181. See D.H. Cattle Holdings Co. v. Smith, 195 A.D.2d 202, 607 N.Y.S.2d 227, 231 (N.Y.App.Div.1994) (statements of belief are "generally considered, not actionable statements of fact, but mere opinion and puffery"); see also San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc., 75 F.3d 801, 811 (9th Cir.1996) (generally statements that a company was optimistic about its prospects were "puffery" that could not mislead a reasonable investor and "cannot constitute actionable statements under the securities laws").


FN183. PX 165 (emphasis added).

FN184. As to the Confidentiality Agreement, Tyson cannot base rescission on any failure on IBP's part to inform Tyson before December 28, 2000 that IBP would not hit the Rawhide target for FY 2000. For one thing, the oral cautions Tyson had received, the disclaimers in the Rawhide Proxy, and results reported in IBP's third quarter 10-Q made any prior reliance unreasonable. Even more important, Tyson expressly reaffirmed the Confidentiality Agreement by signing the Merger Agreement. See Agreement § 7.08.

FN185. Tyson claims that Brady's opinion that DFG was not viable as currently configured is material because it contradicts what Bond told it. But Bond's statement that DFG is a viable business was, I conclude, his true belief and was premised on the sort of reconfiguration that Brady mentioned. Tyson knew that IBP was trying to turn around DFG and that there was no guarantee of success. Indeed, Tyson was skeptical that Bond would succeed. Don Tyson later told Bond to just "blow the thing up."

FN186. See Agreement § 2.01(e), (h).
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(Cite as: 2001 WL 675330 (Del.Ch.))

the serious DFG situation that required a restatement. Tyson's own CFO testified that many of the SEC's concerns were trivial accounting nits.

FN190. Cf. Barrier Systems, Inc. v. A.F.C. Enterprises, Inc., 264 A.D.2d 432, 694 N.Y.S.2d 440, 442 (N.Y.App.Div.1999) (rescission claim failed where plaintiff learned of alleged fraud and then affirmed agreement); Restatement (Second) of Contracts § 380(2) (1979) ("The power of party to avoid a contract for mistake or misrepresentation is lost if after he knows or has reason of the mistake or of the misrepresentation ... he manifests to the other party his intention to affirm it or acts with respect to anything that he has received in a manner inconsistent with disaffirmance.").

FN191. In a footnote in its opening brief, Tyson argues that the Merger Agreement should be rescinded on grounds of unilateral or mutual mistake. These arguments are unpersuasive for two reasons. First, it is inconceivable that the issues that Tyson raises are fundamental enough to constitute a "mistake" were not fundamental enough to manifest themselves in the text of the extensively negotiated Merger Agreement. For example, Tyson premises its mistake claim in part on the failure of the Rawhide Projections to come true in 2001. Yet, as of the time of contracting, Tyson knew that those Projections had already been well off the mark in 2000 and did not seek a specific representation and warranty or escrow tied to the accuracy of the Projections. Tyson has simply not met the heavy burden required under New York law to set aside a contract for mutual or unilateral mistake. See Shults v. Geary, 241 A.D.2d 850, 660 N.Y.S.2d 497, 499 (N.Y.App.Div.1997) (discussing standard for mutual mistake); Long v. Fitzgerald, 240 A.D.2d 971, 659 N.Y.S.2d 544, 547 (N.Y.App.Div.1997) (discussing standard for unilateral mistake).

Second, "[a] party who desires to rescind a contract upon the ground of mistake must, upon discovery of the facts, announce at once his purpose and adhere to it. A failure to notify immediately the other party of the mistake may amount to a waiver of any objection or a ratification of the mistake." 22 N.Y. Jur.2d Contracts § 131 (1996). Tyson's belated cry of mistake comes far too late to be fairly asserted.

FN192. See also PX 183 (e-mail indicating that Tyson and its auditors had assured lenders that the Comment Letter would not affect the pro forma numbers Tyson had given to lenders regarding the combination); PX 181 (Tyson officer's certificate signed by Leatherby to a banking syndicate indicating that Tyson was unaware of any material adverse condition that had occurred at IBP since 9/30/00).

FN193. The shareholder plaintiffs advanced this argument, and have permitted IBP to take the lead in presenting it, as well as the other issues in the case, to this stage.


FN195. PX 274.

FN196. PX 232.

FN197. PX 237.

FN198. PX 263.

FN199. PX 258.

FN200. Throughout the course of this case, IBP has urged upon me another proposition that it believes compels a ruling in its favor. IBP asserts that under New York law, a party cannot refuse to close on a contract in reliance upon a breached contractual representation if that party knew that the representation was false at the time of contracting. Put directly, IBP says it can win this case even if there was a breach of a representation in the Merger Agreement so
long as it can prove that it informed Tyson of facts that demonstrate that the representation was untrue and thus that Tyson did not in fact rely upon the representation in deciding to sign the Merger Agreement. IBP's arguments find some support in some cases applying New York law. See, e.g., Rogath v. Siebenmann, 129 F.3d 261, 264-65 (2d Cir.1997) ("Where the seller discloses up front the inaccuracy of certain of his warranties, it cannot be said that the buyer--absent the express preservation of his rights--believed he was purchasing the seller's promise as to the truth of the warranties."). There is, however, no definitive authority from the New York Court of Appeals to this effect, and the leading case can be read as being at odds with IBP's position. See CBS v. Ziff-Davis Publishing Co., 75 N.Y.2d 496, 554 N.Y.S.2d 449, 553 N.E.2d 997, 1000-01 (N.Y.1990). Most of IBP's cases also deal with a distinct context, namely situations where a buyer signed the contract on day one, learned that a representation is false from the seller on day three, closed the contract on day five, and sued for damages for breach of warranty on day 10. The public policy reasons for denying relief to the buyer in those circumstances are arguably much different than are implicated by a decision whether to permit a buyer simply to walk away before closing in reliance on a specific contractual representation that it had reason to suspect was untrue as of the time of signing. In any event, my more traditional contract analysis applies settled principles of New York contract law and eliminates any need to delve into these novel issues of another state's law.

Likewise, there is no present need to address IBP's other arguments, which are grounded in equitable doctrines such as estoppel, acquiescence, and waiver and ratification. Nor do I address IBP's argument that Tyson breached the Agreement's implied covenant of good faith and fair dealing by terminating for pretextual reasons (i.e., DFG and the Comment Letter) that had no relationship to Tyson's actual motives (i.e., Tyson's alleged desire to renegotiate the deal to a much lower price or terminate because of its own poor performance).

FN201. 96 N.Y. Jur.2d Specific Performance § 50 (1992) ("Courts of equity have decreed specific performance of contracts for the sale of a business, particularly where an award of damages would have been inadequate or impracticable.").


FN203. The parties need to consider the issue of how any delay in payment of the Merger consideration plays into an award of specific performance.

FN204. It may also be Tyson's preference, if it has to suffer an adverse judgment. Any damages award will be huge and will result in no value to Tyson.

END OF DOCUMENT
Supplemental Material

Defining a "material adverse effect"

From the Agreement and Plan of Merger, dated as of October 7, 2001, by and among AT&T Wireless Services, Inc., TL Acquisition Corp. and TeleCorp PCS, Inc.:

As used in this Agreement, a "TeleCorp Material Adverse Effect" means any change, event, occurrence, effect or state of facts (a) that is materially adverse to or materially impairs (i) the business, assets (including intangible assets), liabilities, financial condition or results of operations of TeleCorp and its Subsidiaries, taken as a whole, or (ii) the ability of TeleCorp to perform its obligations under this Agreement, or (b) prevents consummation of any of the transactions contemplated by this Agreement; provided that none of the following shall be considered a Material Adverse Effect except to the extent TeleCorp is affected in a materially disproportionate manner as compared to other wireless telecommunications service providers: (x) changes in general economic conditions in the United States, (y) conditions affecting the wireless telecommunications services industry generally, and (z) any changes resulting from the announcement of the Merger.

[Introductory paragraph in Article II]

As used in this Agreement, an "AWS Material Adverse Effect" means any change, event, occurrence, effect or state of facts (a) that is materially adverse to or materially impairs (i) the business, assets (including intangible assets), liabilities, financial condition or results of operations of AWS and its Subsidiaries, taken as a whole, or (ii) the ability of AWS to perform its obligations under this Agreement, (b) prevents consummation of any of the transactions contemplated by this Agreement; provided that none of the following shall be considered a Material Adverse Effect except to the extent AWS is affected in a materially disproportionate manner as compared to other wireless telecommunications service providers: (x) changes in general economic conditions in the United States, (y) conditions affecting the wireless telecommunications services industry generally and (z) any changes resulting from announcement of the Merger.

[Introductory paragraph in Article III]

As used in this Agreement, the term “Material Adverse Effect” means, with respect to Parent or the Company, as the case may be, a material adverse effect on (i) the business, operations, results of operations or financial condition of such entity and its Subsidiaries taken as a whole or (ii) the ability of such entity to timely consummate the transactions contemplated hereby.

[Excerpt from Section 4.1]

From the Agreement and Plan of Merger, dated as of December 2, 2000, among PepsiCo, Inc., Beverage Co, Inc. and The Quaker Oats Company:

“Material Adverse Effect” means, with respect to any entity any event, change, circumstance or effect that is materially adverse to (i) the business, consolidated financial condition or results of operations of such entity and its Subsidiaries taken as a whole, other than any event, change, circumstance or effect relating (x) to the economy or financial markets in general or (y) in general to the industries in which such entity operates and not specifically relating to (or having the effect of specifically relating to or having a materially disproportionate effect (relative to most other industry participants) on) such entity or (ii) the ability of such entity to consummate the transactions contemplated by this Agreement. The term “material” or “in all material respects” shall have a corresponding meaning of similar importance.

[Section 8.11(h)]

ACCOUNTING ISSUES: DEVELOPMENTS AND CHANGES

Mark A. Kristy

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Accounting Issues: Developments and Changes
Agenda

- Changes in Accounting Standards
- Recent developments at the SEC
- Impact of Enron
Changes in Accounting Standards

- Goodwill and intangible assets
- Impairment of assets
- Stock options
Business Combinations and Goodwill / Intangible Assets

FAS 141 and 142
OVERVIEW
FAS 141 - Business Combinations

- Replaces APB 16
- Poolings eliminated prospectively for business combinations *initiated* after June 30, 2001
- Application of purchase accounting, including:
  - Separate recognition criteria for intangible assets
  - Identifying the acquiring entity
  - Accounting for negative goodwill - extraordinary gain treatment
  - Other APB 16 provisions generally carried forward
OVERVIEW
FAS 142 - Goodwill and Other Intangible Assets

• Replaces APB 17
• Primarily addresses the post-acquisition accounting for goodwill and intangibles
  – Nonamortization of goodwill and indefinite-lived intangibles
  – Impairment testing for goodwill and indefinite-lived intangibles
  – Amortize intangible assets over useful lives (no longer 40 yr. max)
• Also addresses acquisition of a group of intangible assets in other than a business combination (no goodwill)
SCOPE - FAS 141/142

• Includes multi-party business combinations
• Does not include joint ventures (FASB did not modify definition of a joint venture in APB 18 in this phase)
• Does not change accounting for internally developed intangible assets
• Does not change accounting for purchased IPR&D
INTANGIBLE ASSETS
Key Provisions/Issues - FAS 141/142

• Separate recognition and valuation of intangible assets acquired in a business combination

• Amortizable intangible assets
  – Determining useful lives
  – Impairment testing - FAS 121

• Indefinite-lived intangible assets
  – Nonamortization
  – Impairment testing - FV vs. BV

• Transition rules and existing goodwill balances
### EXAMPLES

Intangibles Acquired in a Business Combination

<table>
<thead>
<tr>
<th>Intangible/Acquisition Category</th>
<th>Contractual / Legal Criteria</th>
<th>Separability Criteria</th>
<th>Not Separately Recognized</th>
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<tr>
<td>Trademarks</td>
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<tr>
<td>Noncompetition Agreements</td>
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<td>General Customer Base - &quot;walk-ins&quot;</td>
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<tr>
<td>Licensing / Royalty Agreements</td>
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<tr>
<td>Lease Agreements</td>
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<tr>
<td>Assembled Workforce</td>
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<td>Databases</td>
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</table>

(9)
INTANGIBLE ASSETS
Separate Recognition - Cornerstone of FAS 141

- Appendix A - Illustrative list of intangible assets

SEC
- SEC staff believe there is a *rebuttable presumption* that any intangible asset identified in the listing will be evaluated in a purchase price allocation
GOODWILL
When to Test for Impairment - Annual

- Goodwill must be tested for impairment at least *annually* (changed from trigger-based approach)
- First annual (interim) goodwill impairment test after acquisition / reorganization will set methods and key assumptions used in future impairment tests
GOODWILL

When to Test for Impairment - Interim

• *Interim* impairment tests required if an event occurs or circumstances change that would "more-likely-than-not" reduce the fair value of a reporting unit below its carrying value. Examples:
  
  - Significant adverse change in business climate, market, legal issue, regulation, competition, personnel
  - A "more-likely-than-not" expectation arises that a reporting unit (or significant portion) will be sold or otherwise disposed of
  - A significant asset group is tested under FAS 121
  - A subsidiary recognizes an impairment loss in its standalone GAAP F/S
Accounting for the Impairment of Disposal of Long-Lived Assets
FAS 144
OVERVIEW
FAS 144

- Coordinates impairment with FAS 141/142
- Any component disposed of is a discounted operation
- Spin-off/exchange now requires loss recognition
- Clarification as to financial statement recognition
Stock Option Update
EITF 00-23
Cancellations/Repricings

- Exchanges within 6 months
  - Options offered
  - Restricted stock offered
- Exchanges outside 6 months
  - Options, restricted stock
  - Contingencies
- When is original option cancelled?
Cancellations/Repricings

- Exchanges for 1.X at-the-money awards
- Implied cancellations
- Replacement awards granted immediately and in six months
- Cancellation of unvested, compensatory award without new grants

- Accounting for profit interests in an LLC
SEC Update
Changes at the SEC

- Harvey Pitt appointed chairman, succeeding Levitt
- Bob Herdman appointed chief accountant, replacing Turner
- Alan Beller replaces David Martin
- Robert Bayless becomes special assistant to the Director of CorpFin
- A new and constructive SEC
Current CorpFin Focus

- Back-to-basics
- Review more periodic filings
CorpFin Comment Trends

- Revenue recognition (SAB 101)
- Segment reporting (SFAS 131)
- M D & A
- Alternate measures of performance
  - Staff Training Manual Topic 8/FRP 202
Enforcement Trends

- Revenue recognition
  - Cut off
  - “Bill and hold” (AAER 108 & SAB Topic 13-A)
  - Contingent sales
- Valuation of shares and assets in exchange transactions
- Materiality judgments
  - Waste Management
Other SEC Matters

- Audit Committees
  - Charters and composition
  - Disclaimers
  - Non-audit fees
- SAB 74 – goodwill transitional impairments
- Interim review not completed by 10-Q filing date
Impact of Enron
Recent Developments

“Impact of Current Economics and Businesses Environment on Financial Reporting”

- Big 5 Accounting Firms
- AICPA
Recent Developments

- Financing Reporting Release FR-60
  "Cautionary Advice Regarding Disclosure About Critical Accounting Policies"
Recent Developments

- Big Five Petition for additional MDA disclosure, followed by Commission Statement
  - Liquidity and capital resources including “off balance sheet” arrangements
  - Trading activities that include non-exchanged-traded contracts
  - Relationships/transactions with non-clearly independent third parties
Recent Developments

Proposal for new oversight board and Public Oversight Board vote to disband
Recent Developments

Impact?
- Audit committee involvement
- Auditor independence
- Further new rules and regulations
Questions???
AGENCY: Securities and Exchange Commission

ACTION: Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases

SUMMARY: The Securities and Exchange Commission is issuing a statement regarding the use by public companies of "pro forma" financial information in earnings releases.

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, at 202-942-4400, or Paula Dubberly, Chief Counsel of the Division of Corporation Finance, at 202-942-2900.

SUPPLEMENTARY INFORMATION:

As we approach year end, we believe it is appropriate to sound a warning to public companies and other registrants who present to the public their earnings and results of operations on the basis of methodologies other than Generally Accepted Accounting Principles ("GAAP"). This presentation in an earnings release is often referred to as "pro forma" financial information. In this context, that term has no defined meaning and no uniform characteristics. We wish to caution public companies on their use of this "pro forma" financial information and to alert investors to the potential dangers of such information.

"Pro forma" financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations. To a large extent, this has been the intended function of disclosures in a company's Management's Discussion and Analysis section of its reports. There is no prohibition preventing public companies from publishing interpretations of their results, or publishing summaries of GAAP financial statements.

Moreover, as part of our commitment to improve the quality, timeliness, and accessibility of publicly available financial information, we believe that - with appropriate disclosures about their limitations - accurate interpretations of results and summaries of GAAP financial statements taken as a whole can be quite useful to investors.

Nonetheless, we are concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.
For these reasons, we believe it is appropriate to alert public companies and their advisors of the following propositions:

First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information.

Second, a presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP, raises particular concerns. Such a statement misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this "pro forma" financial information without any indication of the principles that underlie its presentation. To inform investors fully, companies need to describe accurately the controlling principles. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

Third, companies must pay attention to the materiality of the information that is omitted from a "pro forma" presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a "pro forma" presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

Fourth, we commend the earnings press release guidelines jointly developed by the Financial Executives International and the National Investors Relations Institute and we encourage public companies to consider and follow those recommendations before determining whether to issue "pro forma" results, and before deciding how to structure a proposed "pro forma" statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

Fifth, as always, and especially in light of the disclosure that we expect to see accompanying these presentations, we encourage investors to compare any summary or "pro forma" financial presentation with the results reported on GAAP-based financials by the same company. Read before you invest; understand before you commit.

Companies with questions about the use of "pro forma" financial presentations in earnings releases are encouraged to call John M. Morrissey, Deputy Chief Accountant, at 202-942-4400, or Paula Dubberly, Chief Counsel of the Division of Corporation Finance,
at 202-942-2900. Investors are encouraged to read our investor alert on "pro forma" financial statements (available at http://www.sec.gov/investor.shtml).

By the Commission.
Jonathan G. Katz
Secretary
Dated: December 4, 2001

http://www.sec.gov/rules/other/33-8039.htm
Impact of the Current Economic and Business Environment on Financial Reporting

The purpose of this document is to provide those with a role in high-quality financial reporting with information relevant to the current financial reporting environment. It includes an assessment of risk factors that may be important for financial statement preparers, auditors, and audit committees to consider during the current reporting cycle. It also offers suggestions as to how each of these major constituencies can contribute to enhancing financial reporting for the benefit of investors.

The current economic downturn, the unprecedented events of September 11, and recent business failures have combined to create a financial reporting environment unlike any in recent memory. Investor confidence, already shaken by significant volatility in the capital markets, has been further unsettled by highly publicized restatements of financial statements, which have generated questions about the quality of financial reporting, the effectiveness of the independent audit process, and the efficacy of corporate governance. This environment is creating significant challenges for U.S. businesses and their management, boards of directors, audit committees, and auditors.

Always fundamental to the well-being of our capital markets, reliable and transparent financial reporting is particularly important in this troubled environment. Financial reporting cannot forecast the strengths and weaknesses of the economy. However, financial statements and related information, such as Management's Discussion and Analysis (MD&A) can provide useful information that allows users to make informed decisions and facilitates the continued efficient functioning of our capital markets. This requires the attention of management, auditors, and audit committees, who not only must carry out their unique responsibilities in their respective areas, but also must work together to produce the high-quality financial reporting that is vital to our capital markets.

We have summarized the particularly challenging factors affecting financial reporting today, and have identified some of the financial reporting issues that are especially relevant in this difficult business environment. We also have highlighted the actions that management, auditors, and audit committees can take to effectively address these risks and produce reliable financial reporting.

Environmental Factors Affecting Financial Reporting

Difficult Economic Times

The economic slowdown began with a decline in business capital spending and investment. With the burst of the dot.com bubble, businesses took a more pessimistic view of the economic future and curtailed spending on equipment, software, real estate, inventories, and other investments. One of the first sectors to suffer the effects of the
reduction in capital spending was the high-tech industry, where earnings and share prices nose-dived.

As the effects of cutbacks in corporate spending rippled through the economy, temporarily soaring energy prices took money out of consumers' pockets and ate into corporate revenues. Earnings sank, borrowing capacity dwindled, growth slowed, energy prices dropped, and the stock market tumbled. Investor wealth declined by trillions of dollars. Layoffs followed, and with the unemployment rate rising (although still historically low), the surprisingly hardy consumer spending finally started to wane. Companies initiated restructurings, inventory liquidations, and write-offs. The events of September 11 and their aftermath only worsened already deteriorating economic conditions.

These factors put downward pressure on earnings and other performance measures that, for most of the previous decade, had been on an upward trend. This change in direction has created a growing sensitivity in the capital markets to bad news.

Pressures to Perform

Businesses deal with pressures that arise from a variety of sources, both internal and external. External pressures come primarily from the capital markets, with many believing that Wall Street's expectations too often drive inappropriate management behavior. Management often is under pressure to meet short-term performance indicators, such as earnings or revenue growth, financial ratios tied to debt covenants, or other measures. Most often the intentions of management are to follow sound and ethical practices, but pressure may build when analysts and shareholders demand short-term performance and when competitors move closer to the edge of the range of acceptable behavior.

Members of top management also may be pressured to demonstrate that shareholder value has grown as a consequence of their leadership. Boards of directors often create pressure on management to meet financial and other goals. There also is a well-established practice of motivating management with stock options and other equity instruments that attempt to align management and shareholder interests. With their own performance and compensation tied to operating or financial targets, management can in turn push hard on personnel throughout the company, including those in operating business units, to meet what may be overly optimistic goals. This high-pressure environment can create an incentive to adopt practices that may be too aggressive or inconsistently applied in an effort to meet perceived expectations of the capital markets, creditors, or potential investors. At some point, the motivation behind earnings management can become strong enough for individuals with the right opportunity to move beyond acceptable practices, even though they are otherwise honest individuals. The greater the pressures, the more likely individuals will rationalize the acceptability of their actions.
Complexity and Sophistication of Business Structures and Transactions

The increasing sophistication of the capital markets and the creativity of investment bankers and other financial advisers have fostered a wide variety of complex financial instruments and structured financial transactions. Many companies now use complex transactions involving transactions with one another in the form of purchases/sales of assets, derivative transactions, and intricate operating agreements designed to meet a specific reporting objective as well as an economic objective. Some companies have transferred assets off-balance-sheet or arranged for units to be acquired by special purpose entities, joint ventures, limited liability corporations, or partnerships, retaining substantially all the risks and rewards of ownership but without “control.” Recent business failures, including the boom-bust cycle of dot.com enterprises, have focused attention on the potential risks of these business structures and transactions and the challenge of reporting them in a way that is easily understood by financial statement users.

Many companies have adopted rapid and innovative forms of business expansion, either through acquisitions and mergers, or internal development. Such rapid expansion may have been necessary to support high price-to-earnings multiples. However, it also creates many challenges, including integrating disparate operations, melding internal control processes, and meeting expanded financing needs. Liquidity crises or financial reporting failures may result.

Complex and Voluminous Standards

Adding to the challenges businesses face are the number of accounting standards, interpretations, SEC staff positions, task force consensuses, statements of position, and so on, that continue to expand the body of technical material that must be understood and applied in the financial reporting process. Understanding this vast body of literature can be a daunting task, even for large sophisticated companies. Furthermore, as transactions become more complex, the accounting rules for them become highly technical and detailed, such as Statements of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities; No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities; No. 141, Business Combinations; No. 142, Goodwill and Other Intangible Assets; and No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Complex and detailed rules become self-perpetuating, promising that their complexity will continue to increase. Every new regulation specifying how a certain transaction should be accounted for presents an opportunity for someone to find a way around it by creating an even more complex transaction. This, in turn, creates the need for a new rule to tighten the loophole, and so on. These rules have become so complex that management struggles increasingly to comprehend and apply them. Proper application often requires the attention and involvement of senior financial management and senior technical people in the auditing firms, and even then the decisions are subject to alternative interpretations.

The SEC recently has announced its desire to help registrants “get it right the first time” by discussing and pre-clearing registrants’ proposed accounting for anticipated events, planned transactions, or other unusual accounting matters prior to their inclusion in...
registrants' financial information. The pre-clearance process should help registrants apply complex accounting standards to unusual situations, helping to ensure that financial statements reflect appropriate accounting policies and disclosures and reducing the risk of subsequent restatements.

Financial Reporting Issues

The fundamental objective of financial reporting is to provide useful information to investors, creditors, and others in making rational decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with appropriate diligence. Financial reporting, including MD&A, should provide investors with management's perspective on the historical and prospective financial condition and results of operations.

A discussion of key financial reporting issues that are especially relevant in the current environment follows.

Liquidity and Viability Issues

The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges for some companies, particularly those with reduced access to capital. A company particularly sensitive to negative changes in economic conditions can rapidly develop a liquidity crisis and ultimately fail. Certain conditions, considered in the aggregate, may lead management or a company's auditors to question the entity's ability to continue as a going concern. These include negative trends such as recurring operating losses or working capital deficiencies, financial difficulties in the form of loan defaults or denial of credit from suppliers, dependence on the success of a particular product that is not selling well, legal proceedings, loss of a principal customer or supplier, destabilization of a trading partner or contract counterparty, and excessive reliance on external financing rather than funds generated from operations.

Key in evaluating these risk factors is whether:

Existing conditions and events can be mitigated by management’s plans and their effective implementation.

The company has the ability to control the implementation of mitigating plans rather than being dependent on actions of others.

The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly optimistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.

Liquidity challenges have been appropriately satisfied and disclosed.
Changes in Internal Control

Large layoffs, staff reductions, and notifications to employees of impending termination can affect internal control over financial accounting and reporting systems. Remaining employees may feel overwhelmed by their workloads, lack time to complete tasks and consider decisions, and simply be performing too many tasks and functions to meet the required levels of accuracy. In addition, rapid business expansion, changes in business strategies, and integration of different businesses may outstrip the ability of a company’s financial systems to remain under effective internal control. Furthermore, controls at business units whose divestiture has been announced may be disrupted. As a result of any of these factors, internal control may become less effective or ineffective.

Relevant considerations are whether:

The attention to internal control has been maintained in the face of significant changes in the business.

As a result of unfilled positions, key control procedures are no longer being performed, are being performed less frequently, or are being performed by individuals lacking proper understanding to identify and correct errors.

Layoffs of information technology (IT) personnel have had a negative effect on the entity’s ability to initiate, process, or record its transactions, or maintain the integrity of information generated by the IT system.

Key functions that should be segregated are now being performed by one person.

The impact of changes to the control environment have altered internal control effectiveness and potentially resulted in a material control weakness.

Changes in internal control caused by past or pending layoffs or staff reductions create an opportunity for fraudulent activities, including misappropriation of assets.

Unusual Transactions

Among the most frequently cited sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near the quarter-end or year-end. Unusual transactions might include sales of assets outside the ordinary course of business, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of a business. These types of transactions and adjustments often occur outside the company’s ordinary course of business and, therefore, may not be subject to the checks and balances imposed by the internal control system.
Key points include:

Recognizing the underlying business purpose for entering into unusual transactions, as well as the resulting financial benefits or obligations.

Whether unusual transactions – particularly those executed close to period-end – are subject to effective controls.

The impact of these types of transactions on annual and quarterly results, and whether they have been appropriately described in the company’s financial reports.

Existence of any “special” or “side” arrangements not considered in determining the appropriate accounting and disclosure for the transactions.

Whether so-called “non-standard” journal entries, including the adjusting entries made at the end of the closing process, are subject to appropriate review and oversight.

*Transactions with Related Parties*

Increased pressures on management to maintain or achieve financial targets may heighten the risk of improper accounting or disclosure of related party transactions. Related party transactions lack the independent negotiations as to structure and price that are present in transactions with unrelated parties. Difficult economic times also increase the possibility that the economic substance of certain transactions may be other than their legal form, or that transactions may lack economic substance. Parties that have no independent substance may have no separate ability to carry out transactions or stand behind agreements.

Key to these issues is whether:

Management has a process in place to identify related parties and related party transactions.

There is sufficient information available to thoroughly understand and evaluate the relationship of the parties to the transaction.

The parties have substance and the ability to carry out the transaction.

The transaction’s substance, including any unusual conditions, determines the accounting for the transaction.

The disclosures are complete with respect to the nature and extent of the transaction and relationship among the parties in conformity with FASB and SEC rules.
Transactions Involving Off-Balance Sheet Arrangements including Special Purpose Entities

Some business entities make use of off-balance sheet arrangements to conduct financing or other business activities. These may involve unconsolidated, non-independent, limited purpose entities, often referred to as structured finance or special purpose entities (SPEs). These entities may be used to provide financing, liquidity, or market risk or credit support, or may involve leasing, hedging, or research and development services. These arrangements or entities may result in contractual or other commitments by the company, such as requirements to fund losses, provide additional funding, or purchase capital stock or assets, or may otherwise have financial impacts resulting from the performance or non-performance of the other party.

Transactions with special purpose entities intended to shift assets or liabilities off-balance-sheet require special attention due to the complicated accounting and disclosure rules applicable to many of these transactions. The ownership structure of the entity and the terms of the transactions may be critical to determining whether off-balance sheet treatment is appropriate under generally accepted accounting principles. The adequacy of disclosure also is important since the potential impact of these transactions may not be evident from the basic financial statements.

Key considerations in understanding transactions involving SPEs include whether:

The SPE is a so-called “qualifying special purpose entity” or a non-qualifying SPE, since different accounting standards apply to each.

The SPE, if it is non-qualifying, is appropriately capitalized to support non-consolidation, including whether a third party has made a substantive investment that is residual equity in legal form, has voting control, and has substantive residual risks and rewards of ownership of the SPE.

The level of capital in the non-qualifying SPE is adequate, particularly when multi-tiered SPE structures are used.

The requisite outside investment in the non-qualifying SPE existed at the time of the transaction and continues to exist.

Any involvement of related parties as investors or otherwise is consistent with non-consolidation.

Any modifications have been made to an existing SPE in the current period that could affect the accounting determined at the date of the transaction.

The arrangements are outside the normal course of business.
Materiality

Materiality is a concept that plays a critical role in the judgments of various parties to the financial reporting process. Although generally accepted accounting principles recognize the concept that accounting standards need not be applied to immaterial items, this recognition is more for matters of convenience than for the basic purpose of maintaining accurate books and records. Therefore, while management may consider materiality in selecting the accounting principles to use in the financial statements (including footnotes) and in preparing MD&A, it is generally inappropriate to permit known errors to remain in the financial information based merely on their immateriality. ²

Management also may consider materiality in determining the disposition of identified misstatements, including those identified by the auditors. Auditors consider materiality in assessing the application of accounting principles, in planning the audit and designing audit procedures, and in evaluating the significance of misstatements (also referred to as audit differences) identified during the audit if management decides not to record some or all of them.

Both quantitative and qualitative factors should be evaluated when assessing the materiality of misstatements, focusing on:

- Individual and aggregate misstatements and their impact on key financial statement line items, totals, and ratios.
- Whether a misstatement increases management’s compensation by satisfying requirements for the award of bonuses or other incentives.
- Whether a misstatement masks a change in earnings or other trends or hides a failure to meet analysts’ consensus expectations.
- A misstatement’s impact on compliance with financial statement-related debt covenants.
- A misstatement indicative of intentionally misleading financial reporting or illegal acts.
- A misstatement particularly important to a segment of the business.

Adequacy of Disclosure

In a recent op-ed in the Wall Street Journal, SEC Chairman Pitt summarized actions management, auditors, and audit committees should take to enhance the current financial reporting and disclosure system and reassure and restore investor confidence. Among his recommendations, Chairman Pitt urged public companies and their advisers to identify the three, four, or five critical accounting principles upon which a company’s financial status depends, and that involve the most complex, subjective, or ambiguous decisions or assessments. Investors should be told, concisely and clearly, how these principles are
applied, and be given information about the range of possible effects from different applications of these principles.

As a follow-up to the Chairman’s op-ed, the SEC recently issued cautionary advice regarding disclosure about critical accounting policies, in which it indicated an intention to consider new rules to elicit more precise disclosures about the accounting policies that management believes are most “critical” – that is, that both are most important to the portrayal of the company’s financial conditions and results and require management’s most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The SEC points out that a technically accurate application of the disclosure rules may nonetheless fail to communicate important information if clear analytic disclosures are not included to facilitate an investor’s understanding of the company’s financial status, and the possibility, likelihood, and implication of changes in its financial and operating status. The SEC encourages companies to employ a disclosure regimen along the following lines:

Management and the auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements.

Management should ensure that disclosure in MD&A is balanced and fully responsive.

Prior to finalizing and filing annual reports, audit committees should review the selection, application, and disclosure of critical accounting policies.

If companies, management, audit committees, or auditors are uncertain about the application of specific GAAP principles, they should consult with the SEC’s accounting staff.

The SEC also has expressed continuing concern that some registrants are simply repeating the financial statement disclosures in their MD&A or merely recalculating the dollar and percentage changes in financial statement captions without providing meaningful information about the underlying reasons for the changes as well as what might happen in the future. MD&A requires disclosure about trends, events, or uncertainties known to management that would have a material impact on reported financial information. The SEC has observed that, even where trends, events, and uncertainties are disclosed, the implications of those matters on the methods, assumptions, and estimates used for recurring and pervasive accounting measurements are not always addressed.

The SEC informally has suggested that the following matters be considered for MD&A disclosure in the current environment: loss of a significant customer; impairments of long-lived assets; business restructurings; factors affecting the cost or availability of insurance coverage or energy; declines in the value of investment securities or pension plan assets; violations, amendments or waivers of debt covenants; credit or market risks; and effects of related party transactions.
On another matter, over the past few years, companies increasingly have presented earnings and results of operations on the basis of methodologies other than GAAP, sometimes referred to as "pro forma earnings." Such information may be presented to provide a meaningful comparison to results in prior years, to emphasize the results of core operations, or for other purposes. While there is no prohibition against public companies publishing interpretations of their results or summaries of GAAP financial statements, there is a growing concern that pro forma financial information can mislead investors if it obscures GAAP results.

The SEC recently issued cautionary advice to preparers, as well as an alert to investors, about the use of pro forma financial information in earnings releases. The SEC staff cautioned that earnings releases are subject to the antifraud provisions of the federal securities laws and should not be used to mislead investors through the inclusion of such pro forma information. Earnings releases that contain pro forma and other non-GAAP information without a plain English reconciliation to GAAP, including amounts and appropriate explanations, may be viewed as misleading.

Furthermore, the SEC suggests that companies:

- Provide an accurate description of the controlling principles that underlie the pro forma presentation. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

- Consider the materiality of the information that is omitted from a pro forma presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they obscure GAAP results or omit material information otherwise included in GAAP financial statements. For example, investors are likely to be deceived if a company uses a pro forma presentation to change a loss to a profit, or to hide a significant fact, without clear and comprehensible explanations of the nature and size of the omissions.

- Consider the guidelines jointly developed by the Financial Executives International and the National Investors Relations Institute before determining whether to issue pro forma results, and before deciding how to structure a proposed pro forma statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

As an overall matter, clear and complete disclosure is key. In particular, complex transactions such as those with related parties, special purpose entities, off-balance-sheet vehicles, or situations that involve contingent obligations, derivatives, financial...
guarantees, and liquidity, among others, heighten the importance of financial disclosures to present a complete picture of a company and its risks. Therefore, it is important not only to assess whether the technical disclosure requirements of GAAP and MD&A have been met, but also to consider the depth and transparency of the disclosures with a focus on helping the reader more fully understand the substance of the company’s risks and rewards.

Specific Financial Statement Risks

In these difficult times, new risks directed at specific financial statement areas can arise, among them:

Long-lived assets, goodwill, and other intangible assets

Are there events or changes in circumstances indicating that a long-lived asset’s carrying amount may not be recoverable, triggering an impairment consideration?

Are the assumptions underlying the calculation of fair values of hard-to-value assets reasonable and based on current information? Are they based on assumptions that are difficult to determine, such as occurrences over long periods of time? Do the disclosures adequately portray the methods for calculating fair value and the related degree of uncertainty?

Impairment of inventory

Are there events or changes in the demand or price indicating that carrying amounts of inventory may be too high?

Revenue recognition

What are the significant judgment areas and estimates underlying the company’s revenue accounting?

Do the company’s revenues meet required standards, including, where applicable, the four criteria in SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements: (1) persuasive evidence of an arrangement; (2) delivery occurred or services rendered; (3) price fixed or determinable, and (4) collectibility reasonably assured?

Have any “special” or “side” arrangements been appropriately considered in determining reportable revenues?

Are the company’s revenue recognition policies adequately disclosed in the financial statements?

Are there unusual seasonal trends or period-end “spikes” in revenue?
Accounting estimates

What are the most significant estimates and judgments management makes in preparing the financial statements?

Is enough attention – resources, rigor of process, level of review – given to these estimates?
Are underlying assumptions based on reliable, up-to-date information?

Is there appropriate disclosure regarding significant assumptions, changes in assumptions, and uncertainty in estimates?

Deferred taxes

Have there been cumulative losses in recent years or other conditions that may require a valuation allowance for net deferred tax assets?

Restructuring charges

Does the company’s initial and ongoing accounting and disclosure for restructuring provisions meet the requirements of EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring), and SEC Staff Accounting Bulletin No. 100, Restructuring and Impairment Charges?

Debt covenants

Is or has the company been in violation of debt covenants, possibly requiring disclosure and reclassification of long-term debt to a current liability?

Are there cross-default provisions that could be triggered by a single debt covenant violation?

Are there debt covenants relating to unspecified “material adverse changes”?

Other than temporary declines in value of marketable debt and equity securities, and investments

Has there been an “other than temporary” decline in investment securities classified as held-to-maturity or available-for-sale, or in equity- or cost-basis investments, requiring loss recognition?

Is there a need to disclose an “early warning sign” related to a decline that has been experienced but not yet deemed other than temporary?
Pensions and other post-retirement benefits

Do factors such as falling securities market values, significant drops in interest rates, and projected increases in health care costs require that management revise key assumptions underlying accounting estimates related to pension and other post-retirement plans?

Employee stock options

Has the company made changes to its options plans, such as repricings or extending the term of outstanding options, that require expense recognition and disclosure?

Other risks and uncertainties

Is the company exposed to credit/default risk of a significant supplier/customer, service provider, lessor/lessee, debtor, financial guarantor, investor/ investee, joint venture partner, derivative counterparty, and/or trading partner due to financial problems or bankruptcy?

Have credit and default risks been adequately disclosed?

Have contingent liabilities been adequately identified and, as appropriate, disclosed?

Newly issued standards

Have newly issued standards, such as Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, been fully addressed and disclosed?

Changes to accounting principles and methods

Have all discretionary changes to accounting principles and methods that, individually or collectively, materially affect reported results of operations for an interim or annual period been disclosed?

The risks described above are general in nature. Further information on financial statement risks related to specific industries can be obtained by reading the industry-specific risk alerts produced by the American Institute of Certified Public Accountants.

A Call to Action

Management, auditors, and audit committees each have their separate roles and responsibilities. Still, their goal must be the same – making sure that a company’s financial reporting is of the highest quality.
Following are the most important actions that should be taken to achieve this common goal.

**Management**

Ensure the proper tone at the top and an expectation that only the highest-quality financial reporting is acceptable.

Review all elements of the company’s internal control – control environment, risk assessment, control activities, information and communication, and monitoring – in light of changes in the company’s business environment and with particular attention to significant financial statement areas.

Ensure that appropriate levels of management involvement and review exist over key accounting policy and financial reporting decisions.

Establish a framework for open, timely communication with the auditors and the audit committee on all significant matters.

Strive for the highest quality, most transparent accounting and disclosure – not just what is acceptable – in both financial statements and MD&A.

Make sure estimates and judgments are supported by reliable information and the most reasonable assumptions in the circumstances, and that processes are in place to ensure consistent application from period to period.

Record identified audit differences.

Base business decisions on economic reality rather than accounting goals.

Expand the depth and disclosure surrounding subjective measurements used in preparing the financial statements, including the likelihood and ramifications of subsequent changes.

When faced with a “gray” area, consult with others, consider the need for SEC pre-clearance, and focus on the transparency of financial reporting.

**Auditors**

Understand how a company is affected by changes in the current business environment.

Understand the stresses on the company’s internal control over financial reporting, and how they may impact its effectiveness.
Identify key risk areas, particularly those involving significant estimates and judgments.

Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management’s integrity.

Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.

Consider whether additional specialized knowledge is needed on the audit team.

Make management aware of identified audit differences on a timely basis.

Question the unusual and challenge anything that doesn’t make sense.

Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.

When faced with a “gray” area, perform appropriate procedures to test and corroborate management’s explanations and representations, and consult with others as needed.

**Audit Committees**

Evaluate whether management exhibits the proper tone at the top and fosters a culture and environment that promotes high-quality financial reporting, including addressing internal control issues.

Question management and auditors about how they assess the risk of material misstatement, what the major risk areas are, and how they respond to identified risks.

Challenge management and the auditors to identify the difficult areas (e.g., significant estimates and judgments) and explain fully how they each made their judgments in those areas.

Probe how management and the auditors have reacted to changes in the company’s business environment.

Understand why critical accounting principles were chosen and how they were applied and changed, and consider the quality of financial reporting and the transparency of disclosures about accounting principles.

Challenge management for explanations of any identified audit differences not recorded.
Understand the extent to which related parties exist and consider the transparency of the related disclosures.

Read the financial statements and MD&A to see if anything is inconsistent with your own knowledge.

Consider whether the readers of the financial statements and MD&A will be able to understand the disclosures and risks of the company without the access to management that the committee enjoys.

Ask the auditors about pressure by management to accept less than high-quality financial reporting.

When faced with a “gray” area, increase the level of communication with management and the auditors.

Management, auditors, and audit committees each must diligently fulfill its own role and effectively work together with the others through proactive communication and information sharing. In working together, we can collectively improve the financial reporting process. This requires a renewed commitment by each of the parties to the needs of financial statement users.

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1 This document has been prepared and distributed by the five largest accounting firms (Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers) and the American Institute of Certified Public Accountants. The five firms and the AICPA recognize the responsibility of our profession to work toward enhanced financial reporting and audit effectiveness and have made significant commitments toward those ends. Preparing and distributing this document is just one of several actions taken to fulfill this commitment.

2 The SEC staff has expressed their views on the subject of materiality in Staff Accounting Bulletin No. 99, Materiality, issued August 12, 1999.
Agency: Securities and Exchange Commission

Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies

Summary: The Securities and Exchange Commission is issuing a statement regarding the selection and disclosure by public companies of critical accounting policies and practices.

For Further Information Contact: Robert A. Bayless, Special Assistant to the Chief Accountant, 202-942-4400.

Supplementary Information:

As public companies undertake to prepare and file required annual reports with us, we wish to remind management, auditors, audit committees, and their advisors that the selection and application of the company's accounting policies must be appropriately reasoned. They should be aware also that investors increasingly demand full transparency of accounting policies and their effects.

Reported financial position and results often imply a degree of precision, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of generally accepted accounting principles ("GAAP") may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

Of course, public companies should be mindful of existing disclosure requirements in GAAP and our rules. Accounting standards require information in financial statements about the accounting principles and methods used and the risks and uncertainties inherent in significant estimates. Our rules governing Management's Discussion and Analysis ("MD&A") currently require disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information.

We have observed that disclosure responsive to these requirements could be enhanced. For example, environmental and operational trends, events and uncertainties typically are identified in MD&A, but the implications of those uncertainties for the methods, assumptions and estimates used for recurring and pervasive accounting measurements are not always addressed. Communication between investors and public companies could be improved if management explained in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements. We intend to consider new rules during the coming year to elicit more precise disclosures about the accounting policies that management believes are most "critical" - that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's
most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Even before new rules are considered, however, we believe it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. We encourage public companies to include in their MD&A this year full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

Investors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid change. To minimize such a loss of confidence, we are alerting public companies to the importance of employing a disclosure regimen along the following lines:

1. Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements. As part of the normal audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Special attention to the most critical accounting policies will enhance the effectiveness of this process. Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application and disclosure.

2. Management should ensure that disclosure in MD&A is balanced and fully responsive. To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.

3. Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.  3 Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.
4. If companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with our accounting staff. We encourage all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out our staff's assistance. We are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.

By the Commission.

Jonathan G. Katz
Secretary

Dated: December 12, 2001


2 The underlying purpose of MD&A is to provide investors with "information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." Item 303(a) of Regulation S-K [17 CFR 229.303(a)]. As we have previously stated, "[i]t is the responsibility of management [in MD&A] to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the company." Securities Act Rel. No. 6835 (May 18, 1989) [54 FR 22427] (quoting Securities Act Rel. No. 6349 (Sept. 28, 1981) [not published in the Federal Register]).

3 See Codification of Statements on Auditing Standards, AU § 380, Communication with Audit Committees or Others with Equivalent Authority and Responsibility ("SAS 61"). SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; and (4) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements. Id.
Securities and Exchange Commission

[Release Nos. 33-8056; 34-45321; FR-61]

Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations

Agency: Securities and Exchange Commission ("Commission")

Action: Commission statement

Summary: The Commission today is issuing a statement regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. The release sets forth certain views of the Commission regarding disclosure that should be considered by registrants. Disclosure matters addressed by the release are liquidity and capital resources including off-balance sheet arrangements; certain trading activities that include non-exchange traded contracts accounted for at fair value; and effects of transactions with related and certain other parties.

For Further Information Contact: Questions about this statement should be referred to Jackson Day or Robert Bayless, Office of the Chief Accountant (202 942-4400) or Paula Dubberly, Division of Corporation Finance (202 942-2900), Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103.

Supplementary Information:

I. Background

On December 31, 2001, the Commission received a petition from the accounting firms of Arthur Andersen LLP, Deloitte and Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. The petition, which was endorsed by the American Institute of Certified Public Accountants, requested that the Commission issue additional interpretive guidance regarding Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations, Item 303 of Regulation S-B, Management's Discussion and Analysis or Plan of Operations, and Item 5 of Form 20-F, Operating and Financial Review and Prospects (collectively, "MD&A" or "the MD&A rules"). The petition requested that additional guidance be provided to public companies preparing their annual reports for the fiscal year just ended.

The petition identified three areas of concern regarding disclosure in MD&A:

- liquidity and capital resources, including off-balance sheet arrangements;
- certain trading activities involving non-exchange traded contracts accounted for at fair value; and
• relationships and transactions with persons or entities that derive benefits from their non-independent relationship with the registrant or the registrant's related parties.

Generally, we believe that the quality of information provided by public companies in the three areas identified in the petition should be improved. Because many companies are currently preparing disclosures for fiscal 2001 annual reports, the Commission believes it is appropriate to issue this statement so that public companies can consider the petition and this statement in preparing year-end and interim financial reports and other disclosures made after the issuance of this release.

While the Commission intends to consider rulemaking regarding the topics addressed in this statement and other topics covered by MD&A, the purpose of this statement is to suggest steps that issuers should consider in meeting their current disclosure obligations with respect to the topics described. This statement does not create new legal requirements, nor does it modify existing legal requirements.

II. Regulation S-K. Item 303. Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Paragraph (a) of Item 303 of Regulation S-K identifies a basic and overriding requirement of MD&A: to "provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." The Commission has explained this requirement on a number of occasions. In 1987, we said:

The Commission has long recognized the need for a narrative explanation of the financial statements, because numerical presentations and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.6

And, as we said in 1989, "[t]he MD&A requirements are intended to provide in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future."2

Disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on the registrant's financial condition or results of operations.8 Accordingly, the development of MD&A disclosure should begin with management's identification and evaluation of what information, including the potential effects of known trends, commitments, events, and uncertainties, is important to
providing investors and others an accurate understanding of the company's current and prospective financial position and operating results.2

Investors have become increasingly concerned about the sufficiency of disclosure regarding liquidity risk, market price risks, and effects of "off-balance sheet" transaction structures. Also, many readers of financial statements have cited a lack of transparent disclosure about transactions with unconsolidated entities and other parties where that information appeared necessary to understand how significant aspects of the business were conducted.

Accordingly, the Commission is reminding companies of the requirements of MD&A as they relate to (1) liquidity and capital resources, including off-balance sheet arrangements; (2) certain trading activities involving non-exchange traded contracts accounted for at fair value; and (3) relationships and transactions on terms that would not be available from clearly independent third parties on an arm's-length basis. This statement suggests steps that companies should consider in meeting their disclosure obligations.

We also want to remind registrants that disclosure must be both useful and understandable. That is, management should provide the most relevant information and provide it using language and formats that investors can be expected to understand. Registrants should be aware also that investors will often find information relating to a particular matter more meaningful if it is disclosed in a single location, rather than presented in a fragmented manner throughout the filing.

A. Disclosures Concerning Liquidity and Capital Resources, Including "Off-Balance Sheet" Arrangements

Paragraphs (a) (1) and (a)(2)(ii) of Item 303 of Regulation S-K set forth certain requirements for disclosures about "Liquidity" and "Capital Resources."

(1) Liquidity. 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.

* * * * *

(2)(ii) Capital Resources. Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and any off-balance sheet financing arrangements.

A registrant's liquidity and capital resources are closely aligned. Disclosures about each are likely to be affected by many of the same facts and circumstances. And off-balance
sheet financing arrangements often are integral to both. Management should consider all of these items together, as well as individually, when drafting disclosures responsive to the MD&A rules.

1. Liquidity Disclosures

MD&A disclosures should not be overly general. For example, disclosure that the registrant has sufficient short-term funding to meet its liquidity needs for the next year provides little useful information. Instead, registrants should consider describing the sources of short-term funding and the circumstances that are reasonably likely to affect those sources of liquidity.

For example, a registrant that identifies its principal source of liquidity as operating cash flows may need also to disclose the extent of the risk that a decrease in demand for the company's products would reduce the availability of funds. That risk might arise, to further the example, where customer demand is reasonably likely to fluctuate in response to rapid technological changes. Similarly, if commercial paper is a principal source of liquidity, the registrant should consider the need to disclose how this facility could be adversely affected by a debt rating downgrade or deterioration in certain of the company's financial ratios or other measures of financial performance. The discussion should be limited to material risks, and, as with MD&A generally, should be sufficiently detailed and tailored to the company's individual circumstances, rather than "boilerplate."

If the registrant's liquidity is dependent on the use of off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, the registrant should consider disclosure of the factors that are reasonably likely to affect its ability to continue using those off-balance sheet financing arrangements. Registrants also should make informative disclosures about matters that could affect the extent of funds required within management's short- and long-term planning horizons.

Registrants are reminded that identification of circumstances that could materially affect liquidity is necessary if they are "reasonably likely" to occur. This disclosure threshold is lower than "more likely than not." Market price changes, economic downturns, defaults on guarantees, or contractions of operations that have material consequences for the registrant's financial position or operating results can be reasonably likely to occur under some conditions. Material effects on liquidity as a result of any reasonably likely changes should be disclosed pursuant to Item 303(a).

In 1989, the Commission identified two assessments management must make where a trend, demand, commitment, event or uncertainty is known:

1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. 12

The Commission further reminded registrants that each final determination resulting from the assessments made by management must be objectively reasonable, as viewed at the time the determination is made. 13

To identify trends, demands, commitments, events and uncertainties that require disclosure, management should consider the following:

- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of an additional financial obligation, such as adverse changes in the registrant's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked or indexed assets;

- circumstances that could impair the registrant's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable, such as the inability to maintain a specified investment grade credit rating, level of earnings, earnings per share, financial ratios, or collateral;

- factors specific to the registrant and its markets that the registrant expects to be given significant weight in the determination of the registrant's credit rating or will otherwise affect the registrant's ability to raise short-term and long-term financing;

- guarantees of debt or other commitments to third parties; and

- written options on non-financial assets (for example, real estate puts).

2. Off-Balance Sheet Arrangements

Registrants should consider the need to provide disclosures concerning transactions, arrangements and other relationships with unconsolidated entities or other persons that are reasonably likely to affect materially liquidity or the availability of or requirements for capital resources. Specific disclosure may be necessary regarding relationships with unconsolidated entities that are contractually limited to narrow activities that facilitate the registrant's transfer of or access to assets. These entities are often referred to as structured finance or special purpose entities. These entities may be in the form of corporations, partnerships or limited liability companies, or trusts.
Material sources of liquidity and financing, including off-balance sheet arrangements and transactions with unconsolidated, limited purpose entities, should be discussed pursuant to Item 303(a). 14 The extent of the registrant's reliance on off-balance sheet arrangements should be described fully and clearly where those entities provide financing, liquidity, or market or credit risk support for the registrant; engage in leasing, hedging, research and development services with the registrant; or expose the registrant to liability that is not reflected on the face of the financial statements. Where contingencies inherent in the arrangements are reasonably likely to affect the continued availability of a material historical source of liquidity and finance, registrants must disclose those uncertainties and their effects.

Registrants should consider the need to include information about the off-balance sheet arrangements such as: their business purposes and activities; their economic substance; the key terms and conditions of any commitments; the initial and ongoing relationships with the registrant and its affiliates; and the registrant's potential risk exposures resulting from its contractual or other commitments involving the off-balance sheet arrangements. For example, a registrant may be economically or legally required or reasonably likely to fund losses of an unconsolidated, limited purpose entity, provide it with additional funding, issue securities pursuant to a call option held by that entity, purchase the entity's capital stock or assets, or the registrant otherwise may be financially affected by the performance or non-performance of an entity or counterparty to a transaction or arrangement. In those circumstances, the registrant may need to include information about the arrangements and exposures resulting from contractual or other commitments to provide investors with a clear understanding of the registrant's business activities, financial arrangements, and financial statements. Other disclosures that registrants should consider to explain the effects and risks of off-balance sheet arrangements include:

- Total amount of assets and obligations of the off-balance sheet entity, with a description of the nature of its assets and obligations, and identification of the class and amount of any debt or equity securities issued by the registrant;

- The effects of the entity's termination if it has a finite life or it is reasonably likely that the registrant's arrangements with the entity may be discontinued in the foreseeable future;

- Amounts receivable or payable, and revenues, expenses and cash flows resulting from the arrangements;

- Extended payment terms of receivables, loans, and debt securities resulting from the arrangements, and any uncertainties as to realization, including repayment that is contingent upon the future operations or performance of any party;

- The amounts and key terms and conditions of purchase and sale agreements between the registrant and the counterparties in any such arrangements; and
• The amounts of any guarantees, lines of credit, standby letters of credit or commitments or take or pay contracts, throughput contracts or other similar types of arrangements, including tolling, capacity, or leasing arrangements, that could require the registrant to provide funding of any obligations under the arrangements, including guarantees of repayment of obligors of parties to the arrangements, make whole agreements, or value guarantees.

Although disclosure regarding similar arrangements can be aggregated, important distinctions in terms and effects should not be lost in that process. The relative significance to the registrant's financial position and results of the arrangements with unconsolidated, non-independent, limited purpose entities should be clear from the disclosures to the extent material. While legal opinions regarding "true sale" issues or other issues relating to whether a registrant has contingent, residual or other liability can play an important role in transactions involving such entities, they do not obviate the need for the registrant to consider whether disclosure is required. In addition, disclosure of these matters should be clear and individually tailored to describe the risks to the registrant, and should not consist merely of recitation of the transactions' legal terms or the relationships between the parties or similar boilerplate.

3. Disclosures about Contractual Obligations and Commercial Commitments

Accounting standards require disclosure concerning a registrant's obligations and commitments to make future payments under contracts, such as debt and lease agreements, and under contingent commitments, such as debt guarantees. Disclosures responsive to these requirements usually are located in various parts of a registrant's filings. We believe investors would find it beneficial if aggregated information about contractual obligations and commercial commitments were provided in a single location so that a total picture of obligations would be readily available. One aid to presenting the total picture of a registrant's liquidity and capital resources and the integral role of on- and off-balance sheet arrangements may be schedules of contractual obligations and commercial commitments as of the latest balance sheet date. Examples that could be adapted to the registrant's particular facts are presented below.

<table>
<thead>
<tr>
<th>Contractual Obligations</th>
<th>Payments Due by Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Less than 1 year</td>
<td></td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td></td>
</tr>
<tr>
<td>Capital Lease Obligations</td>
<td></td>
</tr>
<tr>
<td>Operating Leases</td>
<td></td>
</tr>
<tr>
<td>Unconditional Purchase Obligations</td>
<td></td>
</tr>
<tr>
<td>Other Long-Term Obligations</td>
<td></td>
</tr>
<tr>
<td>Total Contractual Cash Obligations</td>
<td></td>
</tr>
</tbody>
</table>

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The preceding table could be accompanied by footnotes to describe provisions that create, increase or accelerate liabilities, or other pertinent data.

<table>
<thead>
<tr>
<th>Other Commercial Commitments</th>
<th>Total Amounts Committed</th>
<th>Amount of Commitment Expiration Per Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Less than 1 year</td>
</tr>
<tr>
<td>Lines of Credit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standby Letters of Credit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standby Repurchase Obligations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Commercial Commitments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Commercial Commitments</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

B. Disclosures about Certain Trading Activities that Include Non-Exchange Traded Contracts Accounted for at Fair Value

The Commission is concerned that there may be a lack of transparency and clarity with respect to the disclosure of trading activities involving commodity contracts that are accounted for at fair value but for which a lack of market price quotations necessitates the use of fair value estimation techniques. These contracts may be indexed to measures of weather, commodities prices, or quoted prices of service capacity, such as energy storage and bandwidth capacity contracts. Companies engaged a material extent in trading activities involving these contracts should consider providing disclosures in MD&A that supplement those required in the financial statements by applicable accounting standards. Investor understanding and financial reporting transparency may depend on additional statistical and other information about these business activities and transactions. That information should include any contracts that are derivatives involving the same commodities that are part of those trading activities (for example, energy derivatives that are part of energy trading activities).

The Commission reminds registrants that accounting standards require disclosures in financial statements of material energy trading and risk management activities. Discussion in MD&A of material trends and uncertainties arising from those activities is also required. Information about these trading activities, contracts and modeling methodologies, assumptions, variables and inputs, along with explanations of the different outcomes reasonably likely under different circumstances or measurement methods, should be considered for inclusion in management's discussion of how the activities affect reported results for the latest annual period and subsequent interim period and how financial position is affected as of the latest balance sheet date. The Commission recently issued cautionary advice encouraging companies to include in their MD&A full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially
different amounts would be reported under different conditions or using different assumptions.\textsuperscript{20}

Consistent with that advice, registrants should consider the need to furnish information, quantified to the extent practicable, that does the following:

- disaggregates realized and unrealized changes in fair value;
- identifies changes in fair value attributable to changes in valuation techniques;
- disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and
- indicates the maturities of contracts at the latest balance sheet date (\textit{e.g.}, within one year, within years one through three, within years four and five, and after five years).

An example of this disclosure in the form of a schedule is provided below.

<table>
<thead>
<tr>
<th>Source of Fair Value</th>
<th>Maturity less than 1 year</th>
<th>Maturity 1 - 3 years</th>
<th>Maturity 4 - 5 years</th>
<th>Maturity in excess of 5 years</th>
<th>Total fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prices actively quoted</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prices provided by other external sources</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prices based on models and other valuation methods</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In addition, issuers should consider the need to disclose the fair value of net claims against counterparties that are reported as assets at the most recent balance sheet date,
based on the credit quality of the contract counterparty (e.g., investment grade; noninvestment grade; and no external ratings).

Registrants should also consider their disclosure obligations regarding risk management in connection with the trading activities discussed above. Registrants should consider whether they should provide fuller disclosure regarding the management of risks related to, for example, changes in credit quality or market fluctuations of underlying, linked or indexed assets or liabilities, especially where such assets are illiquid or susceptible to material uncertainties in valuation.

C. Disclosures about Effects of Transactions with Related and Certain Other Parties

Statement of Financial Accounting Standards No. 57 (FAS 57), Related Party Disclosures, sets forth the requirements under GAAP concerning transactions with related parties. As noted in that standard, "[t]ransactions involving related parties cannot be presumed to be carried out on an arm's length basis, as the requisite conditions of competitive, free-market dealings may not exist." Accordingly, where related party transactions are material, MD&A should include discussion of those transactions to the extent necessary for an understanding of the company's current and prospective financial position and operating results. In addition, Item 404 of Regulation S-K and Item 404 of Regulation S-B require disclosure of certain relationships and transactions with related parties.

Registrants should consider whether investors would better understand financial statements in many circumstances if MD&A included descriptions of all material transactions involving related persons or entities, with clear discussion of arrangements that may involve transaction terms or other aspects that differ from those which would likely be negotiated with clearly independent parties. Registrants should consider describing the elements of the transactions that are necessary for an understanding of the transactions' business purpose and economic substance, their effects on the financial statements, and the special risks or contingencies arising from these transactions. Discussion of the following may be necessary:

- the business purpose of the arrangement;
- identification of the related parties transacting business with the registrant;
- how transaction prices were determined by the parties;
- if disclosures represent that transactions have been evaluated for fairness, a description of how the evaluation was made; and
- any ongoing contractual or other commitments as a result of the arrangement.

Registrants should also consider the need for disclosure about parties that fall outside the definition of "related parties," but with whom the registrant or its related parties have a
relationship that enables the parties to negotiate terms of material transactions that may not be available from other, more clearly independent, parties on an arm's-length basis. For example, an entity may be established and operated by individuals that were former senior management of, or have some other current or former relationship with, a registrant. The purpose of the entity may be to own assets used by the registrant or provide financing or services to the registrant. Although former management or persons with other relationships may not meet the definition of a related party pursuant to FAS 57, the former management positions may result in negotiation of terms that are more or less favorable than those available on an arm's-length basis from clearly independent third parties that are material to the registrant's financial position or results of operations. In some cases, investors may be unable to understand the registrant's reported results of operations without a clear explanation of these arrangements and relationships.

By the Commission.
Jonathan G. Katz
Secretary
January 22, 2002

Endnotes

1 The petition is posted on the Commission's web page (www.sec.gov) under Regulatory Actions, Petitions for Rulemaking.

2 17 CFR 229.303.

3 17 CFR 228.303.

4 See 17 CFR 249.220f.


8 Securities Act Release No. 6835 (May 18, 1989), Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 FR 22427, 22429 ("Required disclosure is based on currently known
trends, events, and uncertainties that are reasonably expected to have material effects. In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.

2 See Instructions to Item 303 ("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.").

10 See Securities Act Release No. 6835 (May 18, 1989), Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 FR 22427, particularly Section III.C.

11 "The scope of the discussion should thus address liquidity in the broadest sense, encompassing internal as well as external sources, current conditions as well as future commitments and known trends, changes in circumstances and uncertainties." [Securities Act Release No. 6349 (September 28, 1981)].


13 Id.

14 Securities Act Release No. 6835 (May 18, 1989), Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 FR 22427, at III.C.


16 Commercial commitments are intended to include lines of credit, guarantees, and other potential cash outflows resulting from a contingent event that requires registrant performance pursuant to a funding commitment.

17 Companies that may find the suggested disclosures particularly valuable are those engaged to a material extent in (a) energy trading activities as defined in Emerging Issues Task Force Issue 98-10 (EITF 98-10), Accounting for Contracts Involved in Energy Trading and Risk Management Activities, (b) weather trading activities as defined in Emerging Issues Task Force Issue No. 99-2, Accounting for Weather Derivatives, or (c) non-exchange traded commodity trading contracts that are marked to fair value through earnings and are part of analogous trading activities (for example, nonderivative trading contracts on pulp, bandwidth, newsprint, and so on).
18 Emerging Issues Task Force No. 98-10 (September 23, 1999) identifies factors that distinguish energy trading activities from other activities that involve the purchase or sale of energy.

19 Emerging Issues Task Force Issue 98-10 (September 23, 1999), *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*.


21 Statement of Financial Accounting Standard No. 57, *Related Party Disclosures* (March 1982). See also 17 CFR 210.4-08(k)(1), which states, "Related party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows."

22 *Id.*, paragraph 3.

23 17 CFR 229.404 and 17 CFR 228.404, which require, with certain exceptions, disclosure of transactions or series of transactions in which the company was, or is to be, a party, the amount involved exceeds $60,000, and a director, executive officer, nominee for election as director, security holder of more than five percent of any class of the company's voting securities, or any member of the immediate family of any of such persons, had or will have a direct or indirect material interest. Required disclosures include the name of the person and the person's relationship with the registrant, the nature of the person's interest, the amount of the transaction(s), and, where practicable, the amount of the person's interest in the transaction(s). In addition, section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1, requires that each audit of financial statements pursuant to that Act include procedures designed to identify related party transactions that are material to the financial statements or that require disclosure. Statement on Auditing Standards No. 45, *Related Parties*, published by the Auditing Standards Board and effective for periods ended after September 30, 1983, provides guidance on auditing related party transactions.

24 Audit committees may wish to include a review of such relationships and transactions in their discussions with management and auditors, including a review of their terms and internal corporate and Board actions involving the transactions, prior to their recommendation that the financial statements be included in the company's Form 10-K. *See generally*, Regulation S-K Item 306, 17 CFR 229.306, and Regulation S-B Item 306, 17 CFR 228.306.

http://www.sec.gov/rules/other/33-8056.htm
INTEGRATION DOCTRINE

Rutheford B. Campbell, Jr.
Alumni Professor of Law
University of Kentucky College of Law
Lexington, Kentucky
THE INTEGRATION DOCTRINE

Rutheford B. Campbell, Jr.

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THE INTEGRATION DOCTRINE

Rutheford B Campbell, Jr.
Alumni Professor of Law
University of Kentucky College of Law

I. AN OVERVIEW OF THE DOCTRINE

A. Under the integration doctrine, a single "offering" or "issue" of securities cannot be split, offering, for example, one-half of the shares under the private placement exemption from registration provided by Section 4(2) of the 1933 Act and one-half of the shares under the intrastate exemption provided by Section 3(a)(11). The rule similarly prohibits splitting a single offering or issue between a registration statement and any exemption from registration. In all events, therefore, the whole of any discrete offering or issue of securities must be offered and sold only under one exemption or registration statement.

1This paper is based in parts on my recent article, The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933, 89 Ky. L. J. 289 (2001). I take the liberty of utilizing language and thoughts from that piece without further footnotes or quotation marks so indicating. The author is indebted to Rodney Chrisman, Jonathan Helton and David Longenecker for their research assistance in connection with the original article.


3That section provides an exemption from registration for:

Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation incorporated by and doing business within, such State or Territory.


4For the purposes of this article, the author generally uses simple and somewhat sterile examples. While these examples are typical of situations one might encounter in practice, they are far from exhaustive. A couple of other examples may be helpful in appreciating the pervasiveness of the integration issues faced by companies engaged in capital formation.

One of the most difficult integration problems faced by this author in his practice days involved the unseasoned and unsophisticated (but otherwise honest and efficient) entrepreneur who, before seeking legal advice, made an offer of its securities in a manner that destroyed all available
Accordingly, if an issuer attempts to bifurcate a single offering into two separate components and qualify each component under a separate exemption or, alternatively, under an exemption and a registration statement, courts or the Commission may conclude that the two putatively separate offering in fact amount to a single offering and thus may “integrate” the two transactions into a single offering. Once this integration occurs, the breadth of the offering or issue is defined, and all the offers and sales within this defined offer or issue must either meet all the requirements of a single exemption or, alternatively, be made subject to an effective registration statement.5

B. Although the integration doctrine, described in these abstract terms, has a sensible ring to it, commentators over the years have picked at the doctrine.6

exemptions from registration. The only way to cure that problem is to separate the prior illegal offer from the proposed financing through the application of the integration doctrine.

Another example arose some years ago when tax shelter deals were fashionable and, apparently, at least, profitable. Entrepreneurs would form multiple limited partnerships for the purpose of engaging in certain activities, drilling for oil and gas, for example. Each of these partnerships would have different properties and investors but would have the same promoters and be engaged in the same type of enterprises. The question arose as to whether the separate offerings by these separate entities would integrated. See, e.g., Donohoe v. Consolidated Operating & Production Corp., 982 F. 2d 1130 (7th Cir. 1992)(refusing to integrate separate limited partnerships formed to drill separate oil wells). For a discussion of this in the context of multiple partnership offerings, see Subcommittee on Partnerships, Trusts, and Unincorporated Associations, Integration of Partnership Offerings: A Proposal for identifying a Discrete Offering (hereinafter “Integration of Partnership Offerings”), 37 Bus. Law. 1591 (1982). This matter receives additional, but briefer, treatment in ABA Task Force on Integration, Integration of Securities Offerings: Report of the Task Force on Integration (hereinafter “Task Force on Integration”), 41 Bus. Law. 595, 621-23, 624-31 (1986).


6For criticism from commentators, see, e.g., C. Steven Bradford, Regulation A and the Integration Doctrine: The New Safe Harbor (hereinafter, “Bradford, Regulation A”), 55 Ohio St. L. J. 225 (1994)(characterizing changes to the safe harbor rules of Regulation A as “generally positive and responsive to . . . criticisms”, but lamenting that “Rule 251(c) has failed to reach its potential”. Id., at 289); In his most recent, Professor Bradford has mounted a substantial criticism of the integration doctrine, proposing a solution to the difficulties generated by integration through adopting a “weighted exemption system”. C. Stephen Bradford, Expanding the Non-Transactional Revolution: A new Approach to Securities Registration Exemptions (hereinafter “Bradford, Expanding”), 49 Emory L.J. 438 (2000); Lyman Johnson & Steve Patterson, The Reincarnation of Rule 152: False Hope on the Integration Front, 46 Wash. & Lee L. Rev. 539 (1989) (offering a
1. Much of their critical comment has focused on the confusion and uncertainty in the doctrine’s terms\(^7\) and the pernicious impact such ambiguity has on the capital formation activities of issuers.\(^8\)

2. On at least two occasions, therefore, committees of the American Bar Association have tried their hands at bringing some sense and order to portions of the integration doctrine.\(^9\) The most significant of these ABA initiatives occurred in the mid-1980s, when a prestigious committee,\(^10\) driven primarily by concerns of the practicing bar over the unmanageable levels of ambiguity in the doctrine, proposed regulatory amendments that would establish a series of broadly available safe harbors from integration.\(^11\) Interestingly, and tellingly, however, critical analysis of Rule 152). Writing in 1986, this author criticized the doctrine as applied to Regulation D offerings. Rutheford B Campbell, Jr., *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems that Need Attention*, 74 Ky. L. J. 127, 162-70 (1985-86).

\(^7\)Even those who generally support the concept of integration admit that the doctrine in its application is confusing and inconsistent. See, e.g., Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula that Fosters the Policies of Securities Regulation*, 25 Loy. Chi. U.L.J. 199, 208-30 (1994).

\(^8\)E.g., Johnson and Patterson provide some description of the “irksome manner in which the integration doctrine constrains capital financing decisions”, Johnson & Patterson, *supra* note 6, at 539, appropriately focusing on the special problems of start-up businesses. *Id.* at 540.

Interestingly, one author seems nearly prepared to argue that ambiguity in the integration doctrine actually contributes to capital formation, albeit the type of capital formation she dislikes. Professor Wade states: “The ability of issuers to manipulate the factors of the SEC’s current integration formula allows them to avoid the application of the integration doctrine and thereby successfully evade the Act’s registration requirements.” Wade, *supra* note 7, at 240.

\(^9\)See *Integration of Partnership Offerings, supra* note 4 (discussing and making proposals respecting the application of the integration doctrine to successive offerings by affiliated partnerships). This article and its proposals drew sharp criticism from Dean Morrissey. See, Morrissey, *supra* note 5, at 77 (characterizing the proposal as “an elegant attempt to circumvent the registration process by artificially expanding its carefully restricted exemptions”). The second ABA paper was *Task Force on Integration, supra* note 4 (dealing more broadly with the integration doctrine and making recommendations of broad application respecting the doctrine).

\(^10\)For members of the Task Force, see *Comments of Chair, ABA Task Force on Integration*, 1 Selected Articles on Securities Law 230, note * (hereinafter “Comments of Chair”)(1991).

\(^11\)The Task Force divided its safe harbor suggestions into six categories: “issuer distinctions, temporal separations, differences in securities offered, purpose differences, policy considerations,
the Chair of the Task Force admitted some years later that “the hopes of the task force have largely not been realized . . . , with the result that integration issues remain a serious problem . . . .”

C. Even the Securities and Exchange Commission, which is the doctrine’s principal architect, appears to recognize that the integration doctrine has its problems.

1. For example, for a period during the late seventies and early eighties, the SEC refused to respond to no-action requests, seemingly overwhelmed by the complexity of the issues and the volume of requests from attorneys.13 In 1985, however, the SEC reversed itself and again began to issue no action letters on integration questions.14

2. Over the years, the Commission has developed certain discrete, regulatory safe harbors from integration and recently has been especially generous in its rules protecting issuers, at

and domestic and foreign offering distinctions.” Task Force on Integration, supra note 4, at 624. These proposals are discussed at id. at 624-41. The specific regulatory proposals of the Task Force are found at id. at 642-43.

12Comments of Chair, supra note 10, at 230.

The report of the Task Force reflects the extreme theoretical difficulties encountered when one attempts to bring clarity and consistency to the integration doctrine. The problem is that the integration doctrine itself is fundamentally nonsensical. Drafting rules without a principled theoretical footing is, of course, a problematic exercise. Thus, one can sympathize with the Task Force’s frustration as it attempted to bring order in such circumstances.

In fact, the approach of the Task Force, in light of such circumstances, makes sense. The Task Force opted to propose a series of safe harbor provisions designed to clarify, simplify and reduce somewhat the application of the doctrine. This approach makes sense, because modest reductions in the perniciousness of a nonsensical doctrine result if the rules respecting its application are simple and clear. At least such clarification and simplification reduce the transaction costs in those deals in which the doctrine is implicated, since, for example, the legal costs in determining the application of the doctrine are reduced by the enhanced clarity of the rule. Further, to the extent the scope of integration is reduced by such safe harbors, the perniciousness of the doctrine is once again reduced.

13Some indication of this, as well as an indication of the significance of the doctrine to issuers and thus to capital formation generally, is seen in the sheer numbers of integration no-action requests received by the SEC. Professor Wade reports, for example, that from 1971 to 1979, the SEC received nearly 200 no-action requests on integration. Wade, supra note 7, at 220.

least in limited situations, from the perniciousness of the doctrine.  

II. A BRIEF LOOK AT THE HISTORY OF THE DOCTRINE

In connection with my recent article, *The Overwhelming Case for Elimination of the Integration Doctrine*, I researched the origins of the integration doctrine, and what I found was at least mildly surprising.

A. The Original Securities Act of 1933 contained no clear mandate for an integration doctrine. Some sections of the original 1933 Act suggest an integration doctrine; some sections suggest the contrary.

B. The doctrine first appeared during the first year of the new act, 1933, and was constructed and

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15 See, e.g., Rule 251(c) of Regulation A, 17 C.F.R. § 230.251(c) (2001), which was amended in 1992 in connection with the Commission’s small business initiatives, Securities Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,439 (July 30, 1992), and minimized the impact of integration on Regulation A offerings. For an outstanding discussion of this provision, see Bradford, *Regulation A*, supra note 6. Unfortunately, the Commission’s effort to eliminate uncertainty in the application of the integration doctrine has been unsuccessful in most instances.

16 See Campbell, supra note 1.

17 See Campbell, supra note 1, at 295-300.

18 Securities Act Release No. 33-1459, 1 Fed. Sec. L. Rep. (CCH)¶2261-62 (May 29, 1937). Apparently in the months following the adoption of the 1933 Act, the Federal Trade Commission (the “FTC”), which was initially assigned administrative responsibility over the 1933 Act, began to respond in letters to inquiries about the new 1933 Act. In 1933, therefore, the FTC issued the foregoing Release, which consisted of excerpts from a number of these letters, including one letter dealing with integration.

The facts underlying the FTC’s opinion in the Release are as follows. Shortly after the 1933 Act was passed, a company apparently filed a registration statement for an offering of securities to be sold to the public in various states. The question posed by the issuer was whether during the waiting period it could begin to sell these securities under an intrastate exemption and then after the effective date of the registration statement complete the offering across state lines pursuant to the registration statement.

These facts, therefore, are particularly compelling for the administrative adoption of an integration concept. The “issue” of securities clearly had been defined by the registration statement...
promulgated by the Federal Trade Commission, which originally was assigned the administrative oversight of the 1933 Act.19

C. Five years later when the SEC had taken over from the FTC as the regulatory agency with primary responsibility for the administration of the 1933 Act,20 the SEC with seeming facility promulgated its famous Unity Gold opinion in which it reaffirmed the FTC’s integration doctrine, applied it to an offering under Section 3(b) and commenced an articulation of the criteria it proposed to use to determine whether putatively separate offerings would be integrated.21 Integration at that

filed by the company, which proposed to register for sale a defined number of shares of the company’s stock. The issuer, by its own admission, proposed to sell a portion of those particular securities pursuant to the intrastate exemption and then to sell the balance of the securities pursuant to a registration statement.

When these unusually strong facts were considered by the inexperienced agency under the relatively strong integration language in the original intrastate exemption, the FTC’s adoption of an integration concept in the opinion is, perhaps, unsurprising. Unfortunately, it was the wrong conclusion and one that since 1933 has generated confusion and inappropriate outcomes. To make matters even more unfortunate, the conclusion was one that was not required by the words of the Act.


213 S.E.C. 618 (1938). In March of 1937, Unity Gold sold 75,000 shares of its stock to Mr. Cronan under Section 3(b) and the Commission’s regulations that were the predecessor to today’s Regulation A. When in May of 1937 Unity Gold filed a registration statement for approximately 600,000 additional shares of its stock, the question arose as to whether that subsequent, registered offering would be integrated back into the prior sales under Section 3(b), thereby destroying the Section 3(b) exemption due to the failure to abide by the $100,000 amount limitation of that section.

The Commission easily found that the Section 3(b) offering was part of the same issue as the registered offering and thus integrated the two, which destroyed the availability of the Section 3(b) portion of the offering. The Commission concluded that the determination of whether the two components will be considered a “single ‘issue’” depends upon “various factors concerning the methods of sale and distribution employed to effect the offerings”. The following were cited by the Commission as factors indicating the appropriateness of integration: “securities of the same class,
point became firmly established as a Commission doctrine, and the Commission has never wavered in its position that the integration is an integral part of the 1933 Act.\textsuperscript{22} 

D. Courts did not get involved in any significant integration matters until nearly 1960, and then their contribution to the development of the doctrine was simply to accept the doctrine as developed previously by the Commission.\textsuperscript{23} Thus, while these early judicial decisions on integration reflect the inherent difficulty that unspecialized tribunals of general jurisdiction have in dealing with matters as technical and complex as integration,\textsuperscript{24} courts without hesitation accepted the integration

offered on the same general terms to the public in an uninterrupted program of distribution” a “single integrated plan for distribution” also indicates the appropriateness of integration. The Commission cited “material differences in the use of the proceeds, in the manner and terms of the distribution” as factors weighing against integration. \textit{Id.} at 625.

\textsuperscript{22}As discussed in this paper, the SEC has, however, developed different criteria for integration, depending on the particular exemption or registration involved and has ameliorated the impact of the doctrine in certain limited cases.

\textsuperscript{23}For example, in \textit{Securities and Exchange Commission v. Hillsborough Investment Corporation},("Hillsborough I") 173 F. Supp. 86, 88 (D. N.H. 1958), which this author considers the second ever integration court case, the court relied on a 1937 SEC Release, Securities Act Release No. 1459 (1937), in dealing with what the court considered to be an integration matter. A court in the next series of significant integration cases then relied on \textit{Hillsborough I} as a basis for its integration decision. \textit{S.E.C. v. Los Angeles Trust Deed & Mortgage Exchange}, 186 F. Supp. 830, 871, \textit{modified, aff'd and remanded} 285 F. 2d 162 (9\textsuperscript{th} Cir. 1960). Professor Loss and Dean Seligman observe that “the Commission's standard [for common law integration] in recent years has often been followed by courts.” Loss & Seligman, \textit{supra} note 5, at 1213. Professor Deaktor, however, seems to be of a different mind, stating that “a relatively large proportion of the integration cases make no mention of the work of the SEC, nor of cases or authorities which have drawn on that work.” Deaktor, \textit{supra} note 5, at 509.

\textsuperscript{24}For example, the court’s treatment of the integration issue in \textit{Shaw v. U.S.}, 131 F.2d 476 (9\textsuperscript{th} Cir. 1942) is essentially unintelligible. The next following cases after \textit{Shaw}, while broadly intelligible, are nonetheless confusing and based on uncertain principles and fail to articulate with clarity the criteria of integration.

Thus, in \textit{S.E.C. v. Hillsborough Investment Corporation} ("Hillsborough I"), 173 F. Supp. 86 (D.C.N.H. 1958), the second reported case dealing with integration, the Court held that Hillsborough could not rely on the intrastate exemption because recent interstate sales of its securities. About the only explanation offered for integration in this case was a statement of the court indicating that it would integrate “all the shares of common character originally though successively issued by the corporation”. \textit{Id.} at 88, quoting from \textit{Shaw v. U.S.}, 131 F.2d 478, 480 (9\textsuperscript{th} Cir. 1942). Obviously, such a statement is overly broad and essentially useless as a single criterion for integration. The case
essentially as it had been developed by the Commission and continue to apply the doctrine today.

is otherwise devoid of meaningful reasoning or criteria for integration.

The third reported integration case once again involved Hillsborough. *S.E.C. v. Hillsborough Investment Corporation* ("Hillsborough II"), 176 F. Supp. 789, *aff'd* Hillsborough Investment Corporation *v. S.E.C.*, 276 F. 2d 665 (1st Cir. 1960). Shortly after the injunction was entered against Hillsborough in *Hillsborough I*, Hillsborough offered New Hampshire residents holding the previously issued shares the opportunity to exchange their shares for new shares that had somewhat different contractual terms. Hillsborough planned to sell additional, similar shares to other New Hampshire residents for cash, claiming that the entire new offering (i.e., both the part sold in the exchange and the part sold for cash) was therefore exempt from registration under the intrastate exemption. Apparently based on the its determination that the new securities “differ from the old securities [that were sold illegally] ... only in a small degree ...”, the court determined that the sale of the new securities under such a condition would be in violation of the 1933 Act. While the outcome seems based on the notion that the old offering must be integrated with the new offering, once again, the analysis is far from crisp, relying more on generalized notions of bad faith and providing no meaningful analysis of the application of the integration doctrine or the criteria used to determine that the two offerings should be combined.

The fourth of the earliest integration cases is *S.E.C. v. Los Angeles Trust Deed & Mortgage Exchange*, 186 F. Supp. 830, *modified, aff'd and remanded* 285 F. 2d 162 (9th Cir. 1960), and once again the analysis of the court is less than precise. In that case the Court seemed to apply the integration concept to offerings purportedly made under the intrastate exemption. Apparently, although once again this is less than entirely clear, the Court integrated the offerings because “the terms and conditions under which [the offerings were made were] ... identical”. 186 F. Supp. at 871.

The point of this overly long discussion is to demonstrate that courts had difficulty in their early integration cases and also to express some sympathy for the courts, which were dealing with complicated and technical matters for the first time.

E. The author’s conclusion from the foregoing is that statutory language, history and precedent provide no compelling support for the continuation of the integration doctrine.

III. THE STATE OF THE INTEGRATION DOCTRINE TODAY

A. Over the years, able commentators have written on the integration doctrine and its application both broadly and to specific situations. Some of the most significant works are cited in the footnotes. 26

B. The discussion of today’s integration doctrine can profitably be bifurcated into the common law rules of integration and the Commission’s discrete safe harbor rules of integration.

1. The Common Law of Integration

a. The common law of integration is applicable to offerings of securities in the absence of any specific Commission rule dealing with a particular integration matter.

b. The common law doctrine is best understood as the five factor integration test that is consistently articulated by the Commission. Thus in determining, for example, whether securities sold in January of a particular year under the intrastate offering will be integrated with securities sold in April of the same year under the private placement exemption, courts (or the Commission) will consider whether the two blocks of securities (i) “are part of a single plan of financing”, (ii) “involve issuance of the same class of securities”, (iii) are offered “at or about the same time”, (iv) generate the “same type of consideration” for the issuer, and (v) are offered “for


the same general purpose".27 In a common law analysis, therefore, the presence of each of the foregoing is a factor that increases the probability that the January and April blocks of securities will be integrated and thus considered a single offering.28

c. The very nature of these criteria make them difficult to apply.29

(1) In the first place, the meanings of the individual factors themselves are generally ambiguous and confusing. The “single plan of financing” factor, for example, not only is itself inherently ambiguous30 but also appears to be similar to the “same general purpose” factor.31

27See the discussion in Loss & Seligman, supra note 5, at 1212-13. The Commission, for example, both in Rule 147, 17 C.F.R. § 230.147 (Preliminary Note 3) (2001), and in Regulation D, 17 C.F.R. § 230.502(a)(Note) (2001), cited these factors as the applicable criteria for integration determinations made outside the safe harbor provisions of those particular rules.

28Professor Deaktor’s 1979 article, Deaktor, supra note 5, at 529-38, and Professor Wade’s later, 1994 article, Wade, supra note 7, at 211-20, provide a separate, in-depth discussion of each of the five common law factors of integration. The Report by the Task Force on Integration, Task Force on Integration, supra note 4, at 600-23, is also particularly rich in its research on the five common law factors of integration, although its discussion is organized around particular exemptions rather than the factors themselves.

29Loss and Seligman state, for example, that this “multifactor test may fairly be criticized as . . . ‘indeterminate’”. Loss & Seligman, supra note 5, at 1213. Professor Wade, although clearly supportive of the integration doctrine, concedes that doctrine is confusing in its application. See Wade, supra note 7, at 211-27 (“the SEC’s no-action letters and the opinions of courts have provided very little guidance with respect to the analysis that must be performed under the five factor test.” Id. at 221.)

30Loss and Seligman conclude that the “Commission staff’s no-action letters are not entirely consistent” on the definition of a “single plan of financing”. They state, however, that the term “tends to refer to factors such as the method of offering the security, the timing of plans for raising capital, and whether the offerings are financially interdependent.” Loss & Seligman, supra, note 5, at 1214. Professor Wade agrees with Loss and Seligman on the three factors that make up the single plan of financing factor, also finding “. . . confusion . . . from the SEC’s and the courts’ failure to define precisely and apply consistently the three suggested components of the single plan of financing factor.” Wade, supra note 7, at 212. Professor Deaktor states that the staff’s definition of this factor “has lacked consistency”. Deaktor, supra note 5, at 529.

31See Loss & Seligman, supra note 5, at 1214 (“there tends to be considerable overlap between instances in which there is a ‘single plan of financing’ and those in which there is the ‘same
The other integration factors are equally uncertain in their meaning. Thus, it is unclear what types of contractual variances are necessary to establish that two securities are not part of the “same class of securities.” How different do the contractual terms have to be in order to be separate classes? Are debt and equity always separate classes of securities? What if the equity is a preferred stock and the debt is a subordinated debenture that have essentially the same rights, except for the preference of the debentures over the preferred in bankruptcy?

Finally, and certainly without attempting to be exhaustive regarding the inherent ambiguity in the common law integration factors, consider the “at or about the same time” factor. Obviously, the time between the sale of two blocks of securities can be one day, one month, one year, etc. How far apart do the two sales have to be in order not to be considered “at or about the same time”? A related uncertainty regarding the “at or about the same time” factor is the question of whether it is an all or nothing matter or, instead, a factor that counts more (or less) as the two offering become closer (or more remote) in time? Under an all or nothing regime, the existence of the factor might be established by a discrete line (six months, for example) and all sales within that six month period would be considered “at or about the same time” and would count the same toward integration, whether such sales are one day apart or five months and twenty-nine days apart.

32Interestingly, Professor Deakor in his discussion of the meaning of separate classes emphasizes, instead of contractual differences between or among securities, the identity of the issuer and the identity of the offerees. Deakor, supra note 5, at 531-32.

33See, Wade, supra note 7, at 216-18 (“the SEC and courts have failed to articulate a precise formula to determine whether securities are of the same class.” Id. at 216). Although Loss and Seligman characterize the Commission’s approach to this element as “relatively straightforward”, Loss & Seligman, supra note 5, at 1218, their subsequent discussion of the element suggests the significantly uncertain nature of this element. Id. at 1219-21.

34For example, although Loss and Seligman opine that the six months safe harbor provision of Rule 147 and Regulation D “suggests” that a six month period “will be necessary to demonstrate that it was not made “at or about the same time””, the authors state that a separation of “six months or more will alone not necessarily lead to nonintegration.” Loss & Seligman, supra note 5, at 1221-22.
Alternatively, the factor could operate without a discrete line and vary in its weight, depending on how far apart in time the two blocks are sold. Under this analysis, offerings one year apart, for example, may still have a small tendency to support integration, while offerings one day apart may have a much stronger tendency to support integration.\(^{35}\)

(2) Ambiguity is also generated by the uncertainty about the particular mix of the factors required for integration.\(^ {36}\)

Is one of the five factors sufficient to require integration? Are two sufficient? Do some factors count more than others?\(^ {37}\) What is the relationship between strength and number? Does the strength of a factor count more than the number of factors, and thus perhaps three strong factors count more than four weak factors?\(^ {38}\)

(3) Everyone concedes the ambiguity in the common law criteria of integration and the difficulty of applying the criteria and that the search for workable “rules of thumb” does not always resolve questions.

(4) Nonetheless, the author quotes from an old piece of his and offers this up as some help:

A noted commentator “has taken the position that separate issues can be established either by separate classes of securities [the

\(^{35}\)Professor Deaktor opines that [p]roximity in time . . . has seldom been determinative”. Deaktor, supra, note 5, at 534.

\(^{36}\)“Neither the Commission nor the courts have provided express guidance on how to weigh these factors when analyzing an integration problem.” Loss & Seligman, supra note 5, at 1222.

\(^{37}\)Loss & Seligman suggest that “a review of cases and no-action letters strongly suggests that the “single plan of financing” and ‘same general purpose’ factors normally are given greater weight than the other factors.” Loss & Seligman, supra note 5, at 1222. Professor Deaktor opines that “even if [offerings are] simultaneous [and thus made “at or about the same time], one or more of the other integrations factors often will be viewed as more important.” Deaktor, supra note 5, at 534. See also, Wade, supra note 7, at 214 (“Like the single plan of financing factor, the weight of the same general purpose factor in integration analysis is unclear.”)

\(^{38}\)At one point in its work the ABA Task Force on Integration lamented: “. . .nowhere is there any indication of how to evaluate these five criteria. In a number of no-action letters, a single criterion established in the release has taken precedence over the remaining four.” Task Force on Integration, supra note 4, at 623.
commentator “warns, however, that ‘the differences must be substantial’] or separate plans of financing.” Additionally, “the position of the Commission seems to be that a one year delay may be sufficient to ensure separate issues of stock.”


2. The SEC’s Safe Harbors

a. Over the years, the Commission has established a number of safe harbor regimes respecting integration.39 Compliance with the Commission’s criteria for the particular safe harbor ensures the absence of integration; failure to meet the specific terms of any particular safe harbor, however, only means that the safe harbor is unavailable and that integration, therefore, is determined under the common law rules.

b. One purpose for these regulatory safe harbors respecting integration was to increase certainty. While the safe harbor rules may have decreased, at least to some degree, the ambiguity of integration, the regulatory integration regimes are needlessly and significantly complex and fail to connect the criteria for the safe harbor with any legitimate policy.40 The complexity in the regulatory safe harbors is due at least in

39Although Commission’s first safe harbor from integration appeared as early as 1935, Securities Act Release No. 33-305, 1935 WL 2617 (Mar. 2, 1935)(the earliest version of what became Rule 152), it was not until the 1970s that the Commission seriously pursued integration safe harbors through its adoption of certain regulatory exemptions from registration. The first of these was incorporated into old Rule 146, 17 C.F.R. § 320.146 (1975), which became effective in 1974 and was the predecessor to today’s Rule 506. Nearly contemporaneously with its adoption of Rule 146, the Commission also adopted Rule 147, 17 C.F.R. § 230.147 (2001), which contained an integration safe harbor identical to the integration safe harbor of Rule 146.

40Even the Commission’s more recent attempts to deal with integration through safe harbor provisions draw fire from commentators. For example, Professor Bradford writing on the current integration provisions of Regulation A states:

“The changes adopted [to the integration safe harbor rules in Regulation A] are generally positive and responsive to some of [the] . . . criticisms [from commentators,] . . . [b]ut the SEC’s failure to explain or justify provisions like Rule 251(c) produces unnecessary ambiguity and uncertainty. As a result . . . Rule 251(c) has failed to reach its potential.”
part to the sheer number of safe harbor regimes and the differences among the various regimes’ criteria. These complexities become especially apparent when two of the regulatory regimes interface with one another.

c. Presently, the Commission has at least seven different integration safe harbor regimes in its rules.42

d. In more recent years, the Commission seems to have made some effort to simplify and reduce the pernicious effects of its safe harbor regimes, thereby conceding, at least implicitly, the problematic worth of the integration doctrine. Thus, for example, the 1992 amendments to Regulation A43 appear to be an attempt both to simplify and ameliorate the impact of the integration doctrine in Regulation D.41

Bradford, Regulation A, supra note 6, at 289.

41Even those regimes that appear to be similar are not. Compare, for example, the integration regimes in Regulation D and Rule 147. Under Regulation D, offers and sales outside the six month window period will not destroy the integration safe harbor, so long as during the six month window periods the issuer makes no offers or sales of the same class of securities as are offered in the Regulation D offering. 15 C.F.R. § 230.502(a)(2001). Under Rule 147, however, safe harbor from sales outside the six month window periods requires not only clean windows but also that the sales outside the window periods be made “pursuant to [emphasis added] the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to [emphasis added] a registration statement . . . .” 15 C.F.R. § 230.147(b)(2) (2001).


A offerings. Briefly a Regulation A offering is now protected by safe harbor from any prior offering and from certain prescribed subsequent offerings (including all offerings made "more than six months after the completion of the Regulation A offering"), and the safe harbor of Regulation A, when applicable, provides two-way integration protection (i.e., it protects the Regulation A offering from contamination by the other offering and also protects the other offering from contamination by the Regulation A offering).

Rule 701, which essentially provides an exemption from registration for employee stock purchase plans of non-1934 Act companies, offers an even more generous safe harbor from integration by providing complete, two-way protection for and from any Rule 701 offering. Once again, integration is not applied to Rule 701 offerings; accordingly, a Rule 701 offering cannot contaminate any other offering and the other offering cannot contaminate the Rule 701 offering.

e. Regulation D's safe harbor is a regulatory regime you are likely to encounter

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44Regulation A provides an exemption from registration for offerings of up to $5 million by non-1934 Act companies. The exemption is predicated upon the filing of an "offering statement" with the Commission and providing each investor with an "offering circular". 17 C.F.R. §§ 230.251-.263 (2001).

45Rule 251(c), 17 C.F.R. § 230.251(c)(2001).

46Id. Professor Bradford provides an excellent discussion of this matter. Bradford, Regulation A, supra note 6, 270-73. Professor Bradford points out some scholarly disagreement on the notion that the integration protection under Regulation A is two-way. Id., at note 89, citing 3A Harold S. Bloomenthal, Securities and Federal Corporate Law 5-12 to 5-14 (1992 rev.)


48Once again, Professor Bradford provides a discussion of this integration provision. Bradford, Regulation A, supra note 6, at footnote 82. Professor Bradford points out that Professor Hicks has characterized the safe harbor as only "one directional", but Bradford argues that Hicks is wrong on this particular issue. Id.

49The Commission has also taken a special, generous integration approach for extra-territorial offerings made in compliance with Regulation S. In the Release adopting that Regulation, the Commission stated: "[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act, even if undertaken contemporaneously." Offshore Offers and Sales, Securities Act Release No. 33-6863 [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524, at 80,681 (Apr. 24, 1990).
when representing clients in financings.

(1) Regulation D offerings are protected by safe harbor from:

Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering ... so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act.50

(2) In most cases, the protection of the Regulation D offering from contamination depends on “clean window periods” and transactions that occur outside the “window period”.

(3) But, there are lurking complexities, including, for example, the matter of “one-way” protection. That is, the safe harbor of Regulation D only protects the Regulation D offer and thus offers no protection for the other non-Regulation D offering that may be matched with the Regulation D offering.

f. Rule 155 is the Commission’s newest regulatory safe harbor respecting integration. The Rule provides safe harbor in certain cases where private offerings are abandoned and followed by registered offerings and in certain cases where a registered offering is abandoned and followed by a private offering.

(1) Rule 155(b) provides a safe harbor for an abandoned private offering followed by a registered public offering.

(A) This is a classical integration problem. The private offering exemption is destroyed if the private offering is integrated with the subsequent public offering, and integration causes the offers made earlier in the private offering to amount to “gun jumping” in respect of the public offering.

(B) Safe harbor under Rule 155(b) is conditioned on the following: (i) No sales having been made in the private offering; (ii) terminating all offering activity in the private offering before the registration statement is filed; (iii) the prospectus in the registered offering must

disclose the abandoned offering; (iv) unless the private offering was limited to “Accredited” or sophisticated investors, the issuer must wait 30 days after the last selling activity before filing its registration statement.

(C) The private offering must have been undertaken under Section 4(2), Section 4(6) or Rule 506. This means, for example, the safe harbor will not work if the “private offering” were under Rule 504 or Rule 505.

(2) Rule 155(c) provides a safe harbor for an abandoned registered offering followed by a later private offering. 

(A) Safe harbor under Rule 155(c) is conditioned on the following: (i) No sales having been made pursuant to the registered public offering; (ii) the formal withdrawal of the registration statement; (iii) the passage of 30 days between the withdrawal of the registration statement and the start of the private offering; (iv) providing the private offerees with certain disclosures (including that the private offering is not registered, that the securities they take will be restricted, that the private purchasers do not have the protection of Section 11 of the 1933 Act, and facts about the abandonment of the original public offering); and (v) disclosure of any changes in the issuer occurring after the registration statement was filed.

(B) The private offering must have been undertaken under Section 4(2), Section 4(6) or Rule 506. This means, for example, the safe harbor will not work if the “private offering” were under Rule 504 or Rule 505.
ARTICLE

THE OVERWHELMING CASE FOR ELIMINATION OF THE INTEGRATION DOCTRINE UNDER THE SECURITIES ACT OF 1933

Rutheford B. Campbell, Jr.
ARTICLES

The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933

BY RUTHEFORD B CAMPBELL, JR.*

I. INTRODUCTION

The integration doctrine is one of the most vexing and pointless concepts of the Securities Act of 1933 (the "1933 Act").

* Alumni Professor of Law, University of Kentucky College of Law. B.A. 1966, Centre College; J.D. 1969, University of Kentucky; LL.M. 1972, Harvard University. The author is indebted to Rodney Chrisman, Jonathan Helton and David Longenecker for their research assistance.

Some indication of this, as well as an indication of the significance of the doctrine to issuers and thus to capital formation generally, is seen in the sheer numbers of integration no-action requests received by the Securities Exchange Commission (the "SEC"). Professor Wade reports, for example, that from 1971 to 1979, the SEC received nearly 200 no-action requests on integration. Cheryl L. Wade, The Integration of Securities Offerings: A Proposed Formula That Fosters the Policies of Securities Regulation, 25 LOY. U. CHI. L. J. 199, 220 (1994). Indeed, the SEC was apparently so overwhelmed by the volume of letters that in 1979 it announced it would no longer respond to no-action letters respecting integration matters. Cloer Fin. Corp., SEC No-Action Letter, 1979 WL 13557, at *7 (Apr. 5, 1979) (citing as reasons for discontinuing its prior practice of issuing no-action letters on integration "the complexity" of the matter and "the possibility that staff positions . . . may be misconstrued and misapplied"). In 1985, the Commission's Corporation Finance Division announced it would resume responding to no-action requests on integration matters. 17 Sec. Reg. & L. Rep. (BNA) 403 (Mar. 8, 1985) (stating that the five factors in § 502(a) of Regulation D would be considered in the letters).
Under the integration doctrine, a single "offering" or "issue" of securities cannot be split. Offering, for example, one-half of the shares under the private placement exemption from registration provided by section 4(2) of the 1933 Act and the other one-half under the intrastate exemption provided by section 3(a)(11). The rule similarly prohibits splitting a single offering or issue between a registration statement and any exemption from registration. In all events, therefore, the whole of any discrete offering or issue of securities must be offered and sold under only one exemption or a registration statement.


3 That section provides an exemption from registration for:
   Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

4 For the purposes of this Article, the author generally uses simple and somewhat sterile examples. While these examples are typical, they are far from exhaustive. Several additional examples may be helpful in appreciating the pervasiveness of the integration issues faced by companies engaged in capital formation.

One of the most difficult integration problems that this author faced in his practice days involved the unseasoned and unsophisticated (but otherwise honest and efficient) entrepreneur who, before seeking legal advice, made an offer of its securities in a manner that destroyed all available exemptions from registration. The only way to cure such a problem is to separate the prior illegal offer from the proposed financing through application of the integration doctrine.

Another example is derived from an actual case arising some years ago when tax shelter deals were fashionable. Entrepreneurs would form multiple limited partnerships for the purpose of engaging in certain activities—drilling for oil and gas, for example. Each of these partnerships would have different properties and investors but would have the same promoters and be engaged in the same type of enterprises. The question arose whether the separate offerings by these separate entities must be integrated. See, e.g., Donohoe v. Consol. Operating & Prod. Corp., 982 F.2d 1130 (7th Cir. 1992) (refusing to integrate separate limited partnerships formed to drill separate oil wells). For a discussion of this in the context of multiple partnership offerings, see ABA Subcomm. on P'ships, Trusts and Unincorporated Ass'ns, Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering, 37 BUS. LAW. 1591 (1982) [hereinafter Integration of Partnership Offerings]. For additional treatment, see ABA Comm. on Fed. Reg. of Sec., Integration of Securities Offerings: Report of the Task Force on Integration, 41 BUS. LAW. 595, 621-23, 624-31 (1986) [hereinafter Task Force on Integration].
Accordingly, if an issuer attempts to bifurcate a single offering into two separate components and qualify each component under a separate exemption or, alternatively, under an exemption and a registration statement, courts or the Commission may conclude that the two putatively separate offerings in fact amount to a single offering and thus may "integrate" the two transactions into a single offering. Once this integration occurs, the breadth of the offering or issue is defined, and all the offers and sales within this defined offer or issue must either meet all the requirements of a single exemption or be made subject to an effective registration statement. 5

Although the integration doctrine, described in these abstract terms, has a sensible ring to it, commentators over the years have picked at the doctrine. 6 Much of their critical comment has focused on the confusion and uncertainty in the doctrine's terms 7 and the pernicious impact such ambiguity has on the capital formation activities of issuers. 8


6 For criticism from commentators, see, for example, C. Steven Bradford, Regulation A and the Integration Doctrine: The New Safe Harbor, 55 Ohio St. L.J. 255, 289 (1994) [hereinafter Bradford, Regulation A]. Bradford characterizes changes to the safe harbor rules of Regulation A as "generally positive and responsive to... criticisms," but laments that "Rule 251(c) has failed to reach its potential." Id. See also Johnson & Patterson, supra note 5 (offering a critical analysis of Rule 152). Writing in 1986, this author criticized the doctrine as applied to Regulation D offerings. Rutheford B Campbell, Jr., The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention, 74 Ky. L.J. 127, 162-70 (1985-86). In his most recent article, Professor Bradford mounted a substantial criticism of the integration doctrine, proposing a solution to the difficulties generated by integration through adoption of a "weighted exemption system." C. Steven Bradford, Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions, 49 Emory L.J. 437, 473-85 (2000) [hereinafter Bradford, Expanding].

7 Even those who generally support the concept of integration in theory admit that the doctrine is confusing and inconsistent in application. See, e.g., Wade, supra note 1, at 208-30.

8 For example, Johnson and Patterson provide a description of the "irksome manner in which the integration doctrine constrains capital financing decisions."
On at least two occasions, committees of the American Bar Association (the "ABA") tried their hands at bringing some sense and order to portions of the integration doctrine. The most significant of these ABA initiatives occurred in the mid-1980s, when a prestigious committee, driven primarily by concerns of the practicing bar over the unmanageable levels of ambiguity in the doctrine, proposed regulatory amendments to establish a series of broadly available safe harbors from integration. Interestingly and tellingly, however, the Chair of the Task Force admitted some years later that "the hopes of the task force have largely not been realized, . . . with the result that integration issues remain a serious problem."12

Johnson & Patterson, supra note 5, at 539. The authors appropriately focus on the special problems of start-up businesses. Id. at 540.

Interestingly, one author seems prepared to argue that ambiguity in the integration doctrine actually contributes to capital formation, albeit the type of capital formation she dislikes. Professor Wade states: "The ability of issuers to manipulate the factors of the SEC's current integration formula allows them to avoid the application of the integration doctrine and thereby successfully evade the Act's registration requirements." Wade, supra note 1, at 240.

Integration of Partnership Offerings, supra note 4 (discussing and suggesting proposals respecting the application of the integration doctrine to successive offerings by affiliated partnerships). This article and its proposals drew sharp criticism from Dean Morrissey. Morrissey, supra note 5, at 76 (characterizing the proposal as "an elegant attempt to circumvent the registration process by artificially expanding its carefully restricted exemptions"). The second ABA paper was Task Force on Integration, supra note 4 (dealing more broadly with the integration doctrine and making recommendations of broad application respecting the doctrine).


11 The Task Force divided its safe harbor suggestions into six categories: "issuer distinctions, temporal separations, differences in securities offered, purpose differences, policy considerations, and domestic and foreign offering distinctions." Task Force on Integration, supra note 4, at 624. For a discussion of these proposals, see id. at 624-41. For a reproduction of the specific regulatory proposals, see id. at 642-43.

12 Goldwasser, supra note 10, at 230-31.

The report of the Task Force reflects the extreme theoretical difficulties encountered when one attempts to lend clarity and consistency to the integration doctrine. The problem, from the author's perspective, is that the doctrine itself is
Even the Securities and Exchange Commission, which is the doctrine's principal architect, appears to recognize that the integration doctrine has its problems. As a result, the Commission has developed certain discrete, regulatory safe harbors from integration13 and recently has been especially generous in its rules protecting issuers, at least in limited situations, from the perniciousness of the doctrine.14

Scholars and the Commission, however, misperceive the true nature of the integration problem, and, as a result, their prescriptions are overly modest. The fundamental problem with integration is not its terms; rather, the problem lies in the essential vacuousness of the doctrine itself. At its core, the doctrine makes no sense. Indeed, the doctrine is so utterly unsupported by any valid policy15 that

fundamentally nonsensical. Drafting rules without a principled theoretical footing is, of course, a problematic exercise. Thus, one can sympathize with the Task Force's frustration as it attempted to establish order in such a context.

In fact, the approach of the Task Force, in light of such circumstances, makes some sense. The Task Force opted to propose a series of safe harbor provisions designed to clarify, simplify, and reduce the application of the doctrine. See supra note 11. The perniciousness of a nonsensical doctrine is ameliorated if the rules respecting its application are simple and clear. At least clarification and simplification reduce the transaction costs in those deals in which the doctrine is implicated, since, for example, the legal costs in determining the application of the doctrine are reduced by the enhanced clarity of the rule. Similarly, to the extent the scope of integration is reduced by such safe harbors, the perniciousness of the doctrine is once again mitigated.

13 For a list of the Commission's integration safe harbor rules, see infra note 77.

Unfortunately, the Commission's effort to eliminate uncertainty in the application of the integration doctrine has been unsuccessful in most instances. See discussion infra accompanying notes 56-65.

15 Other commentators, however, are able to find purpose and sound policy at the core of the integration doctrine. See, e.g., Wade, supra note 1, at 209 (stating that the doctrine was designed "to prevent issuers from circumventing the Act's registration requirements"), and id. at 240 (concluding that without the doctrine, issuers may "successfully evade the Act's registration requirements"); Johnson & Patterson, supra note 5, at 542-43 (remarking that "the doctrine of integration still is needed"), and id. at 543 (finding "all-important... policy underpinnings" for the
one can only marvel that it has existed essentially unchallenged since 1933.\textsuperscript{16}

The thesis of this Article is that the Commission should entirely eliminate the integration doctrine from the 1933 Act. The doctrine is expensive for society\textsuperscript{17} and furthers no valid policy of the 1933 Act. More

\textsuperscript{16} As indicated above, commentators have occasionally argued for a limited elimination of the integration doctrine. For example, Professor Deaktor, writing in 1979, expressed a preference for the SEC to “exercise its rulemaking authority to eliminate the applicability of integration to all offerings made pursuant to a transactional exemption other than section 3(a)(9).” Deaktor, supra note 5, at 550. Professor Deaktor apparently would condition this limited elimination of integration on the Commission's enactment of a series of new rules pursuant to the transactional exemptions “which will contain every precaution necessary to protect investors who are offered or purchase securities in the offerings made pursuant to these rules.” \textit{Id.} at 544.

\textsuperscript{17} The integration doctrine increases the costs of capital formation in various ways, some of which are apparent and some of which are not. Obvious costs are encountered, for example, when the integration doctrine necessitates the registration of an offering when a valid exemption from registration otherwise would be available. At least one author, however, may even dispute the significance of this cost. \textit{See} Morrissey, supra note 5, at 77 (stating that “registration is not . . . a serious impediment to capital formation”). Dean Morrissey, however, may be in a minority in his view on this issue. \textit{See}, e.g., 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.6, at 49 (2d ed. 1990) (estimating that in 1990 the costs of a public offering, including underwriting fees, may have been “more than several hundred thousand dollars”); Carl W. Schneider et al., \textit{Going Public: Practice, Procedure, and Consequences}, 27 VILL. L. REV. 1, 31 (1981) (estimating in 1981 that costs for an initial public offering, not including underwriting fees, ran \$175,000 to \$350,000).

A less obvious economic cost of the integration doctrine, however, is the economic costs of the risk it generates. To use a simple example, an issuer may propose to sell a block of securities under a section 4(2) exemption today and another block under the section 3(a)(11) exemption four months from now. The lawyer may tell the issuer: “It is more likely than not that the two offerings will not be integrated, but there is a 20% chance, nonetheless, of integration. If integration occurs, your liability will be approximately \$1 million.” This risk is a cost to the
specifically, the doctrine does not promote investor protection but does retard capital formation, an outcome that is contrary to the presently articulated purposes of the 1933 Act.\textsuperscript{18}

Part II of this Article traces the history of the adoption of the integration doctrine both by the Commission and the courts, demonstrating the less than compelling case for the original adoption of the rule.\textsuperscript{19} Part III then outlines the shape of the rule today, in an attempt to demonstrate its uncertainty, complexity, and lack of connection to any valid principle.\textsuperscript{20} In Part IV, the Article proposes the author's simple prescription for the problems of integration, and that prescription is the complete elimination of the doctrine.\textsuperscript{21}

II. A HISTORY OF THE INTEGRATION DOCTRINE

A. The Original 1933 Act

As originally signed into law, the 1933 Act contained no clear statement of an integration doctrine.\textsuperscript{22} Thus, while at various points in the original 1933 Act one finds words that can be interpreted as relevant to the matter of integration, the statutory language is inconclusive. Indeed, to the extent the original language is suggestive of integration, it actually indicates different integration regimes for different types of offerings.\textsuperscript{23}

At least four of the major exemptions from registration in the original version of the 1933 Act contained language that can be considered relevant to the matter of integration, and no language from any of the four sections

\begin{itemize}
  \item \textsuperscript{18} See infra notes 99-102 and accompanying text.
  \item \textsuperscript{19} See infra notes 22-47 and accompanying text.
  \item \textsuperscript{20} See infra notes 48-95 and accompanying text.
  \item \textsuperscript{21} See infra notes 96-108 and accompanying text.
  \item \textsuperscript{22} Although, not surprisingly, the Securities Act of 1933 (the "1933 Act") has been amended on numerous occasions since it was originally enacted, the structure of the original 1933 Act and, indeed, even its content, are fundamentally similar to today's version. \textit{Compare} Securities Act of 1933, ch. 38, 48 Stat. 74, \textit{with} 15 U.S.C. §§ 77a-77aa (1994). For a discussion of the four major exemptions in the original 1933 Act, see infra notes 24-31 and accompanying text. For a history of the enactment of the 1933 Act, see \textit{1 Loss & Seligman, supra} note 5, at 168-223.
  \item \textsuperscript{23} A valid policy reason supporting multiple integration schemes is difficult to imagine. See infra note 32 and accompanying text.
\end{itemize}
is consistent with the language from any other section. Consider first the original private placement exemption, which was found in section 4(1) of the original version of the 1933 Act and stated that "[t]he provisions of section 5 shall not apply to ... [t]ransactions by an issuer not with or through an underwriter and not involving any public offering." On its face, this exemption arguably excludes any application of an integration concept. If a "transaction" meets the requirements of the exemption, prior or subsequent additional transactions appear, under the terms of the statute, to be irrelevant.

Next, consider the exemption provided by the first clause of the original section 4(3), which was essentially the same exemption for single company reorganizations provided by today's section 3(a)(9). The original section 4(3) stated that "[t]he provisions of section 5 shall not apply to ... [t]he issuance of a security of a person exchanged by it with its existing security holders exclusively." Once again, an integration concept does not appear on the face of this exemption. Instead, the language seems to exempt from registration the issuance of any security that is sold in exchange for an outstanding security, without regard to whether the issuer, for example, may recently have sold securities under another exemption. Nothing in the language of the section suggests that such prior sales would ever exclude the availability of the exemption, unless one is able to bend the word "exclusively" into some indication of an integration concept, and that appears to be something of an interpretative stretch.

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26 Securities Act of 1933, § 4(3).

27 Notwithstanding the author's view about the clear language of the exemption, the Commission later took the position that the word "exclusively" required the application of the integration concept. Securities Act Release No. 33-2029, 1939 WL 1053 (Aug. 8, 1939). See also 3 LOSS & SELIGMAN, supra note 5, at 1232. These distinguished authors disagree with the author regarding the proper interpretation of the statute, and give the Commission's interpretation mild approval by characterizing the Commission's interpretation as one "which seems as logical as any." Id. Professor Loss and Dean Seligman characterize the Commission's interpretation of the word "exclusively" as doing "double duty." Id. In fact, the word does triple duty: It means that shareholders making the exchange
The third significant original exemption was section 3(b), which authorized the appropriate administrative agency to enact additional exemptions, if such regulatory exemptions were consistent with the "public interest" and "investor protection." Exemptive regulations under section 3(b) were subject to the following limitation, however: "no issue of securities shall be exempted [if] . . . the aggregate amount at which such issue is offered to the public exceeds $100,000." §28 This language seems significantly more suggestive of an integration doctrine than does the language of the two exemptions discussed above, since, at least arguably, the perimeter of the section 3(b) "issue" must be established in order to calculate whether the amount limitation has been exceeded.

Finally, consider the original intrastate exemption, which at the time of the adoption of the 1933 Act was in section 5(c) and provided that the registration obligation "shall not apply to the sale of any security where the issue of which it is a part is sold only" pursuant to the terms of the intrastate exemption. §29 This language may seem even more indicative of

cannot throw in any additional contribution, that the sale of any security to a non-shareholder is not eligible for the exemption, and that the common law integration doctrine is applied to the exemption.

For an outstanding discussion of section 3(a)(9), see J. William Hicks, Recapitalizations Under Section 3(a)(9) of the Securities Act of 1933, 61 VA. L. REV. 1057 (1975).

§28 Securities Act of 1933, ch. 38, § 3(b), 48 Stat. 74, 77 (current version at 15 U.S.C. § 77c(b) (1994)). The original section 3(b) provided:

The Commission may . . . add any class of securities to the securities exempted . . . , if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $100,000.

Id. at 76-77.

integration than the language in the original section 3(b). Arguably, the language of this original intrastate exemption suggests that valid sales under the exemption would be lost if subsequent sales, which were part of the same issue, were sold under another exemption or a registration statement. 30

One must, however, be careful not to overstate the validity of any of the foregoing interpretations. 31 Indeed, while this discussion suggests that

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30 Even this original intrastate exemption, however, is amenable to other interpretations that would avoid the problems of integration. For example, a court could define "the issue of which [the intrastate sale] is a part" to include only offers and sales that meet the requirements of the intrastate exemption. To illustrate this interpretation, assume that on January 1 an issuer offered and sold 100 shares of stock pursuant to the private placement exemption, on January 5 offered and sold 100 shares of stock pursuant to the intrastate exemption, and, finally, on January 10, offered and sold 100 shares illegally. Under the interpretation proffered here, the criteria for including the January 1 and January 10 offerings in the January 5 "issue" would not include, for example, whether the January 1 and January 10 offerings were made virtually contemporaneous with and involved the same class of securities as the January 5 offering. Rather, the criteria for including the January 1 and January 10 offerings as a part of the "issue" of January 5 would require assessing whether the January 1 and January 10 offerings were made to persons residing in the same state as that in which the issuer was incorporated and doing business.

By defining "issue" in such a way, the court could avoid the pernicious effect of permitting offers and sales taking place around the intrastate offering from eliminating the availability of the exemption when the policy bases for its application are otherwise legitimate. Notice that under this interpretation purchasers of securities in the January 1 offering and the January 5 offering would not have a cause of action, while those purchasing in the illegal January 10 offering would have a cause of action. This is the sensible and correct outcome. This interpretation would also bring the interpretation of the integration matter with respect to the intrastate exemption into line with the plain meaning of the private placement exemption, which has no hint of any integration concept. See supra note 24 and accompanying text.

Another, less pernicious interpretation of the integration matter in the intrastate exemption is offered later in this Article. See infra note 40 and accompanying text.

31 While the point of this section is to recount the birth of the integration doctrine, it is also relevant to consider the modern language respecting integration and the question whether the post-1933 amendments have altered the obligation to read an integration concept into the 1933 Act.

The original private placement exemption provided an exemption for "transactions by an issuer not with or through an underwriter and not involving any public offering." Securities Act of 1933, ch. 38, § 4(1), 48 Stat. 74, 77 (current
the language of the particular exemptions provides essentially no support for integration in the case of the original private placement exemption, only a small amount of support for integration in the case of the original single company recapitalization exemption, but more support for integration in the cases of the section 3(b) exemption and the old intrastate exemptions, in fact, none of these conclusions is founded on anything approaching clear language.32

The other interesting and somewhat confounding observation to be made here is the fact that those original exemptions contain such different language respecting a possible integration concept. The problem, of course, is that a valid policy reason supporting multiple integration schemes is difficult to imagine. Thus, one is hard pressed to articulate, for example, a plausible basis for different rules defining the scope of an “issue” or an “offering” made under the intrastate exemption, on the one hand, and one made under the private placement exemption, on the other.

version at 15 U.S.C. § 77d(2) (1994)). Today’s private placement language is identical, except that the requirement that the transaction not be “with or through an underwriter” has been eliminated. 15 U.S.C. § 77d(2). This change appears irrelevant to the matter of integration.


The original section 3(b) exemption is substantially unchanged in the modern version of the 1933 Act; the only difference is that the amount limitation has been raised from $100,000 to $5,000,000. Compare Securities Act of 1933, ch. 38, § 3(b), 48 Stat. 74, 76-77, with 15 U.S.C. § 77c(b) (1994).

As originally adopted, the intrastate exemption excluded from the registration obligation “any security where the issue of which it is a part is sold only to” local residents. Securities Act of 1933, ch. 38, § 5(c), 48 Stat. 74, 77-78 (current version at 15 U.S.C. § 77c(a)(11) (1994)). Today’s intrastate exemption excludes from registration “[a]ny security which is part of an issue offered and sold only to” local residents. 15 U.S.C. § 77c(a)(11). This change appears to be immaterial as concerns integration.

32 See, e.g., discussion supra note 30. Johnson and Patterson, in their thoughtful work on Rule 152, state that the integration doctrine is “not expressly a part of federal securities statutes.” Johnson & Patterson, supra note 5, at 542. Instead, they describe integration as “a doctrinal construct born of regulatory necessity.” Id. Unlike the author, however, these authors find several “all important . . . policy underpinnings of the integration doctrine” and argue that the doctrine “still is needed.” Id. at 543.
Perhaps one can argue that Congress had more faith in one or the other of those exemptions, and thus, through varying the terms of the integration concept, determined to expand the scope of the doctrine for sound exemptions while contracting it for those less sound. Such an indirect way of limiting exemptions, however, makes little sense. If, for example, Congress were afraid that offerings under the intrastate exemption would simply get too big to justify an exemption, it could have imposed an upper limit on the exemption, perhaps $1,000,000. To argue that Congress somehow purposefully chose to deal with such a matter by imposing differing integration concepts on the various exemptions seems far-fetched.\footnote{On the other hand, a more plausible explanation for the “differing” approaches to integration in the four original exemptions may be that no one ever envisaged an integration doctrine at all or certainly ever imagined it would take on such a life as it presently enjoys. For this author, therefore, the apparently differing treatments of integration in the original 1933 Act actually weaken any argument that integration is required by the language of the 1933 Act.}

B. The “Creation” of the Doctrine


As luck would have it, the first administrative opinion on the matter of integration involved an interpretation of the original intrastate exemption,\footnote{Securities Act Release No. 33-97, 1933 WL 2080 (Dec. 28, 1933). Apparently in the months following the adoption of the 1933 Act, the Federal Trade Commission (the “FTC”), which was initially assigned administrative responsibility over the 1933 Act, began to respond in letters to inquiries about the new 1933 Act. In 1933, therefore, the FTC issued the foregoing Release, which consisted of}
which, as described above, contained some of the most compelling language supporting an integration concept. Also, as luck would have it, the facts involved in that first opinion appear about as strong as one can imagine for the application of an integration concept. Since this opinion is the genesis of the integration doctrine, it merits discussion.

Shortly after the 1933 Act was passed, a company apparently filed a registration statement for an offering of securities to be sold to the public in various states. The question posed by the issuer was whether during the waiting period it could begin to sell these securities under an intrastate exemption and then after the effective date of the registration statement complete the offering across state lines pursuant to the registration statement.\(^{37}\)

These facts, therefore, were particularly compelling for the administrative adoption of an integration concept. The “issue” of securities clearly had been defined by the registration statement filed by the company, which proposed to register for sale a defined number of shares of the company’s stock. The issuer, by its own admission, proposed to sell a portion of those particular securities pursuant to the intrastate exemption and then to sell the balance of the securities pursuant to a registration statement.\(^{38}\)

Considering these unusually strong facts, the agency’s lack of experience, and the relatively compelling integration language of the original intrastate exemption, the FTC’s adoption of an integration concept in its opinion is perhaps not surprising.\(^{39}\) Unfortunately, it was a wrong decision and one that since 1933 has generated confusion and inappropriate outcomes. To make matters even more unfortunate, the decision was one that was not required by the words of the Act.\(^{40}\)

excerpts from a number of these letters, including one letter dealing with integration. Id. at *1.

\(^{37}\) Id. at *5.

\(^{38}\) Id.

\(^{39}\) Id.

\(^{40}\) An administrative opinion by the SEC two years later provides support for interpreting the language of the intrastate exemption as intended to deal with resales, a vertical matter, instead of integration, a horizontal matter.

In In re Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935), the issuer, a New York Corporation, attempted to utilize the intrastate exemption by selling bonds to four New York banking houses. The banking houses, however, resold the bonds to non-New York residents. The Commission relied on the language in section 3(a)(11), which limited the availability of the exemption to a “security which is a part of an issue sold only to persons resident within a single State,” and found that this language prohibited quick resales of such securities to persons who
Nonetheless, five years later, after the SEC had taken over for the FTC as the regulatory agency with primary responsibility for the administration of the 1933 Act, the SEC with seeming facility promulgated its famous *In re Unity Gold Corp.* opinion in which it reaffirmed the FTC's integration doctrine, applied it to an offering under section 3(b), and commenced an articulation of the criteria it proposed to use to determine whether putatively separate offerings would be integrated. Integration at that point resided outside the state of New York. *Id.* at 161-62. In broad terms, the Commission found that to be "an issue sold only to persons resident within" New York, all shares of the offering had to come to rest in the hands of New Yorkers. The FTC could have taken the same position in its Release and further concluded that the language of the intrastate exemption was intended only to limit resales.

Interestingly, the *In re Brooklyn Manhattan Transit Corp.* opinion is sometimes cited—mistakenly, in the author's view—as an integration case. See Morrissey, *supra* note 5, at 55 n.133 (stating that it was "the SEC's first application of the integration doctrine to intrastate offerings").

In a release promulgated in 1937, two years after its opinion in *In re Brooklyn Manhattan Transit Corp.*, the Commission once again interpreted the same language in section 3(a)(11) (language predicating the availability of the exemption on the fact that the securities are "part of an issue sold only to persons resident within" a particular state) as limiting interstate resales until the shares had "reached the hands of [local] purchasers buying for investment and not with a view to further distribution or for purposes of resale," or, as the Commission said elsewhere, until the shares "actually come to rest in the hands of resident investors." Securities Act Release No. 33-1459, 1 Fed. Sec. L. Rep. (CCH) ¶ 2260, at 2261-62 (May 29, 1937).


42 *In re Unity Gold Corp.*, 3 S.E.C. 618 (1938). In March of 1937, Unity Gold sold 75,000 shares of its stock to Mr. Cronan under section 3(b) and the Commission's regulations that formed the predecessor to the modern Regulation A. When, in May of 1937, Unity Gold filed a registration statement for approximately 600,000 additional shares of its stock, the question arose as to whether that subsequent registered offering would be integrated back into the prior sales under section 3(b), thereby destroying the section 3(b) exemption due to the failure to abide by the $100,000 amount limitation of that section. *Id.* at 624-25.

The Commission easily found that the section 3(b) offering was part of the same issue as the registered offering and thus integrated the two, which destroyed the availability of the section 3(b) portion of the offering. The Commission concluded that the determination whether the two components should be considered a "single issue" depended upon "various factors concerning the methods of sale and distribution employed to effect the offerings." The following were cited by the Commission as factors indicating the appropriateness of integration: "securities of the same class, offered on the same general terms to the
became firmly established as a Commission doctrine, and the Commission has never wavered in its position that integration is an integral part of the 1933 Act.43

Interestingly, courts did not get involved in any significant integration matters until nearly 1960,44 and even then their contribution to the development of the doctrine was simply to accept the doctrine as developed previously by the Commission.45 Thus, while these early judicial decisions on integration reflect the inherent difficulty that unspecialized tribunals of general jurisdiction have in dealing with matters as technical and complex as integration,46 courts without hesitation accepted the integration doctrine public in an uninterrupted program of distribution,” and a “single, integrated plan for the distribution.” The Commission cited “material differences in the use of the proceeds, [and] in the manner and terms of [the] distribution” as factors weighing against integration. Id. at 625.

43 The SEC has, however, developed different criteria for integration, depending on the particular exemption or registration involved. See infra notes 70-77 and accompanying text. Also, the Commission has ameliorated the impact of the doctrine in certain limited cases. See infra notes 85-92 and accompanying text.

44 For a discussion of the early integration cases, see infra note 45.


Professor Loss and Dean Seligman observe that “the Commission’s standard [for common law integration] in recent years has often been followed by courts.” Loss & Seligman, supra note 5, at 1213. Professor Deaktor, however, seems to disagree, stating that “a relatively large proportion of the integration cases make no mention of the work of the SEC in the area, nor of cases or authorities which have drawn on that work.” Deaktor, supra note 5, at 509.

46 For example, the court’s treatment of the integration issue in Shaw v. United States, 131 F.2d 476 (9th Cir. 1942), is essentially unintelligible. The cases following Shaw, while broadly intelligible, are nonetheless confusing and based on uncertain principles and fail to articulate with clarity the criteria of integration.

Thus, in Hillsborough I, 173 F. Supp. at 86, the second reported case dealing with integration, the court held that Hillsborough could not rely on the intrastate exemption because of recent interstate sales of its securities. Virtually the only explanation offered for integration in this case was a statement of the court indicating that it would integrate “all the shares of common character originally
essentially as it had been developed by the Commission and continue to apply the doctrine today.47

Id. at 88 (quoting Shaw, 131 F.2d at 478, 480). Obviously, such a statement is overbroad and essentially useless as a single criterion for integration.

The third reported integration case once again involved Hillsborough. SEC v. Hillsborough Inv. Corp. ("Hillsborough II"), 176 F. Supp. 789 (D.N.H. 1959), aff'd, 276 F.2d 665 (1st Cir. 1960). Shortly after the injunction was entered against Hillsborough in Hillsborough I, Hillsborough offered New Hampshire residents holding the previously issued shares the opportunity to exchange their shares for new shares that had somewhat different contractual terms. Hillsborough planned to sell additional, similar shares to other New Hampshire residents for cash, claiming that the entire new offering (i.e., both the part sold in the exchange and the part sold for cash) was exempt from registration under the intrastate exemption. Id. at 790.

Apparently based on its determination that the new securities "differ from the old securities [that were sold illegally] . . . only in a small degree," the court determined that the sale of the new securities under such a condition would be in violation of the 1933 Act. Id. While the outcome seems based on the notion that the old offering must be integrated with the new offering, the analysis is far from crisp and relies more on generalized notions of bad faith. In short, the opinion provides no meaningful analysis of the application of the integration doctrine or the criteria used to determine that the two offerings should be combined.

The fourth of the earliest integration cases is Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. at 830; here, too, the analysis of the court is less than precise. That case involved the application of the integration concept to offerings purportedly made under the intrastate exemption. The court apparently integrated the offerings because "[t]he terms and conditions under which [the offerings were made were] . . . identical." Id. at 871.

The purpose of this review is to point out that courts had difficulty in early integration cases. Such difficulty is understandable, given that the courts were dealing with complicated and technical matters for the first time.

C. Observations and Conclusion

The author offers two observations from his examination of the history of the integration doctrine. The first is that the original statutory language of the 1933 Act provided a less than compelling mandate for agencies or courts ever to adopt the integration doctrine in the first place. In some instances, the wording of the exemptions contained absolutely no language suggesting an integration doctrine; in other cases, the language was suggestive of integration but amenable to alternative interpretations. The second observation is that the entire integration doctrine goes back to an administrative opinion rendered by the FTC only a few months after the 1933 Act was passed. Thus, the doctrine was created approximately seventy years ago in the middle of the Great Depression by a completely inexperienced agency interpreting a new, highly technical statutory regime.

The conclusion of the author, therefore, is that statutory language, history, and precedent provide no compelling support for the continuation of the integration doctrine.

III. THE STATE OF THE INTEGRATION DOCTRINE TODAY

Over the years, able commentators have written on the integration doctrine and its application both broadly and in the context of specific situations. Professor Deaktor's article,48 although now over twenty years old, continues to be the most exhaustive law review article on the doctrine. Later works by Dean Morrissey,49 Professor Johnson and Steve Patterson,50

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48 Deaktor, supra note 5.
49 Morrissey, supra note 5.
50 Johnson & Patterson, supra note 5.
Professor Bradford, and Professor Wade all make significant contributions to the literature on integration, as do, of course, treatises, such as the definitive work by Professor Loss and Dean Seligman and the fine treatise by Professor Hicks. The point of this section of the Article, therefore, is not to restate the work of prior commentators by describing in detail the integration doctrine and its application to various situations. Instead, the description of the doctrine offered here is only for the purpose of supporting the author's critical points by highlighting the doctrine's ambiguity, the absence of any relationship between the criteria of integration and the purposes of the 1933 Act, and, finally, the doctrine's overwhelming and unnecessary complexity.

The discussion of today's integration doctrine can profitably be bifurcated into the common law rules of integration and the Commission's discrete safe harbor rules of integration.

A. The Common Law of Integration

The common law of integration traces its roots to the early administrative and court decisions described in the immediately preceding section and is applicable to offerings of securities in the absence of any specific Commission rule dealing with a particular integration matter.

The common law doctrine is best understood as the five factor integration test that is consistently articulated by the Commission. Thus in determining, for example, whether securities sold in January of a particular year under the intrastate offering will be integrated with securities sold in April of the same year under the private placement exemption, courts (or the Commission) will consider whether the two blocks of securities are (i) "part of a single plan of financing," (ii) "of the same class of securities," (iii) offered "at or about the same time," (iv) offered to generate the "same type of consideration" for the issuer, and (v) offered "for the same general purpose." In a common law analysis, therefore, the presence of each of

51 Bradford, Regulation A, supra note 6.
52 Wade, supra note 1.
53 3 Loss & Seligman, supra note 5, at 1211-28.
55 See supra notes 34-47 and accompanying text.
56 See the discussion in 3 Loss & Seligman, supra note 5, at 1212-13. The Commission, for example, both in Rule 147, 17 C.F.R. § 230.147 preliminary note 3 (2000), and in Regulation D, 17 C.F.R. § 230.502(a) note (2000), cited these
The foregoing is a factor that increases the probability that the January and April blocks of securities would be integrated and thus considered a single offering.\textsuperscript{57}

The very nature of these criteria makes them difficult to apply.\textsuperscript{58} In the first place, the meaning of the individual factors themselves are generally ambiguous and confusing. The "single plan of financing" factor, for example, not only is itself inherently ambiguous\textsuperscript{59} but also appears to be similar to the "same general purpose" factor.\textsuperscript{60}

\textsuperscript{57} Professor Deaktor's 1979 article, Deaktor, \textit{supra} note 5, at 529-38, and Professor Wade's later 1994 article, Wade, \textit{supra} note 1, at 211-20, provide separate, in-depth discussions of each of the five common law factors of integration. \textit{Task Force on Integration, supra} note 4, at 600-23, is also particularly rich in its research on the five common law factors of integration, although its discussion is organized around particular exemptions rather than around the factors themselves.

\textsuperscript{58} Loss and Seligman state, for example, that this "multifactor test may fairly be criticized as... 'indeterminate.'" \textit{3 Loss & Seligman, supra} note 5, at 1213. Professor Wade, although clearly supportive of the integration doctrine, concedes that the doctrine is confusing in its application. Wade, \textit{supra} note 1, at 211-27. "[T]he SEC's no-action letters and the opinions of courts have provided very little guidance with respect to the analysis that must be performed under the five factor test." \textit{Id.} at 221.

\textsuperscript{59} Loss and Seligman conclude that the "Commission staff's no-action letters are not entirely consistent" on the definition of a "single plan of financing." \textit{3 Loss & Seligman, supra} note 5, at 1214. They state, however, that the term "tends to refer to factors such as the method of offering the security, the timing of plans for raising capital, and whether the offerings are financially interdependent." \textit{Id.} Professor Wade agrees with Loss and Seligman on the three factors that make up the "single plan of financing" factor, also finding "confusion... from the SEC's and the courts' failure to define precisely and apply consistently the three suggested components of the single plan of financing factor." Wade, \textit{supra} note 1, at 212. Professor Deaktor states that the staff's definition of this factor "has lacked consistency." Deaktor, \textit{supra} note 5, at 529.

\textsuperscript{60} 3 \textit{Loss & Seligman, supra} note 5, at 1214 ("[T]here tends to be considerable overlap between instances in which there is a 'single plan of financing' and those in which there is the 'same general purpose.'"); Deaktor, \textit{supra} note 5, at 529 ("In some inquiries, the single plan of financing factor appears to have been equated with the purpose of the offerings factor."); Wade, \textit{supra} note 1, at 213 ("[C]ases and no-action letters commonly fail to distinguish between the single plan of financing and the same general purpose factors.").
The other integration factors are equally uncertain in their meaning. For example, it is unclear what types of contractual variances\(^{61}\) are necessary to establish that two securities are not part of the “same class of securities.”\(^ {62}\) How different do the contractual terms have to be in order to be separate classes? Are debt and equity always separate classes of securities? What if the equity is a preferred stock and the debt is a subordinated debenture that have essentially the same rights, except for the preference of the debentures over the preferred in bankruptcy?

Finally, and certainly without attempting to be exhaustive regarding the inherent ambiguity in the common law integration factors, consider the “at or about the same time” factor. Obviously, the time between the sale of two blocks of securities can be one day, one month, one year, etc. How far apart do the two sales have to be in order to be considered not “at or about the same time”?\(^ {63}\) A related uncertainty regarding the “at or about the same time” factor is the question of whether it is an all-or-nothing matter or, instead, a factor that counts more (or less) as the two offerings become closer (or more remote) in time. Under an all or nothing regime, the existence of the factor might be established by a discrete line (six months, for example) and all sales within that six month period would be considered “at or about the same time” and would count the same toward integration, whether such sales are one day apart or five months and twenty-nine days apart. Alternatively, the factor could operate without a discrete line and could vary in its weight, depending on how far apart in time the two blocks are sold. Under this analysis, offerings one year apart, for example, may still have a small tendency to support integration, while

\(^{61}\) Interestingly, Professor Deaktor in his discussion of the meaning of separate classes emphasizes, instead of contractual differences between or among securities, the identity of the issuer and the identity of the offerees. Deaktor, supra note 5, at 531-32.

\(^{62}\) Wade, supra note 1, at 216-18. “[T]he SEC and courts have failed to articulate a precise formula to determine whether securities are of the same class.” Id. at 216. Although Loss and Seligman characterize the Commission’s approach to this element as “relatively straightforward,” 3 LOSS & SELIGMAN, supra note 5, at 1218, their subsequent discussion of the element suggests significant uncertainty. Id. at 1219-21.

\(^{63}\) For example, although Loss and Seligman opine that the six months safe harbor provision of Rule 147 and Regulation D “suggests that a six-month period ... will be necessary to demonstrate that it was not made ‘at or about the same time,’” 3 LOSS & SELIGMAN, supra note 5, at 1221, the authors state that a separation of “six months or more will alone not necessarily lead to nonintegration.” Id. at 1222.
offerings one day apart may have a much stronger tendency to support integration.\footnote{64}

Beyond the inherent ambiguity in the common law integration factors themselves, an additional and perhaps even more significant ambiguity is generated by the uncertainty about the particular mix of factors required for integration.\footnote{65} Is one out of five factors sufficient to require integration? Two out of five? Do some factors count more than others?\footnote{66}

What is the relationship between strength and number? Does the strength of a factor

\footnote{64} Professor Deaktor opines that “[p]roximity in time . . . has seldom been determinative.” Deaktor, \textit{supra} note 5, at 534.

\footnote{65} “Neither the Commission nor the courts have provided express guidance on how to weigh these factors when analyzing an integration problem.” 3 \textsc{Loss & Seligman, supra note 5, at 1222.}

One is, of course, reminded of the old Treasury Regulations for determining whether a business entity other than a trust (called an “association” by the regulations) was to be taxed as a partnership or a corporation. In order to make this determination, the regulations set forth four major corporate characteristics that distinguished a corporation from a partnership. These characteristics were (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of ownership interests. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1960). An entity exhibiting any three of these corporate characteristics would be taxed as a corporation, while an entity exhibiting less than that number would be taxed as a partnership. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1960). See Thomas M. Hayes, \textit{Note, Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification, 54 Wash. & Lee L. Rev. 1147, 1151-1160 (1997), for a discussion of how the old regulations functioned.}

Interestingly, and perhaps instructively for this paper, the Treasury eventually replaced the corporate resemblance test with a regime allowing the taxpayer, within broad rules, to elect whether it will be taxed as a partnership or a corporation. Treas. Reg. §§ 301.7701-1 to -6 (as amended in 1996). \textit{See generally} Hayes, \textit{supra}, at 1160 (describing the function of the new regulations).

\footnote{66} Loss & Seligman suggest that “[a] review of the cases and no-action letters strongly suggests that the ‘single plan of financing’ and ‘same general purpose’ factors normally are given greater weight than the other factors.” 3 \textsc{Loss & Seligman, supra note 5, at 1222.} Professor Deaktor opines that “even if [offerings are] simultaneous [and are thus made ‘at or about the same time’], one or more of the other integration factors often will be viewed as more important.” Deaktor, \textit{supra note 5, at 534.} \textit{See also} Wade, \textit{supra note 1, at 214 (“Like the single plan of financing factor, the weight of the same general purpose factor in the integration analysis is unclear.”).
count more than the number of factors—for example does three strong factors weigh more heavily than four weak factors?  

The point need not be belabored. Essentially, everyone concedes the ambiguity in the common law criteria of integration and the difficulty of applying the criteria. Indeed, this view appears to be held even by commentators who, unlike this author, are able to find a policy basis for integration and thus (broadly, at least) support some continued role for the doctrine.  

An even more troubling aspect of the current common law of integration is the absence of any connection between the integration criteria and sound policy. Indeed, the common law criteria of integration actually encourage conduct on the part of issuers that is socially counterproductive. This problem is best demonstrated by focusing on the common law integration factors and the steps an issuer may take under those tests in order to avoid integration. Assume once again a simple situation in which an issuer completes an intrastate offering of its common stock in January and then proposes to offer more securities in April under the private placement exemption. To avoid integration in such a case, the issuer is encouraged by the common law integration criteria to offer a different class of securities, perhaps preferred shares, in its subsequent April offering and to delay the proposed April offering, perhaps for many months.  

67 At one point in its work the ABA Task Force on Integration lamented: “[N]owhere . . . is there any indication of how to evaluate these five criteria. In a number of no-action letters, a single criterion established in the release has taken precedence over the remaining four.” Task Force on Integration, supra note 4, at 623.  

68 See, for example, Wade, supra note 1, at 211-20, and the discussion of Professor Wade’s ideas in supra notes 57-60, 62.  

69 Another option for the issuer, a response that some commentators find to be socially advantageous, is for the issuer to register the offering. See supra note 15. This alternative, however, is problematic, both for its facts and for its policy. First, if the total offering is small, registration is practically impossible because costs are prohibitively high. Second, registration of the April tranche following the January intrastate offering will likely destroy the intrastate exemption for the January offering, if out-of-state offers are made in April. Registration of the April offering does not protect the January offering from backwards integration. Finally, registration is not always an attractive outcome for society. Indeed, Congress has determined that, based on policy consideration, certain types of offerings and certain types of offerees and purchasers do not need the special protections of mandated, scheduled disclosures that accompany registration. See infra text accompanying notes 99-105.
One is, of course, at a total loss to find any social benefit in varying the class of securities or delaying the April offering. Neither of these steps protects investors nor generates any other perceivable benefit. The January investors are unaffected by the issuer’s alteration of either the contractual terms of the securities to be offered in April or the timing of the proposed April offering. Similarly, the subsequent April investors are accorded no additional protection as a result of such a change.

Importantly, of course, the incentives created by these criteria generate societal and economic costs, as the issuer is forced (or is, at least, encouraged) to change the terms of its optimal investment contract and postpone its offering. In economic terms, such outcomes raise the issuer’s cost of capital and make the issuer less competitive in the product market. Stated alternatively, in more human terms, such an outcome is unfair to the issuer and its constituents, especially in light of the fact that such issuers are often small entrepreneurs with limited opportunities to acquire capital. Indeed, in extreme situations these criteria may effectively deny the issuer access to capital.

In short, issuers, in order to avoid integration under the common law criteria for integration, are encouraged to act in ways that are actually socially detrimental. To avoid integration, they are likely to offer investment contracts that have inefficient financial terms and to market their securities pursuant to inefficient strategies, and these societal costs are not counterbalanced by any enhanced investor protection or any other apparent social benefit.

B. The Commission’s Safe Harbor Rules

Over the years, the Commission in a number of instances abandoned a common law approach to integration matters in favor of a safe harbor regime. While the terms of the various safe harbor regimes differ, compliance with the Commission’s criteria for a particular safe harbor ensures the absence of integration; failure to meet the specific terms of any particular safe harbor, however, only means that the safe harbor is unavailable and that integration, therefore, is determined under the common law rules.

1. Earlier Safe Harbors

Although the Commission’s first safe harbor from integration appeared as early as 1935, it was not until the 1970s that the Commission seriously...
pursued integration safe harbors through its adoption of certain regulatory exemptions from registration. The first of these was incorporated into old Rule 146,\textsuperscript{71} which became effective in 1974 and was the predecessor to today's Rule 506.\textsuperscript{72} Virtually contemporaneously with its adoption of Rule 146, the Commission also adopted Rule 147,\textsuperscript{73} which for the first time established intelligible criteria for compliance with the intrastate exemption. Rule 147 also contained an integration safe harbor, which was


For purposes of this rule only, an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, \textit{Provided}, That there are during neither of said six month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.


\textsuperscript{72} 17 C.F.R. § 230.506 (2000). The safe harbor integration language for Regulation D differs from the safe harbor language in old Rule 146. Specifically, Regulation D offerings are protected by safe harbor from:

Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering . . . so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in rule 405 under the Act.

\textit{Id.} § 230.502(a).

\textsuperscript{73} \textit{Id.} § 230.147.
identical to the integration safe harbor of Rule 146. Although the new safe harbors in Rule 146 and Rule 147 mitigated, at least to some degree, the ambiguity of integration, the new regulatory integration regimes introduced by these rules were significantly and needlessly complex and again failed to connect the criteria for the safe harbor with any legitimate policy.

The complexity inherent in these early safe harbors and, indeed, in all of the Commission's integration safe harbors, is due at least in part to the sheer number of safe harbor regimes and the differences among the various regimes' criteria. Presently, for example, the Commission has at least

74 Id. § 230.147(b)(2). The safe harbor language of Rule 147 states:
For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemption provided by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, Provided, That, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

Id.
This language is essentially identical to the safe harbor language in old Rule 146. See supra note 71, for the language of the safe harbor provision in Rule 146.

75 Even the Commission's more recent attempts to deal with integration through safe harbor provisions have drawn fire from commentators. For example, Professor Bradford, writing on the current integration provisions of Regulation A, has observed:
The changes adopted [to the integration safe harbor rules in Regulation A] are generally positive and responsive to some of [the] ... criticisms [from commentators]. But the SEC's failure to explain or justify provisions like Rule 251(c) produces unnecessary ambiguity and uncertainty. As a result . . . , Rule 251(c) has failed to reach its potential.
Bradford, Regulation A, supra note 6, at 289.

76 Even those regimes that appear to be similar are not. Consider, for example, the integration regimes in Regulation D, see supra note 72, and Rule 147, see supra note 74. Under Regulation D, offers and sales outside the six-month window periods do not destroy the integration safe harbor, so long as during the six-month window periods the issuer makes no offers or sales of the same class of securities as are offered in the Regulation D offering. 17 C.F.R. § 230.502(a). Under Rule 147, however, safe harbor from sales outside the six-month window periods requires not only "clean windows" but also that the sales outside the window periods be made "pursuant to the exemptions provided by section 3 or section 4(2) of the Act or pursuant to a registration statement." Id. § 230.147(b)(2) (emphasis
seven different integration regimes in its rules.\(^7\) Accordingly, even
ignoring the difficulty of the interfaces among the safe harbor regimes and
the interfaces between each of those regimes and the common law rules of
integration, one struggles to understand why the Commission would
complicate integration with so many differing sets of integration criteria.\(^8\)

When one begins to apply these safe harbors in instances where two or
more various integration regimes interface with one another, the complexi­
ties of the safe harbor rules increase dramatically. Consider the following
example, which is built primarily around the safe harbor of Rule 147. That
particular safe harbor protects a Rule 147 offering from integration with
prior sales, if such prior sales were made more than six-months prior to the
Rule 147 offering, if such sales were made "pursuant to" a section 4(2)
exemption, a section 3 exemption, or a registration statement, and if during
the last six months the issuer has made no offers or sales of a "similar"

\(^7\) These include: Rule 152, 17 C.F.R. § 230.152 (2000) (dealing with
integration in certain cases between public and private offerings); Rule 147, id. §
230.147(b)(2) (1999) (safe harbor from integration in intrastate offerings made
under Rule 147); Regulation D, id. § 230.502(a) (safe harbor for certain small
offerings and private placements made under Regulation D); Rule 701(f), id. §
230.701(f) (safe harbor for certain offerings involving employee compensation
made under Rule 701); Rule 144A, id. § 230.144A(e) (safe harbor for resales of
restricted securities to certain qualified institution buyers); Regulation A, id. §
230.251(c) (safe harbor for small offerings made pursuant to the requirements of
Regulation A). In the Release adopting Regulation S, the Commission stated:
"[o]ffshore transactions made in compliance with Regulation S will not be
integrated with registered domestic offerings or domestic offerings that satisfy the
requirements for an exemption from registration under the Securities Act, even if
undertaken contemporaneously." Offshore Offers and Sales, Securities Act Release

\(^8\) Even if the Commission wants different integration standards as a way to
open up or shut down exemptions that it considers more or less desirable, a more
principled and direct path is open to the Commission to reach this objective.
Suppose, for example, the Commission wishes to limit the availability of intrastate
offerings under Rule 147 because (for whatever reason) the Commission concludes
that such offerings are especially ripe for fraud. Rather than making integration
more expansive, which is haphazard in its outcome and essentially unprincipled,
the Commission could impose additional, substantive conditions on the availability
of the exemption—such as limiting the dollar limit of the exemption (e.g., limit
Rule 147 to $1,000,000 per year) or requiring disclosure as a condition for
exemption.
class of securities like those in the Rule 147 offering. This last criterion is referred to as a requirement of having “clean windows” or “clean window periods.”

In this example, assume that on January 1 Issuer sold a block of its common stock in reliance on the private placement exemption provided by the common law of section 4(2), and that on July 1 Issuer sold additional common shares under a valid registration statement. On August 1, Issuer proposes a third offering of its common stock, this time as an intrastate offering under Rule 147. In evaluating the availability of the Rule 147 exemption, Issuer must determine whether either of the prior offerings will be integrated into its August offering.

Applying the safe harbor criteria from the Rule, one first finds that the Rule 147 offering in August will not be protected from the July offering, even though the July offering was registered and thus represents, one assumes, the ideal way for the distribution to take place. The problem, obviously, is that the July offering was within six months of the proposed August offering, and accordingly the Issuer lacks the clean windows that are required for safe harbor qualification under Rule 147.

Consider now whether the safe harbor provisions of Rule 147 protect the proposed August offering from integration with the prior January offering. Since the section 4(2) offering in January was more than six months prior to the Rule 147 offering in August, one may preliminarily think that the safe harbor is available to protect the August offering from the January offering. The obvious problem, however, is that the safe harbor, even for sales outside the six month period, requires clean windows, and the July sale of common stock destroyed the clean windows for the August sale.

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79 17 C.F.R. § 230.147(b)(2). For the text of the integration safe harbor provision in Rule 147, see supra note 74.

80 If, however, the July securities are not of “the same or similar class” as the August securities, safe harbor may still be available, since under Rule 147 safe harbor from the effects of offers and sales outside the six-month window period is lost if offers or sales within the six-month window period involve securities “of the same or similar class as those offered . . . pursuant to” Rule 147. 17 C.F.R. § 230.147(b)(2). For the language of the safe harbor provision of Rule 147, see supra note 74.

81 The contamination of sales during the six-month window period is eliminated only if those securities are not “of the same or similar class” as the Rule 147 stock. 17 C.F.R. § 230.147(b)(2). The fact that the sales during the window period were made pursuant to a registration statement, therefore, is irrelevant. For the language of the safe harbor provision of Rule 147, see supra note 74.
Even if, however, the Issuer were able to ensure that the July sale involved securities that were not of the "same or similar class" as the August sale, the safe harbor may not protect the August sale from the January sale. Assume that in looking at the January offering, Issuer discovers that an offer was made to an unsophisticated person, thereby destroying the availability of the section 4(2) exemption for the January offering. Given this new fact, the safe harbor may not be available to protect the August Rule 147 offering from the January offering, even though the window periods are clean and the January offering was more than six months before the August offering. The possible loss of the safe harbor rests on the argument that the January offering was not made "pursuant to" (i.e., in compliance with) the exemption "provided by" section 4(2), as required by the integration language of Rule 147, which under the Rule is a prerequisite to safe harbor protection.

Even if, however, the January offering were at the time entirely in compliance with the requirements of section 4(2), safe harbor protection for the August offering still may be uncertain. Now the problem is the notion of one-way integration. Although the safe harbor of Rule 147 is available to protect the August offering, it does not protect the section 4(2) January offering. Thus, the question of whether the January offering is contaminated by either the registered offering in July or the Rule 147 offering in August is determined by the common law of integration. The bizarre outcome here is that, if under common law integration the July offering or the August offering is integrated backwards into the January offering, then the January offering does not meet the requirements of section 4(2). This,

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82 Section 4(2) of the 1933 Act provides an exemption from registration for "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1994). Broadly, this exemption is predicated on all offerees and purchasers having sufficient sophistication to be able to evaluate the merits and risks of the offering and having access to the same information that would be contained in a registration statement. See THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 4.21, at 224-34 (3d ed. 1996) (suggesting that "[a] literal reading of more recent cases" leads one to conclude that "[e]ach offeree must have access to the types of information which would be disclosed" in a registration statement, id. at 229 (emphasis added), "offerees must also be sophisticated," id., and "each offeree must be provided with an opportunity to ask questions of the issuer and verify information," id. at 231 (emphasis added)).

83 Professor J. William Hicks, certainly one of the leading authorities on Rule 147, reaches a similar conclusion. 7 HICKS, supra note 54, § 4.03[3], at 4-28.

84 A compact and excellent discussion of one-way integration is found in Bradford, Regulation A, supra note 6, at 270-72.
in turn, may mean that the January offering was not made "pursuant to" section 4(2), and thus the safe harbor may no longer be available to protect the August Rule 147 offering from the January offering.\footnote{Professor Hicks opines that such a result would "defeat the whole purpose of the [safe harbor integration provision of the] Rule." \textit{7 Hicks, supra} note 54, \S 4.03[3], at 4-27. He characterizes such an outcome as "perverse" and generously concludes that it is "very unlikely that the SEC would intend such a result." \textit{Id.}}

While instinctively one is skeptical that such overwhelming complexity can ever be justified, the problematic nature of these safe harbor rules can be fully appreciated only when one realizes that, as was the case with the common law rules of integration, the safe harbor criteria for integration are unconnected to any sound policy. Thus, the Commission's regulatory criteria to qualify for a safe harbor from integration again lead issuers to engage in conduct that is socially counterproductive.

To illustrate this point, consider the steps that the Issuer in the foregoing example may be encouraged to take in order to garner safe harbor protection for its proposed August offering in light of potential contamination by the January offering. Most obviously, the Issuer will likely take steps to ensure that the August offering has clean windows. This could be done either by varying the contractual terms between the July offering and the August offering\footnote{Under Rule 147, the July offering would not destroy the safe harbor protection the August offering otherwise enjoys, so long as the July offering does not involve "offers ... or sales of securities ... \textit{of the same or similar class} as those [securities] offered ... or sold" in the August, Rule 147 offering. \textit{17 C.F.R.} \S 230.147(b)(2) (emphasis added).} or by delaying the August offering for another five months.\footnote{By delaying the August, Rule 147 offering for an additional five months (a total of six months from the July offering), the Rule 147 offering would be protected from the January and the July offering, since those prior offerings would then be outside the six-month window period and no sales would have occurred during the window period. \textit{17 C.F.R.} \S 230.147(b)(2).}

Once again, however, one is unable to find any social benefit for the requirement that the Issuer take such steps. Neither of these steps protects the January, July or August investors nor generates any other perceivable benefit for society. Importantly, such cumbersome steps once again generate societal and economic costs, as the Issuer is forced to change from its optimal investment contract or delay its optimal offering date for the August offering.

Safe harbor criteria, therefore, have done nothing to relieve the disconnect between the criteria of integration and any valid economic or
societal policies. Under the safe harbor criteria, issuers are still encouraged to offer inefficient investment contracts and to market their securities inefficiently. These costs are not counterbalanced by any enhanced investor protection or any other apparent social benefit.

2. More Recent Safe Harbors

In more recent years, the Commission seems to have made some effort to simplify and reduce the pernicious effects of its safe harbor regimes. Thus, for example, the 1992 amendments to Regulation A appear to be an attempt both to simplify and ameliorate the impact of the integration doctrine in Regulation A offerings. Briefly, a Regulation A offering is now protected by safe harbor from any prior offering and from certain prescribed subsequent offerings (including all offerings "made more than six months after the completion of the Regulation A offering"), and the safe harbor of Regulation A, when applicable, provides two-way integration protection (i.e., it protects the Regulation A offering from contamination by the other offerings and also protects the other offerings from contamination by the Regulation A offering).

Rule 701, which essentially provides an exemption from registration for employee stock purchase plans of non-1934 Act companies, offers an even more generous safe harbor from integration by providing complete, two-way protection for and from any Rule 701 offering. In short,

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89 Regulation A provides an exemption from registration for offerings of up to $5,000,000 by non-1934 Act companies. The exemption is predicated upon the filing of an “offering statement” with the Commission and providing each investor with an “offering circular.” 17 C.F.R. §§ 230.251-.263 (2000).
90 Id. § 230.251(c)(2)(v).
91 Id. § 230.251(c). Professor Bradford provides an excellent discussion of this matter. Bradford, Regulation A, supra note 6, at 270-73. Professor Bradford points out some scholarly disagreement on the notion that the integration protection under Regulation A is two-way. Id. at 272 n.89 (citing 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW 5-12 to 5-14 (2d ed. 2000)).
93 Once again, Professor Bradford provides an excellent discussion of this integration provision. Bradford, Regulation A, supra note 6, at 270 n.82. Professor Bradford points out that Professor Hicks has characterized the safe harbor as only “one directional,” but Bradford argues that Hicks is wrong about this. Id. (citing 7A
integration is not applied to Rule 701 offerings. Accordingly, a Rule 701 offering cannot contaminate any other offering, and the other offering cannot contaminate the Rule 701 offering. 94

These are, of course, encouraging signs, although the Commission is moving in an extremely slow, uneven, and piecemeal manner and, at least from the perspective of some commentators, is still leaving substantial ambiguity and problems untreated. 95 Nonetheless, these regulatory developments reflect, on the part of the Commission, some appreciation of the nonsense of the integration concept and may signal a willingness by the Commission to engage in a broader reexamination of the concept.

IV. INTEGRATION PRESCRIPTION

The prescription offered by this Article for the problems created by the integration doctrine is simple and direct: the integration doctrine should be entirely eliminated from the 1933 Act. 96

Hicks, supra note 54, § 8.03[3][b], at 8-48 (1993)).

94 The Commission has also taken a special, generous integration approach for extra-territorial offerings made in compliance with Regulation S. In the Release adopting that Regulation, the Commission stated: "[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act, even if undertaken contemporaneously." See Offshore Offers and Sales, Securities Act Release No. 33-6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. ¶ 84, 524, at 80,681 (Apr. 24, 1990).

95 Professor Bradford is somewhat critical of the continued ambiguity in the new Regulation A integration safe harbor, characterizing it at one point as "expansive yet enigmatic." Bradford, Regulation A, supra note 6, at 255.

96 The wholesale elimination of the integration doctrine would not eliminate the necessity of resolving certain integration-like problems. For example, the Commission in recent years has always had some type of regulatory small-offering exemption from registration enacted under section 3(b) of the 1933 Act, and that exemption has always had some size limitation. Today, that exemption is found in Rule 504 and is limited to $1,000,000 within any twelve month period. 17 C.F.R. § 230.504 (2000). In a world without an integration concept, an issuer might sell $200,000 in securities on Monday under the exemption provided by section 4(2), and $200,000 on Tuesday under section 3(a)(11). If the issuer on Wednesday decides to sell additional securities under Rule 504, a rule would be needed to determine whether the issuer could then sell securities in the amount of $1,000,000, $800,000 or $600,000 under the Rule.

Obviously, it would not be difficult to construct a rule dealing with that matter and to do so without resorting to the integration doctrine.
While the uncertainty, complexity and misdirected criteria described in the immediately preceding section are important to the analysis underlying this recommendation, these problems, standing alone, may be insufficient to compel a complete elimination of the integration doctrine.97 Such problems are not, of course, unique to securities laws and, more importantly, are ones that often can be eliminated or at least ameliorated by procedural and doctrinal adjustments that are less drastic than the elimination of an entire doctrine.

In the case of the integration doctrine, however, these less drastic adjustments are inappropriate prescriptions because the doctrine itself makes no sense.98 Indeed, the integration doctrine is inconsistent with the very policies underpinning the 1933 Act itself.

The 1933 Act strikes a balance between investor protection and capital formation.99 The common sense of this is overwhelming, of course. The 1933 Act could never have been intended to protect investors to such a degree that capital formation is precluded. At the same time, investors must be protected, even if the price of raising capital is increased somewhat. This balance was in recent years reiterated in the National Securities Markets Improvement Act of 1996 ("NSMIA").100 Specifically, section 106(a) of NSMIA amended section 2 of the 1933 Act to indicate

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97 The uncertainty and complexity of the integration doctrine have captured most consistently the attention of commentators and the bar. An interesting manifestation of this was the charge to the Task Force on Integration, which did its work in the early 1980s. The charge was "to make proposals that would help the Commission and the securities bar to answer questions of integration." Task Force on Integration, supra note 4, at 596.

In this writer's view, that was an unfortunate and overly modest charge.

98 In Part III of this Article, the author argued that the criteria for the application of the integration doctrine are nonsensical. See supra notes 48-95 and accompanying text. Here the author makes a somewhat similar but different argument, arguing now that the doctrine itself is nonsensical.

99 Wade, supra note 1, at 227 (recognizing, before NSMIA, "the emerging importance of the Act's policy to assist in capital formation where disclosure through registration would be unduly burdensome"). An example at the Commission level of the recognition of the balance can be seen in the way the Commission developed and ultimately approved Regulation D, with its increasingly rigorous investor protection as deal size increases. See Campbell, supra note 6, at 127-31 (outlining the history leading to the adoption of Regulation D).


101 Id. § 106(a), 110 Stat. at 3424 (codified as amended at 15 U.S.C. § 77b(b) (Supp. IV 1998)).
that the 1933 Act was intended both to provide for "protection of investors" and to "promote efficiency, competition, and capital formation."\textsuperscript{102}

These articulated policies, in turn, can be reconciled with a sensible economic view of the 1933 Act. Under this economic interpretation, the 1933 Act is seen as a legislative scheme requiring mandatory disclosure of investment information in situations where bargaining between or among the parties for investment information is inefficient or impossible. This explains, then, the fundamental rule of section 5 of the 1933 Act, which mandates disclosure by the issuer to offerees and purchasers in connection with a public offering of securities. Bargaining for individually customized investment information between the issuer, on the one hand, and, on the other hand, each of the hundreds or thousands of investors in the public offering, could be considered to be either prohibitively expensive or literally impossible. As a result, the 1933 Act through section 5 mandates particularized disclosures that must accompany such public offerings.

Consistent with this analysis, the rule of mandatory disclosure is relaxed through the exemptions in the 1933 Act in situations where bargaining for investment information is possible and efficient.\textsuperscript{103} Accordingly, in the private placement exemption in section 4(2), mandatory disclosure is not required, because the investors have "access to...information" and thus are able to "fend for themselves."\textsuperscript{104} Similarly, in the

\textsuperscript{102} Section 2(b) of the 1933 Act now requires the Commission, when engaged in rulemaking in the public interest, to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 77b(b).

\textsuperscript{103} This is somewhat of an overly simplistic view of the 1933 Act, because in certain instances the 1933 Act eliminates mandatory disclosure for reasons other than ease of bargaining for investment information. For example, in section 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2) (1994), offerings by banks are exempt from registration, and one may conclude that this exemption is based, not on the ability to bargain for investment information, but on the protection of investors by the regulatory scheme applicable to banks. Another example is section 3(a)(4), 15 U.S.C. § 77c(a)(4), which provides an exemption for securities issued by charitable organizations and may best be understood as designed to promote charities.

\textsuperscript{104} These are the broad criteria for the availability of section 4(2) as announced by the U.S. Supreme Court in \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119, 125 (1953). Today, probably the two most important requirements for exemption from registration under section 4(2) are the requirement that the offerees be sophisticated and the requirement that they have access to the same information that would be contained in a registration statement. For a good discussion of this, see \textit{HAZEN}, supra note 82, § 4.21, at 224-34.
intrastate exemption in section 3(a)(11), Congress apparently concluded that geographic proximity between the investors and the issuer ensures efficiency in bargaining for investment information, thereby alleviating the need for mandated disclosure.\(^{105}\)

With these basic ideas in hand, one is able to demonstrate that the integration doctrine is antithetical to the balances struck within the 1933 Act and thus leads to a mandatory disclosure regime in instances where Congress indicated that the proper balance between investor protection and capital formation called for investors and issuers to bargain for investment information.

Again, this is best demonstrated by an example. Imagine an intrastate offering in January under the common law of section 3(a)(11) and a private placement in April of the same year under the common law of section 4(2). Assuming integration is inapplicable, the January tranche is exempt from mandated disclosure because, presumably, Congress determined that the geographic proximity of the parties eliminated any need for mandated disclosure. All investors in that intrastate block of securities are able to protect themselves by bargaining for their investment information, and capital formation is encouraged by eliminating the requirement that the issuer underwrite the costs of mandatorily providing information that the investors may not desire. Continuing the assumption that integration is inapplicable, the April private placement tranche is also exempt from mandated disclosure, in this instance because Congress determined that the investors’ access to information eliminated the need for mandated disclosure.

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\(^{105}\) Some uncertainty exists regarding the basis for the intrastate exemption in section 3(a)(11). In his early article on Rule 147, Professor Hicks stated:

The following reasons have been offered from time to time in support of the intrastate exemption: (1) In terms of economic policy, it is useful to allow securities offerings by a small businessman to his friends, relatives, business associates, and others, without federal restrictions; (2) registration for such small offerings would, as a practical matter, be almost impossible; (3) investors in local financings are protected by the sanctions of public opinion; (4) such investors are protected by their proximity to the issuer; (5) such investors are protected by state regulation; and (6) intrastate offerings do not present questions of national interest.

J. William Hicks, Intrastate Offerings Under Rule 147, 72 MICH. L. REV. 463, 499 (1974) (footnotes omitted). In its Release adopting Rule 147, the Commission stated that if the conditions of section 3(a)(11) were met, "[i]n theory, the investors would be protected both by their proximity to the issuer and by state regulation." Conditions for Intrastate Offering Exemption, Securities Act Release 33-5450, 1 Fed. Sec. L. Rep. (CCH) ¶ 2340, at 2611-2 (Jan. 7, 1974).
disclosure. Once again, all investors in the private placement block are able to protect themselves by bargaining for investment information, and the costs of capital formation are reduced by eschewing mandated disclosure.

In this case, therefore, rejecting any application of integration and thereby preserving each exemption is the sensible outcome, since it maintains the statutory balance struck between investor protection and capital formation. The critical point here, of course, is that the existence of neither tranche compromises the policy bases for the other tranche’s exemption from registration. Thus, the policy bases for not imposing a regime of mandated disclosure on the January offering is unaffected by the subsequent April offering. With or without the April offering, the January investors have the same geographic proximity to the issuer and accordingly are able to bargain with equal efficiency for their investment information. The same holds true for the April investors. With or without the January offering, the April investors have the same access to information and sophistication levels that support the private placement exemption contained in section 4(2). Sales by an issuer, therefore, whether before or after an exempt offering, are neutral events as concerns the policy bases for the exemption.

Applying the integration doctrine to this situation, however, reverses all this and leads to an inappropriate result. Assume, for example, that the outcome of applying the integration doctrine to our example is to cause the exemptions from registration to become unavailable, thus forcing the issuer to register the entire offering.

This result is inconsistent with the 1933 Act and the balance it strikes between investor protection and capital formation. Congress determined that the proper balance between investor protection and capital formation was to be achieved by foregoing registration in instances where either geographic proximity (the intrastate exemption) or investor sophistication and access to information (the private placement exemption) made private bargaining for investment information efficient. By hypothesis, those conditions exist in our example, and as a result, integration, which forces this offering into a mandated disclosure regime, essentially and inappropriately reshapes the policies of and balances struck in the 1933 Act.

Some commentators, however, object to the elimination of the integration doctrine, fearing that such an approach would allow issuers to evade the strictures of the 1933 Act, specifically the registration requirements, by permitting a single public offering to be fragmented under multiple exemptions—thereby avoiding registration.106

106 Professor Bradford makes this argument in its most persuasive form. He argues that elimination of the integration doctrine "allows an issuer to avoid
To demonstrate this concern, consider an extreme example in which an issuer sells 100 shares of stock under section 4(2) on January 1, 100 shares under the intrastate exemption on January 5, 100 shares under section 4(2) on January 10, and 100 shares under the intrastate exemption on January 15. The issuer may continue this basic pattern, selling at every opportunity 100 shares under the private placement exemption or the intrastate exemption. Devotees of integration would likely consider this example strongly demonstrative of the need for the application of the integration doctrine, arguing as they would that without the doctrine the issuer is able to make a continual unregistered public offering while evading the registration obligations of section 5.\(^{107}\)

When examined closely, however, the argument in favor of an integration doctrine, even in this extreme case, flounders for the very reasons stated above. Even in this extreme example, each 100 share tranche is made in a situation in which Congress concluded that free bargaining is the most efficient way to generate investment information and, accordingly, that society in such transactions is better off by allowing free bargaining to determine the scope of disclosure. None of the investors is in any way harmed by the fact that other securities are sold around the same time as her or his purchase. The legitimate bases for Congress's willingness to forego mandated disclosure are similarly uncompromised by the other offerings.

In short, the integration doctrine makes no sense in any setting. The availability of an exemption should be entirely independent of the fact that other offers or sales have (or have not) been made by the issuer.\(^{108}\) Other such sales are irrelevant to the question of whether or not the policy bases for an exemption exist for a particular sale. Such other offers and sales are neutral events respecting the question if investment information should be mandated or be the subject of free bargaining between parties.

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\(^{107}\) Bradford, *Expanding*, supra note 6, at 472. If, he argues, issuers are able to combine exemptions, the total amount issuers are able to raise through exempt offerings increases. At some point, he concludes, the total transaction gets large enough that costs of registration are not prohibitively large, and, at that point, society benefits from registration.

\(^{108}\) This should not be understood as limiting the Commission's right to enact regulatory exemptions that contain size limitations, or the right of the Commission to impose "bad boy" provisions on exemptions (see, e.g., 17 C.F.R. § 230.505(b)(2)(iii) (2000)).
V. CONCLUSION

The 1933 Act contains no clear mandate for an integration doctrine. Nonetheless, the Commission tumbled into the doctrine shortly after the enactment of the 1933 Act, and thereafter neither the Commission nor the courts ever bothered to consider whether the doctrine is consistent with the policies of the 1933 Act.

This exceedingly thin doctrinal history should not be overlooked when adjustments to or elimination of the integration doctrine are considered. Thus, the thinness—indeed, the non-existence—of the mandate for the creation of the integration doctrine should free the Commission and the courts from the normal restraints of precedent, if they were to choose to make sense out of this messy situation.

The prescription proposed by this paper is the complete elimination of the integration doctrine. The doctrine is confusing and complex for issuers and thus expensive for society. The criteria of integration provide perverse incentives and thus lead issuers to engage in conduct that is counterproductive. Finally, and perhaps most importantly, the doctrine is antithetical to the balances struck in the 1933 Act between mandatory disclosure and free bargaining for investment information, often forcing into a mandatory disclosure regime offerings in which the policy bases for free bargaining are intact.

The Commission and its predecessor, the FTC, created this mess. The Commission, therefore, should through the exercise of its rule-making power take the lead in eliminating integration. Not only would such Commission action be consistent with agency accountability, but also the Commission is best positioned and equipped to effect an efficient remedial action.
UPDATE ON PRIVATE SECURITIES LITIGATION & ANALYSIS OF SECONDARY LIABILITY ISSUES

Plaintiff Views:

SIX YEARS OF PRACTICE AND PROCEDURE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Kevin P. Roddy
Hagens Berman LLP
Los Angeles, California

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SECTION E
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Kevin P. Roddy
Hagens Berman LLP
Los Angeles, California

I. INTRODUCTION

A. The Purposes Of The PSLRA


Since December 1995, approximately 1,250 securities fraud cases have been filed in federal district courts. As set forth herein, approximately 25% of those cases have settled, and an additional 25% have been dismissed, in whole or in part. The passage of six years and this litigation experience allows one to draw some preliminary conclusions about the effectiveness of the PSLRA and the so-called "reforms" of securities fraud class action litigation that it heralded.

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

1 Member, California and Virginia bars. Managing Partner of the Los Angeles office of Hagens Berman LLP. B.A., with Honors, University of North Carolina, 1977; J.D., University of North Carolina School of Law, 1980.
(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). On the other hand, as set forth herein, the PSLRA “era” has witnessed a near-doubling in the average settlement value of securities fraud class actions, as well as the settlement of several “mega” cases in which plaintiffs’ counsel achieved unprecedented results for defrauded investors.

B. **The Effectiveness Of Statutory Reforms Of Securities Litigation**

If, as numerous 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, one could logically conclude that the statutory purpose has largely 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 stated in 1998:

[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....

investors to step forward and serve as lead plaintiffs, for a variety of reasons this has largely failed to materialize.

Indeed, in 1997 the Securities and Exchange Commission ("SEC") drew 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). At the same time, another commentary was more equivocal in its judgment:

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.


It is still unclear that the presence of such institutional investors as plaintiffs in securities fraud 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). Recent commentary claims that under certain circumstances, the involvement of institutional investors in securities fraud litigation leads to benefits for all shareholders. See also Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1394 (asserting that institutional investors’ participation “provides a systemic benefit where such investors control litigation [and] pursue meritorious [securities fraud] claims”).

C. The PSLRA’s Effective Date

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 (Congress intended to limit application of § 21D(a) of PSLRA to securities fraud class actions).


What if the securities class action was filed after December 22, 1995, but concerns alleged wrongdoing committed by defendants before 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 (December 22, 1995). On motion to dismiss, 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 and limiting the number of times that a plaintiff may serve as Lead Plaintiff. See 15 U.S.C. §§ 77z-1(a) and 78u-4(a); see also Aronson v. McKesson HBOC, Inc., 79 F. Supp. 2d 1146, ______ (N.D. Cal. 1999) (district court disqualifies institutional investor - Florida State Board of Administration - as lead plaintiff because it was already serving as lead plaintiff in six other securities fraud class actions). It is unclear, however, whether these statutory limitations apply to institutional investors. See also Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1388-89 (collecting cases: "Although some district courts have held that this requirement does not apply to institutional investors, other courts have reached the opposite conclusion.") (footnotes and citations omitted).

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); Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1383 (same).

Given the passage of six years since the enactment of the PSLRA and the filing of approximately 1,250 securities class actions during that period, it could be asserted that this supposed salutary purpose of the statute has largely gone unfulfilled; however, Professor Weiss stated in 1997:

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.

In his 1997 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 1997 decision in the 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. More recently, we have seen substantial settlements in securities fraud class actions in which institutional investors served as lead plaintiffs.

II. THE PSLRA'S 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 in order to participate in a lawsuit; and (3) 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).

In Blaich v. Employee Solutions, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,403 (D. Ariz. 1997), the court held that institutional investors seeking to become lead plaintiffs after the filing of an initial complaint need not comply with the certification requirement. However, one commentary states that "[i]n light of the important information provided by this certification, including a statement of the potential lead plaintiff's interests in the action, it would seem prudent for the
courts to require all plaintiffs, including institutional investors, to file such certifications.” Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1384-85.

The PSLRA's certification requirement has not impeded the filing or effective prosecution of securities class actions. Moreover, 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 securities 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; plaintiffs successfully argued that the lead plaintiffs' sworn certifications provided all the information that defendants needed in order to challenge plaintiffs' adequacy); compare In re DIGI Int'l, Inc. Sec. Litig., Master File No. 97-5, Memorandum Order (D. Minn. Feb. 24, 2000) (refusing to permit defendants to depose co-lead plaintiffs who had not been identified as proposed class representatives) with In re Grand Casinos, Inc. Sec. Litig., 181 F.R.D. 615, 619-21 (D. Minn. 1998) (recognizing need for defendant, in securities fraud litigation, to be able to depose named plaintiffs so as to be able to rebut presumption of reliance provided by fraud-on-the-market theory).

B. Notice Requirements

1. 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 statutory 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.

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).

3. Timing And Content Of Notice

Under these statutory provisions, the named plaintiff in the first filed action must file notice within twenty (20) days of filing suit in order to inform potential class members of their right to file a motion seeking 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 shall inform potential class members that within sixty (60) 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., MDL Docket 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).

4. 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/RLF), 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); Tarica, 2000 U.S. Dist. LEXIS 5031, at *9 ("Courts have repeatedly recognized Business Wire as a business-oriented wire service within the meaning of the PSLRA, and as an acceptable means of publishing notice under the statute") (citation omitted); 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).

5. 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.
In that decision, 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) 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 – is 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); Martin & Metcalf, *Institutional Investors*, 56 Bus. Law. at 1385 (outlining PSLRA notice procedures).

As a result, § 78u-4(a) of the Exchange Act effectively requires the district court to appoint a lead plaintiff and lead counsel at the very beginning of securities fraud class action litigation. *See Christman v. Brauvin Realty Advisors, Inc.*, 185 F.R.D. 251, 254 (N.D. Ill. 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."); *see also 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); *Winn v. Symons Int'l Group*, No. IP 00-0310-C-B/S, 2001 U.S. Dist. LEXIS 3437, Fed. Sec. L. Rep. (CCH) ¶ 91,364 (S.D. Ind. Mar. 21, 2001) (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 claimed 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. As 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.

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 (emphasis added; 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
otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.


E. Rebutting The Presumption

As Judge Buchmeyer has explained the applicable procedures governing appointment of lead plaintiffs and how the above-referenced presumption may be rebutted:

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; Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1387-88 ("Rebutting the Presumption").

Under the PSLRA, some district courts have instituted competitive bidding (or "auctions") governing the selection of lead plaintiffs' counsel. See, e.g., In re Lucent Technologies, Inc. Sec. Litig., 194 F.R.D. 137, 156-57 (D.N.J. 2000); In re Banc One Shareholders Class Actions, 96 F. Supp. 2d 780, 784-85 (N.D. Ill. 2000). In two securities fraud class actions that were consolidated for motion practice – In re Quintus Sec. Litig. and In re Copper Mountain Networks Sec. Litig., 201 F.R.D. 475 (N.D. Cal. 2001) – Judge Walker issued a lengthy opinion explaining his view of the respective lead plaintiffs' "adequacy." In one case, the court rejected the lead plaintiff candidates with the largest losses and instead appointed the
plaintiff who, in the court’s opinion, had negotiated the best attorney’s fee arrangement with prospective class counsel. In the companion case, Judge Walker found no plaintiff with the ability to negotiate a favorable arrangement with counsel, and so the court appointed a “nominal lead plaintiff” and initiated a competitive bidding procedure to select class counsel. This unusual approach, however, has not found favor with other district courts.

Indeed, in In re Cendant Corp. Litig., 264 F.3d 201 (3rd Cir. 2001), the Third Circuit addressed the question of whether a district court may use an auction to select lead counsel. Cendant, a securities fraud class action, involved the appeal of a $3.2 billion settlement of securities fraud class action litigation; objectors to the settlement challenged the district court’s use of an auction to choose lead counsel and establish the attorney’s fee compensation structure. The Third Circuit held that the PSLRA does not generally permit an auction to select lead counsel in a securities class action. But an auction might be permissible under limited circumstances, which the court explained in the context of how to evaluate the lead plaintiff’s choice of counsel under the statute. The import of the court’s decision was summarized by one recent commentary:

The 3d Circuit has struck a sharp blow against the increasing use of auctions to select lead counsel in a class action, but only in the PSLRA context. It has placed control over counsel selection and retention under the PSLRA back into the hands of the lead plaintiff, absent extraordinary circumstances. Other courts and circuits will likely follow its lead in varying degrees.


F. Combinations Of Persons Or Entities

The district courts remain 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"; many reported 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)).

Judge Cedarbaum, however, 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.


Following Judge Cedarbaum's lead, the aggregation of plaintiffs has been disallowed by several district courts in securities fraud class actions. _See, e.g., Banc One_, 96 F. Supp. 2d at 783 (choosing lead plaintiff "based on the number of shares held by such an assemblage of small holders would really subvert the purposes of the [PSLRA] by maximizing the prospect that the lawsuit would truly be run by the lawyers and not by the client class members"); _In re Network Assocs., Inc. Sec. Litig._, 76 F. Supp. 2d 1017 (N.D. Cal. 1999) (based upon assumption that "[t]he whole point of the [PSLRA] was to install a lead plaintiff with substantive decision making ability and authority," court held that aggregations of unrelated investors cannot satisfy lead plaintiff provisions of PSLRA); _Aronson v. McKesson HBOC, Inc._, 79 F. Supp. 2d at 1153-54 ("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). _See generally_ Jonathan C. Dickey, _et al., Defense Strategies in Securities Class Actions_ 5-6 (ALI-ABA 2001) (collecting and analyzing cases); W. Reece Bader, _Further Developments in the Lead Plaintiff/Lead Counsel Wars_, 8 Securities Reform Act Litig. Rptr. 802 (Mar. 2000) (same); 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) (same).

_in Oxford Health Plans_, the Colorado Public Employees Retirement Association (CoIPERA) sought appointment as sole lead plaintiff in a securities class action. In its motion, CoIPERA alleged losses in excess of $20 million due to Oxford's allegedly fraudulent activities. A competitor for appointment as lead plaintiff - a group consisting of 35 individuals (the "Vogel Group") - alleged collective losses of $10 million. Another institutional holder, 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 CoIPERA'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_ Saporoff & 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 CoIPERA, 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 CoPERSA’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 (2nd Cir. 1988).

In the view of this author, the position taken by Judge Brieant in *Oxford Health Plans* upholding the aggregation of investors (both institutional and individual) to serve as co-lead plaintiffs clearly represents the majority (and correct) view of the PSLRA. See, e.g., *In re Bank One Shareholders Class Actions*, 96 F. Supp. 2d 780 (N.D. Ill. 2000) ("Pension Group" – consisting of six employee benefit funds whose aggregate purchases during Class Period totaled 77,200 shares – chosen as "lead plaintiff"); *Tarica*, 2000 U.S. Dist. LEXIS 5031, at *15-16 (court approves appointment of group of four to serve as "lead plaintiff"); *In re The First Union Corp. Sec. Litig.*, No. 3:99CV237-MCK, 2000 U.S. Dist. LEXIS 2267, at *11-12 (W.D.N.C. Jan. 28, 2000) (approving stipulation between plaintiffs' counsel appointing two groups of investors as co-lead plaintiffs); *Baan*, 186 F.R.D. at 216 ("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"); rejecting appointment of 20-person group as too large to control litigation, but appointing three individual members of 466-person shareholder group as co-lead plaintiffs); *Takeda v. Turbodyne Tech., Inc.*, Case No. CV 99-00697 MMM, 7 Securities Reform Act Litig. Rptr. 783 (C.D. Cal. May 28, 1999) (rejecting proposed group of more than 100 investors, but appointing seven-person subgroup as lead plaintiff; each of the seven had sustained losses of more than $100,000 and subgroup included institutional investment adviser); *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."). 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).

Echoing Judge Cedarbaum's reasoning in *Donnkenny*, other district courts have concluded that a large group of co-lead plaintiffs would be unable to control the litigation, effectively negotiate retention agreements, and supervise the conduct of counsel. See, e.g., *Sakhrami v. Brightpoint, Inc.*, 78 F. Supp. 2d 845, 849-54 (S.D. Ind. 1999) (appoints individual investor with greatest losses as lead plaintiff and approves his selection of two law firms as co-lead counsel; court criticizes practice of aggregating groups of unrelated investors as lead plaintiffs and concludes that absent an institutional investor stepping forward, the individual with the greatest losses should serve as lead plaintiff); *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 shareholder and one individual shareholder -- who had sustained the largest losses of the group); *Baan*, 186 F.R.D. at 217 (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). See generally William F. Alderman, Recent Developments in the Lead Plaintiff/Lead Counsel Wars, 8 Securities Reform Act Litig. Rptr. 663 (Feb. 2000) (collecting and analyzing cases).

The SEC has taken the position that "ordinarily this group should be no more than three to five persons." Baan, 186 F.R.D. at 215 (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 SEC as 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.").

In those districts where the courts have allowed groups of investors to serve as lead plaintiffs, certain plaintiffs' counsel have aggressively sought to enlist shareholders to join such a group. These tactics have led, in turn, to ethical challenges brought by competing plaintiffs' counsel. For example, in Knisley v. Network Assocs., Inc., No. C99-1729, 8 Securities Reform Act Litig. Rptr. 18, 59 (N.D. Cal. Aug. 16, 1999), Judge Armstrong held that a law firm seeking to assemble a lead plaintiff group in a securities fraud class action did not violate the PSLRA or the Model Rules of Professional Conduct when it paid broker-dealers to distribute a notice regarding the class action to the broker-dealers' customers who had purchased the security in question.

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 competing plaintiff only if that challenger 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."); see also Martin & Metcalf, Institutional Investors, 56 Bus. Law. at 1388 (discussing when such discovery of "most adequate" plaintiff(s) is appropriate).

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 between proposed lead plaintiffs and their counsel:

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 (discussing propriety of discovery directed at proposed “most adequate” plaintiff).

H. What Do Defendants Have To Say About “Lead Plaintiffs”?

What is the position of defendants in the event of a contest between competing “most adequate” plaintiffs? Most courts have held that defendants have no standing in this contest, with Magistrate Judge Erickson stating that "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, 186 F.R.D. at 215 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."). Other district courts have reached the opposite conclusion. See, e.g., 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"). Accord First Union, 2000 U.S. Dist. LEXIS 2267, at *6 ("nothing in the [PSLRA] prevents this Court from considering the arguments raised and authorities cited by Defendants"); 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 the majority rule:

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 (emphasis added). 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").

As noted above, the district courts have recognized that defendants' right to contest class
certification on various grounds under Fed. R. Civ. P. 23 "is preserved," even if they are accorded no voice to contest the appointment of "lead plaintiffs." 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.

As noted above, 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, Fed. Sec. L. Rep. (CCH) ¶ 90,686 (N.D. Ill. Sept. 30, 1999); Martin & Metcalf, _Institutional Investors_, 56 Bus. Law. at 1385-86.

In ruling on such challenges, the district court can and should take into account the individual facts and circumstances of each proposed "lead plaintiff." For example, 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 did so _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). In _Bank One_, 2000 U.S. Dist. LEXIS 6254, relying upon this
statutory exception, Senior Judge Shadur recently employed a “bidding process” to select lead counsel in a securities fraud case, choosing a law firm that had not been selected by lead plaintiffs (an aggregation of six employee benefit funds). Id. at *15-33.

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.

This ruling represents the majority rule adopted by the district courts under the PSLRA. See also Advanced Tissue, 184 F.R.D. at 353 (approving appointment of three law firms to represent co-lead plaintiffs); 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).

Some recent decisions observe that the appointment of co-lead counsel for lead plaintiffs, or appointment of lead counsel “executive committees” is inconsistent with the PSLRA’s goals because they create a significant potential for inefficient management of the litigation and make it more difficult for the lead plaintiff to monitor the conduct of lead counsel. See, e.g., In re Nice Sys. Sec. Litig., 188 F.R.D. 206, 221-24 (D.N.J. 1999). See also 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"); in that case, Judge Baird of the Central District of California refused to appoint as co-lead counsel the Philadelphia-based law firm whose client, a Pennsylvania-based municipal employees retirement fund, was the institutional investor that had been selected as one of two co-lead plaintiffs; on reconsideration, however, the court relented and appointed the disappointed
law firm as co-lead counsel); *Milestone*, 187 F.R.D. at 180 (rejecting proposal that court appoint several co-lead counsel, executive committee and liaison counsel); *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*). Cf. *In re Party City Sec. Litig.*, 189 F.R.D. 91, 114-17 (D.N.J. 1999) (appointing co-lead counsel, but noting that this was a rare case that called for more than one lead counsel, due to the potential size of the class and the nature of the litigation).

V. RULE 9(B) PLEADING WITH PARTICULARITY REQUIREMENT

A. The Level Of Particularity Required

Rule 9(b) of the Federal Rules of Civil Procedure, which is applicable to securities fraud claims, 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 plaintiff to 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 constituting 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. For each statement alleged to be false or misleading, plaintiffs must identify who made the statement, where and when the statement was made, and why the statement was false or misleading. See *Novak v. Kasaks*, 216 F.3d 300, 305-06 (2nd Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3rd Cir. 1999); *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273, 1281 (D. Minn. 1997); *In re Phycor Corp. Sec. Litig.*, No. 3:98-0834, 2000 U.S. Dist. LEXIS 2218, at *8 (M.D. Tenn. Feb. 17, 2000) *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); see also *Bryant v. Apple South*, 25 F. Supp. 2d 1372, 1379 (M.D. Ga. 1998) (plaintiffs adequately pled that defendants' statements were false when made), vacated and remanded on other grounds, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999); *Robertson v. Strassner*, 32 F. Supp. 2d 443, 448 (S.D. Tex. 1998) (same).

In the 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)); see also *SEC v. ICN Pharmaceuticals, Inc.*, 84 F. Supp. 2d 1097, 1098 (C.D. Cal. 2000) (PSLRA's "more rigorous" pleading requirements "go beyond the
Rule 9(b) [pleading] requirements”). Thus, plaintiff’s complaint must set forth with particularity facts that 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 Upon Information And Belief


However, in Branca v. Paymentech, Inc., Civil Action No. 3:97-CV-2507-L, 2000 U.S. Dist. LEXIS 1704 (N.D. Tex. Feb. 8, 2000), Judge Lindsay reached the opposite conclusion:

Plaintiffs have not met their duty to plead “with particularity” the facts supporting their belief that these statements are actually [actionable] misrepresentations ... Plaintiffs’ general statement that the allegations in the Complaint are based on public filings, news articles, press releases, analyst reports, and meetings with consultants does not sufficiently identify the facts upon which Plaintiffs’ beliefs are based. Plaintiffs have not identified the particular articles, releases, filings, documents, or other information, including the substance of the meetings with consultants, that would support their allegations that Defendants made false representations....

Id. at *22-23 (citations omitted).

Numerous plaintiffs have sought to “plead around” the statutory requirements by alleging that their claims are based upon "an investigation of counsel" or "information obtained from former employees" of the defendant company, rather than "information and belief”; however, the
courts are divided on whether this strategy passes muster under the PSLRA. Indeed, the courts are sharply divided on whether plaintiffs must divulge the sources of their information in order to allege falsity with the requisite particularity. Compare In re Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 763 (N.D. Cal. 1997) (rejecting plaintiffs' characterization of their complaint as "based upon the investigation of their counsel" and holding that "because the sources [cited] do not provide plaintiffs with personal knowledge, the complaint must be based on information and belief "), aff'd, 183 F.3d 970, 985 (9th Cir. 1999) (requiring plaintiffs to divulge sources of information in order to allege falsity with requisite particularity) with Novak, 216 F.3d at 313 (finding that if sources must be revealed in order to provide an adequate basis for believing that statements were false, plaintiffs generally may provide particularized information about the source’s position rather than stating the source’s name). The Second Circuit’s holding in Novak that named identification of confidential sources was not required was followed by district courts in In re Theragenics Corp. Sec. Litig., 105 F. Supp. 2d 1342, _____ (N.D. Ga. 2001), and Fitzer v. Security Dynamics Tech., 119 F. Supp. 2d 12, _____ (D. Mass. 2000).

One commentator sought to elucidate the applicable rules of pleading and procedure:

Section 21D(b)(1) of the [PSLRA] imposes a tough standard for pleading securities fraud which can provide the basis for attacking an "information and belief" complaint that is distinct from that available under [Fed. R. Civ. P.] 9(b).

In responding to a securities fraud complaint, defense counsel initially should determine whether the complaint, wholly or in part, is pled on information and belief. Such a determination depends, significantly, on whether the facts supporting the allegations are within plaintiff's or a third-party's knowledge. Where the allegations are stated to be based on facts acquired through counsel's investigation – and even when plaintiff denies that the allegations are based on information and belief – defense counsel may still be able to prevail on an argument that the complaint is based on information and belief and is required, but fails to meet the "particularity" requirements of [Section] 21D(b)(1) of the [PSLRA].

By the same token, in preparing a complaint, counsel should give careful consideration to whether some or all of the allegations are based on information and belief. Those which are should include a statement of the actual sources relied upon. A boilerplate clause generally describing the types of documents reviewed is inadequate. Where third party witnesses, such as consultants or former employees, are referred to as having supplied information that forms the basis of the complaint, they, too, should be identified in the complaint.

Miranda S. Schiller & Haron W. Murage, "Information and Belief" Pleading Under the Reform Act, 8 Securities Reform Act Litig. Rptr. 8, 12-13 (Oct. 1999) (footnote omitted).
VI. PLEADING SECTION 10(B) VIOLATIONS

A. Primary Violators Only: No Aiding Or Abetting Liability

Section 10(b) of the Exchange Act prohibits the "use or employ, in connection with the purchase or sale of any security, ... [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. 15 U.S.C. § 78j(b). Rule 10b-5, promulgated by the SEC under § 10(b), makes it unlawful for any person "to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. To state a claim under Section 10(b)/Rule 10b-5, plaintiff must allege that the defendant (1) made a misstatement or an omission of a material fact; (2) with scienter; (3) in connection with the purchase or the sale of a security; (4) upon which the plaintiff reasonably relied; and (5) that the plaintiff's reliance was the proximate cause of his or her injury. See Semerenko v. Cendant Corp., 223 F.3d 165 (3rd Cir. 2000).

Only primary participants in a violation of Section 10(b)/Rule 10b-5 may be held liable. Section 10(b)/Rule 10b-5 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 Section 10(b)/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

1. Introduction

To state a valid claim for violations of Section 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. In re Peritus Software Svcs., Inc., 52 F. Supp. 2d 211, 219 (D. Mass. 1999); Bryant, 25 F. Supp. 2d at 1377; see also Powers, 977 F. Supp. at 1037. Chief Judge Young elucidated the pleading requirements established by the PSLRA:

[A] securities fraud plaintiff must allege with particularity the who, what, when, where, and why of each materially false or misleading misrepresentation or omission. This Court concludes that [plaintiff] has satisfied this requirement. The Complaint sets forth the content of each statement alleged to be false or misleading, the name of the speaker, the date on which each statement was made, the document in which each statement was made public, and a detailed explanation of why each statement was false.

Chalverus, 59 F. Supp. 2d at 232-33 (citations omitted).

2. Falsity

Plaintiff's securities fraud complaint must set forth what is false and misleading about the statement and why it is false. See Chalverus, 59 F. Supp. 2d at 232-33 (quoted above); Marksman Partners, 927 F. Supp. at 1308 (complaint alleged in sufficient detail precise dates, manner, content and nature of statements alleged to be fraudulent); In re Olympic Finan. Ltd. Sec. Litig., Civil File No. 97-496, 1998 U.S. Dist. LEXIS 14789, at *5-11 (D. Minn. Sept. 10, 1998) (refusing to dismiss claims alleging misrepresentation of nature of loan portfolio and mischaracterization of loans as "prime"); 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; failure to disclose problems with products). 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. 1997); see also Summit Med., 10 F. Supp. 2d at 1071 (Rule 9(b) pleading requirements held satisfied).

3. 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).

4. 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: The Circuits Are Divided

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) (emphasis added). "However, the [PSLRA] does not give a good definition of 'strong inference,'" Schaffer, 29 F. Supp. 2d at 1225, and the circuit and district courts are clearly divided as to the methods by which a plaintiff can plead 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."); affirming dismissal of complaint alleging that company had falsely claimed that it was not for sale in order to depress its stock price and facilitate merger; there was no motive for scienter because contentions that corporate officer somehow benefited
from depressing company's stock price were too speculative); see also In re Ciena Corp. Sec. Litig., Civil No. JFM-98-2946, 2000 U.S. Dist. LEXIS 7305, at *17-18 (D. Md. May 15, 2000) (same); 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, Fed. Sec. L. Rep. (CCH) ¶ 90,738 (N.D. Ill. Jan. 4, 2000) (refusing to reconsider prior denial of company's motion to dismiss for failure to plead scienter, and reiterating that plaintiff had sufficiently pled scienter through circumstantial evidence of company's recklessness; surveying previous decisions addressing scienter pleading requirements under PSLRA); 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"; holding that insiders' sales of 15% and 72% of stockholdings during class period created strong inference of scienter) (citation omitted).


2. The Second Circuit Standard

a. "Motive and Opportunity"

Prior to the PSLRA's enactment, in the Second Circuit a strong inference of fraudulent intent could be established in a securities fraud case 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 (2nd Cir. 1994); see also In re Oxford Health Plans, Inc., 187 F.R.D. 133, 138 (S.D.N.Y. 1999).

b. The Press Decision and Its Progeny

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 and holding that allegations of officers' misuse of funds cannot support inference of scienter for earlier alleged misrepresentations); 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. Dec. 31, 1998) ("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.") (citation omitted).
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 (2nd Cir. 1999). In *Press*, the plaintiff purchased a $100,000 Treasury Bill through a registered broker-dealer. After he had purchased it, he was told that he could not pick up a check for the proceeds in New York City on the date of maturity but, rather, would have to wait for the proceeds to arrive via regular mail. (He could, however, have the proceeds sent via express mail or wire transfer for an additional fee.)

Press sued the broker-dealer and its clearing firm, alleging that they fraudulently failed to disclose that the funds would not be immediately available to him at maturity. He alleged that the yield should have been calculated over a longer period of time, thus making the advertised yield fraudulently inaccurate. He also claimed that defendants had structured the transaction in this manner to allow themselves more time to use the funds.

Defendants sought dismissal of Press's complaint, contending that he had not pled scienter in accordance with the PSLRA's heightened pleading requirement. After citing the statute's requirement that a plaintiff 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 Second Circuit stated without analysis that this requirement could be satisfied by its traditional two-pronged standard. 166 F.3d at 538. Under this standard, fraud could be established by allegations of either (1) "both motive and opportunity to commit fraud" or (2) "strong circumstantial evidence of conscious misbehavior or recklessness." *Id.* (citation omitted).

The *Press* court also noted that it had "been lenient in allowing scienter issues to withstand summary judgment based on fairly tenuous inferences" because "we are not inclined to create a nearly impossible pleading standard when the 'intent' of a corporation is at issue." *Id.* The investor in *Press* alleged that defendants "had a motive to keep possession of his proceeds to have the 'float' or use of the funds," and that they "had the opportunity to do this since the proceeds of the T-bill at maturity were in their control." *Id.* While characterizing the allegations before it as "the barest of all pleading that would be acceptable," the Second Circuit nevertheless found that they were sufficient to satisfy the PSLRA. *Id.*

In *Stevelman v. Atlas Research, Inc.*, 174 F.3d 79 (2nd Cir. 1999), the Second Circuit found that violations of generally accepted accounting principles (GAAP) or SEC accounting rules were not, in and of themselves, sufficient to support an inference of scienter. *Id.* at 84. However, the appellate court found that the "motive and opportunity" test could be satisfied by the fact that the CEO, along with other officers, "sold off large portions of his stock holdings during the period of the misrepresentations." *Id.* at 85. As the court elaborated:

Some of the sales occurred after the representations were made, several officers made large sales, and a motive for inflation of the stock price can be inferred from these sales. Moreover, the statements that continued to be made after the sales that followed the earlier statements could well be probative of an intent to keep the stock price high in order to avoid detection of the alleged fraud.
174 F.2d at 86. Thus, the court held that the insider trading, in combination with the timing of the misrepresentations, satisfied the pleading requirements of Rule 9(b) and the PSLRA. *Id.*

More recently, in *Novak v. Kasaks*, 216 F.3d 300 (2nd Cir. 2000), the Second Circuit reaffirmed that the PSLRA

- Did not change the substantive standard of scienter and, therefore, continued to include recklessness
- Would permit facts raising a strong inference of state of mind or evidence including motive and opportunity to defraud to satisfy a scienter allegation
- Would not require name identification of confidential informants who provide a basis for "information and belief" allegations
- Would not require *all* information upon which "information and belief" pleadings were based

*See also In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74-76 (2nd Cir. 2001) (reversing district court decision holding that securities fraud plaintiff’s complaint was not sufficiently particular and that it failed to allege facts showing a strong inference of scienter; investor relations officer’s sale of 80% of his stock within single week following material, negative event that went unreported met “motive and opportunity” test for pleading scienter; court also followed *Novak’s* rule on pleading on “information and belief”);
*see also In re Carter-Wallace Sec. Litig.*, 220 F.3d 36, 39 (2nd Cir. 2000).

The Second Circuit has made clear, however, that a strong inference of scienter does not arise merely by pleading facts that are common to all corporate insiders. *See Chill v. General Elec. Co.*, 101 F.3d 263, 268 (2nd Cir. 1996). Instead, a plaintiff must allege facts showing that “defendants benefited in some concrete and personal way from the purported fraud,” *Novak*, 216 F.3d at 307-08, and received “special benefit” not shared by all corporate insiders or all shareholders. *Kalnit v. Eichler*, 224 F.3d 131, 142 (2nd Cir. 2001).

c. District Courts Apply The Second Circuit’s "Motive and Opportunity" Test

In a variety of factual settings, district courts within the Second Circuit have applied the "motive and opportunity" formulation for pleading scienter. *See, e.g., In re Complete Mgmt. Sec. Litig.*, No. 99 Civ. 1454 (NRB), 2001 U.S. Dist. LEXIS 3663, Fed. Sec. L. Rep. (CCH) ¶ 91,361 (S.D.N.Y. Mar. 30, 2001) (company failed to disclose that its critical receivables were tainted by fraud and uncollectible; scienter alleged as to individual officers because collectibles were huge proportion of business and defendants were members of top management; company’s need to inflate share value to conduct acquisitions was evidence of motive to commit fraud); *In re Revlon, Inc. Sec. Litig.*, No. 99 Civ. 10192 (SHS), 2001 U.S. Dist. LEXIS 3265 (S.D.N.Y. Mar. 27, 2001) (denying motion to dismiss claims that defendants prematurely booked revenue, dumped inventory, and engaged in counterproductive cost-cutting measures in order to inflate revenue; scienter was satisfied by allegations of defendants’ monitoring and awareness of challenged practices); *Rizzo v. MacManus Group, Inc.*, No. 00 Civ. 772 (WHP), 2001 U.S. Dist. LEXIS 3655, Fed. Sec. L. Rep. (CCH) ¶ 91,354 (S.D.N.Y. Mar. 29, 2001) (denying motion to dismiss claims by former CEO who negotiated a severance agreement and received payment for
his stock after receiving misleading representations about the prospect of an imminent merger; plaintiff alleged that defendants "knew but concealed" material information; \textit{Fellman v. Electro Optical Sys. Corp.}, No. 98 Civ. 6403, 2000 U.S. Dist. LEXIS 5324, at *29-30 (S.D.N.Y. Apr. 25, 2000) (allegations that defendant corporate insiders were compensated via direct payment, stock ownership, or through other "financial dealings" were insufficient to allege their motivation to commit fraud); \textit{In re MCI Worldcom, Inc. Sec. Litig.}, No. 99-CV-3136 (ILG), 2000 U.S. Dist. LEXIS 5038, at *16-22 (E.D.N.Y. Apr. 13, 2000) (denying motion to dismiss claims by former shareholders of acquired company who alleged that acquirer had implied that it had no plans just days before completing takeover; plaintiffs asserted that MCI was motivated to deflate SkyTel's stock price in order to keep the acquisition price lower and yet make terms of offer more attractive to SkyTel shareholders); \textit{In re American Bank Note Holographies, Inc. Sec. Litig.}, No. 99 Civ. 0412 (CM), 2000 U.S. Dist. LEXIS 5367, at *51-60 (S.D.N.Y. Apr. 6, 2000) (denying motion to dismiss securities fraud claims against officers and company that spun off subsidiary whose financial statements were seriously misstated and subsequently went bankrupt; alleged GAAP violations were so large and perpetuated for such a long time that court found that they created strong circumstantial evidence of scienter, even though plaintiffs failed to alleged individual defendants' motive to commit fraud).

In one case, \textit{In re Fine Host Corp. Sec. Litig.}, 25 F. Supp. 2d 61 (D. Conn. 1998), Judge Hall held that the language in the PSLRA relating to "information and belief" pleading applies \textit{only} to pleading fraud, not scienter. Thus, there is no requirement that plaintiff plead the source of the information upon which the allegations regarding a particular defendant's scienter are based. In that case, the court held that allegations of specific facts indicating that a defendant corporate officer had falsified the company's financial statements were sufficient to plead scienter, where plaintiffs alleged that he admitted in a telephone call that he had knowingly (and improperly) capitalized current expenses to increase the company's earnings.

d. Other District Courts Apply "Motive and Opportunity"

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. \textit{See Branca}, 2000 U.S. Dist. LEXIS 1704, at *17 ("Because the PSLRA did not amend or alter existing pleading standards, the court joins those other courts who have recognized the continuing validity of the motive and opportunity test for pleading scienter.") (citations omitted); \textit{In re Datastream Sys., Inc. Sec. Litig.}, C/A No. 6:99-0088-13, 2000 U.S. Dist. LEXIS 1468, at *8 n.3, *9 (D.S.C. Jan. 31, 2000) (noting that "the Fourth Circuit has not adopted a standard for pleading scienter under the PSLRA" but asserting that "this Court believes the Second Circuit offers a sufficient standard for determining whether a 'strong inference' exists"; upholding complaint's allegations of defendants' motive and opportunity); \textit{McNamara v. Bre-X Minerals Ltd.}, 57 F. Supp. 2d 396, 408 (E.D. Tex. 1999) (citations omitted) (dismissing securities fraud action against potential business partner and underwriter, financial adviser, securities analysts and engineering consultant of company that allegedly misrepresented its gold reserves; complaint's reliance on "must have known" scienter grounded in defendants' visits to site gold reserves held insufficient to plead scienter, even under "motive and opportunity" test); \textit{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); \textit{In re BankAmerica Corp. Sec. Litig.}, 78 F. Supp. 2d 976, 990-91 (E.D. Mo. 1999) (permitting
plaintiffs to proceed with claims that merger partner failed to disclose major investment losses and that merger was falsely portrayed as marriage of equals; expressly adopting Second Circuit "motive and opportunity" standard for pleading scienter); 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). 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 Second Circuit Decisions On "Motive And Opportunity"

a. The Advanta Decision

In In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3rd 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)).

Advanta involved a class action against a credit card issuer that attracted new customers with unusually low introductory interest rates ("teaser" rates) that remained in effect for a limited period of time, after which the interest rate would then return to a higher, permanent level. Advanta shareholders brought suit against the corporation and several of its officers, alleging that they had made false and misleading statements and material admissions regarding the company's earnings potential.

The focus of the securities fraud litigation was a $20 million loss that Advanta announced in the first quarter of 1997. In September 1996 -- about six months before this loss -- one of Advanta's officers had projected a "large increase in revenues" as Advanta converted more than $5 billion in accounts from teaser rates to its normal interest rate. 180 F.3d at 528. Nine months later -- and three months following Advanta's announcement of its first quarter 1997 loss -- Advanta's chairman and former CEO explained that "[w]hat happened is that when the introductory period ended, we were probably not as aggressive as we could have been" in repricing the interest rates. Id. Plaintiffs alleged that the latter statement (Alter statement) demonstrated that the earlier statement (Point) statement was fraudulent when made. They also alleged that Advanta had made a series of false "positive portrayals" about its earnings and future. Id.

The Third Circuit found that the "precise extent to which Congress intended to adopt the Second Circuit standard is not clear," id. at 531, and that the PSLRA's legislative history on this point was "ambiguous and even contradictory." Id. Given the contradictory and inconclusive nature of the legislative history, the appellate court instead focused on the statute's plain
language "requir[ing] the plaintiff to allege facts supporting a 'strong inference' of ... the required state of mind." *Id.* at 533-34. Because this language "closely mirrors" the language employed by the Second Circuit, *id.* at 533, the Third Circuit concluded that

Congress's use of the Second Circuit's language compels the conclusion that the [PSLRA] establishes a pleading standard approximately equal to that of the Second Circuit. Because the Second Circuit standard was regarded as the most restrictive prior to the [PSLRA], this interpretation is consistent with Congress's stated intent of strengthening pleading requirements and deterring frivolous securities litigation.

*Id.* at 534. The court also held that recklessness was still sufficient to satisfy the scienter requirement, and that the PSLRA "did not purport to alter the substantive contours of scienter." *Id.*

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.

The Third Circuit found that the pleading at issue did not satisfy its standard. *Id.* at 539. First, the statement that Advanta "'will experience a large increase in revenues'" was found to be a "forward-looking" statement under the PSLRA. *Id.* Accordingly, it was protected under the PSLRA's safe harbor, unless it was made with "actual knowledge" that it was false and misleading. *Id.*

Plaintiffs argued that the falsity of the statement was proven by Advanta's CEO's later statement that "'we were probably not as aggressive as we could have been'" in repricing the company's interest rates. The Third Circuit found that this was not sufficient to support an inference that Advanta had actual knowledge that the forward-looking statement was false at the time it was made:

The complaint's only specific factual allegation regarding the falsity of the Point statement is the existence of the Alter statement some nine months later. But the Point statement and the Alter statement are not inconsistent: Point stated in September 1996 that Advanta planned to reprice its teaser rates to 17%; nine months later, Advanta expressed regret that Advanta did not reprice to that level.

*Id.* Accordingly, the appellate court found that the statement was protected by the safe harbor provision for forward-looking statements under the PSLRA.

The Third Circuit also found that the plaintiffs had not alleged facts sufficient to support an inference that the positive portrayals of Advanta's business were made with scienter. *Id.* at 539. The court found that these positive portrayals fell into two categories: "accurate reports of
past earnings" and "non-actionable expressions of optimism for the future." Id. With respect to the first category, the Third Circuit states that "[f]actual recitations of past earnings, so long as they are accurate, do not create liability under Section 10(b)" of the Exchange Act. Id. at 538 (citation omitted). The second category of statements, expressing optimism for the future, were found to "constitute no more than 'puffery' and are understood by reasonable investors as such." Id. (citation omitted).

Even if these positive portrayals had been materially misleading, the Third Circuit found that the complaint should still be dismissed because it contained no more than conclusory allegations that the "defendants must have been aware of the impending losses by virtue of their positions within the company." Id. at 539. Such "[g]eneralized imputations of knowledge do not suffice," the court held, "regardless of the defendants' positions within the company." Id.

b. Third Circuit District Court Opinions

District courts within the Third Circuit have applied the standard for alleging scienter in a wide variety of securities fraud cases. See, e.g., In re Reliance Secs. Litig., MDL Docket No. 1304, 2000 U.S. Dist. LEXIS 5111 (D. Del. Apr. 19, 2000) (refusing to dismiss claims by shareholders who objected to failure of officers, directors and an outside accounting firm to disclose seriously deteriorating state of company's loan portfolio; substantial inference of recklessness held established by combination of GAAP violations, fact that loan losses were increasing substantially at same time that reserves were declining substantially, and fact that new chief financial officer identified problem quickly after taking office); In re Cendant Corp. Sec. Litig., 76 F. Supp. 2d 531, 536-38 (D.N.J. 1999) (permitting investment management firm to proceed with § 10(b) claims against company and two executives who assured plaintiff that original announcement of need for income restatement was accurate when, soon thereafter, company had to substantially increase size of restatement; sufficient allegations of scienter found where individual defendants were aware of requests for very large transfers of money from merger reserves into income statements, thereby exceeding the size of original restatement; court noted that one of the insiders had sold all of his shares in the company before the original report was issued); 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"); denying securities fraud claims against officer of company that disguised marketing expenses and artificially inflated financial statements; complaint alleged his direct participation in scheme and he had direct financial interest in propping up stock price to better enable sale of his shares and use them as collateral for loan); In re Cendant Corp. Sec. Litig., 60 F. Supp. 2d 354, 369 (D.N.J. 1999) (denying most of motion to dismiss by defendants charged with omissions and misleading disclosures of accounting irregularities that later required substantial downward restatement of revenue; scienter held sufficiently pled because individual defendants were company insiders privy to knowledge of problems and many of them engaged in substantial stock sales during class period; allegations also supported strong inference of reckless on part of accounting firm defendant); Kenilworth Partners L.P. v. Cendant Corp., 59 F. Supp. 2d 417, 428 (D.N.J. 1999) (claims dismissed because complaint alleged little more than that corporate officer and director
defendants "must have known" of the true facts simply by virtue of their positions at company; "if the court inferred scienter from mere fact of director's position, then 'executives of virtually every corporation in the United States would be subject to fraud allegations'") (citation omitted).

c. Other District Courts Follow Advanta

District courts in other circuits have followed the Third Circuit's formulation of the PSLRA's scienter requirement. 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."; court dismissed claims that company's failure to promptly disclose erroneous loan prepayment assumption that affected incentive-based compensation did not suffice as scienter; while defendants' compensation was based on company's earnings, they could not profit from artificially inflated earnings because they suffered substantial losses when earnings were restated; individual defendants' increase in shareholdings during class period countered alleged motive to defraud shareholders); accord In re Engineering Animation Sec. Litig., Civil No. 4-99-CV-10117, 2000 U.S. Dist. LEXIS 5118, at *20-22 (S.D. Iowa Mar. 24, 2000) (following Advanta and Green Tree); 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."; holding that individual officer defendants' sale of 34% to 94% of their stockholdings during three-month class period was unusual enough to support inference of scienter) (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 Third Circuit 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); 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, Fed. Sec. L. Rep. (CCH) ¶ 90,711 (N.D. Tex. Oct. 28, 1999) (dismissing action brought by physicians against medical support company that misrepresented its abilities in order to win contract with plaintiffs; plaintiffs failed to allege "motive and opportunity" scienter because only motive asserted was defendants' general desire to preserve capital by offering stock to plaintiffs and this was too general a motive to support scienter under PSLRA).
4. Other Formulations Of The Scienter Pleading Requirement

a. Introduction

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).

b. *Silicon Graphics*: The Ninth Circuit's Approach

In a district court opinion issued following enactment of the PSLRA, Judge Smith held that in order to state a private securities fraud claim, "plaintiffs must create a strong inference of knowing or intentional misconduct," explaining that "[m]otive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the circumstances creates a strong inference of fraud." *Silicon Graphics*, 970 F. Supp. at 757. Judge Zilly termed this the "Second Circuit plus" test for determining whether plaintiffs have adequately pled scienter. *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1176 (W.D. Wash. 1998) (holding that knowing misstatements and defendants' motive to complete corporate merger were sufficient to establish a strong inference of scienter).

Prior to the Ninth Circuit's *Silicon Graphics* decision, district courts within the circuit were divided as to what allegations of scienter passed muster under the PSLRA. *Compare In re Ascend Comm. Sec. Litig.*, No. CV 97-8861 MRP, 1999 U.S. Dist. LEXIS 20716 (C.D. Cal. Feb. 2, 1999) (recognizing that motive and opportunity method of pleading scienter is still appropriate, but finding plaintiffs' allegations that defendants wished to inflate company's stock prices too conclusory to suffice); *Head v. Netmanage, Inc.*, No. C 97-4385 CRB, 1998 U.S. Dist. LEXIS 20433, at *11-14, Fed. Sec. L. Rep. (CCH) ¶ 90,412 (N.D. Cal. Jan. 4, 1999) (allegations of insider trading held insufficient to establish scienter because they did not establish sales that were unusual or suspicious enough); *Lawrence v. Zilog, Inc.*, No. C-98-20420-JF, 6 Securities Reform Act Litig. Rptr. 220, 224 (N.D. Cal. Sept. 30, 1998) (forward-looking statements; complaint dismissed because plaintiff's conclusory allegations were insufficient to give rise to a strong inference of actual knowledge under "any possible standard") and *Plevy v. Haggerty*, 38 F. Supp. 2d 816, 834-35 (C.D. Cal. 1998) (shareholders failed to adequately allege scienter on part of corporate officers and directors; allegations that defendants were motivated to issue misleading statements to cash in on artificially inflated stock prices failed to raise strong inference of scienter because plaintiffs failed to show that defendants' trades were unusual) *with PETS MART*, 61 F. Supp. 2d at 990 (recognizing that Second Circuit's "motive and opportunity" test to plead scienter under PSLRA was still valid, but failing to determine whether plaintiffs' allegations were sufficient because of other pleading deficiencies); *Schlagal v. Learning Tree Intl, Inc.*, No. CV 98-6384 ABC, 1998 U.S. Dist. LEXIS 20306, at *48-56, Fed. Sec. L. Rep. (CCH) ¶ 90,403 (C.D. Cal. Dec. 23, 1998) (recognizing that Second Circuit standard for pleading scienter remained viable; allegations grounded on the boosting of executives' bonus compensation and inflating corporation's stock price met "motive" test, and evidence of "conscious" or "reckless" behavior met by alleging stock sales shortly after positive announcements, violations of GAAP, and defendants' regular receipt of internal corporate reports); *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*, Master File No. CV 96-
0872 WJR, 1998 U.S. Dist. LEXIS 12743, at *2-4 (C.D. Cal. Aug. 12, 1998) (refusing to dismiss '10(b) claims brought against corporation alleged to have participated in ship-hold-and-return scheme aimed at fraudulently inflating stock price of related concern where it was alleged to have made knowingly false statements to securities analyst); In re Ancor Comms., Inc. Sec. Litig., 22 F. Supp. 2d 999, 1006 (D. Minn. 1998) (failure to disclose product's incompatibility with another manufacturer's component, combined with allegations of insider trading and GAAP violations, were sufficient even under Silicon Graphics' "conscious behavior" test).

The Ninth Circuit adopted the most stringent pleading standard in In re Silicon Graphics, Inc. Sec. Litig., 183 F.3rd 970 (9th Cir.), rehearing denied, 195 F.3rd 521 (9th Cir. 1999) (en banc), holding that

a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.... [A]lthough 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.

183 F.3rd at 974 (emphasis in original).

The Silicon Graphics court's holding rested on the conclusion that Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so. Instead, as the Ninth Circuit held:

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 PSLRA.

Id. See also Heliotrope Gen'l, Inc. v. Ford Motor Co., 189 F.3rd 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).

Several district courts within the Ninth Circuit have applied this stringent standard and nevertheless found plaintiff's allegations to be sufficient. See Marks v. Simulation Sciences, Case No. SA CV 98-546 GLT, 2000 U.S. Dist. LEXIS 4536, at *12 (C.D. Cal. Feb. 28, 2000) (plaintiffs sufficiently pled specific facts regarding fraudulent accounting practices to survive defendant company's motion to dismiss); In re Imperial Credit Indus., Inc. Sec. Litig., Case No. CV 98-8842 SVW, 2000 U.S. Dist. LEXIS 2340, at *6-8 (C.D. Cal. Feb. 22, 2000) (plaintiffs alleged defendants' scienter with sufficient particularity by alleging "numerous e-mails and internal reports" raising a strong inference that defendants knew that their public statements were false and misleading at time they were made); 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 defendants' motion to dismiss, holding that allegations that Sonus failed to report FDA inspections revealing problems with pending approval of its drug showed strong inference that defendants acted with required state of mind; In re Imperial Credit Indus., Inc. Sec. Litig., Case No. CV 98-8842 SVW, 2000 U.S. Dist. LEXIS 2340, at *5-9 (C.D. Cal. Feb. 22, 2000) (complaint pled defendants' scienter with sufficient particularity by "point[ing] to numerous e-mails and internal reports that raise a strong inference that Defendants knew [their public statements] were false or misleading at the time they were made"; "inference of scienter" was supported by plaintiffs' allegations of motive: "Defendants had a strong incentive to inflate SPF's financial status because they were shopping SPF for a buyer and sought to attract a large bid"; "[a]lthough evidence of motive is not sufficient to support an inference of scienter" under the Ninth Circuit's decision in Silicon Graphics, "it is still probative to the inquiry")

In In re Southern Pacific Funding Corp. Sec. Litig., Civil No. 98-1239-MA, 1999 U.S. Dist. LEXIS 20833 (D. Or. Dec. 7, 1999), Judge Marsh offered an extensive discussion of the Ninth Circuit's opinion in Silicon Graphics, explaining first the concept of "deliberate recklessness":

I find that the Silicon court raised the substantive standard applicable to § 10(b) claims to that of deliberate recklessness and that "deliberate recklessness" constitutes a higher degree of recklessness than previously contemplated. I further find that "deliberate recklessness," means that the defendants must have acted with full knowledge of the risks of the consequences of their actions in a manner akin to that of a driver that attempts to speed across railroad tracks in front of a rapidly approaching and clearly visible oncoming train. This formulation takes into account the level of risk as measured against the severity of the consequences and the knowledge of the defendant of both factors.

Id. at *13. The court also found that "materiality" and "factual context" are "critical factors in examining the adequacy of pleading scienter." Id. at *14. As Judge Marsh explained:

If a corporate president receives a report that his largest factory has burned to the ground and nevertheless attends a stock holder meeting and publicly claims that there will be no slow down in a production schedule, the degree of materiality of the omission must have a bearing upon just how wrong his public statement was at the time. The greater the materiality, the greater inference of scienter. Thus, while motive and opportunity are insufficient to give rise to a strong inference of scienter standing alone, motive and opportunity coupled with highly material misrepresentations or omissions may well satisfy the standard. It is one thing to ignore reports of potential bad weather; it is quite another to set sail in the face of a storm.

Id. Finding that plaintiffs had met the heightened particularity requirement of the PSLRA, Judge Marsh analyzed the allegations of the complaint:
Overall, the complaint paints a picture of a group of corporate insiders who knew that the entire mortgage lending industry was facing significant hardships due to the drop in lending rates. The complaint further reveals that the defendants attempted to distinguish SPF from others in the industry by assuring investors that SPF was utilizing particularly conservative assumptions relative to pre-payment rates and delinquencies such that the general industry downturn should not have adversely affected SPF. In spite of these assurances, the complaint alleges that defendants were aware, over a lengthy period, of the fact that their pre-payment and delinquency assumptions were grossly inaccurate and that these inaccuracies threatened the financial stability of the company. Board meeting minutes and e-mail reveal that defendants were aware of the seriousness of the situation SPF faces. I find that these allegations satisfy the "deliberate recklessness" pleading standard set forth in Silicon [Graphics]. If proven, the facts alleged support a finding that the defendants knew that they were driving in front of a speeding freight train and that there was a high likelihood of getting hit.

Id. at *17-18 (emphasis added). See also Symposium, Securities Fraud Litigation After Silicon Graphics, 7 Securities Reform Act Litig. Rptr. 798 (Aug.-Sept. 1999).

In SEC v. Dain Rauscher, Inc., 254 F.3d 852 (9th Cir. 2001), where the Ninth Circuit reversed a dismissal of an SEC action brought against an investment banker that allegedly participated as an underwriter in Orange County's too-risky investment strategy, resulting in the county's bankruptcy and its consequent defaults on bonds used to finance the strategy, the court defined scienter without reference to Silicon Graphics. The court stated that "[s]cienter is satisfied by recklessness." Id. (citing Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc)). Whether this opinion signals an abandonment of the stringent pleading standard stated in Silicon Graphics remains to be seen.

Thus far, none of the other circuit courts have adopted the Ninth Circuit's rigorous 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").

c. The Sixth and Eleventh Circuits

In contrast to the approach taken in the Second and Third Circuits, 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. In one case, In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 549-51 (6th Cir. 1999), the Sixth Circuit held 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 In re Prison Realty Sec. Litig., No. 3:99-0452, 2000 U.S. Dist. LEXIS 2228, at *10-11 (M.D. Tenn. Feb. 17, 2000) ("Defendants' alleged knowledge of facts that contradicted public statements, in combination with the proximity in time between the alleged misrepresentations and the disclosure ... are enough to create a strong inference of scienter"). See also Phycor, 2000 U.S. Dist. LEXIS 2218, at *12 (amended complaint "alleges sufficient circumstantial evidence of knowing or reckless

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In *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001), however, by a 7-6 *en banc* decision the Sixth Circuit rejected the Ninth Circuit's holding in *Silicon Graphics* that "recklessness" is insufficient to establish scienter under Rule 10b-5. The Sixth Circuit adopted the Second Circuit's view of the PSLRA's pleading standard for scienter (as elucidated in *Novak*) thereby representing a shift from the prior perception that the Sixth Circuit had rejected "motive and opportunity" facts as inadequate. The Sixth Circuit's pleading standard for scienter is now congruent with the standard followed in the First and Second Circuits, which require a "strong inference" of scienter (which may be mere recklessness), and allowing any facts to show this strong inference including, but not limited to, facts which show "motive and opportunity" to defraud sufficient to raise that "strong inference."

In *Bryant*, 25 F. Supp. 2d at 1379-81, Judge Fitzpatrick adopted the Second Circuit's standard for pleading scienter, refusing to dismiss § 10(b) claims against a restaurant company that was alleged to have fraudulently inflated the price of its stock. The court held that plaintiffs' allegations raised a sufficient inference of scienter where they charged that the individual defendants' knowledge of the corporation's problems were at odds with the company's public statements. Moreover, three of the individual defendants had sold substantial portions of their stockholdings. The district court, however, coupled its rulings in favor of plaintiffs with a recommendation that the Eleventh Circuit permit an immediate interlocutory appeal of the decision. See also *In re Baker Hughes Sec. Litig.*, No. H-99-4281 (S.D. Tex. Mar. 30, 2001) (rejecting "motive and opportunity" as basis for scienter); *Malin v. Ivax Corp.*, 17 F. Supp. 2d 1345, 1357-58 (S.D. Fla. 1998) (ruling that allegations regarding defendants' motive and opportunity do not suffice to allege scienter under PSLRA); *In re Physician Corp. of America Sec. Litig.*, No. 97-3678-CIV-MIDDLEBROOKS, 1999 U.S. Dist. LEXIS 7229, at *33, Fed. Sec. L. Rep. (CCH) ¶ 90,479 (S.D. Fla. Feb. 18, 1999) ("We disagree ... that 'motive and opportunity' evidence alone will meet the pleading requirements in the Eleventh Circuit.").

The Eleventh Circuit addressed the scienter pleading issue in *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283, 1285 (11th Cir. 1999), where it stated that "we are in basic agreement with the Sixth Circuit," and it "reject[ed] the notion that allegations of motive and opportunity to commit fraud, standing alone, are sufficient to establish scienter in this Circuit." Accord *Theoharous v. Fong*, 2001 U.S. App. LEXIS 15499, at *8 (11th Cir. July 11, 2001) (plaintiff must allege facts "giving rise to a strong inference that the defendant acted 'in a severely reckless manner'") (quoting *Bryant*). See also *In re World Access, Inc. Sec. Litig.*, Civil Action No. 1:99-CV-43-ODE, 2000 U.S. Dist. LEXIS 4245, at *22-24 (N.D. Ga. Mar. 28, 2000) (plaintiffs met pleading threshold by alleging eight identifiable problems associated with a switch identified in
defendants' press release, averring that defendants' financial statements were false or misleading because they did not make appropriate accounting entries to reflect non-payments arising from disputes about the switches, and by alleging that defendants routinely employed "bill and hold" practices).

d. The First Circuit Follows the Sixth Circuit

Prior to the PSLRA, the First Circuit required securities fraud plaintiffs to allege "specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading." Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992). Following the statute's enactment, the court asserted that "we do not interpret the [PSLRA] standard to differ from that which this court has historically applied." Maldonado v. Dominguez, 137 F.3d 1, 9 n.5 (1st Cir. 1998) (citing Greenstone); see also Peritus, 52 F. Supp. 2d at 219. In Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999), however, 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 Gelfer v. Pegasystems, Inc., No. CV 98-12527-JLT, 2000 U.S. Dist. LEXIS 834, at *11-25,

e. Other Circuits Join The Fray

Recently, in Nathenson v. Zonagen, Inc., 267 F.3d 400 (5th Cir. 2001), and City of Philadelphia v. Fleming Co., 264 F.3d 1245 (10th Cir. 2001), the Fifth and Tenth Circuits weighed in on this issue. In Nathenson, plaintiffs contended that defendants had sold as a large amount of stock at a price inflated by misrepresentations. The Fifth Circuit was not persuaded by the arguments of plaintiffs and the SEC (as amicus curiae) that the motive-and-opportunity method of pleading scienter survived passage of the PSLRA. The Fifth Circuit viewed the debate over whether the PSLRA adopted the Second Circuit’s pleading standard as somewhat beside the point because motive and opportunity “was only an analytical device for assessing the logical strength of the inferences arising from particularized facts.” 267 F.3d at 411. The court observed that “simply because motive and opportunity is alleged does not of itself automatically and categorically mean that that the necessary strong inference of scienter is present.” Id. at 412. The court held that the plaintiff must allege “particularized facts giving rise to a strong inference of scienter.” Id. at 410.

In City of Philadelphia, the Tenth Circuit found insufficient plaintiffs’ allegations that defendants fraudulently concealed facts to facilitate an offering of the company’s securities, to avoid jeopardizing the success of the company, to minimize the possibility of other similar lawsuits, to protect and enhance their executive positions and compensation, and to enhance the value of their stock positions. 264 F.3d at 1256-57.

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, several years ago the SEC 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 diminsh 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).

The SEC's expressed concern is understandable: Since January 1997, at least $33 billion in market value has been wiped out as a result of accounting errors (based upon the decline in stock prices following disclosures by more than a dozen companies, including:

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Value Lost</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oxford Health Plans</td>
<td>market value lost</td>
<td>$4.25 billion</td>
</tr>
<tr>
<td>Sunbeam</td>
<td>market value lost</td>
<td>$3.75 billion</td>
</tr>
<tr>
<td>Green Tree Financial</td>
<td>market value lost</td>
<td>$1.62 billion</td>
</tr>
<tr>
<td>Philip Services</td>
<td>market value lost</td>
<td>$1.42 billion</td>
</tr>
</tbody>
</table>

According to a recent study published by accounting firm Arthur Andersen, over the last four years nearly one in five accounting restatements – red flags for potential misconduct – have been by companies in California. During the same four-year period, the total number of restatements has nearly doubled. According to the Arthur Andersen study of accounting restatements from 1997 to 2001, 27% of the restatements nationwide were filed in the software and computer industries. See Karl Schoenberger, *When the Numbers Just Don't Add Up*, N.Y. Times, Aug. 19, 2001.

The most visible indicator of improper accounting – and source of new SEC investigations – is the growing number of restated financial reports. Restatements ballooned to 233 last year, twice the number in 1997, according to a recent study by Arthur Andersen LLP. Of those, only 9% resulted from new accounting methods required by the SEC.


Financial Executives International (FEI), which studies accounting issues, reported in the Spring of 2001 that there have been 464 cases of financial statements being restated during the previous three years. *That's more than all restatements during the previous seven years.* Matt Krantz & Greg Farrell, *Fuzzy accounting raises flags*, usatoday.com, June 22, 2001. *FEI says that more than $31.2 billion in market value was wiped out following earnings restatements in 2000.* Id.
<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mercury Finance (April 1997)</td>
<td>Auto finance company</td>
<td>Restated 1996 results: In Jan. 1997, initially reported earnings of $120.7 million; Apr. 1997 &quot;update&quot; anticipated 1996 loss of $48-$55 million  1995 results changed from net income of 57 cents per share to 43 cents per share  $2.64 billion market value lost</td>
</tr>
<tr>
<td>Centennial Technologies (June 1997)</td>
<td>Maker of computer memory cards</td>
<td>Restated results for 14 quarters through end of 1996  $28.1 million loss for restated period, versus aggregate net income of $12.1 reported for 42-month period  Restatement resulted from audit following dismissal and arrest of founder and ex-CEO on securities fraud charges  Restatement showed that company never had profitable quarter during period in which it often reported record earnings growth  Stock was top-performing issue on NYSE for 1996  Securities fraud claims settled for $24 million</td>
</tr>
<tr>
<td>Informix (Nov. 1997)</td>
<td>Database software maker</td>
<td>Restated 14 quarters of financial statements due to accounting irregularities  1996 reported net income of $97.8 million restated to net loss of $73.6 million  Company recognized revenue from software that was shipped to distributors, even though products were never sold through to final</td>
</tr>
<tr>
<td>Company</td>
<td>Date</td>
<td>Description</td>
</tr>
<tr>
<td>------------------</td>
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<tr>
<td>Medaphis</td>
<td>Nov. 1997</td>
<td>Provider of business management and software services to doctors and hospitals. Disclosed that federal regulators were examining its bookkeeping practices. Securities fraud claims settled for $142 million.</td>
</tr>
<tr>
<td>Fine Host</td>
<td>Feb. 1998</td>
<td>Food concession operator. Restated financial results for four years, wiping out all of its earnings during that time and posting losses due to &quot;accounting irregularities&quot;. <em>Wall Street Journal</em> reported: &quot;In revising its results downward, Fine Host cited a failure to properly record expenses and a tendency to prematurely record profit.&quot; Stock delisted by NASDAQ. $244 million market value lost.</td>
</tr>
<tr>
<td>Company</td>
<td>Event Date</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
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| Vesta Insurance | Aug. 1998  | Property and casualty insurer  
Earnings were restated for four years due to improper accounting practices  
Restatement lowered net income by $72.4 million  
$874 million market value lost                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | $874 million      |
| Livent       | Aug. 1998  | Theatrical production company  
Announced it would restate earnings because of "serious irregularities" in its financial records  
Company said it was "virtually" certain it would restate financial results back to 1996 due to "millions of dollars" in irregularities  
Subsequent bankruptcy filing                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               | $113              |
| Cendant      | Aug. 1998  | Product of $14 billion merger in late 1997 between HFS (franchise operator) and CUC Int'l (membership club operator)  
Announced it had uncovered substantial accounting irregularities in former CUC business unit  
Revealed that CUC had been padding its results since 1995, creating more than $500 million of imaginary profits to meet Wall Street "expectations"                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |                  |
In 2000, Virginia-based MicroStrategy, Inc.'s common stock price fell $140 (to $86.75), a decline of 62%, after the company reported that its auditors had forced it to defer about one-quarter of the $205.4 million in revenue it had reported for 1999. The plunge wiped out nearly $12 billion in market value for the company. See Floyd Norris, MicroStrategy Shares Plunge On Restatement, N.Y. Times, Mar. 21, 2000, at C1; Greg Miller, Software Stock Falls 62% After Sales Revision, L.A. Times, Mar. 21, 2000, at C1.

And then we come to the recent revelations about Enron Corp., a pioneer of energy trading, a way of using financial techniques of trading forward commitments in natural gas and electricity to establish future prices on long-term supply contracts. As the business boomed, Enron’s reported revenue soared, from $20 billion in 1997 to $100 billion in 2000. Through the first three quarters of 2001, the firm was on course to exceed $200 billion in revenue. But in October 2001, Enron announced that it had lost more than $600 million in the third quarter, and that it needed to reduce shareholder equity by $1.2 billion due to certain undisclosed transactions with one of its partnerships. Then, on November 8, 2001, Enron restated its accounts back to 1997. **The restatements resulted in a reduction of reported profit by more $586 million.** James Flanigan, Enron's Troubles Could Spur Securities Reform, L.A. Times, Nov. 25, 2001, at C1; see also Andersen Could Face SEC Sanction, Suits Over Enron Accounting Error, L.A. Times, Nov. 13, 2001, at C7.

Recent disclosures about the “culture” of fraud at Cendant Corp. (the successor to CUC International) made clear that for more than ten years (from approximately 1985 to 1998) its top executives directed a conspiracy to inflate profit so as to meet Wall Street analysts' forecasts and to keep the stock price high. See Floyd Norris & Diana B. Hendriques, 3 Admit Guilt in Falsifying CUC’s Books, N.Y. Times, June 15, 2000, at C1 (“Three former executives of CUC International pleaded guilty today to federal charges in what the authorities said was the largest and longest accounting fraud in history, continuing at least 12 years and costing investors $19 billion.”). One commentator wondered how the company’s auditors missed the fraud:

For all those years, the books were audited by Ernst & Young or its predecessor, Ernst & Whinney. In hindsight, they missed more than a few red flags. A report by Arthur Andersen, another accounting firm hired after the fraud was exposed, described meetings in which Ernst & Young officials asked questions and got odd answers. In one case, there was no explanation or documentation for $25 million in profits. The auditors decided that was not a material amount, and let it go. The Andersen report did not criticize Ernst & Young, but that was no surprise. Ernst & Young had refused to supply...
information to Andersen until it was promised that the report would not comment on the quality of the Ernst & Young audits.

The S.E.C. says that the fraud was easier to pull off because CUC officials knew which subsidiaries would be audited, and therefore hid the most obvious frauds in subsidiaries that they knew the auditors would not look at.

As the fraud grew, CUC's old tactics of inflating revenues and suppressing expenses were no longer adequate. So it took to manipulating merger reserves, which are supposed to cover one-time costs related to takeovers and are often ignored by investors. The reserves became a cookie jar in which operating losses could be fraudulently concealed. Unfortunately for CUC, some of its acquisitions were such dogs that the merger reserves were soon exhausted, making it necessary to make more acquisitions.

Did the auditors know what was going on? They deny it, and there is no proof that they did. But they didn't show much suspicion when confronted with some odd-looking transactions of funds between various accounts.


In litigation arising out of Cendant’s cross-claims against its auditor, Ernst & Young ("E&Y"), for settlement payments made to defrauded investors, the district court held:

- Contribution by E&Y was barred on both the Section 11 (Securities Act) and Rule 10b-5 (Exchange Act) claims because § 21D of the Exchange Act bars contribution claims against a settling defendant, and that rule applies where Securities Act (or other) claims are “integrally related” to the Exchange Act claims.
- Section 21D of the Exchange Act does not bar indemnity claims, although indemnity is not ordinarily available for securities law violations.
- State law claims for tort, breach of contract and/or breach of fiduciary duty may be actionable.
- Under a standard audit engagement, an auditor contracts to report fraud to the non-defrauding managers or directors. Whether an account acting in any capacity is a fiduciary presents a question of fact.

B. Specific Allegations Of Accounting Fraud Supporting Strong Inference Of Scienter Under The PSLRA

1. Earnings/Revenue Misrepresentations

"A defendant's failure to recognize revenue in accordance with GAAP does not, by itself, suffice to establish scienter." Chalverus, 59 F. Supp. 2d at 233 (citation omitted). Rather, the court must determine "whether the alleged GAAP violations, combined with other circumstances indicative of fraudulent intent, raise a strong inference that the defendants acted with scienter." Id. at 233 (emphasis added) (citing In re Ancor Comms., 22 F. Supp. 2d at 1005 (noting that "violations of GAAP, in combination with other factors, may support a strong inference of scienter").

A number of district courts have held that misrepresentations about the company's earnings or revenue, if pled with requisite particularity, satisfy the applicable standard for pleading scienter under the PSLRA. See Gelfer, 2000 U.S. Dist. LEXIS 834, at *18-19 (magnitude of revenue overstatements during class period tends to support strong inference of scienter); Phycor, 2000 U.S. Dist. LEXIS, at *16 ("Plaintiffs ... allege in the Amended Complaint that Defendants not only violated GAAP, but also made false and misleading public statements as a result. This is sufficient to overcome a motion to dismiss."); Cendant, 60 F. Supp. 2d at 372-73 (allegations that public accounting firm failed to discover that corporation's operating income and earnings per share were overstated, that firm's audits were not performed in accordance with GAAP, and that its unqualified audit reports filed with SEC were materially false and misleading adequately pled scienter); Chalverus, 59 F. Supp. 2d at 234-36 (investors adequately pleaded scienter in suit involving overstatement of revenue; investors alleged overstatement of $5 million in single quarter, in violation of GAAP; violation of internal policies on income recognition; failure to disclose that cross-license agreement cited as source of $50 million of income over next few years required payment of $12.9 million to cross-licensee; and alleged that both CEO and CFO had motive and opportunity to commit fraud; significant financial restatements may support a conclusion that defendants acted with scienter); 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); 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); Fine Host., 25 F. Supp. 2d at 70 (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, Fed. Sec. L. Rep. (CCH) ¶ 90,431 (S.D.N.Y. Feb. 17, 1999) (closely-held corporation under reported losses and accounts payable and over reported 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. See Peritus, 52 F. Supp. 2d at 223 ("A host of courts have held that a mere failure to recognize revenue in accordance with GAAP does not, by itself, suffice to establish scienter.") (citations omitted). When combined with other circumstances suggesting fraudulent intent, however, "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 In re Oxford Health Plans, Inc. Sec. Litig., 51 F. Supp. 2d 290, 294-95 (S.D.N.Y. 1999) (refusing to dismiss claims against auditors because allegations of GAAP violations, defective computer system and state regulatory discovery of fraud held sufficient to support strong inference of scienter); 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 Comms., 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 (holding sufficient allegations of GAAP and GAAS violations, the auditor's six-year engagement, the magnitude of the misrepresentations, and the auditor's ignorance of "red flags"); 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

In the words of one district court, "[w]hile 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); Vanyjen, 1998 U.S. Dist. LEXIS 10493, at *15 (defendants falsely inflated earnings by including income from fraudulent Medicare billings).

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) (finding sufficient allegations of GAAS violations, including a failure to confirm accounts receivable properly, to support strong inference of auditor scienter; "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 Great Neck Capital Appreciation Investment P'ship, L.L.P. v. PricewaterhouseCoopers, L.L.P., Case No. 99-C-0598, 2001 U.S. Dist. LEXIS 5235 (E.D. Wis. Mar. 30, 2001) (accounting firm was potentially liable for GAAS violations in financial statements in light of firm's knowledge of "red flags"). See also Transcrypt Intl, 1999 U.S. Dist. LEXIS 17540, at *29 (denying motions to dismiss claims against auditor for company that had to substantially restate its financial statements; because the corrected accounts receivable
were less than 30% of the original number, the magnitude of the discrepancy, along with alleged "red flags" and GAAS violations, was sufficient to create necessary strong inference of scienter; 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, Judge Coar of the Northern District of Illinois permitted a complaint to proceed against corporate auditors whose recklessness was evidenced by GAAP violations, "red flags," and the magnitude of the fraud in the company's false financial statements. The court held that plaintiffs satisfied the applicable 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. Following Central Bank, however, the federal courts have split over the threshold required to show that a "secondary" actor's conduct constitutes primary liability. Compare In re Software Toolworks, Inc., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (secondary actors may be held primarily liable for statements made by others in which the former significantly participated) with Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability ... for a statement not attributed to that actor at the time of its dissemination"). See also Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1998) (denying Deloitte & Touche's motion to dismiss securities fraud claims when complaint alleged that accountants certified false revenues); Carley Capital Group v. Deloitte & Touche LLP, 27 F. Supp. 2d 1324, 1333-36 (N.D. Ga. 1998) (refusing to dismiss claims that accounting firm had primary liability for its client's material misrepresentations, including improper revenue recognition, in financial statements; the accountants' direct involvement in the representations, the magnitude of the GAAP violations, and Deloitte's dual role as management consultant and
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 releases, 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, 29 F. Supp. 2d at 1225.

Defendants argue that the "group pleading" doctrine was abolished by the PSLRA, and some district courts have agreed, see Marra, 1999 U.S. Dist. LEXIS 7303, at *13 ("[T]he court concludes that the presumption inherent in group pleading is inconsistent with the PSLRA's purpose") (citing Coates, 26 F. Supp. 2d at 915-16, and Allison v. Brooktree Corp., 999 F. Supp. 1342, 1350 (S.D. Cal. 1998)). In Coates, the court reasoned that because the PSLRA requires plaintiffs to set forth facts raising a strong inference that each defendant acted with the required state of mind, group pleading is inconsistent with the statutory language and purpose: "[I]t is nonsensical to require that a plaintiff specifically allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made the statement or omission." 26 F. Supp. 2d at 916. The Allison court reached the same conclusion for the same reasons, holding that group pleading was suspect because the "judicial presumption"

The greater weight of authority, however, holds that the PSLRA did not prohibit the "group pleading" doctrine. See, e.g., BankAmerica, 78 F. Supp. 2d at 988 ("[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"); In re PeopleSoft Sec. Litig., 2000 U.S. Dist. LEXIS 10953 (N.D. Cal. 2000) (same); 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..."); Learning Tree, 1998 U.S. Dist. LEXIS 20306, at *18 ("Until the Ninth Circuit speaks otherwise, the Court finds the rationale behind the group-pleading doctrine sound and will not disturb it. Given that Plaintiffs have adequately alleged that Defendants ran LTI on a day-to-day basis, Defendants are not entitled to a dismissal on this basis.") (footnote omitted); Miller Indus., 12 F. Supp. 2d at 1329 (group pleading survives enactment of PSLRA); Stratosphere, 1 F. Supp. 2d at 1108 (holding that the PSLRA did not abolish the "group pleading" doctrine); Powers v. Eichen, 977 F. Supp. 1031, 1040 (S.D. Cal. 1997) (same), reconsideration denied, 1997 U.S. Dist. LEXIS 10881 (S.D. Cal. 1997) (same); In re Health Mgmt. Sec. Litig., 970 F. Supp. 192, 208-09 (E.D.N.Y. 1997) (same).

IX. PSLRA SAFE HARBOR FOR "FORWARD-LOOKING" STATEMENTS AND "BESPEAKS CAUTION" DOCTRINE

A. When Forward-Looking Statements Are Protected

Following long-standing efforts by the SEC to create a "safe harbor" for certain forward-looking statements made by corporate management, see SEC Securities Act Release No. 33-6084, 44 F.R. 33810 (June 25, 1979) (promulgating Rule 175 under Securities Act and Rule 3b-6 under Exchange Act), and judicial attempts to immunize statements accompanied by sufficient warnings (the so-called "bespeaks caution" doctrine, see, e.g., In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1414 (9th Cir. 1994), in the PSLRA Congress also attempted to encourage the quality and quantity of forward-looking information disseminated to investors by including a "safe harbor" from liability for certain "forward-looking statements." 15 U.S.C. § 78u-5. Congress enacted the safe harbor provision "in order to loosen the 'muzzling effect' of potential liability for forward-looking statements, which often kept investors in the dark about what management foresaw for the company." Harris v. Ivax Corp., 182 F.3d 799, 806 (11th Cir. 1999) (quoting H.R. Conf. Rep. 104-369, at 42 (1995), reprinted in 1995 U.S. Code Cong. & Admin. News 730, 741)).

Under the PSLRA, the court must determine, at the pleading stage, whether a "forward-looking" statement falls within the "safe harbor." 15 U.S.C. § 78u-5(e); see Karacand, 53 F. Supp. 2d at 1243; MobileMedia, 28 F. Supp. 2d at 930 n.18 ("Before deciding whether the safe
harbor is available, it must first be determined whether there is a 'forward looking statement,' as defined in the [PSLRA].") Because the statute "closes the universe of supposedly false statements under scrutiny to those 'specif[ied]' in the complaint," the 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)).

Whether under the statutory definitions or otherwise, to qualify for the protection offered a statement, either oral or written, must first be deemed to be "forward-looking." See In re Secure Computing Corp. Sec. Litig., 120 F. Supp. 2d 810, 818 (N.D. Cal. 2000) (notwithstanding statutory definitions, court may take more simplistic approach and look to see whether statement is a prediction as to future events as opposed to a statement of current business conditions). If a statement qualifies as "forward-looking," it will fall within the safe harbor if it is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A)(i). Oral statements, such as those made to securities analysts or the press, may also fall within the statutory protection. See 15 U.S.C. § 78u-5(b)(2).

Even if the "forward-looking" statement has no accompanying cautionary language, the plaintiff must prove that the defendant made the statement with "actual knowledge" that it was "false or misleading." 15 U.S.C. § 78u-5(c)(1)(B). These statutory provisions operate independently, see Harris, 182 F.3d at 803; Fellman v. Electro Optical Sys. Corp., 2000 WL 489713, at *4 (S.D.N.Y. Apr. 25, 2000), by which Congress intended to immunize statements with meaningful warnings regardless of allegation of actual knowledge possessed by the speaker. See Greebel v. FTP Software, Inc., 194 F.3d 185, 201 (1st Cir. 1999) ("The safe harbor has two alternative inlets: the first shelters forward-looking statements that are accompanied by meaningful cautionary statements."); see also In re 2TheMart.com Sec. Litig., 114 F. Supp. 2d 955, 961 (C.D. Cal. 2000) ("statements of expectation and belief are, however, actionable if '(1) the statement is not actually believed (2) there is no reasonable basis for the belief or (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy.'") (citation omitted).

Under the PSLRA, 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. See 15 U.S.C. § 77z-2(i) (Securities Act definition of "forward-looking statement"); 15 U.S.C. § 78u-5(i)(1)(A) (Exchange Act definition). Courts have recognized that predictions are often founded upon current facts or interlace present understanding with a belief of possible outcomes. In Harris, 182 F.3d at 803-07, the Eleventh Circuit recognized that such mixed presentations should be viewed "as a whole" and "be either forward-looking or not forward-looking in its entirety"; thus, it held that a statement in a drug company's press release that challenges unique to period in its history were not behind it, when considered in context of anticipated improvements in business, qualified as "forward-looking" statements). See also Adanta, 180 F.3d at 536 (statements predicting that company "will experience a large increase in revenues" as a result of actions to be taken in future "clearly qualifies" as projection and constituted "forward-looking" statements). Other courts have held that it is the overall nature of an assertion that governs whether a statement will qualify, and not whether the statement is
predicated on current facts even if it is alleged that current facts have been omitted. See, e.g., Eizenga v. Stewart Enters., Inc., 124 F. Supp. 2d 967, 978-79 (E.D. La. 2000) (projections were forward-looking despite allegation that they failed to disclose then-existing decline in demand for product); Fitzer v. Security Dynamics Tech., Inc., 119 F. Supp. 2d 12, 31 (D. Mass. 2000) (predictions as to release date of “complex technical product” are “forward-looking”); Bryant v. Avado Brands, Inc., 100 F. Supp. 2d 1368, 1378 (M.D. Ga. 2000) (earnings estimates, plans for expansion and expected contribution of development project were “clearly” forward-looking statements), rev’d, 252 F.3d 1161 (11th Cir. 2001); In re Ciena Corp. Sec. Litig., 99 F. Supp. 2d 650, 661 (D. Md. 2000) (prediction of earnings and future performance were forward-looking statements despite allegation that they were based upon historical purchasing patterns of consumers); Stratosphere, 1 F. Supp. 2d at 1114 (statements regarding hotel-casino’s marketing plans were forward-looking).

If a statement qualifies as forward-looking, the next task for the court is to determine whether (1) the statement is accompanied by “meaningful cautionary statements,” or (2) if it is not, whether plaintiff has alleged that the speaker had “actual knowledge” of the falsity of the statement. As to the first test, the PSLRA requires that cautionary statements must warn investors of “important factors that could cause actual results to differ materially from those in the forward-looking statement.” 15 U.S.C. § 78u-5(c)(1)(A)(i). While courts uniformly hold that mere “boilerplate” warnings are insufficient to invoke the protections of the safe harbor, see In re World Access, Inc. Sec. Litig., 119 F. Supp. 2d 1348, 1356 (N.D. Ga. 2000) (neither the statutory safe harbor nor the bespeaks caution doctrine applies where a warning “contain[s] only minimal boilerplate language”), the courts differ on how precise warnings must be and to what extent they must foreshadow the ultimate problem encountered. In Harris, 182 F.3d at 807, where the Eleventh Circuit posed the question as “must the cautionary language explicitly mention the factor that ultimately belies a forward-looking statement?,” id. (emphasis in original), the court held that “when an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.” Id. (emphasis added). In Ehlert v. Singer, 245 F.3d 1313 (11th Cir. 2001), the same court held that a warning that cautioned that “[t]here can be no assurance that the Company will successfully complete the development of the market for practice management systems” was sufficient to put an investor on notice that important company software would not be upgraded to Year 2000 compliance. Articulating the test as one of “similar significance,” the court held that “the warnings actually given were not only of a similar significance to the risks actually realized but were also closely related to the specific warning which Plaintiffs assert should have been given.”

Applying the standard elucidated by the Eleventh Circuit (or similar standards) other courts have held that various warnings were adequate. See, e.g., In re Republic Ser. Inc. Sec. Litig., 2001 WL 253244, at *5 (S.D. Fla. Feb. 12, 2001) (difficulties in assimilation of acquisitions were sufficiently forewarned by statement observing that the company faced “significant challenges” in that regard); Carney v. Cambridge Tec. Partners, Inc., 2001 WL 322759, at *9 (D. Mass. Mar. 30, 2001) (corporate officer who publicly disagreed with pessimistic analyst reviews held protected by safe harbor: “[T]he idea that reasonable investors would ignore the advice and cautions of independent securities analysts based solely on the optimistic opinions of ... the company's president, is at odds with common sense. In their consideration of whether broad, optimistic statements about a company's future can be a
predicate for liability under the securities laws, courts have recognized that corporate executives often make vague, optimistic statements about their firms' outlook. Thus courts generally have declined to impose liability for such statements.

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 In re Reliance Sec. Litig.*, 2001 WL 326870, at *21 (D. Del. Mar. 29, 2001) (holding no safe harbor because statement of belief of adequacy of loss reserve was one of "then-present state" of company's financial condition, not future event); *In re Splash Tech. Holdings, Inc. Sec. Litig.*, 2000 WL 1727377, at *6 (N.D. Cal. Sept. 9, 2000) (statement regarding "planned investment" was a statement of past fact of planning rather than forward-looking statement); *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, the plaintiff shareholders alleged that the company's officers and directors knew that their predications that a hotel-casino construction project would be on budget were false because the insiders had received construction estimates showing that the project would have cost overruns. On a motion to dismiss, Judge Pro held that those allegations were sufficient to withstand dismissal under the PSLRA's "actual knowledge" scienter standard for forward-looking statements. Following discovery, the court reached the same conclusion once a complete factual record had been presented. *See 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 hotel-casino construction project and company's 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). Other courts have reached similar conclusions. *See, e.g., Weiss v. Mentor Graphics Corp.*, No. CV-97-1376-ST, 1999 U.S. Dist. LEXIS 17026, at *45-46 (D. Or. Oct. 6, 1999) (interpreting "actual knowledge" standard to require 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"); *Geffon v. Micrion Corp.*, No. 96-11596-REK, 1998 U.S. Dist. LEXIS 15773, at *10-11, Fed. Sec. L. Rep. (CCH) ¶ 90,307 (D. Mass. Sept. 24, 1998) (denying summary judgment on claims that defendants had misrepresented to market that they had firm commitments and an order backlog, when purchaser retained right to cancel significant portion of order; held that comments were not protected by safe harbor because such statements were clearly not forward-looking and because cautionary language did not clearly express nature of cancellation right). *See generally Edward Brodsky, Making the Safe Harbor Safer: Giving Meaning to "Meaningful Cautionary Statements," 7 Securities Reform Act Litig. Rptr. 7 (Apr. 1999).

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 PSLRA's 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).

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 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**

In a variety of cases, courts have held that defendants' 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 Finan.*, 1998 U.S. Dist. LEXIS 14789, at *13 (documents containing some cautionary language did not specifically address heart of plaintiffs' claim); *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 must analyze 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 Finan.*, 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. *See 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

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(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 construction cost overruns and construction delays which would necessarily affect operating revenues once hotel-casino opened, they cannot insulate these statements with general language in securities disclosures concerning 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. See also 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

Federal regulation of securities began with the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). The goal of both statutes can best be understood as the promotion of a more efficient securities market. See House Committee on Interstate and Foreign Commerce, 95th Cong., Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission 560 (1977) ("1977
To achieve this goal, the legislation mandates company disclosure of material information and establishes liability for false and misleading statements. *Id.* at 564-65.

Market efficiency has two components: informational efficiency and allocational efficiency. James D. Cox, *et al.*, *Securities Regulation*, 36-38 (Aspen 2d ed. 1997). "On close inspection, there are really two distinct aspects of market efficiency: informational efficiency and allocational efficiency. Informational efficiency describes the speed with which market prices adjust to new information. Allocational efficiency concerns the allocation of resources to their best or highest use." *Id.* at 38. "Prices in an efficient market more closely reflect underlying value than in an inefficient market, and scarce resources are therefore allocated more efficiently." *Id.* at 36. By mandating company disclosures, with the Securities Act and the Exchange Act Congress sought to increase informational efficiency and thus increase allocational efficiency." 1977 *Report*, at 562. "The Securities Act was founded on the theory that informed investors seeking to maximize their own investment needs and objectives resulted in the most efficient allocation of capital among innumerable alternative investment opportunities." *Id.* at 563.

In open market securities cases brought by defrauded investors under Section 10(b) of the Exchange Act and SEC Rule 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); see also *Semenenko*, 2000 U.S. App. LEXIS 14046, at *31-34 (offering an extensive discussion of the "fraud-on-the-market" theory). *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).

**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, 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). 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").

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.

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). 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).
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 impliedly represented that the information in the forecasts was accurate or coincided with the company's views.


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. SEC v. Robert Howard, No. 97 Civ. 9378 (SWK), Litigation Release No. 15599, 1997 SEC LEXIS 2623 (Dec. 22, 1997). 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 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; Helwig, 2000 U.S. App. LEXIS 7341, at *22
(Sixth Circuit: "[A] corporation cannot be held responsible for analysts' statements about the
corporation's financial health unless the corporation takes more affirmative action than simply
providing information to the analysts") (citation omitted); In re Stac Elecs. Sec. Litig., 89 F.3d
1399, 1410 (9th Cir. 1996) (same); In re Nokia Corp. Sec. Litig., No. 96 Civ. 3752 (DC), 1998
had no duty to correct inaccurate analysts' reports circulating in market).

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
caus[ed] 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."

_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). _See also In re Crown Am. Realty Trust Sec. Litig._, No. 95-2021, 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).

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. _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'
themse[lves 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. 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.").

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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). *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.").

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." 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. See, e.g., In re Sunbeam Sec. Litig., No. 98-8258-CIV-MIDDLEBROOKS, Fed. Sec. L. Rep. (CCH) ¶ 90,735 (S.D. Fla. Dec. 10, 1999) (refusing to dismiss claim that "Defendants used private securities analysts to mislead the public about the financial condition of Sunbeam and its operations" where plaintiffs alleged that it was "Sunbeam's practice to have officers communicate with analysts frequently, in conference calls, meetings and analyst briefs, in order to falsely present the operations and allegedly successful prospects of Sunbeam to the marketplace and inflate artificially the price of Sunbeam common stock"). 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 third parties.

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). (It should be noted that in Presstek, 1997 SEC LEXIS 2645, the SEC did not address the "conduit" theory of liability.)

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 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.


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:
If 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 by 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 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."


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. *See also* Weiss, *Securities Analysts*, 8 Securities Reform Act Litig. Rptr. at 669 (discussing *Cooper*).

**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"). 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). 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.

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"). 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). 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.

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.

I. Public Company Practices In Dealing With Securities Analysts

Given the perils inherent in public companies' "entanglement" with securities analysts, it is surprising to see the frequency with which their officers (and directors) review drafts of analysts' reports, selectively disclose material information to analysts, and engage in similar practices. See Cholakis, Company Disclosures, 39 Santa Clara L. Rev. at 845-47. A study published in May 1998 revealed the following practices employed by public companies in dealing with securities analysts:

<table>
<thead>
<tr>
<th>Does any officer of your company review drafts of securities analysts' reports on a regular basis?</th>
<th>Yes  86% (78% in 1995)</th>
<th>No   14%</th>
</tr>
</thead>
</table>

E-74
<table>
<thead>
<tr>
<th>Question</th>
<th>Yes (%)</th>
<th>(1995)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does any officer of your company check analysts' earnings projections or models before they are published?</td>
<td>79%</td>
<td>(69% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>Does any officer of your company challenge analysts' assumptions if they appear &quot;out of line&quot;?</td>
<td>77%</td>
<td>(same in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>Does any officer of your company express a general level of comfort with analysts' earnings estimates?</td>
<td>71%</td>
<td>(same in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>29%</td>
<td></td>
</tr>
<tr>
<td>Does your company provide analysts with guidance and/or financial data relating to future trends?</td>
<td>46%</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>54%</td>
<td></td>
</tr>
<tr>
<td>Does your company limit its comments on analysts' reports to correcting errors of historical fact?</td>
<td>45%</td>
<td>(34% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>55%</td>
<td></td>
</tr>
<tr>
<td>If guidance has been given to analysts during the quarter but results are expected to be well below expectations, would your company issue a press release to correct misperceptions?</td>
<td>70%</td>
<td>(47% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Would an officer of your company follow up with investment professionals, either individually or by conference call?</td>
<td>70%</td>
<td>(47% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Would an officer of your company inform analysts that results are expected to be well below expectations without first issuing a press release?</td>
<td>26%</td>
<td>(40% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>74%</td>
<td></td>
</tr>
<tr>
<td>Does your company set aside a period of days in advance of an earnings announcement during which corporate representatives do not provide analysts with earnings guidance?</td>
<td>77%</td>
<td>(56% in 1995)</td>
</tr>
<tr>
<td>No</td>
<td>23%</td>
<td></td>
</tr>
</tbody>
</table>
Does your company have a written disclosure policy for dealing with analysts?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>40% (50% in 1995)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No</td>
<td>60%</td>
</tr>
</tbody>
</table>


The following "rules of the road" have been recommended for companies when dealing with securities analysts:

Don't distribute analyst reports

Don't link to analyst reports on your Web site

Don't incorporate analyst projections into Web pages

Don't review or comment on reports

Don't express "comfort" with or comment on projections

Steven E. Bochner & Ignacio E. Salceda, Over the Wall: Handling Analysts' Conference Calls, Earnings Forecasts, and Reports Effectively, 2 wallstreetlawyer.com 1, 7 (Apr. 1999).
UPDATE ON PRIVATE SECURITIES LITIGATION & ANALYSIS OF SECONDARY LIABILITY ISSUES

Defense Views:
CURRENT DEVELOPMENTS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT – FOCUS ON SECONDARY LIABILITY ISSUES

Daniel S. Floyd
Gibson, Dunn & Crutcher LLP
Los Angeles, California

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SECTION F
# UPDATE ON PRIVATE SECURITIES LITIGATION & ANALYSIS OF SECONDARY LIABILITY ISSUES

**Defense Views:**

CURRENT DEVELOPMENTS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT – FOCUS ON SECONDARY LIABILITY ISSUES

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SECTION F
I. INTRODUCTION

Recent high profile securities class action cases, including the so-called "IPO laddering" cases and the multiple cases filed as part of the fallout from the Enron bankruptcy, have placed renewed scrutiny on the possible liability of professionals in connection with securities fraud. While the issue of whether securities class action litigation in fact benefits investors continues to be hotly debated (even on the internet investor chat boards of companies being sued) the reality is that securities litigation is alive and well, albeit different in important ways than prior the Private Securities Litigation Reform Act (the "PSRLA" or the "Reform Act"). The five years since passage of the Reform Act have proven that the Reform Act was neither the death knell for investor protection predicted by the plaintiff's bar, nor was it the protection from lawsuits hoped...
for by companies and professionals. Securities litigation filings continue, at a significant pace, with professionals becoming increasing targets once again.3

For example, over the past year, the law firm of Milberg Weiss Bershad Hynes & Lerach LLP, among others, has filed more than 180 class actions against Wall Street investment banking houses. Included as defendants are virtually all the leading firms, including Credit Suisse First Boston, Goldman, Sachs, Merrill Lynch, Morgan Stanley and Salomon Smith Barney, and numerous internet technology companies and their officers and directors. The claims include allegations that underwriters demanded that some investors pay secret, "excessive" commissions to receive allocations of shares of IPO's of internet companies, and that underwriters entered into "laddering" arrangements with investors in which investors agreed to purchase additional shares at inflated prices in the aftermarket in the days after the offering. The "IPO laddering" cases, which are not traditional Section 10(b) cases in that they involve claims of "manipulation," are scheduled for motions to dismiss in early 2002.4 As a result of these IPO laddering cases, the total number of securities cases filed jumped from 216 in 2000 (a rate roughly equivalent to pre-Reform Act levels) to 487 in 2001.

While the Enron debacle is the most prominent accounting fraud case pending, accounting fraud and accounting restatement cases have been on the rise ever since passage of the Private Securities Litigation Reform Act. This may be because such fraud is on the rise, it may be because accountants are struggling to define revenue in the internet age, or it may be because accounting restatements, i.e., a concession of a material misstatement of fact, provides a major leg up in satisfying the difficult pleading requirements under the PSLRA so the plaintiff's bar is focusing on those types of cases. According to the Stanford Law School's Securities Action Clearinghouse, in the year 2000 60% of the cases filed involved accounting fraud, compared to approximately 35% prior to the PSLRA. The most frequent form of accounting allegation is improper revenue recognition, with high technology still the most commonly sued industry. Insider trading allegations were present in 56% of the cases filed in 2000.

Despite concerns that the PLSRA would seriously restrict securities litigation, after a brief decline, the number of class actions has increased from pre-Act levels, and both the average settlement, and high end of settlements has increased, with three post-Act settlements over $200 million. However, two effects of the Reform Act are an increase in dismissals, particularly in the Ninth Circuit, and delays in litigating the actions, because of the lead plaintiff process and the discovery stay in place pending completion of motion to dismiss process.

3 In addition, in an application of the law of unintended consequences, plaintiff's class action firms that focused primarily on securities litigation have branched out into new areas, including consumer protection, antitrust and anti-discrimination.

4 It was recently announced that Credit Suisse had settled with the SEC for $100 million on the excessive commissions claim, without admitting or denying liability.
This paper will focus primarily on securities liability of so-called secondary actors, including what actions potentially subject a professional to the private securities laws, and the scienter requirements. In addition, the paper will discuss some of the more important appellate decisions this past year, 2001, on various procedural issues in securities class action litigation.

II. SECONDARY LIABILITY ISSUES UNDER THE FEDERAL SECURITIES LAWS, INCLUDING THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

A. The Supreme Court's Decision in Central Bank

The Supreme Court dramatically altered the scope of liability for "secondary" actors in the securities world (i.e., accountants, investment bankers, attorneys) in 1994 in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), where the court held that, despite many years of lower court decisions to the contrary, aiding and abetting cannot be a basis for liability under Section 10(b). Under Central Bank's holding, unless a defendant "commit[ted] a manipulative or deceptive act within the meaning of Section 10(b)," the defendant has not violated the federal securities laws. Id. at 191.

Central Bank's clear rejection of aiding and abetting liability, however, has not led to consistent standards being applied by the Federal courts. The inconsistency in the approaches of the courts to the scope of liability for secondary actors is due in significant part to the fact that Central Bank did not involve the most common secondary actors in securities matters - underwriters, accountants, and lawyers - who are involved in preparing disclosures and offering materials. Instead, Central Bank involved a securities claim against a bank acting as an indenture trust with no participation in drafting statements. Thus, the legal principles articulated in Central Bank were not applied in the factual contexts most frequently encountered by courts in this area. Thus, it has been left to the lower federal courts to grapple with the difficult issues surrounding the "primary" liability of secondary actors. Pre-Central Bank cases are of limited utility because previously there was no need to distinguish aiding and abetting from primary liability.

B. Independent Conspiracy Liability Has Effectively Been Eliminated By Central Bank

One area where there has been general agreement is conspiracy liability. The courts that have considered the issue have, with one exception, concluded that the reasoning of Central Bank extends to prohibit liability under the Section 10(b) and Rule 10b-5 premised on conspiracy. Compare Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin, 135 F.3d 837, 841 (2d Cir. 1998) (recognizing that "every court to have addressed the viability of a conspiracy cause of action under § 10(b) and Rule 10b-5 in the wake of Central Bank has agreed that Central Bank precludes such a cause of action" (citing cases)) and Cooper v. Pickett, 137 F.3d 616, 624 (9th Cir. 1998), with Wenneman v. Brown, 49 F. Supp. 2d 1283, 1290 n.3 (D. Utah 1999) ("the Court reads nothing in Central Bank as a wholesale adoption of the notion that one who willingly conspires with others to disseminate fraudulent information in connection with a purchase or sale of a security is immune from liability . . . because that person is intelligent or lucky enough to avoid being the one who actually drafts the fraudulent documents or who deals
directly with the victims. Conspiracy is a separate and distinct concept from aiding and 
abetting.

However, even under Dinsmore and Cooper, allegations of a conspiracy are not improper 
per se, and may indeed be valuable in pleading scienter against each defendant, as coordinated 
action more likely raises a "strong inference" of fraud. Thus, a "scheme" to defraud can be 
alleged, but to be sufficient each member of the scheme must have committed a deceptive or 
manipulative act subjecting him or her to primary liability. Wenneman appears to be the only 
case where the primary liability has been extended to someone who agrees with another to have 
the other disseminate a fraudulent misstatement, and there is little reason to believe its reasoning 
will be accepted by other courts.

C. The Courts Have Split on When Secondary Actors Can Be Subject to 
Primary Liability

The fact that secondary liability was eliminated by Central Bank has not eliminated 
liability for secondary actors. The U.S. Supreme Court recognized that "the absence of . . . 
aiding and abetting liability does not mean that secondary actors in the securities markets are 
always free from liability." Id. at 191. Indeed, the Supreme Court noted that there are likely to 
be multiple violators in any complex securities fraud, and thus, a secondary actor, "including a 
lawyer, accountant, or bank, who employs a manipulative device or makes a material 
misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a 
primary violator under 10b-5," so long as all the requirements for primary liability are 
established. Id.

1. The "Bright Line" Test

The Courts have taken two basic approaches to evaluating whether a secondary actor's 
involvement in an alleged securities violation is sufficient to potentially subject that person to 
primary liability. The clear majority view, termed by the Second Circuit as the "bright line" test, 
"requires that 'a defendant must actually make a false or misleading statement in order to be held 
liable under Section 10(b).'" Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998), 
cert. denied, 525 U.S. 1104 (1999) (citing Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997)). 
While under this standard the primary violator does not have to communicate the 
misrepresentations directly, "a secondary actor cannot incur primary liability under [Section 
10(b)] for a statement not attributed to that actor at the time of its dissemination." Id. This 
requirement in turn is based on the requirement of reliance as an element of liability. Thus, to 
satisfy the "bright-line" test the "misrepresentation must be attributed to that specific actor at the 
time of public dissemination, that is, in advance of the investment decision." Id. This is referred 
to as the "bright line" test because the degree of a person's participation in the drafting of the 
statement is irrelevant, absent public attribution.5

5 However, the Second Circuit rejected an attempt to extend Howard's holding to a claim by a 
corporate defendant that imposition of primary liability of a principal for the statements of an 
[footnote continued on next page]
The "bright line" test of the Second Circuit has been expressly adopted by the 11th Circuit in Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) ("Following the Second Circuit, we conclude that, in light of Central Bank, in order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made."). as well as by several district courts. See, e.g., Roger Copland v. Grumet, 88 F. Supp. 2d 326, 332 (D.N.J. 1999); Great Neck Capital Appreciation Investment Partnership, LLP v. Pricewaterhousecoopers, LLP, 137 F. Supp. 2d 1114 (E.D. Wis. 2001). Several decisions prior to Wright adopted the requirement that to be subject to primary liability a defendant must make a false and misleading statement that he or she knew or should have known would reach investors (as opposed to mere participation, without specifically addressing whether the false statement must be expressly attributed to the defendant. See, e.g., Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-1227 (10th Cir. 1996); In re Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 (D. Mass 1994) (rejecting argument that accountant's review and approval of financial statements could give rise to a 10b-5 violation).

2. The "Substantial Participation" Test

The second standard for when secondary actors are subject to Section 10(b) liability has been termed the "substantial participation" test. The Ninth Circuit has described that "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements." Howard v. Everex Sys., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000), relying upon In re Software Toolworks Sec. Litig., 50 F.3d 615, 628-29 n. 3 (9th Cir. 1995).

In Software Toolworks the Ninth Circuit reversed summary judgment granted in favor of Deloitte & Touche in connection with two allegedly fraudulent letters sent to the SEC, which allegedly falsely stated that the company did not have preliminary financial data available for the June 1990 quarter and misleadingly described the nature of Toolworks' contracts with original equipment manufacturers. 50 F.3d at 628. The Court found evidence that (1) one letter was "prepared after extensive review and discussions with ... Deloitte," and referred the DEC to two Deloitte partners for more information, and (2) Deloitte "played a significant role in drafting and editing" the second letter, as "sufficient to sustain a primary cause of action under section 10(b), and, as a result, Central Bank does not absolve Deloitte on these issues." Id. at 628. This approach has not been accepted by any other circuit court, but it, or at least a similar approach, has been adopted by a few District Courts. See Carley Capital Group v. Deloitte & Touche, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) ("This Court ... concludes that a secondary actor can be primarily liable when it, acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it."); In re ZZZZ Best Sec. Litig., 864 F. Supp. 960,

[Footnote continued from previous page]

agent was barred by Central Bank, particularly given that a corporation can only act through its employees and agents. See Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 100-101 (2d Cir. 2001).
970 (C.D. Cal. 1994) (an accounting firm that was "intricately involved" in the creation of false documents subject to primary liability).

The practical difference between the "bright line" test and the "substantial participation" test can be significant, particularly for attorneys and financial advisers, who, unlike auditors, are often not required to make statements on their own behalf to properly perform their services. For example, to use the Enron case as an example, if the bright-line test is applied, it is unlikely that Enron's counsel could properly be sued under the Federal Securities laws, even crediting allegations that the firm offered a legal opinion supporting Enron's conduct. See, e.g., Ziemba, 256 F.3d at 1205-06 (no securities claim against the lawyers because they made no statements and had no duty to disclose). The "bright-line" test in effect exempts various participants in the drafting process for statements that later are the basis for a securities action.

However, the lines between "substantial participation" and the "bright line" test are not always so clear, particularly for underwriters or other participants in an offering of securities. For example, in Gabriel Capital, L.P. v. NatWest Fin., Inc., 94 F. Supp. 2d 491 (S.D.N.Y. 2000), the court held that the listing of the two defendant financial institutions (initial purchasers of the debt securities of a company being offered to the plaintiff investors) on the offering materials, as well as the defendants' use of the materials as part of the sales pitch, satisfied the "bright line" test. The court further held that it was not necessary to attribute specific representations in the Offering Memorandum to particular defendants because of the involvement of the financial institutions in drafting of the Offering Memorandum and participation in the sale of the securities. Id. at 502-503. The court distinguished the role of these defendants from the typical role of an attorney and accountant in an offering, who generally merely advise on the contents of the offering materials, but do not participate in the sale. Id. at 503.

The complexities of this issue are further illustrated by In re Livent, Inc. Noteholders Sec. Litig., 2001 U.S. Dist. LEXIS 19688 (174 F. Supp. 2d 144) (S.D.N.Y. 2001). In that case the court held that to impose liability on a securities dealer in connection with a notes offering, merely soliciting or serving as a "substantial factor" in connection with a particular securities transaction is insufficient; rather, the plaintiff must show either that the plaintiff purchased securities directly from the securities dealer or that "whatever injury they suffered was caused by the material misstatement that induced Notes sales to them and was communicated by [the investment bank] rather than by [the company] or some other securities dealer." Id. at *14-15. Thus, where an investment bank sells stock in an offering on its own behalf, or communicates directly with investors, it can be subject to primary liability, even under the "bright line" test.

While a secondary player in an purported fraud can escape liability by not making a statement, it does not appear that a defendant who signs a document on behalf of a corporation can escape liability by arguing that he or she neither drafted, nor participated in the drafting, of a statement, Howard, 228 F.3d at 1061-1062; Suez Equity Investors, 250 F.3d at 101 ("A corporation can only act through its employees and agents [citation omitted], and an allegation that a particular agent may have doctored or conveyed the report will not immunize the principals from liability for a knowing deception.").
D. The General Standards for Pleading Scienter Under the PSLRA Vary Among the Circuits, Although Some Consensus Is Emerging

Under the PSLRA, Congress enacted two specific pleading requirements for securities actions. The first is that a complaint must specify each false statement or omission and explain why the statement or omission was false and misleading. 15 U.S.C. § 78u-4(b)(1). The second is that a complaint must state "with particularity" facts giving rise to a "strong inference" that the defendant acted with scienter. 15 U.S.C. § 78u-4(b)(2). However, "[b]ecause falsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts," courts have often incorporated the two pleading requirements into a "single inquiry." Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001).

While application of the pleading requirement for scienter has not been uniform among the circuits, there appears to be a consensus that the Reform Act did not change the substantive standard for scienter, which includes actual knowledge and so-called "severe" recklessness. See, e.g., Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001) (citing cases); Nathenson v. Zonagen Inc., 267 F.3d 400, 407 (5th Cir. 2001); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1258 (10th Cir. 2001) (defining scienter by reference to pre-PSLRA cases); Howard v. Everex, 228 F.3d at 1064 ("Because the PSLRA did not alter the substantive requirements for scienter under § 10(b), however, the standard on summary judgment or JMOL remains unaltered by In re Silicon Graphics"). This type of recklessness is derived from the standard set forth in Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977), and is generally defined as involving "not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." Fla. State Bd., 270 F.3d at 654 (citation omitted). This is generally viewed as a lesser version of intentional conduct, as opposed to a heightened form of negligence.

Despite substantial agreement on the substantive standard for scienter, the application of the pleading requirements is not the same, although the differences in pleading standards in some instances are more formalistic than real. On the whole, the effect of the heightened pleading requirements has led to a higher rate of dismissals (now reported as approximately 25-30%). In addition, the effect on so-called secondary actors appears to be even greater, as the claims against secondary parties have been dismissed at a higher rate.

It is generally recognized that the highest standard for pleading scienter is in the Ninth Circuit, as established in the case of In re Silicon Graphics Sec. Litig., 183 F.3d 970 (9th Cir. 1999). Under Silicon Graphics, plaintiffs must plead "at a minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness." 183 F.3d at 979. A "mere showing of motive and opportunity" is insufficient to survive a motion to dismiss. Howard, 228 F.3d at 1064. In addition, the Ninth Circuit concluded in Silicon Graphics that "a plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief" that the facts supporting the claim are true. 183 F.3d at 985. It is perhaps this requirement of very specific and detailed pleading of the basis for the belief in the truth of the allegations, more than the substantive scienter standard itself, that has raised the pleading bar in the Ninth Circuit, because the absence of specific, detailed facts supporting a strong inference of intentional or deliberately
reckless behavior leads to dismissal. This pleading requirement also includes the names of any confidential sources. Id. at 984-85; see also In re Green Tree Financial Corp. Stock Litig., 61 F. Supp. 2d 860, 872 (D. Minn. 1999) (source of statement attributed to unnamed money manager was "a central fact (if not the central fact) on which plaintiffs' belief is formed.")

Nevertheless, even the Silicon Graphics standard has not been interpreted as rigidly as its language might support. While "motive and opportunity" pleading has been rejected, the existence of "unusual" or "suspicious" stock sales, "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information," is circumstantial evidence that a statement was false when made and the defendant "knew it." Ronconi, 253 F.3d at 434-435. However, if plaintiffs seek to "rely on insider trading as circumstantial evidence of falsity, they must allege sufficient context of insider trading" for the Court to determine whether the level of trading provides such circumstantial evidence. Id. at 436-437. Thus, while simple "motive and opportunity" allegations are insufficient, highly unusual or suspicious "motive and opportunity" pled in detail, is at least an important factor that must be considered in evaluating scienter.

The standard adopted by the Second Circuit is generally viewed as the most lenient standard. The Second Circuit has most recently held that a plaintiff may be plead the requisite "strong inference" of scienter by pleading that defendants: "(1) benefited in a concrete and personal way from the purported fraud"; (2) "engaged in deliberately illegal behavior;" (3) "knew facts or had access to information suggesting that their public statements were not accurate;" or (4) "failed to check information they had a duty to monitor." Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir.), cert. denied, 531 U.S. 1012 (2000). However, to the extent that a claim is based on an omission, scienter cannot be established in the absence of a "clear duty to disclose." Kalnit v. Eichler, 264 F.3d 131, 144 (2d. Cir. 2001). The Second Circuit indicated courts should "not be wedded" to motive and opportunity concepts, but that the motive and opportunity cases provide meaningful guidance. Novak, 216 F.3d at 310-311.

The motive prong of scienter set forth in (1) above is "generally met when corporate insiders were alleged to have misrepresented to the public material facts about the corporation's performance or prospects in order to keep the stock price artificially high while they sold their own shares at a profit." Id. at 308; Stevelman v. Alias Research Inc., 174 F.3d 79, 85 (2d Cir. 1999) (allegation that officers sold off large portions of stockholding during period of alleged misrepresentations "supports the inference that [defendant] withheld disclosures that would depress his stock until he profitably sold his shares").6 While there are some cases that suggest that the insider trades must be "unusual" to qualify as supporting a "strong inference" of scienter,

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6 The Second Circuit expressly rejected such motives as "(1) the desire to maintain a high corporate credit rating or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment'" or "(2) the desire to maintain a high stock price in order to increase executive compensation or prolong the benefits of holding corporate office," as being important motives for fraud. (citation omitted) Novak, 216 F.3d at 307; accord Kalnit v. Eicher, 264 F.3d 131, 139 (2d Cir. 2001).
see, e.g., Rothman v. Gregor, 220 F.3d 81, 94 (2d Cir. 2000), the inquiry is less rigorous than the Ninth Circuit's standard of trading patterns "dramatically out of line" with the past. See, e.g., In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 75 (2d Cir. 2001) (finding gross proceeds of $1.25 of one officer in class period sufficient to allege motive, stating that there is no "per se rule that the sale by one officer of corporate stock for a relatively small sum can never amount to unusual trading").

Furthermore, the Second Circuit has also expressly rejected Silicon Graphics requirement that a plaintiff must provide in great detail all facts upon which the allegations are based. Plaintiffs need not plead with "particularity every single fact upon which their beliefs concerning false and misleading statements are based," but rather plaintiffs "need only plead with particularity sufficient facts to support those beliefs." 216 F.3d at 313-314. Thus, unlike in the Ninth Circuit, plaintiffs in the Second Circuit are not required to identify confidential personal sources unless necessary to support "a reasonable belief as to the misleading nature of the statement or omission." Id. at 314 n.1. Requiring disclosure of a confidential source "serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them. Id. at 314. The Third Circuit has essentially adopted the Second Circuit pleading standard. In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999). Indeed, the Third Circuit recently ordered a district court to allow amendment of a pleading after judgment was entered to allege facts from Board meeting minutes obtained by the plaintiffs after the case was dismissed, and raised by the plaintiffs in their reply brief on appeal. Werner v. Werner, 267 F.3d 288, 297, (3d Cir. 2001) ("[P]laintiffs were precluded from engaging in discovery in the District Court ... We will not add to the strict discovery restrictions in the [PSLRA] by narrowly construing Rule 15 in this case").

The remaining circuits have adopted a middle road between the positions of the Second and Ninth Circuit. The most influential of these decisions appears to be the Sixth Circuit's decision in Hoffman v. Comshare, 183 F.3d 542 (6th Cir. 1999), as further clarified by Helwig v. Vencor, 251 F.3d 540 (6th Cir. 2001)(en banc). The Sixth Circuit held that plaintiffs must plead facts "that give rise to a strong inference of reckless behavior," but not by alleging facts that illustrate nothing more than a defendant's motive and opportunity to commit fraud. Comshare, 183 F.3d at 551. However, facts of motive and opportunity are "relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred, and may, on occasion, rise to the level of creating a strong inference of reckless of knowing conduct . . ." Id. As further explicated by Helwig, motive and opportunity cannot be equated with scienter, but "can be catalysts to fraud and so serve as external markers to the required state of mind." Helwig, 251 F.3d at 550. "[R]ecklessness in securities fraud is an untidy, case-by-case concept," and thus while "facts presenting motive and opportunity may be of enough weight to state a claim under the PSLRA," pleading "conclusory labels of motive and opportunity will not suffice." Id. at 551. Thus, the Sixth Circuit has left the issue to a case by case analysis, with the express recognition that specific of motive and opportunity is potentially an important component of pleading securities fraud.

The Eleventh Circuit, Fifth Circuit and Tenth Circuit have expressly stated they have adopted the Sixth Circuit's approach, although the Eleventh Circuit has held that "motive and opportunity" allegations, without more, are insufficient to plead scienter. See Bryant v. Avado Brands, Inc., 187 F.3d 1271 (11th Cir. 1999); Nathenson v. Zonagen Inc., 267 F.3d 400, 410 (5th
Cir. 2001) ("The most sensible approach appears to us to be the one first generally articulated by the Sixth Circuit in Comshare"); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1261 (10th Cir. 2001) ("We agree with the middle ground chosen by the First and Sixth Circuits . . . allegations of motive and opportunity may be important . . . but are typically not sufficient in themselves to establish a 'strong inference' of scienter"). The First Circuit view is "close to that articulated Sixth Circuit," neither rejecting nor accepting motive and opportunity pleading, but "without adopting any pleading litany of motive and opportunity," the First Circuit has held that "merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough," although "allegations of unusual insider trading by a defendant with access to material non-public information can support a strong inference of scienter." Greebel v. FTP Software, Inc., 194 F.3d 185, 197-198 (1st Cir. 1999).

The Eighth Circuit most recently adopted a similar approach to the Sixth Circuit's in Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 660 (8th Cir. 2001). In that case the Eighth Circuit had the following to say about "motive and opportunity" allegations:

First, motive and opportunity are generally relevant to a fraud case, and a showing of unusual or heightened motive will often form an important part of a complaint that meets the Reform Act standard. Second, in some cases the same circumstantial allegations that establish motive and opportunity also give additional reason to believe the defendant's misrepresentation was knowing or reckless. For instance, in insider trading cases, the timing of trades shows motive and opportunity, but it may also provide additional circumstantial evidence that the defendant knew of an advantage. Such allegations may meet the Reform Act standard, but if so it is because they give rise to a strong inference of scienter, not merely because they establish motive and opportunity. Third, when the complaint does not show motive and opportunity of any sort – either the unusual, heightened motive highlighted in the Second Circuit cases, or even an everyday motive such as keeping one's job – then other allegations tending to show scienter would have to be particularly strong in order to meet the Reform Act standard.

Id. at 660. Thus, the Eighth Circuit views the "motive and opportunity" facts as very important, though generally not dispositive, of the scienter pleading.

The teaching of the various court of appeal decisions is that the ultimate determination of the sufficiency of pleading will be very fact specific. The challenge for defendants in any circuit is to bring to the court's attention facts that tend to undermine the circumstantial tie between the timing and amount of any stock sales and knowledge of undisclosed material bad news. These may include consistent past selling practices, adherence to corporate trading policies, specific needs to sell stock, purchases or lack of sales by similarly situated persons, retention of

7 In reaching this result, the Fifth Circuit disavowed "mere passing dicta" in Williams v. WMX Technologies, Inc., 112 F.3d 175, 177-178 (5th Cir. 1997) that appeared to adopt the Second Circuit standard.
significant percentage of stock or large sales explained by a prior inability to sell. See, e.g., Ronconi, 253 F.3d at 435. Once such a reasonable explanation is proffered, the focus in the pleading can be on whether the plaintiff has specific, contemporaneous information to support a strong inference that the defendant acted with knowledge or deliberate recklessness. Those facts are much harder to come by than allegations that senior executives sold stock.

E. Application of the Scienter Standards to Claims Against Secondary Actors

The difficulties presented to plaintiff's lawyers in pleading a securities fraud claim against a corporation and its officers and directors, who through often large stock sales, have a readily available "motive and opportunity" to commit securities fraud, are magnified in claims against secondary actors. While the standard for scienter is the same, the practical ability to assemble the necessary facts is more difficult in connection with secondary actors, because it will not necessarily be presumed that the secondary actor had access to the contrary information upon which the fraud is premised. Instead, the claims are typically grounded more in a failure to discover, or investigate, which are closer in type to negligence or even ordinary recklessness, as opposed to the "deliberate" recklessness (a lesser version of intent) required under the securities laws.

As one district court put it "[w]here the allegations of recklessness pertain to third-party advisers, such as underwriters or accountants, plaintiffs' allegations must be commensurately stronger, 'approximating an actual intent to aid in the fraud being perpetrated by the company.'" In re Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 764 (S.D.N.Y. 2001). Thus, "[a]llegations of conduct that demonstrate 'merely simple, or even inexcusable negligence' are not sufficient to state a claim under the securities laws." Id. In addition, allegations of motive and opportunity, even when available, are more difficult with secondary actors, who typically do not have the large stock sales of corporate insiders. Obtaining ordinary and typical fees for services, whether auditing fees or underwriting fees, are not viewed as a sufficient motive to participate in fraud. Id. at 765-766 (citing cases); In re Complete Management Inc. Sec. Litig., 153 F. Supp. 2d 314, 335 (S.D.N.Y. 2001) ("[M]any federal courts have held that the fact that the professional services firms like [defendant] receive fees for their services is insufficient to supply the motive essential to the motive-and-opportunity theory under Rule 9(b)"). However, the desire of a investment banking firm to sell stock on its own behalf, if the quantities are sufficiently large, has been viewed as satisfying a "motive" standard. 154 F. Supp. 2d at 766; In re Livent, Inc. Noteholders Sec. Litig., 2001 U.S. Dist. LEXIS 19688 at *21. ("Rather than generally reflecting the profit motive of any securities dealer, the concrete benefit derived by CIBC from Livent's fraud alleged here was uniquely personal to CIBC in several ways"). In addition, substantial fees for contemporaneous the consulting services obtained by an auditor has also been viewed as potentially satisfying the motive and opportunity standard. Complete Management, 153 F. Supp. 2d at 335.

Notwithstanding the high standards applied to allegations of scienter involving secondary actors, plaintiffs have, in several recent instances, successfully alleged claims against auditors for certification of financial statements that allegedly violated Generally Accepted Accounting Principles ("GAAP") or Generally Accepted Auditing Standards " ("GAAS"), particularly where formal restatements were involved. See, e.g., Complete Management, 153 F. Supp. 2d at 335;

All the courts that have considered the issue of accountant securities law liability agree that a violation of GAAP, or even a restatement of financials, is not, on its own, sufficient to give rise to a "strong inference" of scienter. See, e.g., Microstrategy, 115 F. Supp. 2d 634-635 n. 28. Instead, violations of GAAP or GAAS provide evidence of scienter only when accompanied by additional facts and circumstances that raise an inference of fraudulent intent. Novak, 216 F.3d at 309. The circumstances vary by case, but "the magnitude of a restatement," the "pervasiveness and repetitiveness" of the violations, "the simplicity of the accounting principles" involved, and the importance of the revenue involved, are all important factors in pleading scienter. Microstrategy, 115 F. Supp. 2d at 636. The pleading of facts setting forth "red flags" known to, but ignored by, the accounting firm, have also been found critical to pleading scienter. In re Ikon Office Solutions Inc. Sec. Litig., 66 F. Supp. 2d 622, 629 (E.D. Pa. 1999). The scope of the auditors involvement with the company is also important. Carley Capital, 27 F. Supp. 2d at 1339 (holding that where defendant auditor also provided extensive consulting services, and had "unrestricted access to its financial records and data," and thus suggesting that "Defendant knew that its client was understating expenses and improperly recognizing revenue").

It is not surprising that the highest standard articulated for auditor liability is in the Ninth Circuit, based on the application of Silicon Graphics. Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp. 2d 1003, 1008 (S.D. Cal. 2000) ("In sum, the lack of a rational economic incentive for an independent accountant to participate in fraud, the client's central role in providing information to the accountant, and the complex professional judgment required to perform an audit, make it exceedingly difficult for a securities plaintiff to plead facts suggesting that an independent accountant acted with the deliberate state of mind now required to withstand a motion to dismiss").

The Reiger court addressed the types of factors adopted by various courts as sufficing to establish scienter, and, consistent with Silicon Graphics, required a higher level of specific fact pleading than required in other courts. Indeed, the court specifically concluded, contrary to other district courts, that "to avoid undermining the policies of the Reform Act through reliance on hindsight and speculation, a court should not infer an independent accountant's scienter based solely on the magnitude of its client's fraud." Id. at 1013. Instead, consistent with Silicon Graphics' requirement of highly specific pleading, the plaintiff must plead "specific and detailed facts showing that the magnitude [of the alleged fraud] either enhanced the suspiciousness of specifically identified transactions, or made the overall fraud glaringly conspicuous." Id.; accord In re SCB Computer Technology, Inc. Sec. Litig., 149 F. Supp. 2d 334, 357 (W.D. Tenn. 2001) (finding the analysis in Reiger "persuasive").

In addition, in Reiger the court addressed several allegations of "red flags," that plaintiff alleged supported a strong inference of scienter. However, the court rejected the view that merely alleging that the accountants had access to specific documentation revealing the GAAP violations was insufficient. The court concluded that in order to find a strong inference of scienter based on such allegations of access to information, the court would need to engage in
prohibited speculation that (1) the auditor closely reviewed the documents, (2) discovered the violations and (3) deliberately chose to ignore them. 117 F. Supp. 2d at 1011-1012; see also In re Raytheon Sec. Litig., 157 F. Supp. 2d 131, 155 (D. Mass. 2001) ("The magnitude of the misstatement, combined with the internal documents . . . at most supports a garden-variety inference of recklessness or a strong inference of negligence – but that is not enough"); but see Bovee v. Cooper & Lybrand, C.P.A., 272 F.3d 356, 362 n.7 (6th Cir. 2001) (suggesting in dicta that allegations of "Coopers' recklessness in its failure to examine the risks of material misstatements in MAW's accounting estimates," "may" support an inference of recklessness under Section 10(b)).

Drawing the line between negligence, even gross negligence, and deliberate recklessness is often difficult, and thus the cases in this area are very fact specific, and not always reconcilable. The primary difference between the approaches of Reiger and cases finding scienter allegations against accountants sufficient is the requirement of Reiger that the red flags either be true "smoking guns" on their face, or there be other specific facts that establish that the auditor was actually aware of the accounting violations or had sufficient actual knowledge to satisfy a deliberate recklessness standard. The Reiger standard, as opposed to one premised on availability of information, appears to more closely follow the standard that the conduct of the auditor must "approximate an actual intent to aid in the fraud being perpetrated by the audited company." Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000). Given the rash of restatements and cases premised on accounting fraud, how this debate within the lower courts is resolved will be critical in determining the scope of securities liability of accountants.

III. OTHER IMPORTANT RECENT DEVELOPMENTS

A. Lead Plaintiff Issues -- In re Cendant Securities Litigation

One significant change with the PSLRA from prior practice in securities class action litigation is the process for the appointment of lead plaintiff and lead counsel. Section 21D of the Exchange Act provides a rebuttable presumption that the "most adequate plaintiff" is the one with "the largest financial interest in relief sought by the class" and "otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure." This "lead plaintiff" standard has led to ongoing solicitation of potential clients by plaintiff's firms, as the firms attempt to represent either the individual, institution or "group" with the largest financial interest, where before the rush was often to be the first case filed. The courts have taken very different approaches to the role of the Court in selecting lead plaintiff and lead counsel.

One view, set forth most notably by Judge Vaughn Walker of the Northern District of California, contemplates an active role by the District Court in determining the appropriate plaintiff and counsel. Under this view, "[t]he PSLRA's rebuttable presumption in favor of the class member having the largest claimed loss may only be invoked by a plaintiff who satisfies the requirements of Rule 23." In re Quintus Sec. Litig., 148 F. Supp. 2d 967, 970 (N.D. Cal. 2001). In Judge Walker's view "[a]t the outset of litigation, 'a proposed lead plaintiff can best demonstrate the willingness and ability to discharge the fiduciary duties of the lead plaintiff by demonstrating the willingness and ability to take charge of the litigation and negotiate a reasonable representation arrangement with class counsel.'" Armour v. Network Assocs., 171 F. Supp. 2d 1044, 1049 (N.D. Cal. 2001). The failure of a plaintiff to "select appropriate class
"counsel" is a basis for the court to reject the lead plaintiff. Under this interpretation of the lead plaintiff provisions, the court is to take an activist approach to insuring that the class receives, in the court's judgment, the most cost effective representation. This, in turn, has led in many instances, particularly involving individual lead plaintiffs, to a competitive bidding process overseen by the court.  

*Id.* at 1049-1050; see also *Wenderhold v. Cylink Corp.* 191 F.R.D. 600 (N.D. Cal. 2000) (appointing lead counsel through in PSLRA action pursuant to auction).

However, the Ninth Circuit is hearing oral arguments on February 15, 2002, on a petition for mandamus filed by Milberg Weiss after Judge Walker rejected their lead plaintiff (otherwise presumed the most adequate plaintiff), and them as class counsel, based on the court's conclusion that the fee arrangement negotiated by the other plaintiff vying for lead plaintiff was significantly less expensive than that proposed by Milberg Weiss, and the record showed no qualitative factors favoring Milberg.  

*See In re Quintus Sec. Litig.*, 148 F. Supp. 2d at 987. The resolution of this case is being closely watched, as it will likely provide significant appellate guidance on a number of issues surrounding the lead plaintiff.

The Ninth Circuit will not be the first appellate court making law in this area. The Third Circuit, in its recent opinion in *In re Cendant Corporation Sec. Litig.*, 264 F.3d 201 (3d Cir. 2001), affirming the $3.2 billion settlement of a securities class action against Cendant and its auditors, addressed multiple issues related to the appointment of lead counsel, clearly rejecting the approach of Judge Walker. The court specifically held that the practice of several District Judges of holding an "auction" to appoint lead counsel (264 F.3d at 258 n. 35 (identifying eleven cases where an auction was held to select class counsel)), and to set the fees, is not generally permitted under the PSLRA.

While the Court recognized various advantages (reduced cost) and disadvantages (including difficulty in performing the "cost/quality" analysis usually performed by clients) of a court-supervised competition for class counsel, *id.* at 258-260, the basis of the ruling was that the intent of Congress was to permit the lead plaintiff to choose counsel and negotiate the fee, subject to court supervision. The only possible exception is when the trial court does not believe that there is a sophisticated investor with sufficient losses to be "counted on to serve the interests of the class in an aggressive manner."  *Id.* at 273-277. In those limited circumstances, the trial court could assume a direct role in selecting counsel and hold a bidding process for counsel. *Id.* at 277.

The Third Circuit in *Cendant* also set forth in some detail its interpretation of the lead plaintiff provisions. While it specifically held that defendant has no role in the court proceedings leading to the selection of lead plaintiff and counsel, the court's tying of the decision in appointing the lead plaintiff to the formal class certification requirements provides guidance to the defendant on the standards to be addressed in the class certification procedure. Unlike some courts, which have indicated that a court may "sua sponte" consider the arguments of a defendant on lead plaintiff, see, e.g., *Takeda v. Turbodyne Techs., Inc.*, 67 F. Supp. 2d 1129, 1138 (C.D. Cal. 1999), the *Cendant* court held that a "court should not permit or consider any arguments by
defendants or non-class members." 8 Id. at 268. The issue is limited to whether the lead plaintiff is adequate, not whether another plaintiff could do "a better job of protecting the interests of the class." Id.

Specifically, the Cendant court held that the burden of the lead plaintiff is to make a prima facie showing of both typicality and adequacy of representation, applying the common standards on both issues. Id. at 264. For the issue of typicality, the question is "whether the circumstances of the movant 'are markedly different or the legal theory upon which the claims [of that movant] are based differ[] from that upon which the claims of other class members will perforce be based.'" Id. at 265 (citation omitted). As to the adequacy requirement, the court stated that the trial court should consider whether the proposed lead plaintiff "has the ability and incentive to represent the claims of the class vigorously, [whether it] has obtained adequate counsel, and [whether] there is [a] conflict between [the movant's] claims and those asserted on behalf of the class. Id. (alterations in original).

The Cendant court identified two additional factors to be considered in evaluating whether the prima facie showing of adequacy has been made. The first is "whether the movant has demonstrated a willingness and ability to select competent class counsel and to negotiate a reasonable retainer agreement." Id. at 265. This is not an approval process by the trial court of counsel or the fee, but a threshold inquiry into the movant's legal experience or sophistication, and whether the counsel selection and fee agreement were plainly unreasonable. Id. at 266.

The second adequacy issue is whether the movant is a group versus an individual person or entity. Id. at 266. The court rejected any hard and fast rules for evaluating a group, but suggested that a "kind of 'rule of reason prevails.'" Id. at 267. The court further rejected the idea that an unrelated group was always improper, but suggested that an unrelated group assembled by lawyers seeking to become lead counsel "could not be counted on to monitor counsel in a sufficient manner." Id. The size of the group is also important, with the Third Circuit effectively accepting the SEC's view that groups greater than five are too large. Id. at 267. The court did not purport to limit the factors that could be considered by the trial court, and held that "the court should explain its reasoning on the record" for rejecting the presumptive lead plaintiff. Id. If the presumptive lead plaintiff is rejected, the trial court should undertake the process for the plaintiff or group with the next highest financial interest. Id. at 267-68.

One factor that the court considered, but ultimately rejected, in determining whether the lead plaintiff group in the Cendant litigation (the CalPERs group) was proper was whether the

8 However, it is clear that the preliminary showing on the class certification standards is without prejudice to the defendants' ability to relitigate the issues fully on the class certification motion. See, e.g., In re Oxford Health Plans, Inc. Sec. Litig., 191 F.R.D. 369, 373 (S.D.N.Y. 2000) (on motion for class certification, "proposed class and Class Representatives are to be reviewed according to the standards of Rule 23, without any deference to the earlier determinations made in the appointment of Lead Plaintiffs."); In re Nice Sys. Ltd. Sec. Litig., 188 F.R.D. 206, 218 n.11 (D.N.J. 1999).
lawyers had obtained the status as lead counsel by virtue of political contributions, known as "pay-to-play," on the basis that actual proof was lacking. The Court made no mistake, however, that such allegations were serious: "Lest we be misunderstood, we observe that actual proof of pay-to-play would constitute strong (and, quite probably, dispositive) evidence that the presumption had been rebutted." Id. at 269. What is interesting, however, is that it is common practice to provide "bonuses" to lead plaintiffs upon the settlement of securities class actions. While not directly analogous, the practice of paying bonuses may come under greater scrutiny based on the lead plaintiff provisions of the PSLRA.

B. Injunctions Against State Court Actions Based on the PSLRA or SLUSA

One of the early responses to the PSLRA was the filing of simultaneous federal and state court class actions. Plaintiffs could avoid the heightened pleading requirements and obtain discovery prohibited the PSLRA. In some instances, federal cases were dismissed, while state cases went to trial. To address this issue, in 1998, Congress passed the Securities Litigation Uniform Standards Act ("SLUSA"), 15 U.S.C. §§ 77p, 78bb(f). SLUSA preempts state court class litigation involving "covered securities," mainly securities trading on national securities markets.9 SLUSA also empowers federal courts, "upon a proper showing," to "stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to the stay of discovery." Securities Act § 27(b)(4); Exchange Act § 27D(b)(4)(D).

Even after SLUSA, in many cases, particularly those involving accounting restatements, companion state court derivative lawsuits are filed, seeking damages from directors for the costs to the company from the ongoing investigations and class action litigation. This raises the specter of an end-run around the discovery stay imposed by the PSLRA, and appear on their face, to be vulnerable to a stay based on SLUSA. However, the first case interpreting the scope of SLUSA, In re Transcrypt International Sec. Litig., 57 F. Supp. 2d 836, 847 (D. Neb. 1999), held that SLUSA does not authorize the federal courts to stay non-class state court actions. The holding in Transcrypt has already been the subject of criticism, but if its reasoning prevails, companion derivative suits to class actions will likely become more common.

The Eighth Circuit, in In re BankAmerica Corporation Sec. Litig., 263 F.3d 795, 2001 U.S. App. LEXIS 19035 (8th Cir. August 24, 2001), issued an opinion upholding an injunction issued against a California securities class action brought prior to the November 3, 1998 effective date of SLUSA. While the case appears to be of limited direct effect, because it addressed a state court litigation filed prior to SLUSA, it could possibly have a wider impact as it

9 The Second Circuit recently held that a "variable annuity" is a covered security under SLUSA because it is (1) a security and (2) most be sold by companies registered under the Investment Company Act of 1940, and thus any state court class action alleging fraud in the sale of annuities is preempted under SLUSA. Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101 (2d Cir. 2001).
appears to reject the reasoning of Transcript, while not expressly ruling on the point. \textit{Id.} at 802 ("SLUSA's limited injunction power is instead aimed at plaintiffs who would use state-court actions to circumvent the automatic discovery stay that applies in federal actions upon the filing of a motion to dismiss").

The specific issue in \textit{BankAmerica} was whether the injunction fit within the exception provided in Anti-Injunction Act, 28 U.S.C. § 2283 for injunctions expressly provided for in a federal statute. The district court answered the question in the affirmative, and the Eighth Circuit, in a 2-1 opinion, affirmed. The Eighth Circuit's opinion concludes that "the lead-plaintiff provisions of the PSLRA create significant federal rights that previously did not exist," and that permitting a parallel state court action would improperly interfere with those rights. 263 F.3d at 801. The Court recognized that if SLUSA applied, the action would have been preempted altogether, but did not directly respond to the argument that the decision not to give SLUSA retroactive effect itself indicated the intent of Congress to permit previously filed parallel state suits to proceed, instead using the policies of SLUSA as support for its ruling. \textit{Id.} at 802-03.

\textit{BankAmerica} is certainly direct authority to seek to stay any existing parallel state court actions. It may also be used to support an argument under SLUSA that the federal court should stay any state court action filed that circumvents the automatic discovery stay that applies upon the filing of a motion to dismiss (15 U.S.C. § 77z-1(b)(1)), whether it is a class or individual action. \textit{Id.} at 802 (discussing, without deciding, SLUSA's limited injunction power against plaintiffs who use state court action to circumvent the PSLRA's automatic discovery stay).

C. Class Representative Must be Knowledgeable, and Control the Litigation To Be Adequate, According to the Fifth Circuit

One practical issue that was created by the lead plaintiff provisions of the Reform Act was whether the procedures involved effectively eliminated any reasonable possibility of challenging the class representative. In fact, some plaintiff's counsel took the position that discovery of the class representative, including a deposition, was unnecessary and protective orders should be routinely granted. This approach has been rejected by the Fifth Circuit in \textit{Berger v. Compaq Computer Corp.}, 257 F.3d 475 (5th Cir. 2001). In \textit{Berger} the circuit court granted an interlocutory appeal and reversed the certification of a securities class action on two grounds: (1) the trial court improperly shifted the burden of proof away from the plaintiff on the issue of adequacy of representation; and (2) the court applied a lax standard of adequacy that ignored that the class representatives, and not class counsel, "must direct and control the litigation." \textit{Id.} at 481. As the Fifth Circuit stated, "[c]lass action lawsuits are intended to serve as a vehicle for capable, committed advocates to pursue the goals of the class members through counsel, not for capable, committed counsel to pursue their own goals through those class members." 257 F.3d at 484.

Although the Fifth Circuit specifically addressed the standards under the Private Securities Litigation Reform Act ("PSLRA"), its opinion makes clear that the adequacy standard
being articulated should be generally applied. While it is expected that experienced class counsel will assume a larger role in managing and directing a class action as opposed to one with a single client, the *Berger* court specifically rejected the argument that adequate counsel is sufficient to satisfy the adequacy of representation requirement. Instead a class representative must "possess a sufficient level of knowledge and understanding to be capable of 'controlling' or 'prosecuting' the litigation." 257 F.3d at 482-483. The exact parameters of the necessary knowledge and understanding are not defined, but trial courts have not typically imposed a high standard. See, e.g, *Williams Corp. v. Kaiser Sand & Gravel Co.*, 146 F.R.D. 185, 187-188 (N.D. Cal. 1992).

Given that it is undisputed that a defendant's full rights to challenge a class certification motion are unaffected by the PSLRA, see *In re Nice Sys. Sec. Litig.*, 188 F.R.D. 206, 218 n.11 (D.N.J. 1999), the tactical issues for defense counsel to consider is whether waiting until class certification to raise issues concerning the plaintiff is too late, or whether attempting to prompt a court to *sua sponte* address objections in the lead plaintiff stage will effectively foreclose a challenge at the class certification stage, when the defendant should be able to obtain discovery to rebut the adequacy of the class representative. Any argument that the lead plaintiff should not be subject to discovery based on the lead plaintiff based on the "sworn certification" filed pursuant to 15 U.S.C. §§ 77z-1(a)(2)(A) and 78u-4(a)(2)(A) has been effectively rejected by the Fifth Circuit opinion in *Berger* which, if anything, supports the view that the scrutiny of a lead plaintiff is heightened under the PSLRA. If the *Berger* opinion is generally accepted, that will counsel in favor of waiting until the class certification process, and after some discovery, before raising any objections to the class representative.

**D. The Seventh Circuit Rejects Duty to Update Unless Positive Law Creates a Duty to Disclose**

The Seventh Circuit has not spoken yet on many of the important issues under the Reform Act, including the pleading requirements for scienter. However, in *Gallagher v. Abbott Laboratories*, 269 F.3d 806 (7th Cir. 2001), the court, in an opinion by Judge Easterbrook, rejected a general duty on the part of companies to update information, holding that "firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty

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10 The Fifth Circuit recently denied rehearing of *Berger*, 2002 U.S. App. LEXIS 579 (5th Cir. January 14, 2002) (per curiam), specifically rejecting the argument of plaintiff that the court had "created an additional, independent requirement for the adequacy standard for class certification under Federal Rule of Civil Procedure 23 by reading the provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA") into rule 23(a)(4)". *Id.* at *1. The court stated "[w]e have not, however, created an additional requirement under rule 23(a)(4) that, after completing the process of selecting the lead plaintiff and lead counsel, a court may grant class certification only if the putative class representative possesses a certain level of experience, expertise, wealth or intellect, or a level of knowledge and understanding of the issues, beyond that required by our long-established standards for rule 23 adequacy of class representatives." *Id.* at *1.

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to disclose." *Id.* at 808. In *Gallagher*, the Seventh Circuit affirmed a dismissal of a complaint under Section 10(b) claiming that Abbot's decision to defer public disclosure of ongoing settlement talks with the FDA that led to a $168 million write-down constituted a fraud on the shareholders. *Id.* at 807.

While the court acknowledged that the periodic reports required under the Securities Act of 1933 and Section 13 of the 1934 Act, 15 U.S.C. § 78m, including the implementing regulations, affirmatively required disclosure of corporate information, the court characterized those reports as "snapshots of the corporation's status on or near the filing date, with updates due not when something "material" happens, but on the next prescribed filing date." 269 F.3d at 809. Accordingly, "a corporation does not commit fraud by standing on its rights under a periodic-disclosure system." *Id.* at 809-10. Finally, statements need only be "corrected" if they were "incorrect when made," and not rendered incorrect by subsequent developments. *Id.* at 810.11

E. Insurance Developments

The most important development, not captured in the published case law, is the increasing attempt by Directors and Officers Insurance carriers to rescind policies based on material misrepresentations in the policy application, particularly in accounting restatement cases. The approach works as follows: the company is required to attach its most recent SEC filings to its policy application, verify that the financial statements are correct, and acknowledge in the application that the attachments are material to the insurance company's decision to issue coverage. Thus, if the company and its officers and directors are later sued based on a restatement of the financial statements, the insurer can seek rescission based on a material misrepresentation in the policy application, which under state law often does not require intent. This is a serious issue because on some level it renders the coverage illusory.

The Sixth Circuit addressed two other D & O insurance issues in *Owens Corning v. National Union Fire Ins.*, 257 F.3d 484 (6th Cir. 2001). The first was whether or not allocation between covered and uncovered claims was required when a joint settlement was entered into including both covered directors and an uncovered corporation. (With entity coverage widely available this scenario is less common). The court affirmed a summary judgment on behalf of the corporation, holding that, under Ohio law, an allocation provision that required the parties to cooperate in good faith to allocate a settlement payment between covered and uncovered claims was ambiguous, and should be interpreted to only require allocation to the extent that the uninsured claims actually increased the insurer's liability. *Id.* at 492, 493.

The second issue considered by the court was whether the underlying indemnification obligation by the company of the directors for the settlement was proper under Delaware law.

11 The primary exception to this rule is that "[a] registration statement and prospectus for a new issue of securities must be accurate when it is used to sell stock, and not just when it is filed." *Id.* at 811 (citing Section 12(a)(2) of the 1933 Act, 15 U.S.C. § 77l(a)(2) and Regulation S-K, Item 512(a)).
257 F.3d at 494. Under Section 145 of Delaware General Corporations Law there are two types of indemnification, mandatory and permissive. "Mandatory indemnification for defense expenses occurs when the director is 'successful on the merits or otherwise' in defense of the action," Section 145(c), while "[p]ermissive indemnification may occur . . . for the costs imposed on directors who have been determined to have acted in good faith" (Section 145(a) and (b)). *Id.*

Owens Corning took the position that (1) its by-laws provided an alternative basis for permissive indemnification that did not require "good faith," and (2) a settlement of approximately $10 million should be viewed as success on the merits, mandating indemnification. *Id.* National Union argued that Owens Corning admitted failure to follow the procedures contained in Section 145(d) for determining the good faith of its directors barred permissive indemnification. *Id.*

The Sixth Circuit rejected all of the arguments made by the parties, but nevertheless found in favor of Owens Corning. The court first rejected the argument that the by-laws could override the requirements of Delaware law, stating that "the ability [of the company] to provide indemnification is constrained by its corporate form as governed by the law of Delaware." 257 F.3d at 494-495. The court also found it to be "extremely dubious that a payout of almost ten million dollars would be deemed 'success' by the courts of Delaware," expressed "no opinion on whether a payment in *any* amount must be considered a failure." *Id.* at 495 n.6. The court recognized that a blanket rule against a settlement being considered a success would "compel litigants to seek a Pyrrhic victory in court," but a rule not tied to a specific factual showing would allow any pre-trial settlement to be viewed as a success. *Id.* The court concluded, however, that "[i]t is not impermissible for a Delaware corporation to accord a director seeking indemnification a rebuttable presumption of good faith." 257 F.3d at 495. The failure of National Union to rebut the presumption led to affirmance of summary judgment. *Id.*
PROFESSIONAL RESPONSIBILITIES OF SECURITIES COUNSEL:
DUTIES TO CLIENT AND NONCLIENTS

Manning G. Warren, III
H. Edward Harter Chair of Commercial Law
University of Louisville Louis D. Brandeis School of Law
Louisville, Kentucky

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SECTION G
Professional Responsibilities of Securities Counsel: Duties to Clients and Nonclients

Professor Manning G. Warren III
H. Edward Harter Chair of Commercial Law
University of Louisville

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SECTION G
Professional Responsibilities of Securities Counsel:
Duties to Clients and Nonclients

Professor Manning G. Warren III
H. Edward Harter Chair of Commercial Law
University of Louisville

I. Introduction
   A. Recent Experience
   B. The Standards Setting Function and Civil Liability

II. The Securities Lawyer’s Standards of Care
Example: The Securities Lawyer’s Due Diligence Standard
   A. Conduct a preliminary review to determine client’s quality and integrity and any potential conflicts.
   B. Form, direct and oversee a competent working group for the disclosure process.
   C. Establish a due diligence atmosphere making certain every participant knows of liability risks.
   D. Conduct meetings with key personnel to determine the terms of the offering and its purpose and the nature of the issuer’s business.
   E. Prepare a due diligence checklist covering every material aspect of issuer’s business.
   F. Distribute questionnaires to directors, officers and principal shareholders covering their background, experience and conflicts of interest.
   G. Prepare a working draft of disclosure document, after review of sample documents used by other issuers in similar business and after consultation with working group.
   H. Conduct and control an extensive “due diligence” investigation for the purpose of obtaining and verifying all information necessary for inclusion in the disclosure document.
   I. Compare all information from different sources in order to determine “red flags” and inconsistencies.
   J. Write, edit, review and revise various drafts of the disclosure document in consultation with entire working group - and reach a consensus that the final draft fully and completely discloses all facts material to the issuer and its offering of securities.
III. The Sources of the Securities Lawyer’s Standard of Care

A. Federal Securities Laws

1. The Securities Act of 1933 (1933 Act) has two main purposes:

(a) to provide investors with material financial and other information concerning securities offerings in the primary market; and

(b) to prohibit misrepresentation, deceit and other fraudulent acts and practices in the distributions of securities generally (whether or not required to be registered).

§11 of the 1933 Act:

(a) in case any part of the registration statement . . . contained an untrue statement of a material fact or omitted . . . a material fact . . . , any person acquiring such security . . . may sue - (1) every person who signed the registration statement . . . , (2) every director . . . , (3) every person named in the registration statement as being or about to become director . . . , (4) every accountant engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has been named . . . , (5) every underwriter . . . [but]

(b) . . . no person, other than the issuer, shall be liable . . . who shall sustain the burden of proof - (3) that (a) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements . . . were true and that there was no omission to state a material fact.

§12 of the 1933 Act:

(a) any person who - (2) offers or sells a security (whether or not exempted . . . ) by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . 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, shall be liable to the person purchasing the security . . . .
2. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (1934 Act) primarily concerns the regulation of secondary or trading markets. The Act, for example, contains antifraud provisions such as Rule 10b-5, extensive periodic and continual reporting, as well as other requirements, for certain issuers of securities, oversight of broker-dealers and national securities exchanges, and regulations focusing on proxy solicitation, tender offers and going private transactions.

Rule 10b-5 of the 1934 Act

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

(a) to employ any device scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

B. The Common Law of Torts

American Law Institute (ALI) Restatement (Second) of Torts.

Section 526

A misrepresentation is fraudulent if the maker (a) knows or believes the matter is not as he represents it to be, (b) does not have the confidence in the accuracy of his representation that he states or implies, or (c) knows that he does not have the basis for his representation that he states or implies.

Section 529

A representation stating the truth so far as it goes but which the maker knows or believes to be materially misleading because of his failure to state additional or qualifying matter is a fraudulent misrepresentation.
Section 552(1)

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

C. Rules of Professional Conduct

1. The ABA Model Rules of Professional Responsibility

Duty of Competence

Model Rule 1.1

A lawyer must provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation. To handle securities transactions, the lawyer must be a prudent expert or must associate special counsel.

Duty to Consult

Model Rule 1.2(a)

A lawyer must consult with the client, which means communication of information reasonably sufficient to apprise the client of the significance of the transaction. See also Restatement of the Law Governing Lawyers, §20.

No Assistance to Fraudulent Conduct

Model Rule 1.2(d)

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows or should know is fraudulent. See also Restatement of the Law Governing Lawyers, §94. A lawyer who assists a client in conduct that violates the rights of a third person is subject to liability to both the third person and the client.

Duty to Communicate

Model Rule 1.4

A lawyer is required to explain the consequences of the transaction and assure that the client fully understands the substantive and legal
effects of the transactions to which the lawyer's work relates.

Duty to Withdraw

_Model Rule 1.16_

A lawyer must not represent a client if the representation would result in any violation of the law or the rules of professional conduct.

Advisory Duties

_Model Rule 2.1_

A lawyer must exercise _independent_ professional judgment and provide candid advice, even if that advice involves unpleasant facts and alternatives the client would rather not confront.

_Model Rule 2.3_

A lawyer may undertake an evaluation of a matter effecting a client for the use of someone other than the client if:

(a) the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client; and

(b) the client consents after consultation.

See also Restatement of the Law Governing Lawyers, §95. In providing the results of the lawyer's investigation and analysis of facts or professional evaluation, the lawyer must exercise care to the nonclient and must not make false statements.

Duty of Truthfulness

_Model Rule 4.1_

In the course of representing a client, a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.

See also Restatement of the Law Governing Lawyers, §98, Statements to a Nonclient, _infra._
Note the Rule 1.6 exception to the lawyer's duty of confidentiality. A lawyer's disclosure of information is impliedly authorized where necessary to carry out the representation, e.g., federally-mandated disclosure requirements in the client's securities offerings. See also Restatement of the Law Governing Lawyers, §67. Moreover, neither the attorney-client privilege nor work product immunity applies when a client uses the lawyer's services to engage in or assist a fraud. *Id.* at §§82, 93.

**Supervisory Duty**

*Model Rule 5.1*

Partners are required to ensure that the firm has measures in effect to assure that all lawyers in the firm conform to the Model Rules, including the duty of competence, among others. Moreover, a lawyer having direct supervisory authority over another lawyer must make reasonable efforts to ensure the subordinate lawyer conforms to the Model Rules. See also Restatement of the Law Governing Lawyers, §11.

**Duty of Subordinates**

*Model Rule 5.2*

A lawyer is bound by the Model Rules even when acting at the direction of another person. See also Restatement of the Law Governing Lawyers, §12.

**Professional Misconduct**

*Model Rule 8.4*

It is professional misconduct for a lawyer to:

(a) violate or attempt to violate the rules of professional conduct, knowingly assist or induce another to do so, or do so through the acts of another;

(b) commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects;

(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation; and

(d) engage in conduct that is prejudicial to the administration of justice.
2. **ABA Formal Ethics Opinions**

The American Bar Association has issued Formal Ethics opinions specifically advising lawyers to perform independent disclosure and not blindly rely on clients' statements (Formal Op. 335 (1974)), to withdraw if disclosures made in offerings do not satisfy the lawyer's ethical responsibility (Formal Op. 346 (1982)), and to withdraw and disavow his work product if the client is using the lawyer's work product to commit fraud, and failure to repudiate constitutes assistance to the unlawful conduct (Formal Op. 92-366 (1992)).

D. **ALI Restatement (Third) of the Law Governing Lawyers**

**Section 51. Duty of Care to Certain Nonclients**

For purpose of liability under §48 [professional negligence], a lawyer owes a duty to use care within the meaning of §52 [standard of care] in each of the following circumstances:

1. to a prospective client, as stated in §15 [duties to prospective clients];

2. to a nonclient when and to the extent that:

   (a) the lawyer or (with the lawyer's acquiescence) the lawyer's client invites the nonclient to rely on the lawyer's opinion or *provision of other legal services*, and the nonclient so relies, and

   (b) the nonclient is not, under applicable tort law, too remote from the lawyer to be entitled to protection;

3. to a nonclient when and to the extent that:

   (a) the lawyer knows that a client intends as one of the primary objectives of the representation that the lawyer's services benefit the nonclient;

   (b) such a duty would not significantly impair the lawyer's performance of obligations to the client; and

   (c) the absence of such a duty would make enforcement of those obligations to the client unlikely; and

4. to a nonclient when and to the extent that:

   (a) the lawyer's client is a trustee, guardian, executor, or
fiduciary acting primarily to perform similar functions for the nonclient;

(b) the lawyer knows that appropriate action by the lawyer is necessary with respect to a matter within the scope of the representation to prevent or rectify the breach of a fiduciary duty owed by the client to the nonclient, where:

(i) the breach is a crime or fraud, or

(ii) the lawyer has assisted or is assisting the breach;

(c) the nonclient is not reasonably able to protect its rights; and

(d) such a duty would not significantly impair the performance of the lawyer's obligations to the client.

Section 52. Standard of Care

1. For purposes of liability under §§48 [professional negligence] and 49 [breach of fiduciary duty], a lawyer who owes a duty of care must exercise the competence and diligence normally exercised by lawyers in similar circumstances.

2. Proof of a violation of a rule or statute regulating the conduct of lawyers:

(a) does not as such give rise to an implied cause of action for professional negligence or breach of fiduciary duty;

(b) does not preclude other proof concerning the duty of care in Subsection (1) or the fiduciary duty; and

(c) may be considered by a trier of fact as an aid in understanding and applying the standard of Subsection (1) or §49 to the extent that:

(i) the rule or statute was designed for the protection of persons in the position of the claimant, and

(ii) proof of the content and construction of such a rule or statute is relevant to the claimant's claim.

Section 98. Statements to a Nonclient

A lawyer communicating on behalf of a client with a nonclient may not:
1. knowingly make a false statement of material fact or law to the
nonclient,

2. make other statements prohibited by law; or

3. fail to make a disclosure of information required by law.

See also Model Rules of Evidence 702-703

E. SEC Opinions:

* In re Keating, Muething & Klekamp (1979)

* In re Fields (1973)

* In re Carter (1981)

* In re Ferguson (1974)

F. Basic Case Law:

* U.S. v. Benjamin, 328 F.2d 854 (2d Cir. 1964)

* SEC v. Frank, 388 F.2d 486 (2d Cir. 1968)


* Greycas v. Proud, 826 F. 2d 1560 (7th Cir. 1987)

G. Exemplary Cases:

   v. Frank, supra, the court held that an attorney with primary
   responsibility for drafting disclosure documents was primarily
   liable to investors under Rule 10b-5 as a result of misleading
   financial information “which he should have investigated.”

   54 (1978). The court held an attorney, who had no experience in
   securities law, liable to purchasers of promissory notes. The court
   stated “the duty of the lawyer includes the obligation to exercise
due diligence, including a reasonable inquiry, in connection with
   responsibilities he has voluntarily undertaken.” The attorney, as a
lawyer for the issuer, secured an exemption for the securities sold to investor solely based on promotional material furnished by the issuer without making a reasonable inquiry to ascertain the truth or falsity of the representation that could have been easily verified.

3. *Flight Transportation Corporation Securities Litigation v. Reavis & McGrath*, 593 F. Supp. 612 (1984). Purchasers of securities brought an action against law firm which represented underwriter in connection with a public offering. The court, in holding the Plaintiff's complaint stated a cause of action, stated that "the defendant was not some stranger in the market. Rather, according to the allegations, it undertook the preparation of allegedly fraudulent and misleading prospectus. The duty has been fairly asserted by the complaint to withstand a motion to dismiss.

4. *Mercer v. Jaffe, Snider, Raitt and Heuer*, 713 F. Supp. 1019 (1989). Investors brought securities fraud action against attorneys who prepared offering circulars. The court held that "A person undertaking to furnish information which contains a material misstatement or omission is a primary participant, so long as he or she is not so far removed from the transmission of the misleading information that liability would necessarily become vicarious. The attorneys' approval or assistance in the preparation of misleading disclosure documents is "conduct that certainly qualifies as 'furnishing' or supplying' information to potential investors in a sufficiently direct manner to impose 10b-5 primary liability."

5. *Breard v. Sachnoff & Weaver, Limited*, 941 F.2d 142 (2nd Cir. 1991). Investors brought state and federal securities actions against attorneys for a limited partnership. The investors alleged that attorneys preparing the offering memorandum had omitted and misstated over twenty-two material facts, including issuer's conviction of mail fraud in connection with a previous fraudulent limited partnership scheme. The court held that lawyers who recklessly prepare misleading disclosure documents may be primary violators of Rule 10b-5.

6. *Molecular Technology Corporation v. Valentine*, 925 F.2d 910 (6th Cir. 1991). The purchasers of convertible debentures brought action against issuer and its attorneys to recover for securities fraud and negligent misrepresentation. The Court of Appeals for the Sixth Circuit held that attorneys could be liable for misrepresentations made in an offering circular for a private placement of convertible debentures if they should reasonably foresee third parties' reliance. In this case, corporate counsel for the issuer drafted a private placement memorandum and forwarded it to outside counsel for review. The court held that outside counsel knew or should have known that the disclosure document he edited
failed to disclose materials facts concerning the issuer. As a primary participant in the disclosure process, counsel could be held liable as a primary violator of Rule 10b-5.

7. *O'Melveny & Myers v. Federal Deposit Insurance Corporation*, 969 F.2d 744 (9th Cir. 1992). The FDIC, a receiver for a failed savings and loan, sued former counsel for S&L for legal malpractice and breach of fiduciary duty regarding counsel's advice and services in connection with public offering. O'Melveny & Myers argued that a lawyer owes no duty to uncover a client's fraud or to advise the client and the world of that fraud. The Court of Appeals for the Ninth Circuit held that there are two problems with O'Melveny's approach. The first is the implication that if a client happens to be committing a fraud, of which the attorney may or may not be aware, the presence of the fraud cancels the attorney's duty to use due care. The second problem with O'Melveny's approach is its sharp differentiation between a "duty to investors," which it concedes, and a "duty to the client," which it denies. Given the broad duty to protect the client, this distinction is a false one. Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials."

8. *Florida Bar v. Calvo*, 630 So.2d 548 (Fla. 1994). The court disbarred an attorney for violations of Disciplinary Rules 1-102(A)(1) and 1-102(A)(6) and assessed $7,252 in costs in connection with preparing a fraudulent securities offering. The court rejected attorney's arguments that his client was the crook and thus was bound by the code of ethics to keep his mouth shut. The court reminded him that the "rule of attorney-client confidentiality comes to an end when an attorney knows that the client is engaging in a crime or fraud."

9. *Walco Investments, Inc. v. Thenan*, 881 F. Supp. 1576 (S.D. Fla. 1995). Investors brought suit against law firms which had prepared private placement memorandums on behalf of limited partnerships. The court, in denying the law firms' motions to dismiss, held that the law firms were aware that investors would be relying upon and induced to purchase securities based upon the information contained in the private placement memorandum. This knowledge may be sufficient to create a relationship between the law firm and plaintiff-investors.

company to sue for contribution against a law firm who drafted an entire prospectus which contained misrepresentations and omissions. The court held that “such allegations are not to be characterized as failure to disclose but as affirmative misrepresentations or omissions described under 10b-5.” The court held that plaintiffs need not show a duty to disclose where counsel has participated in the preparation of disclosure documents containing material omissions.

IV. Conclusion
VENTURE CAPITAL DEALS

David W. Harper
Law offices of David W. Harper
Louisville, Kentucky

Richard H. Sinkfield
Sidley Austin Brown & Wood LLP
Washington, D.C.

Caryn F. Price
Wyatt, Tarrant & Combs, LLP
Louisville, Kentucky

and

William G. Strench
Frost Brown Todd LLC
Louisville, Kentucky


SECTION H
VENTURE CAPITAL DEALS

David W. Harper
Richard H. Sinkfield
Caryn F. Price
and
William G. Strench

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I. HYPOTHETICAL................................................................................... H-1
II. TERM SHEET FOR THE NEW NEW THING, INC. ......................... H-3
III. CAPITALIZATION SPREADSHEET................................................. F-11
Joe N. Vence founded The New New Thing, Inc. in February, 1999. Mr. Vence serves as its CEO, owns 55% of the outstanding shares of New New Thing, but through a special class of common stock held by him carrying 10 votes per share, holds approximately 92% of the voting power of New New Thing. Vence took $200,000 out of his retirement plan at his former employer of 15 years to start New New Thing. Through loans and private placements of shares to friends, family and several “angel investors,” New New Thing raised almost $1,500,000 over the last three years to keep the company alive. During this time, New New Thing developed and patented a wrapping foil for hotdogs and similar type sandwiches that keeps the dog, brat or sausage “just off the grill hot” for up to one hour while allowing the bun to keep its natural fresh texture and not get soggy. New New Thing had been working on a foil that could be used for hamburgers, which because of their circular shape present a special R&D challenge that Vence and his one R&D employee are confident they can overcome. However, a shortage of funds has stopped this R&D work.

At a recent trade show, a sales rep for the national firm that holds concession rights to most of the Major League Baseball ballparks discovered New New Thing’s wrapping foil for hotdogs and came away favorably impressed, promising to get back with Mr. Vence. The problem is, New New Thing is out of money and behind on its office rent, Vence hasn’t taken salary for two months, his savings are depleted and Mrs. Vence wants her husband to get a “real job,” the R&D employee has not been paid in four weeks and is threatening to quit, the sales and marketing person Vence wanted to hire couldn’t wait any longer and took another job, and his investor friends and family are tapped out.

Vence wants to follow up with the concession firm for those Major League Baseball ballparks but literally has no money on which to travel. And if this concession firm gets the slightest whiff of that, he’ll have no negotiating leverage and get taken to the cleaners. Vence believes that if New New Thing only had the funding to keep the doors open, hire a top notch sales and marketing person, and look more like a viable business, that it could also get in the near future some significant sales from concession firms serving the National Football League stadiums, the National Hockey League and NBA arenas like Madison Square Garden, and the NCAA Division I universities. And that doesn’t even include the wholesalers that sell to the hotdog street vendors! If only he had the financial and other resources to get New New Thing’s foot in the door with even one of these behemoths. Vence also remains convinced New New Thing can develop a wrapping foil for hamburgers with funding for further research and development.
One angel investor, weary of putting money in and now on to something else, knows I. M. Rich, the founder and managing partner of Friendly Capital Group LLC. In one last effort to help New New Thing before he writes off his investment, he contacts Mr. Rich and requests that he meet with Vence. Friendly Capital has investments in a portfolio of companies, including several in the food services business. Even though I. M. is Ivy League Old School with a preference for premium-priced vodka and Vence a college dropout with a preference for Miller Genuine Draft®, the two hit it off quite well at their first meeting. That meeting ends with I. M. Rich wholeheartedly agreeing with Vence that there is nothing worse than pealing back a concession vendor’s wrapper at the game and biting into a lukewarm hotdog in a soggy bun. After further meetings, a thorough review of New New Thing’s business plan and some due diligence, Friendly Capital offers to invest $1.2 million in New New Thing on the terms set forth in the following cap table and term sheet.
THE NEW NEW THING, INC.

Summary of Principal Terms of Series A Preferred Stock Offering

This term sheet summarizes the principal terms with respect to a potential private placement of equity securities of The New New Thing, Inc. (the "Company") by Friendly Capital Group, LLC, or its designees (the "Purchaser").

<table>
<thead>
<tr>
<th>Type of Security:</th>
<th>Shares of the Company's Series A Convertible Redeemable Participating Preferred Stock (&quot;Series A Preferred&quot;) representing approximately 33% of the outstanding equity of the Company on a post-closing fully diluted basis.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Investment:</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Pre-Money Valuation of the Company:</td>
<td>$2,400,000</td>
</tr>
<tr>
<td>Price Per Share:</td>
<td>$0.38, subject to adjustment based on the actual shares issued (the &quot;Issue Price&quot;).</td>
</tr>
<tr>
<td>Capitalization of the Company:</td>
<td>The pre-investment and post-investment capitalization of the Company shall be as set forth on Exhibit A.</td>
</tr>
<tr>
<td>Use of Proceeds:</td>
<td>The proceeds from the sale of the Series A Preferred shall be used by the Company for working capital.</td>
</tr>
<tr>
<td>Dividends:</td>
<td>Cumulative dividends at the rate per annum of 8% of the Issue Price, compounded annually, will accrue on the Series A Preferred. If the Company declares a dividend on the Common Stock, the Series A Preferred shall also be entitled to participate pro rata on an as-if converted basis.</td>
</tr>
<tr>
<td>Liquidation Preference:</td>
<td>In the event of any liquidation, dissolution or winding up of the Company, the holders of Series A Preferred will be entitled to receive in preference to the holders of all other equity securities an amount equal to (i) the Issue Price per share of Series A Preferred, plus (ii) all accrued but unpaid dividends, plus (iii) an amount which, after receipt, the holders of Series A Preferred shall have received an internal rate of return on the Issue Price equal to</td>
</tr>
</tbody>
</table>
Optional Conversion:

A holder of Series A Preferred will have the right to convert the Series A Preferred, at any time, into shares of Common Stock. The total number of shares of Common Stock into which a share of Series A Preferred may be converted initially will be determined by dividing the Issue Price by the conversion price. The initial conversion price will be the Issue Price.

Anti-Dilution Adjustments:

The conversion price will be subject to adjustment in the event of any stock dividend, stock split, recapitalization or the like. If the Company issues additional shares at a purchase price per share less than the applicable conversion price (other than in connection with the conversion of the Series A Preferred, the issuance and sale of, or the grant of options to purchase, shares of Common Stock pursuant to a Company stock option or employee purchase plan approved by the Board of Directors), the conversion price will be adjusted to such lower price to prevent dilution.

Automatic Conversion:

The Series A Preferred will be automatically converted into Common Stock, at the then applicable conversion price, upon the closing of a sale of the Company's shares of Common Stock pursuant to a firm commitment underwritten public offering by the Company with aggregate net proceeds to the Company (after deducting underwriters' commissions and discounts) of at least $10,000,000 and at a public offering price per share of at least $3.00, as
Redemption:

The Company shall, at the option of a holder of Series A Preferred, at any time and from time to time after five years from the Closing and upon not less than 90 days prior notice to the Company, redeem such holder's shares of Series A Preferred for a price per share equal to the greater of (i) the Issue Price per share of Series A Preferred, plus all accrued and unpaid dividends, or (ii) the fair market value per share of Series A Preferred, as determined by a qualified, independent appraiser acceptable to both the Company and the holder. If unable to agree on an appraiser, the Company and the Purchaser shall each designate an appraiser and the average of the fair market value as determined by each appraiser shall be deemed the fair market value per share. The costs of any appraiser shall be paid for by the Company.

Voting:

Except with respect to the election of directors, each share of Series A Preferred will have the right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of such share of Series A Preferred.

Protective Provisions:

The Company shall not, without the consent of the holders of at least a majority of the outstanding Series A Preferred: (i) amend any provision of the Company's certificate of incorporation or bylaws; (ii) create any new series or class of shares having rights, preferences or privileges senior to or on parity with the Series A Preferred or issue any class or series of equity securities or additional shares of existing classes or series; (iii) effect any transaction resulting in a change in control; (iv) liquidate, dissolve or change the nature of the Company's business; (v) effect a merger or consolidation of the Company or sale of all or substantially all of its assets; (vi) enter into any transaction with affiliates; (vii) incur any obligations for borrowed money of more than $100,000 in the aggregate in any 12 month period; (viii) repurchase or redeem any equity securities of the Company except as contemplated herein or make any distribution on the Common Stock or any shares ranking junior

adjusted for stock splits, stock dividends, recapitalizations and the like occurring after the date hereof (a "Qualified Public Offering").
Registration Rights:

If, at any time after 180 days following the Company's initial public offering, the Purchaser requests that the Company file a registration statement for at least 25% of the Common Stock issued or issuable upon conversion of the Series A Preferred, the Company will use its reasonably diligent efforts to cause such shares to be registered under the Securities Act of 1933 and applicable state securities laws. The Company will not be obligated to effect more than two registrations (other than on Form S-3 as described below) under these demand registration right provisions. The Purchaser will have full piggyback rights to register its shares in any registration of the shares of the Company by the Company or its shareholders (other than an offering related solely to an employee benefit plan or a Rule 145 transaction), subject to the right of the Company and its underwriters, in view of market conditions, to reduce or eliminate the number of shares of the Purchaser proposed to be registered. The Purchaser shall have unlimited Form S-3 registration rights, provided that the Company shall not be obligated to effect more than two S-3 registrations in any 12 month period. All registration expenses (exclusive of underwriting discounts and commissions and special counsel fees of a selling shareholder) shall be borne by the Company. Subsequent purchasers of the Company's securities may not be granted registration rights on parity with or superior to the registration rights of the Purchaser without the consent of the holders of at least a majority of the Series A Preferred. Any underwriter shall be selected by the Purchaser and shall be reasonably acceptable to the Company.

Option Pool:

The Company will reserve up to 10% of the pre-money equity in the Company for issuance upon the exercise of outstanding options granted to employees, officers and consultants of the Company pursuant to an employee stock option or purchase plan approved by the Board of
Information Rights:
The Company will provide standard financial reports to the Purchaser, including monthly and year to date income, balance sheet and cash flow statements as compared to budget, and shall provide a written one or two page summary of operations each month. Not later than 30 days before the end of each fiscal year, the Company shall provide a business plan and projections for the next fiscal year. An annual audit of the Company’s financial statements shall be performed by a “big five” or other accounting firm acceptable to the Purchaser.

Board of Directors:
The number of directors of the Company shall be fixed at five members. The Series A Preferred voting as a class shall elect two directors and the Common Stock voting as a class shall elect two directors. One director shall be elected by the holders of the Series A Preferred and the Common Stock voting together as one class. The Purchaser shall also have the right to have one observer attend all meetings of the Board. The representatives of the Series A Preferred shall be entitled to customary indemnification from the Company and reimbursement of the reasonable costs of attending meetings of the Board and its committees.

Compensation Committee:
The Board shall establish a compensation committee composed of non-management directors, which shall administer the Company’s stock option plan and make decisions with respect to executive compensation.

Preemptive Rights:
In the event that the Company offers equity securities (other than upon conversion of outstanding shares of Series A Preferred or upon exercise of outstanding options under a Board approved employee stock option or purchase plan), the Purchaser shall have a right of first refusal to purchase a pro rata percentage of shares in the new offering, based on the Purchaser’s percentage ownership interest in the Company on a fully diluted basis. The right will terminate upon the Company’s initial public offering.
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right of First Refusal and Co-Sale Agreement:</td>
<td>The Founder shall execute a Right of First Refusal and Co-Sale Agreement with the Company and the Purchaser which contains, with respect to the Founder’s shares, customary buy-sell covenants and restrictions in favor of the Purchaser. In addition, if the Founder proposes to sell shares of the Company, the Purchaser will be entitled to participate in such sale by selling the same percentage of its Series A Preferred as the Founder is selling. The Founder shall participate in any sale of the Company by the holders of a majority of the Company’s outstanding securities.</td>
</tr>
<tr>
<td>Confidentiality and Proprietary Information Agreements:</td>
<td>Each officer, employee and consultant of the Company shall have entered into an agreement containing provisions satisfactory to the Purchaser with respect to confidentiality, corporate ownership of inventions, and non-competition and non-solicitation of employees and customers during and after employment.</td>
</tr>
<tr>
<td>Stock Restriction Agreement:</td>
<td>The Company and the Founder will execute a Stock Restriction Agreement with the Company pursuant to which the Company will have a repurchase option to buy back at cost a portion of the shares of Common Stock held by the Founder in the event that the Founder’s employment with the Company is terminated prior to the expiration of 48 months from the date of the closing. 1/48th of the shares will be released from the repurchase option at the end of each month based upon continued employment by the Company. The restriction will terminate upon any sale of substantially all the assets or stock of the Company.</td>
</tr>
<tr>
<td>Key Person Life Insurance:</td>
<td>The Company shall obtain and maintain a key person life insurance policy of $2,000,000 on the Founder, with proceeds payable to the Company.</td>
</tr>
<tr>
<td>Purchase Agreement:</td>
<td>The purchase of the Series A Preferred will be made pursuant to a Series A Preferred Stock Purchase Agreement to be drafted by Purchaser’s counsel which shall contain among other things, appropriate representations and warranties of the Company and the Founder, indemnities for breach, covenants of the Company and the Founder reflecting the</td>
</tr>
</tbody>
</table>
Due Diligence:

The Closing of this transaction is subject to the Purchaser's due diligence investigation of the Company (which must be satisfactory to the Purchaser in its sole discretion).

Expenses:

The Company will pay all reasonable legal, out-of-pocket and due diligence expenses incurred by the Purchaser in connection with this transaction, whether or not the transaction closes.

Closing:

Closing of the purchase of the Series A Preferred (the "Closing") shall occur on or before __________, 2002 or as soon thereafter as reasonably practicable.

Exclusivity:

Upon execution of this Term Sheet and until __________, 2002 or such earlier date on which the Purchaser informs the Company that it is no longer interested in financing the Company, the Company and the Founder shall deal exclusively with the Purchaser and neither the Company nor the Founder will initiate, respond to, or participate in any way, in any discussions regarding, or accept any proposal for, any equity financing or sale of the Company.

Confidentiality:

The existence and terms of this term sheet, and the fact that negotiations may be ongoing with the Purchaser, are strictly confidential and may not be disclosed to anyone except the Company's directors, senior executive officers, and legal counsel.
This term sheet is intended solely as a basis for further discussion and is not intended to be and does not constitute a legally binding obligation of any party except as provided under “Confidentiality”, “Exclusivity” and “Expenses” above. No other legally binding obligation will be created, implied or inferred until a definitive purchase agreement is executed and delivered by all parties.

THE NEW NEW THING, INC.

By: _____________________________
Title: ____________________________

JOE N. VENCE

FRIENDLY CAPITAL GROUP, INC.

By: _____________________________
Title: ____________________________
# New New Thing Capitalization

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Investment(1)(2)</th>
<th>Class A Common</th>
<th>Class B Common</th>
<th>Series A Preferred</th>
<th>Ownership Outstanding</th>
<th>Ownership fully diluted</th>
<th>Pro Forma Ownership</th>
<th>Voting Control(5)(6)</th>
<th>Pro Forma Voting Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joe N. Vence(3)</td>
<td>$ 199,404</td>
<td>265,872</td>
<td>2,565,027</td>
<td>55.17%</td>
<td>44.69%</td>
<td>29.80%</td>
<td>91.85%</td>
<td>42.42%</td>
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</tr>
<tr>
<td>G. Monet Banks</td>
<td>$ 550,000</td>
<td>1,000,000</td>
<td></td>
<td>19.49%</td>
<td>15.79%</td>
<td>10.53%</td>
<td>3.54%</td>
<td>1.64%</td>
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</tr>
<tr>
<td>Forrest Gump</td>
<td>$ 550,000</td>
<td>1,000,000</td>
<td></td>
<td>19.49%</td>
<td>15.79%</td>
<td>10.53%</td>
<td>3.54%</td>
<td>1.64%</td>
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<tr>
<td>Alice Wunderlin</td>
<td>$ 59,373</td>
<td>107,950</td>
<td></td>
<td>2.10%</td>
<td>1.70%</td>
<td>1.14%</td>
<td>0.38%</td>
<td>0.18%</td>
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<tr>
<td>D. N. Ventor</td>
<td>$ 33,000</td>
<td>60,000</td>
<td></td>
<td>1.17%</td>
<td>0.95%</td>
<td>0.63%</td>
<td>0.21%</td>
<td>0.10%</td>
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<tr>
<td>U.R. Friendly</td>
<td>$ 17,600</td>
<td>32,000</td>
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<td>0.62%</td>
<td>0.51%</td>
<td>0.34%</td>
<td>0.11%</td>
<td>0.05%</td>
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<tr>
<td>Buddy Lee</td>
<td>$ 16,500</td>
<td>30,000</td>
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<td>0.47%</td>
<td>0.32%</td>
<td>0.11%</td>
<td>0.05%</td>
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<tr>
<td>Lois Price</td>
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<td>0.49%</td>
<td>0.39%</td>
<td>0.26%</td>
<td>0.09%</td>
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<tr>
<td>Wright Price</td>
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<td>25,000</td>
<td></td>
<td>0.49%</td>
<td>0.39%</td>
<td>0.26%</td>
<td>0.09%</td>
<td>0.04%</td>
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<tr>
<td>Kathleen Price-Vence</td>
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<td>20,000</td>
<td></td>
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<td>0.32%</td>
<td>0.21%</td>
<td>0.07%</td>
<td>0.03%</td>
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<tr>
<td><strong>Joe N. Vence(3)</strong></td>
<td>$ 1,200,000</td>
<td>3,167,044</td>
<td></td>
<td>33.33%</td>
<td>25.00%</td>
<td>16.67%</td>
<td>11.11%</td>
<td>5.56%</td>
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<tr>
<td><strong>G. Monet Banks</strong></td>
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<td><strong>Forrest Gump</strong></td>
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<tr>
<td><strong>Alice Wunderlin</strong></td>
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<tr>
<td><strong>D. N. Ventor</strong></td>
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<tr>
<td><strong>Buddy Lee</strong></td>
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<tr>
<td><strong>Lois Price</strong></td>
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<tr>
<td><strong>Wright Price</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Kathleen Price-Vence</strong></td>
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</tr>
<tr>
<td><strong>Hope Springs (4)</strong></td>
<td>$ 200,000</td>
<td>379,886</td>
<td></td>
<td>6.00%</td>
<td>4.00%</td>
<td></td>
<td>0.62%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Patience Wells (4)</strong></td>
<td>$ 100,000</td>
<td>189,943</td>
<td></td>
<td>3.00%</td>
<td>2.00%</td>
<td></td>
<td>0.31%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Option Pool</strong></td>
<td>$ -</td>
<td>633,409</td>
<td></td>
<td>10.00%</td>
<td>6.67%</td>
<td></td>
<td>1.04%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Friendly Capital Group, LLC</strong></td>
<td>$ 1,200,000</td>
<td>3,167,044</td>
<td></td>
<td>33.33%</td>
<td>25.00%</td>
<td>16.67%</td>
<td>11.11%</td>
<td>5.56%</td>
<td></td>
</tr>
<tr>
<td><strong>Pre-Money Total</strong></td>
<td>$ 1,764,377</td>
<td>3,769,060</td>
<td>2,565,027</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Post-Money Total</strong></td>
<td>$ 2,964,377</td>
<td>3,769,060</td>
<td>2,565,027</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
1. Class A Common Stock price per share in Round 1: $0.75
2. Class A Common Stock price per share in Round 2: $0.55
3. Convertible debt holders in Round 2. Conversion price:
4. 1 vote per share of Class A Common
5. 10 votes per share of Class B Common
REGULATION FD and NEW INSIDER TRADING RULES

C. Craig Bradley, Jr.
Stites & Harbison PLLC
Louisville, Kentucky

Burton W. Rice
Corporate Communications, Inc.
Nashville, Tennessee

Janet Kelley
K-Mart Corporation
Troy, Michigan

and

Timothy Jerzyk
Tricon Global Restaurants, Inc.
Louisville, Kentucky

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SECTION I
REGULATION FD and NEW INSIDER TRADING RULES

SELECTIVE DISCLOSURE AND INSIDER TRADING:
REGULATION FD AND RULE 10b5-1 AND 10b5-2

C. Craig Bradley, Jr.
Stites & Harbison PLLC
Louisville, Kentucky

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SECTION I(a)
SELECTIVE DISCLOSURE AND INSIDER TRADING: 
REGULATION FD AND RULES 10b5-1 AND 10b5-2

C. Craig Bradley, Jr. 
Brandon J. Kessinger

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SECTION I(a)
II. INSIDER TRADING RULES

A. Introduction

B. Analysis

III. SUPPLEMENTAL MATERIALS

A. NIRI Executive Alert: Guidance for Compliance with Regulation FD (September 10, 2001)

B. NIRI Standards of Practice for Investor Relations (2nd Edition; January 2001)
SELECTIVE DISCLOSURE AND INSIDER TRADING:
REGULATION FD AND RULES 10b5-1 AND 10b5-2

On August 10, 2000, the Securities and Exchange Commission (the “Commission”) adopted new issuer disclosure rules, Regulation FD (Fair Disclosure), to address the issue of selective disclosure of material nonpublic information to securities analysts and other market insiders. At the same meeting, the Commission adopted two new insider trading rules, Rules 10b5-1 and 10b5-2. The first of these two rules clarifies when liability arises from a trader’s “use” or “knowing possession” of material nonpublic information. The second clarifies how the misappropriation theory of insider trading liability applies to family and other non-business relationships. Each of these rules is summarized below.

I. REGULATION FD

A. Introduction

The new selective disclosure rules were proposed for public comment on December 20, 1999. The Commission’s rulemaking initiative was a response to what it perceived to be a systemic problem within the U.S. securities markets; that is, the practice of issuers selectively disclosing material nonpublic information to securities analysts and institutional investors before disseminating that same information publicly. This creates opportunities for market insiders (and their clients) to profit from that information by trading ahead of its public announcement, at the expense of public investors. In the Commission’s view, “the current practice of selective disclosure poses a serious threat to investor confidence in the fairness and integrity of the securities markets.”

The Commission received nearly 6,000 comment letters on proposed Regulation FD. Individual investors universally supported the Commission’s effort to “level the playing field” for access to significant corporate information. Issuers, securities industry participants, the securities bar and other professional trade organizations criticized the breadth of the proposed rule and expressed concerns about the potential chilling effect on issuer disclosure practices from a mandatory selective disclosure rule. The final rule was modified in several important respects to address these issues. First, the coverage of the rule was narrowed to focus on those communications which are most likely to lead to insider trading abuses. In so doing, the Commission intended to avoid interfering with exchanges of otherwise legitimate and valuable corporate information such as ordinary course business communications with an issuer’s customers or suppliers or communications with the news media. Second, the liability provisions were revised to protect issuers against the possibility of private litigation under the antifraud provisions of the federal


“Our markets are strong because investors are confident of their basic fairness. Trading on inside information -- and giving early tips to other potential traders -- damages the entire structure of our markets, because it deeply shakes this vital investor confidence. It can especially demoralize individual investors.”
securities laws for failure to disclose material nonpublic information under Regulation FD. Third, exclusions were added for foreign private issuers and information disclosed in connection with most registered public offerings.

The purpose of Regulation FD is to deter selective disclosure of material nonpublic information to securities analysts, institutional investors and other market insiders in advance of general public announcement. As adopted, the rule requires that all domestic public issuers make simultaneous (or prompt) public disclosure of all material nonpublic information that it, or persons acting on its behalf, communicates to its security holders and securities market professionals. The rule became effective on October 23, 2000.

B. Reasons For Regulation FD

In its release accompanying the new rule, the Commission cited two fundamental problems caused by the practice of selective disclosure. First, selective disclosure undermines the integrity of the securities markets and reduces investor confidence in the fairness of those markets. Second, selective disclosure may also create conflicts of interest for securities analysts, who may have an incentive to avoid making negative statements about an issuer for fear of losing their access to nonpublic information.\(^4\)

Several commenters on proposed Regulation FD, citing concerns over the breadth of the rule and the associated risks of unintended consequences, urged the Commission to address the issue of selective disclosure through the issuance of additional interpretative guidance and, where appropriate, enforcement actions rather than a mandatory disclosure rule.\(^5\) As discussed in the Proposing Release,\(^6\) the Supreme Court’s decision in Dirks v. SEC\(^7\) raises doubts over the extent

\(^4\) In his opening statement at the August 10, 2000 Commission meeting at which Regulation FD was adopted, then-Chairman Arthur Levitt stated:

High quality and timely information is the lifeblood of strong, vibrant markets. It is at the very core of investor confidence.

But when that information travels only to a privileged few, when that information is used to profit at the expense of the investing public, when that information comes by way of favored access rather than by acumen, insight, or diligence, we must ask, “Whose interest is really being served?” If investors see a stock’s price change dramatically – but are given access to critical market-moving information only much later – we risk nothing less than the public’s faith and confidence in America’s capital markets.

... Today, as Wall Street analysts play an increasingly visible role in recommending stocks, some in corporate management treat material information as a commodity – a way to gain and maintain favor with particular analysts. What’s more, as analysts become more and more dependent on the “inside word,” the pressure to report favorably on a company has grown even greater, as analysts seek to protect and guarantee future access to selectively disclosed information.


\(^6\) Proposing Release, Part II.A.

\(^7\) 463 U.S. 646 (1983). In Dirks, the Supreme Court addressed the issue of liability under the federal securities laws when a corporate insider “improperly” discloses material nonpublic information to a securities analyst. It stated that courts must first look to “whether there has been a breach of duty by the insider. This requires courts to 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.” Id. at 663.
to which selective disclosures by issuers to securities analysts who then trade on the basis of the nonpublic information (or advise their clients to trade) constitute violations of the insider trading laws. In the end, the Commission chose to adopt a “more measured approach” to the issue of selective disclosure through rulemaking rather than a more aggressive enforcement program.

C. The Elements of Regulation FD

Rule 100 of Regulation FD sets forth the basic rule regarding selective disclosure. It provides that whenever:

- An issuer, or person acting on its behalf,
- Discloses material nonpublic information,
- To certain enumerated persons (in general, securities market professionals or holders of the issuer’s securities who may reasonably be expected to trade on the basis of the information),
- The issuer must make public disclosure of that same information,
- Either simultaneously (in the case of intentional disclosures), or promptly (in the case of non-intentional disclosures).

1. Issuer and Persons Acting on its Behalf

Rule 101(b) of Regulation FD defines “issuer” to include any domestic issuer with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or one that is required to file reports under Section 15(d) of the Exchange Act. Foreign governments and foreign private issuers are specifically excluded from the rule.

The rule also covers communications by certain persons acting on behalf of the issuer. These include any senior official of the issuer or any other officer, employee or agent of an issuer who regularly communicates with securities market professionals and the issuer’s security holders. “Senior official” is defined to mean any director, executive officer, investor relations or public relations officer, or other person with similar functions. Any person who discloses material nonpublic information in breach of a duty of confidence owed to the issuer is not considered to be acting on behalf of the issuer. Issuers will therefore not be held responsible for material information improperly tipped by insiders.

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8 Disclosures made in connection with initial public offerings are therefore not covered by Regulation FD.
9 Rule 405 under the Securities Act of 1933 excludes from the definition of “foreign private issuer” any foreign issuer which maintains its principal office in the United States, or whose management or assets are principally located in this country, if a majority of its outstanding voting securities are owned by United States residents. Consequently, these foreign issuers would be subject to Regulation FD.
10 Rule 101(c).
11 Rule 101(f).
12 An issuer may limit its liability for unauthorized disclosure by adopting a written disclosure policy which identifies the senior officials who are authorized to communicate with securities market professionals and investors. Selective disclosures by persons not authorized to speak under the policy would be made in violation of a duty of trust to the issuer and would, therefore, not be subject to Regulation FD. See U.S. Securities and Exchange Commission, Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supp. (rev. July 18, 2001) (the “Telephone Interpretations Manual”), Question No. 14. The Telephone
As proposed, Regulation FD would have applied to statements made by virtually any person acting within the scope of his or her corporate authority. In response to public comments, the final rule was narrowed to limit its application to senior management, investor relations personnel and others who regularly communicate with securities market professionals and security holders. In the Adopting Release, the Commission notes, however, that neither an issuer nor a covered person may escape liability under the rule by directing a non-covered person to make a selective disclosure. In that case, the covered person would still be held responsible for the selective disclosure.

2. Material Nonpublic Information

(a) Materiality

The Commission chose not to expressly define the term "material" in Regulation FD. Instead, the rule relies on existing judicial interpretations of materiality. Under existing case law, information is considered material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision and it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." The Adopting Release contains a non-exclusive list of information and events that, in the Commission's judgment, should be "reviewed carefully" to determine whether or not they are material. These include:

- Earnings information;
- Mergers, acquisitions and tender offers;
- New products or discoveries, or developments regarding customers or suppliers;
- Changes in control or management;
- Change in auditors;
- Dividends, stock splits and defaults on senior securities;
- Issuance of additional securities; and
- Bankruptcy.

(1) Earnings Guidance and Analyst Reports

Perhaps the most difficult issue confronting issuers since the adoption of Regulation FD is the subject of earnings guidance and what issuers can say to analysts about earnings models and previously published earnings expectations without communicating the same information publicly. In a strongly worded message to issuers, the Commission warned in the Adopting Release that issuer officials who engage in private discussions with analysts seeking guidance on earnings estimates assume "a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated

"Adopting Release at 8.
"TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). In the case of contingent or speculative information, the Supreme Court has held that materiality will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Basic, Inc. v. Levinson, 485 U.S. 224, 238 (1988).
earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect 'guidance,' the meaning of which is apparent though implied.\textsuperscript{16}

At the same time, the Commission confirmed that issuers may continue to selectively disclose non-material information to analysts on the basis of the "mosaic theory\textsuperscript{17} without violating Regulation FD. In the Commission's view, "[t]he focus of Regulation FD is on whether the issuer discloses material nonpublic information, not on whether an analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor."\textsuperscript{18}

Issuers continue to struggle with the question of how and when they may properly confirm previously issued earnings forecasts. The Commission staff has stated that an issuer should consider whether the confirmation of its own forecast itself conveys new material information. In assessing that question, issuers should consider the amount of time that has elapsed between the original forecast and the confirmation. Confirmations of prior earnings estimates made late in a quarter are more likely to contain material information than ones made within a few days or weeks of the original statement. Companies should be cautious in referring to previously issued forecasts. In the staff's view, statements by an issuer that a forecast hasn't changed or that it is "still comfortable" with the prior guidance are no different than an express confirmation.\textsuperscript{19}

Regulation FD has prompted many issuers to rethink the practice of reviewing and commenting on draft analyst reports.\textsuperscript{20} Issuers which limit their review to historical facts and reminders of previously published earnings information should not trigger the rule's public disclosure requirements.\textsuperscript{21} On the other hand, nonpublic information which is shared privately with an analyst whose own earnings estimate seems outdated or varies from the company's projections would likely be considered material and necessitate public disclosure.\textsuperscript{22}

\textsuperscript{16} Adopting Release at 10.
\textsuperscript{17} The "mosaic theory" was first articulated by the Second Circuit in \textit{Elkind v. Liggett & Myers, Inc.}, 635 F.2d 156, 165 (2d Cir. 1980), where the court observed that a "skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information." \textit{See also SEC v. Bausch & Lomb, Inc.}, 420 F.Supp. 1226, 1231 (S.D. N.Y. 1976) (corporate officers and analysts may engage in a "general discussion out of which a skilled analyst could extract pieces of a jigsaw puzzle which would not be significant to the ordinary investor but which the analyst could add to his own fund of knowledge and use toward constructing his ultimate judgment.").
\textsuperscript{18} Adopting Release at 10.
\textsuperscript{19} \textit{See} Telephone Interpretations Manual, Question No. 1.
\textsuperscript{20} Only 50% of the companies surveyed by NIRI in August 2001 continue to review analysts' earnings models, down from 87% prior to Regulation FD.
\textsuperscript{21} \textit{See} Telephone Interpretations Manual, Question No. 7.
\textsuperscript{22} The Commission staff has made it clear that the practice of managing quarterly earnings expectations through private discussion with analysts would be prohibited by Regulation FD. "In short, walking the Street up or down is almost certainly prohibited and can no longer be done privately. I'm hard-pressed to think of a scenario where the reasonable investor would not be interested in knowing whether an analyst's forecast is too high or low, if even by a penny, under current market dynamics." Remarks of Richard H. Walker, former Director, Division of Enforcement, to the Compliance and Legal Division of the Securities Industry Association, "Regulation FD – An Enforcement Perspective," New York, N.Y., Nov. 1, 2000 (the "Walker Speech").

I(a)-5
(2) Staff Accounting Bulletin 99

A footnote reference in the Adopting Release to Staff Accounting Bulletin 99 has prompted concern over the materiality threshold which the Commission staff may apply in possible enforcement actions.\(^{23}\) SAB 99 requires that both quantitative and qualitative factors must be considered in evaluating materiality for financial reporting purposes. Items that may be quantitatively immaterial may nevertheless be considered qualitatively material if, among other things, they have the potential for causing a significant movement in the issuer's stock price.\(^{24}\) By drawing a connection between SAB 99 and Regulation FD and potentially defining materiality in terms of market-moving information, issuers and securities attorneys are concerned that the Commission has lowered the materiality threshold and effectively eliminated the concept of the mosaic theory.

(b) Nonpublic Information

Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. In addition to the manner of dissemination, issuers must also consider whether a reasonable time has passed for the information to reach the market. What constitutes a reasonable time depends on the circumstances of dissemination.\(^{25}\)

3. Disclosures to Enumerated Persons

Regulation FD was created to address the problem of selective disclosure to persons who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading. The rule is therefore limited to communications with the following securities market professionals and institutional investors:

- any broker-dealer, investment adviser or institutional investment manager, or their associated persons; and
- any investment company or hedge fund or their affiliated persons.

The rule also covers holders of the issuer's securities under circumstances where it is reasonably foreseeable that such holders would trade on the basis of the information.\(^{26}\) The rule excludes communications with the following persons:

- Any person who owes the issuer a duty of trust or confidence;
- Any person who expressly agrees to maintain the information in confidence;\(^{27}\)

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\(^{23}\) Adopting Release, fn. 38.

\(^{24}\) Other considerations cited in SAB 99 that may render material a quantitatively small amount in a financial statement are: (1) does the item disguise a change in earnings or other trends; (2) does the item hide a failure to meet analysts' consensus expectations; (3) does the item change a loss into income or vice versa; and (4) does the item concern a segment or other portion of the issuer's business that is significant to the issuer's profitability or operations.

\(^{25}\) Adopting Release, fn. 40.

\(^{26}\) Rule 100(b).

\(^{27}\) An express agreement to maintain the information in confidence is sufficient. The issuer is not required to obtain an additional agreement from the recipient that the recipient will not trade on the information. See Telephone Interpretations Manual, Question No. 10. Also, there is no requirement that the agreement be in writing or that it be
• Credit rating agencies; and
• Any communication made in connection with most registered public offerings. 28

The exclusion for statements made in connection with a registered public offering was added in the final rule to address potential conflicts between Regulation FD and Section 5 of the Securities Act. Commenters feared that a public disclosure mandated by Regulation FD could constitute an illegal offer for purposes of Section 5(c) ("gun-jumping") or a non-conforming prospectus pursuant to Section 5(b)(1). Because of their continuous nature, certain registered shelf offerings under Rule 415 of the Securities Act (such as secondary offerings, DRIPs, employee benefit plans and stock options) are not excluded from Regulation FD.

Communications made in connection with private offerings remain subject to the rule. 29 Issuers engaged in private unregistered offerings of their securities will therefore be required to either obtain confidentiality agreements for any nonpublic information which they propose to provide to prospective investors in the course of the offering or disclose the information publicly (and thereby risk the availability of an exemption from registration under the Securities Act.) 30

The Commission's initial proposal would have extended the coverage of Regulation FD to any disclosure of material nonpublic information made by an issuer, or person acting on its behalf, to any person or persons outside the issuer. 31 In response to public comments, the Commission modified the final rule to restrict its coverage to those persons who are most likely to trade securities on the basis of information selectively provided by issuers or advise others about securities trading. Ordinary-course business communications with an issuer's customers, suppliers, strategic partners and employees and communications with the news media, credit rating agencies and government agencies are excluded from the rule.

4. Public Disclosure

Rule 101(e) defines the types of "public disclosure" that will satisfy the requirements of Regulation FD. The Commission intentionally created a definition which affords issuers significant flexibility in selecting the most appropriate medium of public disclosure under the rule. Issuers may satisfy their public disclosure obligations under Regulation FD in several ways. Issuers may choose to either file or furnish a report on Form 8-K with the required disclosures. Alternatively, issuers may select another method (or combination of methods) of obtained prior to disclosure, so long as the recipient provides the confidentiality agreement before the recipient discloses, or trades on the basis of, the disclosed information. Adopting Release, fn. 28.

28 Rule 101(g) defines the relevant offering period for purposes of Regulation FD. Ordinary course communications such as a regular quarterly conference call, even though made at a time when the issuer is in registration, would remain subject to the rule.

29 Thus, for example, road show materials distributed to prospective investors in connection with an unregistered offering must be disclosed publicly under Regulation FD, in the absence of an exemption from disclosure under the rule. Similarly, information disclosed by an issuer during a road show while the issuer is not in registration and otherwise not engaged in a registered securities offering is subject to Regulation FD. See Telephone Interpretations Manual, Question No. 12.

30 The risk to an unregistered offering such as a traditional private placement or a Rule 144A offering is that a public disclosure mandated by Regulation FD could be construed as a form of general solicitation, invalidating the relevant private offering exemption. Information used in connection with the offering, as well as the fact of the offering itself, may be material and, if not previously disclosed, required to be made public under Regulation FD.

31 See Proposing Release, Part II.B.3.
disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.\textsuperscript{32}

(a) Form 8-K

Issuers may choose to either “file” a report under Item 5 of Form 8-K with the required disclosures or to “furnish” a report under new Item 9 of Form 8-K that is not deemed “filed.” If an issuer elects to file the information on Form 8-K, the report will be subject to liability pursuant to Section 18 of the Exchange Act and Sections 11 and 12(a)(2) of the Securities Act of 1933 if the information is automatically incorporated by reference in a Securities Act registration statement. Reports furnished to the Commission pursuant to Item 9 will not be subject to Section 18 liability unless it takes steps to include the information in a filed document such as a periodic report, proxy statement or Securities Act registration statement. Neither filing nor furnishing information on Form 8-K will, by itself, constitute an admission that the information is material.

(b) Other Disclosure Methods

As an alternative to a Form 8-K filing, issuers are permitted to meet their Regulation FD disclosure obligations through any other method (or combination of methods) that is “reasonably designed to provide broad, non-exclusionary distribution of the information to the public.” The Commission states in the Adopting Release that “acceptable methods of public disclosure for purposes of Regulation FD will include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission (including use of the Internet). The public must be given adequate notice of the conference or call and the means for accessing it.”\textsuperscript{33} The rule doesn’t mandate use of a specific disclosure method for all issuers; rather, it provides a flexible standard that allows issuers to select the method (or combination of methods) that are best suited to their specific circumstances. However, the rule places responsibility on the issuer to assure that the method(s) chosen are, in fact, “reasonably designed” to effect a broad and non-exclusionary distribution of information to the public. Small issuers should heed the Commission’s warning in the Adopting Release that press releases alone may not be sufficient if the issuer knows that its press releases are not routinely carried by the major wire services (such as Dow Jones, Bloomberg, Reuters, Business Wire or PR Newswire). In those cases, the issuer must utilize other or supplemental methods to assure that the information is broadly circulated to the public. For some small issuers, a Form 8-K filing may be the only effective means of complying.

\textsuperscript{32} Another source of disclosure regulation for public companies are the listing rules of the self-regulatory organizations (“SROs”). The New York Stock Exchange, American Stock Exchange and Nasdaq require all listed companies to make prompt disclosure of material information by means of a press release. These requirements have been cited by commentators as factors which limit the flexibility otherwise available to issuers under Regulation FD. In particular, the SRO rules create impediments to the expanded use of alternative electronic disclosure methods (such as the internet).

\textsuperscript{33} In the staff’s view, an adequate advance notice must include the date, time and call-in information for the conference call. Additionally, public notice should be provided a reasonable period of time in advance of the call. For regular quarterly earnings announcements, several days prior notice would be considered reasonable. The staff also suggests that, if a transcript or replay of the conference call will be made available, issuers indicate in the notice where, and for how long, the transcript or replay will be available to the public. See Telephone Interpretations Manual, Question No. 3.
The Commission goes on to suggest the following disclosure model for making the required public disclosure under the rule.

- First, issue a press release, distributed through regular channels, containing the required information.
- Second, provide adequate notice, by a press release and/or website posting, of a scheduled conference call to discuss the announced results, giving investors both the time and date of the conference call, and instructions on how to access the call.
- Third, hold the conference call in an open manner, permitting investors to listen in either by telephonic means or through Internet webcasting.

The posting of information on an issuer’s website will not, by itself, be considered adequate public disclosure under the rule. Additionally, issuers utilizing webcasts or conference calls as a means of public disclosure should archive the webcast or call for some reasonable period of time to allow persons who missed the original broadcast to access its contents at a later date.

Issuers are not required to wait some minimum period of time after filing or furnishing an Exchange Act report before making disclosure of the same information to a private audience. The issuer need only confirm that the Exchange Act report has received a filing date that is no later than the date of the selective disclosure.

5. Intentional and Non-Intentional Disclosures

The timing of the required disclosures under Regulation FD is dependent upon whether the issuer has made an intentional or non-intentional selective disclosure of the information. If the selective disclosure is intentional, public disclosure must be made simultaneously. If the selective disclosure is non-intentional, the issuer must make public disclosure of the same information promptly. “Promptly” is defined in Rule 101(d) to mean as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day’s trading on the New York Stock Exchange) after a senior official of the issuer learns that there has been a non-intentional disclosure by the issuer or a person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic.

A selective disclosure of material nonpublic information is “intentional” when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic. Whether or not a particular statement is made “intentionally” may depend upon the circumstances in which it is made. In accordance with prevailing judicial interpretations of recklessness, liability should only arise for mistaken judgments for materiality if no reasonable person under the circumstances would have reached

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34 The Adopting Release confirms that conference calls need not be open to questions from all listeners. Public participants and members of the media could, for example, access the call in a listen-only mode.

35 This procedure would enable the issuer to discuss the earnings release in detail on the conference call without fear of engaging in improper selective disclosure if additional material information relating to the original earnings release is discussed with analysts in the subsequent call. Because no further guidance is provided in the Adopting Release regarding the meaning of “relating to” in this context, however, it is unclear to what extent an issuer may safely discuss information in the conference call which is arguably unrelated to the subject matter of the earlier press release even though proper public notice of the conference call was given.

36 See Telephone Interpretations Manual, Question No. 6.
the same conclusion. The Commission acknowledges, for example, that the level of mistaken judgment necessary to show recklessness in the context of a prepared written statement would be different than that necessary to establish liability in the case of a spontaneous answer to an unanticipated question.37

D. Liability Issues

Regulation FD is strictly an issuer disclosure rule. As the Commission emphasized in both the Proposing Release and the Adopting Release, the rule is designed solely to create disclosure obligations under Sections 13(a) and 15(d) of the Exchange Act and not to subject issuers to additional liability under the antifraud provisions of the federal securities laws. To address concerns raised by commenters, the rule was expanded to expressly provide that no failure to make a public disclosure required solely by Regulation FD will be deemed to be a violation of Rule 10b-5 under the Exchange Act. This eliminates the possibility that private plaintiffs may sue for securities fraud on the basis of violations of Regulation FD. An issuer’s selective disclosure may still provide the basis for liability under Rule 10b-5 on other theories, such as liability for tipping and illegal insider trading.38 Failure to comply with the disclosure requirements of Regulation FD could still subject the issuer to an enforcement action by the Commission for violations of Section 13 or 15(d) of the Exchange Act.39 To date, no enforcement actions alleging violations of Regulation FD have been filed by the Commission, although several investigations of possible disclosure violations have been reported in the press.40

37 Adopting Release at 11.
38 See SEC v. Phillip J. Stevens, Litigation Release No. 12813 (Mar. 19, 1991). In Stevens, the Commission initiated an enforcement action against a corporate executive who allegedly disclosed nonpublic information to securities analysts ahead of its release to the public. The executive’s calls to the analysts were allegedly motivated by a desire to enhance his reputation among the analysts who covered his company. The Commission argued that this motive was sufficient to meet the “personal benefit test” set forth in the Supreme Court’s decision in Dirks v. SEC. See supra note 7.
39 In a speech to the Compliance and Legal Division of the Securities Industry Association on November 1, 2000, Robert H. Walker, then-Director of the Commission’s Enforcement Division, stated that the staff would be focused initially on two types of violations: egregious cases involving the intentional or reckless disclosure of information that is “unquestionably” material (such as selective disclosure of significant corporate events like mergers or acquisitions and earnings information), and instances of persons who “deliberately attempt to game the system either by speaking in code, or stepping over the line again and again, thus diminishing the credibility of a claim that their disclosures were non-intentional.” He further stated:

   the express language of the rule says that in order to violate Regulation FD, an issuer must have acted recklessly or intentionally in making a selective disclosure. What this means is that we’re not going to second-guess close calls regarding the materiality of a potential disclosure. An issuer’s incorrect determination that information is not material must represent an “extreme departure” from standards of reasonable care in order for us to allege a violation of FD.

Walker Speech, supra note 22.
40 In one situation, senior executives of Raytheon Co. reportedly provided additional “color” regarding its earnings forecast to analysts following the company’s annual investor conference, which was broadcast over the internet. After the conference, analysts reduced their quarterly earnings estimates for Raytheon, with several analysts explaining in written reports that the change followed conversations with Raytheon management. In a second situation, analysts reduced their earnings and revenue estimates for Motorola Inc. after company representatives reportedly made a series of calls to analysts whose estimates were out-of-line with the company’s previous earnings guidance. According to analysts contact by the company, no new information was exchanged on the calls, and the Motorola representatives simply repeated the earlier guidance. See Michael Schroeder, Raytheon’s Disclosure to Analysts is Investigated, Wall St. J., Mar. 15, 2001.
Issuers should consider the advisability of adopting written disclosure policies as a potential defense in the event of a possible Regulation FD violation. The rule doesn’t expressly require that issuers adopt a corporate disclosure policy. However, as stated in the Adopting Release, the Commission expects that “most issuers will use appropriate disclosure policies as a safeguard against selective disclosure. . . . The existence of an appropriate 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.”

E. Duty to Update

As public companies increase the frequency and detail of their public disclosures (in particular, financial forecasts and other forward-looking statements), the question of whether an issuer has an affirmative legal duty to continuously update prior disclosures which, when made, were truthful and accurate becomes more critical. Aside from any legal duties which may exist, will the financial markets expect companies to update prior forecasts as current results and expectations indicate that the company is not likely to achieve projected targets? The number of companies routinely issuing earnings warnings each quarter suggest the answer to this question is yes.

Existing case law considering the subject of an issuer’s duty to update prior disclosures which, although correct at the time, have become inaccurate due to intervening events or the passage of time, provides no clear precedent. While some federal circuits have found a legal duty to update under the federal securities laws, at least one circuit court has consistently refused to impose such a duty. The Commission staff has confirmed that Regulation FD does not change existing law with respect to any duty to update. Until this conflict is resolved, issuers remain at risk under the antifraud provisions of the federal securities laws for missed earnings estimates and other failed predictions of future results. This liability risk may ultimately affect the current trend under Regulation FD toward more disclosure by issuers of forward-looking information, particularly earnings guidance.

F. Response to Regulation FD

The debate over Regulation FD has continued since its adoption. Not surprisingly, sharply different perspectives have emerged regarding the practical impact of Regulation FD. Members of the investor community have generally praised the rule for leveling the playing field and “democratizing” access to corporate information. Issuers have expressed concerns about the lack of meaningful guidance from the Commission on the subject of materiality and their potential liability for being second-guessed on disclosure issues which often involve difficult matters of

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41 Adopting Release, fn. 90.
42 The duty to update should not be confused with the duty to correct prior statements which are later discovered to have been inaccurate or misleading when made. In the latter case, issuers have a clear duty to immediately correct the prior misleading statement upon learning of its inaccuracy. See Backman v. Polaroid Corp., 910 F.2d 10, 16-17 (1st Cir. 1990).
43 See Backman v. Polaroid Corp., supra note 42; Weiner v. Quaker Oats Co., 129 F.3d 310 (3rd Cir. 1997).
44 See Eisenstadt v. Centel Corp., 113 F.3d 738, 746 (7th Cir. 1997); Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1333 (7th Cir. 1995).
45 See Telephone Interpretations Manual, Question No. 2.
judgment. Analysts (particularly sell-side analysts) have complained about reduced access to issuer personnel and the quality of information being provided by issuers. Other market observers have suggested that Regulation FD, by reducing the amount of meaningful information being communicated to analysts, has resulted in greater stock price volatility, especially among small and mid-cap companies. Some also fear that, as the flow of information to analysts decreases and companies become less willing to talk outside of press releases and public conference calls, the level of analyst coverage of small and mid-cap issuers will decline.

A number of organizations have conducted surveys to track the effect of Regulation FD on corporate disclosure practices. The Commission has sponsored a roundtable discussion to solicit views from issuers and market participants on ways to improve the effectiveness of the rule. Various organizations have also provided the Commission with their own reform proposals. A summary of some of these developments follows.

1. NIRA Survey

On February 26, 2001, the National Investor Relations Institute (“NIRA”) released the results of a survey of public company disclosure practices following the adoption of Regulation FD. The results suggest that Regulation FD has in some ways significantly influenced the manner and scope of corporate disclosures. The survey indicated that 27% of the 577 NIRA member companies surveyed are providing more information to investors than before the effective date of Regulation FD. Forty-eight percent of the respondents reported that they are providing about the same amount of information, and 24% said they are providing less information. Other highlights of the survey are:

- Regulation FD seems to have prompted companies to make their corporate disclosures more easily accessible by the general public. Prior to the adoption of the rule, 60% of NIRA members were providing full public access to quarterly earnings conference calls. Since that time, 89% reported doing so, mostly through webcasts. Only one percent of the survey respondents stated that they restrict calls to analysts and major investors.
- Eighty-four percent of member companies include notice of their upcoming conference calls in their earnings releases, and 75% post a notice of the call on their corporate website.
- Seventy-nine percent of member companies are providing some form of earnings guidance. Fifty-six percent are updating their guidance in a news release if material facts or circumstances change during the quarter. Thirty-five percent reported that they do not update earnings guidance once it is issued.
- Of those companies that choose to provide earnings guidance, 67% are including it in a news release and 33% are filing it with the Commission. Most companies indicated that the news release is also being posted on their website.

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47 See Jonathan Fuerbringer, When Companies Talk, Who Gets to Listen?, N.Y. Times, Oct. 20, 2000 (citing as an example the case of Intel Corporation, whose stock declined 22% in one day in September 2000 after the company announced reduced revenue expectations for the quarter.)

48 A summary of the survey findings is available online at NIRA’s website, http://www.nira.org/publications/alerts/ea070201.cfm.

49 This number continues to increase. A September 2001 survey of NIRA members shows that nearly all companies (92%) are webcasting their quarterly conference calls.
• Despite warnings from the Commission about the risks of providing earnings guidance to analysts in one-on-one meetings, 74% of NIRI companies reported that they continue to hold the same number of individual analyst meetings and five percent indicated that they have increased the number of one-on-ones since Regulation FD went into effect.

• Regulation FD seems to have had very little direct effect on the level of analyst coverage and institutional market following. Only one percent of companies attributed a loss of sell-side analyst coverage or the sale of company securities by institutional investors to changes in the company's disclosure policies as a result of Regulation FD.

• Forty-three percent of companies reported that they are still reviewing analysts' earnings models. Seventy-nine percent said they reviewed earnings models prior to Regulation FD. Fifty-seven percent are still reviewing analysts’ draft reports when asked to do so, down from the 79% who reported doing so before Regulation FD.

2. ABA Survey

In April 2001, the American Bar Association Task Force on Regulation FD surveyed members of the securities bar regarding their clients' experiences under the rule. Highlights of the responses include:

• Forty-five percent of the respondents reported that their clients were providing more information to analysts and investors since Regulation FD went into effect. Twenty-four percent stated that clients were providing the same amount of information, and 25% stated that clients were providing less information.

• Thirty percent reported that the quality of the information being disclosed had improved since the adoption of Regulation FD. One-half said the quality had not changed, and 17% said the quality of information had declined.

• An overwhelming majority of the respondents (almost 76%) said their clients’ practices with respect to disclosure of forward-looking information had changed as a result of Regulation FD. Specific responses suggest that issuers are generally disclosing more forward-looking information since the adoption of Regulation FD, particularly in press releases and conference calls, and that information and earnings guidance previously shared with analysts is now being publicly disseminated. Additionally, as the number of companies publishing forecasts increases, greater attention is being given to the safe harbor provisions of the PSLRA.

• Seventy-seven percent of the respondents reported that, prior to Regulation FD, most of their clients conducted one-on-one meetings with analysts, and only one percent said few of their clients did so. After Regulation FD, the number of respondents who reported that most of their clients held one-on-ones declined to 27%. Twenty-seven percent reported that few clients held one-on-ones after Regulation FD.

3. SEC Special Study

On April 24, 2001, SEC Commissioner Laura Unger convened a roundtable discussion in New York City to hear comments from issuers, securities analysts, investors, information disseminators, attorneys, academics and members of the Commission staff on their initial experiences under Regulation FD. In December 2001, Commissioner Unger published a report summarizing the views expressed at the roundtable and making recommendations for improving
the effectiveness of Regulation FD. The principal issues raised by the roundtable participants concerned the need for greater clarity from the Commission regarding the definition of material information and current regulatory impediments to the expanded use of technology to satisfy Regulation FD disclosure requirements. Conflicting views were also expressed regarding the impact of Regulation FD on the quantity and quality of corporate information flow.

Commissioner Unger’s report, which was based on comments from the roundtable discussions and on information generated from post-Regulation FD surveys, makes the following recommendations:

- The Commission should provide more guidance on materiality. Specifically, the Commission should consider issuing an interpretative release to make its position on materiality under Regulation FD clearer. Commission guidance on materiality should focus particularly on clarifying the meaning of “earnings information” as used in the Adopting Release.
- The Commission should make it easier for issuers to use technology to satisfy their Regulation FD disclosure obligations. The Commission should work with the SROs (including the New York Stock Exchange and the National Association of Securities Dealers) to explore ways for the SROs to amend their rules to permit listed companies to meet their disclosure and information dissemination requirements through media other than press releases. Additionally, the Commission should make it clear that options such as adequately noticed website postings, fully accessible webcasts and electronic mail alerts would satisfy Regulation FD.
- The Commission should study both the amount and type of information being disclosed by issuers in Form 8-K filings, press releases, webcasts and conference calls to assess whether Regulation FD has, in fact, chilled the flow of corporate information to the securities markets or had other negative, unintended consequences.

4. NIRI Compliance Guidelines

On September 10, 2001, NIRI published a compilation of interpretations and guidance to assist issuers in understanding and complying with Regulation FD. The advisory also sets forth NIRI’s recommended best practices for communicating with analysts and investors after FD. The advisory may be accessed at NIRI’s website, www.niri.org.

G. Corporate Disclosure and Investor Relations Practices After Regulation FD

Although relatively simple in its basic construction, Regulation FD presents issuers with a number of practical and legal challenges as they adjust to a new disclosure regime. Public companies must reevaluate the manner in which they communicate with securities analysts, investors and the financial community generally. As companies modify their corporate disclosure and investor relations practices to conform to the new selective disclosure rules, they must also evaluate how much information (particularly forecasts and other forward-looking information) they are willing to disseminate publicly.

Many companies have chosen to limit the exchange of information with securities market professionals to avoid potential liability under the rule. Others have continued the practice of communicating informally with analysts and institutional investors, albeit on a different basis than before Regulation FD, while increasing the amount of information disclosed to the public. At the same time, it appears that virtually all companies have opened up their conference calls, news conferences and investor conferences to the public.

Set forth below is a list of common disclosure and investor relations practices which should be considered and analyzed in light of the new selective disclosure rules and changing relationships among issuers and members of the financial community.

1. Does the company conduct regular conference calls to discuss financial results and other significant developments. If so, do all listeners have an opportunity to ask questions during the call.

2. Does the company webcast and/or provide toll-free telephone dial-in access to its earnings (and other) conference calls. If so, how much notice of the call does the company provide.

3. Does the company discuss material information in its quarterly conference calls that is not contained in the previously-issued earnings release.

4. Does the company issue a press release describing the subject matter of an upcoming conference call and providing details of the material information to be discussed on the call. Or, does the company only issue a public notice of the call with no additional detail.

5. Does the company archive its webcasts. If so, for how long.

6. Does the company provide earnings guidance in its press releases.

7. Does the company review draft analyst reports.

8. Does the company routinely provide interim updates of previous earnings forecasts. If so, how frequently are formal updates provided. Is this done through a press release or open access conference call.
9. Does the company have a written disclosure policy. If so, what level of detail is appropriate or advisable. Does the policy identify specific corporate personnel that are authorized to communicate with securities analysts, major investors, other market professionals and the media.

10. Does the company observe a black-out period at quarter end. If so, for how long.

11. Does the company conduct one-on-one and small group meetings with analysts. If so, does the company require that a member of the IR staff, legal department or other company personnel responsible for corporate disclosures be present at all analyst meetings and discussions.

12. Does the company participate in investor and broker-sponsored conferences. If so, does the company require as a condition of its participation that the event be webcast.

13. Does the company fulfill its Regulation FD disclosure requirements by filing or furnishing a report on Form 8-K or through use of other broadly disseminated communications such as press releases.

II. INSIDER TRADING RULES

A. Introduction

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit insider trading, that is, buying or selling securities on the basis of material nonpublic information. An unsettled issue within insider trading cases has been what, if any, causal connection must be shown between a trader’s possession of inside information and his or her trading activities. While some courts have held that a trader may be liable for trading while in “knowing possession” of material

Section 10(b) of the Exchange Act provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

... 

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

nonpublic information,52 others instruct that the proper test for determining whether a violation of
the insider trading provisions has occurred is whether one in possession of material inside
information used the information in connection with the trades that formed the basis for the
alleged violations.53

New Rule 10b5-1 attempts to clarify the issue of when insider trading liability arises in
connection with a trader’s “use” or “knowing possession” of material nonpublic information.
Rule 10b5-1(a) states:

The “manipulative and deceptive devices” prohibited by Section 10(b) of the
Exchange Act and Rule-10b-5 thereunder 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.

Rule 10b5-1(b) further states that “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.” Generally, under the rule, a trade is made on the basis of material nonpublic information if
the trader was aware of the information at the time of the purchase or sale. In the Adopting
Release, the Commission states that while the SEC staff believes the knowing possession
standard best accomplishes the goal of protecting investors and the integrity of securities
markets, it recognizes that the standard could be overbroad in some respects.54 “The new rule
attempts to balance these considerations by means of a general rule based on “awareness” of the
material nonpublic information, with several carefully enumerated affirmative defenses.”55

Responses to the rule expressed concerns that the awareness standard for insider trading might
eliminate the scienter element from insider trading cases.56 The Preliminary Note to Rule 10b5-
1, however, provides that the rule does not modify the scope of insider trading law in any respect
other than to define when a purchase or sale constitutes trading “on the basis” of material
nonpublic information.57

Rule 10b5-1(c) contains an affirmative defense to alleged violations. It provides that a person’s
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 had:

• entered into a binding contract to purchase or sell the security,
• instructed another person to purchase or sell the security for the instructing person’s
  account, or
• adopted a written plan for trading securities.

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52 See United States v. Teicher, 987 F.2d 112, 120-21 (2d Cir. 1993).
53 See SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).
54 Adopting Release at 19.
55 Id.
56 Id.
57 Id.
In order to qualify for the defense provided by this section, the contract, instruction or plan must have either:

- specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
- included a written formula or algorithm, or computer program, for determining the amount of the securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
- prohibited the person from exercising any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must have been aware of the material nonpublic information when doing so; and

the purchase or sale that occurred was pursuant to the contract, instruction, or plan.\(^{38}\)

Of course, the defense will be available only if the contract, instruction or plan was entered into in good faith and not as part of a scheme to evade the prohibitions of the rule.\(^{59}\)

As outlined above, Rule 10b5-1 not only resolves the possession-use dichotomy by establishing the standard for the causal connection that is required to be shown between a trader’s possession of inside information and the related trading activity, but it also provides an affirmative defense for properly structured transactions.

B. Analysis

The SEC anticipates that Rule 10b5-1 will produce two significant benefits. First, the rule should increase investor confidence in the integrity and fairness of the market by clarifying and strengthening existing insider trading law.\(^{60}\) Second, the SEC hopes to benefit corporate insiders by providing greater clarity and certainty on how they can plan and structure securities transactions.\(^{61}\) These benefits should come at little cost, the SEC contends, as 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 demonstrate an exclusion from the rule.

10b5-1 trading plans will in most instances be far easier to administer than the traditional window period approach.\(^{62}\) A plan can be entered into in good faith at any time, provided you do not possess material inside information. For example, an issuer operating a repurchase program will not need to specify with precision the amounts, prices and dates on which it will repurchase its securities. Rather, the issuer could adopt a plan at a time when it is not aware of material nonpublic information, that uses a written formula to derive amounts, prices and dates; or simply

\(^{38}\) Rule 10b5-1(c).

\(^{59}\) Id.

\(^{60}\) See Adopting Release at 29.

\(^{61}\) Id.

delegate all the discretion to determine such variables to another person who is not aware of the information.\textsuperscript{63}

Similarly, an employee wishing to adopt a plan for exercising stock options and selling the underlying shares could adopt a plan while unaware of inside information that contained a formula for determining the specified percentage of the employee’s vested options to be exercised and/or sold at or above a specific price.\textsuperscript{64} For instance, the formula could provide that the employee will exercise options and sell the shares one month before each date on which her son’s college tuition is due, and link the amount of the trade to the cost of the tuition.\textsuperscript{65}

The Rule could also be applied to an employee’s payroll deductions under a Section 401(k) plan.\textsuperscript{66} The transaction price could be computed as a percentage of market price, and the transaction amount could be based on a percentage of salary to be deducted under the plan, with the transaction date determined pursuant to a formula set forth in the plan. Alternatively, the date of a transaction could be controlled by the plan’s administrator or investment manager, assuming that he is not aware of the material, nonpublic information at the time of executing the transaction, and the employee does not exercise influence over the timing of the transaction.\textsuperscript{67}

The defense provided by Rule 10b5-1 is designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision.\textsuperscript{68} This should provide flexibility to those who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information.

The defense is also available to entities. An entity will not be liable if it demonstrates that the individual making the investment decision on behalf of the entity was not aware of the information and that the entity had implemented reasonable policies and procedures to prevent insider trading.\textsuperscript{69} Policies of this nature are likely already in place with those entities to whom the defense would be relevant—broker-dealers and investment advisers—and the Rule should therefore provide additional protection at little or no cost.\textsuperscript{70}

As of the beginning of 2002, the Commission has provided little guidance beyond that included in the Final Release. The staff has, however, issued a series of telephone interpretations addressing Rule 10b5-1 concerns, the most noteworthy of which include the following:

- A plan may have hybrid instructions, part of which are fixed and part of which delegate discretion.\textsuperscript{71}
- The adoption of a written plan for selling securities that satisfies the affirmative defense conditions of Rule 10b5-1(c) will not change the due date for the filing of a Form 144.\textsuperscript{72}

\textsuperscript{63} Id.
\textsuperscript{64} Id.
\textsuperscript{65} Id.
\textsuperscript{66} Id.
\textsuperscript{67} Id.
\textsuperscript{68} Id.
\textsuperscript{69} Id.
\textsuperscript{70} Id.
\textsuperscript{71} See Telephone Interpretations Manual, Question No. 12.

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• A person may make an additional sale (if a “same way”, but not a hedging or offsetting transaction) outside a trading plan without it being deemed an alteration or deviation from the plan.73

• The exercise of a put or call option held by an insider is a separate investment decision from the original purchase of the option and must be exercised when the insider does not possess inside information. 10b5-1 would be available, however, if before becoming aware of inside information, the insider specifies the amount, price and date of exercise or delegates all discretion to a third party who is not in possession of inside information at the time of exercise.74

• A foreclosure sale of stock pledged as collateral for a loan does not satisfy 10b5-1, because the seller may have discretion to pay off the loan or substitute or provide additional collateral.75

• Termination of a plan, even when the person is aware of insider information does not result in liability under 10b5-1. However, termination or cancellation of an order could result in the loss of the 10b5-1 defense for prior transactions as an issue would arise as to whether the plan was “entered into in good faith and not as part of a plan or scheme to evade.” Following the termination of a plan, the 10b5-1 defense would be available for transactions under a new or modified plan only if that plan satisfies 10b5-1.76

By enacting Rule 10b5-1, Congress has expressed strong support for the Commission’s insider trading enforcement program. Rule 10b5-1 should prove to be a step towards maintaining the fairness, health and integrity of our markets.

72 See id., Question No. 1 (Rule 10b5-1 Interps., Oct. 2000).
73 See id., Question No. 13.
74 See id., Question No. 5.
75 See id., Question No. 8.
76 See id., Question No. 15.
GUIDANCE FOR COMPLIANCE WITH REGULATION FD

Reg. FD has been in effect almost a year, and it is time to examine how companies and the investment community have adjusted to the new rule. There have been numerous forums examining how to comply with Reg. FD and forums examining the consequences of the rule. The SEC conducted a one-day roundtable in April. NIRI held a symposium on May 8 at the National Press Club in Washington. Meanwhile, the SEC has provided some guidance through its Manual of Publicly Available Telephone Interpretations (fourth supplement) available on the SEC Web site. (www.sec.gov/interps/telephone/phonesupplement4.htm).

This advisory will attempt to digest the guidance and interpretations regarding various aspects of the rule.

The goal of Reg. FD is to ensure that all market participants have equal access to market moving, material news. The goal of achieving fairness in today's securities markets has been embraced throughout NIRI's 31-year history, first in our Code of Ethics and later in our Standards of Practice for Corporate Disclosure published in 1996.

Reg. FD requires that:

- When a public company has material, nonpublic information to discuss in a selective forum, it must disclose that information publicly prior to or simultaneously with the disclosure in a nonpublic forum. Normally, this would be through a news release, filed under Item 5 or furnished under Item 9 in a Form 8-K or in a fully accessible conference call.
- Should there be unintentional disclosure of material, nonpublic information, once the person covered by Reg. FD realizes that has occurred, the company has 24 hours to issue a news release or file an 8-K. If the inadvertent disclosure occurs over a weekend or holiday, the company must publicly disclose the information before the opening of the next trading day.

Regulation FD Coverage

The rule covers material communications between issuer officials (i.e., officers, directors, investor relations officers, public relations/corporate communications officers) and analysts, professional investors or any other holder of the company's securities who might be expected to trade on that information. It is important that companies designate those who, under normal circumstances, are authorized to speak for the company. Normally, this is done in a written disclosure policy - a subject that will be addressed later.

Since Reg. FD allows analysts to use information gleaned from employees not covered by the rule, one may assume analysts will pursue such sources with vigor to obtain information they would not get from those covered by the rule. This means that a company should carefully educate employees participating in trade shows, technical conferences, and facilities/headquarters tours conducted for analysts.

Conference Calls

A September 2001 survey of NIRI members shows that 92% are webcasting their quarterly conference calls. The other 8% are not conducting conference calls since most do not have analyst coverage. Millions of investors are listening to the live calls and more than three times that number are listening to the archived call. About 80% of companies leave their calls up for at least one to two weeks. One out of four leave them up for the remainder of the quarter.

Reg. FD requires companies to provide investors "adequate notice" when scheduled conference calls
are to occur. About 80% of companies provide such notice about a week in advance in a news release and on the company's Web site.

In situations where a conference call will occur after an unscheduled announcement (e.g., a merger or acquisition), the notice of the conference call should be in the news release announcing the event and then posted on the company's Web site.

NIRI issued an Executive Alert on August 17, "Handling Disseminated information in the Internet Environment," which provides guidance when posting conference calls on Web sites and how to deal with forward-looking information once it is disseminated in cyberspace and is beyond the company's control.

**Earnings Guidance**

Most companies have adopted a process for disclosing their earnings guidance. About 80% of companies are providing guidance. Harvard Business School Professor Amy Hutton examined the consequences of guidance vs. no guidance policies based on NIRI survey data and found:

- Companies that provide guidance build a greater earnings consensus than those that do not.
- Companies that provide guidance generally beat analyst's forecasts. Those providing no guidance tend not to.
- Companies that provide guidance experience a more positive impact from good news than those that provide no guidance.
- Those that provide no guidance experience a more negative impact to bad news than companies that provide guidance.

Following NIRI's best practices and the listed company requirements of the New York Stock Exchange, the Nasdaq Stock Market and the American Stock Exchange, most companies put their earnings guidance in the news release before discussing it in their fully webcast conference call.

The best practice is for a company to put as much guidance in the quarterly news release as it is comfortable in providing. About 10% of companies publish their financial model in the release. More than 60% publish the major factors that drive earnings. The more information a company has publicly released, the more it can comment on when analysts are seeking additional guidance. For example, NIRI believes that a company can explain to an analyst how the company arrived at a material component (e.g., a revenue estimate) in its financial model, assuming that component is fully disclosed and assuming the explanation does not get into material, nonpublic information.

One should steer clear of commenting on material assumptions in an analyst's model. In reviewing analysts' models, one can only correct errors of historical fact that are in the public domain or errors in assumptions that are clearly non-material. Prior to Reg. FD, 87% of our members reviewed draft earnings models. That has dropped to just over 50%.

The SEC, in its Manual of Publicly Available Telephone Interpretations, says, "An issuer also would not be conveying such (material, nonpublic) information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgment about the issuer. An issuer may not, however, use the discussion of an analyst's model as a vehicle for selectively communicating either expressly or in code - material, nonpublic information."

**What should you do if you see an analyst's earnings estimate that has obviously not been updated?** You can call that analyst and suggest that he/she look at the guidance the company issued in its quarterly release but provide no additional comment. If one were to call an analyst whose earnings estimate is significantly different from the company's and provide material, nonpublic information in an attempt to get the analyst to change his/her estimate, that would most likely be a violation of Reg. FD.
One area that continues to concern companies is how far into the quarter can one confirm guidance published early in the quarter in response to an individual analyst's question before triggering the rule's public reporting requirements? The issuer must consider whether that confirmation conveys any material nonpublic information beyond what was stated in the original forecast. In other words, has there been any material change in the facts and/or circumstances associated with that guidance?

If one does not want to confirm or deny an earlier forecast, the issuer official can say, "We are not commenting on previously published guidance."

Various SEC officials have said, in their view, most companies have enough information on how the quarter is going by mid-quarter that such a confirmation may need to be made in a news release, fully accessible conference call or in an 8-K. Their rationale is that the forecast made in the quarterly release was purely a forecast and now you have additional historical information about the quarter. Therefore, that additional information, even though it may not change the earlier guidance, is considered material. NIRI has pointed out that companies may have a sense about how the quarter is going by mid-quarter but has insufficient information to issue a substantive news release without raising questions for which there are inadequate answers.

This is why we have seen a significant increase in the number of pre-announcements issued by mid-quarter or after.

**Does Reg. FD Create a Duty to Update?**

The SEC says in its Manual of Publicly Available Telephone Interpretations that Reg. FD does not change existing law with respect to any duty to update. There is an ongoing legal debate over the duty to update in which case law is not as clear as in those cases pertaining to the duty to correct. (A duty to correct would arise if a company stated a piece of historical news in a release and later discovered that the statement was incorrect).

There is an argument that when companies issue guidance or other forward-looking information and later discover that the guidance has changed materially, that may give rise to liability under a "duty to correct or "duty to update" in certain circumstances. While a violation of Reg. FD itself does not create a liability under Rule 10b-5, there could still be a liability under 10b-5 if investors believed they were defrauded by the failure of the company to update guidance that changes materially. ("Earnings Guidance Best Practices: SEC Regulation FD and the Duty to Update," Thomas J. Dougherty, Skadden, Arps, Slate, Meagher & Flom LLP, March 2001)

The courts are increasingly suggesting there are two types of forward-looking earnings guidance: (1) soft or qualitative guidance, and (2) "hard" or quantitative guidance such as, "We expect revenue range for the quarter of ______." Generally, the courts recognize that a company has no duty to update soft guidance. However, federal appellate decisions are cited, including by the SEC, as imposing a duty to update those forecasts. Regardless of the merits of the various legal points of view on a duty to update, NIRI's Standards of Practice for Investor Relations states that it is both good business and good investor relations to update material changes in publicly released information.

**Materiality**

Materiality raises some of the most difficult and debated issues. Materiality decisions are the lynchpin for enforcing Reg. FD. The rule clearly points out that selective disclosure occurs when an issuer official, covered by the rule, intentionally communicates material, nonpublic information to an analyst, professional investor or anyone else who might trade on the information.

SEC officials have repeatedly said they are not about to "second guess" materiality decisions when made on the spur of the moment in such settings as conference calls or other meetings with analysts or professional investors. And, as discussed before, should an inadvertent disclosure of material, nonpublic information occur in a closed forum, the company must release that information within 24 hours or before the next trading day.
There are five key elements that the Commission must prove in a Reg. FD enforcement action: (1) Was the person who selectively disclosed the information covered by the rule? (2) Was the information clearly material? (3) Did the issuer official know it was material or was reckless in not knowing? (4) Did the issuer official intentionally disclose the information, and (5) Was the information disclosed in a nonpublic setting such as a phone call, one-on-one meeting or a group meeting that was not made fully accessible to the public.

The U.S. Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* found that a fact is material if "there is a substantial likelihood that a reasonable shareholder should consider it important" in making an investment decision, or if the fact would have "significantly altered the 'total mix' of information made available." So, what is a reasonable investor? Reg. FD, draws a distinction between the "reasonable investor" and the "sophisticated" analyst or professional investor who, using the mosaic, collects information from various sources and through detailed knowledge of the industry and the company and through his/her insight draws a material conclusion from the mosaic.

Specifically, Reg. FD says, "Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst."

The 1976 Bausch & Lomb, Inc. decision, 420 F. Supp. 1226 (S.D.N.Y.) states that corporate officers and analysts may engage in a "general discussion out of which a skilled analyst could extract pieces of a jigsaw puzzle (the mosaic) which would not be significant to the ordinary investor but which the analyst could add to his own fund of knowledge and use toward constructing his ultimate judgment." The Reg. FD implementing release says that the "mosaic theory" is alive under the rule.

Therefore, an issuer official may selectively communicate public or nonpublic, immaterial information to an analyst that helps that analyst in his/her effort to complete a mosaic and come to a material conclusion. The rule says, "...an issuer official is not prohibited from disclosing a non-material piece of information to an analyst, even if unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material."

Complicating the determination of what information is material is the linkage of Reg. FD, through a footnote reference, to the SEC's August 1999 Staff Accounting Bulletin 99. SAB 99 further defines material information as that which is "qualitative" and that which may move the market in one's stock. The latter, theoretically gives the SEC the ability, with 20/20 hindsight, to say that certain information was material because it moved the market.

SAB 99 was originally designed to address materiality in filed financial statements. By linking it to Reg. FD, the Commission extends the SAB 99 materiality definitions to all corporate communications. Trying to anticipate, for example, whether the response to an analyst's question may move the market in one's stock and, therefore, may be judged material in hindsight, may be stifling some of the communication between companies and analysts/professional investors.

In the Reg. FD implementing release, the SEC provides a list of material factors that, in most circumstances, would be material. At the top of the list is "earnings guidance." Yet, earnings guidance can include both material and nonmaterial information.

One-on-One Discussions with Analysts and Investors

NIRI believes that one-on-one discussions, whether by phone or face-to-face, continue to be an important component of a company's investor relations program. Company officials, directors and spokespersons covered by Reg. FD must be careful to avoid disclosing material, nonpublic information in these discussions. Should it happen unintentionally, the company is obligated to promptly issue a news release or to provide that information in some other form that constitutes full disclosure.

To that end, we believe it is advisable to have an IRO present or on the phone with any company official, engaged in a one-on-one discussion, who is not intimately familiar with the company's disclosure record. If that official gets a question that could elicit a material response, the IRO could interrupt and advise the official not to respond. If an unintentional disclosure of material, nonpublic
information should occur, the IRO is there to discern that and promptly issue a news release after consultation with legal counsel, if that is possible.

IROs or CFOs may engage in one-on-one discussions without someone else present, so long as they are fully knowledgeable of the company's disclosure record.

The NIRI survey indicates that most companies are maintaining the same number of one-on-ones that they did prior to Reg. FD. Some have even increased their one-on-one meetings with analysts and investors.

**One-on-One Meetings**

It is most important that companies recognize that there is much that they can talk about in one-on-one meetings besides earnings. Information such as long-term strategy, the company's history, its mission and goals, management's philosophy, competitive advantages and disadvantages are valuable to analysts and investors in making investment decisions.

The most recent NIRI trends survey shows that four out of the top seven factors that IROs say drive share value are non-financial. Quality of management and strategy execution were rated slightly higher than earnings growth and cash flow respectively. The company's long-term strategy and specific industry conditions were rated about the same as sales/revenue growth.

Studies by Ernst & Young and PricewaterhouseCoopers demonstrate that the institutional investors place significant importance on non-financial measures and intangible assets. Moreover, it would be difficult to determine materiality of such factors as quality of management, strategy execution, customer relationship management, development of human capital, etc.

**Confidentiality Agreements**

Reg. FD provides for confidentiality agreements between issuers and analysts/investors whereby a company may provide material nonpublic information to the recipient, providing the recipient agrees in writing or orally not to use the information or trade on it until the company releases it publicly. These agreements are generally not being accepted by analysts/investors, primarily because they do not want their hands tied for trading should information they agreed to hold confidentially be leaked or be revealed through other means, thus allowing others to have a trading advantage.

Under Reg. FD, absent a confidentiality agreement, if the official knows a response to a question is material, he/she cannot respond without violating the rule. Should an analyst/investor verbally agree to hold material nonpublic information confidentially, the company should make a memorandum for record of such agreement.

**Investor and Broker Sponsored Conferences**

NIRI urges continued participation in investor and broker-sponsored conferences. Companies should consider webcasting their presentations. Increasingly, sponsors of such meetings are providing webcasting services. It is still incumbent on the company to provide adequate notice to investors of such webcasts, even though the sponsor is providing the webcasting services. By making the presentation fully accessible through a webcast, the company official can then engage in the Q&A without concern over intentionally or unintentionally disclosing new material information.

A substantial number of companies are also "furnishing" their presentations under Item 9 of the Form 8-K and are also placing them on the company Web sites. While the SEC does not consider a Web posting to constitute full disclosure, furnishing the presentation under Item 9 does make it fully public.

**Headquarters and/or Facilities Visits**

There is no reason under Reg. FD that companies should curtail headquarters and/or tours of its facilities for analysts and investors. Being able to "kick the tires," so to speak, is part of the information
gathering process for the mosaic. Issuer officials must be careful not to provide those attending these sessions material, nonpublic information through statements or comments.

Analysts and investors may also ask questions of employees who are not covered by Reg. FD. Therefore, companies may want to advise those employees on what they should or should not comment on.

**Quiet Periods**

Most companies represented by NIRI’s membership observe a “quiet period” prior to normal quarterly earnings announcements. Our survey shows that the average quiet period is 25 days, slightly longer than before Reg. FD. Companies use the quiet period to avoid discussing earnings information as the results for the quarter become more evident. However, some say that Reg. FD has rendered the quiet period irrelevant, particularly if a company undertakes a duty to update material changes in its earnings guidance. Results could materially depart from earlier guidance, particularly toward the end of the quarter, triggering the need to update those changes publicly, regardless of whether the company is in the quiet period.

**Written Disclosure Policy**

NIRI recommends in our Standards of Practice for Investor Relations that companies have a written disclosure policy. Moreover, footnote #90 of Reg. FD states, “The existence of an appropriate policy, and the issuer’s general adherence to it, may often be relevant to determining the issuer’s intent with regard to selective disclosure.”

Our survey of members in March 2001 showed that 65% had a written policy with another 25% saying one was being developed. The NIRI board believes there is no “one-size, fits-all” disclosure policy under Reg. FD. For NIRI to publish a sample policy might imply there is one. Companies have numerous options under Reg. FD in how they handle disclosure. Therefore, each company should tailor its policy to fit its preferred approach to disclosure. However, this guidance paper addresses most of the areas that a company would want to consider in preparing a written policy.

**Regulation FD and the Media**

Reg. FD does not cover communications between companies and the media. The SEC provided a “media carve-out” based on First Amendment concerns and the fact that the media are part of the information dissemination process as opposed to being in a trading role.

However, the SEC has said in its Manual of Publicly Available Telephone Interpretations that merely having a reporter at a meeting or conference with analysts and/or investors does not render that forum public for purposes of Reg. FD. One cannot assume that a journalist will report a material statement by an issuer official. Moreover, a single publication - other than a wire service - would be insufficient for full disclosure even if it were reported.

**Market Implications of Regulation FD**

There were initial concerns that Reg. FD would result in a wider dispersion of earnings estimates, greater stock price volatility and would produce a major chill on the flow of information from companies to the investment community. The media hail Reg. FD for significantly increasing the amount of corporate information being made available through fully accessible conference calls and in their news releases, in particular. Individual investors are experiencing an information bonanza.

Some analysts, on the other hand, complain they now have to live from conference call to conference call to get earnings guidance. Some institutional investors have said the “quality” of information has deteriorated. They say companies are still meeting with them, but are saying less. NIRI does not have survey information to dispute or support either contention. We do have data that says more than three quarters of our members say they are disseminating the same or a greater amount of information than before Reg. FD. And, clearly, earnings guidance is far more transparent than before.
In summary, NIRI believes that companies are adjusting to the Reg. FD environment by, generally, providing more information than before. Earnings guidance is more transparent and more broadly disseminated than before. Virtually all companies are webcasting their conference calls, and the audience of individual investors listening to the live and archived calls is growing substantially. And, finally, companies are increasingly recognizing the value of communicating information about non-financial performance measures and intangible assets in their meetings with the investment community.

As SEC Chairman Harvey L. Pitt said in his confirmation hearings, the underlying premise of Reg. FD is unassailable. Providing a level playing field through equal access to material corporate information and developments for all market participants is essential for maintaining a credible marketplace.
SECOND EDITION

STANDARDS OF PRACTICE FOR INVESTOR RELATIONS

JANUARY 2001

NATIONAL INVESTOR RELATIONS INSTITUTE

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The National Investor Relations Institute encourages publicly traded companies and their staffs to provide the Standards of Practice for Investor Relations to all professional staff members. Additional copies are available for purchase. The price is $25 each. Discounts are available for bulk orders. Please contact the NIRI Bookstore at the address above.

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BACKGROUND

Investor relations is defined as a strategic corporate marketing activity combining the disciplines of communications and finance that provides present and potential investors with an accurate portrayal of a company’s performance and prospects. Conducted effectively, investor relations can have a positive effect on a company’s total value relative to that of the overall market and to the company’s cost of capital.

The process of marketing a company’s stock involves identification of the target audiences (institutional, individual and employee investors and analysts) who might have an interest in investing in or analyzing the company’s securities and presenting historical and prospective information about the company to enable them to make an informed investment decision or recommendation. This is done through the careful development of corporate documentation; response to queries from analysts, investors and the media; and group and face-to-face meetings with analysts, investors and the media (including conference calls, Webcasts and management visits). Marketing in this context does not mean “selling” a company’s securities to investors, but rather a process of identifying target audiences and educating them about the present and potential value of those securities.

Critical to the marketing process is the provision of accurate and complete information about the company, along with a duty to update that information when material changes occur. Although a more complete definition of “materiality” will be addressed in Appendix A, it basically means information that, taken together with the total mix of information, would cause a reasonable investor to make an investment decision.

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The Securities and Exchange Commission implemented Regulation Fair Disclosure on October 23, 2000, which was designed to address the Commission's concern that selective disclosure of material nonpublic information was affecting the integrity of the financial markets, and out of fairness, all investors should have equal access to market-moving information. The methods for achieving equal access as stipulated in Regulation FD were based on dissemination means spelled out in NIRI's Standards and Guidance for Disclosure (Appendix A). While Regulation FD has numerous implications for the investor relations practice, perhaps the most important is that it elevates the role of the investor relations officer as a key participant in senior management.
RESPONSIBILITIES OF THE CORPORATE INVESTOR RELATIONS OFFICER

Integral Participant in the Evolution of Corporate Strategy

To be effective, the investor relations officer (IRO) has a “need to know” and, therefore, must have full access to senior management and, preferably, be a part of senior management. In this way, he or she can speak authoritatively and credibly about the company’s strategic direction and prospects for performance. If an IRO is restricted by a company’s top officers from providing strategic and other forward-looking information to the investment community, there will often be greater demands for access to the CEO and CFO from analysts and investors to obtain this information.

Full knowledge about the company’s strategy, budgets, forecasts and various developments under consideration (e.g., mergers, acquisitions, spin-offs, etc.) does not mean that a spokesperson will discuss these subjects with the investment community at will. Rather, he or she will do so only upon authorization by the company’s CEO or other senior officer with responsibility in this area and in line with the company’s disclosure policy.

Anyone in a spokesperson role must be completely familiar with the company’s record of disclosure in order to guard against unauthorized disclosures of material, nonpublic information. Moreover, in SEC v. Carnation, Inc., the court decided that ignorance of a spokesperson who misspoke and unknowingly provided misleading information in response to a question is not excused. (Carnation’s treasurer, who was unaware the company was engaged in premerger discussions with Nestlé, denied rumors to that effect.) Moreover, under Regulation FD, to detect inadvertent disclosure of material, nonpublic information or to avoid potentially intentional disclosure of such information, the IRO should accompany senior officials in meetings with analysts and investors. If there

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should be an inadvertent disclosure of such information, the company
must promptly issue a news release (within 24 hours of when the official
became aware of such disclosure or before the market opens next, whichever is later).

Credibility comes not only from knowledge of the company and provision of accurate, complete and timely information, but also from a demonstrated willingness to correct or update changes in information on a timely basis. Failure to do so may cause long-term or irreparable damage to the company management’s and to the spokesperson’s credibility.

The IRO is also responsible for assuring a level playing field for investors by providing information on a fair and impartial basis. However, under the concept of “differential disclosure,” analysts and portfolio managers may receive more detailed information regarding a company’s performance and prospects than is required by most individual investors or financial reporters, so long as that information is not material, nonpublic information and is not withheld from the noninstitutional investor, if requested. Differential disclosure may become a form of selective disclosure, which can be detrimental to the financial markets, when a company goes into greater supporting detail in its discussions with analysts and institutional investors yet refuses to provide the same information to reporters or the general public when requested.

Providing Market Intelligence to Senior Management and the Board of Directors

IROs should also play a key role by providing market intelligence to senior management and the board of directors for use in strategic decision making. This might include analyst and investor comments about the company, both in published reports as well as in questions gleaned from daily discussions. This market intelligence may also include information about competitors and market research on the industry that may

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be valuable in developing corporate strategy. Monitoring the company’s mix of shareholders (institutional, individual, employees, officers and directors, etc.) and their investment styles is essential to determining the company’s desired shareholder mix.

**Keeping Senior Management Apprised of What Corporate Information Has Been Publicly Disclosed**

Keeping senior management apprised of the company’s disclosure record is a very important function for the investor relations officer, particularly following the adoption of Regulation Fair Disclosure. Knowing what one should not say is just as important as knowing what to say. Avoiding inadvertent disclosure of nonpublic, material information in selective forums is essential if one wants to avoid allegations of selective disclosure. The IRO should keep a record of all public disclosures of material information. Training or briefing senior managers who serve as spokespersons at analyst meetings, on conference calls, etc., on matters that have been publicly released, is one way to avoid selective or inadvertent disclosure.

It is critical that all management spokespersons are communicating the same message and that they understand the extent to which corporate matters will be discussed with analysts and investors. Moreover, it is important that they discuss these matters with one voice.

Controlling access to inside information also helps avoid inadvertent disclosure. A policy of restricting access to material inside information should be part of a company’s written disclosure policy.
CORPORATE IMPLICATIONS OF INVESTOR RELATIONS

Representing the Company Credibly and Objectively

Credibility is an essential component of an effective investor relations program and a cornerstone of good business. Credibility is built by reporting company information truthfully, accurately and completely throughout the continuous disclosure process.

Duty to Correct in a Timely Manner

Avoiding investor surprises in the process of continuous disclosure is important, but even more important is a willingness to disclose information beyond what the investment community is expecting in a timely, complete and accurate manner using a news release, a fully accessible, nonexclusionary Webcast conference call or presentation, or an SEC filing. Excessive delays in disclosing negative information can erode a company’s long-term credibility. As a matter of law, companies have a duty to correct material information that they believed was correct when first disclosed but that later determined to be incorrect. In *Ross v. A. H. Robins*, the company had reported in its annual reports and other publicly disclosed documents on the safety and efficacy of the Dalcon shield. Once it was discovered that there were some safety problems with the product, it did not promptly correct its previous public statements and was found liable in this regard.

Duty to Update in a Timely Manner

A duty to update occurs in situations in which information was correct at the time of public disclosure but results in a material change. Though the case law supporting a duty to update is not as strong as in a duty to correct, it is nevertheless a matter of good investor relations practice and

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good business to update material changes, positive or negative, in public information in a timely manner.

**Corporate Disclosure Policy**

A complete disclosure policy represents a public company's commitment to full, fair and consistent disclosure and to maintain realistic investor expectations as best it can. It is also a commitment to tell the truth in a timely manner, even when it may be tempting to downplay bad news. Having a corporate disclosure policy, and following it, can bring structure and discipline to the disclosure process. It provides clear policies to all parties who have a direct or indirect role in disclosing corporate information, with respect to the various issues companies face on a daily basis. In addition, having a written disclosure policy, along with a written insider-trading policy, may result in a lower cost of directors and officers' liability insurance. In footnote 90 of Regulation FD, the SEC recommends that companies express their disclosure policies in writing and goes on to say, "The existence of an appropriate 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."

A disclosure policy should be a policy document, not a how-to or operational statement. Being too specific in how you deal with various disclosure issues, should you vary from the written procedures in the course of handling a disclosure matter, may be later cited in shareholder litigation.

When a company begins developing a disclosure policy, the most obvious and important question is how much corporate information, beyond that which is required by the SEC, should be volunteered to the investment community. A most important consideration under Regulation FD is how much publicly released earnings guidance a company believes it can provide, in what publicly available forms earnings guidance will be presented and how that guidance is updated during the quarter.

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A 1996 study by professors Russell Lundholm, University of Michigan, and Mark Lang, University of North Carolina, found that companies with a more open disclosure policy have a tighter consensus in earnings estimates; less dispersion in earnings forecasts; lower stock price volatility and a larger analyst following than peer companies disclosing less information. Imputed in this research is the notion that these factors can result in a lower cost of equity capital, depending on the company, the industry in which the company operates and the number of shares outstanding.

Also at issue is how much prospective or forward-looking information the company should disclose voluntarily. Companies that have gone public relatively recently often feel the need to provide more forward-looking information than established companies with long track records of performance. Yet concerns over failure to meet such forecasts or to fulfill market expectations still prevail, in spite of the 1995 passage of the Shareholder Litigation Reform Act that contains the Safe Harbor for Forward-Looking Information provision.

A company should appoint a disclosure policy committee and a disclosure officer from that committee. The committee, at a minimum, should consist of the senior investor relations officer, the chief financial officer or treasurer, the general counsel and the chief corporate communications officer (if the latter is separate from the IR function). The committee should be kept small so it can react quickly to developments requiring, e.g., a decision on whether new information is material and the timing of its disclosure or how the company should respond to a significant market rumor. It is important that the role of the disclosure policy committee is not construed as conducting investor relations activities by committee.

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Using the Safe Harbor for Forward-Looking Information

When the U.S. Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), a cornerstone of the legislation was the Safe Harbor for Forward-Looking Information. The Safe Harbor was designed to provide protection from securities litigation for companies that make forward-looking statements, so long as investors are warned that there are risks that those projections might turn out to be wrong in a material way.

In passing the PSLRA, Congress recognized that companies need to discuss their prospects for performance with the investment community. One of the objectives of the act is to level the playing field between professional and individual investors by encouraging companies to provide equal access to forward-looking information, using the Safe Harbor as protection against shareholder litigation. It is particularly important in the Regulation FD era of disclosure that companies publicly providing forward-looking information with respect to earnings guidance, as well as other forms of forecasting, develop and disclose risk factors specific to those forecasts and not rely on “boilerplate,” generalized statements of risk.

A 1998 University of Michigan survey² of 547 firms in three industry areas (computers, software and pharmaceutical) found an increase in the frequency of sales and earnings forecasts along with the mean number of forecasts following enactment of the reform act. The researchers also found an increase in short horizon, bad-news forecasts that they attribute to the reputational costs of disappointing security analysts. The net benefit of providing guidance was higher during the post-reform-act period. Two other findings were that the net benefit of providing guidance to analysts was higher in the post-reform-act period, and that managers have become less hesitant to disclose forecasts specifying a more precise estimate of future earnings or sales.


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In a 1997 4th U.S. District Court decision, *Racheedi v. Cree Research*, Judge Richard Erwin dismissed a suit against Cree Research. In his decision he noted that Cree, in its public statements, used the Safe Harbor, and even though the factor that caused Cree's actual results to differ materially was not mentioned among the cautionary factors, the judge believed that in the total mix of information, investors were warned that there was risk involved in the forward-looking statements. The judge specifically referred to the Private Securities Litigation Reform Act "Statement of Managers" (the House-Senate Conference Committee report that interprets the Act) to support his decision.

The statement says that not all potential risk factors need to be listed among the cautionary factors, and even if the risk factor that eventually causes the statement to change materially is not listed, so long as in the "total mix of information" investors are warned that there is a risk involved, the Safe Harbor has been accomplished. In written documents, the forward-looking statements must be accompanied in the same written document.

In oral statements (e.g., conference calls with analysts and investors, analyst conferences or meetings), one may refer to other readily available written documents (public releases or documents filed with the SEC) for the risk factors. To be safe, companies should consider archiving these teleconferences or other Webcast events or transcripts of the same on its Web site to provide other investors and the media an opportunity to listen to or view these sessions. Once this information becomes dated (i.e. changes in a material way), it should be taken off the site or moved to a historical section on the site that is clearly labeled as historical, dated information that should not be relied on in making investment decisions.

There is no value in using the Safe Harbor "warning" in documents that do not contain any forward-looking statements. In fact, using the Safe Harbor in this situation might deceive investors by causing them to
look for prospective information when there is none. However, companies that make written or oral forward-looking statements and fail to use the Safe Harbor may well subject themselves to unnecessary risk.

**What Is Not Covered by the Safe Harbor**

The Safe Harbor does not cover forward-looking statements made in conjunction with an initial public offering (IPO), tender offer, Section 13(d) disclosure or a going-private or roll-up transaction. Additionally, financial statements are not covered.

**What Is Considered a Forward-Looking Statement**

The following are considered forward-looking statements:

- Projections of revenues, income, earnings per share (EPS), capital expenditures, dividends, capital structure or other financial items
- Management’s plans or objectives for future operations
- Plans or objectives for the company’s products or services
- Statements relating to future economic performance
- Information in the Management’s Discussion and Analysis (MD&A) in Forms 10-K and 10-Q.
- Any statement of the assumptions underlying the above
- Any report issued by an outside reviewer retained by the company that assesses forward-looking statements made by the company

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Discussion of Nonfinancial Performance Factors

There is growing evidence that discussion of a company's nonfinancial performance factors is an important component of an investment decision. In a 1997 Ernst & Young study, Professor Sarah Mavrinac found that, on average, 35 percent of the investment decisions by 275 portfolio managers were based on nonfinancial factors. Quality of management, overall, was at the head of the list, followed by quality of products and services, strength of market position, effectiveness of new-product development, effectiveness of compensation policies, quality of investor communications, level of customer satisfaction and strength of corporate culture.

The relative importance of these factors varied by industry groups of the companies involved in the study. A 1997 Conference Board study group on reporting nonfinancial performance measures recommended in its final report that there be no specific disclosure regime for reporting on these factors, but said that there is value in discussing these factors with analysts and investors. Obviously, most of these measures cannot be quantified or audited for reporting purposes, but are nonetheless significant considerations in an investment decision.

The importance of the "quality of management" factor suggests that companies expose their senior managers to the investment community on a periodic basis so analysts and investors have an opportunity to evaluate who is running the company and determine if they can articulate a vision of where the company is going and whether they have the resources to accomplish this vision.

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ISSUES ADDRESSING CORPORATE PRACTICE

Dissemination of Information

Beyond disseminating information required under “structured” disclosure—i.e., information filed with the SEC in the Form 10-K annual report, 10-Q quarterly report and Form 8-K current report—is information disseminated within the realm of “unstructured” disclosure: the annual and quarterly reports, earnings and other news releases, management speeches, the Internet Website, conference calls, face-to-face meetings and phone calls with analysts and investors. How this information is disseminated and under what conditions are covered in Appendix A, “Standards and Guidance for Disclosure.” The accepted means for accomplishing full public dissemination of information are contained in the disclosure sections of the listed company manuals published by the self-regulatory organizations (New York Stock Exchange, Nasdaq Stock Market and American Stock Exchange).

COMMUNICATING INFORMATION INTERNALLY

To Management and the Board of Directors

Certain senior managers and the board of directors will normally be considered insiders under Section 16 of the Securities and Exchange Act. When they buy or sell stock in the company or exercise their stock options, they must file with the SEC. When in possession of material, nonpublic information, an insider may not trade in the company’s stock. Full disclosure of the material information must be accomplished before an insider may trade (SEC v. Texas Gulf Sulfur). Normally, when companies establish trading windows, the windows are not opened until several days after the information has been fully disclosed through a news release to the public. This is to allow sufficient time for the information to be fully disseminated to the marketplace.

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Here is one area where the roles of the IRO and the corporate counsel are critical in keeping a record of what material information has been fully disclosed and what has not to avoid insider trading. Most companies (93% of companies surveyed by NIRI in 1998) have established written insider trading policies. These policies generally cover what kind of material inside information is provided to the various levels of corporate managers as well as the board of directors. Some companies are relatively open in terms of communicating inside information to corporate management; others tend to compartmentalize information so relatively few have the full picture or are aware of all material developments. These policies also establish trading windows and when officials are allowed to trade their shares or options.

Increasingly, companies in their insider trading policies are requiring that all trades by corporate managers and, in some cases, all employees, be cleared by the general counsel, who should know which parties have access to each area of inside information. Moreover, the total value of shares traded at any one time should be limited to an insignificant level in order to avoid the issue of heavy insider trading associated with possession of material nonpublic information.

An important role for the IRO is to bring information and intelligence from the investment community to management and the board of directors.

To Nonmanagement Employees

One question that often arises is, Should the company treat its employee shareholders who are not corporate insiders under Section 16 any differently than nonemployee investors when it comes to providing them with information about the company? Some companies adopt the position that they will not provide any information to employee shareholders that they would not provide to nonemployee shareholders. A more prevalent practice is to provide employee shareholders information about the

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company that is fully public, (if nonpublic, it should be nonmaterial information) along with a digest of analyst reports on the company. (Some provide all, others a representative sample.)

NOTE: The practice of disseminating analyst reports to nonemployee investors is strongly discouraged since the courts contend that such dissemination implies that the company endorses the report or reports. From a legal viewpoint, the company has entangled itself with the report. This issue is sometimes raised in shareholder lawsuits when a company has provided to brokers or investors analyst reports that say the company's prospects for performance will likely be better than the results that actually occur. Many companies provide, on their Web sites or in investor packets, a complete listing of analysts that follow the company.

When employees are briefed on corporate plans or developments or provided nonpublic forecasts, corporate management must advise them that they are insiders and must not trade on that information.
MONETARY FACTORS IN COMPANY DEALINGS WITH ANALYSTS AND INVESTORS

Company-Sponsored Trips for Analysts and Investors

Companies may sponsor trips for analysts and investors to see the company's operations in various locations. Some companies conduct their annual analyst meetings at company facilities to better demonstrate the company's lines of business. Most analysts are restricted by their firm's rules on what they may accept with respect to these trips.

Analysts and investors are expected to pay their ordinary expenses (transportation to and from the trip site). It is appropriate for the companies to provide group transportation, meals and overnight accommodations at the site. However, many firms have a policy that their analysts pay for their overnight accommodations at the site.

Company Gifts for Analysts and Investors

Analysts and professional investors are often restricted by the chartered financial analyst designation on what they may accept in the form of gifts from companies they cover or in which they invest. Companies that manufacture low-cost consumer products will often provide a gift bag of these products at a site visit, other group or individual presentations or at Christmas. If a company produces products that are not appropriate as a gift, alternative gifts are appropriate that do not exceed $50 in value.

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THE ROLE OF THE INVESTOR RELATIONS COUNSELOR

Investor relations counselors are expected to practice their profession in a way that provides the highest levels of professionalism, knowledge, expertise and value-added services in support of their clients’ goals and objectives. In so doing, they will serve the public interest, honor the public trust, adhere to society’s laws and maintain the integrity of the capital markets.

Counselors have an overriding obligation to judiciously balance public interests with those of their clients and to place both those interests above their own. Counselors should exercise careful professional and ethical judgments in assisting their clients in carrying out their responsibilities, as detailed in the corporate section of this document. Counselors should act with integrity, objectivity and due care, guided by the precept that when investor relations consultants fulfill their responsibilities to the public, they best serve the interests of their clients and employers.

Counselors are expected to provide quality services, enter into fee arrangements and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with NIRI’s Standards of Practice for Investor Relations. In return for the faith the public reposes in investor relations counselors, they should continually seek to demonstrate their dedication to professional excellence.

Counselors should diligently discharge responsibilities to clients, employers and the public; render services promptly, carefully and thoroughly; and comply with all applicable technical, legal and ethical standards. A counselor’s competence represents the ability to impart a level of understanding and knowledge that enables the investor relations professional to render services with competence and sound judgment. If a professional engagement begins to exceed the competence of a counselor or

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his or her firm, the counselor should recommend a consultant specializ­ing in that particular area to provide the greater professional experience, education and judgment required for the specific client engagement.

A counselor should also maintain objectivity and be free of conflicts of interest in discharging his or her professional responsibilities. Integrity requires a counselor to be, among other things, honest and candid within the constraints of client confidentiality. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principles for personal gain or advantage.

Counselors must not work for more than one client or employer whose goals may be in conflict without the express consent of those concerned, given after a full disclosure of the facts. Additionally, counselors must be particularly sensitive and alleviate situations where a conflict of interest or even a perception of such a conflict could originate. In no instances will counselors use or share inside information, which is not otherwise available to the general public, for any manner of personal gain as might be realized, for example, through trading in the stock of a client company. Further, counselors are expected to respect the confidentiality of information pertaining to present, former and prospective clients, and avoid future associations wherein inside information is used that would give a desired advantage over the respective counselor’s previous clients.

It should be noted that there a few firms operating in the U.S. markets that call themselves “investor relations firms,” when their primary function is to promote the status of their clients’ stocks. These firms often work in conjunction with so-called boiler-room brokerage firms that promote micro- and small-cap stocks traded on the OTC bulletin board but do not file periodic financial reports with the Securities and Exchange Commission. This practice of stock promotion, in the name of “investor relations,” is in no way condoned as a proper practice.

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The following is an alphabetical list of typical services offered by investor relations counseling firms. The range of services provided may vary based on a firm’s expertise in certain areas.

**Arranging Analyst and Investor Meetings.** Arrange company presentations to brokerage-sponsored or corporate-hosted analyst and portfolio manager conferences or meetings. Assist with effective targeting of investors and the conduct of one-on-one or group meetings with selected analysts and institutional investors.

**Counsel.** Provide strategic counsel, policy guidance and program execution leading to sound investor relations performance and consistent, credible communications programs with the domestic and international investment communities.

**Crisis Communications.** Structure and implement effective crisis communications programs in anticipation of or in response to litigation, rating/regulatory agency actions, restructuring announcements, product recalls, plant closures, market withdrawals, a significant earnings shortfall, competitive rumors, loss of a key manager, takeover or merger speculation, stock volume and price volatility, natural catastrophes, theft, fire and other crises.

**Disclosure.** Guide the management team with respect to public disclosure requirements, issues and practices surrounding financial reporting, managing investor expectations and fast-breaking corporate events that impact the price of a company’s debt and equity issues. Assist management in developing a corporate disclosure policy if it does not have one.

**Financial Communications.** Develop customized, cost-effective, high-quality, high-impact and fully integrated financial communications programs and platforms, including annual reports, financial fact books, corporate profiles, capabilities brochures, analyst meetings or presentations, investor fact sheets and information kits, quarterly earnings releases,
analyst conference calls, executive financial presentations, retail brokerage meetings and other individually tailored activities designed to support corporate objectives.

**IR Spokesperson Training.** Train company executives and investor relations contacts to be effective and consistent presenters in analyst and investor conferences, before the media and in day-to-day interaction with the investment community.

**Media Relations.** Leverage proactive investor relations programs with fully integrated national and regional financial and trade media placements to provide all-important third-party testimonials for growing investor awareness of the company’s unfolding investment story.

**Messages.** Develop investor relations messages that will most proactively leverage senior management’s strategic vision, operational and financial performance and ongoing business expertise to deliver the optimum P/E multiple and lower the company’s cost of capital.

**Positioning.** Highlight the company’s management team to effectively personify the who and how behind the strategy and objectives so Wall Street can “quantify the critical qualitative” aspects of potential buy decisions.

**Research.** Research and track current and prospective securities analysts and institutional and individual shareholders, their perceptions and attitudes. Benchmark these measureables against realization of program objectives.

**Strategy Development.** Assist management with the development of high-impact strategic approaches to the equity and debt markets that will deliver enhanced shareholder value and lower the company’s cost of capital.

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The Role of the Investor Relations Counselor

**Targeting.** Target the most suitable buy- and sell-side analysts and portfolio managers whose investment style and interests best fit the company's characteristics. Identify the most suitable and cost-effective individual investor forums. Assist management in determining the ideal shareholder mix to support the company's investment objectives.

**Compensation of Counseling Firms**

In general, counseling firms receive cash compensation for work performed for their clients. Occasionally, clients or prospective clients will offer compensation in the form of stock, stock options or warrants (or a combination of these) in addition to or in lieu of cash. Typically, these offers are made by start-up companies that have limited cash flow to pay for consulting services on the part of attorneys, accountants, investor relations consultants or public relations consultants.

In April 1999, the SEC amended its Form S-8 stock distribution regulation and specifically stated that investor relations and shareholder communications consultants could not receive stock or stock options distributed through a Form S-8 filing for their services. In a letter to NIRI dated June 14, 2000, the SEC stated, “The amendments and release addressed only the availability of Form S-8 to register compensatory transactions, not the availability of equity compensation generally. The release stated that Form S-8 will not be available to register equity compensation to consultants who provide investor relations or shareholder communications services. These consultants may continue to receive equity compensation, provided that is registered on another available registration form or issued in a bona fide private placement, consistent with the federal securities laws.”

This essentially means that stock or options registered in a Form S-1 or S-3 filing may be used to compensate IR consultants for their services. The Form S-1 is available for any publicly traded company. The S-3 is only available for those publicly traded companies that have filed at least one Form 10-K annual report with the SEC and have a market float of at

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least $74 million. The reason stock registered through these forms may be used to compensate IR consultants is that these forms are reviewed by the SEC staff, whereas the Form S-8 is not.

Should an employee of a counseling firm already hold securities in a newly acquired corporate client, at a minimum, that person should inform the client company that he or she holds shares in the company and should be considered an insider. As an insider, the employee should clear transactions with the client company before executing any trades of the company's securities to ensure that the company is not in possession of material, inside information of which the employee may not be aware.

As outlined in the NIRI Code of Ethics (Appendix C), investor relations services performed by consultants must not have even the appearance of being promotional in nature. And a consultant must consider herself or himself an insider in relation to the company and observe the company's insider-trading policies, as well as the federal securities laws, with respect to insider trading.

**Speaking for the Client Company**

A counselor should exercise caution when speaking on behalf of a client company and should refrain from addressing matters related to future company performance. Consultants who speak for a client company, in this regard, are potentially liable for the veracity of the information provided by the company that they might, in turn, communicate to analysts or investors.

It is, however, appropriate for consultants to describe the nature of a company's business and discuss historical company information when arranging meetings between company officials and analysts and/or investors who may not be familiar with the company. It is also appropriate for consultants to interview the participants following company presentations as a third-party means of evaluating the presentations and providing feedback to the company's management.

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APPENDIX A
STANDARDS AND GUIDANCE FOR DISCLOSURE

INTRODUCTION

The integrity of the capital markets is based on full and fair disclosure of information. Although the securities laws in the United States encourage the disclosure of material information to the marketplace, the laws do not impose a general disclosure obligation upon participants in the securities markets beyond the specific disclosure requirements mandated by the Securities and Exchange Commission. In fact, the mere possession of material, nonpublic information does not give rise to a legal duty to disclose that information.

Of course, as numerous insider-trading prosecutions have shown, corporate insiders who wish to trade their stock must disclose any material, nonpublic information in their possession or abstain from trading on the basis of that information. Absent such trading, corporations have no obligation to inform the market of facts that may influence investment decisions.

Similarly, the “selective disclosure” of information by corporations, whether to institutional investors, securities analysts or others, raises concerns about the fairness of the dissemination of information to the securities markets as well as the specter of liability.

In May 1995, NIRI completed a survey of corporate practices in the area of investor communications. The survey revealed a strong need for standards and guidance with respect to corporate disclosure and communications practices. In response, the NIRI Board of Directors commissioned a NIRI task force to examine the disclosure issues confronting corporate investor relations professionals and, with input from representatives from the Association for Investment Management and Research, developed the following Standards and Guidance for Disclosure.

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These standards and guidance have been revised to conform with relevant provisions of the SEC’s Regulation FD, which went into effect on October 23, 2000. It should be noted that the NIRI “Standards and Guidance for Disclosure” served as a model for the basic disclosure requirements in Regulation FD.

Comment: Since the following standards and guidance are intended for corporations and those acting in an investor relations role, and are thus beyond the scope of AIMR’s mission, AIMR cannot endorse these standards and guidelines as statements of AIMR policy. NIRI members are urged to read AIMR’s Standards of Practice Handbook in order to better understand the role and practices of analysts and portfolio managers. NIRI gratefully acknowledges the participation of AIMR in the preparation of these standards and thanks AIMR’s members for their insight concerning the role of financial analysts in the disclosure process.
DISCLOSURE CONTENT GUIDELINES

Materiality of Information

Corporations must continually identify the information they are required to release to the public and determine how and when to release that information. The first step in making these determinations is deciding whether the information at issue is "material." Materiality should be viewed from the perspective of anyone making an investment recommendation or decision, not merely a decision to trade securities. For example, an analyst will consider such information in the context of making an investment recommendation, which may or may not result in a trade.

In determining whether facts are material, a company may apply the legal definition of materiality adopted by the U.S. Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* as the standard of materiality for actions under SEC Rule 10b-5 (antifraud provisions), which has been stated as follows:

There must be a substantial likelihood that the disclosure of an omitted fact would have been viewed by the reasonable investor as having significantly altered the "total" mix of information made available.

A more clearly stated definition of materiality that enlarges upon the Supreme Court's statements has been developed by AIMR:

Information is material if its disclosure would be likely to have an impact on the price of a security or if reasonable investors would want to know the information before making an investment decision. In other words, information is material if it would significantly alter the total mix of information currently available regarding the security.


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There are obviously no “bright lines” from a legal standpoint to assist in determining what information is material and what is not. The SEC in Regulation FD provides a list of types of information or events that should be carefully reviewed to determine whether they are material. The SEC cautions that the list is not “exhaustive” and includes the following: “(1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor’s notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.

SEC Staff Accounting Bulletin 99, issued in August 1999, also discusses issues related to materiality and says, among other things, that movement in a company’s stock price may be evidence of materiality and that quantitative information, in addition to qualitative information, may also be material.

The process of determining the materiality of information is made even more difficult by the fact that company officials often have little time for deliberation. For example, a company official may disclose information that analysts believe is material given in response to questions during a meeting with analysts or investors. The company must then determine whether it has made an inadvertent disclosure of material, nonpublic information so it can release it promptly as described under Regulation FD. At that point, analysts are then free to use that information.

Determining the materiality of information is clearly an area where judgment and experience are of great value. In addition to examining information in the context of the legal definition of materiality, one should use good judgment, and if it is a borderline decision, the information

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should probably be considered material and released using broad means of dissemination. Similarly, if several company officials have to deliberate extensively over whether information is material, they should err on the side of materiality and release it publicly.

**Timing of Disclosure of Material Information**

Once a decision is made that information is material, the timing of its release becomes an issue. Regulation FD says that once an official becomes aware that she/he made an inadvertent disclosure of material, nonpublic information in a selective forum, the company has 24 hours or before the market opens next (which ever is later) to issue a news release and/or make an 8-K filing. Under the rules of the self-regulatory organizations (SROs), including the exchanges and The Nasdaq Stock Market, in normal circumstances, once a determination is made that facts are material and that there is a duty to disclose those facts, the information at issue must be disclosed immediately and broadly disseminated to the investment community. “Broad dissemination” normally requires that the information be released in the form of a press release and disseminated over one or more of the major wire services.

Regulation FD gives an issuer considerable flexibility in choosing appropriate methods of public disclosure, but it also places a responsibility on the issuer to choose methods that are, in fact, “reasonably designed” to effect a broad and nonexclusionary distribution of information to the public. In some circumstances, according to the Regulation, an issuer may be able to demonstrate that disclosure made on its Website could be part of a combination of methods that are “reasonably designed” to provide broad, nonexclusionary distribution of information to the public.

Decisions to promptly disclose material information that has not been selectively disclosed may be qualified by “confidentiality.” Company officials may withhold material information for legitimate business purposes, such as the benefit of the company or its shareholders, as long as no insider trades on that information. For example, information about
pending acquisition discussions or premerger negotiations, information that might damage a company’s competitive position or information about a new product in development that the company is not yet prepared to release may appropriately be withheld from immediate disclosure.

Note: Information regarding pending acquisition discussions and premerger negotiations presents a particularly sensitive timing issue. Companies often withhold such information until an “agreement in principle” is reached by the respective parties. However, if there is a high probability that an agreement in principle will be reached and there are strong market rumors to that effect, the company may be required to disclose such information prior to reaching an agreement in principle. In all of these instances, controlling the knowledge of this information by insiders is critical, so that it is not inadvertently disclosed.

This does not mean that a company can withhold “bad news” indefinitely because such information may not be beneficial to the company or its shareholders owing to its effect on share price. The SEC has stated that a company must disclose information having a significant effect on its profits or losses in the Management’s Discussion and Analysis (MD&A) section of the company’s next periodic report. Circumstances may arise where that information may be required to be publicly released before the next 10-Q is filed.

Discussing Public Information

Material or nonmaterial information that the company has publicly released or that is already in the public domain may be discussed on an individual or selective basis. Nonmaterial, nonpublic information may also be provided on an individual or selective basis. However, should a company give such information to one individual or group of persons and not to another, and should someone else request it, that company may be practicing selective disclosure. For example, if a company has provided certain nonmaterial, nonpublic information to analysts or portfolio managers, it should also provide that information to a reporter or individual investor upon request.
Specifically, companies must not disclose material projections or forward-looking information orally or in handouts to analysts before disseminating that information through a news release, during a fully accessible, nonexclusionary conference call or in an 8-K filing (see "Methods of Dissemination," p. 45).

The Private Securities Litigation Reform Act provides a Safe Harbor for Forward-Looking Statements. In general, the Safe Harbor provides protection from litigation to companies making public projections and providing other forward-looking information so long as the information is identified as such, and is accompanied by meaningful cautionary statements contained in readily available documents. A "meaningful" cautionary statement must relate to the risk that the forward-looking information disclosed can change materially.

**Differential Disclosure**

The concept of "differential disclosure" is based on the notion that, ordinarily, analysts and portfolio managers use more detailed information to make their analyses and assessments regarding a company's performance and prospects than individual investors or financial reporters might require. It is entirely appropriate to provide detailed nonmaterial information to those who request it. This practice, however, can be a form of selective disclosure that can be detrimental to the financial markets when a company goes into greater detail in its discussions with analysts and portfolio managers, yet refuses to provide the same level of information to the media or the general public upon request.

**Use of Mosaic Information**

The "mosaic" theory is based on the concept that analysts may put together pieces of public information and nonmaterial, nonpublic information to create a mosaic from which a material, nonpublic conclusion may be drawn. An analyst may not use material, nonpublic information
obtained from a company in this process. The information used in creating the mosaic may be gathered from all of the sources at the analyst’s disposal, including the company itself, and sources outside of the company, such as suppliers, customers and competitors. An analyst may use conclusions reached under the mosaic theory as the basis for investment recommendations without the need for the company to release the information through broad, public means. A company is under no obligation to confirm or deny conclusions reached under the mosaic theory.

The mosaic theory recognizes that analysts provide a valued service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. Regulation FD suggests that skilled analysts can extract pieces of a jigsaw puzzle that would not be significant to the ordinary investor but are useful in constructing the analyst’s ultimate judgment, and this remains a legitimate practice. The rule goes on to say, “[A]n issuer is not prohibited from disclosing a nonmaterial piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a ‘mosaic’ of information that, taken together, is material.” The SEC says that Regulation FD is not intended to discourage discussions between companies and analysts on the basis of nonmaterial information or information that is material but fully public.

**Distributing or Referring to Analysts Reports**

Companies should exercise caution before distributing or referring to analysts reports. The practice—particularly on the part of companies with minimal analyst coverage—of distributing analysts reports to brokers, fund managers or individual investors is fraught with potential legal problems. First, analysts reports are proprietary and should not be distributed without the approval of the analyst or analyst’s firm. In addition, distributing an analyst’s report, even with permission, may expose the company to the appearance of “entanglement” with the report. By distributing the report, the company runs the risk of appearing to embrace

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or endorse the report's contents and conclusions. Further, the distribution of analysts reports, particularly those that are more optimistic about a company's prospects for performance than may be warranted, may be cited as evidence in shareholder suits of a "conspiracy" between the company, the analyst and perhaps the analyst's firm to defraud investors.

If a company decides, however, to distribute an analyst's report with permission of the analyst's firm, at a minimum the company should include a statement that its distribution of the report does not imply the company's endorsement.

Companies, using fact sheets and/or the IR section on their Web site, can list those analysts and their firms that are covering them but should refrain from including analysts reports. Whatever the mode of communication, a company's risk in distributing reports is the same. Individuals who request analysts reports from companies should be referred to the analyst's firm, which may provide reports if it is the firm's policy to do so.

A company that distributes or refers to an analyst's "buy" recommendation must ask itself if it would be willing to make the same distribution should that analyst change his or her recommendation to a "sell."

Companies should avoid the practice of commissioning (paying for) and distributing research reports that have the appearance of being an independent opinion of a brokerage or buy-side firm. However, some companies that have little or no sell-side research coverage may decide to commission or pay for research on the company as an entrée to the buy-side or to local or regional brokerage firms. Such reports should contain factual research conducted by a qualified analyst and should avoid the expression of opinions about the company's prospects and must not contain a recommendation that one should acquire the stock.

Moreover, it is essential that it be fully disclosed in the research report itself that the company commissioned or paid for the research directly or indirectly. Failure to make such a disclosure could be a violation of federal securities laws.

Companies should also be aware that there are stock promotion firms that operate under the auspices of "investor relations" consultants that will write research coverage on a client company as one of its services and disseminate that coverage over the Internet or distribute it through other means. Some of these firms, or individuals within the firms, have been cited by the SEC for stock promotion activities in violation of federal securities laws, in particular for failure to fully disclose that the client company had paid for the research. Before engaging a firm that offers to write research reports on a

*See Rasterops Corp. securities litigation, U.S. District Court of the Northern District Court of California.
client company, one should check the SEC's Web site (www.sec.gov) to ensure that the firm offering such services is not among those that have been sanctioned for stock promotion.

Dealing with Rumors or Leaks

The self-regulatory organization (i.e., an exchange or Nasdaq) listed company manuals address the obligations of companies to respond to market rumors. Companies are generally required by their SRO to respond publicly to market rumors if they are likely to have a material effect on their securities.

Under the federal securities law, however, where a company is not the source of a rumor, it may choose a no comment response to market rumors. A more palatable way of saying no comment is to say, "We do not respond to market rumors." To maintain a consistent no comment policy, a company should not comment even if no significant corporate developments are taking place or if the company knows of no reason for stock activity. For example, it is an inconsistent (and likely ineffective) use of a no comment policy if a company were to say, "There are no significant corporate developments at this time," when such is the case, but respond, "No comment," when M&A developments are under consideration. Using a no comment policy in this fashion may act as a signal to the market and defeats the purpose of the policy.

A written disclosure policy, which identifies authorized spokespersons for the company and underscores how unauthorized leaks of information can place it in a very vulnerable position, can aid a company in this area. A company’s disclosure policy should also define how it responds to market rumors under various contingencies. All authorized company spokespersons must be fully apprised of corporate developments so they do not fall into the trap of denying significant activity when, in fact, there are developments occurring. The SEC has sanctioned both a corporation and its spokesperson for making fraudulent statements where the spokesperson denied the existence of merger talks when, in fact, talks were taking place without his knowledge (SEC v. Carnation Inc.).

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A company should, at a minimum, inform all employees who the authorized company's spokespersons are and of those elements of the disclosure policy that are applicable to employees and/or those considered insiders (those covered by insider-trading rules). Policies should be updated to address employees' use of technology with regard to disclosure issues, including participation in Internet chat rooms and use of e-mail (see NIRI Executive Alert, "Electronic and Telephonic Communications System Policy," July 1, 1999).

**Responding to Rumors or Inquiries Regarding a Possible Earnings Decline**

Companies are often called upon to respond to rumors or inquiries regarding possible earnings shortfalls below the current Street estimates. Under Regulation FD, companies may no longer comment on or express comfort with the Street's earnings consensus unless they do so in a fully public forum or in a news release.

Should a company simply state the current range of Street earnings estimates and go no further than this, it has not triggered a disclosure obligation.

**Quiet Period**

Many companies voluntarily impose a quiet period before announcing earnings, during which time they will not provide any additional earnings guidance. A quiet period shields a company that normally provides earnings guidance or commentary on business from providing that information once it has much better idea of what the final earnings are likely to be. In light of Regulation FD's language regarding earnings guidance, companies may want to consider lengthening their quiet period. Regardless of how long the company decides its quiet period should be, it should be consistent from quarter to quarter and should be observed by all company officials.

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Nondisclosure Briefings

Companies within certain industries occasionally conduct nondisclosure briefings for selected financial analysts and the trade press to provide background on information, usually on products in R&D or in the conceptual stage. It is very important that the participants agree to maintain the information on a confidential basis and not use it for any purposes that may lead to illegal trading activity. Regulation FD allows for the use of oral or written confidentiality agreements between companies and analysts or investors in which the recipients of confidential, nonpublic information agree not to use it until it is publicly released. The SEC recommends that companies maintain a list of those individuals who orally agree to keep information confidential.

Regulation FD creates a new situation with respect to the involvement of the trade press in these nondisclosure briefings in that communications between a company and the media are excluded from the rule. Therefore, while the rule does not prevent the media from using material, nonpublic information from a company, reporters may agree to embargo the information until the company releases it. Moreover, while Regulation FD does not provide any sanctions against analysts who may use material, nonpublic information from a company, most firms have rules that prevent them from doing so.

A company still runs the risk of selective disclosure liability anytime it holds such a briefing, particularly if any unusual trading activity should occur that can be traced to the briefing. Therefore, the use of such briefings to disseminate information should be very carefully considered. NIRI recommends that companies avoid this practice.

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Providing Material Information to Reporters on an Exclusive Basis

Companies should refrain from providing information on upcoming material events or announcements to a specific publication on an exclusive basis. Some companies, in anticipation of a major development, offer to give a specific publication details of the event providing that it embargoes or holds the story, until the day that the company makes the full public announcement. Although the practice does not violate rules regarding selective disclosure, it is always conceivable that the story could break prior to the company’s announcement. Newspapers often publish news items on their Internet page in the early-morning hours before the printed version is circulated and before a company issues its news release.

NIRI believes that out of fairness, the media should receive material information at the same time as everyone else when a full public announcement is made. Providing exclusive news of a major event to one publication and not others may well create a media relations problem.

Duty to Correct/Duty to Update Material Changes in Information

If a company discovers that a statement it made was, in fact, materially incorrect at the time it was disclosed, the company is obliged to publicly issue a correction of the prior misstatement as soon as the error is discovered. Such a duty to correct arises when new facts are developed that render a previous disclosure false or misleading.

In contrast, there is no clear legal duty to update material changes in information that do not fall under a duty to correct. The Safe Harbor for Forward-Looking Information explicitly states that it does not impose on any person a duty to update forward-looking statements. Nevertheless, it is often prudent for a company to update its forward-looking statements. Publicly held companies would be well advised, as a matter of
good business and credible investor relations, to consider updating forward-looking statements to reflect material changes in information, to the extent possible.

Comment: It has consistently been AIMR's position that a company has a business obligation to update material changes in information in a written form.

Virtually all companies represented by NIRI's membership have IR sections on their Web sites. Although the Internet provides a tremendous opportunity to disseminate information to a wide audience on a timely basis, it also requires that a company be vigilant in keeping its information current, particularly with regard to material changes.

NIRI recommends that companies put dated information in an archive section on its Web site where there is an explicit warning that one is entering an area where information is being provided for historical purposes but which may be dated and should not be relied on for making investment decisions.

National Investor Relations Institute
GUIDELINES FOR THE DISSEMINATION OF INFORMATION

After the company decides that information is material and should be disclosed to the public, the process of dissemination begins. One of the defining functions of investor relations professionals is the dissemination of information to investors, analysts and the general public. There are many different issues to consider and many different ways of properly disseminating information. Each company has its own unique position in its industry and in the general marketplace, and circumstances surrounding each disclosure may vary. There is no one correct way of disseminating information in every circumstance. There are, however, general guidelines regarding the dissemination of information that reflect the best practices within the industry and compliance with Regulation FD and that all are urged to follow.

Nonselective Flow of Information

Companies should disseminate information equitably and respond in a timely manner to all legitimate requests for information. Companies should never discriminate among types or manner of legitimate requests for information that may be legally disclosed. For example, companies should respond to requests from individual or small investors in the same manner that they would respond to a request for information from a large investor, an analyst or the media. An analyst from a small investment firm should receive the same attention and level of service that an analyst from a large investment firm would receive, and there should be no distinction between buy-side and sell-side analysts.

That companies should respond in the same manner to all legitimate requests for information does not mean that companies are required to respond to all requests for information. Any request for material, nonpublic information should be denied. If a company does give material, nonpublic information to one person, then it absolutely must under-
take an immediate effort to disseminate the information as broadly as possible, usually through the issuance of a news release. Even if such measures are taken, the damage may already be done, and the company may be exposed to liability.

**Blackballing of Analysts or Others**

Under no circumstances should a corporation blackball an analyst or investor, thereby denying one access to information. Nor should a company pressure an analyst to change a recommendation by threatening to withhold information from that analyst in the future. The free flow of information to the marketplace should never be impeded by mere differences of opinion, issues that involve the relationship of a company to an analyst or reporter. Companies must not discriminate among recipients of information.

If a company has a legitimate, serious and objective difference of opinion with a particular analyst, then the company should contact the analyst’s employer, explain its position and possibly request that another analyst be assigned to cover the company.

*National Investor Relations Institute*
METHODS OF DISSEMINATION

Use of Technology

Information should be released in a manner designed to reach the widest public audience possible, including the individual investor. Companies should encourage the use of multiple technologies to disseminate information. There are many different ways to reach investors and the public; some of the most obvious technologies include the major wire services, conference calls, broadcast fax and fax-on-demand services, e-mail, video conferences, Internet Web sites and electronic EDGAR filings.

Although new technologies are important and useful ways to disseminate information, they are not substitutes for a broadly disseminated news release. The use of technology to disseminate timely or up-to-the-minute information should be used to supplement consistent and regular communications with investors, analysts and the public through regular mailings of the company’s annual and quarterly reports, proxy mailings, SEC filings, fact sheets and fact books to legitimate interested parties. Certainly, electronic dissemination can be substituted for paper mailing if requested. Companies should strive to disseminate all corporate sources of information. For example, a company should provide in its annual report items such as its telephone and fax numbers and e-mail and Internet addresses.

Mailing of Quarterly Reports and Other Materials

Many companies are moving toward alternative means of delivering quarterly reports to investors, replacing the traditional glossy quarterly report. The most widely used alternative has been the quarterly news release, sometimes accompanied by a chairman’s message. Other alternative means include 800 numbers that investors can call to hear recorded information directly or to request that the information be sent to

National Investor Relations Institute
them. Some companies provide the information via fax-on-demand. If, however, a company does publish a quarterly report, it should mail the report to every party that asks to receive it.

While companies may experience some cost savings using alternative means, the real issue for most companies is that the alternative means provide information in a more timely manner. Investors typically wait at least six weeks from the end of the quarter to receive the traditional glossy report. By using alternative means, a corporation can make information available almost immediately upon its release. However, for some companies the value of a quarterly report as a marketing tool should be considered, in addition to the value of ongoing quarterly communication with the investment community.

The National Investor Relations Institute and the American Society of Corporate Secretaries adopted similar position statements in 1994 with respect to fairness in the distribution of quarterly report information. The SEC urged both organizations to adopt a position in which companies would be encouraged to make quarterly information available to all investors on an equal basis, as opposed to mailing it to registered shareholders but not to shareholders who held their accounts in Street name.

**Internet**

The Internet has become a primary means for disseminating information about a company. There are still segments of the public that do not have access to the Internet, so companies must continue to use more traditional sources of dissemination. It is just as important to update and correct information that is contained on a company’s Internet Web site as it is to update and correct information made in oral or written statements.

Companies should note that there can be a great deal of information on the Internet about the company that is not found in the IR section of its Web site, and that there are many sources of information about a com-

*National Investor Relations Institute*
pany on the Internet that the company cannot control. Companies should also monitor other sites on the Internet for information about the company but should not respond to market rumors or participate in chat rooms about the company. Such responses may, under certain circumstances, be considered a form of selective disclosure. The fact that a company responds to one rumor and not others may leave the impression that the others are true.

Conference Calls

Following news releases to the wire services, conference calls are the most widely used means for disseminating corporate information to the investment community. They are often used as a forum in which the company disseminates detailed information expanding on the news release that has been issued prior to the call.

The information from conference calls should be made available to all interested parties, including investors, analysts and members of the media. Regulation FD considers a fully accessible, nonexclusionary Webcast or telephonic conference call as a means for real-time, full and fair disclosure. The rule calls for adequate notification of interested investors of upcoming Webcasts or teleconferences. While the SEC recognizes that there are circumstances where a conference call may be held on short notice, it believes interested investors should be given several days notice when a company has scheduled a call that far in advance. Proper notification means issuing a news release with the date, time and means for accessing the call. The use of push technology and the posting on the company’s Web site are additional methods of providing notification. The last two alone do not constitute adequate notification.

The SEC recommends that companies archive the conference call on their Web sites for at least several days. As mentioned before, once it becomes dated, it should be taken off the Web site or moved to an archive section that is clearly labeled as historical information. Another method of distributing conference call information is to make transcripts avail-
able upon request or to place transcripts on the company's Internet home page. The latter methods do not constitute full and fair disclosure as the live, fully accessible call does.

A company may want to use several means for achieving full disclosure. NIRI recommends a conference call should be preceded by a news release containing all new material, nonpublic disclosures that are intended to be discussed. If, however, information discussed in a conference call modifies or expands upon information included in the preceding news release, a fully accessible call serves as a means for full public disclosure.

The advantage of issuing a news release before the conference call is that analysts and institutional investors have a chance to review its contents and are better prepared to ask questions during the call. Moreover, if the company wishes to provide earnings guidance or other forward-looking information for the next quarter or more, having that information in the news release, with the accompanying risk factors, fulfills the Safe Harbor requirements. Companies that do not want to archive their conference calls on their Web sites for more than a few days will have the news release as a reference when analysts and investors request guidance during the quarter.

A company may promote order and efficiency by using its best judgment as to audience comment and participation in a conference call. It is not necessary that everyone be allowed to ask questions or to make comments. It is recognized that there will be some participants on the conference call who may ask irrelevant or misleading questions, who may not ask questions in good faith or who may not want to ask a question at all but who simply may want to make a statement.
One-on-One Meetings

One-on-one meetings with individuals or groups are a common and indispensable way to disseminate information about a company and to answer legitimate requests for a discussion of long-term strategies as well as for detailed information about it. One-on-one meetings help to build goodwill and make a company more approachable in the eyes of the investment community. Companies should continue the practice of face-to-face meetings; however, companies should note that, as in all other types of meetings, there is the possibility that information may be selectively disclosed. Companies should conscientiously avoid discussing material, nonpublic information in face-to-face meetings and discuss only legally disclosable information. Moreover, the company should treat investors fairly and without discrimination by providing equal access to information.
GUIDANCE OF ANALYSTS

One of the most important functions of the investor relations professional is providing analysts with information about the company. Providing information to analysts helps the free flow of information to the marketplace and assists the public in determining accurately the value of the company's stock and its business. Investment analysts play a critical role in the free flow of information in the marketplace. They add value to publicly available information, ideally through diligent, thorough research and skilled, independent analysis. When the analyst cannot perform fully the role of bringing such value-added information to the marketplace, the investing community is hindered in its efforts to make fully informed decisions, and the efficiency of the capital markets is compromised.

Companies should take caution to refrain from overstepping legal boundaries in providing an analyst with selective guidance and absolutely refrain from disclosing material, nonpublic information on a selective basis. If material, nonpublic information is inadvertently disclosed, the company must take action immediately to achieve broad public dissemination of the information and to avoid anyone from taking action on selective information.

Not all information, however, exposes the company to liability under Regulation FD. Mosaic information gathered by analysts that is material, public or nonmaterial, nonpublic information and is used in combination with perceptive analysis to arrive at investment conclusions can provide a valuable service to the marketplace. However, companies should not give information to one person or group that they would not give to another person or group.

National Investor Relations Institute
Review of Draft Analyst Reports

Companies and investor relations professionals should take special precautions if they are invited to review draft analyst reports or earnings models, because review or comment on draft analyst reports may expose the company to liability under Regulation FD or may be viewed, in a class-action law suit, as an endorsement of the report.

Companies that review analyst reports or models should review them only for historical, factual information that is in the public domain. Regulation FD would appear to make it most difficult to comment on an analyst’s underlying assumptions, unless the company considered each to be nonmaterial or it has discussed them publicly. They should take special care not to become “entangled” in an analyst’s report. Corporations can minimize the threat of claims of entanglement by limiting comment or review to discussion or correction of historical fact. One best practice is to refer analysts to the company’s full public guidance information and have the analysts pursue their further research under the “mosaic” theory.

Should a company decide to comment on an analyst’s underlying assumptions in an earnings model, it should document those comments so that it can later prove that its comments were made in good faith that they were not material and had a reasonable basis in fact at the time they were made.

Investor relations officers should take special caution when commenting on drafts of reports that make significant changes in earnings projections, investment ratings or any other information that could materially affect the market in the company’s stock. Investor relations officers should treat such reports as they would nonpublic, inside information.

If a company provides specific earnings guidance in fully public documents or forums, then it may have a duty to update or correct that information. Material updates or corrections should be made in a news release before it is provided to one or more analysts.

National Investor Relations Institute
Forward-Looking Information

The Safe Harbor for Forward-Looking Information contained in the Private Securities Litigation Reform Act of 1995 provides corporations an opportunity to more openly discuss prospects and projections, given the appropriate caveats, both orally and in writing, with analysts and investors without an overriding fear of litigation. Forward-looking statements must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. In making oral forward-looking statements, company spokespersons may refer to readily available written information that contains the factors that could cause the results to differ materially.

While companies with established investor relations programs have, for the most part, discussed forward-looking information with analysts and professional investors in the past, companies should take advantage of this new Safe Harbor to communicate appropriate forward-looking information in writing to the broader investment community (see p. 15).

Duties of an Analyst Who Receives Material, Nonpublic Information

Financial analysts who receive material, nonpublic information in their dealings with investor relations personnel are subject to liability as tippees under federal securities laws if they use that information as a basis for investment decisions. The appropriate course for the analyst who receives such information is to encourage the public dissemination of the information. Unless and until the information is disseminated publicly, the analyst may not legally trade in the company's securities or change his or her recommendations with respect to those securities.

National Investor Relations Institute
The AIMR Standards of Professional Conduct recognize two divergent sets of circumstances in which an analyst may receive material, nonpublic information. The analyst's duties vary with these circumstances. First, analysts may receive information as a result of their confidential relationships with securities issuers. For example, an analyst may receive information when acting as a financial consultant or as the representative of a rating agency, lender or underwriter to an issuer. When acting in these roles, analysts are likely to be considered “temporary insiders” of the issuer. In these situations, analysts can use the information they receive for its intended purpose without encouraging further disclosure of the information. They cannot, however, use the information for any other purpose or share the information with other members of their firms. Selective disclosure is not normally a concern in these circumstances. Note that analysts do not become temporary insiders by attending nondisclosure briefings but may incur tippee liability by basing investment decisions on information learned in such briefings. For this reason, and because of the potential breaches of duty discussed above, AIMR recommends that analysts should avoid such briefings (see p. 40, “Nondisclosure Briefings”).

Next, an analyst may receive information from an issuer, although there is no confidential relationship between them. The conduct of analysts who receive information through selective disclosure by investor relations personnel or other company executives is governed by this section of the AIMR standard. In this situation, the AIMR standard requires analysts to evaluate the materiality of the information they receive and consider whether the source of the information is violating a duty by disclosing it. The analyst should make these decisions in consultation with a compliance officer or supervisor. If the information is deemed material, the analyst should make reasonable efforts to achieve public dissemination of the information. This usually means encouraging the company to issue a news release, or otherwise make the information public. Until the information is publicly disseminated, the analyst should not take any investment action on the basis of the information. To be fully protected from liability, the analyst should refrain from taking
any action at all with respect to the company’s securities, even if that action can be justified on other grounds. An analyst is subject to insider-trading liability for investment decisions made while he or she is in possession of material, nonpublic information, even if those decisions are made for independent reasons. Last, the analyst should not communicate the information to anyone other than designated supervisory and compliance personnel within his or her firm unless and until the information becomes public.
APPENDIX B
GUIDANCE FOR COMPLIANCE WITH REGULATION FAIR DISCLOSURE

Many companies are developing or revising their existing disclosure policies to comply with the requirements in the SEC's Regulation Fair Disclosure. The following is some guidance to help those engaged in that process. This guidance is based on a compilation of various law firm advisories on Regulation FD and an extensive discussion of the issues related to the new rule at the October 6-7, 2000, NIRI Board of Directors meeting. The NIRI board is charged in the organization's bylaws with the responsibility for policy development.

The board recognizes there is no one-size-fits-all policy to comply with Regulation FD. Each company will have to look at its own situation and circumstances in determining which of the following guidelines are relevant. As a general proposition, we believe Regulation FD offers an expanded role for investor relations and greater opportunities for companies to communicate information more broadly to the investment community.

When the rule was published the week following its approval, companies, analysts and securities lawyers were most surprised to read the language regarding earnings guidance in the commentary leading to the actual rule. That paragraph reads as follows:

When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than or even the same as what analysts have been forecasting, the issuer will likely have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect 'guidance,' the meaning of which is apparent.

National Investor Relations Institute
though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly nonmaterial pieces.

This paragraph will clearly change the way most companies provide earnings guidance under Regulation FD. Absent further clarification or guidance from the SEC, we believe companies should observe the following procedures if they intend to continue to provide earnings guidance.

1. Guidance may only be based on:

   a. information the company has publicly issued,
   b. nonmaterial information, whether in the public domain and/or
   c. industry related information.

2. To accomplish this, a company may consider publishing an outlook section in its quarterly earnings release that forecasts its expectations with respect to those factors that drive the company's earnings (generally those factors that analysts use in their earnings model assumptions). These may be expressed as a range or using specific numbers. Some companies may want to publish their own earnings estimate or range of estimates. As the quarter progresses, the company may express comfort with its own projections as opposed to commenting on or expressing comfort with the assumptions in an analyst's earnings model, a consensus number or an individual analyst's estimate. The latter practice would appear to be no longer possible under Regulation FD without issuing a news release. If facts and circumstances should change during the quarter, thus altering the earlier projections, the company should update that information. Furthermore, as the quarter progresses, an expression of comfort with projections made early in the quarter may be viewed as a material disclosure as the results become more apparent. Under these circumstances, the company may be obligated to issue a news release.

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3. It is essential that any forward-looking information be accompa­
nied by safe harbor language containing risk factors specifically
related to the forecasts or projections.

4. A company should consider updating material changes in its pro­
jections as a matter of good business and good investor relations,
regardless of whether it believes there is a legal obligation to do so.
At the same time, it should not publicly commit to a duty to update
material changes in information.

5. We believe that reviewing or commenting on analysts earnings
models or draft reports must be limited to:

   a. correcting errors of historical fact
   b. pointing out information that is in the public domain
   c. providing information the company believes is clearly non-
      material

NOTE: Some companies are eliminating this practice all together. Many of the law
firm advisories are recommending that companies no longer review analysts draft
reports or earnings models. Securities lawyers have never been comfortable with this
practice in that, from the standpoint of legal liability, it could appear that the com­
pany embraced or endorsed the report as a result of the review process.

6. Companies that choose to forecast as a means of providing earn­
ings guidance will want to consider:

   a. their ability to provide such information early in the quarter,
   b. the risks in doing so and
   c. the risk factors that need to be communicated in a readily
      available written document (news release or SEC filing)
      related to their projections.
Conference Calls

Regulation FD does not require companies to conduct conference calls. However, if one does, NIRI urges the company to conduct them on a fully accessible, nonexclusionary basis through a Webcast or by telephonic means, giving interested investors and the media adequate notice of the call. A company may still conduct a call with limited access but must recognize this exposes management to much greater risk under Regulation FD. The SEC has not specified what constitutes adequate notice since circumstances may require a call be held on short notice. However, as a general proposition, the more notice you can give, the more likely the call would be considered adequate for full disclosure purposes.

These calls should be preceded with a news release containing any new material information you plan to discuss in the call. While the fully accessible, nonexclusionary call alone may legally be a means for full and fair disclosure, companies should use additional means, such as a news release or an 8-K filing, particularly if they intend to provide earnings guidance during the call. By having that information in a readily available written document containing the relevant Safe Harbor risk factors, the issuer may use that document as a basis for future reference when analysts ask for earnings guidance.

One-on-One Discussions with Analysts and Investors

NIRI believes one-on-one discussions, whether by phone or face-to-face, will continue to be an important component of a company’s investor relations program. Clearly, company officials, directors and spokespeople covered by Regulation FD must be very careful to avoid disclosing material, nonpublic information in these discussions. Should it happen unintentionally, the company is obligated to promptly issue a news release or provide that information in some other form for full disclosure. To that end, NIRI believes it is most advisable to have an IRO present or on the phone with any company official engaged in a one-on-one discussion with an analyst or investor.

National Investor Relations Institute
The IRO must be the most knowledgeable person in the company with respect to its disclosure record. If an official is asked a question that could elicit a material, nonpublic answer, the IRO may need to interrupt and advise him or her not to respond to the question. If an unintentional disclosure of material, nonpublic information should occur, the IRO is there to discern that and promptly issue a news release, if possible, after consultation with legal counsel.

IROs themselves may continue to engage in one-on-one discussions with analysts and investors without someone else present, so long as they are fully knowledgeable of the company's disclosure record. For IROs to do their job in this respect, they must know all of the company's material corporate developments, whether public or not. Companies cannot afford to keep company spokespersons in the dark on nonpublic corporate developments in the new Regulation FD environment.

One-on-one meetings will continue to be an important venue for discussing information such as a company's

1. long-term strategy
2. history
3. mission
4. goals
5. management philosophy
6. strength and depth of management
7. competitive advantages and disadvantages
8. previously disclosed material and nonmaterial information
9. earnings guidance based on previously released information

These meetings are also useful forums for discussing industry trends and issues.
Investor- and Broker-Sponsored Conferences

NIRI urges continued participation in these meetings. At the same time, we believe companies may want to consider Webcasting their presentations and the Q&A live as a condition of participation. We understand some sponsors of these conferences are already planning to offer Webcasting services or opportunities for those who want to use them.

NOTE: If a company wants its live Webcast to serve as a means for real-time, full and fair disclosure, it must take the initiative to inform interested investors and the media through a news release and a posting on its Web site stating the date, time of the Webcast and how to access it. *The company must do this*, even if the conference sponsor or some other entity provides the Webcast service. Companies that do not choose to Webcast their presentations and the Q&A may want to consider putting the presentation script and slides (if applicable) on the company's Web site and/or furnish them under item 9 of an 8-K. *We believe the more information a company has in the public domain, the greater the basis for reference when analysts are seeking guidance.*

Breakout sessions at these conferences should be conducted in the same way as one-on-one discussions, and officials should take all of the appropriate precautions with what they say. Remember, analysts like to say in their First Call notes, for example, "In discussions with management today, we learned . . ." Such representations sometimes suggest the analysts got exclusive information, when in fact they did not.

Headquarters and/or Facilities Visits

Companies may want to continue conducting visits to their headquarters and/or tours of their facilities for a limited number of analysts or investors. In doing so, companies should be mindful that visitors might be exposed to employees who are not covered by Regulation FD. *Under the rule, analysts can use information gleaned from these employees.* (See "Regulation FD Coverage" regarding designated spokespersons, p. 55.) Therefore, companies will want to control these visits so analysts may gain additional insight into the company's business and operations while avoiding opportunities where they might gain material, nonpublic information in the process.

*National Investor Relations Institute*
Regulation FD Coverage

This rule covers material communications between company officers, directors, IROs, public relations officers and other authorized spokes­persons, and analysts, professional investors or any other holder of the company's securities who the company could expect might trade on that information. Therefore, in its written disclosure policy, the company should designate those who, under normal circumstances, are autho­rized to speak for the company. Conversely, it should warn employees who are not authorized spokespersons that they are not to speak to ana­lysts or investors unless authorized to do so under special circumstances.

Moreover, a company may choose to implement a policy whereby such unauthorized discussions may result in company-imposed disciplinary actions.

Since Regulation FD allows analysts to use information gleaned from employees not covered by the rule, one may assume analysts will pursue such sources with vigor to obtain information they may no longer get from those covered by the rule. This implies that a company should care­fully guide employees participating in trade shows, technical conferences, etc. on what they can say when approached by analysts.

Regulation FD and the Media

The SEC, under pressure from several media companies, exempted the media from Regulation FD. This means that any company communi­cations with the media are exempt from SEC enforcement actions. The basis for the media's concerns was based on 1st Amendment issues. In spite of NIRI's objection to the media carve-out, it was approved as part of the rule.

Our objection was based largely on the premise that the financial me­dia, particularly the televised financial programs, are often in competi­tion with the analysts in terms of who can get the best information and

National Investor Relations Institute
analysis to investors the fastest. With the restrictions Regulation FD places on communications between companies and analysts but not on those between companies and the media, we believe the SEC has created a competitive imbalance with this rule.

NIRI recommends, as it has in its Standards of Practice for Investor Relations, that companies treat their communications with analysts, professional investors and the media equally. We recommend that companies should not provide "exclusives" to selective media of material, nonpublic news even though the recipient may agree to embargo that information until the company releases it. Even when a story is planned to appear in the printed version of a publication the same day as the company issues its news release, the publication's online component may well publish that news in advance of the company's release. In that event, material, nonpublic news has appeared in a medium not recognized as a means for full and fair disclosure under the self-regulatory organizations' listed company rules (NYSE, Nasdaq or AMEX).

National Investor Relations Institute
APPENDIX C
NIRI CODE OF ETHICS

I. An investor relations practitioner should assist in maintaining the integrity and competency of investor relations.

II. An investor relations practitioner should assist in preventing the unethical or improper practice of investor relations.

III. An investor relations practitioner should preserve the properly confidential information of an employer or client.

IV. An investor relations practitioner should exercise independent professional judgment on behalf of an employer or client.

V. An investor relations practitioner will keep himself/herself abreast of the affairs of his/her company or client and the laws and regulations affecting him/her and the practice of investor relations so that he/she will discharge his/her responsibilities competently.

VI. An investor relations practitioner should recognize his/her obligation to continually assist in maintaining and improving the free access of individuals to a healthy securities market.

VII. An investor relations practitioner should avoid even the appearance of professional impropriety.

National Investor Relations Institute
REGULATION FD and NEW INSIDER TRADING RULES

Burton W. Rice
Corporate Communications, Inc.
Nashville, Tennessee

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SECTION I(b)
REGULATION FD and NEW INSIDER TRADING RULES

Burton W. Rice

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SECTION I(b)
DINOSAURS, DODOS & SELL-SIDE ANALYSTS

Burton W. Rice, CFA
Corporate Communications, Inc.
523 Third Avenue South (Zip 37210)
P.O. Box 101190
Nashville, Tennessee 37224
(615) 254-3376
(615) 254-3420 (fax)
burton.rice@cci-ir.com
SAFE HARBOR

I attribute any forward-looking statements today to a childhood void of the Internet where fictional settings and imaginary play friends were strongly encouraged. I no longer believe in the Easter Bunny or Santa Claus, but I have read three of the four Harry Potter novels. I expressly disclaim, however, any responsibility to offer a rational explanation why clients may act irrationally in disclosing material, non-public information.

Corporate Communications
OUT WITH THE OLD

Corporation → Sell-Side Analysts → Investors

I/R Program

Corporate Communications

IN WITH THE NEW

Corporation → I/R Program → Investors

Sell-Side Analysts

Corporate Communications

I(b)-3
A TRAIL OF TEARS
Sell-Side Research Coverage
(U.S. Corporations)

1998  1999  2000  2001
6,000  5,600  4,600  3,900

Source: I/B/E/S

SELL SIDE CONTRACTION
Big Dough News

- Aerospace and defense analyst David Ainsworth left Merrill Lynch.

- Herbert Maher left H.C. Wainright & Co. His coverage is in transition.

- Thomas Postek, CFA retired from William Blair.
### ON THE ROPES

**Companies With No Sell-Side Coverage**

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Source: I/B/E/S

### “HAVE’S” AND “HAVE-NOT’S”

**Published Brokerage Estimates**

- 3,900 Companies
- ≥10 Estimates: 18%
- 4-9 Estimates: 34%
- 1-3 Estimates: 48%
- 22% = 1 Estimate

Source: I/B/E/S
**KNOW YOUR CUSTOMER**

**Institutional Needs**

**Industry Knowledge**

- Earnings Estimates
- Stock Selection
- Written Reports
- Visits/Conferences

* Institutional Investor (10/00)

**HOT POTATO**

**Equity Fund Redemption Rate**

47% (2000)

- 8% (1960s)
- 15% (1970s)
- 25% (1980s)
- 30% (1990s)

Source: The Vanguard Group

Corporate Communications
**Average Fund Share Ownership**

- 12.5 years
- 2.0 years

Source: The Vanguard Group

**The Makeover**

- □ Consistent profitability
- □ Increasing margins
- □ Efficient facilities
- □ Six Sigma initiative
- □ Sound growth strategy
- □ Specific growth targets
- □ Experienced management
- □ Incentivized team
- □ Commitment to shareholders
- □ Low relative valuation

Corporate Communications
DO YOU REMEMBER?

20 Years Ago

"Chrysler needs $400 million, and I'm supposed to invest in the market?"

$182,930 - 15.6% CAGR
(1981 - 2001)

Corporate Communications

DO YOU REMEMBER?

10 Years Ago

"We're days away from a war with Iraq. Could there be a worse time to invest?"

$46,679 - 16.7% CAGR
(1991 - 2001)

Corporate Communications
DAYS BEFORE YEAR-END, A YOUNG PAINEWEBBER analyst broke into electronic print with a forecast that Qualcomm (then $126, split-adjusted) would double in price over 12 months. As a result, the telecom stock surged 319% Dec. 29. Now, Qualcomm is a promising telecom company with a lock on a technology (called code division multiple access) that is becoming the standard for digital cell phones. But that's not enough to justify such a projection. Lately the stock has dropped back almost to its previous level on signs of slowing chip sales growth.

Qualcomm's round trip shows how the solid and necessary profession of security analysis has become a farce. It has moved investors' focus from long term to instant gratification—and done so amid the noise level of a busy craps table. Part of the problem these days is that too many analysts thirst for the instant stardom that an outrageous projection delivers.

Brokerage-house management encourages them to seek high visibility because that's good for business. And the proliferation of TV investment shows—which staccato bursts of trivia are something out of Walter Winchell, c. 1940—provide the forum. Security analysis is now show business, with analysts the circus dogs jumping through hoops of fire.

Tellingly, money managers who haven't the time or the need to shill themselves are seldom the performers. You don't see Robert Stansky, who manages $100 billion at Fidelity Magellan, as a CNBC regular.

Wall Street firms view their celebrity analysts as calling cards for underwriting assignments. These high-profile analysts lasso investment banking clients, then hawk the clients' stocks 30 days after an initial public offering. And their sales pitches—a hm, analysts' reports—frequently just condense the legal verbiage of a prospectus some even helped to write. In that fashion Henry Blodget of Merrill Lynch is one who offers direction and sometimes contributes a paragraph here and there to a prospectus, blurring the line between security analysis and investment banking, which is supposed to be ethically separated by a Chinese wall.

Small wonder that analysts are easily manipulated into groupthink, guided by conference calls and investor relations people, rarely stepping out of the earnings consensus. Investors aren't well served when an analyst shrinks from the bald truth. So a troubled stock isn't a sell; it's just of average attractiveness. Look at Coca-Cola at its peak, when dozens of analysts were within a penny of one another. Too bad they didn't see the coming slowdown abroad that crashed their projections in late 1998.

What analysts do with numbers to justify their recommendations is ridiculous, especially for Internet and biotechnology companies that have no discernible earnings power for years to come. Making a profit, of course, is irrelevant. To overcome any quessiness about seas of red ink, analysts take refuge in ten-year discounted cash-flow models. That way they can rationalize Amazon's going to the moon and back in one day. But can anyone seriously predict what will happen a year, let alone a decade, from now?

The other buzzword we hear from analysts is "metrics," most often meaning revenue projections every bit as absurd as cash-flow models. Write a biotech or telecom business plan with enormous metrics, and analysts fall in love with you. Analysts didn't use to be such patsies. Back in the early 1960s, the small firm of Donaldson, Lufkin & Jenrette revolutionized what was then a sleepy corps of desk-bound statisticians. Led by its trio of young M.B.A. partners, DLJ studied businesses in the field, looking for the good and the bad based on fundamentals. They unleashed a series of 50-page papers that were godsend to investors. Today, there are few pure research outfits like DLJ was then (it, too, is into investment banking now). The real downfall for analysts came in 1995, when then-profitless Netscape Communications went public, doubling in price the first day. That's when metrics started creeping into their vocabulary.

Maybe the Nifty Twenty-Five now leading the market will correct individually like Coca-Cola and Lucent. If they all go down at the same time, it'll make Black Monday look like Thanksgiving. Either way, don't count on the analysts to alert us to problems ahead.

Full disclosure: We own Qualcomm, Cisco, Microsoft, Sun Microsystems and other tech highfliers. At least we bought them years ago, when you could model companies using only one metric: old-fashioned earnings per share. F

Martin Sosnoff is chief investment officer of Atlanta/Sosnoff Capital in New York and author of Silent Investor, Silent Loser.
Small companies unable to attract coverage from the big wirehouses and regional brokers are turning to another source — specialty firms paid a fee to write and distribute "research" reports. The easy access to this information on the Internet is helping these providers claim large on-line investor audiences. But the real issue is: How useful is this research to investors? Do they even read it? And, do they act on the information and recommendations?

Research for Sale
Can't get any research coverage from the brokers? Don’t despair. You can always buy it.

Encouraged by the bull market and the frustrations of CFOs at small companies at not being able to garner any following by the sell-side brokerages, so-called independent firms have sprouted up, offering research for a price. Judging from the flow of fee-based research reports flooding cyberspace and filling fax machines, the practice has taken off big-time.

Maybe to the surprise of some, the sliding economy and stock market don't appear to be putting any brakes on the momentum. In fact, the opposite is occurring. Desires by micro, small, and even mid-size companies to get more exposure in the face of a down market seem only to be feeding the paid research frenzy.

The question for company executives is: How valuable is this coverage? In fact, there are lots of questions. Are investors paying any attention to it? After all, the argument goes, since companies are paying for it, it must be positively slanted. Is it aimed strictly at individuals, or are the institutional pros looking at any of it? Indeed, is it even legal?

And then there's perhaps the most practical question: Accepting the notion that there is a legitimate role for fee-based research, which providers are really adding value to the investment process and which ones are hype artists who are probably doing their company clients more harm than good? The bottom line for CFOs and IROs buying this research: Buyer beware!

Serving Ignored Companies

A sound premise supports the explosion of paid research: Thousands of companies are being overlooked in the battle for investor attention. Facts prove the contention.

Richard J. Wayman, a chartered financial analyst (CFA) and founder of stockresearch.com, cites research from Thomson Financial/Baseline showing that 1,558 of 4,890 companies with market caps under $500 million have no analyst coverage. Further, those remaining 3,332 companies have fewer than two analysts, on average, covering them. Read one, probably the investment banker.

Contrast those numbers with the 25 analysts, on average, following companies with market caps of over $200 billion, says Wayman.

Wall Street easily rationalizes its focus on the big stocks. That's where most of the investment money is going. Large institutions provide the bulk of stock transaction commissions, and they need liquidity to buy and sell sizable positions without moving share prices. With volatility at all-time highs, these money managers are willing to pay a premium for liquidity.

That's just one reason. Razor-thin trading spreads, caused by competition and regulation, exacerbate the need for brokers to have liquidity to ensure some profit margin on high-volume transactions.

Then, there's the competition for investment banking deals. It has led to accusations of tainted research, namely positive coverage to help banks curry favor with corporate CFOs and CEOs. "With every investment banker vying for the same deal, research coverage has become a lemmings market with everybody following the same stocks," says Wayman.

Still one more factor is the merging of regional brokerages into the major houses, significantly reducing opportunities for small local companies to raise capital and gain coverage. In raising money, companies often worked their way up the chain of small and regional investment houses that provided support from infancy through development.

Purveyors of paid research argue that all research costs companies money, in one way or another. Small companies aren't likely to be followed without an indication of investment banking business. "Our program gets the company coverage without having to offer an investment banking deal," argues Sherry Grisewood, CFA, who does research for The Public Analysis and Research (PAR) program of Investrend Research, one of the many firms offering research for a price.

Serious conflicts of interest exist at Wall Street firms, say fee-based proponents in claiming their research can be just as objective. "At least we’re not trading in the stock," claims Karen Snedeker, managing director of BlueFire Partners in Minneapolis, an investor relations firm that also has registered to be an investment advisor. BlueFire requires companies to be an IR client before research is written. But not all clients qualify, says Snedeker. "Basically, it is a service for those that deserve research and do enough with us to warrant it."

Wayman, who collects fees for research at stockresearch.com, questions the objectivity of Wall Street analysts. Their compensation packages, he argues, include a base salary, percentage of banking deals, and trading volume...
Stock Marketing

“Our program gets the company coverage without having to offer an investment banking deal.”
— Sherry Grisewood, of The Public Analysis and Research (PAR) program

At the lowest level are pure hype reports. Unfortunately, these abound in cyberspace, and some are unbelievably bold. Some recent samples make the point: “THIS IS A STOCK TO PURCHASE!” “Thaan Communications is a very strong buy, with a target of $6! We think this is a stock you should own right now.” Or, in reference to another company: “By far the best stock we have ever covered.”

Wayman suggests checking the language for clues into unadulterated hype. He admonishes companies and investors to be cautious of reports full of promotional language while “sparse on details” or using phrases like “the stock will rocket to new highs” or the author “guarantees” a sizable return.

Key Factors in Picking a Provider

Quality of research, length of time coverage is provided, costs, and audience impact are vital factors in deciding if a fee-based approach to gain market coverage is a value-creating proposition for a company. Costs can vary widely; we have seen fees from $7,500 to $50,000. And some providers take stock, which should raise a red flag on the issue of objectivity.

The time frame for giving coverage is a factor. A one-time report should be viewed with suspicion. Investors aren’t likely to give it much weight; hype is written all over a report that isn’t part of an analyst’s commitment to follow the company. By comparison, Wall Street analysts add value by covering a company over time. A year-long contract at least ensures some follow-up reports.

Audiences also matter — in terms of size and quality. The Internet market for fee-based research essentially is individual investors. Some Web site providers claim an institutional following. Quantity and quality of audience don’t necessarily go together. Paid subscriber and opt-in
The Internet market for fee-based research

e-mail audiences are likely to be more serious, upscale investors, compared with purchased audience lists.

Investors and companies are wise to assess the quality of the research on a provider-by-provider basis, covering both the information-only and forecast/recommendation groups.

Key considerations focus on the experience and qualifications of the research analysts. Does the provider truly have a corps of credentialed research analysts? Is the resource essentially an investor relations or public relations firm? Bottom line: Know what you are buying.

Some of the Players

Knowledge is in the details, and in how various providers look at their own service. Skip Nordstrom operates the Growth Stock Newsletter (www.NICStock.com), published by the National Investors Council. He writes a 4-page, glossy, one-time information report for $7,500 per report, plus expenses for a site visit to interview management. Longer-term contracts are encouraged. Client leads typically come from PR and IR firms, and market makers. A proprietary audience database consists of about 3,000 opt-in investors.

PAR (www.investrend.com) has a team of analysts, mostly CFAs, says Grisewood, and the firm doesn’t hold stock in companies it writes about. Fees are $19,700 a year for an initial report, quarterly updates, and any further reports warranted by events. Companies typically are in the $50-$60 million market cap range, but can go as high as $200 million. A 75,000 e-mail audience can expand to a million viewers via several participating Web sites, adds Grisewood.

Alan Stone (www.WallStreetResearch.org) includes recommendations and stacks his research team against the Wall Street firms. He says his background includes stints at Merrill Lynch as an analyst and as a portfolio manager. Because the firm covers microcap companies, fellow analyst Richard Goldman says that time boundaries need to be put on their recommendations. "Things can change so fast, reports are only good for a definitive period of time," according to Goldman.

OTC Growth Stock Watch is a small cap newsletter, profiling companies for an audience of about 300,000 subscribers who opt-in to the site. Companies qualify for inclusion based on certain criteria and don’t pay a fee to be featured. OTC Financial Research, the parent company, also produces "glorified fact sheets" for a fee and conducts IR programs, says Geoff Eiten, president. The firm claims to not make recommendations in its fact sheets, despite a statement in one such profile reading, "We consider the stock to be undervalued."

Steve Reid, editor of the Moebius Free Financial Newsletter, says that services like his are "no different from a brokerage firm’s. The brokers won’t help you unless you’re a corporate finance client." Reid specializes in e-mail distribution and claims to have access to 200 million names on a global scale. His research is mainly information-based, poured into the market on a fee structure with discounts based on size of order. Costs to saturate the market can run over $1 million. Reid also creates streaming videos for online distribution. Most of his clients are trying to raise money, he says. "Much of what we do is create liquidity."

SmallCapReview (www.smallcapreview.com) claims to
essentially is individual investors.

have a large institutional following, with subscribers opting in. "We don't buy mailing lists or swap names," says Thomas Englebert, editor. He says that the Web site focuses on small companies with good growth prospects. "We want to build subscriber loyalty and trust." Englebert won't reveal his site's number of subscribers. "We consider that proprietary, but we are very pleased with our growth rate," he says.

After serving seven years as an equity analyst, Rick Wayman founded stockresearch.com in 1999 as an independent, fee-based research firm based in Columbus, OH. He sees fee-based research as a "useful way to bridge the gap between companies with investment potential and investors looking for new ideas and undervalued stocks."

The Legality of the Matter

Is all this cyberspace traffic legal? The distinction comes in whether the provider is a broker dealer or investment adviser and thus subject to the Investment Advisers Act of 1940, or whether it is a publisher. According to the Act, investment advisers provide advice, make recommendations, issue reports, or furnish analysis on securities, either directly or through publications. As such, they must register with the Securities and Exchange Commission. They can get into trouble by providing materially false or misleading statements about public companies.

Producers of general and regular circulation publications are excluded from the definition of investment adviser as long as they don't offer individualized advice tailored to the investment needs of specific clients. The SEC has gotten publishers to agree to consent decrees and pay penalties. Brian S. Hamburge, an attorney for the law firm of Stark & Stark, suggests that criteria for judging the legality of newsletter or Web site content seem to be determined by the SEC on a case-by-case basis.

Can't Quantify the Value

Our research fell short in finding companies or portfolio managers buoyant about the value of fee-based research. Understandably, companies ponying up the funds aren't anxious to talk about their experiences. Robert Benou, president of Conolog, followed the advice of Geoff Eiten to put out a lot of news. Benou believes it helped in keeping the price from taking a "nosedive" when the market fell in the spring of 2000, and to pick up when some recovery occurred.

Richard Twardowski, IR director at IVG Corp., can't say that the heavy communications urged by Moebius editor Steve Reid has impacted stock price, but he says that it did serve to boost trading volume. And Richard Pierce, CEO at Laredo, said its source, Revealor, "generated a fair number of calls, but it's hard to say what influence it has had on stock price."

On the investment side, Ken Sevinsky, Jr., senior portfolio manager at Fifth Third Bancorp in Cincinnati, sees a place for paid research among small cap companies. But he also has his doubts. "I wonder how you draw the line of being objective while the company you are covering is paying you," comments Sevinsky.

Objectivity? Chuck Hill, director of research for Thomson Financial/First Call, issues a warning to investors about fee research. "If there is no analyst's name on the research, then buyer beware," says Hill. About the opportunity for companies to make the investment screens of institutions requiring at least one analyst earnings forecast, Hill has bad news. "We clearly would not use somebody that does research and was paid for it," he says.

A final word comes from Robert J. Flaherty, longtime editor of Equities magazine, which specializes in understanding small companies. Improved liquidity may be the chief benefit of paid-for research, suggests Flaherty. Plus, it's better than no research, he adds, as long as it's honest. What he doesn't like is stuff like "This is the next General Motors." They're trying to have the company take on the attributes of the giants."

Flaherty says that companies and investors should want information in these reports about management and about risk. "There's a lack of management background in these pieces. Risk needs to be disclosed, especially about competition, adequacy of financing, and other basic financial considerations," he adds. "And, any projections should be reasonable."

Joseph R. Hassett is research editor of Shareholder Value. He has an extensive career as a corporate investor relations officer and consultant. Bill Mahoney is executive editor of Shareholder Value.

Shareholder Value
SIA ENDORSES 'BEST PRACTICES' TO ENSURE ONGOING INTEGRITY OF RESEARCH

Practices Emphasize Pre-Eminence Of Clients' Interests

New York, June 12 -- The Securities Industry Association today endorsed a compilation of “best practices” followed by brokerage firms to ensure the ongoing integrity of securities research and analysis.

The best practices -- which cover, among other things, analyst compensation and stock ownership, relations with investment banking units, and disclosures -- were compiled by an ad hoc committee of senior level research professionals from the association’s largest firms. The practices are the latest in a series SIA has published to guide firms and educate industry employees.

“Our most important goal is to maintain the public’s trust and confidence in capital markets and our industry,” said Mark Sutton, chairman of SIA’s board of directors and president of the private client group of UBS PaineWebber Inc. “SIA’s endorsement of best practices for research demonstrates our commitment to achieving the highest levels of public trust and confidence in our industry. Behind every transaction or piece of advice given to an investor is one simple but important principle: the client’s interests come first.”

The chief executives of the 14 largest underwriting firms all expressed support for the best practices. These firms are: Bear Stearns; CIBC World Markets Corp.; Credit Suisse First Boston; Deutsche Banc Alex. Brown; Goldman Sachs Group Inc.; J.P. Morgan Securities; Lehman Brothers, Inc.; Merrill Lynch; Morgan Stanley; Prudential Securities Incorporated; Robertson Stephens, Inc.; Salomon Smith Barney; Thomas Weisel Partners; and, UBS Warburg.

“These recommendations embody our industry’s aspirations to strengthen ethical and professional standards for securities analysts, underscore broker-dealers’ commitment to the best interest of our clients, and buttress the overall integrity of the securities markets,” said the letter the CEOs signed.

SIA’s best practices address all aspects of the research department’s role within a
firm to ensure that research is objective, independent, and of the highest integrity. The practices cover disclosure, recommendations, compensation, the relationship to investment banking and other business units, the relationship with the companies covered by analysts, the research process, and personal trading and investment.

Among the key recommendations:

- Research departments should not report to investment banking or any other business units that might compromise their independence.
- Analysts should be encouraged to indicate both when a stock should be bought and when it should be sold, and management should support the use of the full ratings spectrum.
- Analysts should not trade against their recommendations and should disclose their holdings in companies they cover.
- Analysts' pay should not be directly linked to investment banking transactions, sales, and trading revenues or asset management fees.


"Helping investors to identify appropriate investment opportunities and develop a financial plan is a vital function securities firms perform for investors," said SIA President Marc Lackritz. "Analysts play a very important role by providing thoughtful and independent analysis for investors. These 'best practices' are part of many efforts to ensure that our industry abides by the highest professional standards."

"SIA members hold their research staffs, like the rest of their employees, to the highest level of integrity," said Sutton. "The commitment of firms to these best practices sends a strong message to the investing public that serving their interests is our first priority."

The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated $314 billion of revenue directly in the U.S. economy and an additional $110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S.
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STOCK WATCH SERVICES:

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SECTION I(b)
A. Refreshing Your Recollection: The Basics

1. **Selective Disclosure Banned.** A registrant must disclose publicly (i.e., by Form 8-K or another method "reasonably designed to provide broad, non-exclusionary distribution to the public") any "material nonpublic information" disclosed by a person acting "on behalf of" the registrant to a broker-dealer or its employee (including a sell-side analyst), an institutional investor or its employee (including a buy-side analyst) or another securityholder who is reasonably likely to buy or sell the registrant’s debt or equity securities while aware of the information (collectively, “the Street”).

2. **Exceptions.** The only exceptions permit disclosures (1) to lawyers, accountants, investment bankers or others who owe a duty of trust or confidence to the registrant, (2) to rating agencies developing published credit ratings for the registrant, (3) to those persons who expressly agree to maintain the information in confidence or (4) in connection with a registered securities offering (other than a "continuous" offering such as an employee benefit plan or a DRIP).

3. **Materiality** Defined. Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. Put another way, a fact is material if there is a substantial likelihood that it would be viewed by the reasonable investor as significantly altering the "total mix" of information made available. For a contingent or speculative event, materiality depends on probability and magnitude. These are legal tests, with qualitative aspects; as emphasized in SAB No. 99, quantitative rules of thumb can be useful but are not dispositive.

4. **Nonpublic** Defined. Information is "nonpublic" if it has not yet been disseminated in a manner making it available to investors generally.

5. **Covered Speakers.** Persons deemed to be acting "on behalf of" the registrant are its "senior officials" and others who regularly communicate with the Street or with the registrant’s securityholders. The registrant’s "senior officials" are its directors, executive officers, investor relations and public relations officers and other persons with similar functions.

6. **Public Dissemination.** Methods "reasonably designed to provide broad, non-exclusionary distribution to the public" include (1) distribution of a press release through a widely disseminated news or wire service and (2) announcement at a conference of which the public had notice and to which the public was granted access, either by personal attendance, by telephone or by other technology (such as webcasting). A website posting, without more, is insufficient.

---

* Ms. Kelley is the General Counsel of Kmart Corporation, headquartered in Troy, Michigan. Mr. Daugherty is a partner of Foley & Lardner in Detroit.
7. **Timing of Required Disclosure.** In the case of an "intentional" disclosure to the Street, the required public disclosure must be made "simultaneously." In the case of a "non-intentional" disclosure to the Street, the required public disclosure must be made "promptly" (within 24 hours after a senior officer learns that there has been such a disclosure that the officer knows, or is reckless in not knowing, is both material and nonpublic or, if later, by the next NYSE opening bell). A selective disclosure is "intentional" when the speaker knows or recklessly disregards that the information is both material and nonpublic.

B. Industry Reaction; Academic Study; Consensus Advice; Evolving Practices

1. **NIRI Survey.** Highlights: 75% said "same amount, or more, information disclosed; 79% said there are at least as many one-on-ones as before; 79% said earnings guidance is given in some form; a significant number reported fewer requests to review analysts' reports; and 89% reported use of open webcast calls for earnings discussions (other 11% reported "no conference calls, period").

2. **USC/Purdue Study.** Sampling nearly 1,600 companies, the researchers examined stock price volatility surrounding corporate earnings announcements and found that volatility, far from increasing, has actually decreased slightly now that Regulation FD is in effect. The researchers also found no significant deterioration in various measures of analyst forecasting performance. For example, they found no change in analyst forecast errors, or in the dispersion of analyst forecasts, after controlling for extraneous factors. This evidence, like the price volatility evidence, is inconsistent with any claimed deterioration in the information environment. The only significant effect of Regulation FD found by the researchers was a near doubling of the number of voluntary public earnings announcements made by managers. This implies that registrants now disclose publicly what they once gave the Street selectively - precisely what the SEC has been trying to achieve.

3. **ABA Task Force Survey.** An ABA Task Force on Regulation FD surveyed the federal securities bar on a broad range of issues relating to public-company practices that have evolved since the regulation became effective. The more notable conclusions include:

- Are clients disclosing more, the same, or less information to analysts and investors? More, 45%; same, 24%; less, 26% (one called it “Regulation Fewer Disclosures”)
- Are disclosures better, the same, or worse? Better, 30%; same, 50%; worse, 18%
- How many clients conduct one-on-ones with analysts? Most or some, 61%
- Do clients have a black-out period? Yes, 87%
- How long? No clear pattern (two to seven weeks)
- What is a "reasonable" period of public notice of an analyst call where material nonpublic information will be disclosed in connection with a routine earnings release? 24 hours or less, 25%; 48 hours or less, 50%
- What is your experience with analysts' willingness to enter into confidentiality agreements? They won't do it, period, 40%; depends, 32%

I(c)-2
Do your clients “correct” analysts whose forecasts vary with the company’s forecasts? No, 57%; yes, 14%; no response, 29%

Do your clients confirm their announced forecasts to analysts? No, 50%; yes, 35%; no response, 15%

How long after the original announcement? No clear pattern, but all specific responses were four weeks or less

4. **Law Firm Survey.** A survey of 22 national law firms revealed that the following advice is most commonly given:

- Determine/designate and limit who will be authorized spokespersons (20/22).
- Educate or inform spokespersons (13/22).
- Review/reexamine written disclosure policies (13/22).
- Create “disclosure” team; prepare for unintentional disclosures (11/22).
- Require earnings calls to be open to public and give public notice of same (12/22).
- Use “safe harbor” language in making forward-looking statements (11/22).
- Script/prepare for analyst calls (10/22).
- Develop system for keeping track of publicly disclosed information (10/22).
- Monitor what the market knows about your company (7/22).
- Hold debriefing sessions after an analyst conference (7/22).
- Require more than one representative to be present during one-on-ones (6/22).
- Put clear limits/ground rules on any private sessions with analysts (5/22).
- If company decides to review analyst report, limit to factual inaccuracies (5/22).

C. Ten Nuances Worth Knowing

1. **“Earnings Guidance”**: don’t do it, says the SEC in its adopting release; don’t even say “earnings are right on target”; what’s banned is selective earnings guidance (e.g., don’t give earnings guidance in a one-on-one); public earnings guidance has become extremely common, but be sure to invoke the safe harbor (and eliminate the boilerplate), and bear in mind that plaintiffs’ lawyers are known to be obtaining and using webcasts; mid-to-late-quarter conference calls are becoming more common; one issuer (named “Progressive”) has gone to monthly reporting
2. **Avoiding Selective Updating of Earnings Guidance:** reiterating guidance is an update (do not say “as we said before” unless you intend to update); merely choosing to quote prior words is also an update; how best to handle questions on guidance in one-on-ones: “I really can’t comment on our prior guidance.”

3. **The “Mosaic Theory”:** has been preserved, indeed celebrated; everyone does it (what you can do in a one-on-one is help the analyst “fill in” his or her mosaic); but it can’t be used to circumvent the rule (e.g., by deconstructing the company’s earnings projection and feeding the assumptions to an analyst one assumption at a time).

4. **The “Road Show” Exception:** applies to statements made “in connection with” a registered offering; does not apply to every statement made in the course of a road show; for example, would not apply to a regularly scheduled investment conference that happened to coincide with a road show; also, does not apply to statements made in connection with a private offering, a real problem in Rule 144A/Regulation S (European) offerings.

5. **Chat Rooms and Personal-Finance Websites:** “don’t go there” to comment, ever; company should have a policy banning employee participation.

6. **Investor Conferences:** usually, and by design, these aren’t “public” events; if making a statement there, assume the Street is present, and try to convince the sponsor(s) to open it up -- e.g., by webcasting; but not that even that won’t be good enough unless your company makes its own public announcement and makes a webcast of your comments in real time from its own website; alternatively, don’t say anything material and nonpublic or, if you plan to say something material and nonpublic, then issue a press release concurrently; plan what you are going to say and don’t deviate; and remember that it’s safer to schedule these conferences earlier in your quarter than later.

7. **Form 8-K versus Press Release:** the sense of the federal securities bar is that Form 8-K is beloved by the SEC Staff, but in the real world a press release connotes “greater dignity”; also, the major SROs require a press release for disclosure of material information (the NYSE rules stipulate that the “normal method of publication of important corporate data is by means of a press release” while the NASD rules mandate disclosure “through international wire services or similar disclosure media”); the better practice is to use both; and the best practice is to use both plus a website posting; but remember that a website posting alone is currently deemed insufficient because of the so-called “digital divide.”

8. **Confidentiality Agreements:** generally, analysts (especially sell-side analysts) won’t sign (their firms tell them to “just say no”); exception – an analyst might sign a confidentiality agreement before initiating coverage, while coming up to speed; breach of a confidentiality agreement is not a Regulation FD violation, is rather more serious than that (Rule 10b-5); it’s not good enough to say “I won’t trade” or “I won’t violate the law”; must actually agree to keep the information “confidential.”

9. **Shareholder Meetings:** traditionally, these aren’t “public” in the manner Regulation FD demands for provision of material nonpublic information; therefore, say nothing material and nonpublic unless there is a press release and an 8-K; in my opinion, the innovation of electronic shareholder meetings will eventually change this, but we’re nowhere near that point yet.

10. **Restructurings:** Restructuring talks with public debtholders require confidentiality agreements under Regulation FD. Debtholders who want to remain free to trade while the restructuring proceeds will refuse to sign these agreements.
D. Enforcement Activity

No actions have been brought (in the United States); “investigations” only; according to outgoing DOE Director Richard Walker in May 2001, fewer than ten investigations were pending at that time, and he thought this proved that it's no big deal; Walker’s enforcement position was, and Chairman Pitt’s position is, not to sue companies that have made mistaken but reasonable and good-faith attempts to comply with Regulation FD; what irks the SEC most is the kind of incident that led to the adoption of Regulation FD in the first place (e.g., calling pet analysts and tipping them to bad news ahead of a public announcement).

Situations suggested by Walker to be abusive:

- Calling multiple analysts to review prior announcements, resulting in the analysts lowering their earnings estimates
- Calling analysts serially and talking them down from their earlier assumptions
- Calling a single analyst late in the quarter to confirm guidance given publicly “months earlier when market conditions were very different”

The common thread of all these alleged abuses is – making a phone call. According to Commissioner Hunt at the ABA Annual Meeting in August, the hottest “hot button” for the SEC is any situation where it’s the issuer’s management that places the call (and not vice-versa). The thinking is: analysts are supposed to ferret out information, not be spoon-fed; if management feels a need to “reach out,” then it should issue a press release. (Note that this thinking is contra the common practice of calling the out-of-contact rogue analyst whose estimates are skewing the averages. It’s also contra management’s acceptance of a standing invitation to call on an analyst “while in town.”)

Publicized investigations to date include: Raytheon (selectively disclosed “color” comments); Motorola (selective confirmation of earnings guidance). Regulation FD investigations are commenced quickly, move along quickly, so it looks doubtful that Raytheon or Motorola will be sanctioned.

There has been one enforcement action in Canada, under Canadian law (not under Regulation FD, although clearly the result would have been the same), resolved by consent decree last summer: Air Canada’s CFO and CIO conceded that they developed and used a script to call 13 analysts, serially, to tell them that earnings would be lower than expected. A press release was issued the next day, and even then only because the Toronto Stock Exchange had inquired. The company was fined (Can.) $1 million for this misconduct, which has been illegal for years in Canada but was never before enforced.

E. Unger Report

1. Background. Bearing a date of December 2001, this report expresses the views only of Commissioner Unger. The report draws upon evidence gathered from the SEC’s April 24, 2001 “roundtable” discussion of Regulation FD and from eight surveys pertaining to the new rules to identify issues of common concern and to make recommendations to the SEC for increasing the effectiveness of Regulation FD. (See note 8 to the Unger Report for the website addresses of all eight surveys.)
2. Recommendations. Commissioner Unger, who alone dissented from the adoption of Regulation FD, characterizes her recommendations as "fine tuning." The recommendations include:

- The SEC should consider issuing an interpretive release to make its position on materiality under Regulation FD clearer. This would provide the SEC a constructive opportunity to articulate its views on materiality, using real-world factual scenarios.

- If enforcement action is warranted, the SEC should consider issuing a Section 21(a) report.

- The SEC should explore with the SROs ways to amend their rules to expand the range of tools -- beyond the press release -- that would satisfy both Regulation FD and SRO information dissemination requirements.

- As the digital divide continues to narrow, the SEC should continue to reevaluate its position on how the Internet can further the goals of Regulation FD. The SEC should consider encouraging use of the Internet as a prime dissemination tool.

- In particular, the SEC should deem adequately-noticed website postings, fully-accessible webcasts (without an accompanying press release repeating the substantive information) and electronic-mail alerts to satisfy Regulation FD.

- If the SEC determines that Regulation FD has caused companies to cut back on making future projections, then it should consider using its authority under the Private Securities Litigation Reform Act to expand the safe harbor to encourage more forward-looking disclosure.

- Regulation FD purports to leave intact the mosaic theory so that analysts can use pieces of nonmaterial information to build a material mosaic. Right now, though, the pieces of the mosaic are hard to come by due to the confusion about materiality. In providing guidance, it would be helpful for the SEC to provide concrete examples of what information issuers could give analysts to build their mosaics without running afoul of Regulation FD.

F. Resources

http://www.sec.gov/rules/final/33-7881.htm (the adopting release)
http://www.sec.gov/interpstelephone/phonesupplement4.htm (telephone interpretations)
http://www.sec.gov/news/studies/regfdstudy.htm (the Unger report)
http://www.shareholder.com (turnkey webcasting service found here)
http://www.fedex.com/us/investorrelations/financialinfo/disclosure.htm (a published policy)
http://www.thecorporatecounsel.net (state-of-the-art thinking and practice)


CAPITAL RAISING ALTERNATIVES IN A CHALLENGING MARKET

Karen S. Batchelder
Legg Mason Wood Walker, Inc.
Philadelphia, Pennsylvania

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SECTION J
CAPITAL RAISING ALTERNATIVES IN A CHALLENGING MARKET

Karen S. Batchelder

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Capital Raising Alternatives in a Challenging Market

Karen S. Batchelder
Principal
Private Finance & Sponsors Group

February 16, 2002

Legg Mason Wood Walker, Inc.
Agenda

I. Legg Mason Overview

II. The Economic Outlook

III. The Public Equity Markets

IV. Private Investments in Public Equities – PIPEs

V. The Private Equity Markets

VI. The Debt Markets

VII. Implications for Private Companies
Legg Mason Overview

- Founded in 1899, Legg Mason, Inc. is a NYSE-listed firm with an equity market capitalization of approximately $3.3 billion.

- Legg Mason operates in three principal business segments: securities brokerage, asset management, and capital markets.

- A summary of Legg Mason’s performance during its last nine fiscal years follows:
Legg Mason Overview

- 1,290 financial advisors in 138 offices.
- More than 1,000,000 accounts hold $65 billion in assets.
- Superb brokerage force with high quality client base.
- Commitment to Legg Mason Research.

- $170 billion of assets under management in all major asset classes, domestic and international.
- Separate accounts and proprietary mutual funds.

- Full service capital markets division includes investment banking, research and sales & trading.
- Over 370 professionals.
- Focused on core industry sectors teaming investment banking, research and sales & trading.
Industry Focus
The Economic Outlook
The Economic Outlook

- Little incentive for business expansion in fixed assets.

- Modest corporate profits and overcapacity further reduce the need for capital expenditures.

- Consumer spending unlikely to remain at current levels due to higher unemployment, mounting debt balances and poor equity performance.

- Interest rates are likely to increase as the Fed ends its easing cycle and the government increases its debt issuance.

- Timing and magnitude of the economic recovery is uncertain.

Will demand accelerate enough to warrant an increase in production and, in turn, encourage business development?
### New Environment

<table>
<thead>
<tr>
<th>Cost of Capital</th>
<th>Nearly zero: raise as much as you can</th>
<th>Nearly infinite: make the most of what you have</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Markets Focus</td>
<td>Growth</td>
<td>Profits, cashflow and credit quality – back to basics</td>
</tr>
<tr>
<td>Capital Technology Budgets</td>
<td>Loose</td>
<td>Tight</td>
</tr>
<tr>
<td>Employee Strategy</td>
<td>Recruit for growth</td>
<td>Motivate, screen, cut</td>
</tr>
</tbody>
</table>
The Public Equity Markets
Public Equity Offerings – Number of Transactions

<table>
<thead>
<tr>
<th>Category</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPO</td>
<td>396</td>
<td>438</td>
</tr>
<tr>
<td>ADR IPOs</td>
<td>48</td>
<td>6</td>
</tr>
<tr>
<td>Follow-On Offerings</td>
<td>425</td>
<td>438</td>
</tr>
<tr>
<td>Convertibles</td>
<td>197</td>
<td>299</td>
</tr>
</tbody>
</table>

Source: Equidesk
Public Equity Offerings – Dollar Amounts

IPO

ADR IPOs

Follow-On Offerings

Convertibles

($ in billions)

$0

$25

$50

$75

$100

$125

2000

2001

Source: Equidesk
IPOs – Number of Transactions – at Pricing

- **Above Range**: 165 in 2000, 33 in 2001
- **In Range**: 146 in 2000, 35 in 2001
- **Below Range**: 85 in 2000, 24 in 2001

Source: Equidesk
Size Matters

- Despite 4x fewer IPOs in 2001 than 2000, the average deal size rose approximately 134% to $419 million.

- 11% of the IPOs completed in 2001 raised over $1 billion versus 4% in 2002.

- 45% of the dollars raised from IPOs in 2001 came from 4 deals.

- Current backlog consists of 25 IPOs seeking to raise $2.9 billion for an average deal size of $116 million.
2001 IPO Market by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Count</th>
<th>Profitability</th>
<th>YTD Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Healthcare</td>
<td>29</td>
<td>11.7%</td>
<td>17.2%</td>
</tr>
<tr>
<td>Technology</td>
<td>20</td>
<td>25.7%</td>
<td>41.1%</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>11</td>
<td>8.3%</td>
<td>-4.8%</td>
</tr>
<tr>
<td>Finance</td>
<td>6</td>
<td>10.7%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>Insurance</td>
<td>5</td>
<td>8.1%</td>
<td>19.9%</td>
</tr>
<tr>
<td>Professional Services</td>
<td>5</td>
<td>2.9%</td>
<td>19.8%</td>
</tr>
</tbody>
</table>

1) Sectors with five or more 2001 US Marketed IPOs

- In 2001 50% of IPO companies were profitable vs. 24% for 2000.

Source: Equidesk
Public Equity Markets Summary

- **IPOs** ➔ **Tight – market slowly coming back**
- **Follow-on Offerings** ➔ **Available to larger established companies**
- **Convertibles** ➔ **Available to larger established companies**
- **PIPEs** ➔ **Available**
Private Investments in Public Entities – PIPEs
PIPE Issuers – Typical Characteristics

- Low institutional ownership.
- "Fallen angel" – reduced research coverage by Wall Street.
- Public capital market constraints.
- Dramatic decrease in share price.
- Immediate need for cash infusion.
PIPEs – Structural Issues

- Common security with warrants.
  - Discount of 5% to 20%.

- Common security with resettable warrants.
  - Dependent on future stock performance.

- Common stock issued off of a shelf registration.
  - Shortens time to market.

- Convertible security with warrants.
  - 5% to 25% conversion premium.
  - Coupon of 4% - 7%.
PIPE Transaction Volume

Completed Deals
($ in Millions)

Number of Deals
- $1,411
- $4,091
- $5,368
- $2,886
- $10,403
- $24,491
- $13,717

Dollar Amount
- $1,411
- $4,091
- $5,368
- $2,886
- $10,403
- $24,491
- $13,717

Source: Placement Tracker
## Top 10 PIPE Investors

<table>
<thead>
<tr>
<th></th>
<th>Name</th>
<th>Count</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Vulcan Ventures, Inc.</td>
<td>17</td>
<td>$1,795,653,452</td>
</tr>
<tr>
<td>2</td>
<td>Forstmann Little &amp; Company</td>
<td>6</td>
<td>$1,601,750,000</td>
</tr>
<tr>
<td>3</td>
<td>Janus Capital Corporation</td>
<td>11</td>
<td>$1,581,560,000</td>
</tr>
<tr>
<td>4</td>
<td>Hicks, Muse, Tate &amp; Furst, Inc.</td>
<td>6</td>
<td>$1,015,000,000</td>
</tr>
<tr>
<td>5</td>
<td>E.M. Warburg, Pincus &amp; Co., LLC</td>
<td>29</td>
<td>$884,233,073</td>
</tr>
<tr>
<td>6</td>
<td>Rose Glen Capital Management, L.P.</td>
<td>86</td>
<td>$737,590,195</td>
</tr>
<tr>
<td>7</td>
<td>Microsoft Corporation (Nasdaq: MSFT)</td>
<td>8</td>
<td>$560,555,200</td>
</tr>
<tr>
<td>8</td>
<td>Citadel Investment Group, Inc.</td>
<td>82</td>
<td>$553,380,482</td>
</tr>
<tr>
<td>9</td>
<td>Angelo, Gordon &amp; Co., L.P.</td>
<td>77</td>
<td>$508,707,011</td>
</tr>
<tr>
<td>10</td>
<td>Putnam Investment Management, Inc.</td>
<td>31</td>
<td>$496,453,717</td>
</tr>
</tbody>
</table>

Note: 1995 through Q3 2001
Benefits to the Issuer

- Process increases exposure to sophisticated investors.

- Market is comprised of accredited investors, including: private equity funds, crossover funds, and hedge funds.

- Offering process provides the Company with structuring flexibility and the ability to deliver comprehensive presentations that explain the business model.

- Highly creative and tailored structures. Structuring flexibility allows for offering to consist of common stock, convertible preferred stock, delayed registration convertibles or debt.

- Return parameters depend upon the type of investor - financial or strategic - and typically range from 15% to 40%.
Disadvantages to the Issuer

- Investor will require a discount to market.

- Limited number of "blackout" periods for the issuer during effectiveness period of resale registration statement.

- Can only be marketed to accredited investors.

- Cannot sell more than 20% of issuer’s outstanding stock without receiving prior stockholder approval.
Interneuron Pharmaceuticals, Inc. – PIPE Case Study

3,125,000 Shares

Private Placement
of Common Stock

Legg Mason Wood Walker
Incorporated
The Private Equity Markets
Private Equity Markets Summary

- No standout industry for new investment.
- Investment in existing portfolio projects and follow on financings.
- No liquidity (lack of an IPO market or attractive M&A exit multiple).
Private Equity Markets Summary

- Deal flow has slowed dramatically.

- Investment pace down 53% YTD Q3 2001 over YTD Q3 2000.

- Quality improving slowly.
  - More experienced management teams with solid business plans.
  - Recreational entrepreneur has gone home.

- Prices on average are declining.
  - 60+% declines on average deals; tracking the public market risk premium.
  - Two classes of deals: price elastic and price inelastic.
  - Pricing gets worse with low demand, low cash, high expenses.
Private Equity Markets

Source: Venture One
Investments in Venture-Backed Companies by Industry

Amount Invested
3Q 2001 ($6.5 Billion)

Amount Invested
Year to Date 2001 ($25.5 Billion)

Source: Standard & Poor's
Investments in Venture-Backed Companies by Stage of Development

Dollars Invested Q3 2001 ($6.5 Billion)

- Early: 34%
- Expansion: 46%
- Profitable: 3%
- Restart: 0%
- Confidential/Undisclosed: 15%
- Start-up/Seed: 2%

Source: Standard & Poor's
Commitments to Venture Capital Funds – “Money is Available”

Source: Venture One
Median Pre-money Valuation by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Pre-money Valuation ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>$8</td>
</tr>
<tr>
<td>1993</td>
<td>$9</td>
</tr>
<tr>
<td>1994</td>
<td>$11</td>
</tr>
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<td>1995</td>
<td>$10</td>
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<tr>
<td>1996</td>
<td>$12</td>
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<td>1997</td>
<td>$13</td>
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<tr>
<td>1998</td>
<td>$16</td>
</tr>
<tr>
<td>1999</td>
<td>$23</td>
</tr>
<tr>
<td>2000</td>
<td>$27</td>
</tr>
<tr>
<td>YTD01</td>
<td>$19</td>
</tr>
</tbody>
</table>

Source: Venture One
Median Pre-money Valuation by Round Class

Source: Venture One
Median Pre-money Valuations by Industry

Source: Venture One
The Debt Markets
Credit quality is the primary concern among senior lenders.

- Deteriorating credit quality in existing portfolios.
- External regulatory scrutiny.

Pricing is at record levels in the leveraged market for both spreads and upfront fees.

Declining leverage multiples.

Increased equity contributions to leveraged buyouts.

Tightening of financial covenants and more aggressive amortization schedules.
The Senior Bank Debt Market

Average Debt Multiples of Highly Leveraged Loans

- Senior Debt
- Subordinated Debt

<table>
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<tr>
<th>Year</th>
<th>Multiple of EBITDA</th>
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<tr>
<td>1995</td>
<td>3.3x</td>
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<tr>
<td>1996</td>
<td>3.5x</td>
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<tr>
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Average New Issues BB/BB- Spreads

- Institutional
- Pro Rata

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<td>2001 Q1</td>
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</tr>
<tr>
<td>2001 Q2</td>
<td>320</td>
</tr>
</tbody>
</table>

Source: Portfolio Management Data
Alternatives to Traditional Senior Bank Debt

Asset Based Financing

- Non-bank institutions are filling the void.

- Loans are subject to advance rates against inventory, receivables and plant, property and equipment.

- Borrower receives more flexibility and lenders receive more security.

- Often deemed to be counter cyclical.

- “Lender of last resort” stigma is no longer relevant.
Alternatives to Traditional Senior Bank Debt

*Mezzanine / Subordinated Debt*

- Tremendous capacity from a variety of players – banks, institutional funds, hedge funds, insurance companies.

- Lenders seeking an all-in rate of return of 18% - 25%.

- Flexibility in structure and type of security.
  - All coupon.
  - Warrants.

- Longer term and modest amortization requirements.

- Flexible covenant and security package.
Implications for Private Companies
Implications for Private Companies

*Short term, it's about survival*

- Don't cut it too close.
- Don't run out of money, extend the runway.
- Don't count on a recovery anytime soon.
- Be realistic on valuation vs. capital availability.
- Plan on more modest amounts of financing.
THE NEW SEC and CORPORATION FINANCE UPDATE

Jeffrey J. Minton
Division of Corporation Finance
U.S. Securities and Exchange Commission
Washington, D.C.

The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any of its employees. This outline was prepared by members of the staff of the Division of Corporation Finance and does not necessarily reflect the views of the Commission, the Commissioners or other members of the staff.

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I. DIVISION ORGANIZATION AND EMPLOYMENT OPPORTUNITIES

The Division’s organizational structure is as follows:

Division Director
- David B. H. Martin (202) 942-2800
Deputy Director
- Michael McAlevey (202) 942-2810
Senior Counsel to the Director
- Anita Klein (202) 942-2980

Operations

Principal Associate Director (Disclosure Operations)
- Shelley Parratt (202) 942-2830
Associate Director (Disclosure Operations)
- James Daly (202) 942-2881
Associate Director (Disclosure Operations)
- William L. Tolbert, Jr. (202) 942-2891
Senior Special Counsel (Regulatory Policy)
- James Budge (202) 942-2800
Office of EDGAR and Information Analysis
- Herbert Scholl, Chief (202) 942-2930

Disclosure Support

Associate Director (Legal)
- Martin P. Dunn (202) 942-2890

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1 These are the 2001 quarterly updates to the Securities and Exchange Commission Division of Corporation Finance’s Current Issues and Rulemaking Projects outline. Issuance of the first quarterly update dated March 31, 2001 reflected a new approach by the Division of Corporation Finance. Previously, the Division revised the entire outline periodically by adding new material and deleting dated sections. The users of the outline expressed concern regarding the increasing size of the outline, difficulties in focusing on new material and the loss of deleted sections that continued to include useful, if no longer new, material. In response to these concerns, the Division will leave the most recent version of the complete outline (November 14, 2000) on the Commission’s web site and will publish quarterly updates throughout the year. Those quarterly updates will then be combined with updates from the fourth quarter to comprise an annual update to the outline.
Office of Chief Counsel
   - Paula Dubberly, Chief (202) 942-2900
Office of Rulemaking
   - Elizabeth Murphy, Chief (202) 942-2910
Associate Director (Regulatory Policy)
   - Mauri Osheroff (202) 942-2840
Senior Special Counsel (Regulatory Policy)
   - Mark W. Green (202) 942-2840
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 Small Business Policy
   - Richard Wulff, Chief (202) 942-2950
Associate Director (Chief Accountant)
   - Robert Bayless (202) 942-2850

Assistant Directors

Health Care and Insurance
   - Jeffrey P. Riedler (202) 942-1840
Consumer Products
   - Christopher Owings (202) 942-1900
Computers and Office Equipment
   - Barbara Jacobs (202) 942-1800
Natural Resources
   - Roger Schwall (202) 942-1870
Structured Finance, Transportation and Leisure
   - Max Webb (202) 942-1850
Manufacturing and Construction
   - Steven Duvall (202) 942-1950
Financial Services
   - Todd Schiffman (202) 942-1760
Real Estate and Business Services
   - Karen Garnett (202) 942-1960
Small Business
   - John Reynolds (202) 942-2950
Electronics and Machinery
   - Peggy Fisher (202) 942-1880
Telecommunications
   - Barry Summer (202) 942-1990
Division Employment Opportunities for Accountants and Attorneys

Accountants

The Division has about 104 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

The Division has about 147 attorneys who process filings and draft and interpret regulations. Every year, we recruit top law school graduates, and from time to time have positions for lateral applicants with solid legal skills and experience. Applicants should demonstrate an ability to accept major responsibilities. We prefer applicants who have had 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, including those relating to mergers and acquisitions. The positions involve working directly with companies, their executives, underwriters and investment banking firms, outside counsel and outside accountants. The work involves innovative financing and business structures. Interested persons should send resumes to—Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

II. MERGERS AND ACQUISITIONS

A. Option Exchange Offers

1. Introduction

On March 21, 2001, the Division of Corporation Finance, pursuant to delegated authority from the Commission, issued an exemptive order (<<http://www.sec.gov/divisions/corpfin/repricing.htm>>) under the Securities Exchange Act of 1934 (Exchange Act) for issuer exchange offers that are conducted for compensatory purposes. The order exempts these exchange offers from Rules 13e-4(f)(8)(i) and (ii), the all holders and best price rules, so long as the following conditions are met:
• the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered in the exchange offer will be issued under such an employee benefit plan;

• the exchange offer is conducted for compensatory purposes;

• the issuer discloses in the offer to purchase the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and

• except as exempted in this order, the issuer complies with Rule 13e-4.

2. Background

The Division of Corporation Finance has become aware of issuers conducting exchange offers to reprice their employees' stock options. The structure of these exchange offers varies from issuer to issuer and is based upon their compensation policies and practices. Frequently these exchange offers will require option holders to agree to revised vesting or exercisability terms or to accept a reduced number of securities in exchange for receiving a lower exercise price. The new options or other securities offered in exchange for existing options may be registered under the Securities Act of 1933 (Securities Act), but generally are offered in reliance on an exemption from registration, typically Section 3(a)(9) of the Securities Act.

These offers commonly involve securities issued through broad-based plans, are open to a large number of employees, are not limited to executive or senior officers of the issuers, are not privately negotiated compensation arrangements, have fixed terms, and are open for a limited period of time. Unlike the situation where an issuer unilaterally reprices its options, the option holders have individual decisions to make. Further, the decision whether to accept the offer is an investment decision and not merely a compensation decision. These exchange offers are subject to the issuer tender offer rule, Rule 13e-4 under the Exchange Act, if the issuer has a class of equity securities registered under Section 12 or is required to file reports under Section 15(d) of the Exchange Act.

The exemptive order eliminates the limitations that the all holders and best price rules place on issuers' ability to structure exchange offers consistent with their compensation policies and practices. This will reduce the burdens and costs to issuers that otherwise must seek individual exemptions from the Division. We believe that these exchange offers do not present the same concerns caused by discriminatory treatment among security holders that these rules were intended to address.
3. Disclosure and Processing

Issuers that are subject to Rule 13e-4 are reminded that the remaining provisions of Rule 13e-4, as well as Regulation 14E, apply to these exchange offers. A Schedule TO-I must be filed at the time the exchange offer commences, and the disclosure required by the schedule must be disseminated to option holders in accordance with Rule 13e-4. The disclosure items of the Schedule TO-I must be complied with in the offer to purchase only to the extent applicable. The items do not require a response in the offer to purchase if they are not applicable to the offer. The disclosure should set forth clearly the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer. The disclosure also should include financial information about the issuer, which generally is material to the option holders' investment decisions. See Item 10 of Schedule TO. The financial information in the disclosure may be in summary form if the issuer incorporates its financial statements by reference into the schedule and offer to purchase. See Instruction 6 to Item 10 of Schedule TO.

We understand that issuers contemplating option exchange offers are concerned that staff review may cause issuers to incur additional costs to disseminate revised materials in response to staff comments and also may cause offers to be extended. The Division always balances the necessity of staff review with the best use of staff resources. These types of exchange offers are conducted for compensatory purposes and are less likely to raise the concerns that often are present in non-compensatory tender offers. In this regard, the Division staff's decision to review these exchange offers will take into account the presence of the disclosure discussed above. Issuers should note that they are responsible for full compliance with Rule 13e-4 whether or not the staff reviews the filings. Issuers also are reminded of their disclosure obligations under Item 402 of Regulations S-K and S-B and under generally accepted accounting principles.

Issuers or their counsel should contact the Office of Mergers & Acquisitions at (202) 942-2920 if they have questions about the exemptive order or compensatory option exchange offers generally.

III. ELECTRONIC FILING AND TECHNOLOGY

A. Electronic Signatures in Global and National Commerce Act

In 2000, Congress enacted the Electronic Signatures in Global and National Commerce Act ("E-SIGN") to promote the use of electronic records and signatures in interstate and foreign commerce. Among other things, E-SIGN provides that, if a state or federal law requires that information be retained, this requirement may be satisfied by retaining an electronic record of the original document that accurately reflects the information set forth on the original and remains accessible to all persons who are entitled to access, in a format that is capable of being accurately reproduced for later reference.
As prompted by E-SIGN, the Division undertook a review of the rules under the Securities Act of 1933, the Securities Exchange Act of 1934 and Regulation S-T in order to identify provisions where issuers are required to maintain records. Four significant areas were identified:

- the rules requiring five-year retention of manually-signed signature pages or other documents ("authentication documents") that appear in typed form within documents, such as prospectuses and periodic reports, which are filed with the Commission via EDGAR or which are permitted to be filed in paper form;

- the rule requiring five-year retention of documents comprising a Form S-8 prospectus;

- the rule requiring five-year retention of each publicly distributed document, in the format used, that contains graphic, image, audio or video material where such material is not included in the electronic version filed with the Commission; and

- the rule requiring two-year retention of written representations by persons subject to the reporting requirements of Section 16(a) of the Exchange Act that they were not required to file an annual statement of beneficial ownership of securities on Form 5.

On June 14, 2001, the Commission issued an interpretive release providing guidance on the application of E-SIGN to these recordkeeping requirements (Release No. 33-7985). The release provides that E-SIGN is not applicable to authentication documents since these records are generated principally for governmental purposes. It states that issuers should continue to retain paper copies of these documents. The release also provides that the other identified records may be retained in electronic form, as long as the method selected for retention provides the same assurances of accuracy and accessibility as are provided by paper retention.

B. Mandated Electronic Filing for Foreign Issuers
(See Section V. “Internationalization of the Securities Markets” below)

IV. SMALL BUSINESS ISSUES

A. Small Business Initiatives

The 20th Annual Government-Business Forum on Small Business Capital Formation was held in Washington D.C. on September 6-7, 2001. This platform for small business is the only governmental-sponsored national gathering for small business, which offers annually the opportunity for small businesses to let government officials know how laws, rules and regulations are affecting their ability to raise capital. The next Government-Business Forum will be in September of 2002.
V. INTERNATIONALIZATION OF THE SECURITIES MARKETS

A. Confidential Processing of Foreign Issuer Filings

Filings by public companies are generally available to the public, including filings of amendments to remedy disclosure deficiencies identified by staff reviewers. The Division of Corporation Finance staff recognizes that foreign private issuers and foreign governments often face unique circumstances when accessing the US markets. This is particularly true when a foreign registrant's securities trade publicly in its home market, and the company will be making new and different disclosure as a result of its registration with the SEC.

To address these concerns, the staff often reviews and screens draft submissions of foreign registrants on a non-public basis. The staff, however, is revising its practice in this area. The staff generally will continue to accept on a draft basis registration statements in connection with an issuer's initial registration with the SEC. Except in unusual circumstances, however, once a foreign issuer has registered a transaction under the Securities Act or a class of securities under the Exchange Act, the staff no longer will accept from that issuer additional registration statements on a draft basis and will not review or screen a registration statement until it is publicly filed.

The timing and scope of staff review of draft registration statements is generally the same as for publicly filed registration statements. Foreign issuers are reminded that, when draft registration statements are submitted to the staff, the documents should be complete, as described in "International Financial Reporting and Disclosure Issues," available on the SEC's website. The Division's Office of International Corporate Finance should be contacted in advance of any draft submission.

B. International Disclosure Standards-Amendments to Forms 20-F, F-2 and F-3

On June 15, 2001, the Commission adopted technical amendments to Form 20-F, the basic Exchange Act registration statement and annual report form used by foreign issuers, and to Forms F-2 and F-3 under the Securities Act of 1933 (Release No. 33-7983). The amendments clarify language in the forms that could create confusion as to the forms' disclosure requirements.

The forms were last revised by the Commission on September 28, 1999 (Release No. 33-7745). As revised, Instruction 1 to Item 8.A.4 incorrectly implied that audited financial information for a period of less than a full year would satisfy the requirement that audited annual financial statements are no more than 15 months old at the time of the offering or listing. The technical amendments clarify that a foreign private issuer cannot satisfy the 15-month audited annual financial statement requirement by filing financial statements that cover less than a full fiscal year, even if those statements are audited. Audited financial statements for a period of less than a full year, however, will continue to satisfy
the requirement that the audited financial statements in an initial public offering are no
more than 12 months old at the time of the filing.

The amendments also codify the long-standing practice of accepting two years audited
income statement and statement of cash flows information if the financial statements are
presented in accordance with U.S. GAAP, and conform Item 3.A (Selected Financial
Data) of Form 20-F by adding an instruction to include predecessor information as
already required in Instruction 1 to Item 8 (Financial Information).

Finally, the amendments correct various cross-references in Forms F-2 and F-3 under the
Securities Act. The amendments were necessary only to clarify language in the forms, and
do not alter the current disclosure requirements for companies filing on the forms.

C. Mandated Electronic Filing for Foreign Issuers

On September 28, 2001, the Commission proposed for public comment rule and form
amendments that would require foreign private issuers and foreign governments to file
electronically their securities documents through the Commission's Electronic Data
Gathering, Analysis, and Retrieval (EDGAR) system (Release No. 33-8016). Currently,
the Commission's rules only permit, but do not require, foreign issuers to file their
securities documents on EDGAR. By mandating the electronic filing of foreign issuers'
securities documents on EDGAR, the Commission seeks to achieve the same investor
benefits and the same efficiencies in information transmission, dissemination, retrieval
and analysis realized since it mandated EDGAR filing for domestic issuers.

Mandated EDGAR filing benefits investors by making available to the public information
contained in Commission filings soon after the Commission has received them. Filers
benefit from electronic filing requirements since the electronic format facilitates research
and data analysis, thereby fostering increased market exposure for their securities. Filers
also benefit from the speedy and secure delivery afforded by EDGAR filing as well as
from the efficiencies achieved in the Commission's review and processing of their filings.

The proposal in the release would amend Regulation S-T, the Commission's rules
governing electronic filing, to eliminate the foreign issuer exception from mandated
EDGAR filing for most Securities Act and Exchange Act documents. The proposed
amendments would require the electronic filing of

- foreign private issuers' Securities Act registration statements and Exchange Act
  registration statements and reports;

- foreign governments' Securities Act registration statements and Exchange Act
  registration statements and reports;

- Multijurisdictional Disclosure System forms filed by Canadian issuers;
• statements of beneficial ownership on Schedules 13D and 13G and tender offer schedules that pertain to the securities of a foreign issuer, whether filed by a foreign or domestic person;

• Form CB, the form used for cross-border rights offers, exchange offers and business combinations that are exempt from the tender offer rules or Securities Act registration, if the filer or the subject company is an Exchange Act reporting company; and

• most Trust Indenture Act forms.

The proposed amendments would further

• permit, but not require, a foreign issuer to file a Form 6-K electronically if the sole purpose of the Form 6-K is to submit the foreign issuer's attached annual report to security holders;

• permit, but not require, supranational entities, such as the World Bank, to file their reports electronically;

• continue to require documents submitted under Exchange Act Rule 12g3-2(b) to be in paper only;

• eliminate the option that currently exists for paper filers to provide an English language summary of a foreign language exhibit instead of a complete English translation; and

• provide a transition period of four months from the date of the adopting release before the amendments would become effective.

Comments on the proposals should be submitted by December 3, 2001.

VI. OTHER PENDING RULEMAKING AND RECENT RULE ADOPTIONS

A. Pending Rulemaking

1. Proposed Equity Compensation Plan Disclosure

As the use of equity compensation, particularly stock options, has increased in recent years, so too have concerns about the impact of these programs. These concerns involve (a) the absence of full disclosure to security holders about equity compensation plans, (b) the potential dilutive effect of these plans and (c) the adoption of many plans without the approval of security holders.

On January 26, 2001, the Commission proposed amendments to its rules and forms that would require registrants to disclose, at least annually, information about the total number
of securities that have been authorized for issuance under their equity compensation plans in effect as of the end of the last completed fiscal year, whether or not the plans have been approved by security holders (Release No. 33-7944). Specifically, the proposed amendments would require disclosure in a registrant's proxy statement or annual report on Form 10-K or 10-KSB of the following:

- the number of securities authorized for issuance under each equity compensation plan of the registrant in effect as of the end of the most recently completed fiscal year;
- the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year, under each plan;
- the number of securities to be issued upon the exercise of outstanding options, warrants or rights under each plan; and
- other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for future issuance under each plan.

This disclosure would be set forth in a tabular format in the registrant's proxy or information statement whenever the registrant is seeking security holder action regarding a compensation plan or in the registrant's annual report on Form 10-K or 10-KSB in years when the registrant is not seeking security holder action regarding a compensation plan. The time period for submitting comments on these proposals ended on April 2, 2001.

B. Recent Rule Adoptions

1. Integration Safe Harbors for Abandoned Offerings

On January 26, 2001, the Commission adopted new Securities Act Rule 155 (Release No. 33-7943). This rule provides safe harbors from integration for a registered offering following an abandoned private offering, or a private offering following an abandoned registered offering. For purposes of these safe harbors, Rule 155(a) defines a "private offering" as an unregistered offering of securities that is exempt from registration under Section 4(2) or 4(6) of the Securities Act or Rule 506 of Regulation D under the Securities Act.

The conditions of the Rule 155(b) private-to-registered safe harbor are as follows:

- No securities were sold in the private offering;
• The issuer and any person(s) acting on its behalf terminate all offering activity in the private offering before the issuer files the registration statement;

• Any prospectus filed as part of the registration statement discloses information about the abandoned private offering, including

  • the size and nature of the private offering,
  • the date on which the issuer terminated all offering activity in the private offering,
  • that any offers to buy or indications of interest in the private offering were rejected or otherwise not accepted, and
  • that the prospectus delivered in the registered offering supersedes any selling material used in the private offering; and

• The issuer does not file the registration statement until at least 30 calendar days after termination of all offering activity in the private offering unless the issuer and any person acting on its behalf offered securities in the private offering only to persons who were (or who the issuer reasonably believes were) accredited investors or sophisticated.

The conditions of the Rule 155(c) registered-to-private safe harbor are as follows:

• No securities were sold in the registered offering;

• The issuer withdraws the registration statement;

• The issuer and any person acting on its behalf do not commence the private offering earlier than 30 calendar days after the effective date of withdrawal of the registration statement;

• The issuer notifies each offeree in the private offering that

  • the offering is not registered under the Securities Act,
  • the securities will be "restricted securities" as defined in Rule 144 and cannot be resold without registration unless as an exemption is available,
  • purchasers do not have the protection of Section 11 of the Securities Act, and
  • a registration statement for the abandoned offering was filed and withdrawn, specifying the effective date of the withdrawal; and

• Any disclosure document used in the private offering discloses any changes in the issuer's business or financial condition that occurred after the issuer filed the registration statement that are material to the investment decision in the private offering.
To facilitate reliance on the registered-to-private safe harbor, Rule 477 was amended to provide automatic effectiveness for an application to withdraw an entire registration statement that has not yet become effective, unless the Commission objects within 15 days after the issuer files the application.

Rules 429 and 457 were amended to move the provisions addressing the offset of filing fees from Rule 429 to Rule 457. Amended Rule 429 continues to address combined prospectuses.

Amended Rule 457 provides that where all or a portion of the securities offered remain unsold after a completion or termination of a registered offering, or withdrawal of the registration statement, the aggregate total dollar amount of the filing fee associated with those unsold securities may be offset against the total filing fee due for one or more subsequent registration statements. The subsequent registration statement(s) must be filed within five years of the initial filing date of the earlier registration statement, and must be filed by the same registrant (including a successor within the meaning of Rule 405), a majority-owned subsidiary of that registrant, or a parent that owns more than 50 percent of the registrant's outstanding voting securities.

Amended Rule 457 also provides as follows:

- If a filing fee is paid for the registration of an offering and the same registration statement also covers the resale of the securities, no additional filing fee is required to be paid for the resale;

- Payment of a filing fee is not required for the registration of an indeterminate amount of securities to be offered solely for market-making purposes by an affiliate of the issuer; and

- A registration fee may be calculated on the basis of the maximum aggregate offering price of the securities, without regard to whether the securities are offered by the issuer or selling shareholders.

The effective date for the new rule and the amendments is March 7, 2001.

VII. STAFF LEGAL BULLETINS FOR DIVISION OF CORPORATION FINANCE

A. Addendum to Staff Legal Bulletin No. 1 (CF) – Confidential Treatment Requests

On July 11, 2001, the Division republished Staff Legal Bulletin No.1, with an addendum. The bulletin deals with processing of confidential treatment requests filed in connection with filings under the Securities Act and the Exchange Act. The addendum gives guidance on two issues. First, it specifies that requests for confidential treatment of the
application itself and supporting documentation must be made under Securities Act Rule 406 or Exchange Act Rule 24b-2, whichever is appropriate for the underlying exhibit. Second, the addendum describes the lengths of time we will consider granting extension for confidential treatment of exhibits whose original grants are about to expire.

C. **Staff Legal Bulletin No. 14 (CF) – Rule 14a-8**

Staff Legal Bulletin No. 14 relates to Rule 14a-8 under the Exchange Act. The Division structured the legal bulletin with three overriding purposes in mind, namely, to explain the Division’s role in the Rule 14a-8 no-action process, to provide guidance on a variety of Rule 14a-8 issues, and to suggest ways to facilitate the Division’s review of Rule 14a-8 no-action requests. The legal bulletin addresses procedural matters that are common to shareholders and companies alike and provides a consolidated restatement of many of the Division’s current practices.

VIII. **CURRENT DISCLOSURE, LEGAL AND PROCESSING ISSUES**

A. **Disclosure, Legal and Processing Issues**

1. **Cover Page Gatefold for Registered Public Offerings**

In many registered public offerings, issuers choose to include text and/or artwork inside the front and back cover pages. Graphics depicting a registrant's products or services, or explaining how they are used, can be very helpful to investors – particularly when the products or services relate to a complex process or technical industry. In order to avoid significant reprinting costs, we will review proposed gatefold and other graphic presentations as soon as they are available. Most of our comments are based on the following staff concerns:

- The graphics don't accurately represent current business – for example, the depiction of products that do not exist yet or are not the registrant's products, the selective one-sided presentation of only the most favorable aspects of a registrant's business, excessive hyping, the inclusion of testimonials or statistical data that are taken out of context, or the identification of customers or other third parties upon which the registrant is not substantially dependant;

- The text in the graphics does not adhere to plain English principles – for example, the use of technical industry jargon and terms that are unfamiliar to the average investor or the inclusion of extensive narrative text which repeats information already contained in the summary or business sections; and

- The graphics detract from other prospectus disclosure because it is too confusing or obscure.
The gatefold for each registrant is unique, and we take into account all the information we have learned about the registrant and its industry when we review it. Sometimes the gatefolds for two different registrants seem similar at first glance, but they may raise significant staff concerns in one instance and not in the other, based on the unique facts of each registrant.

Registrants and underwriters can expedite staff review and reduce the number of staff comments if they keep in mind our concerns when they are preparing their gatefold and other graphic presentations.

2. **Section 12 Registration Relief Involving Employee Stock Option Plans**

Companies have granted stock options to broad based groups of employees under stock option plans in anticipation of going public within a short time after the stock option grants. These stock options are granted under stock option plans established for compensatory purposes. Many companies are now finding that they have granted stock options to 500 or more employees and their plans to go public have been delayed.

Under Section 12(g) of the Exchange Act, an issuer with 500 holders of record of a class of equity security and assets in excess of $10 million at the end of its most recently ended fiscal year must register the class of equity security, unless it has an exemption from registration. Stock options are a separate equity security under the Exchange Act. Accordingly, an issuer with 500 or more option holders and more than $10 million in assets is required to register that class under the Exchange Act, absent an exemption. The exemption from registration under Section 12(g) contained in Rule 12h-1(a) for "[a]ny interest or participation in an employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plan which is not transferable by the holder except in the event of death or mental incompetency, or any security issued solely to fund such plans" does not apply to stock options.

Beginning in 1991, the Commission by order, and subsequently the staff by no action letter, exempted or relieved issuers with 500 or more stock option holders from having to register their stock options under the Exchange Act when specified conditions were present. For the conditions necessary to receive relief under these letters and orders see, for example, the no action letter to Mitchell International Holdings, Inc. (available December 27, 2000).

Due to current market conditions, which are delaying the plans of many companies to go public, we are revising the conditions necessary to receive relief from registering their employee stock options under Section 12(g). As in the past, any relief granted by the staff would apply only to the stock options. Once a company has 500 holders of record of any other class of equity securities (e.g., common stock outstanding as a result of stock issuances, including option exercises), it would be required to register that class. The modified conditions would need to be present only when the company is relying on the relief.
We will consider granting relief in situations where the conditions of our prior no action letters noted above are met with the following modifications:

- The options may be immediately exercisable.
- Former employees may retain their vested options.
- As with the current conditions, the options must remain non-transferable in most cases. However, we will permit the options to transfer on death or disability of the option holder. The stock received on exercise of the options may not be transferable, except back to the company or in the event of death or disability.
- Consultants may participate in the option plan if they would be able to participate under Rule 701. We encourage you to review the adopting releases effecting the recent changes to Rule 701 and Form S-8 to understand the categories of consulting services that fall within this group. See Releases 33-7645 and 33-7646.

We will premise any changes in our current position on option holders receiving essentially the same Exchange Act registration statement, annual report and quarterly report information they would have received had the company registered the class of securities under Section 12, including audited annual financial statements and unaudited quarterly financial information, each prepared in accordance with GAAP.

April 30, 2001 is the filing date for registration statements of issuers that met the Section 12(g) registration requirement as of December 31, 2000. We will consider extending that filing date to July 30, 2001 for any issuer that has submitted a no-action request to us by April 30, 2001. Any questions may be directed to Amy Starr in the Office of the Chief Counsel, (202) 942-2900.

3. Equity Line Financings

[Note: The following discussion of our views replaces Interpretation No. 4S in the March 1999 Supplement to the Division’s Manual of Publicly Available Telephone Interpretations.]

a. Description of "Equity Line" Financing Arrangements

In a typical "equity line" financing arrangement, an investor and the company enter into a written agreement under which the company has the right to "put" its securities to the investor. Under this "put," the company has the right to tell the investor when to buy securities from the company over a set period of time and the investor has no right to decline to purchase the securities. The dollar value of the equity line is set in the written arrangement, but the number of shares that the company will actually issue is determined
by a formula tied to the market price of the securities at the time the company exercises its "put."

b. **Private Equity Lines with Registered Resales**

In many equity line financings, the company will rely on the private placement exemption from registration to sell the securities under the equity line and will then register the "resale" of the securities sold in the equity line financing. In these types of equity line financings, the delayed nature of the "puts" and the lack of market risk resulting from the formula price differentiate private equity line financings from financing PIPEs (private investment, public equity). We, therefore, analyze private equity line financings as indirect primary offerings.

While we analyze private equity line financings as indirect primary offerings, we recognize that the "resale" form of registration is sought in these financings. As such, we will permit the company to register the "resale" of the securities prior to its exercise of the "put" if the transactions meet the following conditions:

- The company must have "completed" the private transaction of all of the securities it is registering for "resale" prior to the filing of the registration statement.
- The "resale" registration statement must be on the form that the company is eligible to use for a primary offering.
- In the prospectus, the investor(s) must be identified as underwriter(s), as well as selling shareholder(s).

We have been asked a number of interpretive questions regarding private equity line financings.

**Q.** For the private transaction to be "complete," the investor must be irrevocably bound to purchase all the securities. How does this apply to the "put"?

**A.** Only the company may have the right to exercise the "put" and, except for conditions outside the investor's control, the investor must be irrevocably bound to purchase the securities once the company exercises the "put."

**Q.** If the investor is permitted to transfer its obligations under the equity line, will the transaction be "completed"?

**A.** No.

**Q.** If the investor has the ability to make investment decisions under the equity line agreement after the filing of the "resale" registration statement,
the investor will not be considered irrevocably bound. What are some structures that we consider to continue to provide the investor with an investment decision?

Examples that we have observed include:

- agreements that give investors the right to acquire additional securities (including the right to acquire additional securities through the exercise of warrants) at the same time or after the issuer exercises its "put";
- agreements that permit the investor to decide when or at what price to purchase the securities underlying the "put"; and
- agreements with termination provisions that have the effect of causing the investor to no longer be irrevocably bound to purchase the securities underlying the "put."

Q. Is a "due diligence out" a condition to closing within the investor's control that would prevent us from considering the transaction completed?

A. Yes.

Q. Are conditions such as (a)"bring downs" of customary representations or warranties and (b) customary clauses regarding no material adverse changes affecting the company conditions to closing within the investor's control that would prevent the private transaction from being completed?

A. No.

Q. If the company may "put" securities other than the shares of common stock being registered for "resale," such as a derivative security convertible into common stock (e.g., a convertible note or a convertible preferred security), would the private transaction be considered completed?

A. No. This is because the investor may have further investment decisions to make regarding the purchase of securities underlying the derivative security and will, therefore, not be irrevocably bound to purchase the securities that are being registered for "resale."

Q. If the above conditions are not met, can the company register the "resale" of the securities?

A. As a general matter, no. However, if the following conditions are met, the company may register the "resale" transaction, as these conditions address
our concerns regarding inappropriate use of shelf registration and liability for potential violations of Securities Act Section 5.

- The company is eligible to use Form S-3 or Form F-3 for a primary offering of securities.
- The company complies with Rule 415(a)(4).
- The company addresses, in the prospectus, issues relating to the potential violation of Section 5 in connection with the private transaction.

If the preceding three conditions are not met, the company must withdraw the registration statement and complete the private transaction. After the private transaction is completed, the ability to register the "resale" of the securities underlying the "put" would be analyzed in accordance with the views discussed in this section.

c. **Takedown Off an Issuer's Shelf Registration Statement for Equity Line Financings**

Some companies desire to register, as a primary offering, the issuance of the "put" securities under an equity line. We believe that an equity line financing done as a primary offering in which the "put" price is based on or at a discount to the underlying stock's market price at the time of the "put" exercise is an "at the market" offering under Rule 415(a)(4) and must comply with the requirements of that rule. In this regard, we have been asked the following questions regarding the application of Rule 415(a)(4):

**Q.** May the company and the investor enter into the equity line agreement before effectiveness of the Form S-3 or Form F-3?

**A.** As a general matter, no. However, the company and the investor may enter into the equity line agreement before effectiveness of the registration statement if the investor is a registered broker-dealer acting as an underwriter.

**Q.** Rule 415(a)(4)(iv) states "[t]he underwriter or underwriters must be named in the prospectus which is part of the registration statement." This leads to two questions:

- Is it appropriate to name the underwriter or underwriters in a prospectus supplement?

No. The registration statement must identify a registered broker-dealer as an underwriter, either in the base prospectus or a post-
effective amendment – it is not appropriate to rely on Rule 424 and use a prospectus supplement for this purpose.

- Who must be named as an underwriter?

The prospectus which is part of the registration statement must identify the investor, in addition to the registered broker dealer, as an underwriter.

Q. How do you calculate the 10% test in Rule 415(a)(4)(ii)?

A. The entire amount of securities available under the equity line may not exceed 10% of the aggregate market value of the company's outstanding voting stock held by non-affiliates.

Q. When do you calculate the 10% test in Rule 415(a)(4)(ii)?

A. This calculation is made at the later of the time the issuer enters into the equity line agreement or files the registration statement for the "at the market" offering.

Q. May the company and the investors amend the equity line financing arrangement later to permit the entire number of securities available under the equity line to exceed the 10% test?

A. No. The parties may not amend the agreement in order to exceed the 10% test; the company may not exceed the 10% test unless it enters into an entirely new agreement relating to a separate financing arrangement. In this regard, the company and the investors cannot have agreements to enter into new agreements – we believe that all currently anticipated agreements should be combined in determining the 10% threshold.

d. Division of Market Regulation Issues

There may be other issues relating to the underlying or "resale" transaction, including broker dealer registration, compliance with Regulation M or compliance with pre-filing requirements of the National Association of Securities Dealers. We encourage companies and investors to contact the Division of Market Regulation or the NASDR, as appropriate, regarding these issues.
B. Confidential Treatment of Supplemental Materials, Including Responses to Staff Comments

Issuers requesting confidential treatment of information submitted to the staff in other than a filing must rely on the procedural provisions of Rule 83 and Regulation S-T. Rules 406 and 24b-2 relate only to filed materials, not to materials submitted to the staff supplementally.

While Item 101(a) of Regulation S-T requires that all correspondence, including responses to staff comment letters, be filed in electronic format on EDGAR, confidential treatment cannot be granted for materials filed in electronic format. Confidential treatment can only be granted for information filed in paper.

If you wish to request confidential treatment for any portion of a supplemental submission, you must submit the supplemental submission on EDGAR with the information subject to the confidential treatment request omitted from the electronic submission. You must also submit the entire supplemental document to the staff in paper. You must mark the information for which you are requesting confidential treatment as sensitive or confidential in the paper copy and include the legend required by Rule 83.

1. Confidential Treatment Requests in Connection with Transactional Filings

We must complete the processing of all of an issuer’s pending applications for confidential treatment prior to taking action on a transactional filing. To avoid delays in the processing of transactional filings, it is helpful when an issuer notifies the examination staff of pending confidential treatment applications when a transactional filing is made. The notification can be part of the cover letter to the filing or can be made to the Office of the Assistant Director responsible for processing the issuer’s filings.

C. Industry-Specific Issues

1. Clarification of Oil and Gas Reserve Definitions and Requirements

The following are additions to the Division’s discussion regarding this matter in the November 14, 2000 Current Issues and Rulemaking Projects outline at Section VIII.A.16.

a. Determination of Reserves Under Production Sharing Agreements

Under Production Sharing Agreements, a host government typically retains the title to the hydrocarbons in place, although the contracting company usually assumes all the costs for exploration and carries all risks. When a discovery is made, the contract provides for the contracting company to recover all of its exploration and development expenditures and receive a share of profits, subject to certain limits. The amounts due to the contracting company are typically taken in kind.
In general, two methods of determining oil and gas reserves under production sharing arrangements have been proposed by registrants: (a) the working interest method and (b) the economic interest method. Under the working interest method, the estimate for total proved reserves is multiplied by the respective working interest held by the contracting company, net of any royalty. Under the economic interest method, the company's share of the cost recovery oil revenue and the profit oil revenue is divided by the year-end oil price, which represents the volume entitlement. The lower the oil price, the higher the barrel entitlement, and vice versa.

Reserve volumes determined by various owners should add up to 100% of the total field reserves, but that is not always the case using the working interest method. If the working interest is different from the profit entitlement, the economic interest method is the method acceptable to the staff because it is a closer representation of the actual reserve volume entitlement that can be monetized by a company. Also, use of the economic interest method avoids violating the prohibition in paragraph 10 of SFAS 69 against reporting reserves owned by others.

2. Sample Letter Sent to Coal Mine Operators Regarding Compliance with Industry Guide 7

(This letter is available at <<http://www.sec.gov/divisions/corpfin/guidance/coalmineletter.htm>>)

3. Accounting and Disclosure by Companies Engaged in Research and Development Activities

Biotechnology companies and others engaged in research and development activities often provide services and transfer rights under complex arrangements that present many accounting and disclosure issues. The arrangements may include payment terms that include receipt of up-front fees and milestone payments. These arrangements may include multiple elements such as product licensing agreements, manufacturing/supply agreements, royalty agreements, research and development agreements, and equity issuances, among others. Different methods of accounting for revenue and expense recognition may be appropriate under each of these arrangements. If these arrangements comprise a significant portion of revenues, clear and balanced disclosure should be provided about the terms of the arrangements, the methods of accounting for them, the specific risks and uncertainties associated with them, and their historical and expected effects on operations and financial position.

a. Revenue Recognition

Question 5 to SAB 101 advises that up-front fees, such as technology license fees, should be deferred and recorded over the term of the agreement unless it is clear that the earnings process is completed. In evaluating whether the earnings process is complete, the
perspective of the licensee must be considered. If the licensee requires from the registrant future products or services to exploit the license, the license fee ordinarily should be deferred because the earnings process is not complete.

Many arrangements provide for milestone payments to be received either based on the passage of time or the occurrence of specific events. The timing of milestone payments may be reflective simply of project financing terms, rather than representative of the culmination of any particular earnings process. Diversity in accounting for milestone payments exists. In some cases, registrants defer milestone payments and recognize contract revenue on a systematic basis corresponding with services, costs, or time. In other cases, registrants recognize milestone payments as earned upon the occurrence of contract-specified events, if those events coincide with the achievement of a substantive element in a multi-element arrangement or measure substantive stages of progress toward completion under a long-term contract.

To make the arrangements transparent to investors, the following disclosures are encouraged:

- **Business Discussion** – Describe each type of arrangement entered into by the company, explaining its business purposes and the underlying activities. Examples of agreement types are product/technology licenses, research and development agreements, production/supply agreements, royalty agreements, equity sales agreements, etc. Disclose the significant terms and characteristics of material agreements, including the various elements of products and services to be delivered by each party, the contract period, payment terms and amounts, obligations of the parties, events and circumstances that trigger milestone payments, and termination provisions. If the company has more than one arrangement with the same party, or that party has other types of relationships with the company, such as vendor, customer, or stockholder, discussion of the multiple relationships and arrangements together may be necessary for investor understanding.

- **Management's Discussion and Analysis** – Discuss the historical and expected effects of material new contracts and the achievement of revenue recognition milestones on operations and financial position. Disclose the amounts of material up-front and milestone fees scheduled to be received and to be recognized as revenue over each of the next five years. Material uncertainties affecting realization of fees should be highlighted.

- **Financial Statements** – Disclose your revenue recognition policies. Describe specifically how you apply your policies for each major revenue stream (i.e., research and development services, license agreements, product sales, consulting) and payment form (i.e., up-front fees, milestone fees, royalty payments). If different revenue recognition policies are followed for a particular major revenue stream or payment form due to varying facts, circumstances or contractual terms, each policy should be separately described. In many cases, especially for
recognition of milestone payments, it will be necessary to discuss the facts and circumstances resulting in the culmination of the earnings process. Disclose your accounting policies for multi-element arrangements. Disclose the major terms of material arrangements/agreements.

b. **Research and Development Expenses**

Many biotechnology registrants incur significant research and development expenses. Although these expenditures may represent the majority of the expenses for many of these registrants, the discussion of R&D expense in Commission filings is generally uninformative. As indicated in FRC 501.01, MD&A is intended to give an investor an opportunity to view a registrant through the eyes of its management. The following disclosures are encouraged to enhance an investor's understanding of the company's use and expected use of resources in R&D activities:

- **Business Discussion** – Disclose the nature and status of each major R&D project or group of related projects currently in process.

- **Management's Discussion and Analysis** – Disclose for major R&D projects or groups of related projects the costs incurred to date, the current status, and the estimated completion dates, completion costs and capital requirements. If estimated completion dates and costs are not reasonably certain, discuss those uncertainties. Disclose the risks and uncertainties associated with completing development projects on schedule and the consequences if they are not completed timely.

- **Financial Statements** – Disclose your accounting policies for internal research and development expenditures, research and development conducted for others, and research and development services for which you have contracted. Disclose the types of costs included in R&D costs, including salaries, contractor fees, building costs, utilities, administrative expenses and allocations of corporate costs. Disclose the amount of research and development expenses incurred in each year.

IX. **ACCOUNTING ISSUES**

A. **Auditor Association with Interim Financial Statements**

Rule 10-01(d) of Regulation S-X and Rule 310(b) of Regulation S-B require the review of interim financial statements by an independent public accountant prior to their filing in Form 10-Q or 10-QSB. The registrant is not required to state in the filing that the interim

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financial statements have been reviewed. A report of the independent public accountant is required to be included in the filing only if the registrant states that the financial statements have been reviewed. The interim review should be conducted in accordance with SAS 71. The AICPA's Professional Issues Task Force issued Practice Alert No. 2000-4, which provides auditors with important information they will need to consider for quarterly reviews of financial statements of public companies.

If the registrant fails to obtain a review of the interim financial statements prior to their filing in Form 10-Q or 10-QSB, the filing is deficient and the registrant is deemed not to be current or timely in its Exchange Act filings. If a review was not obtained, the staff believes the registrant should disclose in a headnote, under Item 1 of Part I and preceding the quarterly financial statements, that it did not obtain a review of the interim financial statements by an independent accountant using professional review standards and procedures, although such a review is required by the form. Completion of a review after the interim financial statements have been filed with the Commission will make the filing current, although it will not be deemed timely.

Auditors have professional responsibilities to consider when the registrant files interim financial statements in a Form 10-Q or 10-QSB that have not been reviewed. Unless otherwise disclosed in the filing, investors are likely to presume that the review required by the form has been performed by the auditor of record. If financial statements with which the independent accountant would be associated are included in a Form 10-Q or 10-QSB without the accountant's timely review, the auditor should consider Practice Alert 2000-4, AU§504 and Exchange Act Section 10A. Practice Alert 2000-4 advises that the auditor should consider discussing that failure with the company's audit committee and the company's legal counsel. If the deficiency is not immediately addressed through the accountant's completion of a review, the accountant should request that the client promptly amend the filing to disclose that the financial statements have not been reviewed by an independent accountant as required by the form. In addition, the auditor has a responsibility to follow the guidance in Section 10A. Under that section, if the company and its board fail to take appropriate remedial action with respect to an illegal act that is material to the financial statements, and the auditor reasonably expects to modify its report or resign due to the illegal act, then the auditor should report the violation of the law to the SEC.

B. Pooling-of-Interests Accounting

Following the tragic events of September 11, 2001, the Commission took temporary action in a series of emergency orders and interpretive releases to respond to market developments.

On September 14, 2001, the Commission issued an emergency order pursuant to Section 12(k)(2) of the Exchange Act with respect to several different matters, including a registrant's repurchase of its own securities under Exchange Act Rule 10b-18 (see Section XI below). One aspect of the order affects the Commission’s accounting rules.
In connection with registrant repurchases, the Commission ordered that, notwithstanding the current accounting literature, acquisitions by registrants of their own equity securities during the period from September 17, 2001 until September 21, 2001 will not affect the availability of pooling-of-interest accounting. (See Release No. 34-44791.)

On September 21, 2001, the emergency order was extended until September 28, 2001. (See Release No. 34-44827.) On September 28, 2001, similar relief was granted from October 1, 2001 until October 12, 2001 under Section 36(a)(1) of the Exchange Act. (See Release No. 34-44874.)

C. Auditor Independence

On September 14, 2001, the Commission also issued Release No. 33-8004. This interpretive release expresses the Commission’s view that, for purposes of Rule 2-01 of Regulation S-X (which addresses auditors’ independence from their audit clients), an accounting firm with audit clients that had offices in and around the World Trade Center may assist these clients in recovering their records and systems destroyed in the events of September 11, 2001, without impairing the firm’s independence from these clients. (See Release No. 33-8004.) For further information, see Commission Press Releases Nos. 2001-91, 2001-97 and 2001-106.


A. Sections 2(a)(3) and 5 of the Securities Act

1. Liberty Media Corporation – February 7, 2001

The Division was unable to advise that it would not recommend enforcement action if the registrant redeemed its outstanding shares of tracking stock in exchange for shares of a subsidiary corporation holding the assets and liabilities the tracking stock was designed to track without registering the exchange under the Securities Act of 1933. The letter noted that this will be the Division's position going forward in similar situations involving the redemption of tracking stock of a parent company in exchange for shares of a subsidiary.

XI. SPECIAL RELIEF ACTIONS TAKEN IN THE WAKE OF THE SEPTEMBER 11, 2001 TERRORIST ATTACKS

A. Emergency Order

Following the tragic events of September 11, 2001, the Commission issued an emergency order pursuant to Section 12(k)(2) of the Exchange Act on September 14, 2001, taking temporary action to respond to market developments. Section 12(k)(2) grants the Commission the authority, in the event of certain major market disturbances, to issue summarily orders to alter, supplement, suspend or impose requirements or restrictions
with respect to matters or actions subject to the regulation of the Commission. The Commission relied on Section 12(k)(2) to take temporary action with respect to several different matters, including registrant repurchases of securities under Exchange Act Rule 10b-18 and the profit recovery provisions of Section 16(b) of the Exchange Act and the rules adopted under it. (See Release No. 34-44791.)

1. **Registrant Repurchases Relief**

The Commission ordered that an issuer, or an affiliated purchaser of an issuer, would not be deemed to have violated Section 9(a)(2) of the Exchange Act or Exchange Act Rule 10b-5 in connection with an Exchange Act Rule 10b-18 purchase of or bid for its own securities made during the period from September 17, 2001 until September 21, 2001 that did not strictly comply with the time or volume restrictions of Exchange Act Rule 10b-18.

2. **Exchange Act Section 16 Relief**

The Commission ordered that, notwithstanding the profit recovery provisions of Section 16(b) and the rules adopted under it, any purchase during the period from September 17, 2001 until September 21, 2001 by a person subject to Section 16 shall be exempt from the operation of Section 16(b) with respect to any sale by that person during the preceding six months, and accordingly shall not be matched with such sale. The purchase continues to be reportable on Form 4 under Section 16(a) of the Exchange Act. The Form 4 should use transaction code "J" and describe the transaction in a footnote, making specific reference to the emergency order.

On September 21, 2001, the emergency order was extended until September 28, 2001. (See Release No. 34-44827.)

On September 28, 2001, the Commission issued an exemptive order pursuant to Section 36(a)(1) of the Exchange Act temporarily easing some of the conditions of Exchange Act Rule 10b-18 for issuers repurchasing their own securities during the period from October 1, 2001 through October 12, 2001. First, issuers whose equity securities trade at sufficiently high volumes (meeting an average daily trading volume and public float test) may effect purchases up to 10 minutes before the scheduled close of trading on the primary market for such security. An issuer’s purchase may not constitute the opening transaction. Second, the volume condition for issuer repurchasers has been eased to allow purchases of 100% of trading volume. (See Release No. 34-44874.) For further information, see Commission Press Releases Nos. 2001-91, 2001-97 and 2001-106.

B. **Calculation of Average Weekly Trading Volume under Securities Act Rule 144 and Termination of an Exchange Act Rule 10b5-1 Trading Plan**

On September 21, 2001, the Commission issued Release No. 33-8005A. This interpretive release expresses the Commission’s view on how to calculate the average weekly reported volume of trading in securities under Securities Act Rule 144(e), and
also expresses the Commission’s view regarding termination of an Exchange Act Rule 10b5-1 trading plan during the period between September 11, 2001 and September 28, 2001.

Because the markets were open for only one day during the week beginning on September 10, 2001, law firms and registrants asked how to calculate the average weekly reported volume of trading in an issuer’s securities for purposes of Rule 144 under the Securities Act. Rule 144(e) prescribes that the average weekly trading volume for a class of securities will be calculated using the average weekly reported volume of trading in such securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the four calendar weeks preceding the dates outlined in Rule 144(e). The Commission determined that the week of September 10, 2001 does not provide a representative trading volume, and so should be excluded from the calculation of the average weekly reported volume of trading in an issuer’s securities under Rule 144(e) during a four calendar week period. Instead, an additional prior week should be included, for a total of four calendar weeks.

The release also addresses Rule 10b5-1 under the Exchange Act. Rule 10b5-1 generally defines when a purchase or sale constitutes trading on the basis of material nonpublic information. The release expresses the Commission’s view that termination of a Rule 10b5-1 trading plan during the period between September 11, 2001 and September 28, 2001, inclusive, does not, by itself, suggest that the plan was not “entered into in good faith and not as part of a plan or scheme to evade” the insider trading rules within the meaning of Rule 10b5-1(c). Accordingly, the availability of the Rule 10b5-1(c) defense for transactions under the written plan would not be affected solely by termination of that plan between September 11, 2001 and September 28, 2001. (See Release No. 33-8005A and Press Release No. 2001-91.)

C. Assistance to the Airline and Insurance Industries in Accessing the U.S. Capital Markets

On September 28, 2001, the Commission issued a Press Release stating that, in support of the desire of President Bush and Congress to foster the continued vitality of the nation’s airline and insurance industries, and to help companies in these industries reach U.S. capital markets expeditiously, it has taken the following administrative steps for airline and insurance companies covered by Congressional legislation in the wake of the September 11 terrorist attacks.

The Commission established separate telephone ((202) 942-2816) and e-mail (cfhhotline@sec.gov) hotlines for the airline and insurance industries, their underwriters and other advisors. These hotlines will allow companies in these industries to obtain immediate responses to financing and disclosure questions.

The Commission also stated that it wished to help companies in these industries use our short-form registration on Form S-3 to raise capital quickly. It directed the Division of
Corporation Finance to take the following short-term actions to enhance the usefulness of short-form registration on Form S-3 for companies in these industries:

- For companies with existing shelf registrations pursuant to Rule 415(a)(1)(x), the staff will permit the extended use of our brief “notice” registration of additional securities under Rule 462(b). Under this extension, the staff will permit use of those procedures – including notice by fax and immediate effectiveness – to register additional securities in an amount up to 20% of the dollar amount of securities originally registered on that shelf registration statement (rather than the amount remaining on that registration statement).

- The Commission directed the Division to permit use of Form S-3 for primary offerings by companies even if they have been late with a required Exchange Act report during the last year, as long as the companies meet all other reporting requirements for Form S-3 registration of primary offerings.

- A requirement to use Form S-3 is that the company’s public float be at least $75 million. A number of companies that met this test on September 10, 2001 may no longer. The Commission believes that issuers in the airline and insurance industries that were eligible to use Form S-3 on September 10 should be eligible to use it for the remainder of the year. Accordingly, those issuers may calculate their public float for purposes of Form S-3 on any date between July 1, 2001 and December 31, 2001.

The Commission has directed the Division of Corporation Finance to process Securities Act filings by reporting companies in the airline and insurance industries within not more than five business days of their receipt.

The Commission has instructed the Division of Corporation Finance to continue these administrative steps through the end of 2001.

Any company in these industries or shareholder that was or will be unable to meet a deadline (including those applicable to shareholder proposals) as a result of the events of September 11, 2001 should contact the Division of Corporation Finance at the hotline phone number or e-mail address. If the deadline was or will be met within ten business days of the original due date, the Division will consider the deadline to have been met, in assessing the “timeliness” of the required action.

An internal task force will monitor federal programs regarding airline and insurance companies and will prepare appropriate disclosure guidance for companies affected by these federal programs, after discussion with outside professionals and experts.

The Commission solicits public views on any other relief it can give, consistent with investor interests, and asks that comments be received on the hotline e-mail or telephone address or through the U.S. mail at Office of Chief Counsel, Division of Corporation
D. Administrative Relief Regarding Price Ranges in Initial Public Offerings

Historically, the staff has not processed amendments to Securities Act registration statements relating to initial public offerings that did not include the bona fide price range required under the Securities Act. Because of the current unusual situation, the staff will process amendments even if they do not include a price range. This temporary relief applies only to firm commitment underwritten initial public offerings. Once a range is included in a filing, the staff may need additional time to review the revised disclosure, and there may be additional comments issued. Of course, a preliminary prospectus that is circulated must include an estimated range. Refer to Instruction 1 to Item 501(b)(3) of Regulation S-K.

In addition, the staff has also agreed that under current market conditions, estimated price ranges of up to 20%, based on the high end of the range, may be deemed "bona fide" for purposes of requirements under the Securities Act.

In addition to this outline, several other sources of information relating to the Division of Corporation Finance are available on the Division’s homepage located on the Securities and Exchange Commission’s web site, http://www.sec.gov:

- Manual of Publicly Available Telephone Interpretations & Supplements
- Current Accounting and Disclosure Issues
- Other Accounting & Disclosure Guidance
- International Financial Reporting & Disclosure Issues
- Staff Legal Bulletins
- Plain English Initiative
- Information for EDGAR filers
- Information for Small Businesses

Commission releases and Staff Accounting Bulletins also are available on the Commission’s website under the caption “Commission Business.”