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Securities Law

Michael K. Wolensky*

WOLENSKY: I note that although there are many alumni, I am the only person currently employed by the Securities and Exchange Commission on the panel. As always, there is a standard disclaimer that we at the Commission make. The things that I will say today are not necessarily the views of my colleagues on the staff of the Commission or of the members of the Commission. The Commission disclaims responsibility for anything I might say.

I will try to focus on some areas that I think are of particular interest to you and some that are of particular interest to me. First, I want to talk about the Commission's Atlanta regional office. That regional office serves North Carolina and the other southeastern states. The Atlanta office has had a twenty-five percent growth in staff in the last two years, which is unusual in the face of government cutbacks. The office had not grown for several years, however, and in view of the tremendous amount of growth in the securities and financial industry in the South, and in the Southeast in particular, the Chairman and Executive Director have taken a serious view of the situation and have upgraded the staff in the office. Our staff has grown from fifty-two to sixty-four in the last two years.

About two months ago the Commission reorganized its bankruptcy program. It placed a bankruptcy branch in the Atlanta office, and has just filled the positions in that branch. We at the Commission will soon start our participation in bankruptcies, primarily Chapter Eleven proceedings around the Southeast. There have been several large Chapter Eleven cases recently, particularly the Charter Company in Jacksonville, Florida. If you practice bankruptcy law, you will soon be dealing with the people from my office, rather than with the people from Washington. We are proud to expand into this area, and I have always found it to be interesting. In the era of uncertainty that we face in bankruptcy, I think it is going to be a very interesting field of law.

In 1983 the Atlanta region had a very effective regulatory program, and in my view, a very effective enforcement program. We

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brought enforcement actions in every state, and we brought more actions in North Carolina than anywhere else in 1983. The subject matter of those cases was varied.

The one thing that we at the Commission have found in Atlanta is that we engage in a great deal of actual litigation. The Commission settles at the outset approximately ninety percent of the cases it brings. In Atlanta, however, we settle at the outset fewer than forty percent of the cases we bring. For the first six months of fiscal year 1984 more than eighty percent of the Atlanta office's enforcement resources were spent in litigation. Using most of the resources for litigation obviously can be stifling. We are going to undertake a program over the next few years to communicate with local and state bar associations, particularly the banking, corporate, and security sections of the bars. We want to meet with them and explain to them what the Securities and Exchange Commission is and what our consent judgments mean, and try to create an environment that will foster settlement.

We at the Commission like to think that we are not going to bring a case if there is not a very good factual position. We recognize that there are legal arguments in many cases, but generally when we bring a suit we have a good factual case. Ordinarily, it is in the best interest of everyone to settle the case if an appropriate settlement can be reached. If it is a very close question of law, certainly it may be in the client's best interest to litigate. But I would like to generate some feedback from the people with whom I am dealing on programs such as this for ideas on how the Commission can better deal with its constituency to create an environment for settlement. This assumes, of course, that the Commission is going to continue bringing cases, as it is.

I now turn to the primary subject matter—the events of 1983. There have been a number of highly important matters, as well as some seemingly significant matters that probably are not very significant. I will address the decisions of the Supreme Court in this area. Because other members of the panel will talk about some of these decisions in some detail, I will not spend a lot of time on them. First, I will discuss a case in which I was involved, *Dirks v. SEC*,¹ decided in July 1983. I argued the *Dirks* case in the Court of Appeals in Washington, D.C. and won it.² Subsequently, I left the General Counsel's office. I find it difficult to disagree seriously with what the Supreme Court did, assuming its reasoning is sound. I believe, however, that the Court created more problems for itself and for the other federal

¹ 103 S. Ct. 3255 (1983).

² See *Dirks v. SEC*, 681 F.2d 324 (D.C. Cir. 1982) (affirming a Commission finding that petitioner had aided and abetted in violations of the antifraud provisions of the federal securities/laws).

courts than it solved. It raised and left unanswered many issues, and those issues are rearing themselves now in the courts as the Commission brings cases involving people who are not strictly insiders, but who may have gained some benefit from the use of nonpublic information that came into their possession. I cite two examples: *SEC v. Thayer*,³ brought by the Commission and currently in litigation, and *SEC v. Brant*,⁴ the recently filed suit against the Wall Street Journal reporter.

In my view, the pending case of *SEC v. Jerry T. O'Brien, Inc.*⁵ is the most significant Supreme Court case as far as the Commission is concerned, since *SEC v. W.J. Howey*.⁶ As Stanley Sporkin will speak about *O'Brien*, I will not go into much detail except to say that it is the first time the Supreme Court has addressed the Commission's investigative procedures. The Court has extensively scrutinized Internal Revenue Service procedures and has examined other federal agencies having statutes similar to those of the Commission, but this is the first time the Court has examined the Commission's procedures.

The Ninth Circuit in *O'Brien* ruled that the Commission must give notice to the subject or target of the investigation whenever it issues subpoenas requiring documents or testimony from any other person, so that the target of the investigation may challenge the subpoena.⁷ The Ninth Circuit did not suggest what jurisdictional hook the courts might use to entertain that challenge, and there does not appear to be any such hook. But the decision is a very serious inroad on the Commission's ability to investigate promptly and thoroughly and to bring enforcement actions where necessary. The Commission petitioned for certiorari, which the Court granted, and the case was argued in April 1984.⁸

*Seagrave Corp. v. Vista Resources*⁹ is another case in which certiorari was recently granted. In *Vista Resources* the Second Circuit examined the sale of business doctrine. I want to focus on this because

³ The Commission charged W. Paul Thayer, a former company chief officer, with disclosing material nonpublic information concerning proposed acquisitions to persons who later purchased securities of the companies about to be acquired. The traders were also charged. The Commission seeks an injunction against further violations and disgorgement of the illegally obtained profits. Although a final decision is still pending, recent developments in the case are noted in *SEC v. Thayer*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,607 (S.D.N.Y. 1984) and *SEC v. Thayer*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,718 (S.D.N.Y. 1984).

⁴ File No. 84 Civ. 3470 (CBM) (S.D.N.Y. 1984).

⁵ 704 F.2d 1065 (9th Cir. 1983).

⁶ 328 U.S. 293 (1946).

⁷ *O'Brien*, 704 F.2d at 1069.

⁸ Subsequent to Mr. Wolensky's speech, the Supreme Court rendered its decision in *SEC v. Jerry T. O'Brien, Inc.*, 104 S. Ct. 2720 (1984), *rev'g* 704 F.2d 1065 (9th Cir. 1983).

⁹ 696 F.2d 227 (2d Cir. 1982), *clarified*, 710 F.2d 95 (2d Cir. 1983), *cert. granted*, 104 S. Ct. 2341 (1984). On August 9, 1984 the writ of certiorari granted in this case was dismissed pursuant to Rule 53 of the Supreme Court Rules. 53 U.S.L.W. 3115.

I think that in practice most lawyers will at some time face this issue. The sale of business doctrine was formulated in the district courts and then in the courts of appeals. Virtually every court of appeals has ruled on the issue, and they are evenly divided.

The sale of business doctrine states that, if in connection with the sale of a business there is a transfer of stock, the business transaction is merely a commercial transaction. It is a sale of the business, not a sale of stock covered by the securities laws. The protections of the securities laws do not attach to such a transaction, and therefore, a defrauded purchaser or a defrauded seller may not sue under the securities laws to seek relief under an implied right of action.

In *Vista Resources* one hundred percent of the stock of the company was transferred. In other cases less than one hundred percent has been transferred without the protections of the securities laws.¹⁰ Generally, a one hundred percent transfer occurs in privately held or very closely held corporations. I do not know of any case where the Commission has brought an enforcement action on facts such as these. Ordinarily, we would not get involved in these types of cases, involving small closely held corporations that do not have much investor impact. Presumably, the same result would occur if the Commission brought an action. The Seventh, Ninth, Tenth, and Eleventh Circuits have embraced the sale of business doctrine which states that the sale of a business is not covered by the federal securities laws. The Second, Fourth, Fifth, and Eighth Circuits have rejected the sale of business doctrine, and the Third Circuit has hinted that it would reject the doctrine, although there has not been an express holding.

The recent Ninth Circuit decision in *Landreth Timber Co. v. Landreth*¹¹ is a short opinion, containing a very good discussion of the area. The Supreme Court accepted the case on certiorari and will resolve the issue next term.

I have been involved in discussions with lawyers in private practice and it seems that frequently, a purchaser of a business is extremely interested in having the securities laws attached. That is the reason for which purchasers buy the stock of the company, rather than buying the assets or assuming the assets and liabilities of the business. They wish to have the protections of the securities laws in case there are misrepresentations concerning the financial position, inventories, or any of the other things that are considered in deciding to purchase an ongoing business.

¹⁰ See, e.g., *Sutter v. Green*, 687 F.2d 197 (7th Cir. 1982); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981).

¹¹ [1983-1984 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 99,705 (9th Cir. 1984), modified, [Current] FED. SEC. L. REP. (CCH) ¶ 91,469 (9th Cir. 1984). A petition for certiorari to the Supreme Court was filed on May 31, 1984.

In other cases, there have been decisions where both sides had agreed in side letters or in the purchase and sales contracts that they did not want the securities laws to attach. Parties, of course, may not waive the protections of the securities laws. For instance, someone who is defrauded and desires the protections of the securities laws will say that the contract is not binding, and the parties will end up in federal court. Those are the most difficult cases. Thus, in advising clients you should know exactly where you are going to be, in what circuit you will be at least over the next six months to one year, and how you want to tailor the transaction.

The other Supreme Court case I want to mention is *United States v. Arthur Young & Co.*,¹² decided on March 21, 1984. In that case, the Supreme Court reversed a Second Circuit decision that a limited accountant-client privilege applied when the Internal Revenue Service sought tax accrual workpapers of an accountant. Interestingly, the Second Circuit held that the Commission could obtain these documents, but the IRS could not. Tax accrual workpapers are the auditor's and the company's best estimates of a "worst case scenario" of the company's tax liability if the IRS were to challenge a given transaction. The company is required to accrue a certain amount of reserve for contingency, if in fact it believes it would contest a transaction. The IRS believed that this would be an excellent roadmap to audit a corporate return because the company and the auditor had given their best estimate of a worst case scenario should their return be challenged.¹³

The Supreme Court in *Arthur Young* said that the IRS could obtain those worst case records and that there is no federal accountant-client privilege. The Court went so far as to say that auditors doing independent accounting work have a public duty; their obligations in preparing financial statements are imbued with a public interest. They must adhere to the letter and spirit of the law and should not be engaged in helping the client conceal anything.¹⁴

It is interesting that this was an *Arthur Young* case, because several years ago the Commission lost a case in the Ninth Circuit called *SEC v. Arthur Young & Co.*¹⁵ The Ninth Circuit held that an auditor is no more than a private contractor and does not have a public duty merely because he prepares financial statements to be filed with the public. The new *Arthur Young* decision seems to flip the coin the other way in holding that accountants, when doing independent auditing work, have a public duty.

The broker-dealer relationship is another area in which there

¹² 677 F.2d 211 (2d Cir. 1982), *aff'g in part, rev'g in part*, 104 S. Ct. 1495 (1984).

¹³ *Arthur Young*, 677 F.2d at 214-15.

¹⁴ *Arthur Young*, 104 S. Ct. at 1503.

¹⁵ 584 F.2d 1018 (D.C. Cir. 1978), *cert. denied*, 439 U.S. 1071 (1979).

has been much activism in the courts, particularly in the courts of appeals. There probably have been more broker-dealer courts of appeals decisions in 1983 than in any previous single year within the last ten years. One of the most interesting decisions is *Berner v. Lazzaro*,¹⁶ which held that when a customer sues a broker who is a corporate insider for fraud on the theory that the customer was told he was being given a tip—inside information—and that tip was false, the customer could nevertheless maintain a suit over a claim of *in pari delicto*. The *in pari delicto* defense has been upheld by the Fifth, Eleventh, and other circuits. The Ninth Circuit departed from that line of decisions, reasoning that broker-dealers who deal with customers have a very high obligation—a fiduciary obligation—to deal fairly and equitably. The fact that the customer tried to take advantage of an inside information tip does not make him quite as guilty as the person who lied to him by saying that he had such a tip.

In 1983 the regional office in Atlanta instituted an action against a registered representative of a brokerage firm who had allegedly falsely claimed that he possessed inside information. A dozen customers were involved, and we had such statements from them as “Yes, he told me he had inside information about a merger.” It turned out that there was no merger, and the registered representative claimed, first, that he did not say it, and second, that he did not have it. We tried to prove that he had indeed received a tip because there had been rumor of a merger. After a year of investigation, we could not prove that the representative had been privy to any information, but we brought the case on the theory that he had defrauded his customers by falsely representing to them that he did have inside information. The case was settled without admitting or denying this allegation.

The Ninth Circuit, however, seems to allow customers who are defrauded by a brokerage firm or its registered representatives with this type of information to bring their own cases, despite the fact that they were looking to make money on inside information, too.¹⁷ I have little sympathy for customers who are doing that. They are not victims.

The thing that bothers me most about the *in pari delicto* defense is that it is rather insidious. The broker starts tipping off customers—“I have a tip that Social and Gulf are going to merge and you can make a fortune”—which creates a rash of buying activity. This will generate a tremendous number of commissions for the broker, especially if the customers are trusting. I am talking about the registered representative who is going to become rich, and does so with impunity where there is an *in pari delicto* defense. This representative

¹⁶ 730 F.2d 1319 (9th Cir. 1984).

¹⁷ See *supra* note 10 and accompanying text.

knows he can say whatever he wants to say, and as long as he hooks the customer who wants to take advantage of the "hot tip," the customer can never sue because of the *in pari delicto* defense.

I believe the prophylactic effect of the Ninth Circuit decision in *Berner* is very good. I think it will have significant impact in this area, and I hope other courts will follow the decision because of its prophylactic effect, not because the customers are so righteous that they should be allowed to take advantage of inside information whether or not they win. The important thing about *Berner* is that it strongly emphasizes the fiduciary duty brokers owe to their clients, and this is a tune that the Commission has been singing for a number of years. More and more courts have adopted it. An attorney should keep in mind in advising broker-dealers that they have a very high standard of care to meet in dealing with their clients.

*Ryan v. SEC*¹⁸ is the first markup case in a long time. The *Ryan* court found eminently reasonable the Commission's position that a ten percent markup over a dealer's contemporaneous cost was fraudulent. The ten percent markup rule has been around for a long time, but it has not been reviewed recently by the courts. A ten percent markup generally has been found to be fraudulent, and the courts have again reaffirmed that position.

*SEC v. Blinder, Robinson & Co.*¹⁹ was a parking case, involving a "hot issue offering," in which the broker, the underwriter, could not get rid of the last ten percent. He wished to start making the aftermarket, so he "parked" it in a number of nominee accounts until the secondary market became active, and entered that market. This is not a full distribution in the sense that the escrow account can be broken if it is an all-or-none or a best-efforts-or-none offering. The result is a situation where the broker reaps a tremendous benefit because in the aftermarket it is a "hot issue." The stock increases in value, and the broker reaps a benefit that he should not have. In effect, the company is not as high a quality as one would expect from a hot issue market.

The Commission also brought a case involving underwritings,

¹⁸ No. 82-7312 (9th Cir. May 23, 1983). The *Ryan* court affirmed Commission administrative sanctions imposed upon the president of a broker-dealer company, arising from Commission findings that he failed to disclose excessive markups, illegally sold unregistered stock, and failed to comply with the recordkeeping requirements of the Securities Exchange Act.

¹⁹ 692 F.2d 102 (10th Cir. 1982). The court affirmed the district court decision permanently enjoining Blinder, Robinson & Co. and its president from further violations of the Securities and Exchange Act. The violations arose as a result of the firm's activities when acting as managing underwriter for an unseasoned issuer offering securities to the public on a best-efforts, all-or-none basis. When defendants were unable to sell the entire offering by the specified date, they engaged in a series of transactions designed to create the impression that the offering was sold on the terms stated. After the purported completion of the offering they continued the distribution while making a market in securities of the same class.

which is still in litigation in Greensboro, North Carolina. The case is the first "gun jumping" case the Commission has brought in some time. The Commission alleged that the broker was accepting money from customers prior to the effective date of a registration statement, and, indeed, in a case or two, prior even to the filing of a registration statement. The money was placed in the customer's account—noted as a free credit balance, not for any specific purchase of securities—with the understanding that when the registration statement became effective the money would be used to purchase the stock in the initial offering. For many years, the Commission has viewed that as "gun jumping," and it is not permissible until the registration statement is effective.

Finally, another interesting case in the broker-dealer area is *Carter v. SEC*²⁰ in the Ninth Circuit. In *Carter* the registered representatives had been doing business away from the firm. When they did business at the firm, of course, the firm had an obligation to supervise them. Occasionally, a few representatives would get together to sell a few tax shelters on the side or to engage in some securities activity, not through the auspices of the firm, but at home during evenings and weekends, to the customers with whom they dealt at the firm. *Carter* held that there is no such thing as an "away from the firm" transaction for a registered representative dealing with customers of the firm. The firm still has a strong obligation to supervise those people to ensure that they comply with the federal securities laws.²¹

Another area that has received some scrutiny from the courts of appeals is the grant, denial, or dissolution of injunctions. In a case out of the Atlanta regional office, the Sixth Circuit recently ruled on the so-called "Black test" in *SEC v. Youmans*.²² That is the test the Fifth Circuit had developed in 1979 or 1980 setting out the factors to determine whether to enter an injunction in an SEC enforcement action. The *Youmans* court held that no single factor is controlling. A mere change of occupation at or about the time the Commission files its suit is not sufficient for the court to deny the injunction, if that is the only change.

There is nothing drastic about the *Youmans* decision, but it seems as though every year or two the Commission is compelled to get a decision from a court of appeals such as this so that the district courts will pay heed. In Tennessee we brought a similar suit against

²⁰ 726 F.2d 472 (9th Cir. 1983). The Commission found that defendants had sold unregistered securities in violation of the 1933 Securities Act, and that they had effected those transactions without the knowledge or approval of their employer, a registered broker-dealer. Defendants argued that there was no evidence that the sales were concealed from their employer or were effected without notification to their employer.

²¹ *Id.* at 473-74.

²² 729 F.2d 413 (6th Cir. 1984).

a loan and thrift operation called Southern Industrial Banking Corporation.²³ Defendants had claimed the fifth amendment throughout our investigation. They would not provide us with any information, would not give us their wives' or children's names or any basic background information. We had fairly strong evidence and filed an affidavit in court showing that approximately twelve million dollars had been withdrawn from Southern Industrial Banking Corporation. This money had been withdrawn in a one-year period on forged notes and could be traced to one particular defendant's bank account. We did not allege that this person forged the notes, although we traced the money, or at least a very large part of it, to his bank account. Also, there were numerous other allegations of insider loans.

The Loan and Thrift that had been in business for fifty to sixty years, had started making commercial loans, and some were made to individual defendants to the tune of approximately sixty percent of the total loan portfolio. They were all signature loans without collateral; for instance, a five million dollar loan with no collateral and no payments ever made on it. Every three months the loans merely increased to cover the interest.

We brought suit against the individual defendant seeking a preliminary injunction. The judge denied our preliminary injunction on the basis that we could not prove, right then, that the individual was engaged in that kind of conduct. We said, "But your Honor, he will not tell us what he is doing now. He took the fifth, along with everybody else. We do not know what he is doing now." The individual never denied any of the allegations and did not file an answer denying anything. He merely argued that, "Because the Commission cannot show that I am engaged in the same occupation, the court should not enjoin me."

Consequently, the court denied the preliminary injunction on the basis that we could not prove that he was engaged in that conduct at the time we filed the suit. We promptly appealed, and that case is currently pending in the Sixth Circuit. The Commission will not walk away from cases in which a preliminary injunction is denied. In egregious cases, we are going to pursue them.

One other case I would like to mention in that area is *SEC v. Clifton*,²⁴ which involved the dissolution of an injunction. The Commission will soon issue a statement with respect to what it will or will not be doing in the area of dissolution and modifications of injunctions. In *Clifton* the District of Columbia Circuit affirmed the district court's refusal to dissolve an injunction and adopted the *Swift* test.²⁵

²³ *Kohntopp v. Butcher*, 98 F.R.D. 551 (E.D. Tenn. 1983).

²⁴ 700 F.2d 744 (D.C. Cir. 1983).

²⁵ *Clifton*, 700 F.2d at 747 (citing *Swift v. United States*, 286 U.S. 106, 119 (1932)).

*Swift v. United States*²⁶ is an early antitrust case in which the Court said there had to be a new, unforeseen, and drastic change that caused the injunction no longer to have merit. Many people have questioned the efficacy of *Swift* after all the years, but the *Clifton* court seems to have adopted that holding.

I want to discuss briefly legislation in the securities area. The recent "tender offer" legislation²⁷ developed by the Tender Offer Advisory Committee does several things. First, it cuts down the ten-day window period for many companies once they reach the five percent level. They then have ten days to file their 13D acquisition report. Once they reach the five percent mark, they buy everything in sight to try to get as much as they can before they have to report. One of the objects of the proposed legislation is to cut that window down. If there is a tender offer taking place, there is a proposed requirement to file immediately. Another object of the legislation is to eliminate the golden parachutes and certain poison pill defensive tactics.

There is other proposed legislation dealing with enforcement remedies. The Commission is seeking to broaden its authority in the administrative proceeding area to include proxy violations and to include officers and directors of corporations, currently a questionable area.

Finally, in the Freedom of Information Act²⁸ area, the Commission is seeking to give itself the opportunity to avoid subpoena enforcement problems and other things through legislation stating that documents presented to the Commission in the course of an investigation are not records of the Commission subject to disclosure under the Freedom of Information Act. A few years ago the Commission issued a proposed rule that these documents are not records subject to disclosure. The rule defined records as not including investigative records. We received a letter from Washington criticizing this position and stating that Congress would sue us if we tried to go through with it. In the era of the Central Intelligence Agency and the Justice Department trying to exempt themselves from the Freedom of Information Act, we felt we would get on the bandwagon and propose legislation in that area. I do not know what is going to happen to it. I believe that, under this Administration, the chances are better than they would be under some other administrations, but I do not know how to project that.

²⁶ 286 U.S. 106 (1932).

²⁷ See generally Proposed Tender Offer Reform Act, [Current] FED. SEC. L. REP. ¶ 83,630 (Letter of SEC Chairman John Shad to Congressman Timothy Wirth, May 21, 1984).

²⁸ 5 U.S.C. § 552 (1982).

Recent Developments in Corporate Law

*Russell M. Robinson, II**

ROBINSON: I have selected three particular cases in two general areas in which corporate law developments have been most noticeable in the past several years. First, in the area of shareholder derivative actions, I have chosen to discuss *Aronson v. Lewis*,¹ recently decided by the Delaware Supreme Court, and *Miller v. The Register and Tribune Syndicate, Inc.*,² decided by the Supreme Court of Iowa in 1983. Second, in the area of closely held corporations, I want to discuss *Meiselman v. Meiselman*,³ decided by the North Carolina Supreme Court in January 1984.

The derivative action area is probably one of the most active areas in corporate development and has been in the past few years. The derivative action is the most effective, perhaps the only effective, private means by which the duties and responsibilities of management may be enforced. It has long been recognized as a means by which corporate management may be called to account by the shareholders.

It is also recognized, however, that the derivative action is subject to great abuse because in any derivative action there is a self-appointed plaintiff who frequently has motives other than benefiting the corporation or enforcing some corporate principle. That, of course, sets up a classic tension between two fundamental principles in corporate law. On the one hand, there is the principle of managerial freedom, which is the authority that directors of the corporation must have to manage the corporation; they are the ones who manage it and not the shareholders. On the other hand, there are the directors' fiduciary duties, responsibilities, and accountability to the shareholders. Courts and commentators in this area struggle with the question of how to resolve the tension between those two conflicting and basic principles.

Several years ago corporations began to use special litigation

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¹ 473 A.2d 805 (Del. 1984).

² 336 N.W.2d 709 (Iowa 1983).

³ 309 N.C. 279, 307 S.E.2d 551 (1983).

committees to provide a voice for the corporation to examine, express, and assert the corporate interest. This evolved out of the broader development of using committees in general to perform various functions of the board. It was also prompted by the Supreme Court decision in 1979 in *Burks v. Lasker*,⁴ which resulted in the use of the special litigation committee appointed by the directors to examine the merits and the cost/benefit analysis of a derivative action and to report to the board. On the basis of such a report, the corporation would move for summary judgment or dismissal.

Two lines of authority developed in the area of special litigation committees. One of the early cases is *Auerbach v. Bennett*,⁵ a tightly reasoned decision by the Court of Appeals of New York, holding that a special litigation committee's report and recommendation are subject to limited inquiry by the court. The court is to examine only the good faith and independence of the committee and the regularity of its investigative procedures. If those elements pass the test, the court will not look beyond the recommendation of the committee. It will not inquire into the merits, which, of course, is a very pro-management decision. *Auerbach* has been followed by a number of courts.⁶

On the other end of the scale, there developed a line of authority to the effect that the special litigation committee's report and findings are in fact subject to judicial scrutiny. Probably the strongest statement of that authority is the Delaware Chancery Court opinion in *Maldonado v. Flynn*,⁷ holding that the business judgment rule was intended to shield directors against liability for decisions made in good faith. It was not intended to be used, and should not be used, as a sword to cut off a derivative action.

That lower court decision in Delaware was followed by several courts⁸ until that case reached the Delaware Supreme Court, which handed down its famous decision in *Zapata Corp. v. Maldonado*.⁹ In *Maldonado* the court tried to steer a middle course between the two extremes of no review on the merits and full review on the merits. It ruled that a trial court should examine the good faith and independence of the special litigation committee. The trial court should go further in some cases, however, and examine the factual basis on which the committee reached its recommendation to dismiss the action, as it almost always recommends. Furthermore, a trial court

⁴ 441 U.S. 471 (1971).

⁵ 419 N.Y.S.2d 920, 47 N.Y.2d 619, 393 N.E.2d 994 (1979).

⁶ See, e.g., *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980); *Gaines v. Haughton*, 645 F.2d 778 (9th Cir. 1979); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979).

⁷ 413 A.2d 1251 (Del. Ch. 1980).

⁸ See, e.g., *Abella v. Universal Leaf Tobacco Co.*, 495 F. Supp. 713 (E.D. Va. 1980) (applying Virginia law).

⁹ 430 A.2d 779 (Del. 1981).

should inquire whether the dismissal of an action would serve a broader public purpose. In sum, *Maldonado* tried to resolve the tension between the managerial freedom of directors on the one hand, and the managerial responsibility of the directors on the other hand.

In defining the proper scope of inquiry as to a special litigation committee's report, the *Maldonado* court classified the cases into those in which the demand on the directors is required and those in which it is not required. Before maintaining a derivative action, a shareholder must satisfy the court that intracorporate remedies have been exhausted by making demands on the directors to assert the claims that are being asserted in the suit. The purpose of that requirement is to give management the opportunity to correct the wrongs if possible or to take control of the litigation and seek a remedy on behalf of the corporation. Demand is excused if it would be futile. Under the Federal Rules of Civil Procedure and the state statutes in virtually all states, a shareholder who claims that demand would be futile must allege with particularity the reasons it would be futile.

In *Maldonado* the Delaware Supreme Court said that a distinction must be drawn between a demand-required and a demand-not-required case. If demand is required, that is, if the directors are independent of the action and disinterested in the claims or the transaction being asserted, the action of the directors in refusing the demand is protected by the business judgment rule, and is therefore, subject to very limited judicial scrutiny.¹⁰ The special litigation committee probably will not be needed. In virtually all cases in which demand is required the courts have held that the directors' action on that demand is conclusive. In cases in which demand is excused, the court must apply a two-step analysis: first, examine the good faith and independence of the special litigation committee and the factual basis on which it reached its conclusions; and second, determine whether the dismissal of the action would serve a broader public purpose.

The *Maldonado* court explicitly left open the question of when demand is or is not required; that is, what test is to be applied to determine whether or not demand is required. The Delaware Supreme Court addressed this issue in 1984 in the definitive *Aronson* opinion.

The Delaware Chancery Court in *Aronson* had adopted a rule of reasonable inference. The court held that if the allegations in the complaint permit or raise a reasonable inference that the directors' action on the demand would not be protected by the business judgment rule, demand is excused. That, of course, is a pro-plaintiff rul-

¹⁰ *Maldonado*, 430 A.2d at 782.

ing. The Delaware Supreme Court rejected that test, reasoning that it is too liberal, and that if that test were to be applied, demand futility would be virtually automatic in derivative actions based on conclusory allegations in the complaint.

The Delaware Supreme Court instead announced another rule, a rule of reasonable doubt. To prove demand futility, the allegations in the complaint must be particular enough to raise a reasonable doubt that the directors are interested and not independent, and that their action on the demand would not be protected by the business judgment rule. The court stressed the particularity of the facts that must be alleged in meeting that requirement. They may not be merely conclusory allegations; they must be particular facts. If the alleged facts raise a reasonable doubt as to the independence or good faith of the directors, demand will be excused. If the directors appoint a special litigation committee, the recommendations of that committee would be subject to the second level of scrutiny prescribed by the court in *Maldonado*.¹¹

The *Aronson* court also addressed the question of when a director is interested. What constitutes "interest"? How does one determine whether a director's participation in or affiliation with the transactions constitute interest? Mere board approval of a transaction does not overcome the presumption of propriety. The personal liability of the directors for approving a questioned transaction, standing alone, would not be sufficient to challenge either the independence or the disinterestedness of the directors. In announcing that principle, the *Aronson* court was implicitly following the Second Circuit decision in *Lewis v. Graves*,¹² which held that naming a director as a defendant does not alone taint that director with interest, because if that were the case, plaintiffs could readily circumvent the demand requirement merely by naming all board members as defendants.

Another question addressed by the court in *Aronson* was when the test of disinterestedness and the propriety of the proceedings should be applied. Is it to be applied at the commencement of the action or at a subsequent time? In *Aronson* plaintiff had argued that the court should look not only to the interestedness or independence of the directors at the time the action is brought, but also to future events. Plaintiff in *Aronson* had asserted that the hostility of the board and the futility of demand was shown by the board's move to dismiss the derivative action. The court disagreed, stating that the test is to be applied at the time the action is brought. The court makes a determination on the basis of the facts known and existing at that time as to whether the directors are independent and disinterested

¹¹ See *Aronson*, 473 A.2d at 812, 813.

¹² 701 F.2d 245 (2d Cir. 1982).

enough to be capable of exercising a business judgment on the demand that would be entitled to respect by the court.

In other cases, defendants, the board of directors or management, have argued that the test of disinterestedness should be applied at a later time when the board of directors has been reconstituted after the derivative action is brought. Then there will be directors who are not involved in the action, and the board may move to dismiss the action or may require demand to be made. The courts have rejected that argument.

The *Aronson* case also announced a presumption of good faith on the part of management. It is presumed that the directors are acting in good faith and that the special litigation committee is acting in good faith. Plaintiffs bear the burden of overcoming that presumption.

The final point in *Aronson* is the discussion of what has come to be known in the cases and commentary as "structural bias" of the directors of a corporation. The argument is that there is an inherent, unavoidable structural bias in boards of directors. That structural bias makes it unrealistic to expect any board of directors to name a special litigation committee that is in fact independent and disinterested and that could examine the merits of a derivative action and reach a fair decision on whether it should be dismissed. The idea is that there is a common shared culture among directors, which produces a natural empathy or collegiality among the types of people who serve as directors of corporations. That makes it impossible for them to reach an objective decision on this point.¹³

The Delaware Supreme Court in *Zapata v. Maldonado* referred to that collegiality as the "there-but-for-the-grace-of-God-go-I" syndrome. Plaintiff's lawyers are not appointed to boards of directors, and the history of these cases seems to indicate that is a point. I believe a study showed that on only one occasion has a special litigation committee made any recommendation other than that the action be dismissed.

Courts and commentators have been struggling with the questions of how to recognize structural bias if it does exist and of how to deal with it. In *Aronson* the court rejected the argument that a board, so affected by interest that it cannot make an independent determination on a derivative action, could not delegate to any other committee or body the power to exercise authority that it did not have. If a board is tainted, the committee it appoints would necessarily be tainted by the same disability. The Delaware court said that it realized that it would be criticized for rejecting that argument by those who say that the structural bias is so strong that it should disable

¹³ *Aronson*, 473 A.2d at 815.

even independent committees. Nevertheless, the court announced the rule that a board of interested directors has the authority to appoint a disinterested committee, although careful scrutiny would be applied in such a case.¹⁴

The Iowa Supreme Court in *Miller v. The Register and Tribune Syndicate, Inc.* arrived at the opposite conclusion.¹⁵ The opinion contains a good discussion of structural bias, referring to the American Law Institute Corporate Governance guidelines, and concludes that the potential for structural bias on the part of a litigation committee appointed by interested directors is sufficiently great and difficult of precise proof to require the adoption of a prophylactic rule. Such a rule would prevent the potential for structural bias in some cases by effectively limiting the powers of directors in all cases.¹⁶

The Iowa Supreme Court heard *Miller* on a certified question from a federal court. The court held that the board of directors did not have the authority to appoint a special litigation committee. It observed that the alternative would be to have such a committee appointed by the court itself. This is an interesting way of dealing with the question and one that has been rejected by the Delaware court.

Recently, the question of standing of the parties has arisen. This refers to the standing of the plaintiff-shareholder to bring suit if the status as a shareholder is lost by reason of a transaction occurring after suit was brought. The federal courts are generally stricter than the state courts on the standing rule in requiring continued shareholder status.¹⁷

It is interesting that the ubiquitous Mr. Lewis in *Lewis v. Chiles*¹⁸ was dismissed out of court. He had instituted a derivative action against the corporation, and then the assets of the corporation were sold, including the derivative claim. The buyer moved to dismiss the derivative claim, and the court granted the motion. Lewis ingeniously argued that if the claim was sold and the buyer bought it, it must have been worth something. If it was worth something, he was entitled to attorney's fees. The court rejected that argument.

In a Southern District of New York case, however, the court held that a cash-out merger eliminating plaintiff's status as a shareholder did not disqualify plaintiff from maintaining the derivative action.¹⁹ His name was not Lewis. In another case in the Fifth Circuit Lewis

¹⁴ *Id.*

¹⁵ *Miller*, 336 N.W.2d at 805.

¹⁶ *Id.* at 815.

¹⁷ *See, e.g.*, *Daily Income Fund, Inc. v. Fox*, 104 S. Ct. 831 (1984) (suit brought under Investment Company Act of 1940); *Wolgin v. Simon*, 722 F.2d 389 (8th Cir. 1983); *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982); *Issen v. GCS Enterprises, Inc.*, 538 F. Supp. 745 (N.D. Ill. 1982).

¹⁸ 719 F.2d 1044 (9th Cir. 1983).

¹⁹ *Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270 (S.D.N.Y. 1983).

was bumped out in a reverse stock split which cashed him out.²⁰ Perhaps the lesson is that if your name is Lewis, you lose your status; if it is not, you do not.

There have been some cases on the independence of counsel and conflict of interest. One decision in Oregon held that it is unethical for corporate counsel, counsel of the corporation who has represented the corporation in a derivative action, to represent either the corporation or the majority shareholders in a derivative action.²¹ In some cases such representation has been permitted if there is a perfect identity of interest. In *Lowder v. All State Mills Inc.*,²² decided in 1983, however, the North Carolina Supreme Court held there was not such a perfect identity of interest between derivative plaintiffs and receivers of a corporation, and therefore, dual representation was required. Thus, the area of derivative actions is very lively.

In the world of close corporations, and especially in North Carolina, *Meiselman v. Meiselman*²³ is a landmark decision. North Carolina lawyers know that the North Carolina statute has long been recognized as having been, when it was enacted, in the forefront of the recognition of close corporations.²⁴ The *Meiselman* case represents a situation that is very common in law offices that deal generally with corporate matters. The issue is a dual one. First, there is the withdrawal situation, as in *Meiselman*, where one of the shareholders wants out. Second, there is the situation where the majority wants to eliminate a shareholder. These are essentially two sides of the same situation.

In the withdrawal situation, if it involves a partnership, a partner may dissolve the partnership, get his money, and go his way. But the corporate form presents a different situation; it may not be dissolved at will. The *Meiselman* case presented in the purest form the question whether a court will recognize the difference between close corporations and corporations whose stock is more widely held, and whether it will recognize the different considerations that apply to an incorporated partnership.

Meiselman concerned two brothers, both of whom had received their stock by inheritance from their father in an enterprise that had become very valuable—worth twenty million dollars or more. One brother owned slightly more stock than the other so that he was in control. The controlling brother was married and had a family, and therefore, had entirely different interests from the minority shareholder, who was single, without a family, and wanted a larger current

²⁰ *Lewis v. Knutson*, 699 F.2d 230 (5th Cir. 1983).

²¹ *In re Kinsey*, 294 Or. 544, 660 P.2d 660 (1983).

²² 309 N.C. 695, 309 S.E.2d 193 (1983).

²³ 309 N.C. 279, 307 S.E.2d 551 (1983).

²⁴ N.C. Gen. Stat. § 55-125(a)(4) (Replacement 1982).

return. The controlling brother, who managed the corporation, was interested in the future and in building the corporation—a built-in conflict of interests. There was in fact no fraud, dishonesty, or intentional wrongdoing on the part of the majority shareholder. There was merely an irreconcilable difference of interest and temperament.

The plaintiff, whom I represented, wanted out, so we brought an action to get him out. The trial judge dismissed the case because we did not prove any wrongdoing on the part of the plaintiff. The plaintiff appealed, and in a 2-1 decision the court of appeals reversed. The court noted that under the North Carolina statutes, involuntary dissolution is allowed where reasonably necessary for the protection of the rights or interests of the complaining shareholder.²⁵ The next section of the statute allows the court to fashion any type of alternative remedy it sees fit.²⁶ The statute was intended, the court stated, to allow some remedy when the shareholder had shown, not oppression or fraud, but simply that basic fairness compels the dissolution or the alternative remedy. The court held that the complaining shareholder is not required to show bad faith, mismanagement, or wrongful conduct, but only real harm. The court remanded the case, finding that the trial court had not only misapplied the law, but had abused its discretion in not granting relief.

The North Carolina Supreme Court struck a middle ground. The court recognized the differences between close corporations and publicly held corporations. It stated that this distinction is crucial because the two types of corporations are fundamentally and functionally quite different. The relationships in a close corporation, which is little more than an incorporated partnership, require close cooperation and a high degree of good faith and mutual respect. The opinion quotes Professor O'Neal on Close Corporations to the effect that close corporations are based on personal relationships which give rise to certain "reasonable expectations." Those reasonable expectations include the expectation by the minority shareholder that he will participate meaningfully in the management of the corporation and will be employed by the company.²⁷

The court further stated that when there is a breakdown such that those expectations are frustrated, a court should grant relief. Therefore, applying the North Carolina statutes, the court held that plaintiff has the burden of proving that his rights or interests are being controverted in some manner. Those rights or interests include his reasonable expectations, and reasonable expectations are those that existed at the time the relationship began or that have devel-

²⁵ *Id.*

²⁶ *Id.* § 55-125.1.

²⁷ See O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 *BUS. LAW* 873, 885 (1978).

oped as the participants engaged in the course of dealing within the corporation.²⁸

The court said that the reasonable expectations of the plaintiff minority shareholder must be known to or assumed by the other shareholders and concurred in by the majority shareholders. In the conclusion of the opinion, however, the court omitted the phrase "concurred in by the majority" and stated only that the plaintiff must prove that he had one or more reasonable expectations known or assumed by the other participants, that the expectation has been frustrated, that the frustration was without fault of the plaintiff and was in a large part beyond his control, and that under all circumstances, it would be fair either to dissolve the corporation or require the minority shareholder to be bought out.²⁹

In *Meiselman* plaintiff's most compelling reasonable expectation was his expectation of receiving a reasonable current return on an inheritance worth nine or ten million dollars. He was receiving dividends of \$60,000 sometimes and with some effort. The court did not explicitly mention that, and the settlement of the case leaves open the question as to the weight a court should put on that expectation.

Meiselman is an interesting case that announces a rule difficult to apply because it requires ad hoc application under the facts and circumstances of each case. It remains to be seen how the rule will be handled by the courts in the future, but it is now certain that a disgruntled minority shareholder need not prove fraud, mismanagement, or oppression in the traditional sense to obtain relief from a situation that has become unfair to him.

On the other side of that coin is the expulsion case in which the majority shareholders wish to rid the corporation of a minority shareholder. In *Weinberger v. UOP, Inc.*³⁰ the Delaware Supreme Court rejected the business purpose test and held that a minority shareholder may be cashed out if the test of entire fairness is satisfied. There need not be any specific business purpose to the cash-out merger. It is more complicated than that, but that is a fair summation.

There has been a great deal of commentary on the *Weinberger* case, but it has been applied primarily in the context in which that case arose and was decided. All of the commentary that I have read has been directed to larger corporations with public minority shareholders, or numerous minority shareholders in the second step of a two-step acquisition. I have not seen any commentary directed to the question that arises most often in the normal corporate practice:

²⁸ *Meiselman*, 309 N.C. at 297.

²⁹ *Id.* at 301.

³⁰ 457 A.2d 701 (Del. 1983).

may two or three shareholders have a cash-out merger and eliminate the third, if they are entirely fair to him in that there is no overreaching, and a fair price is offered? If the three shareholders had begun business together, and then went their separate ways so that one now has different views or has gone in a different direction, may the two that are in the majority have a cash-out merger, provided they are completely upfront with the minority shareholder and pay him a fair price and get him out of the business? That question must arise so often that it is bound to get to reported decisions of the courts sometime.

In *Umstead v. Durham Hosiery Mills*³¹ the judge stated in gratuitous dictum, “[p]laintiff’s allegation, taken as true, that defendants intended to freeze out the minority shareholders adequately states a breach of fiduciary duty claim.”³² If that dictum is taken literally, all one needs to do is characterize the cash-out merger as a freeze-out merger, which it virtually always is, and it thereby becomes a breach of fiduciary duty and is prohibited. I do not think the North Carolina courts will go that far. I believe that they will recognize that the entire “fairness doctrine” announced by the *Weinberger* court should apply.

Perhaps the North Carolina courts will apply the reasonable expectations test announced in *Meiselman* to the corollary situation where the minority shareholder is not seeking to withdraw. Instead, he is being expelled by the majority shareholders, and the question whether the right of dissent and appraisal is exclusive so that the majority shareholders may cash him out depends upon the reasonable expectations of all of the parties. If those reasonable expectations of the plaintiff minority shareholder are being unfairly frustrated by the cash-out, then the merger would not be permitted; otherwise it would. No one knows what the courts are going to hold, but I think it is an interesting and important point.

I wish to discuss some changes that have been adopted by the Revised Model Business Corporation Act, and I wish to call attention to the American Law Institute (ALI) project, *The Principles of Corporate Governance and Structure*.

The Principles of Corporate Governance are not stated exclusively in terms of what the law is, although it purports to do that to some extent, but in terms of what the law should be. I believe it is tremendously significant that the Iowa Supreme Court looked to those statements of principles, to that ALI project, in reaching its decision in *Miller* on derivative actions.³³ I think the fact that a state supreme court would look to a project that represents the cutting

³¹ 578 F. Supp. 342 (M.D.N.C. 1984).

³² *Id.* at 345.

³³ *Miller*, 336 N.W.2d at 717.

edge of corporate law development, is very significant. In litigation involving corporate principles it may perhaps be argued that a court should consider the factors being taken into account by the ALI project in saying what corporate law should provide. The *Miller* case is an instance in which one state supreme court has done so, and I believe that is one of the most significant aspects of that decision.

Banking Law

C. Boyden Gray*

GRAY: I have been invited here because of my general role in regulatory reform or deregulation and because of the Vice President's task of formulating recommendations to restructure, if appropriate, the regulatory agencies that govern the financial services industry. There are relationships between all of these things. When you rearrange these relationships, however, either someone will lose a monopoly in the private sector, or a bureaucrat will lose some ground.

The whole area of deregulation is, in many ways, somewhat hopeless because it sometimes takes two steps forward and three steps backward. I thought I would use *D & G Enterprises v. Continental Illinois National Bank*¹ as a focal point for discussing some issues involving deregulation of the banking system. It has become fashionable, at least in Washington, D.C., to use *Continental Illinois* as a way to criticize the Reagan Administration's push for deregulation or regulatory reform. It is said that this is an example of how we must not only stop this deregulation, but we must turn the clock back to where we were a number of years ago. I will discuss the three or four relevant allegations.

The first allegation is that the 1980 Monetary Control Act,² which was a Carter Administration bill, and the 1982 Garn-St

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¹ 574 F. Supp. 271 (N.D. Ill. 1983). Plaintiffs, multiple investors in entities identified as the Longhorn Partnerships, brought this action against Continental Illinois alleging that Continental Illinois, along with Penn Square Bank of Oklahoma and the Longhorn Partnerships, conspired to defraud plaintiffs in connection with the sale of the Longhorn Partnership interests. Plaintiffs alleged that the three entities caused them to invest in the Partnership by furnishing letters of credit in favor of Penn Square, issuing "false and misleading" reports concerning the success of the Partnership, and fraudulently obtaining loans to generate banking business for Penn Square. The court considered defendant's motion to dismiss the complaint ruling that plaintiffs' complaint was insufficient but granting leave to amend.

Subsequent procedural issues involving this case were ruled upon in: *In re Continental Illinois Securities Litigation*, 572 F. Supp. 928 (N.D. Ill. 1983); *In re Continental Illinois Securities Litigation*, 572 F. Supp. 931 (N.D. Ill. 1983); *In re Continental Illinois Securities Litigation*, [Current] FED. SEC. L. REP. (CCH) ¶ 91,457 (7th Cir. April 23, 1984).

² Monetary Control Act of 1980, Pub. L. No. 96-221, Title I, 94 Stat. 132 (1981).

Germain legislation³ are partly responsible for the problems in the banking industry. The theory is that lifting Regulation Q,⁴ which placed a ceiling on the interest payable on small time deposits, has led to an unseemly outbreak of competition for funds for deposits. This has raised the rates that banks have had to offer to get these deposits, and, the theory goes, has forced the banks to make even riskier loans to cover these higher costs. These high-rate loans tend to be high-risk, and this is said to be a source of trouble in *Continental Illinois*.

The problem with that theory is that Continental Illinois did not have a significant proportion of consumer loans or consumer deposits. Like most money center banks, Continental Illinois had been purchasing virtually all of its funds in the uninsured certificate of deposit market where interest rate levels have never been regulated. Indeed, because Illinois law is the most restrictive against branching of any major state, Continental Illinois was probably affected less by the decontrol of interest rates on retail deposits than any other money center bank. Because it was limited by law to only three branches, all in Chicago, Continental Illinois was forced into virtually total reliance on "hot" money, without even the option of attracting a larger proportion of less volatile insured consumer deposits. With ninety percent or more of its funds in uninsured deposits from institutional sources, and often from Europe and Asia, Continental Illinois was more vulnerable to a run than an institution of similar size would be if it were able to branch and attract a larger base of stable consumer deposits. Therefore, regulatory restraints on where it could have branches in Illinois, not deregulation of interest rates, was a contributing factor in Continental Illinois' difficulties.

The second allegation is that the exploitation of loopholes in the Bank Holding Company Act⁵ allowed "nonbank" banks to participate in interstate banking and to create consumer banks that led to financial instability. I do not believe this to be the case, and I think the reverse is probably true. That is, the more that you can diversify your risks, both numerically and geographically, the safer your operation is likely to be. Congressman St Germain's legislation to outlaw the creation of consumer banks seems to be a somewhat misguided proposal. It might make sense on the theory that a consumer bank would siphon away highly reliable business from traditional center banks. But it certainly does not make any sense on the ground that consumer loans are too risky, because they are not. They are far safer in the aggregate than third world country loans, for example.

³ Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469.

⁴ 12 C.F.R. § 217 (1984).

⁵ Bank Holding Company Act, 12 U.S.C. § 1841 (1982).

Outlawing the creation of consumer banks will not make banking safer for the big banks. Even more important than consumer lending is the ability of the nonbank bank to evade current geographic restrictions on bank branching. There certainly can be little doubt that banks with a broad geographic base are safer than "unit" banks limited to a single community or limited area. I believe that the effect of a prohibition on nonbank banks as a tool to allow interstate expansion of traditional banking institutions will be to perpetuate greater risk in the banking system.

The third allegation is that because of the instability that we are now seeing in the unseemly competition that has developed, we should not allow banks to get into any other related financial business, whether it be real estate, insurance, brokerage or underwriting. The theory is that if banks cannot safely handle the banking business, we should protect them from hurting themselves in any other field. This again turns the principle of risk diversification on its head. One way to reduce risk, of course, would be to treat banks as public utilities, but I do not think that it would be a good thing for capital allocation in the United States if our banks generally behaved like public utilities.

The insurance business, the real estate business, and the brokerage business do not want banking in their businesses, although they want to get into banking. They do not want banking in their business, not because they are altruistically worried about banks, but because they think that the competition is going to harm them. In other words, they think it is a profitable activity. If it were not profitable, banks presumably would not want to do it.

Looking at it from the other side, if bankers were bad businessmen as the critics of deregulation say they are, then the people who scream the loudest about broadening their powers, the insurance industry and the real estate brokers, should have nothing to worry about, because the bankers are going to make mistakes to their benefit. They should want banking in their businesses because they could profit by correcting the mistakes.

I am reminded of what the president of Wachovia Bank told me at a meeting. People at Wachovia Bank had started an insurance operation at the turn of the century because no one else in Winston-Salem would do it. When the Bank Holding Company Act was passed, Wachovia's insurance operation was grandfathered. Insurance interests in the community brought pressure to have the bank spin it off. It was a small insurance operation that was profitable, but was not critical to the bottom line of Wachovia. Consequently, as a matter of comity, and not through any legal requirement, Wachovia spun it off. Once liberated from its sleepy bank parent, however, the reinvigorated company has provided new competition that the

existing insurance interests now dislike, and they regret having asked Wachovia to spin it off.

Many people in Washington seem to have a sense that deregulation has led to instability, when in reality the reverse may be true. For instance, Continental Illinois Bank could not do very much. It wanted to grow, its shareholders wanted it to grow, its management wanted it to grow, but it could not grow into anything that was profitable at the time, like insurance or real estate. The bank was limited to what was an increasingly risky and contained business. It became involved in energy and started bidding on loans on a portfolio that was marginal at best, and when it turned sour, there was nothing else on which to fall back. Had Continental Illinois' management been able to think about things other than the limited nature of banking, perhaps the bank would not have put itself in such a risky posture. I cannot guarantee that would have been the case, but I suspect that it would have been likely. I base my conclusion on an article published recently in the *Wall Street Journal*.⁶ It was written by a vice president of a financial services giant that is not regulated as a bank because it is not a bank, and because it has managed to find good lawyers to figure out ways to avoid the clutches of the bank regulators. He wrote that, in fact, securities houses, thrifts, insurance companies, retailers and finance companies have thrived by exploiting loopholes, and thus have diversified both in terms of geography and types of financial services offered. Note that he was concerned about the competition they provided, not the failures they were suffering.

Should it be the national policy that banks should *not* thrive? I think this is not the approach we should take. Preventing banks from maintaining related financial services, services that would help them understand and operate their own banking business better, is tantamount to saying that drugstores should not be selling magazines, food, pencils, or cigarettes. I think the fact that banking is included in this "Securities law" symposium indicates that lawyers who deal in securities or lawyers who deal in banking should be aware of the law that deals with those related services.

In the Bush Task Group on Financial Services we examined the structure of regulation to see how we might confront some of the issues that have arisen. The suggestion that we stop and refrain from doing anything would not be disastrous, but it would mean the loss of a good opportunity.

One defect of the current structure is fragmented responsibility: two and three regulators look at the same business organization. There is a little of the problem of two polite infielders deferring to each other, saying, "You catch the ball. No, you catch the ball." It is

⁶ Garten, *Dealing with a Changed Banking System*, *Wall St. J.*, May 29, 1984, at 30, col. 3.

not now always clear who is ultimately responsible in the federal regulatory scheme. If that is in fact the case—if there is a “No, it is your problem. No, it is your problem” scenario—there may be a situation where two agencies are not giving the proper attention to a bank’s problems or may not fully appreciate the significance of a development in one area of the firm, because they are unaware of other developments in a subsidiary regulated by a different agency.

Moreover, there is probably an irreconcilable conflict of interest between the Federal Reserve Board’s central bank and monetary policy roles and its regulatory and supervisory responsibilities. Can the Board’s use of its regulatory authority and expertise as “leverage” to achieve a goal of monetary policy, such as extending further credit to a debtor nation, always be consistent with sound *regulatory* policy? It might make more sense, as we have proposed, to strengthen the Comptroller of the Currency and to have that agency be given the primary rulemaking responsibility to determine what banks can and cannot do, with the Federal Reserve Board having a veto power. It would probably make more sense to have a banking agency rather than the Federal Reserve Board as the principal rulemaking authority.

Similarly, the Federal Deposit Insurance Corporation should be principally an insurance corporation and not a regulator, so that it can oversee its fund. For example, in *Continental Illinois*, if the FDIC had been given enforcement authority and the right to examine troubled banks, it might not have permitted Continental Illinois to pay over \$100,000,000 in dividends after the failure of Penn Square made the size of Continental Illinois’ problems painfully clear. But that is what has happened. People knew that Continental Illinois had purchased almost a billion dollars in loan participations from Penn Square, and it was obvious then, if not before, that most of these loans would be uncollectable. Yet nothing happened, and \$100,000,000 went out in dividends in the interim that eventually had to be replaced by the FDIC. I do not think the FDIC would have let that happen if it had been involved, or had the right to become involved, two years ago. These are just some of the examples of the improvements that the Task Group hopes to make.

Regulatory agencies are sitting on top of a vastly diversified and more complicated financial service industry than existed when the Comptroller of the Currency was established during the Civil War. The regulatory structure has not been rationalized, and it needs rationalization. All of this, of course, is part of an effort to reach the ultimate goal, which is to improve both the soundness and the efficiency of capital creation and allocation in the United States. It may be due more to the capital gains tax cut of 1978 than to any other single thing, but the fact remains that in 1977 the venture capital

industry was able to raise only \$4,000,000. In 1983 the number increased by forty times. The increase is due primarily to the cuts in the capital gains tax in 1978 and 1981, but I believe it is also due to the improvements made at the Securities and Exchange Commission to make it easier for small companies to go to the market.

Reform does help raise and allocate capital. It is very important in this country that this happen. Much of our new job creation has been fueled by venture capital over the last decade. The Europeans and the Japanese are looking back and remarking that what we are doing is working. The financial industry is central to all of this. If allowed to go its own way, the industry might encounter problems, but if it is too closely regulated, it will almost certainly be smothered.

Banking Law

*John D. Hawke, Jr.**

HAWKE: The topic that I will discuss is bank expansion through the process of mergers and acquisitions, and I will speak about some of the details of the legal standards that apply in this area.

In recent years there seem to be larger and larger bank acquisitions being proposed and approved. Several years ago I had occasion to look back through Federal Reserve decisions over a ten-year time span, to try to determine the extent to which size alone might have an effect on regulatory decisions in bank acquisition cases. I found that during that period, which ran approximately from 1965 to 1975, the Federal Reserve Board had not approved any acquisitions in which there were billion dollar banks on both sides of the transaction. In fact, there had been very few transactions of that magnitude even proposed. Indeed, the Federal Reserve had not granted many applications involving a billion dollar bank on one side of the transaction and a five hundred million dollar bank on the other side. It had been denying applications in that size range quite routinely.

In the last two years, things have changed radically. There have been approximately a dozen large bank acquisitions, mostly in Florida, Texas, Virginia, and Pennsylvania, states where there has been much acquisition activity, in which multibillion dollar banks have acquired other multibillion dollar banks. Recently, the Federal Reserve Board approved the acquisition of Southwest Bancshares in Texas, which is the seventh largest bank in the state and a five-and-a-half billion dollar institution, by Mercantile Texas, which is the fifth largest bank in the state and a seven billion dollar institution. Those banks are combining to form the second largest bank in Texas. Last year the Federal Reserve Board also approved an application by First Chicago, a thirteen-and-a-half billion dollar institution, to acquire American National, a two billion dollar institution. It also recently approved the acquisition by Chase, a twenty-six billion dollar bank measured by domestic deposits, of Lincoln First Bank in Rochester, a three billion dollar institution.

Clearly, the magnitude of the size of bank acquisitions has in-

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creased tremendously. One of the reasons for this dramatic shift may be that a billion dollars is not what it used to be, but the change is not simply the result of inflation. There have been a number of significant changes in the law and in the application of the law by the regulators that have led to this change. I will list them first and then explain them in discussing some of the components of bank merger acquisition analysis.

The first and probably most important reason for the change is that as a result of two decisions, *County National Bancorporation v. Board of Governors of the Federal Reserve System*¹ and *Mercantile Texas Corp. v. Board of Governors of the Federal Reserve System*,² the courts have now firmly established the rule that banking agencies do not have discretion to deny a bank acquisition on competitive grounds unless the acquisition would violate the antitrust laws. During a long period of time prior to these decisions the Federal Reserve Board had asserted a broad discretionary authority to apply its own competitive tests, which in some instances were much more stringent than those of the antitrust laws. For example, in the *County National* case, the Board refused to permit a merger of two banks in the St. Louis market with market shares of about two percent and three percent, a combination that even the Board admitted would not rise to the level of an antitrust violation. The court of appeals reversed the Board on that decision, and the reversal was reaffirmed en banc.³ Thus, the rule was established that the Board must follow the antitrust laws, which are built into the governing statutes that relate to bank mergers and acquisitions: the Bank Holding Company Act⁴ and the Bank Merger Act.⁵

The *County National* and *Mercantile Texas* decisions, which withdrew discretion from the agencies to apply a competitive test tougher than the antitrust laws, resulted in a significant change of market expectations about what can be approved. In fact, the Federal Reserve Board has not denied a bank acquisition on competitive grounds in three years, with the exception of a few cases in which there was a dispute about market definition.

The second reason for the increase in the size of mergers has been the demise and virtual destruction of the doctrine of potential competition. I will expand on that further. The third factor is the increased willingness of the banking agencies to include thrift institutions—savings and loans and savings banks—in their competitive analyses of bank acquisitions, that is to treat savings institutions as comparable to banks for purposes of calculating market shares.

¹ 654 F.2d 1253 (8th Cir. 1981).

² 638 F.2d 1255 (5th Cir. 1981).

³ *County Nat'l*, 654 F.2d at 1260.

⁴ 12 U.S.C. §§ 1841-1849 (1982).

⁵ *Id.* § 1828.

Fourth, the increased and more sophisticated use of divestitures to cure competitive problems has facilitated many mergers that otherwise would have been denied. Finally, an additional factor may be a market perception that the Justice Department is not going to be a strong force in the bank merger and acquisition area. I will expand on some of these points as I discuss the elements of bank merger analysis.

First, the Bank Holding Company Act and the Bank Merger Act both expressly embody an antitrust standard in that they prevent the agencies from approving bank mergers and acquisitions that would violate the conventional standards of the Clayton Act and the Sherman Act. Those statutes provide one exception, however. The agencies may approve a transaction that would otherwise violate the antitrust laws if they find that the probable effects of the transaction in meeting the convenience and needs of the community clearly outweigh the anticompetitive effects of the merger. This balancing test was built into the statutes in 1966 to mitigate the application of pure antitrust principles to bank mergers and allow the banking agencies to approve mergers that would have public benefits from a banking point of view, notwithstanding antitrust problems. As a practical matter, that balancing test was undercut by the Supreme Court decision in *United States v. Third National Bank in Nashville*,⁶ which requires that before an agency may justify an anticompetitive merger on the basis of the balancing test, it must find that there is no less anticompetitive way of solving the same problems or providing the same kinds of public benefits. As a result of that decision, few cases have been approved in which an antitrust violation would otherwise be present, and the approval is based on the favorable balancing of public benefits.

The conventional approach to bank merger analysis, as followed by the agencies, involves three quite discrete steps. First is the process of market definition, which further breaks down into definition of the product market and definition of the geographic market. The purpose of formulating a market definition is to establish a matrix in which market shares may be calculated and the competitive analysis of the merger carried out under antitrust standards. The product market definition issue may be reduced essentially to the question whether thrifts are to be included in the calculation of market shares, and if so, to what extent.

Over the past five years the three banking agencies have adopted the viewpoint that thrift institutions should be included in product market analysis. Thrift institutions now have virtually all the powers that commercial banks have. Commercial banks are no longer the unique provider of demand deposit services, nor are they

⁶ 390 U.S. 171 (1968).

the unique provider of commercial loans. Thrift institutions are getting increasingly into those lines of business. Thus, several years ago the Comptroller of the Currency and the Federal Deposit Insurance Corporation, and more recently, the Federal Reserve, concluded that thrifts should be included in the product market analysis. The Federal Reserve Board will now give virtually full credit to thrift institution deposits in calculating market shares if there is any showing that thrift institutions are engaged in, or are trying to engage in, commercial lending, or are offering retail demand deposits or transaction accounts.

I think the reason that the inclusion of thrifts has been a facilitating factor with respect to the increasing size of bank mergers is obvious. The inclusion of thrifts in the product market and the market share calculation increases the size of the denominator in the market share calculation and consequently diminishes the size of the market share that is attributed to the merging parties. Federal Reserve decisions over the past year have increasingly accorded weight to thrift deposits as a mitigating factor.

The second step in the conventional merger analysis is geographic market definition. The three banking agencies have taken different approaches in this area. The Federal Reserve defines geographic markets largely without reference to the locations in which the particular merging banks may be doing business. For example, if you have a bank merger involving the banks in Charlotte, North Carolina, the Federal Reserve Board will tell you what market they use in that area, which will probably be something like the Charlotte Metropolitan Statistical Area or some other predefined area that they perceive to be the economic market centering on the City of Charlotte. The extent of the market in any sizeable metropolitan area will have been predefined by the Federal Reserve Board. Therefore, if a merger has to go to the Federal Reserve Board, the first step is to find out how they define the market and to decide whether to agree with it or to contest it. Obviously, the way in which the geographic market is defined will be outcome-determinative in many cases because it can significantly affect the calculation of the market share fraction.

The Comptroller of the Currency follows quite a different approach, the service area-oriented approach, which looks principally to locations in which the merging banks are doing business. The Comptroller will define markets by determining from what geographic area the merging banks derive approximately seventy-five percent of their deposits and loans. The Federal Deposit Insurance Corporation uses a similar technique. The area may or may not have any relationship to the kind of predefined market used by the Federal Reserve Board. This disparity in technique for defining geographic

markets is of great importance to any lawyer who is involved in planning a merger transaction. To some extent the merger may be structured in such a way as to come within the jurisdiction of one or the other of the federal banking agencies that will apply a market definition most hospitable to a favorable antitrust analysis of the transaction.

The Justice Department does not use any single method. It tends to follow the approach of the Federal Reserve Board but sometimes will follow an approach that sounds like the service area approach. The Justice Department will rarely look to any area of a size smaller than a county for purposes of determining the geographic market, and it tries to define an area in which a customer might turn for alternative services if one of the alternatives that he presently has is eliminated by a merger. To define that area, the Department will try to project from what geographic area other competitors might attempt to enter that market if the local banks tried to raise their prices by five percent. It is not an easy technique for prelitigation analysis.

The Justice Department follows an approach that differs quite markedly from the banking agencies on the issue of product market definition. The Department is willing to give some credit for thrift institution deposits in the product market analysis but basically divides the banking markets into two segments: retail banking and commercial banking. This is the definition used in the most recent suits that the Department has filed in Virginia and New York. The complaint in the New York suit defines retail banking as banking services offered to individual customers, including time deposits, savings deposits, transaction accounts, consumer loans, and residential mortgage loans. In contrast, the complaint defines commercial banking as banking services offered to commercial customers, including commercial type transaction accounts and commercial loans. I do not know how to apply those tests in counseling clients on bank mergers, because the kind of data that is needed to make that analysis generally is not available, and the Department has not yet had an occasion to litigate fully that approach.

Once you have gone through the process of deciding what product market and geographic market you will use, you will be able to calculate market shares. Determining the shares of the incumbent firms in the market—banks, or banks and thrifts, depending on how you define the market—is a simple mathematical exercise. The market shares generally are calculated in terms of deposits. Branch office deposit data is readily available from the Federal Deposit Insurance Corporation as of June 30 of each year, and it is virtually universal to use deposits as a proxy for all of the other measures of market presence.

When you have calculated the market shares, the next step is to determine whether the acquisition is going to have the kind of competitive impact that would rise to the level of a violation of the antitrust laws. Two years ago the Department of Justice issued new guidelines for competitive analysis incorporating the Herfindahl-Hirschman Index (HHI). This economist's measure of market concentration is now being used by virtually all the banking agencies in their analyses of the competitive impact of bank mergers. The HHI is calculated by determining and squaring the market share of each participant in the market, and adding up the squares of all the shares in the market. This Index is the starting point for analysis under the Justice Department guidelines.

The Department divides markets into three categories based on the size of the HHI. There are highly concentrated markets, where the Index is over 1,800; moderately concentrated markets, where the Index is 1,000 to 1,800; and relatively unconcentrated markets, where the Index is under 1,000. Under the Department's guidelines, mergers may or may not be subject to attack under the antitrust laws if the postmerger HHI falls into one of the three categories, and the increase in the HHI resulting from the merger is within certain parameters. If the postmerger HHI is less than 1,000, the Justice Department will tolerate virtually any increase in the HHI. If the postmerger HHI falls in the 1,000 to 1,800 range, and the increase resulting from the merger is less than one hundred, it is a safe harbor, but if the increase is over 100, there is a good chance of Justice Department attack. Finally, if the postmerger HHI is over 1,800 and the merger results in an increase in the HHI of less than fifty points, you are safe, but if the increase is more than one hundred points there is a likelihood of Justice Department attack. If the increase falls in the area between fifty and one hundred, you will probably have to negotiate with the Justice Department because it may or may not attack in that area.

This Index and these advance warnings given by the Justice Department in its guidelines are quite theoretical. In all bank merger and acquisition cases the Department gives an advisory report to the banking agency that has approval authority. This report is intended to indicate the Department's view on the merger. If the Department considers the merger to have a significantly adverse competitive effect, which is the Department's term for a conclusion that the merger would violate the antitrust laws, the merger is supposedly subject to attack. A recent study shows, however, that in the last five years the Department has submitted forty significantly adverse competitive factor reports on bank mergers, and the agencies nevertheless have approved twenty-three of those mergers. The Department has only sued in four cases, however, notwithstanding those approvals. It lost

three of the four cases and settled the fourth. Thus, the Department's record has not been very good in attacking approved bank mergers, nor has their resolve to sue been very strong.

The third reason that I mentioned for the increased size of mergers was the demise of the doctrine of potential competition. This doctrine is basically an antitrust theory that applies where a company is making an acquisition in a new product or geographic market in which it is not presently doing business. In the banking area, this generally means a bank acquiring a bank in a new geographic market, as would be the case in an interstate banking environment. The theory of potential competition is that if a bank proposes to move into a highly concentrated local market by acquiring one of the largest banks in that market, and if it can be shown that if denied that acquisition it would probably to go into the market in a small way, either de novo or by a toehold acquisition, the proposed acquisition of the large bank should be viewed as anticompetitive and the transaction denied.

Several years ago, in the *Mercantile Texas* case the Federal Reserve Board denied Mercantile's proposed entry into the El Paso and Waco markets on the theory of potential competition.⁷ The Fifth Circuit reversed the Board and set a very demanding factual test for the application of the potential competition doctrine,⁸ which has resulted in the decline of the doctrine. In the last three years the Board has not turned down a single acquisition on potential competition grounds. Two years ago the Board issued a set of proposed guidelines to identify those market extension acquisitions that are likely to give rise to potential competition problems. The sieve that they proposed to create with these guidelines has been so coarse that every transaction that has been proposed so far has fallen through it and has not been scrutinized under the potential competition theory. In fact, the Board's hostility to potential competition now seems so extreme that it has even approved mergers in the past year that would have fallen under its own proposed guidelines.

In April 1984 Chairman Volcker dissented in a significant decision as to a merger between the largest bank in Omaha, Nebraska and the largest bank in Lincoln, Nebraska. In his dissent, Chairman Volcker said:

[T]his case raises a significant issue as to the applicability of the potential competition doctrine The standards established in *Mercantile Texas Corporation v. Board of Governors* for application of the probable future competition doctrine, standards reflected in the Board's proposed guidelines for assuring probable future competition, are quite rigorous. Under conditions existing in most banking markets today, particularly in light of the competition afforded by

⁷ *Mercantile Texas*, 638 F.2d at 1255.

⁸ *Id.* at 1264-66.

thrift institutions, it has been the Board's experience that these standards would proscribe only a limited number of proposed market extension mergers.⁹

It is not entirely clear why Chairman Volcker signalled his discomfort with the potential competition doctrine while other members of the Board did not seem to share that discomfort, but certainly his conclusion is right that very few transactions today would be likely to trigger antitrust concerns under the potential competition doctrine. If state lines are broken down in the interstate banking environment, the applicability of antitrust to bank acquisitions will be even less because as the the state line barriers break down, there will be more and more potential entrants into local markets, which will undercut the application of the potential competition doctrine.

There is one final point relating to divestitures of which attorneys should be aware when counseling banks in bank mergers where there may be a competitive problem that can be cured by a divestiture. Divestitures have been used selectively in a number of recent bank mergers to cure competitive problems in local markets so as to eliminate antitrust problems while allowing the consummation of the larger part of the transaction. One of the best examples of this is the merger in Virginia between Virginia National and First and Merchants, the second and fifth largest banks in the state, which combined to create the largest bank in Virginia as of December 31, 1983. There were substantial overlaps in the Richmond and Norfolk markets, among others, which were cured by divesting a total of thirty-four branch offices around the state. This resulted in the elimination of some of the deposit base that would otherwise have been acquired in the merger, without eliminating such a large amount that the principal objectives of the transaction were frustrated.

The most significant point regarding divestitures is determining in advance how much to divest so as to avoid the antitrust problem. Once you have done that, it is important to remember for counseling purposes that under the rules of the Federal Reserve Board and the Department of Justice, divestitures must be accomplished no later than the time that the principal merger itself is consummated. Therefore, since you are working in a regulated area, not only will the principal merger transaction have to satisfy all of its regulatory approval requirements, but the purchaser who is buying the divested properties will have to obtain all of its own regulatory approvals to buy the branches in time to allow the principal transaction to be consummated on your timetable.

Our experience has been that the timing of those divestitures is a continual problem. Everyone wants to close mergers, for example,

⁹ Omaha National Corp., 70 FED. RES. BULL. 522 (1984) (dissenting statement of Chairman Volcker) (majority opinion published at 70 FED. RES. BULL. 447 (1984)).

on December 31 for accounting purposes, and the month of November is generally a frantic month at the banking agencies that are trying to get divestiture transactions approved to facilitate mergers. If you are in that situation, you would be wise to plan well in advance for divestitures.

Banking Law

*Ralph N. Strayhorn**

STRAYHORN: I will discuss some of the recent developments in interstate banking. As a matter of background, it is necessary to consider the statutory framework within which interstate banking works. Geographic restrictions on national bank and state charter banks are covered by the McFadden Act.¹ The McFadden Act defines a branch as being a place of business at which deposits are received, checks are paid, or money is lent.² It further provides that a national bank may, with the approval of the Comptroller of the Currency, operate new branches at any point within the state in which the national bank is located, if such establishment and operation are at the time authorized to start banks by state statutory language affirmatively granting such authority and not merely by implication or recognition.³

The McFadden Act thus specifically prevents national banks from branching if state banks are not permitted to branch. Interstate acquisitions by bank holding companies are governed by the Bank Holding Company Act⁴ and must have the approval of the Federal Reserve Board. This is triggered when one buys five percent or more of the voting shares or obtains control of the bank. The Douglas Amendment, section 1842(d) of the Act, prohibits the Federal Reserve Board from approving any application that

will permit any bank holding company or any subsidiary thereof to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets unless the acquisition of such shares, or assets of a State bank by an out-of-State holding company is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication.⁵

Thus, there must be a specific authorization.

Recently, there has been a great deal of publicity generated

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¹ 12 U.S.C. § 36 (1982).

² *Id.* § 36(g).

³ *Id.* § 36(c).

⁴ 12 U.S.C. §§ 1841-1850 (1982).

⁵ *Id.* § 1842(d)(1).

about the possibilities of amending or repealing the McFadden Act and the Douglas Amendment, which prohibit banking operations from going beyond their home state. Congressional action would be necessary to amend both acts as they are federal laws.

More recently, however, most of the real activity and the easing of geographic barriers has centered on the language of the Douglas Amendment, which arguably permits states to determine conditions under which out-of-state bank holding companies may acquire a bank in another state. The conscious loosening of geographic restrictions by state action is a rather recent phenomenon. The first act to loosen those restrictions was passed by Maine, effective in January 1978.⁶

Currently, there seem to be five main avenues that have been used by states to allow the expansion of out-of-state institutions inside a state. The first avenue is full unrestricted entry. This was enacted by Alaska in 1982 and permits out-of-state holding companies to acquire banks and bank holding companies within Alaska.⁷ Alaskan law does not contain a reciprocity provision. Alaska seems willing for anyone to come in and acquire Alaskan banks without requiring similar treatment by the acquiring state. Maine recently has eliminated its reciprocity provision, so that both Alaska and Maine now qualify under the first heading of full unrestricted entry.

The second avenue is nationwide reciprocity. New York permits out-of-state bank holding companies to acquire bank holding companies within that state provided that New York bank holding companies may acquire banks in other states.⁸ That impetus of the New York law originates from the money center banks because those banks desire to expand wherever they can.

The third category is a geographically limited reciprocity. Massachusetts⁹ and Connecticut¹⁰ have enacted these types of statutes. Rhode Island¹¹ has passed similar legislation, which will take effect July 1984, and Georgia¹² has passed a reciprocal interstate banking statute for banks within the southeastern region of the country. Florida passed a reciprocal interstate banking statute embracing fourteen southeastern states and the District of Columbia, effective as of May 22, 1984. Kentucky has also passed such a statute embracing only the states contiguous to Kentucky.¹³ The statute also contains a "trigger" provision, which provides that the geographical limitation

⁶ ME. REV. STAT. ANN. tit. 9-B § 1013 (as amended Feb. 7, 1984).

⁷ ALASKA STAT. § 06.05.235 (Supp. 1983).

⁸ N.Y. [Banking] LAW § 142-b (McKinney Supp. 1983).

⁹ MASS. ANN. LAWS ch. 167A, § 1(a) (Michie/Law Co-op. 1984).

¹⁰ See CONN. GEN. STAT. ANN. § 36-418 to 36-430 (Supp. 1984).

¹¹ R.I. GEN. LAWS § 19-30-2 (1984).

¹² GA. CODE ANN. § 7-1-620(10) (1980).

¹³ KY. REV. STAT. ANN. § 287.900(6)(a) (1982).

to contiguous states will be repealed after two years. Utah has passed such a statute also on a reciprocal basis, embracing eleven western states.¹⁴

The fourth type of entry is the limited purpose entry. Limited purposes include the acquisition of single banks and credit card operations. The fifth type is emergency entry. Washington passed such a statute,¹⁵ which permitted the Bank of America in California to take over the Seafirst in Washington. Oregon and Utah also have such types of emergency legislation.

Those are the five main categories that the states have enacted by legislation. There are also grandfather expansion provisions, but I will not discuss those because they are varied, and some of them probably were unintentional and brought about by some very innovative members of the bar.

In Arizona, California, Florida, Illinois, Iowa, Maryland, Michigan, Minnesota, Missouri, Nebraska, Ohio, Oklahoma, South Carolina, Wisconsin, and Washington, interstate bills are pending. I include South Carolina, although it enacted a Reciprocal Interstate Banking law with an effective date in 1986.

Currently, there is pending a report to the General Assembly by the Legislative Research Commission on Taxation, Regulation of Bank Savings and Loan Associations and Credit Unions. A part of that report is the Commission's recommendation that a Reciprocal Interstate Banking bill be passed by the legislature in North Carolina. This recommendation is significant because the legislature is in a short budget session in which there must be a suspension of the rules to discuss anything other than a budget item, a report of a commission, or a bill that has been passed by one house in the 1983 session.

During the latter part of 1983, there were a number of informal gatherings of lawyers and bankers in the Southeast to discuss the possibility of a Reciprocal Interstate Banking Bill. Many bills were prepared, circulated, marked up, and discarded. Finally, Georgia lawyers drafted a model bill. The Florida and North Carolina bills are patterned after the Georgia bill.¹⁶

The Georgia bill required that an eighty percent asset base be required and retained in the region composing the southeastern region, which includes twelve states, including North Carolina and the District of Columbia. This region together with Arkansas and Kentucky, is the earlier Fifth and Sixth Federal Reserve District. The legislation, of course, effectively relaxes the restrictions imposed by the Douglas Amendment, as it permits bank holding companies to

¹⁴ UTAH CODE ANN. § 7-1-702 (1982).

¹⁵ WASH. REV. CODE § 30.04.230 (1982).

¹⁶ GA. CODE ANN. § 7-1-620(10) (1980).

engage in acquisitions and mergers involving banks and bank holding companies across state lines. The legislation does not effect a relaxation of the McFadden Act, however, and consequently, interstate branch banking is still prohibited. Thus, to participate under the terms of the bill, a holding company structure is necessary.

The bill begins with a series of precise definitions of terms such as banks and bank holding companies. A bank holding company's principal place of business must be in the southeastern region, and that principal place of business is determined by the primary location of the deposits of the subsidiary banks of the bank holding company. For a regional bank holding company to acquire a bank in North Carolina, the laws of the state in which the regional bank holding company has its principal office must permit North Carolina bank holding companies to acquire banks and bank holding companies in that state. This is the basic reciprocity test.

There is also a specific transitional reciprocity test, sometimes referred to as the "mirror image" test. The purpose of the "mirror image" test is to ensure that any target institution has a comparable opportunity to make acquisitions in the state where the acquiring bank holding company has its principal place of business. This prevents the other state from imposing burdensome and unfair restrictions on North Carolina bank holding companies desiring to make acquisitions in that state. There is also a requirement that a regional bank holding company that already has a North Carolina bank subsidiary obtain approval of the North Carolina Commission of Banks for any additional acquisitions of North Carolina banks or bank holding companies, assuming all requirements have been met. That provision was inserted in the bill during the committee hearings on the bill, and the North Carolina Commission of Banks is given appropriate authority to promulgate such rules and regulations as are necessary to implement the statutes.

I believe the remainder of the bill is standard. Notably, the bill contains a nonseverability provision, so that if any section of the bill is declared unconstitutional, the entire bill falls. Thus, we will not be compelled to accept nationwide interstate banking without intending to do so. The effective date of the bill is January 1, 1985.

There are, of course, certain constitutional issues raised by these regional banking statutes. The first argument is raised under both the Commerce Clause and Supremacy Clause of the Constitution. The argument for the regional statutes is that Congress limited bank holding company acquisitions to banks in a single state and gave the right to states under the Douglas Amendment to make exceptions to that limitation. Further, since Congress has the right to regulate interstate commerce, including the right to use state boundaries as lim-

its of bank holding company expansions, states acting under that delegated authority should also be allowed to regulate.

One argument against the constitutionality of these statutes is that they violate the Commerce Clause because they seek to prevent bank holding companies located outside the borders of the defined region from expanding into the state, and this is an unconstitutional attempt to regulate interstate commerce. Another consideration is whether such regional banking statutes violate the Equal Protection Clause or the Due Process Clause of the Constitution. In an attempt to strike the statutes under the Equal Protection Clause, the threshold test is whether the statute decrees a suspect classification or impinges on fundamental rights. If neither of these conditions are present, the test is whether the classification bears a rational relationship to a legitimate state purpose.

The argument advanced against the validity of such statutes is that there is no legitimate legislative purpose in lifting the provision of the Douglas Amendment as to a certain region. The argument in favor of these regional statutes is that there are a variety of valid reasons to form a banking region: history, economic affinity, bank structure, and desire to maintain home financial institutions. The final argument against the constitutionality of such banking statutes is that they violate the Compact Clause, which forbids states to enter into compacts unless they are approved by Congress.

Eight states have enacted laws similar to that proposed for North Carolina: Connecticut, Georgia, Kentucky, Massachusetts, Rhode Island, Utah, South Carolina, and Florida. On March 26, 1984 the Board of Governors of the Federal Reserve System had an opportunity to consider the legality of the Regional Reciprocal Interstate statutes. The Board was faced with the merger of the Bank of New England Corporation of Boston, Massachusetts and the Connecticut Bank and Trust Corporation of Hartford, Connecticut.¹⁷ The Board approved the merger of those two banks from two different states under their Regional Reciprocal Banking laws. It had been speculated, however, that the Board would not approve that merger.

By approving this merger, the Board seems to have indicated to courts and to Congress, as well as to the banking community, that it will approve such transactions under these Regional Reciprocal Banking laws. The burden is on Congress and on the courts to deal with the question whether these statutes should be permitted to continue. Chairman Volcker apparently does not like these kinds of statutes, because he has indicated that he considers this type of legislation a Balkanization of the process.

The ruling by the Federal Reserve Board was appealed to the

¹⁷ See *FED. BANKING L. REP. (CCH)* ¶ 99,922 (April 13, 1984).

Court of Appeals for the Second Circuit in New York, in which an injunction against the merger was sought. The case was argued before the Second Circuit on May 14, 1984. I believe it would not be too far afield to speculate that no matter how the Circuit rules, the case will be taken up for a ruling by the Supreme Court.

There are miscellaneous interstate banking developments that I would like to mention. One is the *United States Trust Corporation* decision,¹⁸ holding that, under section 4(c)(8) of the Bank Holding Company Act, United States Trust could convert to something other than a trust company, for instance, to a "consumer bank" where it could receive deposits and make consumer loans, not commercial loans, although the latter is the definition of a bank. Consumer loans are loans that are made for personal, family, household, or charitable purposes. As a consequence of that decision, there has been a flood of applications to form consumer banks all over the country. Some of the North Carolina banks made applications on these kinds of banks, and the Comptroller imposed a moratorium for applications after March 31, 1984 stating the moratorium was "an effort to encourage Congress to enact legislation to set the guidelines for banks and other financial institutions as to what the rules were."

There is one other significant decision, a New York district court decision holding that automatic teller machines are branch banks.¹⁹ I do not know of any other such holding. The Comptroller has ruled that they are not branch banks, and thus, banks have been busy forming networks across state lines. If the New York district court decision should become the law of the land, these networks will have to be dismantled. I doubt very much that would happen.

Not long ago, banks were perceived as public utilities, and their stocks were viewed as safe and sound investments. The image of banks has changed dramatically, however, as banks have expanded into many different fields and are anxious to expand even further. We could conclude that the McFadden Act and the Douglas Amendment are teetering a bit. The web of geographic restraints is unraveling. There are many different views on what restrictions should be retained and which deregulations should and should not be enacted. We have a pool of many different opinions as to the mixing of expansion and freedom and questions of how far and in what direction we should go. Banking today is an exciting field, and what is in vogue and legal today, may not be tomorrow, and vice versa.

¹⁸ 73-78 FED. BANKING L. REP. (CCH) ¶ 49,120.16 (FRB 1973).

¹⁹ *Independent Bankers Assoc. of N.Y. v. Marine Midland Bank*, 1036 FED. BANKING L. REP. (CCH) ¶ 86,031 (W.D.N.Y. Dec. 2, 1983).

Insider Trading

Theodore H. Levine*
with input from Stanley Sporkin

LEVINE: I will focus today on the subject of insider trading by analyzing case law development and suggesting some practical solutions to insider trading problems. As most of you may know, the Securities and Exchange Commission has made its enforcement program against insider trading a very high priority. Since September 1981, there have been sixty-one enforcement cases instituted by the Commission. Even before that time, when Stanley Sporkin and I were working together at the Commission, there were significant efforts in this area. Despite these efforts, there has been a proliferation of insider trading abuses involving not only traditional corporate insiders but also relatives, friends, associates, and other non-traditional corporate insiders such as financial printers, brokers, investment bankers, lawyers, and most recently, journalists and other media persons.

On the whole, the Commission's enforcement program has received favorable treatment in the lower courts, and despite *Chiarella v. United States*¹ and *Dirks v. SEC*,² there has been widespread support. In fact, in the May 28 issue of *Business Week*, there was a poll of corporate executives that overwhelmingly supported keeping or expanding the insider trading regulations, and a majority believed that an insider should be defined to include anyone who possesses non-public corporate information.³ I think the Supreme Court in *Chiarella* and *Dirks* intended to restrict significantly insider trading liability. In some of the decisions that I will mention, however, the lower courts seem to have ignored or at least have interpreted loosely the mandate of the Supreme Court.

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¹ 445 U.S. 222 (1980).

² 103 S. Ct. 3255 (1983).

³ See *A Get-Tough Mood on Insider Trading*, *BUS. WK.*, May 28, 1984, at 16. Approximately two-thirds of the executives believed that insider rules should be maintained in their present form, and one-fifth felt that the rules should be made stricter. Sixty-eight percent felt that anyone with confidential information about a company should be considered an insider.

Except for the prohibition against short-swing trading in the Securities Act of 1934⁴ and the Commission's rule 14e-3,⁵ dealing with insider trading in connection with tender offers, there is no specific statutory prohibition against insider trading. Case law has developed on an ad hoc basis essentially under rule 10b-5 antifraud provisions.⁶ In the classic opinion in *In re Cady Roberts & Co.*⁷ the Commission, under Chairman William Cary, developed a disclose or refrain rule; that is, an insider must either disclose the information if it is material and nonpublic or refrain from trading. When that rule was applied in the 1970s it was assumed to be based on an informational or equal access theory. If an insider had information that someone else did not have, either he had to disclose it or he could not trade. The decision in *SEC v. Texas Gulf Sulphur Co.*⁸ also focused on the equal access theory.⁹

After *Chiarella* and *Dirks*, however, courts became more careful in interpreting the trading prohibitions. Three theories developed. One theory is what has been referred to as the "information" theory.¹⁰ The second is what the Supreme Court has identified as the

⁴ 15 U.S.C. § 78p(b) (1983).

⁵ 17 C.F.R. 240, 14e-3 (1980). Rule 14e-3 states in pertinent part:

If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

⁶ 17 C.F.R. 240.10b-5 (1984).

⁷ 40 S.E.C. 907 (1961).

⁸ 401 F.2d 833 (2d Cir. 1968)(en banc), cert. denied, 394 U.S. 976 (1969), cert. denied, 404 U.S. 1005 (1971), reh'g denied, 404 U.S. 1064 (1972).

⁹ The law of insider trading developed primarily under the federal securities laws, especially section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (1970). There is common law precedent, however, for the disclose or abstain rule. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909) (the "special facts" of a particular case may result in a duty to disclose information). The *Texas Gulf Sulphur* court approved the construction of rule 10b-5 as covering fraud on the marketplace. The court stated:

Whether predicated on traditional fiduciary concepts . . . or on the "special facts" doctrine [citing *Strong v. Repide*], the Rule is based on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.

Texas Gulf Sulphur, 401 F.2d at 848.

¹⁰ See Judge Skelley Wright's decision in *Dirks*, 681 F.2d at 833-37.

“fiduciary” theory, and the third is what some of the justices on the Supreme Court have called the “misappropriation” theory.

Essentially, the Supreme Court has rejected the concept of an equal access or informational theory, stating that a fiduciary relationship must have existed for the disclose or refrain obligation to apply. Clearly, the traditional insider who has distinctly different fiduciary obligations to both the corporation and to the shareholders was bound by the disclose or refrain obligation. In applying that fiduciary concept beyond the traditional insiders, however, courts have encountered much uncertainty, which has resulted in various interpretations, some of which have been favorable to the Commission.

Also left uncertain by *Chiarella* and *Dirks* is the viability of the misappropriation theory. The majority opinion in *Chiarella*, written by Justice Powell, stated that mere possession of material nonpublic information does not create a duty to disclose to shareholders from whom securities were purchased. There was an alternative misappropriation theory, however, argued by the Government in *Chiarella*. The majority stated that because that theory had not been argued before the jury, the Court would not decide its viability. In a dissenting opinion, agreed to by Justices Marshall, Blackmun, and Brennan, Chief Justice Burger raised an alternative theory that has become known as the “Burger misappropriation theory.” According to that theory, the misappropriation of information—unlawfully obtaining and using material nonpublic information—imposes upon the user a general obligation to the entire marketplace, including the shareholders of the target company, to either disclose or refrain from trading.¹¹

In addition to the Burger misappropriation theory, Justice Stevens in a concurring opinion in *Chiarella* suggested a more limited misappropriation theory, which states that if an insider breaches a duty to a person by stealing information, such as wrongfully taking it from an employer and indirectly from the employer’s client, he has breached a duty to that person. That breach coupled with trading possibly could be a rule 10b-5 violation. Justice Stevens observed in his analysis, however, that because of the decision in *Blue Chip Stamps v. Manor Drug Stores*,¹² which denies standing under rule 10b-5 to someone who is defrauded unless he was a purchaser or seller, there were some problems with respect to private plaintiffs. Since the person defrauded was not a purchaser or seller, he could not have standing to sue and thus, was left without a remedy. Justice Stevens wisely left the resolution of that issue for another day.¹³

¹¹ *Chiarella*, 445 U.S. at 239-45.

¹² 421 U.S. 723 (1975).

¹³ *Chiarella*, 445 U.S. at 237-38.

After *Chiarella*, however, the lower courts began applying the Stevens misappropriation theory in almost every case in which there was insider trading in a merger or acquisition context. The court in *United States v. Newman*¹⁴ was forced to deal with the misappropriation theory.

In *Newman* employees of Morgan Stanley were stealing and selling nonpublic information about impending tender offers in which Morgan Stanley was involved. The Second Circuit in *Newman* held that Morgan Stanley had been defrauded because its reputation was sullied. Additionally, the clients of Morgan Stanley were also defrauded because it was more difficult to acquire the securities in a tender offer due to the fraudulent buying activity, which had manipulated the price of the target company stock upward. Endorsing the misappropriation theory suggested by Justice Stevens, the court held that such activity was a rule 10b-5 violation, and the employees could be criminally prosecuted.

When the Second Circuit was faced with the same facts, however, in *Moss v. Morgan Stanley*,¹⁵ it rejected the Burger misappropriation theory. The *Moss* court dismissed the action in the private context, which resulted in a very interesting dilemma. One could be criminally convicted of a rule 10b-5 violation, yet not be subject to a private action for damages. I am certain the Supreme Court did not intend the law to develop that way.

After *Newman* and *Chiarella*, the *Dirks* case was decided. *Dirks* was a decision that focused primarily on aiding and abetting, or tippee liability. In *Dirks* the Supreme Court held that for there to be a tippee, the tipper had to have breached a fiduciary duty. According to the Supreme Court, to determine whether the tipper has breached a fiduciary duty, a court must first determine whether the tipper received any kind of direct or indirect personal benefit. Personal benefit means receiving some type of pecuniary or reputational benefit, or conveying a gift to a friend or relative. A tippee is viewed as being a participant after the fact if he knew or should have known of the breach of fiduciary duty. The Court found that *Dirks* was not in that position, and consequently, the judgment against *Dirks* was reversed.¹⁶

Although the Court in *Dirks* was provided with the opportunity to address the misappropriation theory, it did not discuss the theory. The Supreme Court found that the case was not one in which *Dirks* had misappropriated information. In fact, he had received information from an insider for the purpose of revealing a fraud. Therefore, the Court concluded, there was no breach of fiduciary duty by the

¹⁴ 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983).

¹⁵ 719 F.2d 5 (2d Cir. 1983).

¹⁶ *Dirks*, 103 S. Ct. at 3266-68.

insider and no obligation on the part of Dirks to disclose the information before he traded or passed it on to others.

As a result of *Dirks*, discerning a tippee's liability under rule 10b-5 has become very difficult. If a situation exists where analysts inadvertently are provided with nonpublic information, but personal benefit to the tipper cannot be shown, the tippee is free to do whatever he wants with that information—trade on it or pass it on. On the other hand, if there is any personal benefit to the tipper, the analyst faces liability if he knows or has reason to know of the benefit. Such an approach may encourage analysts to become more active in ferreting out material nonpublic information. While this may benefit the efficient market theory, it creates enormous problems for corporate management, investment bankers, and law firms in controlling information.

Corporations want to control the public release of information in a way that is consistent with their own business planning and not be subject to inadvertent leaks which make transactions in the company's securities more difficult. Controlling information becomes more difficult, and legitimate insider transactions become more difficult to accomplish because insiders never know when information may surface in a manner contrary to the interest of the company. Later I will talk about some procedural steps to guard against that problem. Analysts have more flexibility as a result of *Dirks*, and the determination of whether the insider received personal benefit from the disclosure becomes the dispositive question in the typical tippee case.

Despite the Supreme Court's restrictions of rule 10b-5 in the insider trading area, the lower courts have proceeded as if the cases had never arisen. Three cases are worth mentioning. In *SEC v. Materia*,¹⁷ the facts of which are very similar to those in *Chiarella*, the United States District Court for the Southern District of New York found that a printer who had misappropriated information from his employer, traded on it, and passed it to others, had breached the fiduciary duty to his employer and to the employer's clients. Endorsing the Stevens misappropriation approach, the court found that defendant's actions violated rule 10b-5.

In *SEC v. Lund*¹⁸ the United States District Court for the Central District of California found a rule 10b-5 violation when defendant had received information from an insider concerning a possible joint venture and had then purchased shares in the company. The court viewed the passing of the information as having a legitimate business purpose, because the insider was trying to obtain the opinion of the

¹⁷ [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,526 (S.D.N.Y. 1983), amended, [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,583 (S.D.N.Y. 1983).

¹⁸ 570 F. Supp. 1397 (C.D. Cal. 1983).

tippee to evaluate whether the corporation should proceed with the possible joint venture. The tippee was a confidant of the corporation and the insider. The court said that because of his long-standing relationship with the company, the tippee should be viewed as a "temporary insider," and consequently, bound by the disclose or refrain from trading rule.

The *Lund* opinion seems to focus on footnote 14 in the *Dirks* decision where the *Dirks* court identified a group of persons such as lawyers, accountants, investment bankers, and consultants who may be viewed as quasi-insiders.¹⁹ Persons who have confidential relationships with a corporation and receive information in a situation where the corporation intends that they keep that information confidential must use it only for the purposes for which it was received. If information is received in that context, a person may be viewed as an insider and therefore bound by the traditional fiduciary obligations of an insider. It may be argued that the court narrowly viewed the misappropriation theory by assessing liability only if the person has a certain relationship with the corporation and receives information legitimately, but then misappropriates it. Those who want to read that footnote narrowly view it as a limitation on the misappropriation theory, while others view it as an expansion of the traditional insider concept.

I think the Supreme Court itself is not clear as to the direction in which it intends to go, because Chief Justice Burger, who dissented in *Chiarella* and articulated a broad misappropriation theory, concurred with the majority in *Dirks*. Moreover, in *Chiarella* there were at least four justices who viewed the misappropriation theory as a viable one. I believe it is a viable theory, and I think the lower courts will continue to use it.

Another insider trading case that I think is important is the *SEC v. Musella*²⁰ decision. In that case, the office manager of Sullivan & Cromwell had learned about takeovers and acquisitions and had been passing inside information to different people. Once again the court found the misappropriation theory to be viable and held that the tipper and various tippees had breached their fiduciary duties to Sullivan & Cromwell and to the clients of the firm by misappropriating the information.²¹ The court strongly supported the Commis-

¹⁹ *Id.* at 1402-03. See *Dirks*, 103 S. Ct. at 3261.

²⁰ 578 F. Supp. 425 (S.D.N.Y. 1984).

²¹ The *Musella* court issued an opinion containing an exhaustive analysis of the theories of liabilities upon which a violation of section 10(b) and rule 10b-5 may be premised. Based on that analysis, the court recognized a distinction concerning the source of material nonpublic information. The court stated:

The rather anomalous result of the Supreme Court's holding in *Chiarella*, *supra*, at least from a policy perspective is that an individual who obtains non-public information regarding a tender offer from the acquiring company, rather than from the target company, is not subject to liability at least under

sion's theory of misappropriation. In a footnote to the decision, the court distinguished the Commission's rule 14e-3 on insider trading from section 10(b) and stated that the the fiduciary duty concept of section 10(b) is not a necessary element of a rule 14e-3 action.²²

That brings us to the recent action of the Commission in *SEC v. Brant*.²³ Defendant Winans was the author of the *Wall Street Journal's* "Heard on the Street" column and had allegedly misappropriated information from the *Journal* concerning the publication of articles in the *Journal*. Winans then conveyed the fact of the publication of the articles to certain persons who traded on the information in anticipation of the effect that the article would have on the market price of stocks of the companies discussed in the articles.

The Commission used two theories in its complaint. First, following the misappropriation approach, the Commission alleged that Winans had breached his duty to the *Journal* and possibly to its readers by stealing information from the *Journal*. At least with respect to the *Journal*, that theory made sense and is consistent with *Newman*, *Materia*, and *Musella*. The Commission articulated a second theory, however, which has created substantial controversy. The Commission argued that a journalist should be viewed as a registered investment adviser in the sense of having an obligation to his clients, his readers. This theory follows the 1963 Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*,²⁴ in which Justice Goldberg articulated the "scalping" theory under the Investment Advisers Act of 1940.²⁵ The Commission's attempt to apply the scalping theory to *Brant* has created much controversy. First amendment lawyers cried foul. The *Journal*, even with its self-righteousness, cried foul, and there was a search for precedent. Except for *SEC v. Campbell*²⁶ and the companion Ninth Circuit case, *Zwieg v. Hearst*,²⁷ I am not aware of any other case in which that variation on the scalping theory was actually articulated and used.

SPORKIN: As you know, I have been a proponent of that theory

the *Chiarella* rationale—if he or she chooses to capitalize on this information by trading in the target company's securities.

Id. at 436.

The *Musella* court concluded that the office manager owed a fiduciary duty to Sullivan & Cromwell and its clients not to trade on the basis of misappropriated market information, which was a duty inherited by any tippees who knew or should have known that the information had been obtained improperly. Based on this analysis, the court enjoined defendants from further violations of section 10(b) and rule 10b-5. The court also enjoined defendants from violating section 14(e) and rule 14e-3 and temporarily froze the profits that defendants had realized on their trades.

²² *Id.* at 436 n.10.

²³ File No. 84 Civ. 3470 (CBM) (S.D.N.Y. 1984).

²⁴ 375 U.S. 180 (1963).

²⁵ 15 U.S.C. §§ 80b-1 to 80b-21 (1982).

²⁶ SEC Litigation Release No. 6567 (Oct. 30, 1974).

²⁷ 521 F.2d 1129 (9th Cir.), *cert. denied*, 432 U.S. 1025 (1975).

for quite some time. I think it is a fraud or deception for a person to take a position in a security, to impact that position by putting out some information concerning it, and then once that information causes the price of the stock to rise, to trade on that slight movement in the market. I think it is the theory that is *apropos* to the *Capital Gains* case. There are some distinctions in the *Brant* case. In *Capital Gains* there was the involvement of an investment adviser. But if you can prove the elements that the person was buying, taking a position, and then disseminating the information and capitalizing on that information, you have the elements of a crime aside from the insider trading. It is on a different track than *Dirks*.

LEVINE: I agree with the latter point. But in terms of rule 10b-5, in light of *Dirks* and *Chiarella*, I think the fiduciary theory is a tough road for the Commission to travel. While the Commission did get their temporary restraining order in *Brant*, if the case is litigated, I think the Commission will rely more heavily on the misappropriation theory than on the scalping theory. That raises a second problem that I pose to Stanley Sporkin and the audience. Suppose the *Journal* itself traded. Would there be any violation? If anyone says no because there is no breach of a fiduciary duty to anyone, then how could it be said that a reporter for the *Journal*, who steals information from the *Journal*, has a fiduciary duty? It raises an interesting question, because I think we all might agree that under rule 10b-5, the *Journal* does not owe a fiduciary obligation to anyone. It is a situation where the *Journal* conceivably would not be liable, but an employee under the same facts would be liable under the misappropriation theory. I wonder if that does not skew the entire development of rule 10b-5 in this area. At least it is food for thought, and if anyone has a response or wants to make the argument on behalf of the Commission, I would be happy to hear it.

SPORKIN: I think that the Commission became involved in a fiduciary theory because of some early writings, namely the Fleischer article.²⁸ I agree that unless the civil laws change, it will be required to show the duty and the fiduciary responsibility concepts in connection with traditional insider trading cases. I do think, however, that the scalping theory is a respectable argument and one that must be addressed, because there is a Supreme Court case that does discuss scalping. When someone is disseminating information concerning a stock that will cause that stock's price to move, and they then capitalize on that without disclosure, it seems that the elements of a scalping case have been established.

²⁸ Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973) (management's duty to disclose should be limited to extraordinary situations that are reasonably certain to affect significantly the security's market price).

LEVINE: Assume you are an analyst or a broker-dealer representative being interviewed by a reporter. Often you can determine which way a story will go simply from the nature of the reporter's questions. Assume you do glean the slant of the story, and you trade on that unintentional tip. Does that create liability?

SPORKIN: I think that is a different situation. You might have someone who is taking advantage of a situation, but you do not have a person who is creating the opportunity. I think that is the distinction.

LEVINE: Let me pose another question. Assume that the Supreme Court or another court is going to find an obligation on the part of a newspaper or some other periodical to its readers. Is the newspaper's situation a more difficult one?

SPORKIN: Why? Is it because the first amendment is implicated?

LEVINE: Because of the first amendment and also because normally, newspaper readers are not clients in the sense of investment advisers. Even a regular column, such as "Heard on the Street," should be viewed differently in terms of reporting than an adviser/client situation where one is paying for the investment advice. I do not think you can develop the kind of fiduciary obligations that would support use of rule 10b-5 in that context.

SPORKIN: I do not think you should be intimidated because people raise that issue. Although there has not yet been a test, the Commission recently had to confront that issue. In the national security area, we were confronted with certain underground newspapers publishing the names of our secret agents. Congress became concerned about it and recently passed a law that made it a crime for a newspaper or anyone else to be naming agents for the sake of naming agents.²⁹ That has not been tested by the Supreme Court or by any of the courts, but there is a law on the books that prohibits such activity.

Although there is no comparable securities statute, I would not be concerned merely because a newspaper says that it has the right to take advantage of people because it holds the license of being a newspaper. Remember the facts in this case. They involved a pattern of behavior, not one isolated case, and the reporter had been receiving money for supplying this information. This is not what I would consider to be protected first amendment conduct, but rather a violation of the securities laws. Indeed, one of the theories that I would have put forth in this case is a section 17(b) charge under the Securities Act of 1933,³⁰ which specifically prohibits anyone from

²⁹ 50 U.S.C. § 421 (1982).

³⁰ 15 U.S.C. § 71q(b) (1983). Section 17(b) provides:

It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the

publishing information about a security for payment without disclosing that there has been payment. In other words, it would be similar to a newspaper printing an advertisement as a news item when in fact it was getting paid for an advertisement. Why was that not charged in this case?

LEVINE: I do not know. But I would suggest that the fact that an element of criminality or even conspiracy may be identified does not necessarily suggest that the Supreme Court or any court will find that there is a violation of rule 10b-5. It is a difficult theory under rule 10b-5 today, and it is even more difficult under section 17(a)³¹ because there is a specific charge in section 17(b).

This leads me to what I think are some of the practical problems in this area. The most common problem with insider trading from an investigative point of view is that most people lie about their conduct. Consequently, some close cases, which the Government arguably could have won, resulted in lay-down cases.

Lying also increases the stakes substantially because the Government will routinely refer that case criminally. In fact, forty percent of all insider trading cases are referred criminally, and a good portion of those involve people who initially lied. My advice to clients is to either tell the truth or not talk at all. A client should not tell half-truths or change his story throughout the process. The numerous cases in which people have been indicted for obstruction and perjury lend support to this advice.

As counsel, you should be aware of the fact that you can influence the investigation, thereby minimizing the risk of an enforcement action. You should not wait for a call from the Commission after the investigation, informing you that your client is going to be the subject of an enforcement recommendation. In my experience as Associate Director in the Division of Enforcement, those who were most successful were those who both on factual and legal bases were dealing regularly with the staff, trying to suggest to the Commission

mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

³¹ 15 U.S.C. § 77q(a) (1983). Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

what the applicable theory was and more appropriately, what the correct facts were. These cases essentially depend on circumstantial evidence and credibility, and you can be very effective for your client if you actively participate rather than sit back and hope that the Commission goes away.

If you are involved in representing a financial intermediary such as a broker-dealer, you should be especially careful about the points I just made because of the possibility of losing the broker-dealer's license. For those who want some guidance on the Commission's attitude, look at the *Musella* case. Two of the persons involved in the stealing from Sullivan & Cromwell were bond traders for two broker-dealers. They plead criminally, and afterwards the Commission brought an administrative proceeding. Probably because of negotiation or cooperation, their licenses were withdrawn, with the right to reapply after eighteen months for one and twelve months for the other. I asked someone at the Commission why such a light sanction was given to someone who had plead criminally to receiving inside information. I did not get an answer, and the only answer I could formulate is that the bond traders must have been cooperating criminally, and the administrative sanctions must have been part of the bargain.

I would like to make two other points before concluding. First, Congress has proposed a civil treble penalty that would give the Commission the opportunity in a civil action to seek a penalty fixed by the court of up to three times the profits, gains, or losses avoided due to insider trading. The House passed such a statute, and the Senate held hearings in the spring of 1984. At those hearings, Senator D'Amato floated a definition of insider trading that was not warmly received. There was no consensus, however, as to what the definition should be.

As a consequence, the securities bar has been working on a definition that is acceptable to the various constituents. While I think there is general agreement as to a prohibition of insider trading, everyone has their own views as to what the definition should be. The current belief is that there will not be a definition established soon, but there will be a movement in Congress to pass a treble civil penalty provision without a definition, leaving the formulation of a definition to a later time when the *cogniscentia* can formulate one.³² The Commission does not support a definition at this time.

My second point concerns section 16.³³ Sections 16(a) and 16(b) are rather routine and sometimes confused areas of the law.

³² Subsequent to Mr. Levine's speech, Congress enacted the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, providing for treble penalties for insider trading.

³³ 15 U.S.C. § 78p (1983).

Last fall, Ralph Nader reported that thirty to fifty percent of those required to file Forms 3 and 4 were either filing late or not filing at all.³⁴ This was brought to the attention of the Commission. Nader's numbers were incorrect at least in terms of those who were late. The Commission did not know who did not file, because if it did, it would have gone after them.

The Commission did know, however, that a substantial number of people filed late. Because of that revelation and its publicity, there have been thirty-two enforcement actions brought against late filers of Forms 3 and 4. My advice to those who are advising corporate legal departments is to implement a system that ensures that officers, directors, and ten-percent shareholders will be timely in their filings. The embarrassment is unnecessary, and it creates collateral consequences for officers and directors who have to take injunctions. It is something that should be controlled.

SPORKIN: Were you bringing cases against simply first-time late filers?

LEVINE: No. I think the Commission looked for recurring situations where the filings were more than a few days late. Normally, a one-time problem was not the subject of an enforcement action, and I do not think it should be. I think the Commission identified approximately one hundred different recidivist cases in the first three month period.

AUDIENCE: Does the Commission reconcile Forms 3 and 4 with the proxy statements selected for review?

LEVINE: The Commission looks at them but has no way of connecting information because the system is not mechanized or automated to the point where Forms 3 and 4 can be compared. Sometimes the Commission does not even know which corporations are delinquent in filing an annual report in their 10-Ks, and obtaining a Schedule 13D out of the Commission takes two weeks after the filing. If the new automated electronic system gets into place, the Commission may be more successful with filings.

Given the uncertainty in the insider trading area and the problems that flow from it, my strong recommendation is to adopt procedures and policies to control the flow of information and the points at which insiders can trade. After *Dirks*, a corporation runs into the risk of losing control of the public dissemination of information concerning new contracts, new business opportunities, mergers, earnings, or operations, which could be catastrophic. A corporation loses control if it does not have strict policies and procedures for contacts with the press, analysts, investment advisers, and the public.

Historically, rule 10b-5 insider trading prohibitions were a

³⁴ See Wall St. J., Mar. 14, 1984, at 16, col. 1.

strong discipline in the marketplace. Analysts were very wary of approaching corporations and obtaining information that was material and nonpublic, since there was a possibility that they might have been held liable for trading or tipping. It is clear now that if analysts can obtain the information, and if there is no benefit running to the corporate executive from whom they receive it, they can trade or tip.

That is little solace to the corporation that does not want information revealed prematurely. It must be controlled at the corporate level, and the point of contact must be maintained. Someone must respond to the New York Stock Exchange or the NASD when they inquire to avoid misstatements that could be a source of embarrassment and result in an enforcement action.

I think it would be wise to prohibit short selling by officers and directors. Corporations should adopt clearance or reporting procedures in certain situations designed not to inhibit transactions or interfere in the lives of executives, but to assure an orderly flow of information in a controlled environment.

Finally, law firms and broker-dealers have the same problems. *SEC v. Karanzalis*,³⁵ involving Skadden Arps, *SEC v. Florentino*,³⁶ the Wachtell, Lipton situation, and the *Musella* case, involving Sullivan & Cromwell, are instances where law firms in possession of very sensitive information have had embarrassing leaks. Thus, it is very important to emphasize in the law firm, accounting firm, or to a broker-dealer the need for controls and procedures to protect information, and prohibitions and restrictions on trading. Additionally, there should be periodic reinforcement of those policies and procedures among the employees and professionals in the organization.

³⁵ [Current] FED. SEC. L. REP. (CCH) ¶ 91,513 (S.D.N.Y. June 4, 1984). The Commission alleged that defendant, a word processor and proofreader at Skadden, Arps, Slate, Meagher & Flom, had misappropriated material nonpublic information concerning tender offers. The information was passed to a securities salesman for Prudential-Bache and Paine-Webber. All defendants purchased the securities involved in the takeover battle and made substantial profits.

³⁶ [1983-84 Transfer Binder] FED. SEC. L. REP. ¶ 99,465 (S.D.N.Y. 1983); and [1981-82 Transfer Binder] FED. SEC. L. REP. ¶ 98,290 (S.D.N.Y. 1981). A grand jury in the Southern District of New York indicted Carlo M. Florentino on June 17, 1982. According to the indictment, Florentino, an attorney, had purchased securities of a company that was involved in tender offer and merger negotiations in which his firm was also involved. The indictment charged that while Florentino was associated with various law firms including Wachtell, Lipton, Rosen & Katz, he purchased stock from several companies planning tender offers. Florentino plead guilty to two counts of securities fraud.

O'Brien and RICO

*Stanley Sporkin**

SPORKIN: I have selected two important topics in the field of securities litigation to discuss: the Racketeer Influenced and Corrupt Organizations Act (RICO)¹ and *Jerry T. O'Brien, Inc. v. SEC.*²

RICO was passed in 1970 to protect legitimate businesses from being overtaken by the organized criminal element. It contains some very stiff criminal penalties. The law makes it a crime to conduct a business through a pattern of racketeering activity, or to invest the proceeds obtained from a pattern of racketeering activity into a legitimate business. There is an exception that says you can buy up to one percent of a corporation's stock with the proceeds.³ The penalties are quite steep: up to \$25,000 in fines, up to twenty years in jail, and possible forfeiture of the business interest.⁴

I did not come here to discuss the criminal sanctions, however. In addition to the criminal sanctions, section 1964 of Title 18 provides for certain civil remedies. Section A allows for injunctive proceedings and section B authorizes the Attorney General to institute and conduct those proceedings. Section C is the critical civil action provision, which authorizes the bringing of a civil action by any person injured by a violation of section 1962. Section C further grants to a private plaintiff the right to obtain treble damages and attorney's fees. Usually in the field of securities legislation, we talk about implied private rights of action, but here is an explicit right.

Although the statute has been on the books since 1970, it has been widely used only in the last three years. According to the American Bar Association's Task Force, there was not more than one civil case reported per year between 1970 and 1979. Since 1980, however, the number of cases has increased rapidly. The Task Force Report shows the following statistics: In 1980 there were three cases; in 1981, twenty-two cases; in 1982, twenty-five cases; and in

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¹ 18 U.S.C. §§ 1961-1968 (1982).

² 704 F.2d 1065 (9th Cir. 1983), *rev'd*, 104 S. Ct. 2720 (1984).

³ 18 U.S.C. § 1962 (1982).

⁴ *Id.* § 1963.

1983, fifty-eight cases.⁵

Although it was contemplated when the statute was enacted that the civil actions would parallel the criminal proceedings, this has not been the case. Of the one hundred eight private civil RICO cases studied, only three involved violent crimes, and all three were arson cases.⁶ The ninety-three remaining cases largely involved business-related crimes, such as securities fraud or some type of criminal fraud.

RICO is a complex statute, yet, it can be broken down into several components. There must be: (1) an injury to a person's business or property caused by (2) an enterprise or person engaged in (3) a pattern of racketeering offenses. Thus, a plaintiff must show injury, an enterprise, and a pattern of racketeering offenses.

The first element of injury or standing has been construed on two different levels. Some courts have required that the injury arise out of the RICO violation itself. For example, the injury may be that the plaintiff has been placed in a noncompetitive position because of the RICO enterprise. Since RICO was patterned to some extent after the federal antitrust laws, a line of cases holds that the injury has to be to someone in a legitimate business, competing with the illegitimate business, or competing with a legitimate business that is being financed by illegitimate proceeds.⁷ For example, whereas the racketeering company launders money through the operation, the legitimate business may have to pay the going rate to borrow money. That is a sufficient showing of injury.

There is, however, another line of cases that says that the mere existence of the racketeering activities may be the harm or injury.⁸ If someone is defrauding another in sales of a security, these courts hold that is enough for standing.

The enterprise element is an interesting one because there are also two different lines of cases. One line of cases indicates that an

⁵ ABA COMM. ON TASK FORCE ON RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS, No. 11953 (1984).

⁶ *State Farm Fire & Casualty Co. v. Estate of Caton*, 540 F. Supp. 673 (N.D. Ind. 1982); *Anderson v. Janovich*, 543 F. Supp. 1124 (W.D. Wash. 1982); *Vietnamese Fishermen's Ass'n v. The Knights of the Ku Klux Klan*, 518 F. Supp. 993 (S.D. Tex. 1981).

⁷ *Van Schaick v. Church of Scientology of California, Inc.*, 535 F. Supp. 1125 (D. Mass. 1982); *Erlbaum v. Erlbaum*, [1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,772 (E.D. Pa. 1982); *Landmark Savings and Loan v. Rhoades*, 527 F. Supp. 206 (E.D. Mich. 1981); *North Barrington Development Inc. v. Fanslow*, 547 F. Supp. 207 (N.D. Ill. 1980). These cases hold that there must be injury to a competitive or commercial interest.

⁸ *See, e.g., Bennett v. Berg*, 685 F.2d 1053 (8th Cir.), *cert. denied*, 104 S. Ct. 527 (1982); *D'Iorio v. Adonizio, C.A.*, 554 F. Supp. 222 (M.D. Pa. 1982); *Hanna Mining Co. v. Norcen Energy Resources, Ltd.* [1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,742, at 93,737 (N.D. Ohio 1982); *Engl v. Berg*, 511 F. Supp. 1146 (E.D. Pa. 1981); *Hellenic Lines, Inc. v. O'Hearn*, 523 F. Supp. 244, 248 (S.D.N.Y. 1981); *Parnes v. Heinold Commodities, Inc.*, 487 F. Supp. 645 (N.D. Ill. 1980); *Heinold Commodities v. McCarty*, 513 F. Supp. 311 (N.D. Ill. 1979). In each case fraudulent activity was found to be sufficient "harm or injury" to allege a RICO violation.

enterprise means that it has to be some form of a business entity.⁹ It could be a proprietorship, partnership, or corporation. There is another line of cases, primarily in the Second Circuit, that indicates that the dishonest activity itself may be an enterprise.¹⁰ For example, a conspiracy by two or three people to defraud someone of his property may be an enterprise for the purposes of RICO.

The third element, the pattern of racketeering activity, is met when two predicate offenses take place within a ten-year period. The predicate offenses are defined in the statute and include the normal crimes of violence, as well as mail fraud, wire fraud, and fraud in the sale of securities. I emphasize the word "sale" because of a loophole that exists in the language of the statute, which does not refer to fraud in the sale or the purchase of securities. The cases, however, seem to say that fraud in the sale of securities is enough to encompass the purchaser also.¹¹ Of course, the use of the means and instrumentalities of interstate commerce is also an element of the offense, but that is not hard to establish in these types of cases.

RICO actions federalize many state criminal laws and give the practitioner or plaintiff a new weapon in their arsenal for business fraud or business-related cases. This discovery by some inventive individuals is causing a tremendous increase in the number of cases being filed. As you can see, you need not have a criminal finding.¹² You can prove the predicate offenses in a civil forum using a preponderance of the evidence.

LEVINE: Is the suit *res judicata* if there is a criminal conviction and a later suit is brought?

SPORKIN: The Act itself provides for that where it states that a criminal conviction may not be contested.¹³ There has been much

⁹ *United States v. Turkette*, 452 U.S. 576, 583 (1981) (enterprise includes "a group of individuals associated in fact" for criminal purposes); *United States v. Bledsoe*, 674 F.2d 647, 665 (8th Cir. 1982), *cert. denied*, 103 S. Ct. 456 (1983) (enterprise does not exist where there is no structured association).

¹⁰ *United States v. Hewes*, 729 F.2d 1302 (11th Cir. 1984) (conspiracy to participate in planned bankruptcy to defraud creditors sufficient to constitute an enterprise); *United States v. Elliot*, 571 F.2d 880 (5th Cir.), *cert. denied*, 439 U.S. 953 (1978) (conspiracy to commit criminal activities held sufficient to constitute an enterprise).

¹¹ *See, e.g., Hanna Mining Co.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) at 93,738; *Spencer Cos. v. Agency Rent-a-Car, Inc.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,361, at 92,215 (D. Mass. 1981). *See generally* Bridges, *Private RICO Litigation Based Upon "Fraud in the Sale of Securities"*, 18 GA. L. REV. 43, 62 (1983).

¹² *See Parnes*, 487 F. Supp. at 647.

¹³ 18 U.S.C. § 1964(d) (1982). The section provides that "[a] final judgment or decree in favor of the United States in any criminal proceeding brought by the United States under this chapter shall estop the defendant from denying the essential allegations of the criminal offense in any subsequent civil proceeding brought by the United States." Subsection (c), authorizing civil suits by private plaintiffs, makes no mention of collateral estoppel. Section 9046 of RICO, however, provides that the Act "shall [not] supersede any provision of Federal, State or other law imposing criminal penalties or affording legal remedies in addition to those provided [by RICO]." *Racketeer Influenced and Corrupt Organizations Act*, Pub. L. No. 91-452, § 904(b), 84 Stat. 947 (1961). Since collateral estoppel

movement in Washington, D.C. to bring about a change in RICO. Even though I spent many years on the prosecutor's side, I think a case has been made for an adjustment to this law. I think it is being misused. When an act that addresses the organized criminal element is enacted, and is used in such a way that three of one hundred three cases contain that criminal element, while the remaining cases contain only alleged offenses, there is a problem. The problem is that organized crime cannot be defined constitutionally the way in which organized crime is perceived. The drafters have defined it in a way that is so broad by requiring only two predicate offenses and then listing predicate offenses as having the minimum threshold under the federal law.

LEVINE: What you are really arguing about is whether you need an express or implied private right of action for treble damages.

SPORKIN: I would not want to eliminate the private right of action, and even the people who are seeking to change it—the brokerage firms and accounting firms—would not go so far as to eliminate the private right of action. What they would like is some type of screening mechanism, by requiring that there be either a conviction or an indictment before the explicit right of action would arise.

LEVINE: But then you would effectively eliminate the right of action.

SPORKIN: It is merely a very low threshold.

AUDIENCE: How would an action under RICO interface with an arbitration clause in a customer's agreement? Some time ago the Supreme Court said that violations under the Securities Act of 1933 are not arbitrable. Recently, however, there have been a number of cases that give greater scope to arbitration provisions.

SPORKIN: If you are asking if the signed arbitration provision would preclude that individual from bringing a RICO charge in a civil action, I would say no for several reasons. One is that an arbitration proceeding would not cover fraud anyway. Second, *Wilko v. Swan*¹⁴ indicates that arbitration clauses do not take precedence over the 1934 Securities Exchange Act. Indeed, I think the Commission itself has recently issued something that questions those arbitration provisions in the brokerage contracts.¹⁵

LEVINE: What the Commission announced and what *Swan* says is that you cannot force someone to arbitrate and forego the use of the federal courts in a securities case. *Swan* does not say that you are not precluded from arbitrating, only that it cannot be a defense to a filed

"is without a doubt a civil remedy of historical standing," some courts have said that it is available to private plaintiffs. See, e.g., *Anderson v. Janovich*, 543 F. Supp. 1124, 1128 (W.D. Wash. 1982); *County of Cook v. Lynch*, 560 F. Supp. 136, 138-39 (N.D. Ill. 1982).

¹⁴ 346 U.S. 427 (1953).

¹⁵ 17 C.F.R. § 240.15c2-2 (1983).

action. Recently, the Commission has required specific disclosure of that right in the customer agreement, which in fact forces everyone to arbitrate.

AUDIENCE: My question was predicated on *Southland Corp. v. Keating*,¹⁶ in which the Supreme Court eliminated the ability to maintain an action under California's franchise laws, finding that the Federal Arbitration Act preempted the right of action.¹⁷ The Supreme Court seemed to place great stock in the contrary stipulation of the "void" clause of the 1933 Securities Act.¹⁸ I was wondering if you had any impressions on whether or not that might make it vulnerable to an arbitration covenant?

LEVINE: I do not think so, but there is the argument that the legislature intended to preclude an action.

AUDIENCE: Have criminal sanctions from section C of RICO been asserted against the promoters or sponsors of the abuse of tax shelters?

SPORKIN: I have not seen it. But it would have to fall within the predicate offenses requirement. It would have to be a mail, wire, or securities fraud. Again, there is the *in pari delicto* problem with tax shelter abuses because those that are involved in the abuse of tax shelters are the ones that want abuse. One of the problems we had at the Commission in bringing the abusive tax shelter cases was trying to convince the Commission that there was a victim. The victim is the system itself, quite frankly, not the individual. No individual is going to bring a claim when he is getting a four to one tax deduction. Mike Wolensky, do you have any thoughts on RICO involving the Atlanta region?

WOLENSKY: Yes, I see a lot of it, and I read about it. I think I share your view that it is being misused. I think it is creating many issues of litigation. A plaintiff's lawyer may file a good securities case and have a good claim. The corporation's lawyer goes to the chairman of the board to suggest that they try to work it out, but also tells the chairman that he has been accused of being a racketeer and having a tie-in to organized crime. Of course, the chairman goes through the ceiling and wants to fight it. In other words, it creates a lot of unnecessary litigation. I regret that the Commission has not become involved in it in an *amicus curiae* position. I guess this is too hot for them to handle right now.

LEVINE: I understand that if you are a RICO plaintiff and you go into the Colorado courts you will be running into a brick wall with

¹⁶ 104 S. Ct. 852 (1984).

¹⁷ 9 U.S.C. § 2 (1976).

¹⁸ 15 U.S.C. § 77n (1933). This section provides that: "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

almost every judge. They are so turned off at the district court level by the use of RICO that it is almost a negative. So rather than face malpractice for not asserting it, you have to be very careful using it because it may adversely affect your substantive case because of the way some judges view the use of RICO. You have to know your jurisdiction before you use it.

SPORKIN: Or at least you should tell your client why you are not using it. I would now like to discuss the *O'Brien* case. A party who was the target of an SEC investigation sued the Commission to enjoin the investigation on two grounds. First, the target challenged the appropriateness of the investigation insofar as it involved him. Second, the target asserted his claimed right to be notified of any subpoenas being issued to third party witnesses. The district court stated that it would not accept either of these claims and denied the injunction.¹⁹

The Ninth Circuit Court of Appeals said that on the first issue, the matter was not ripe for decision. The court reasoned that if an individual claims that an investigation is improper, he must wait until he has been subpoenaed to be able to frontally assault the matter. The court reasoned that the Commission's right to issue subpoenas is not self-effectuating. The only way it may compel someone to testify is to obtain a court order. Therefore, until the Commission seeks to enforce a subpoena in court against an individual, the individual does not have standing to resist the subpoena.

On the second issue, the *O'Brien* court issued an injunction against the Commission and required it to provide notice to the party being investigated of subpoenas issued to third parties. The court reasoned that while a target may test a subpoena issued against him in court, he has no ability to have a judicial test of a subpoena issued to a third party. The court reasoned that third parties typically are disinterested innocent stakeholders who will usually provide information to the Government to avoid additional expenses and adverse publicity. A target is therefore entitled to raise objections when a third-party subpoena is issued.

The court based this decision upon *United States v. Powell*,²⁰ a Supreme Court case that dealt with a summons issued by the Internal Revenue Service. *Powell* held that, with respect to the IRS, there are certain standards that the Government must meet in sustaining the right to effect process. The first standard is that there be a legitimate purpose for the investigation. The second is that the inquiry be relevant to the legitimate purpose. The third requires that the agency not possess the information sought. I do not think that standard has been thoughtfully considered because there are many times

¹⁹ See *O'Brien*, 704 F.2d at 1065.

²⁰ 379 U.S. 48 (1964).

when the Government may want the information from a particular person, even though it might have obtained the same information from other parties. For example, perhaps the contract or the agreement obtained from the target has something written in the margins that the other party does not have. Indeed, when I was at the Commission there were several cases that were made on the basis of marginal notes. I do not understand why an agency may not go out and seek the information if it already has it. Do you agree with that Mike Wolensky?

WOLENSKY: I argued that issue a number of times in the courts of appeals in subpoena enforcement cases. I think it is an anomaly to the IRS statutes that prohibit seeking information already obtained without the authorization of the Commissioner of the IRS.

SPORKIN: The fourth standard ensures that the agency adhere to the administrative steps required by law. In other words, did it dot its "i's" and cross its "t's," give proper notice, and observe formalities? The *O'Brien* court said that to meet the *Powell* test, an individual had to know when someone else was being subpoenaed. The Commission argued that the court of appeals decision is neither required by the Constitution, nor by statute. It also argued that the Securities Exchange Act of 1934 authorizes the Commission to conduct investigations without notice to the third parties.

The *O'Brien* decision will cause serious problems with the Commission if a target is notified as to everyone that is being subpoenaed, because the target is given the opportunity to go out and destroy evidence. It gives the target the ability to derail and delay the investigation, and it injects too much uncertainty in the proceeding, because the Commission does not always know who is the target of an investigation. If the Commission neglects to give notice, what are the sanctions that may be imposed? The decision will encourage needless and time-consuming litigation.

It also may be argued that when legislators want to provide a right of notice, they know how to draft a statement of such a right. Therefore, a court cannot legislate, and in effect write such a law when Congress itself has not chosen to do so, or when Congress has chosen to write it in a very narrow and confined way. I agree with Mike Wolensky in that I think the Commission has the better case and will win.²¹

The Commission did several things as a result of the *O'Brien* case. First, it suspended all investigations pending in the Ninth Circuit, hoping it could obtain a quick reversal of the action. When it

²¹ See *O'Brien*, 104 S. Ct. 2720 (1984). On June 18, 1984 the Supreme Court reversed the Ninth Circuit decision in *O'Brien*. As Msrs. Sporkin and Wolensky predicted, the Court held that the Securities and Exchange Commission is not required to notify the target of a nonpublic investigation.

appeared that the Commission could not get a speedy resolution, it continued to investigate those cases in the Ninth Circuit in which notice was feasible. In some instances, the Commission sought waivers.

In connection with the investigation of the Washington Public Power Supply System,²² the Commission did something very interesting to comply with *O'Brien*. It took the extraordinary step of publicly announcing the investigation and stated that copies of all subpoenas issued would be kept in the public file in the Seattle regional office and in Washington, D.C. That would be bothersome to me as defense counsel, because if I represented an innocent client, I would not want to have my name involved in an SEC investigation. I would not want myself listed in a public announcement as a target of an investigation. Nor would I want people to know that I had been subpoenaed, and certain very confidential records had been sought. The waiver practice might be to the advantage of an individual to sign so as to avoid this unnecessary kind of publicity.

With respect to proceedings outside the Ninth Circuit, the Commission is following the same practice that it has for the past fifty years—issuing subpoenas without attempting to make a determination of target status or give notice.

WOLENSKY: For some reason in the last two weeks I have received four *O'Brien* demand letters in my office, and we have been sued in Florida in one case. Everyone has to know that the decision is imminent, and maybe they are trying to jump on the bandwagon. But in the Washington Public Power Supply System investigation the Commission was forced to act as it did. The subject's counsel thought the Commission would halt the investigation. The Commission continued the investigation, however, and even published it in the Federal Register. The Commission is hopeful of containing the damage, but if forced, it will proceed in some other fashion, like publishing the fact of an investigation. We have had two cases impacted, and in one we have worked out voluntary testimony. Both lawyers did not want it prematurely published that their clients were under investigation.

LEVINE: In the home office of the Commission there has been a significant decrease in *O'Brien* requests in the past several months. I think people are anticipating that the Commission will be successful in the Supreme Court. Even if the Commission wins, it is a year-and-a-half behind on this case and it will be very difficult for the Commission to resurrect this investigation because the facts are so dated at this stage. In that respect, the Commission loses, proving that it is a

²² The Commission targeted the Washington Public Power Supply System for investigation when the system defaulted on millions of dollars of revenue bonds. The bonds had been secured by nuclear power plants, most of which were never built.

tremendous risk to say you are going to play hardball. As a defense lawyer, the first thing I would do before I start battling in court is find out what the investigation is about. I would want to know what the potential exposure is for my client, and whether the matter could be successfully disposed of quickly. You might not get one hundred percent of what you want, but it is the better way to proceed because of the time savings involved.

AUDIENCE: Is there any chance that the Supreme Court in *O'Brien* will hold that *Powell* does not apply to the Securities and Exchange Commission?

LEVINE: I think at least that those aspects of *Powell* requiring proper authority, reasonableness of the investigation, and other procedural requirements will remain in the Supreme Court holding because all the courts have applied those standards, and I do not think that the Supreme Court will allow the Commission to do whatever it wants.

Attorney-Client Privilege: Case Law

*Harvey L. Pitt **

PITT: The topic I have been asked to address is attorney-client privilege. It is probably inhospitable of me to start by being critical of the topic. It is divided into two categories: cases and practical problems. I do not think that the topic lends itself to that type of division. First, cases involving attorney-client privilege are infrequent and conflicting. You probably can find a case to support almost any position you wish to espouse in a given set of circumstances. I believe the issue is not so much what the law is, but the practicalities of lawyering when a question of privilege arises.

There is a significant difference between an attorney's role as counselor and an attorney's role as litigator. As counselor, an attorney strives to avoid litigation. In the area of attorney-client privilege and work-product doctrine, however, an attorney essentially must anticipate litigation. Indeed, an attorney cannot derive fully the benefits of work-product doctrine without contemplating actual litigation. Every case in these areas depends heavily on facts and circumstances. Therefore, the attorney's mandate in the attorney-client privilege and work-product areas is to know facts and circumstances.

The work-product doctrine is a well recognized doctrine. Not as well established are the "self-evaluative" privilege and "accountant-client" privilege doctrines. The Supreme Court decision in *United States v. Arthur Young & Co.*¹ has provided a new perspective on this subject.

I would like to highlight some evolving trends and offer some pragmatic observations. I think one has to start in the privilege area by recognizing that the Supreme Court, which has decided very few privilege cases, appears to be on a different wavelength than the lower federal courts. If I were to characterize the way cases have

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¹ 104 S. Ct. 1495 (1984), *aff'g in part, rev'g in part* 677 F.2d 211 (2d Cir. 1982), *aff'g in part, rev'g in part* 496 F. Supp. 1152 (S.D.N.Y. 1980) (Supreme Court firmly rejected work-product immunity for accountants' papers).

been decided since *Upjohn Co. v. United States*,² the seminal decision on attorney-client privilege, I would conclude that the lower courts basically are antagonistic to assertion of the privilege. Although the lower courts have rendered a number of decisions favoring assertion of the privilege, generally they have not accepted the philosophical principles embraced by the Supreme Court. While the *Upjohn* Court emphasized important benefits that flow from attorney-client privilege, lower court decisions, such as *In re John Doe*,³ *In re Sealed Case*,⁴ and *Permian Corp. v. United States*,⁵ stress obtaining evidence, building cases, and doing justice in the public courts.

Placing a great deal of reliance on the Supreme Court decision in *Upjohn*, while intellectually and academically sound, may nevertheless lead to less desirable results than looking to the lower court opinions. In my view, these lower court cases would not have been decided the same way had the Supreme Court heard them. But the Supreme Court has not heard or decided these cases, and thus, we are dealing with the lower courts on most of these issues.

In the area of work-product, I start with ten rules of thumb that are intended to be pragmatic and not scholarly. First and most important, never assume you can keep anything confidential. No matter how fervent your belief in attorney-client privilege, how brilliant

² 449 U.S. 383 (1981). In *Upjohn* the Supreme Court rejected the "control group" test as too narrow and resolved certain aspects of the controversy concerning the scope of attorney-client privilege in the corporate setting. The "control group" test had been formulated in *City of Philadelphia v. Westinghouse Elec. Corp.*, 210 F. Supp. 483 (E.D. Pa. 1962). Several other courts had adopted the "control group" test, citing its purported consistency with the goal of the Federal Rules of Civil Procedure of facilitating broad discovery. *Virginia Elec. & Power Co. v. Sun Shipbuilding & Dry Dock Co.*, 68 F.R.D. 397, 400 (E.D. Va. 1975).

The *Upjohn* decision, however, did more than merely reject the control group test. In accepting the procedures employed by counsel there, the Court articulated those factors that will give rise to a valid corporate claim of privilege. The Court adopted an eight-pronged test, holding that attorney-client privilege applies to:

1. a communication;
 2. to corporate counsel "acting as such;"
 3. made by corporate employees who are aware of the legal implications of the communication;
 4. concerning matters "within the scope of the employees' corporate duties;"
 5. at the direction of corporate superiors;
 6. in order to permit the company to secure legal advice;
 7. where the communications were considered "highly confidential" when made;
- and
8. where the communications have been kept confidential by the company.

Upjohn, 449 U.S. at 394-95.

³ 662 F.2d 1073 (4th Cir. 1981), *cert. denied*, 455 U.S. 1000 (1982) (a showing that attorney was being used to assist in the commission of a fraud or crime may vitiate the application of work-product doctrine).

⁴ 676 F.2d 793 (D.C. Cir. 1982) (by agreeing to investigate itself pursuant to the SEC's voluntary disclosure program, defendant company waived work-product doctrine as to any information needed by the Commission to evaluate the company's disclosure).

⁵ 665 F.2d 1214 (D.C. Cir. 1981) (attorney-client privilege must be "narrowly construed" because it "inhibits the truth-finding process").

your lawyering, how cogent your analysis, if you start with the assumption that you cannot keep anything confidential, you will not be disappointed. In fact, you may well take steps that protect your client.

Second, if secrecy is important, there is no effort too small or too large that should not be undertaken to preserve confidentiality. Courts recently have not only stressed the necessity of establishing all the substantive elements of attorney-client privilege, but have examined whether the communications sought to be protected were intended to be confidential. Did the parties act toward those communications in a way that suggests they believed the communications confidential? The ambience and the surrounding circumstances thus have become critical in attorney-client privilege cases.

Third, no action is too bizarre to pursue. This is an area for creativity, although it should be stressed that it is not an area for bad lawyering. Fourth, the creation of any corporate document must be attended by careful procedures. This is an area in which scien-ter is relevant. An attorney must have scien-ter in creating documents that were intended to be kept confidential.

Fifth, where sensitivity is at issue, the entire process must run through counsel for attorney-client privilege to attach. That means, particularly in the self-evaluative area, the process of hiring accountants and investment bankers and conducting interviews must be channelled through the lawyers. The question arises: is there a difference between corporate counsel and outside counsel in regard to attorney-client privilege? The answer is maybe. Conceivably, there may be a difference depending on the roles each performs. Theoretically and intellectually, it is safe to say that there should not be a difference in the assertion and application of privilege whether the attorney involved is inside or outside counsel. In fact, *Upjohn* involved inside as well as outside counsel.

Sixth, follow procedures carefully. It is important to maintain a record of the steps taken and approaches followed. You need something substantive that will enable you, in the event there is litigation, to prove what you did to protect the privilege and why you believe the privilege applies.

Seventh, never create a document that is not needed. It is very difficult for most corporate clients to adhere to this policy. It is important, however, that an attorney have a sense of discretion about what he or she creates.

Eighth, never keep a document that is no longer required. If the document has served its purpose, there probably is no longer a need to keep it. The pack-rat syndrome, which is peculiar to lawyers, is that every draft, no matter how minor, is kept. If there are five lawyers, two inside counsel, and three senior management officials

working on a problem, there is apt to be ten files created in addition to the central files. Many first drafts created by lawyers are worthless, or worse, are damaging. They may be damaging because the attorneys were trying out ideas on paper. Because of this danger and because they are rarely helpful, counsel should dispose of drafts.

Real documents, unlike drafts should not be destroyed lightly. First, if an attorney is under subpoena or investigation, real documents should not be destroyed. *Berkey Photo, Inc. v. Eastman Kodak Co.*⁶ illustrates the potential magnitude of problems. Second, the ad hoc destruction of documents may be far more devastating than explaining away the document itself. For instance, if the corporation does not have a regular program of document destruction, the ad hoc destruction of critical documents will be a negative inference against the company. Therefore, there should be a sensible, regulated program for the routine destruction of documents. An attorney also should take into account specialized regulatory and other statutes. Some entities have record-keeping obligations under local, state, and federal rules. Other entities simply must keep documents to conduct business effectively. Nevertheless, a corporation should maintain a regular program to eliminate unnecessary documents on transactions long since closed.

AUDIENCE: Word-processing poses a special problem in relation to attorney-client privilege as it is very difficult to get documents out of the system.

PITT: That is a very good point. Because of word-processing equipment with disks, and typewriters that make impressions on specialized ribbons, an attorney may wind up with some unexpected records. Thus, a routine regulated program is important.

If an attorney attempts to destroy a document simply because it is believed to be damaging, there is a strong possibility that after every known copy is destroyed there will be one copy remaining somewhere. If an attorney does not assume this, he or she may be making a serious mistake. A regulated program is the best and perhaps only way to deal with this problem.

Ninth, never claim privilege for more documents than needed. One of the difficulties attorneys have is the notion that once an attorney claims privilege it becomes easy to claim it for everything. For example, an attorney may claim privilege for a large file and then go before a judge only to discover that a few recipes somehow have filtered into the file, along with five newspaper clippings, and two law review articles. Judges or adversaries see this and find it difficult to sympathize with the legitimate claims.

The tenth and final guideline is that if any problem arises in re-

⁶ 74 F.R.D. 613 (S.D.N.Y. 1977) (use of work-product documents to aid a witness's testimony operates as a waiver of work-product privilege).

gard to the privilege, it should be because of the client's records and activities, and not those of the lawyer. This is fundamental to the practice of law. Lawyers never should perceive their files as being inviolate. Case law demonstrates that lawyers' files are being obtained with a fair degree of regularity. Lawyers frequently prepare documents that clients never see, some with good reason. Yet this can be very detrimental to a client's interest. If a client has difficulty asserting attorney-client privilege, it should be only because of something the client has said or done or written, not because of something the attorney has said or done or written.

Another important distinction should be drawn between attorney-client privilege and work-product. Attorney-client privilege and work-product doctrine are two separate privileges. Both emanate out of common law, but attorney-client privilege today is still common law except under some state laws, whereas work-product has at least some modicum of codification in Rule 26 of the Federal Rules of Civil Procedure. The elements of each of these privileges serve different purposes. Although attorney-client privilege, in the absence of any waiver, can be more sweeping, more absolute, and thus, comprehensive, work-product can be more valuable in terms of the claim. An attorney should make certain to assert all applicable privileges to protect documents at both the times of creation and litigation.

Work-product and attorney-client privilege are comprised of different elements. First, for attorney-client privilege to apply, a lawyer must be involved. There must be an attorney acting as such, either with respect to an existing or prospective client. Communications with respect to an attorney are not the only communications protected under attorney-client privilege. Communications of certain entities or individuals working for a lawyer under a lawyer's supervision also may qualify, provided the other elements are met. This concept is not so obvious because in a number of cases courts have recognized the pragmatic fact that lawyers do many things other than simply lawyering. The trend in the lower courts is antagonistic to the assertion of privileges. Courts have said, therefore, that if someone wishes to prevent disclosure of important evidentiary material, they must meet the burden of showing that the lawyer involved in the case was acting as a lawyer.

In *SEC v. Gulf & Western Industries, Inc.*⁷ the outside general counsel also was a close confidant of the CEO of the company and a member of the board of directors. This individual thus wore at least three hats in the organization. When an effort was made to preclude that individual from testifying or the Securities and Exchange Commission from using that testimony, the district court required that the

⁷ 518 F. Supp. 675 (D.C. Cir. 1981).

corporation show that the communications for which it was claiming privilege were communicated or spoken when the attorney had been acting as a lawyer. In *In re Grand Jury Subpoena Duces Tecum Dated September 15, 1983 (Marc Rich & Co. A.G. v. United States)*⁸ the Second Circuit stated that the privilege must relate to legal, not business advice.⁹

Furthermore, the intermeshing of the two types of advice may cause loss of privilege, depending on facts and circumstances. Holding that tax advice suffices as legal advice, the *Marc Rich* court explained that although some of the underlying information forming the focus of the communication ultimately may be disclosed publicly, it does not denigrate the status of the document as legal advice.¹⁰ What is being looked at is the document itself.

Another element of the requirement of a lawyer's involvement is that confidentiality must be intended. Otherwise, the privilege may be lost. In cases such as *In re John Doe*, communications from a lawyer to someone who arguably is not the client conceivably may give rise to a waiver of the privilege.¹¹ Thus, a court will examine the entire requirement of facts and circumstances.

In re Continental Illinois Securities Litigation,¹² a Seventh Circuit decision, involved derivative litigation instituted on behalf of Continental Illinois arising out of the Penn Square fiasco. Continental had set up an independent special litigation committee to decide whether the derivative litigation should be terminated. The special litigation committee, which had retained esteemed counsel, concluded that some though not all of the litigation should be dismissed, including the litigation against Continental's outside directors.

The court ordered the production of the special litigation committee's report to make certain that the committee had reached the proper conclusion. Subsequently, the report was produced under a claim of protection. That is very important. The order pursuant to which that report was produced had specified that Continental was not waiving any applicable privilege. When evidentiary testimony was taken, however, everyone forgot about the confidentiality of the report, full testimony was given, the judge referred to it, and Dow Jones and the Chicago Sun Times sought the report.

Had that been the only disclosure pursuant to the order, perhaps the *Continental* case might not have arisen. Nevertheless, because disclosure was in fact made in the court and there was adequate testimony, the public's right to know superseded any privi-

⁸ 731 F.2d 1032 (2d Cir. 1984).

⁹ *Id.* at 1037.

¹⁰ *Id.*

¹¹ *John Doe*, 662 F.2d at 1079.

¹² [Current] FED. SEC. L. REP. (CCH) ¶ 91,457 (7th Cir. April 23, 1984).

lege; therefore, the Seventh Circuit ordered the report made public. This serious result suggests the propriety, particularly in a litigated context, of obtaining protective orders either by agreement or court order before turning over documentation to ensure the preservation of privileges.

How does one ascertain whether, when lawyers give advice, they are acting as lawyers? For instance, does the writing of a memorandum by a lawyer constitute the giving of advice? When you write a memorandum, you should indicate in writing that you are a lawyer, by adding "Esq." after your name and also the name of your law firm, unless you are inside counsel. If the fact that you are a lawyer is not indicated on a memorandum, when the issue arises eight years later and the records are in disarray, people may not know that it was written by a lawyer, or perhaps more importantly, they may not know that it was written in a legal context.

Always label documents. It is useful to put at the very top of each legal document in capital letters and underscored: "*CONFIDENTIAL and PRIVILEGED*." The next line should read: "Communication from Counsel," or "Communication to Counsel," or "Communication between Counsel." The last line should say "Attorney's Work-Product." Labeling a document, however, will not necessarily grant it the status of privilege, but failure to label it may prevent it from being recognized as privileged, if in fact, it is otherwise entitled to the status.

The form of the memorandum also is important. It is useful to begin a memorandum in which legal advice is being given by saying, "You have requested this law firm's advice." A judge who picks up a document that is clearly labeled for *in camera* inspection and reads the first paragraph as making it clear that the document was intended to convey legal advice is apt to resolve the ambiguities in favor of the proponent of the privilege.

Oral communications, which were involved in the *Gulf & Western* case,¹³ are far more difficult to accord the status of privilege. An attorney who gives oral advice should follow the niceties without unduly formalizing oral discussions. The attorney should make clear exactly what is transpiring between the two individuals and should try not to mix business discussions with legal discussions.

The recent *Arthur Young* decision has a significant impact on lawyers, although the case dealt particularly with accountants.¹⁴ The *Ar-*

¹³ 518 F. Supp. at 678.

¹⁴ See *Arthur Young*, 104 S. Ct. at 1503. In *Arthur Young* Chief Justice Burger stated: The *Hickman* work-product doctrine was founded upon the private attorney's role as the client's confidential advisor and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's finan-

thur Young analysis potentially is troublesome for lawyers. Refusing to recognize the creation of a privilege for accrual workpapers prepared by auditors who essentially were formulating "worst case scenarios," the Court distinguished lawyers from accountants. Accountants supposedly are more independent than lawyers. Noting the Commission's disclosure requirements, the public's confidence, the integrity of information in the marketplace, and the fact that auditors were following prescribed standards by the Commission, the Court concluded that discussions prior to disclosures should not be protected.¹⁵

Arthur Young has not yet been expanded to encompass lawyers; however, there are several possible scenarios. In a number of its disclosure areas in connection with registration and other requirements, the Commission requires an opinion of counsel. What about all the legal work that went into that opinion? Conceivably an argument may be made that the legal work behind counsel's opinion fits within the *Arthur Young* rubric. This has been an area of some dispute on pure disclosure documents such as the 13D statement and its drafts. Although I do not advocate this position, one could argue that lawyers' work is far more analogous to what the auditors were doing in *Arthur Young* than to what lawyers normally do.

A second element of attorney-client privilege is that there must be a communication. The privilege does not protect underlying facts; it protects communications. There must be a legal opinion being given and legal services being performed. There must be some assistance vis-a-vis some type of legal proceeding.

The district court opinion in *In re International Systems and Controls Corp. Securities Litigation (ISC)*¹⁶ is instructive with respect to attorney surrogates. The Fifth Circuit rendered a subsequent opinion that in many respects is far more helpful for protecting privilege.¹⁷ The *ISC* case, however, is valuable as a primer on how not to retain attorney surrogates. A written agreement specifying the nature of the work and particularly the legal purposes, and indicating that the surrogate

cial status, the independent auditor assumes *public* responsibility transcending the employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Id.

¹⁵ *Id.*

¹⁶ 91 F.R.D. 552 (S.D. Tex. 1981).

¹⁷ *In re International Systems and Controls Corp. Securities Litigation*, 693 F.2d 1235 (5th Cir. 1982), *vacating* 91 F.R.D. 552 (S.D. Tex. 1981).

is hired by, reports to, and is paid by the lawyer is required. A lawyer may wish to charge the accounting firm's fees as a disbursement on the bill, but the lawyer should have the primary obligation to the accounting firm.

Finally, there must be a notion that the product being created is not the accountant's or the investment banker's or the surrogate's, but the lawyer's, and that it may not be used under any set of circumstances without the lawyer's permission.

There are two situations in which attorney-client privilege will not apply: waiver and exception. A third much less important category is shareholder derivative and class actions. In *Garner v. Wolfenbarger*¹⁸ the Fifth Circuit developed the startling concept that shareholders are the owners of corporations and applied it to the retention of counsel. The *Garner* court held that where shareholders have brought a derivative or class action suit, it is not necessarily appropriate to view the shareholders as being distinct from and having interests adverse to the corporation. Under certain circumstances, therefore, a corporation may not withhold its legal advice from the true owners of the corporation, the shareholders. This is a facts and circumstances balancing test.¹⁹

The District of Columbia Circuit has taken the *Garner* concept and expanded it in the pension area.²⁰ When the Department of Labor brings suit on behalf of the beneficiaries of a pension plan against the trustees, and the trustees claim privilege, the district courts have held that the Government, in the form of the Department of Labor, may obtain the legal advice because the Government is standing in the shoes of the beneficiaries, and the trustees may manage a pension plan solely for the benefit of the beneficiaries. The Government was, therefore, one step removed. This is potentially a very explosive concept.

In the *ISC* case the Fifth Circuit, which spawned *Garner*, ruled that the *Garner* principle does not apply to bona fide work-product

¹⁸ 430 F.2d 1093 (5th Cir. 1970), *cert. denied sub nom.*, *Garner v. First American Life Ins. Co.*, 401 U.S. 974 (1971), *on remand*, 56 F.R.D. 499 (S.D. Ala. 1972). The court of appeals stated:

The attorney-client privilege still has viability for the corporate client. The corporation is not barred from asserting it merely because those demanding information enjoy the status of stockholders. But where the corporation is in suit against its stockholders on charges of acting inimically to stockholder interests, protection of those interests as well as those of the corporation and of the public require that the availability of the privilege be subject to the right of the stockholders to show cause why it should not be invoked in the particular instance.

430 F.2d at 1103-04.

¹⁹ *Id.*

²⁰ *See, e.g.*, *Washington-Baltimore Newspaper Guild, Local 35 v. Washington Star Co.*, 543 F. Supp. 906 (D.D.C. 1982).

materials.²¹ This should be almost self-evident. At the time of litigation between shareholders in a corporation, materials created after that adversarial relationship cannot be said to have been created for the benefit of shareholders. This is an important distinction, which makes work-product doctrine superior to attorney-client privilege.

The area of waiver relates to the notion of disclosure. Attorney-client privilege is lost if the attorney or client discloses. Courts have focused on two types of disclosures: third party disclosure, which is disclosure to persons not within the attorney-client relationship or not acting for the attorney or client, and disclosure to the Government. The rule of thumb for attorney-client privilege is that if an attorney discloses to anyone, including the Government, he or she may be in serious trouble.

With respect to work-product doctrine, the disclosure issue is not clear. In the *Permian* case the District of Columbia Court of Appeals held that even though an attorney or client might lose attorney-client privilege, they would not necessarily lose work-product doctrine and, indeed, most of the documents were withheld from disclosure on the basis of work-product doctrine that was not challenged adequately on appeal by the Justice Department.²² Nevertheless, an attorney will find himself in positions where he is required to submit documents to the Government.

There are methods of submitting documents to the Government, and most government agencies will cooperate to the extent of allowing the attorney to preserve whatever arguments he or she has. Usually the government agency likewise will preserve its own arguments. The mere act of disclosing a document is deemed not to be a waiver, and thus, arguments are preserved. The Securities and Exchange Commission is now proposing legislation that effectively would deem the submission of materials not to be a waiver of attorney-client privilege. The circuits are in conflict. The Eighth Circuit in *Diversified Industries, Inc. v. Meredith*²³ held that there sometimes may be a limited waiver. Most of the other courts appear to be rejecting the limited waiver theory.

AUDIENCE: I am perplexed as to why it is not advisable to assert a privilege for anything that needs protection. Can an attorney ever be safe about releasing a document of a general subject matter, a part of which he or she may later wish to keep confidential?

PIIT: Undoubtedly, this situation frequently requires compromise. For example, an attorney may negotiate with the Government to take access to, and not possession of, certain documents. An at-

²¹ *ISC*, 693 F.2d at 1238-40.

²² *Permian*, 665 F.2d at 1219-20.

²³ 572 F.2d 596 (8th Cir. 1977), *aff'd in part, rev'd in part*, 572 F.2d 596 (8th Cir. 1978) (en banc).

torney may negotiate with the Government to retrieve documents once the Government has completed reviewing them to avoid claims under the Freedom of Information Act. Whether this will preserve privileges, such as attorney-client privilege, probably depends on the court in which the attorney is litigating. For instance, an attorney in the Eighth Circuit, apparently will be able to preserve the privilege. An attorney in the District of Columbia Circuit, however, will face much more difficulty in preserving it.

Nevertheless, a client's troubles may be far less severe if it cooperates with the Government, makes whatever deal it needs to make, attempts to minimize its losses, and proceeds with its normal corporate activities. Still, that corporate client should not abandon its attempt to protect truly sensitive material in documents. Within those documents there may be things that are irrelevant. The mere disclosure of the existence of the investigation, however, may be so dramatic that it causes the client to claim protection for everything. Thus, it is important to take steps to preserve the privilege, even when it is imperative to cooperate with the Government.

In the work-product area not only is there an exception vis-a-vis the Government, but there is an exception vis-a-vis third parties. For example, in *United States v. American Telephone & Telegraph Co.*²⁴ disclosure by MCI of documents to the Justice Department gave rise to an AT&T claim for all work-product that was computerized. This request successfully was defended against on the theory that the Government and MCI had a community of interest, and therefore, disclosure on that ground would not give rise to any problem.

The crime or fraud exception is an important area, in which there is the same distinction between attorney-client privilege and work-product.²⁵ Essentially, the rule is that if a client consults an attorney about a fraud it has committed without the attorney's knowledge, the communication is fully protected. If the client is seeking to obtain the attorney's advice to continue, further, or perpetrate a fraud or a crime, however, the attorney's advice to the client probably will be exposed under the crime or fraud exception. This is true even though the attorney is not aware that is what the client is doing, and even though if he knew, he would not give any assistance.

The *Marc Rich* case yielded some important rules. First, the client's conduct does not have to constitute a crime. Second, even if it is fraudulent, it does not have to be successful. The fact that a client tried to perpetrate a fraud is sufficient to vitiate. Third, all that is

²⁴ 642 F.2d 1285 (D.C. Cir. 1980) (attorneys representing clients with common interests may share work-product without being deemed to have waived protection of the doctrine).

²⁵ See *supra* notes 3 and 17 and accompanying text; MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102 (A)(7) (1976).

needed is a prima facie showing. In *Marc Rich* the client had retained a law firm to transfer the assets of one of Marc Rich's companies. Marc Rich was under attack, and the transaction took place time-coincident to the day that Marc Rich had to commence paying contempt penalties. A prima facie showing was made that Marc Rich was attempting to use its lawyers to design a way to defraud the Government, to make a fraudulent conveyance that was not a violation of federal law, not a crime, and not successful. The Second Circuit, however, stated that all the materials are not privileged and could be obtained to prevent obstruction of justice.²⁶

The other important case in this area is the Jenner & Block case, *In re Special September 1978 Grand Jury (II)*.²⁷ The law firm of Jenner & Block had been abused by a client in connection with payments made to a campaign fund. The Seventh Circuit decision is important for two reasons. First, the court held that there is a difference between work-product and attorney-client privilege for purposes of the fraud exception.²⁸ The work-product of an attorney's mental impressions may not be disclosed even though it was used for part of an ongoing fraud or crime, because that privilege belongs to the attorney. Everything else will be disclosed, however, because it belongs to the client. The court also adopted the very lenient but broad definition of the term "fraud." Under this definition the statement of making campaign contributions without indicating that they may have been illegal qualifies as a material nondisclosure.²⁹ This is one of the broadest interpretations of materiality under the federal securities laws. The court further held that this definition suffices for the crime or fraud exception, and therefore, raises many concerns.³⁰

That is an overview of where the cases have taken us today.

²⁶ *Marc Rich*, 731 F.2d at 1040.

²⁷ 640 F.2d 49 (7th Cir. 1980).

²⁸ *Id.* at 62.

²⁹ *Id.* at 58-60.

³⁰ *Id.*

Attorney-Client Privilege: Practical Problems

*David B. Russell**

RUSSELL: I propose to deal with some of the non-theoretical problems that confront a practitioner in perfecting the attorney-client privilege for corporate clients and in making its availability in desired circumstances as certain as possible. The best nuts and bolts advice I can give at the outset is that whenever there is any colorable basis for asserting the privilege, do so, even if you have not taken all the desirable precautions for protecting the privilege in the original situation.

I will focus on three areas of attorney-client privilege: procedures that will help to create the confidentiality of communications between corporate employees and corporate counsel, procedures to be followed in corporate internal investigations that will help to preserve that confidentiality, and matters relating to waiver of attorney-client privilege.

The burden of establishing the existence of attorney-client privilege rests, of course, on the person or entity seeking to invoke the privilege.¹ It is therefore essential that a corporation establish procedures that will help to maintain the confidentiality of legal communications. As a first step, it is important to identify particular written communications as coming from or being directed to a lawyer. For example, an internal legal department might have distinctive stationery, or each corporate attorney might have a legal title that is printed or typed on correspondence generated by the law department. All copies of correspondence should include legal titles to facilitate the separate filing of legal communications, as well as to aid in the identification of potentially privileged material during the pre-production process at the discovery stage.

Requests for legal advice or responses to requests should use the attorney's legal title, not business title, especially if the attorney wears more than one hat within the corporation. Persons who maintain files at the various locations within the corporation should file communications to and from the law department or outside counsel

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¹ *People's Bank of Buffalo v. Brown*, 112 F. 652, 654 (3d Cir. 1902).

in separate legal files and should limit access to those files. Maintenance of separate files facilitates screening prior to production. It also helps to prove that such segregated communications were intended to be confidential in the first place.

In addition to using identifiable stationery and legal titles, marking documents that contain privileged material as "Confidential" eases both screening and filing. If some documents are marked properly, and others are not, however, an adversary may argue that the documents that are not marked were not intended to be privileged. Similarly, if privileged documents that are normally segregated are not in fact properly segregated, an adversary may argue that the documents were not intended to be privileged. Everyone at every level of the corporation should be familiar with established procedures and should follow them consistently.

These procedures are particularly important today when inside counsel often is involved actively in business decisions. It is wise to separate legal and business advice into different documents, as only the legal advice is protected by the privilege.² From a practical viewpoint, however, it probably is burdensome to write separate documents on one matter that entails legal as well as business advice. It is therefore important to acquire the habit of using what might be called "legal opinion language" in rendering legal advice. In this way, the practice of segregating business and legal advice becomes second nature, as the author constantly is reminded that a privilege may exist with regard to the legal advice.

Where possible, legal opinions should state the request for legal advice, the facts and questions submitted to the attorney, and finally, the attorney's analysis and legal conclusions. If business advice is also sought, the attorney should state that it is based on his or her view of the applicable legal requirements.

It is also important to limit the distribution of legal opinions to those who requested the advice and who clearly need to know the answers, so that when a claim of privilege is later asserted, confidentiality can be shown. An attorney should not automatically send copies of a legal opinion to everyone who received copies of the initial request. Also, corporate employees should send copies of written requests for legal advice only to those other employees who clearly need to know. Those who receive the legal opinion should be advised specifically by counsel not to disseminate the information without prior consultation.

Disclosures made during board meetings and recorded in corporate minutes are not considered privileged, because they lack the requisite confidentiality.³ Counsel should exercise extreme care in

² *United States v. I.B.M. Corp.*, 66 F.R.D. 206, 212 (S.D.N.Y. 1974).

³ *See, e.g., Wilson v. United States*, 221 U.S. 361, 377 (1911).

reviewing agendas or other documents prepared prior to board meetings. If privileged matters will be discussed at a meeting, the agenda or another document should indicate that the presence of counsel is desired for the purpose of rendering legal advice. Any references in minutes to legal advice from counsel should be drafted in such a manner as to avoid waiving the privilege.

It is also desirable to have a written company policy stating that legal opinions and advice should not be communicated to anyone outside the corporation without prior consultation with counsel. The policy specifically should cover employee contacts with governmental agencies and should emphasize that while it is company policy to cooperate with law enforcement and other governmental agencies in appropriate situations, employees should report formal or informal contacts with governmental personnel to corporate counsel before releasing any information.

Governmental agencies sometimes contact employees informally during a criminal investigation to determine what information the employee has. In exchange for information damaging to the corporation, the agency may offer the employee immunity from prosecution or a reduced sentence recommendation. Because employees' statements may be binding on the corporation and could result in the disclosure of privileged communications, the company policy should address this situation. It should provide that employees must inform their superiors and corporate counsel when they are called or approached for a governmental interview, and if they decide to attend the interview, they must attend with corporate counsel.

The next topic I wish to address is attorney-client privilege in the context of corporate investigations. *Upjohn Co. v. United States*⁴ arose in the context of a corporate investigation of questionable or illegal payments. Often initiated voluntarily before possible SEC or other governmental action begins, such investigations are conducted with the Commission's informal approval or are required by the Commission pursuant to the terms of a formal settlement. If the attorney conducting such an investigation functions solely in an investigative capacity, the privilege does not apply. In addition, the privilege may not apply where a corporation institutes an investigation pursuant to the terms of a settlement, and special counsel is appointed to conduct the investigation, because the corporation may not be the client of the special counsel, since the special counsel may not be rendering legal advice to the corporation.⁵

⁴ 449 U.S. 383 (1981).

⁵ SEC v. Canadian Javelin, Ltd., 451 F. Supp. 594 (D.D.C. 1978) (stating that no attorney-client relationship existed between corporation and special counsel appointed to monitor corporation's compliance with injunctive order); Osterneck v. E.T. Barwick Indus., 82 F.R.D. 81 (N.D. Ga. 1979) (holding that production of documents or deposition

Upjohn and later decisions have established a number of guidelines to be followed by corporate counsel during an investigation.⁶ First, communications between the corporation and its counsel are privileged only when counsel has been retained to provide legal rather than business advice. Therefore, a corporation should seek legal advice in the form of a written request by a corporate officer who has authority to make such a request or in the form of a directors' resolution. Ideally, this request should refer to the possibility of civil or criminal litigation. It also may be useful for the memorandum or resolution to direct counsel to retain appropriate assistance from professional investigators, accountants, and others, if needed.

Inside counsel's use of outside counsel should not present a problem in asserting attorney-client privilege if such counsel is retained for the purpose of rendering legal advice to the corporation. Problems arise, however, when nonlawyer personnel assist corporate or outside counsel in the conduct of an internal investigation. It is advisable for accountants or professional investigators to act under a written directive from counsel if acting pursuant to counsel's control. Such personnel should be instructed to coordinate all activities with counsel and not to discuss any matters learned during the course of the investigation with anyone other than counsel. They should prepare all reports solely for counsel, give all reports and files to counsel, and receive payment from counsel.

In addition, when conducting an internal investigation, top level management should issue a directive notifying middle and lower level employees that counsel has been directed to conduct the investigation for the purpose of rendering legal advice to the corporation and directing the cooperation of employees. This should satisfy the *Upjohn* requirement that communications of employees to counsel be made at the direction of corporate superiors and for the purpose of rendering legal advice.⁷ It also may be advisable to create a record that sustains and substantiates the need for communications between middle and lower level employees and counsel. This record should include evidence that someone in top management decided that such

testimony by special counsel appointed to investigate possible securities law violations would not violate attorney-client privilege).

⁶ *In re John Doe Corp. (Southland) v. United States*, 675 F.2d 482 (2d Cir. 1982) (stating that attorney-client privilege applies only to communications between corporations and attorneys for the purpose of obtaining legal advice). In addition, attorney-client privilege is waived when the attorney discloses information to outside counsel, accountants, or underwriters. See generally Brodsky, *The "Zone of Darkness": Special Counsel Investigations and the Attorney-Client Privilege*, 8 SEC. REG. L.J. 123 (1980); Gergacz, *Attorney-Corporate Client Privilege: Cases Applying Upjohn, Waiver, Crime-Fraud Exception, and Related Issues*, 38 BUS. L. 1653 (1983); Crisman & Mathews, *Limited Waiver of Attorney-Client Privilege in Internal Corporate Investigations: An Emerging Corporate "Self-Evaluative" Privilege*, 21 AM. CRIM. L. REV. 123 (1983).

⁷ *Upjohn*, 449 U.S. at 394.

communications were necessary to receive adequate legal advice or to implement the legal advice rendered by counsel.

One problem with these procedures is a possible chilling effect upon communications between employees and counsel. As a practical matter, therefore, it may be necessary to deviate from these procedures, though the consequent risk that the privilege may be lost must be recognized. A similar problem is whether to warn corporate employees that the matters they are discussing could result in civil or criminal penalties for them as well as for the corporation. In some instances, an attorney interviewing corporate officers or employees during an internal investigation should warn them that their interests may not coincide with those of the corporation and should suggest separate counsel. The problem is determining when this is necessary and how such warning will affect further communications with employees.

Frequently, corporate counsel may have, or be perceived to have, conflicting interests in the context of corporate investigations. While *Upjohn* held that attorney-client privilege applies to communications made to both inside and outside counsel, problems have arisen where inside counsel has conducted an investigation or cooperated in an investigation conducted by outside counsel. For example, an agency, such as the Securities and Exchange Commission, may refuse to accept the conclusions of inside or regularly retained counsel and, as part of consent decree negotiation, may insist that a disinterested special counsel review the relevant material. Such special counsel's mandate is not to give legal advice to the corporation, but to advise the agency whether the underlying facts on which inside counsel rendered an opinion were fully and correctly reported. Conversations between special counsel and employees therefore would not be privileged, although they would have been had they been with company counsel. Likewise, otherwise privileged documents, generated or handled by special counsel, might lose that status.

Accordingly, corporate counsel must give serious consideration to possible loss of privilege before agreeing to such an arrangement. Corporate counsel also should evaluate at the outset the desirability of retaining outside counsel to conduct an investigation, or at least the possibility of having outside counsel participate in an investigation to minimize questions of objectivity that may later arise. Corporate counsel should mark all investigative results "Confidential and Privileged," and should control the dissemination of reports to maintain the required level of confidentiality. Disclosure of the content of interviews should be strictly on a need-to-know basis, and documents containing privileged material should be maintained exclusively by corporate counsel or at least segregated from general

corporate files. Corporate counsel should also maintain interview notes and other raw investigative materials.

While the great source of corporate investigations in past years has been questionable illegal payment investigations similar to the one that spawned *Upjohn*, the current wave of internal investigations is the result of various state and federal laws dealing with both the environment and compliance with various civil rights laws. In both areas it is of utmost importance that the investigation be extremely well organized to prepare the company to defend itself against suits or proceedings in which violations of these laws may be alleged.

Questions of waiver of attorney-client privilege arise in regard to disclosures made during investigations. It is clear that voluntary disclosure to third parties outside the corporation results in waiver of the privilege unless the disclosure is made specifically in furtherance of seeking additional legal advice or pursuant to a protective order. It is less clear, however, under what circumstances the dissemination of otherwise privileged material within the corporation results in waiver. At least one commentator has suggested that this may be an area where the control group concept, otherwise repudiated in *Upjohn*, may apply.⁸ As a practical matter, however, the appropriate course would be to establish formal corporate procedures requiring identification and segregation of privileged materials and to permit access only on a need-to-know basis.

Attorney-client privilege also is waived when a communication is made to counsel with the purpose of perpetrating a fraud or furthering a plan to commit a crime. Corporate counsel must recognize that if a client is subject to the dictates of federal securities laws, communications regarding past wrongdoings may be privileged, but counsel's knowledge of the client's continuing failure to disclose such misconduct may trigger the crime or fraud exception and thus preclude assertion of the privilege.⁹ Conceivably, the ethical dilemma posed for counsel may be alleviated if the client is aware that the communications are not privileged. This knowledge may help the client to decide to make the disclosure, subject to whatever protections can be negotiated with the particular governmental agency.

A corporate client and counsel also may have difficult decisions in making selective disclosures of privileged information to the Internal Revenue Service, the Securities and Exchange Commission, or other governmental agencies. The lack of specific guidance in *Upjohn* has resulted in continued uncertainty in this area and makes it

⁸ See, e.g., ABA SECTION OF LITIGATION, *THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE* 48 (1983).

⁹ *United States v. Bob*, 106 F.2d 37, 40 (2d Cir.), cert. denied, 308 U.S. 589 (1939) (stating that "[i]t has always been settled that communications from a client to an attorney about a crime or fraud to be committed are not privileged."). For a recent case dealing with the crime or fraud exception, see *In re Sealed Case*, 676 F.2d 193 (9th Cir. 1982).

advisable for corporate counsel and client to weigh seriously the advantages of limited disclosure, the promise of leniency, and the incurring of relatively less expense and time than would be necessary to litigate the matter, versus the disadvantages of the potential costs of waiver vis-a-vis other information and vis-a-vis other parties. If a client decides to disclose privileged information, client and counsel should negotiate formal confidentiality stipulations with the agency involved, and in some instances, should seek a protective order.

A final issue relating to waiver of attorney-client privilege is who within the corporation has authority to waive the privilege. Although it is not necessary that the directors exercise this authority in all instances, in some cases it may be appropriate. Nevertheless, a formal corporate policy should vest the authority only in top management.

There are many additional situations involving the existence of attorney-client privilege and the maintenance of its integrity. Two emerging areas worth noting, however, raise special problems concerning the privilege. The first is the so-called "progressive injury" cases. Outstanding examples are the Agent Orange and asbestosis cases involving thousands of plaintiffs, a host of defendant manufacturers, and their insurers. One pattern has emerged in the asbestosis cases in which the defendants and insurers enter into an agreement pursuant to which they designate a facility to be the representative of the manufacturers and insurers in all pending and subsequent cases. This requires turning over to the facility a substantial amount of documentation that the individual defendants have developed. One important question arises: does the information, presumably privileged under either traditional attorney-client privilege or work-product doctrine, continue to be privileged once it is handed over to the facility?

Another interesting area concerns the application of the Hart-Scott-Rodino Pre-Merger Notification Statute.¹⁰ Under the statute, the Federal Trade Commission or the Department of Justice may claim substantial penalties against companies engaged in mergers or acquisitions if the companies close the transactions without fully complying with requests for information by the Commission or Department.

The question arises: does the withholding of privileged communications, otherwise susceptible to inquiry by the Commission or Department, not only preserve the right of the Commission or Department to challenge the merger or acquisition, but also preserve the right to seek penalties on the theory that the parties closed without furnishing complete answers to questions posed? The legislative history of the Hart-Scott-Rodino Statute appears to support the

¹⁰ Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. §§ 1 note, 8 note, 12, 15c, 15g, 16, 18a, 26, 66, 1311-1314; 18 U.S.C. § 1505; 28 U.S.C. § 1407 (1983).

proposition that a company would be considered to have complied substantially with requests although it withheld information that was subject to legitimate privilege.¹¹ The Commission has stated, however, that the statute contemplates the submission of all relevant documents and does not provide an exemption for privileged documents. The Commission has further stated that if the alleged privileged documents are withheld, notification is incomplete, and a statement of reasons for noncompliance must be submitted.¹²

Thus, while the Federal Trade Commission has not completely obviated the possible assertion of attorney-client privilege, a company that intends to claim privilege in a Hart-Scott-Rodino proceeding must comply in exacting detail with the Commission's rules. By recent amendment, these rules require that to satisfy the substantial compliance requirements of the statute, the claimant of a privilege must identify the nature of the privilege claimed, explain all facts relied upon, provide the identity of each document, including its authorship, addressee, date, and subject matter, identify all recipients of the original and copies, and state the present location of each document and who is in control of it.¹³ Thus, where a company and its counsel are likely to be involved in Hart-Scott-Rodino notification, extreme care must be taken to meet all the usual requirements that support attorney-client privilege and to comply strictly with the rules set by the Federal Trade Commission.

¹¹ H.R. REP. NO. 499, 94th Cong., 2d Sess. 3, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2572, 2604.

¹² 15 U.S.C. § 1314(c), however, provides that if documents are withheld after express demand has been made for them, the person from whom discovery was obtained may file a petition for an order of the court to modify the demand requiring production. The petition must include the grounds relied upon and may be based on a privilege of the petitioner.

¹³ 16 C.F.R. § 803.3 (1984).

Capital Formation Alternatives: An Overview

*Stephen J. Friedman**

FRIEDMAN: I thought it would be interesting to discuss some of the major trends in financing in the American financial markets because they are a very good index of the direction in which financing is headed and of what practitioners can expect to be doing over the next five or ten years. I would like to talk about five principal currents in the financial market.

The first development, and by far the most important, is the volatility of interest rates. The second is the "dealerization" of the public securities markets, both for debt and equity. The third is the increasing internationalization of the capital market. A fourth trend is the significant growth and profusion of a very interesting development called "synthetic securities." The fifth trend is in the area of venture capital.

I will start with the volatility of interest rates. In this environment it is hard to imagine that for more than a quarter of a century after the bank crash of 1929 and the remedial legislation of the 1930s there was extraordinary stability of interest rates. Regulation Q¹ is the system of regulation that authorized the Federal Reserve Board and other regulators to impose ceilings on deposit interest rates. Regulation Q authority commenced in 1933, and until 1957, deposit interest rate ceilings were raised only once. The United States experienced a period of extraordinary stability during which a very effective financing device developed called the long-term bond market which was virtually unknown in other parts of the world at that time.

Beginning in 1966 and continuing through the Carter Administration, the United States began to experience a series of sharp interest rate increases, which had a devastating effect on the long-term bond markets. Investors began to shorten their time horizons and even insurance companies, which historically made loans of twenty and twenty-five years duration, began to shorten their maturities to fifteen, ten, and seven years. It became very difficult to finance in-

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¹ 12 C.F.R. § 217 (1984).

dustrial plants on that basis. Of course, the most immediate and dramatic effect was on the mortgage market.

I remember when I was at the Treasury Department in 1978 reviewing the terms of the first variable rate mortgage, which was a device that the Federal Home Loan Bank Board approved to deal with the problem of interest rate volatility and to help thrift institutions withdraw from the uneconomic business of making long-term, fixed rate mortgages. The initial version of the variable rate mortgage was not an attractive instrument and was not used very widely.

That little trickle now has become a river with an incredible profusion of similar instruments. If you have tried recently to finance a house you know that it is almost impossible to comprehend the full range of alternatives. That same profusion of new instruments has developed in the public debt markets. Innovative investment bankers have created an ever-growing "kitbag" of securities designed to do two things. First, the securities give the issuer the protection of long-term maturities by enabling him to keep the money for a substantial period of time. Second, they give the investor protection against erosion of principal due to interest rate movements.

The following excerpt from *Corporate Financing Week*² captures the flavor of what is happening in this market:

Citicorp Person-to-Person came to market last Tuesday with a \$250 million floating rate note issue, a "substantial portion" of which was sitting with sole manager *First Boston* by Friday morning, according to Curt Welling, V.P. The frns float $\frac{1}{8}$ of a point over the *Fed* CD composite, a market that was in turmoil last week with rumors and concerns about banks that are part of the run, and Welling said that *First Boston* had "pulled back from the market" in offering the notes and will "sit until a semblance of sanity comes back." Meanwhile, he said the firm was comfortable holding this paper in inventory, while declining to specify the amount unsold.

Although the source of the trouble was the CD base, Welling said that *First Boston* had made the bid to *Citicorp* to do the deal because the widening spread between the CD rate and *Treasury* bills would offer investors better principle protection than bill-based floaters. The floaters have a weekly yield reset, a feature well-suited to a highly volatile market, Welling noted.³

Although this involved a *Citicorp* financing, it is relevant for those of us who do financing work for medium and small sized companies. All of these financing techniques trickle down, and what seems to be at the cutting edge of the market one year becomes a conventional financing technique five years later.

There is a range of attempts to cope with the effect of volatile interest rates. An interesting development in the public finance mar-

² *Banking Turmoil Slows CD-Based Citicorp Deal*, *Corporate Financing Week*, vol. X, no. 21 (May 28, 1984).

³ *Corporate Financing Week* at 2. *Citicorp Person-to-Person* is a subsidiary bank holding company that does financing throughout the country for Citibank.

ket is the so-called "put-bond," which has been used widely in connection with housing bonds. The housing bond is a long-term revenue bond that is supported by a flow of payments from home mortgages. The revenue bond investor is given the option of "putting" the bond back to the issuer after a period of time or when certain interest rate parameters have been exceeded. From the investor's point of view it is not necessarily a long-term investment, but rather a shorter-term investment which, of course, affects the return.

Typically a bank issues a letter of credit that backs up the issuer's obligation to purchase the bond and effectively promises the issuer and the market the availability of financing to make the purchase. The effect again is to convert the original long-term issue into a shorter-term floating rate if the letter of credit is taken down. An interesting sideline is that the importance of bank credit facilities has given banks larger roles as underwriters of revenue bonds. Housing revenue bonds are bank eligible, and because the letter of credit is such an essential element of financing, banks have been increasingly co-managing underwriters in many of these deals.

There are two other interesting consequences of the development of volatile interest rates that often are not identified with that trend because they are not instruments that are, strictly speaking, securities. The first is the advent of zero coupon securities, and the other is the interest-rate swap. Basically, a zero coupon security pays no current interest, rather it is issued at a discount from face value similar to old fashioned savings bonds or treasury bills today and it is paid only on maturity. The difference between the principal amount of the security and the issued amount represents the interest.

Unlike a treasury bill, however, zero coupons are generally of intermediate or long-term maturity. The advantage to the issuer is that there is no impact on cash flow during the period that the security is outstanding. With an ordinary investment such as a government bond, when interest coupons are paid on a semiannual basis, the investor has to reinvest that interest, and the rate at which that interest can be reinvested affects the yield-to-maturity of the total investment. Although there is a fixed interest rate on the bond, the total return from the investment is a function of the rates that are current at the time those interest payments are made.

Thus, there is considerable uncertainty as to the total yield from an ordinary long-term treasury bond or other long-term bond. A zero coupon, however, is sold at a discount which represents a fixed compound interest at the end of the term, so an investor knows precisely what the yield-to-maturity will be. It is a very convenient tool for financing children's education and other future events. The full

rate of the investment is locked in at the outset. It is a very innovative way to cope with the problem of volatile interest rates.

The second development falls into a category of what has come to be known as "interest rate swaps." This is a market that is growing significantly and can be best described with an illustration. There are two borrowers. Let us call the first borrower "LT." LT is a company that has ready access to the long-term bond market. It can raise money on a long-term basis very cheaply and effectively. Assume that LT wants to use the proceeds from its borrowing for current transactions. LT would like to borrow in the short-term markets and pay current interest rates but does not have satisfactory access to those markets.

Let us call the second borrower "ST." ST has access to the short-term markets but has little access to the long-term markets. ST would like to finance a plant that will pay out only over a long period of time. In determining the economic viability of that plant, ST would like a fixed rate so it can compare the cost of capital to the returns that the plant will produce.

In the theoretical case ST and LT come together, and ST, who has access to the short-term market, agrees with LT to pay him an amount equal to a fixed, long-term rate on a notional amount of \$100 million for the next fifteen years. LT uses that stream of payments to cover his obligations on a \$100 million long-term borrowing that he makes in the long-term markets. In return, LT agrees to pay ST one percent above the prime rate or the LIBOR rate⁴ on \$100 million for the next fifteen years. ST, who is actually paying the long-term rate, uses that stream of payments to cover the interest on his short-term borrowing of \$100 million over the fifteen-year period. ST has accomplished his objective of paying the long-term fixed rate, and LT is paying the short-term rate, yet no principal has changed hands.

Two problems may arise in this theoretical case. First, LT and ST may be unable to find each other. Second, if they found each other, each would worry about the credit of the other over this very long period of time. The result is that a bank acts as intermediary. LT deals with the bank as if the bank were the short-term borrower, ST deals with the bank as if it were the long-term borrower, and the bank runs a "matched book."

Although that is the way it began, the market is changing dramatically. Many banks no longer are running matched books. They are simply taking the interest rate risks on both sides and hedging their risks through interest rates futures and other devices. Other banks now are starting to offer arrangements called "floor/ceiling

⁴ LIBOR rate is the London Inter-Bank Offered Rate. It is the interest rate that London banks charge preferred customers on loans of United States dollars.

agreements." The bank will agree with a short-term borrower who is subject to fluctuations in interest rates that if the short-term rates rise above a certain percentage, the bank will pay the difference. If the rates fall below a certain percentage, the borrower will pay the difference. The borrower has a range in which it is prepared to take the risk, and the bank is compensated by fee income. Some banks now are issuing plain ceiling agreements in which the bank agrees with the short-term borrower that if the rate rises above a certain percentage, the bank will pay the difference.

I have called the second major trend in financing increasing "dealerization" of the market. This is related to rule 415, which provides for shelf registrations for qualified issuers.⁵ In the old days, securities firms had two quite different departments. The corporate finance department handled new issues and dealt with the attorneys who did the prospectuses and the due diligence. The syndicate department would also deal with other investment banking firms and assemble a group of firms to underwrite securities. The other department consisted of the brokers and traders. Except in the case of those over-the-counter securities where the firm made a market and acted as dealer and trader, the firm acted as agent and not as principal. Twenty years ago, acting as dealer was by far the less important part of the firm's business.

One of the most extraordinary financial events of the post-World War II period has been the institutionalization of savings in this country and its profound effect on the financial markets. In 1948 there were approximately \$3 billion in private pension plans. Today there are over \$500 billion in private pension plans. Over seventy percent of the trading on the New York Stock Exchange is represented by financial institutions and that excludes mutual funds which are treated as individuals. This significant change in the nature of the investing community has had a dramatic effect on securities firms.

Institutions buy securities in very large quantities because it is expensive to monitor a large number of issues. Institutions have very large amounts of money to invest, they need liquidity, and they need companies that are widely followed. Because they buy in large quantities, they also sell in large quantities. The auction process on the floor of the stock exchanges, even the New York Stock Exchange which has a very effective auction process, is simply not capable of handling transactions of that size. During the 1970s many securities firms were forced to acquire larger and larger amounts of capital to position sales of blocks of securities. The positioning institutional broker agreed to buy the block at a fixed price and take the risk that the security could be distributed at that price or better.

⁵ 17 C.F.R. § 230.415 (1984).

Those were clearly secondary market transactions, yet they have had an impact on what is happening today in the capital raising market. The need to position securities forced a small number of firms to acquire very large amounts of capital, and those firms developed very sophisticated distribution mechanisms that were quite different from the syndicate process for selling large blocks of securities. The distribution of blocks involved direct dealings between the upstairs dealers at the firms and institutions through a variety of electronic means. They were wholly outside the auction process.

What does all this have to do with rule 415? Not long ago the Securities and Exchange Commission began to feel the effect of interest rate volatility. Companies began to complain that the volatility of interest rates resulted in very short "windows in the market," and that they could not wait fifteen days while the Commission processed their registration statements. In response, in the 1970s, the Commission progressively shortened the registration period applicable to very large issuers to approximately forty-eight hours.

As the Commission was shortening the processing period, interest rates were becoming more volatile and corporate treasurers continued complaining. In 1981 the Commission proposed to extend the availability of shelf registrations to primary offerings by larger issuers. I was a member of the Commission at that time, and I know that no one at the Commission recognized how significant this "small" change would be. Initially, there were virtually no comments. Finally, Morgan Stanley and a group of other firms looked at what the Commission was doing and recognized that it would have a profound effect.

Under rule 415, the registration statement is declared effective before the terms of the offering are fixed. The issuer has very limited discussions with a small number of underwriting firms that indicate an interest in participating. The treasurer or chief financial officer waits for one of these windows in the market to open. When the window is open, immediately the firms are called and invited to bid. The firms bid, the issuer picks a firm, and the offering is made that afternoon or the next day. There is obviously inadequate time to conduct any type of due diligence effort at that point. In a technical sense, the Commission has responded to that problem by integrating the 1933 Act and 1934 Act disclosure systems, but the underlying problem of the underwriter's obligation to learn enough about the company still exists.

Not only is there insufficient time for due diligence, but there is inadequate time to form a large syndicate. Consequently, the major underwriters find themselves taking larger and larger positions that could lose substantial value if the credit markets turn against them before the positions are sold. Only a handful of firms have the capital

necessary for these transactions, which has resulted in a large concentration of investment banking business. The securities industry, and in particular, the underwriting capital raising process, are even more concentrated than the banking industry.

Because there is inadequate time to form a syndicate, the distribution process tends to be undertaken through the trading desk rather than through the syndicate process. This results in an increasing institutionalization of the markets. If a securities firm is holding \$100 million worth of a security in inventory, it wants to dispose of it very quickly. Retail distribution can be slow. Therefore, firms tend to solicit the people who can buy in the largest quantity, the large financial institutions. There is a fair amount of empirical evidence that a higher percentage of rule 415 offerings are sold to institutions than any other kind of offerings.⁶ If the trend continues, one can envision large financial institutions engaging in the kind of sub-underwriting role, with attendant Glass-Steagall⁷ implications, that insurance companies and banks play in Great Britain, where they are an intermediate stage in the public distribution process.

Although legally and practically only very large companies are involved, small issuers also should be interested in this trend. If rule 415 is combined with the integrated disclosure system, the lines between the public and private securities markets are progressively blurred. There are many small and medium sized companies that are in a continuous disclosure mode and have access to Form S-2, for example.⁸ Registration has become a very easy process, and the question whether to sell securities in a registered offering or as a private placement is now much less important. If you distribute to a small number of people and you are unsure whether you qualify for the private placement exemption, it is easy to register. I think we will see increasing numbers of distributions into ongoing trading markets by companies of all sizes and shapes as long as there is enough liquidity in the market to handle the distribution. There is certainly no legal reason why a company that can file a Form S-2 registration statement cannot finance through the ordinary trading market. There is no need for rule 415 as long as the distribution commences at the time of effectiveness of the registration statement. There is no

⁶ See H. BLOOMENTHAL, 1983 SECURITIES LAW HANDBOOK § 6.17(4) (1983). Bloomenthal expresses the Commission's concern that rule 415 will be used to bypass traditional distribution techniques and place large blocks directly with institutional investors. See also SEC Securities Act Release No. 6391, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,108 (1982).

⁷ Glass-Steagall Act, 12 U.S.C. §§ 347a-347b, 412 (1982).

⁸ 17 C.F.R. § 239.12 (1984). Form S-2 provides an abbreviated registration process under the 1933 Act for qualified issuers which have been reporting companies for three years and have filed all reports timely during the past twelve months and the portion of the month in which the registration is filed.

need to have a fixed price underwriting in which the underwriter takes the risk of distribution.

Briefly, I will discuss the internationalization of the securities market. Although it has a small impact on our lives today, in the long run, this trend toward a single, if not worldwide, international capital market will have the most profound impact on the financial regulatory system and ultimately on financing techniques.

In the primary markets, which includes the capital-raising process, it has become routine for the larger companies to decide whether to finance in the Eurodollar market or the United States market. The interest rate windows open up at different times in each market.

More interesting is the growth of the integration of secondary trading. If a financial institution wants an instrument to achieve a certain financial objective for its portfolio, it carefully examines Eurodollar securities of all types, including Eurodollar certificates of deposit and Eurodollar bonds. Ten years ago the Commission issued an elaborate release dealing with the problem of flowback and the steps that should be taken to avoid securities sold in Europe from being traded in the United States markets without registration.⁹ The practices of market participants have advanced miles beyond the conditions of that release. The Commission either does not know what is happening or does not know how to deal with it. More significantly though, when the market is broader than the regulatory system, regulations do not work. Why bother to subject yourself to United States disclosure rules when you can access the same investors by selling in Europe? Why worry about United States insider trading rules when you can buy the same securities in Europe?

"Synthetic securities" is one of the most interesting and quickly developing areas in the financial markets. The underlying idea is that an investment banker takes existing securities that have certain financial attributes and then recombines those attributes in different ways that investors will find more attractive. For example, zero coupon securities are attractive because they lock in yields. Some clever bankers found that it would be possible to combine zero coupon securities with the security and long-term maturity of the treasury credit. The only problem is that while the Treasury issues treasury bills at a discount, it does not issue bonds at a discount. That did not deter the people who ultimately created a zoological garden of synthetic securities called "cats," "tigers," and "cougars."

Basically, these synthetic securities involve the purchase and resale of a very large treasury bond. The coupons are stripped from the bond. There is a stream of semiannual payments, which the cou-

⁹ SEC Release No. 33-4908, 1 FED. SEC. L. REP. (CCH) ¶ 1363 (July 9, 1964).

pons represent, and then a large payment at maturity. The right to each payment is sold on original issue discount basis. In other words, the right to receive each interest payment is sold for a price less than its face amount. The discount represents an agreed upon interest rate that is attractive to an investor looking for a locked-in yield. The treasury bond is divided into many little pieces. Through the magic of compound interest a small investment will triple by the maturity date.

How is the bond split? Typically it is placed in a bank custody arrangement, and the bank sells receipts that represent the right to receive each payment. "Tigers," for example, stands for treasury growth receipts. "Cougars" and "cats" are similar arrangements. The receipts have a federal credit, and a locked-in rate, they trade in the secondary market, and some are listed on the New York Stock Exchange.

There is a host of legal questions related to synthetic securities, including those arising under the Investment Company Act¹⁰ and the Securities Act of 1933. The Commission has issued a series of no-action letters,¹¹ indicating that if it is possible to give investors what the Commission calls direct rights in the underlying securities held in custody, then the arrangement is legitimate.¹² Lawyers have thus created legal structures designed to give investors direct rights to the securities. For example, investors are given the right to sue on the security in the unlikely event that the federal government defaults on its payments. This is the same approach that has been used in the development of a family of new mortgage-based securities. The traditional "Ginnie Mae" (GNMA) arrangement involves taking mortgages, putting them in a pool, and selling a pass-through interest to investors.¹³ Investors are entitled to a pro rata share of the return. Their interest and principal is a function of the aggregate interest and principal payments by all the underlying mortgagors.

These new instruments are called CMOs, or Collateralized Mortgage Obligations. They are not pass-through vehicles. The mortgages are put in a pool, and then the bonds are issued as debt obligations of the entity that maintains the pool. The bond can be issued at an original issue discount or otherwise. Different series of bonds represent the right to receive different payments anticipated by the mortgagors. Short-term investors, for example, are given the

¹⁰ 15 U.S.C. §§ 80a-1 to -64 (1982).

¹¹ Blyth, Eastman, Dillon & Son Co. (December 16, 1974) (SEC No-Action Letter, on WESTLAW, Fsec Library, Nal File); First & Merchants Corp. (September 5, 1975) (SEC No-Action Letter, on WESTLAW, Fsec Library, Nal File).

¹² Direct rights in securities include, for example, the right to return on investment and the right to sue on the security in case of default.

¹³ GNMA is the commonly accepted abbreviation for Guaranteed National Mortgage Association.

first three years of payments, which are priced to produce a yield that is appropriate for a three-year maturity. Later payments would go to pay the longer maturity bonds. It is also possible to use this technique to convert old, low-yield mortgages into short-term instruments through the addition of "put" rights.

One last trend that is particularly interesting is that of pooling and selling interests in financial instruments. Recently, banks have increasingly sought to syndicate, or sell participations in, loans as a way of sharing the credit risk and the need for capital. Banks have now started selling participations in loans to nonbank institutional investors. This practice raises questions as to whether the pool is an investment company and whether the participation interest is a security. Nonbank institutions, especially retailers and companies with finance company subsidiaries that have large amounts of financial assets, such as receivables, are considering pooling these assets and selling the interests. The utility of this idea is growing at a great rate, and like all the recent changes in the world of financing, it is worth understanding.

Capital Formation: Definition of "Security"

Thomas Lee Hazen*

HAZEN: I will attempt to highlight some of the unconventional investment vehicles to which your investor-clients may have been exposed. Through these vehicles investors may find they inadvertently have encountered the federal or state securities laws. Some of the exotic investments that have been held to be securities include scotch whiskey, self-improvement courses, cosmetics, earthworms, beavers, muskrats, rabbits, chinchillas, fishing boats, vacuum cleaners, cemetery lots, and fruit trees.¹ Even religion, marketed in the appropriate manner, has been held to be a security.²

Before discussing the characteristics of a security and the situations in which an investor would face the securities laws, I will briefly remind you of the consequences of a court's holding that a security exists. First, the federal antifraud provisions, including rule 10b-5 under the Securities Act of 1934³ and section 17(a) of the Securities

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¹ Courts have held the following exotic investment schemes to be securities: scotch whiskey, SEC v. Glen-Arden Commodities, Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,142 (E.D.N.Y.); SEC v. M.A. Lundy Assocs., 362 F. Supp. 226 (D.R.I. 1973); SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973), *aff'd*, 496 F.2d 1192 (4th Cir. 1974); self-improvement courses, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); cosmetics, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); earthworms, *In re* Worm World, Inc., [1978-1981 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,414 (S.D. Dept. of Commerce & Consumer Affairs 1978); beavers, Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir.), *cert. denied*, 391 U.S. 905 (1967); muskrats, State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932); rabbits, Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193 (1932); chinchillas, SEC v. Chinchilla, Inc., [1951-1956 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,618 (N.D. Ill. 1953); Hollywood State Bank v. Wilde, 70 Cal. App.2d 103, 160 P.2d 846 (1945); fishing boats, SEC v. Pyne, 33 F. Supp. 988 (D. Mass. 1940); vacuum cleaners, Bell v. Health-Mor, Inc., 549 F.2d 342 (5th Cir. 1977); cemetery lots, Holloway v. Thompson, 42 N.E.2d 421 (Ind. App. 1942); *In re* Waldstein, 160 Misc. 763, 291 N.Y.S. 697 (1936); fruit trees, SEC v. W. J. Howey Co., 328 U.S. 293 (1946); SEC v. Tung Corp. of America, 32 F. Supp. 371 (N.D. Ill. 1940).

For a more complete discussion, see T. HAZEN, HORNBOOK ON THE LAW OF SECURITIES REGULATION § 1.5 (1985).

² SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976) (religious loan program marketed with slogans such as "while the world's economy staggers weakly, God's economy is stronger than ever" and "God's economy does not sink when the world's economy hits a reef and submerges! Wouldn't it be wise to invest in His economy?").

³ 17 C.F.R. § 240.10b-5 (1984). See 15 U.S.C. § 78j(b) (1983).

Act of 1933,⁴ the 1933 Act's counterpart to rule 10b-5, apply to fraud in the sale of securities. Section 12(2) of the 1933 Act also provides an express private remedy for fraud where the injured purchaser is in privity with the defendant seller.⁵ These three sections apply to securities regardless of whether or not they are registered prior to sale.

Perhaps more importantly, if an investor is deemed to have a security and then sells it to another, he or she either has to register that security at both the federal and state levels or find an exemption from registration. The burden is on the party claiming that an exemption applies. Furthermore, failure to register a security grants the purchaser a one-year right of rescission. One year from the sale of an unregistered, nonexempt security the purchaser may rescind that transaction (or recover rescission damages) without having to show fraud or other illegality.⁶ Thus, the risks and costs of issuing or selling unregistered securities can be quite high.

Attorneys who represent investors in these types of ventures may have potential remedies for disgruntled investors. Conversely, attorneys representing issuers may have problems that they did not think existed in the first place. As noted a moment ago, the definition of "security" is broad enough to include many unconventional investment vehicles. The state and federal definitions of a security are virtually identical. "Security" includes the conventional types of vehicles: stock, notes, profit sharing arrangements, and investment contracts.⁷ In some cases, however, even stock is not held to be a security.⁸

The key phrase that I will focus on is the one generally looked to by the courts: "investment contract." Most of the case law that defines "security" has arisen under the concept of an "investment contract."⁹ Two Supreme Court decisions, *SEC v. C.M. Joiner Leasing*

⁴ 15 U.S.C. § 77q(a) (1983).

⁵ 15 U.S.C. § 77l(2)(1983).

⁶ 15 U.S.C. § 77l (1)(19). See also 15 U.S.C. § 77m (1983) (statute of limitations).

⁷ Section 2(1) of the Securities Act of 1933 (15 U.S.C. § 77b(1) (1983)) provides:

The term "security" means any note, stock, treasury stock, bond debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

A similar definition is found in 15 U.S.C. § 78c(a)(10) (1983); N.C. Gen. Stat. § 78A-2(11) (1981); A.L.I., Uniform Securities Act § 401(e).

⁸ See *infra* note 30 and accompanying text.

⁹ The judicial interpretation of the definition of securities has developed primarily from interpretation of the statutory phrase "investment contracts." With the lead of the Supreme Court, federal and state courts have strived to arrive at a workable definition and have formulated various tests and approaches. Throughout the history of struggling for

*Corp.*¹⁰ and *SEC v. W.J. Howey Co.*,¹¹ are helpful in defining "investment contract." The *Howey* test remains relevant today.

In the *Joiner Leasing* case defendants were selling or marketing oil and gas drilling programs. They were selling a fee interest in land to each purchaser and also a drilling service whereby the promoters would drill to determine if the individual lots would be likely to produce oil or gas, and therefore, likely to result in profit. Defendants claimed, of course, that they were not offering securities. They asserted that they merely were selling land and offering the ability or service of drilling that land, and that the success of the investment depended upon the presence of recoverable oil or gas under the land.

Rejecting defendants' argument, the Court found the promotional oil and gas scheme to be a security. The Court focused on three factors. First, the Court scrutinized the terms of the offer or how the interests were being marketed. Second, it examined the plan of distribution. Defendants had been contacting a wide range of investors, promoting the scheme as a profit making enterprise, yet few, if any, of the investors had any background in oil or gas drilling. Finally, the Court examined the economic inducements—the profitability of the drilling operation. Because the economic success of the investment was dependent on the test well, as it was not feasible for an investor to buy a small plot of land and do his own test drilling, the package of the land plus the drilling constituted an investment contract. Therefore, this package was held to be a security which either had to be registered or sold pursuant to an exemption.¹²

In the *Howey* case it appears that defendants had carefully focused on the *Joiner Leasing* decision and had attempted to develop an investment scheme in which there would not be a connection between the service or investment aspect and the underlying land. In *Howey* defendants had been selling orange groves in Florida. They had subdivided an orange grove, and each individual investor would purchase a fee interest and would be free to do whatever he or she wanted with the orange grove. There were no tied-in arrangements for picking the fruit or other related activity.

The promoters also had offered a picking or harvesting service, *Howey-in-the-Hills*, which was an affiliated corporation. Thus, an in-

an appropriate definition, courts have been mindful of the fact that the bottom line question is whether the particular investment or instrument involved is one that needs or demands the protection of the federal (or state) securities laws. See, e.g., *Marine Bank v. Weaver*, 102 S. Ct. 1220 (1982) (bank-issued certificate of deposit not a security subject to federal securities laws since holders are already protected under federal banking laws, and therefore do not need the extra protection that the securities laws afford).

¹⁰ 320 U.S. 344 (1943).

¹¹ 328 U.S. 293 (1946).

¹² 320 U.S. at 352-53.

vestor could to go Florida each year to pick the oranges or pay Howey-in-the-Hills Service to pick them.

Defendants argued that, unlike in the *Joiner Leasing* case, this scheme was not a security; it was a sale of land and the separate offering of a service that was distinct and independent. Defendants also emphasized that the landowner had his choice of accepting or refusing this service.

The *Howey* Court looked to the "economic realities" of the situation, a phrase now used in every securities test.¹³ While acknowledging that the orange grove maintenance and harvesting contracts were not legally tied to the land interests, the Court recognized that as a practical matter, they were. The Court noted the economic realities of the situation: if an investor expected a profit he or she would be compelled to look to Howey-in-the-Hills or some comparable mass picking or harvesting organization to take advantage of economies of scale. Although there was no legal tie-in arrangement, the *Howey* Court observed that owners representing approximately eighty-five percent of the acreage investors had chosen to use the service arrangement.¹⁴

Noting that most of the grove's purchasers were out-of-state investors and had not had any contact with the orange industry in the past, the Court in *Howey* found that the economic realities were that this promotional scheme constituted an investment contract where the success of the investment depended upon not merely the weather and fruit-bearing abilities, but the management, harvesting, and marketing abilities of the promoter.¹⁵

The *Howey* Court established a four-part test for determining the existence of an investment contract.¹⁶ First, there must be the investment of money. This requirement has since been modified to include other types of valuable property. For instance, some cases indicate that investment of services in an appropriate situation may be a sufficient investment to constitute a security. Second, there must be a common enterprise, a concept courts have had difficulty defining.¹⁷ All courts would agree, however, that common enterprise means the involvement of more than one person. Many courts have stated that the promoter and one individual investor—the seller and

¹³ 328 U.S. at 298.

¹⁴ *Id.* at 295.

¹⁵ In finding the promotional scheme to be a security, the *Howey* Court noted that not only are formal stock certificates not required, but a nominal interest in the physical assets of the enterprise, such as actually owning fruit trees, does not preclude the determination that a security in fact exists. *Id.* at 299.

¹⁶ The *Howey* Court stated: "[A]n investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of the promoter or a third party" 328 U.S. at 298-99.

¹⁷ See *infra* notes 27-30 and accompanying text.

the purchaser—may be sufficient to create a common enterprise. Third, there must be the expectation of profit. The profit may not necessarily be in terms of annual return, but may show in the form of capital appreciation or other types of benefits.

Finally, these profits must yield solely from the efforts of others. Subsequent cases have modified substantially this last element. These cases hold that an investor may have a security if the success of the enterprise depends primarily or substantially on the efforts of others.¹⁸ One court has considered whether the success of the enterprise was due to the undeniably significant efforts of others rather than the investor.¹⁹

The difference in treatment under the securities laws between limited partnerships and general partnerships offers an illustrative example of the impact of the requirement that the profits be the result of others' efforts.²⁰ Some states, such as Connecticut,²¹ have statutes that expressly include limited partnership interests within the definition of securities; most state statutes as well as the federal statutes do not. Yet in the overwhelming majority of cases in which a person has invested in a limited partnership interest, that limited partner has purchased or sold a security.²² This is so because under limited partnership law, if a limited partner exercises too much con-

¹⁸ See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

¹⁹ *Turner*, 474 F.2d at 482. Accordingly, the fact that some efforts of the investor are necessary for the success of the operation does not preclude a finding that the scheme is a security. Such may be the case with:

- a. Pyramid sales schemes. *Koscot*, 497 F.2d at 484-85; *Turner*, 474 F.2d at 482.
- b. Licensing agreements where all of the significant efforts are those of the licensor. *SEC v. Aqua-Sonic Products Corp.*, 524 F. Supp. 866 (S.D.N.Y. 1981).
- c. Founder-membership contracts. See, e.g., *Florida Discount Centers, Inc. v. Antinori*, 232 So.2d 17 (Fla. 1970); *Hawaii v. Hawaii Market Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971).

²⁰ The limited partnership is an arrangement that clearly falls within the reach of the securities laws. In some instances, joint ventures and general partnerships might also fall under the acts' coverage. In the case of a limited partnership interest, the Uniform Limited Partnership Act requires that the investment be a passive one. A general partnership interest, however, will not fall within the purview of the securities laws unless there is substantial reliance on the efforts of others.

²¹ Conn. Gen. Stat. Ann. § 34-15 (West 1981).

²² Since virtually all limited partnership interests involve the investment of money or some other property and are geared to the expectation of a profit (sometimes in the form of a tax shelter), the traditional definition of a security is clearly fulfilled. See, e.g., *Siebel v. Scott*, 725 F.2d 995 (5th Cir. 1984); *Mayer v. Oil Field Systems Corp.*, 721 F.2d 59 (2d Cir. 1983); *Kosnoski v. Bruce*, 669 F.2d 944 (4th Cir. 1982); *SEC v. Murphy*, 626 F.2d 633, 640-41 (9th Cir. 1980); *Goodman v. Epstein*, 582 F.2d 388, 406-09 (7th Cir. 1978), cert. denied, 440 U.S. 939 (1979); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d Cir. 1977). See also *Baurer v. Planning Group, Inc.*, 669 F.2d 770 (D.D.C. 1981).

trol over the business, he or she will be exposed to general liability.²³ As there is more than one person involved in a limited partnership, the requirement of common enterprise is satisfied. There is reliance on the efforts of others, specifically the general partner or an outside management firm that has contracted through the general partner. There is also expectation of profit, which would include profit from the ability to take a deduction from a tax shelter.

Virtually every case that has considered the issue has held that a limited partnership interest is a security because of the investor's lack of control of the success of the enterprise. A district court in Ohio recently held that if a limited partner exercises too much control over the enterprise, that limited partnership interest may not be a security.²⁴ Of course, if that limited partner exercises too much control over the business, he or she may no longer be a limited partner but is probably a general partner as a matter of state partnership law.

At the other extreme is the general partnership in which the general partner has the ability to control, if not the obligation to help manage, the business. In most cases a general partnership interest, especially a bona fide general partnership interest, will not be a security.²⁵ On the other hand, persons attempting to take advantage of the limited partnership tax advantages, while avoiding the securities laws, form general partnerships as essentially passive investment deals. Courts have held that, although there may be the ability to control the enterprise, if in fact the general partnership interest is a passive investment where the efforts of an active single managing partner are essential to the success of the business, the interest may be held to be a security.²⁶ Economic reality, and not the form of the investment, is the key factor. Thus, there will always be a small per-

²³ A.L.I., Uniform Limited Partnership Act § 7.

²⁴ *Darrah v. Garrett*, [current] FED. SEC. L. REP. (CCH) ¶ 91,472 (N.D. Ohio 1984).

²⁵ Because a general partnership interest and most joint ventures usually carry with them a substantial say in the management of the enterprise, they will not fall within the purview of the securities laws unless there is substantial reliance on the efforts of others. *Odum v. Slavik*, 703 F.2d 212 (6th Cir. 1983) (general partnership interest not a security); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981) (general partner's managerial rights negate possibility that his interests in limited partnerships were securities); *Slevin v. Pedersen Assoc., Inc.*, 540 F. Supp. 437 (S.D.N.Y. 1982) (joint venture held type of partnership rather than a security); *Vicioso v. Watson*, 325 F. Supp. 1071 (D.C. Cal. 1971) (contract held joint venture rather than a security). See *Pfohl v. Pelican Landing*, 567 F. Supp. 134 (N.D. Ill. 1983) (refusing to dismiss claim that general partnership interest was a security), *Williamson v. Tucker*, 645 F.2d 404, 417-25 (5th Cir. 1981) (considering the impact of reliance on efforts of others in transforming partnership interest into a security). See generally Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. REV. 581 (1972).

²⁶ *E.g.*, *Morrison v. Pelican Land Development*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,863 (N.D. Ill. 1982) (general partnership interest may be a security); *Goldberg v. Paramount Oil Co.*, 143 Cal. App.2d 215, 300 P.2d 329 (1956) (contract held a security rather than a joint venture).

centage of limited partnership interests that will not be securities and a small percentage of general partnership interests that will be securities.

The sale of business doctrine currently is a pressing issue. In *Frederickson v. Poloway*²⁷ the Seventh Circuit held that the sale of one hundred percent of a business is not a security. Recently, the Ninth, Tenth, and Eleventh Circuits have followed *Frederickson*, reasoning that a purchaser is buying a business, not the stock.²⁸ The Second Circuit, however, has taken a much more literal approach by examining the statute and concluding that security includes stock, whether it be a sale of ninety percent or one hundred percent.²⁹ There may be reasons to exclude from the definition of a security the transfer of one hundred percent control of a closely held business. An explicit exemption, however, is not set out in the statute so that if one chooses to sell a business by selling the stock rather than the assets, it is likely that he or she will have to contend with the securities laws.³⁰

Whether a pension plan constitutes a security also has been debated. Involuntary, noncontributory, benefit plans, such as the plan in *International Brotherhood of Teamsters v. Daniel*,³¹ will not be deemed a security because the employee is not making any investment; rather, he or she is receiving a fringe benefit. A defined benefit plan is much less likely to be dependent on the success of the plan man-

²⁷ 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

²⁸ Landreth Timber Co. v. Landreth, 731 F.2d 1348 (9th Cir.), cert. granted, ___ U.S. ___ (1984); Christy v. Cambron, 710 F.2d 669 (10th Cir. 1983); King v. Winkler, 673 F.2d 342 (11th Cir. 1982).

²⁹ Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982). See also Rufenocht v. O'Halloran, [current] FED. SEC. L. REP. (CCH) ¶ 91,514 (3rd Cir. 1984); Daily v. Morgan, 701 F.2d 469 (5th Cir. 1983).

³⁰ Using the economic reality test of earlier cases, many courts have held that the sale of stock in a closely held corporation may not be a "security," especially if it is, in essence, a transfer of the ownership and management of the corporation's assets. E.g., Landreth, 731 F.2d at 1353; Christy, 710 F.2d 669 (10th Cir. 1983); King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981); Anchor-Darling Indus., Inc. v. Suozzo, 510 F. Supp. 659 (E.D. Pa. 1981); Barsy v. Verin, 508 F. Supp. 952 (N.D. Ill. 1981). See generally Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974); Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When is Stock not a Security?*, 61 N.C.L. REV. 393 (1983); Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982). The circuits are in conflict as to the validity of this "sale of business" exception for including stock as a security. In addition to the cases in note 27 *supra*, recent rejections of the sale of business doctrine include Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983); Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982); Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982); Cole v. Ford Motor Co., 566 F. Supp. 558 (W.D. Pa. 1983). See also United Housing Foundations, Inc. v. Forman, 421 U.S. 837 (1975) (shares in cooperative housing venture held not to be securities).

³¹ 439 U.S. 551 (1979) (holding that a compulsory noncontributory defined benefit employee pension plan is not a security under the 1933 Act definition).

ager's investment selections. On the other hand, a voluntary, contributory plan where the employee may or may not contribute and the payout depends upon the success of the plan, will probably be deemed a security, absent some independent exemption.³²

I will mention briefly the issue with regard to notes. The question arises whether short-term commercial paper is included within the definition of security. Although notes generally are held to be securities, short-term notes are exempt.³³ If a short-term note is offered and marketed as an investment contract rather than as typical bank thirty to ninety day short-term commercial paper, it may be deemed an investment contract. The ninety-day period is no longer conclusive on the issue whether the note is an exempt security.³⁴

Sale/leaseback arrangements have been held to be securities where the investor, although in form is participating in the sale/leaseback arrangement, in substance is relying on the activities of the promoter, the manager, or the person operating the plant, and therefore, is a passive investor.

The Sixth Circuit recently held that interest in a trust or an escrow account may be held to be a security even where separate accounts are maintained and the investors' and beneficiaries' interests are not commingled.³⁵ Thus, in the Sixth Circuit the absence of commingling or of what the courts call "horizontal commonality," which refers to the pooling of investor's funds or the common enter-

³² The *Daniel* Court noted not only the involuntary nature of the plan, but also the fact that there was no employee contribution (*i.e.*, no investment of money); these factors strongly negated any inference that a security was involved. *Id.* at 559-60.

³³ Section 3(a)(3) of the Securities Act exempts any "note . . . aris[ing] out of a current transaction" with a maturity not exceeding nine months. The exemption also covers renewals of such loans. 15 U.S.C. § 77c(a)(3) (1983). Section 3(a)(10) of the Securities Exchange Act of 1934 also excludes such short-term notes from the definition of a security. 15 U.S.C. § 78c(a)(10) (1983).

³⁴ The courts, by and large, have employed the economic reality test by asking whether the transaction under scrutiny is an investment vehicle that would trigger the Securities Acts' coverage, or whether it is more properly characterized as a commercial venture. *See, e.g.*, *Vorrius v. Harvey*, 570 F. Supp. 537 (S.D.N.Y. 1983) (participation by commodity trading company's salesman in loan made by his supervisor to company was not a security since investment was contingent on the solvency of the company which depended, in part, on the salesman's efforts); *Cocklereece v. Moran*, 532 F. Supp. 519 (N.D. Ga. 1982) (no expectation of profit from loan itself rendered note not a "security"); *Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981) (requiring inquiry into the "economic realities" using the "commercial-investment" dichotomy); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1185 (6th Cir. 1981) (loan participation agreement not a security; "[t]he securities laws are not a panacea for commercial loans gone awry."); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (bank loans held not to be securities); *Bellah v. First Nat'l Bank of Hereford, Texas*, 495 F.2d 1109 (5th Cir. 1974) (six month note renewing indebtedness is not a security). *See generally* Lipton & Katz, "Notes" Are (Are Not?) Always Securities—A Review, 29 *BUS. LAW.* 861 (1974); Sonnen-schein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 *BUS. LAW.* 1567 (1980).

³⁵ *SEC v. Professional Assoc.*, 731 F.2d 349 (6th Cir. 1984).

prise requirement, will not necessarily preclude the finding of a security.

Commodities generally will not be held to be securities. If gold or silver futures are in reality options rather than futures they may be deemed to be securities, though the underlying commodities themselves will not be so categorized.³⁶

There is a split of authority as to whether the offering of a brokerage firm's management prowess and expertise in managing accounts is a security.³⁷ The issue arising in the cases is whether the placement of the investor's money in a separate account precludes a finding of commonality, in spite of the brokerage's claim that it merely is providing a service for which the investor is paying and that the investor effectively is investing in the commodities.³⁸ A pooled commodity account, which is similar to a mutual fund with stocks or other securities, clearly will be a separate and distinct security, apart from the underlying commodities or securities that the accounts are holding.³⁹

FRIEDMAN: Why is a managed commodities account deemed a security, but a managed securities account is not?

³⁶ Based upon the extent of managerial and market making activities offered by the seller, a gold investment has been held to be a security. *SEC v. International Mining Exchange, Inc.*, 515 F. Supp. 1062 (D. Colo. 1981). Where all that is offered is the underlying commodity, however, even combined with storage and marketing services, there is no security, as the investor is relying upon the market price of the commodity rather than on the seller's marketing or managerial efforts. *See, e.g., Noa v. Key Futures, Inc.*, 638 F.2d 77 (9th Cir. 1980).

³⁷ The Fifth Circuit has held that a managed brokerage account is a "security." *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974). *See also Booth v. Peavey Co. Commodities Services*, 430 F.2d 132, 133 (8th Cir. 1970); *Taylor v. Bear Stearns & Co.*, 572 F. Supp. 667 (N.D. Ga. 1983); *Westlake v. Abrams*, 565 F. Supp. 1330 (N.D. Ga. 1983). In contrast, the Seventh, Third, and Ninth Circuits have held that such accounts are not "securities." *Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982); *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); *Wasnowic v. Chicago Board of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1973).

³⁸ Those cases holding that there is no security generally point to the absence of a common enterprise; the fact that the investor's funds are not pooled with those of anyone else, as is the case with a mutual fund or investment club, precludes the finding of horizontal commonality where the investor shares his risk with other investors. These courts thus have viewed a trading account as a pure service rather than an investment contract. Those courts holding a discretionary trading account to be a security have found sufficient common enterprise in "vertical commonality," which is the common enterprise that exists between the investor and the broker making the investment decisions. These courts point out that the broker's commission is usually tied to the profits and/or the asset value of the account and therefore, he is sharing the risk with the investor. Common enterprise aside, it is clear that all other components of the definition of a security have been met, as there is certainly an investment of money with the expectation of a profit to be derived from the expertise and efforts of the broker or investment advisor who is handling the account.

³⁹ Another way to frame the issue in the brokerage account cases is to ask whether the contract in question represents a bona fide service agreement, or whether the nature of the arrangement is more in line with the traditional investment concept that has led courts to find a security to exist in analogous arrangements.

HAZEN: Because the courts do not have to reach that question to hold the stockbroker accountable under the securities laws. When dealing with a securities account, if the investment advisor has made improvident investment advice or other fraud or fraud-like violations, he or she may be sued for the underlying violation of the securities laws regarding the funds of the securities held in the account. Under the commodities laws, persons defrauded by a broker must either look to the Commodities Futures Trading Act, or find a managed account to take advantage of the securities laws.

FRIEDMAN: That has some strange implications. It means that if an investment advisor advertises his services he is making a public offering.

HAZEN: Without an exemption that could be true. Getting back to the issue of managed commodities accounts, the decisions are split. Most of the decisions, however, seem to hold that without a pooling of interests, there cannot be a security.

Capital Formation: Practical Problems

*Zeb E. Barnhardt, Jr.**

BARNHARDT: I have the topic of practical problems in the capital formation process. When I began this preparation, I listed things I consider to be practical problems. As I looked through the list and thought through the process of capital formation, it seemed that what we are really talking about are "people" problems, and because such problems are practical, they are avoidable in the first place.

In the capital formation process an attorney rarely has a chance to start with a clean slate. Usually by the time a client comes to you, the client has already done something that makes your job difficult from the beginning. In the first place, the client has probably made grandiose plans and is anxious to move very fast. For example, here is a letter written by a client, obviously without legal advice. It arose in a situation in which one group had been planning for several months to enter into a joint venture with another group. The group, however, could not get themselves together to decide how to proceed, and the design of the organization and plans kept changing. I first heard this letter as it was read to me by an examiner from the Secretary of State's office. The letter reads as follows:

Dear Friends:

The Joint Venture is now a reality. Our first venture will lease the space from the landlord and will be equipped, staffed, and run as XYZ business. Other ventures will be organized later.

To pay organizational costs such as legal and accounting fees, each investor is being asked to invest \$1,000 to be applied to his first share of stock. This does not commit you to buy more shares later, but does assure your status as a stockholder in the corporation. The other party will match this investment. This is designed for profit ventures, and therefore, profits are fully taxable. If you want these profits sheltered through your retirement plan, we suggest you consult your accountant and/or lawyer for advice for your particular situation.

We have tentatively set two weeks as the time for this initial investment, and hope to have you as an investor in our future.

Please make checks payable to XYZ Treasurer, Joint Venture Corporation.

This letter is an egregious violation of the securities laws. The

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examiner knew that it could not possibly have been written by anyone who was acting on legal advice. As a result, the examiner called the author of the letter and told him that he was in trouble. The author did not understand what he had done wrong, and he called me. I calmed him down and called the examiner to see what could be done. We were able to resolve the matter by submitting a notarized statement signed by the author, certifying to the Secretary of State that he had not intended to violate the securities laws, that he had not acted on advice of counsel, and that before this venture would go forward at a later date, the proper filings would be made with the Secretary of State's office.

The basis on which we were able to resolve this matter illustrates the "people" aspect of practical problems in the area of capital formation. Instead of immediately obtaining an injunction against this venture, the examiner in the Secretary of State's office took a more practical approach by picking up the telephone and resolving the issue fully in compliance with the intent of the securities laws.

In the area of capital formation, the first step in the process of counseling is to get to know the client. Find out his or her plans by listening. Too often the temptation is to agree initially when the client rushes in and wants everything done immediately. An attorney may form the corporation or draw up the partnership agreements without really understanding what the client needs. Producing what the client says he or she wants may not meet the client's true needs. Therefore, it is important to listen first and explore with the client the ultimate goals.

If you are able to listen and understand your client's ideas, the two of you will have a much more successful relationship. Your client will feel more comfortable coming to you with ideas and will be more open to telling where errors may have already been made. You do not want to learn six months later that your client violated the securities laws at the outset; that knowledge is necessary early in the process.

A great deal of planning is necessary to decide which type of entity, such as a general partnership, limited partnership, or corporation, will fit the client's needs. It is necessary to talk about what is involved in raising capital, particularly for a new venture, and to identify the other people who should be involved in the process. This group of people should be assembled early.

In this situation, the securities lawyer is acting as an expert in the area of raising capital for such operations. In contrast, the regular counsel usually approaches a situation apprehensively because of the knowledge that his or her malpractice insurance policy contains an exclusion for securities laws violations. The regular counsel wants someone else to handle the project and wants to be certain

that the client is getting the best advice possible, but at the same time, does not want to lose a regular client. The specialist needs to work with the regular counsel, who is an excellent source of information about the client.

Obviously, accountants will be needed in this process. The client probably never has had any books audited. There may not even be any books at this point. The attorney must consider the initial offering that is being considered and the next offering that may be considered in six months or a year. Specifically, the attorney must consider whether there will be an integration problem if the second offering is too soon, or whether this offering may be integrated with what the client has already done. Of course, there are the usual registration and exemption considerations.

Accountants should be used to explain what is required by way of financial disclosures. The best time to involve new accountants is at the outset. The worst time is the time of writing the S-1 registration statement¹ for the public offering, because then the new accountants may find they cannot give an opinion that would be acceptable to the Securities and Exchange Commission. If accountants are involved in planning, disclosing, and auditing from the outset, the progression toward the public offering will be easier. Accountants can also be helpful in determining various alternatives available to structure the entity and to raise the capital.

Bankers and other lenders, such as insurance companies and venture capital firms, should also become involved early in the process. The client may not need to go public, but rather, may need a strong bank line.

If an actual offering is undertaken, there will probably be an underwriter or a selling agent, especially if it is a public offering. There may even be a selling agent in an offering that is not registered with the Commission, but is registered under state law. If you as the attorney anticipate such an offering, you should start the process of selecting the underwriter or selling agent early so that you do not end up rushing through that process, perhaps to become disappointed because no one wants to take your client's deal.

The securities regulator should be included as part of the team in capital formation. It may seem strange to include the Securities and Exchange Commission and the state blue sky authorities as a part of the team. They will not be sitting in on the conferences with everyone else involved, but can be invaluable in answering questions that arise. For instance, you may call a regulator and obtain an informal interpretation or clarification as to the meaning of a rule or statute. Of course, you will not obtain a no-action ruling by telephone,

¹ Form S-1, CCH FED. SEC. L. REP. ¶ 7121 (1984).

or a determination as to whether your client's deal is exempt. There are procedures by which you may submit a written request to answer those types of questions, but they take more time.

I have too often seen the situation in which two parties come together to go into business, unprepared for what they face. For example, one party is a salesman, the other an engineer, and neither one knows how to run a business. Nevertheless, they want to be successful in their business and expect the attorney to assist them. In this situation, it may be necessary to persuade the parties at an early stage to hire someone who has managerial experience, and let the salesman sell the product and the engineer supervise the designing and manufacturing.

I will mention briefly another aspect of such capital planning. An attorney should always consider the number of hats worn in a single transaction. For example, if you are an investor in the transaction from the beginning, the situation may have some conflict of interest complications.

In the process of entity formation, it is especially important to do things properly. It is never too burdensome to pull the general statutes book off the shelf and read the limited partnership act. For example, in *Wisniewski v. Johnson*² the Virginia Supreme Court held that the requirement in the Uniform Limited Partnership Act³ that the appropriate individual swear to the certificate of limited partnership will not be satisfied by an acknowledgment rather than a verification. It is therefore important to check to see what constitutes a verification and an acknowledgment.

It is also important to keep abreast of developments in the state blue sky laws. North Carolina has a new set of blue sky laws regulations, effective January 1, 1984. In North Carolina a filing with the Secretary of State must be made ten business days prior to the first sale of the securities for an offering under certain regulations. The filing is due even for offerings exempted from registration.⁴

I will close by mentioning one other aspect that I think is critical: communications. Throughout the entire process of working with a client and the team, an attorney must keep the lines of communications open among the participants. Your client must feel free to discuss everything with you; otherwise, you will not have all the tools needed to give adequate advice. If all the facts are not disclosed, the deal cannot possibly reach its full potential. Communications continue to be important throughout the process and even after the deal is closed. Communications become more important after the financing has been attracted, because the investors will want to know what

² 223 Va. 141, 286 S.E.2d 223 (1982).

³ VA. CODE § 50-45 (1980).

⁴ N.C. GEN. STAT. §§ 78A-1 to -40 (1981 & Supp. 1983).

is happening with their money. If you let them know, even when the news is bad, you will not be accused of concealing things. I am not talking only about periodic reports filed with the Commission, because that is not communications of the type needed with investors in a small business enterprise. A newsletter to let the investors know how the company is running is more appropriate.

In sum, I think if the terms "counsel" and "communication" are kept in mind, an attorney will not have unnecessary practical problems that are difficult to solve.

Capital Formation: Attorney Exposure

Clarence W. Walker *

WALKER: The subject that I will address is the exposure of attorneys in capital formation transactions. Preliminarily, I wish to advise that if you, as an attorney, have excluded securities coverage from your professional liability policy, or if you have limited yourself in your policy to relatively low coverage, you should change it. Enormous costs can accumulate if an attorney becomes involved as a defendant in securities litigation, whether it is an enforcement suit for an injunction brought by the Securities and Exchange Commission, an action for ancillary relief, a civil action for damages by a plaintiff or a class of plaintiffs, or a rule 2(e) proceeding instituted by the Commission for administrative discipline of an attorney because of some alleged malfeasance in connection with a capital formation transaction.¹

In the mid-1960s a change occurred in the judicial and regulatory attitude toward lawyers participating as lawyers in securities transactions. At that time, statements like the one in *United States v. Benjamin*² began surfacing in cases, illustrating the pivotal role lawyers fulfill in the distribution of securities and protection of the investment community. Affirming a criminal conviction of an attorney, the *Benjamin* court stated:

In our complex society the accountant's certificate and the lawyer's opinion can be instruments of inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.³

This change of attitude was accompanied by a revamping of rule 23

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¹ See 17 C.F.R. § 201.2(e) (1984). For an explanation of rule 2(e), see text accompanying note 7.

² 328 F.2d 854 (2d Cir. 1964), cert. denied, 377 U.S. 953 (1964).

³ *Id.* at 863.

of Federal Rules of Civil Procedure. That rule made class actions far easier to bring and to handle.

This combination of events resulted in a quantum change in the trend toward the inclusion of lawyers in lawsuits or actions relating to securities transactions. Some of these suits were civil damage actions, such as *Katz v. Amos Treat & Co.*,⁴ and others were SEC enforcement actions, such as *SEC v. Frank*.⁵

Another area of concern for lawyers now and since the mid-1960s is the enforcement by the Securities and Exchange Commission of its own rule 2(e), which had not attracted much attention until that time.⁶ Rule 2(e) is a disciplinary rule, promulgated by the Commission, that empowers the Commission to suspend or disbar an attorney or other professional from practicing before the Commission if the Commission finds that the professional lacks the requisite qualifications to represent others, that he lacks character or integrity, that he has engaged in unethical or improper conduct, or that he has willfully violated or aided or abetted a violation of any of the securities laws or rules or regulations promulgated by the Commission.⁷

That final ground, violating the securities laws, has been by far the most prolific and pervasive source of rule 2(e) proceedings since the Commission began enforcing the rule in the mid-1960s. The third ground, unethical and improper conduct, was one of the grounds on which the administrative law judge in *In re Carter and Johnson*⁸ found that Carter and Johnson were subject to suspension, although the Commission did not follow that decision.

Enforcement of rule 2(e) and SEC enforcement suits became much more prevalent beginning in the late 1960s. The most dramatic enforcement suit was *SEC v. National Student Marketing Corp.*,⁹

⁴ 411 F.2d 1046 (2d Cir. 1969). In *Katz* an individual brought an action against his attorney, his broker, and the president of the brokerage house, alleging violations of the federal securities laws in sales of unregistered stock and for misrepresentations during sale.

⁵ 388 F.2d 486 (2d Cir. 1968). For a discussion of this case, see text accompanying note 17.

⁶ See generally Comment, *SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney*, 1972 DUKE L.J. 969. While there had been a total of only four rule 2(e) proceedings against attorneys in the period up to 1960, there were eleven such cases in the decade of the sixties, and the pace quickened substantially in the seventies. *Id.* at 983.

⁷ 17 C.F.R. § 201.2(e) (1984).

⁸ [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,847 (Admin. Proc. File No. 3-5464 1981). The Commission held that because it had not adopted standards of professional conduct which covered the attorneys' conduct, the attorneys were not liable. The Commission emphasized, however, that in future proceedings it would apply the interpretation of unethical conduct developed in the opinion.

⁹ [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,4360 (D.D.C. 1972). The Commission brought an enforcement action against two law firms and an accounting firm for antifraud, reporting, and proxy violations that had allegedly occurred during a

decided in 1978. The most dramatic rule 2(e) proceeding was *In re Carter and Johnson*, the case that I previously mentioned. Both of those cases drew much comment and concern from the bar because they dealt with issues that are very important to practicing lawyers in the securities field and involved partners in highly respected New York and Chicago law firms.

Two events have tempered this trend toward greater exposure of securities lawyers to either civil or enforcement suits. The first was the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*¹⁰ that negligence would not suffice as a ground for liability, at least in the case of an implied civil action for damages under rule 10b-5. Liability required what the Court called "scienter," which has been variously defined but is, by all definitions, something more than ordinary negligence. The other event was a shift that occurred a few years ago in the Commission's enforcement emphasis—away from enforcement against lawyers, accountants, and other actors on the periphery of securities transactions, and toward insider trading. In spite of those two events, the trend towards greater exposure for lawyers continues. The trend is important to lawyers who practice a significant percentage of their time in the securities area.

Before turning to the specific areas in which attorney exposure arises, I want to mention the duties imposed upon lawyers in capital formation transactions or in securities transactions generally. The first of those duties is the duty of diligence, which, in these securities transactions, translates into a duty of inquiry into the facts underlying whatever the attorney is doing, whether giving an opinion or preparing a disclosure piece. The key is how far the lawyer must go in making an independent verification of the facts that form the basis of his or her opinion, or of the facts that go into the offering circular, the official statement, or whatever disclosure piece he is being prepared. The cases may offer some guidance on this question.

The second duty is the duty of disclosure placed upon the attorney with respect to facts that come to his or her attention in the course of the representation. The key issue here is: to whom is the duty of disclosure owed? Is it owed to the client, or in the case of a corporate client, to the board of directors or to the shareholders, or in the case of a publicly held client, to the Securities and Exchange Commission or to the public generally? Also, how does that determination interface with the duties of confidentiality that the lawyer has

series of corporate acquisitions by an issuer and the merger of the issuer with another corporation. The Commission asserted that securities attorneys involved in a merger transaction had obligations to the public independent of their duties to their clients, and perhaps paramount to such duties.

¹⁰ 425 U.S. 185 (1976). The Court held that an accounting firm hired for periodic audit purposes was not liable for aiding and abetting in a rule 10b-5 action where there was no scienter.

under the ethical rules relating to client confidences? This problem emerged in *In re Carter and Johnson* and has yielded a great deal of comment.

I will focus primarily on the duty of inquiry as it relates to lawyers participating in capital formation transactions. To what extent and how that duty translates into liability depends in part on whether the issue arises in an enforcement action or in a civil damage action. It also depends to some extent on what role the lawyer plays in the transaction itself. These roles may be divided into three categories. The first is the role of the lawyer as adviser and counselor. In that role the securities lawyer has a relatively low level of exposure. It is the exposure that all lawyers have to a malpractice suit, where liability may be directly to the client and to specific individuals expected to rely upon the professional advice.

An interesting case that illustrates the judicial attitude toward a lawyer who is functioning merely as an advisor is *Nicewarner v. Bleavins*,¹¹ decided in the District of Colorado. *Nicewarner* concerned the sale of a one-percent undivided interest in royalties from an invention, which the lawyer mistakenly concluded was not a security, and therefore, not subject to registration under either state or federal securities laws. The court held that it was a security and that the client had violated the securities laws by selling the undivided interests without registration.

The question arose whether the lawyer was a participant in that sale, such that he was liable under section 12 of the Securities Act of 1933. The *Nicewarner* court noted that the lawyer had represented the inventor, had advised the inventor with respect to tax matters and other concerns, had prepared the documents of transfer on the assignment of the undivided interest in the royalties, and had structured the inventor's entire corporate plan. The court inquired whether this background of involvement with the client reduced the quantum of participation in the sale that is necessary for liability as a seller under section 12(1) of the the 1933 Act. The court stated, "[i]n the present case, while it appears that the sale would not have been consummated without the services of some attorney, the evidence fails to establish that Hudson did more than serve as an attorney."¹² The court held that the attorney was not a participant because he had been counseling the client and had not been interfacing with investors in that situation.

The second role of the attorney is the role of drafter of disclosure documents. In this role there is a significant increase in the

¹¹ 244 F. Supp. 261 (D. Colo. 1965).

¹² *Id.* at 266. This holding echoed the notion, embodied in the American Bar Association Code of Professional Responsibility, that the attorney's primary responsibility is to his client, and short of his active participation in a fraud, he has no liability to others.

level of exposure, because the lawyer knows that the work product will be read and relied upon by others who will use it as the basis for an investment decision. The client frequently relies heavily on the lawyer for the structuring, the emphasis, and many of the substantive materials that go into the offering circular or the disclosure piece. Thus, there will be an increase in the attorney's exposure that is commensurate with that intended use and that level of reliance.

It is not clear how much independent verification a lawyer should do. The best formulation that I have heard is one stated by Leonard Leiman at the Thirteenth Annual Securities Laws Institute in New York. He stated that "[t]he lawyer must be thorough in asking questions, and he must slow the process of preparing an opinion or disclosure document if the client's answers to his questions do not seem reasonable."¹³ I cannot overemphasize the importance of slowing the process, because one thing that attorneys deal with in almost all capital formation transactions is the impatience of the client. The client wants to proceed with it and does not want to be delayed by the ponderous activities of some attorney perfecting a disclosure piece. Nevertheless, it is absolutely essential that an attorney take the necessary time, especially when the client is in a hurry.

The importance of the duty of inquiry is illustrated by *SEC v. Management Dynamics, Inc.*,¹⁴ a civil injunction suit brought by the Commission. *Management Dynamics* involved a shell corporation, which is an inactive publicly held corporation whose shares had become worthless but were still held by hundreds of people. This situation provided an attractive vehicle for a buyer to avoid the registration requirements by purchasing the corporation at a very low price, filling it up with operating assets and automatically establishing a publicly held corporation. In the press releases and other information released to the public after the shell was activated, there were numerous representations about the new company that were clearly false and misleading and very material. At that stage, the Commission became involved and put an end to the shell corporation.

The lawyer had been very active in putting the shell together. The question arose because of the lawyer's participation as a seller in violation of section 5 of the 1933 Act. The district court found that some of the material was deceptive and misleading and that the attorney had violated section 5. The court of appeals affirmed the finding of a violation of section 5, and therefore, enjoined the attorney. In response to the attorney's excuse that he had functioned

¹³ Leiman, *Liability of Attorneys Involved in the Preparation of Disclosure Documents*, PLI, 13 ANNUAL INST. ON SEC. REG. 281 (1982).

¹⁴ 515 F.2d 801 (2d Cir. 1975).

merely as a lawyer and advisor and had acted in good faith, the court of appeals stated:

As an experienced securities lawyer, Levy should have known that contingencies cloud the horizon of almost every business venture, and he should have asked Barrett [the business man] to tell him about potential obstacles to the planned developments. Moreover, and particularly because of his expertise, he should have insisted that these possible impediments be identified in any communication which describes the projects.¹⁵

Management Dynamics illustrates the importance of the attorney's asking probing questions and slowing the process to ensure that the disclosure is proper, even in the absence of any specific red flags that indicate something is wrong.

*In re North American Acceptance Corp. Securities Cases*¹⁶ further illustrates the vulnerability of the attorney in capital formation transactions. This case arose out of the sale of capital notes by the use of sales literature that the court found to be materially misleading. The material had not been prepared by the lawyers but had been submitted to them for their review and comment. Essentially, plaintiffs claimed that the lawyers had failed to show sufficient concern about certain omissions from the sales literature before the material was distributed. The lawyers moved for summary judgment, claiming that even if there were material omissions in the literature, scienter on their part was lacking. Scienter is necessary to support aiding and abetting liability under the *Hochfelder* standard. The court denied summary judgment for the attorneys, stating that there was a genuine issue of fact as to whether the law firm's failure to call attention to the omissions was not a reckless or intentional act.

The attorney in *SEC v. Frank* had prepared an offering circular containing some fairly extensive passages describing tests that had been performed on the client's product, an additive that hastened the curing process of rubber products. The attorney asserted that he had merely acted as a scrivener, and that the client had provided him with this technical information which he included in the offering circular in good faith. The Commission, however, claimed that the attorney had access to information, which should have indicated to him that these claims were, at least in significant parts, spurious and incorrect.¹⁷

The trial court agreed with the Commission and granted a temporary injunction. The Second Circuit reversed and remanded, because the trial court should have held an evidentiary hearing on a highly contested factual issue in an important matter.¹⁸ The case

¹⁵ *Id.* at 809.

¹⁶ 513 F. Supp. 608 (N.D. Ga. 1981).

¹⁷ *Frank*, 388 F.2d 486.

¹⁸ *Id.* at 491-93.

nevertheless demonstrates that even if information appears to be technical material, an attorney should at least ask the right questions, read the material, and make a record of having gone through a careful process of verification before distributing the material to the public.

The third role of the attorney in capital formation transactions is issuer or giver of opinions. The same duty of diligent inquiry applies here that applies to the drafters of disclosure documents. The level of exposure in this role may be higher. An official opinion of an attorney on letterhead and signed with his or her name in relation to some aspect of the securities transaction, is often the key that opens the transaction to participation by public investors. Therefore, the level of exposure and the sensitivity of this role may be somewhat higher than when the attorney is working with disclosure documents. Thus, you as the attorney owe it to yourself and to your client to be diligent, not merely in determining the law, but in ascertaining the underlying facts.¹⁹

The importance of fulfilling this duty is illustrated by several cases. In *SEC v. Universal Major Industries Corp.*²⁰ an attorney gave an opinion to a transfer agent, in connection with a transfer of shares by some insiders, that the stock was free stock, which could be transferred without registration under the securities laws. The opinion reflected an obvious effort by the attorney to satisfy the needs of the transfer agent without involving himself in any exposure by incorporating an earlier opinion by reference, and thus sidestepping the critical legal issue. The Commission sought a civil injunction against the attorney as an aider and abettor of a securities act violation. The district court held that the lawyer was an aider and abettor in a section 5 violation, because it was clear that the transfer agent had understood the opinion the attorney gave him as an opinion that the stock was free stock. The case involved more than negligence because the attorney apparently knew what he was doing.

In *In re North American Acceptance Securities Cases*, which I previously mentioned, the law firm involved had given opinions that the issues of capital notes in question were exempt from registration as an intrastate offering. This case arose prior to rule 147, and there was no certainty in the area of intrastate offerings at the time. The main question was where the principal place of business was for purposes of the intrastate exemption. The court examined the authority

¹⁹ In *SEC v. Spectrum*, 489 F.2d 535 (2d Cir. 1973), the Commission sought injunctive relief against an attorney whose opinion as to the availability of an exemption was allegedly given without factual foundation. The court said: "[i]n the distribution of unregistered securities, the preparation of the opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience." *Id.* at 542.

²⁰ 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977).

on the issue of intrastate exemption and the facts and held that the intrastate exemption was not available. In response to the attorneys' motion for summary judgment, the court held that there was a genuine issue of fact as to whether the lawyers acted intentionally or recklessly in arriving at the wrong conclusion about the availability of the exemption.²¹

The decision in *Stokes v. Lokken*²² is one of the few decisions favorable to the attorney. In *Stokes* in response to an auditor's request, the attorney gave an opinion that his client's bulk sale of gold and silver coins was not a security. He did so after consulting with officers of the company concerning the manner in which the company went about selling and dealing in these bulk gold coins. The court held that the sale was a security. Plaintiffs claimed that the attorney had recklessly and blindly accepted information from an officer of the company about the way in which the company operated. The situation was exacerbated by the fact that the officer was a convicted felon. The court dismissed the idea that the criminal record of the company officer compelled a more probing inquiry and independent verification of what he said about the operation of the company. The *Stokes* court held that the lawyer was simply giving an opinion, was acting in good faith, was not a participant in the transaction, and therefore was not subject to liability.²³

There is little consistency among these cases. They are fact cases and have different results depending on how different judges view them. The point is that you as the attorney should ask skeptical probing questions to determine the facts that are in the offering material or that underlie your opinion. When anything arises that does not seem right, you should slow the process.

I think it is very dangerous for a lawyer to become involved in capital formation transactions in some role other than the professional role, whether as a participant, an advocate for the client, or as an investor. Such participation increases the attorney's motivation to do things that he or she would not do if functioning solely as an attorney and lowers the level of resistance to all of the things that can be done wrong in these transactions.

Moreover, this participation may condition the attitude of the trier of fact if the case is ever litigated. Usually the trier of fact is a judge because SEC enforcement actions typically are bench trials, since the Commission seeks injunctive and equitable relief. Frequently it appears in these cases that when a lawyer is involved as a principal or has become an advocate and not an independent counselor, advisor, or professional, the courts are predisposed against the

²¹ *North American*, 513 F. Supp. at 630.

²² [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,209 (8th Cir. 1981).

²³ *Id.* at 91,462.

lawyer. One such case is *SEC v. Manor Nursing Centers, Inc.*,²⁴ a suit for an injunction against a lawyer and others that arose out of an all-or-none registered public offering. This type of offering involves escrowing the money, and if the securities are not all sold, the money is returned to the investors. As occasionally happens in these offerings, the deal in *Manor Nursing* did not sell out. The lawyer in the transaction became involved in the process of changing transactions to give the false appearance that the offering had sold out so his client could keep the public investors' money. The lawyer again claimed that he was acting merely as a lawyer and in good faith. The Second Circuit concluded that as an experienced securities lawyer, defendant was well aware that failure to correct a misleading prospectus and retention of the proceeds constitute violations of the antifraud provisions of the securities laws, even though the issue had not been fully subscribed. Consequently, the lawyer was held liable for the violations.

Another case that illustrates how an attorney may step beyond his role is *Felts v. National Accounts Systems Ass'n, Inc.*²⁵ The lawyer in *Felts* was a part-time district attorney in a small Georgia town. He was employed by National Accounts Systems Associates to act as its attorney, apparently because he was a well-known local figure, and the company wanted his name. The attorney permitted the company to elect him president and director. He gave persons in the company a signature stamp so that they could use it to stamp his signature on corporate papers as president. His signature was stamped on some promotional material that the court found to be materially misleading. The court held that the lawyer was liable, along with the promoters and others, for the rule 10b-5 violations growing out of this misleading promotional material. The court also held that, absent a showing of good faith on his part, the attorney was subject to joint and several liability for all of the issuers' violations because he had permitted the issuer to use his name as its president and director and had given them his unrestricted use of his signature stamp.²⁶

I want to cover briefly the statutory grounds of a lawyer's liability under the securities laws. The most pervasive of these statutory grounds is rule 10b-5²⁷ of section 10(b) of the Securities and Exchange Act of 1934.²⁸ The significant breakthrough in terms of attorneys' exposure under rule 10b-5 was the development the concept of aiding and abetting liability in the late 1960s. As aiding and abetting liability in securities cases developed, the range of defendants in se-

²⁴ 458 F.2d 1082 (2d Cir. 1972).

²⁵ 469 F. Supp. 54 (N.D. Miss. 1978).

²⁶ *Id.* at 68.

²⁷ 17 C.F.R. § 240.10b-5 (1984).

²⁸ 15 U.S.C. § 78j(b) (1982).

curities cases broadened, and that broadening of the net caught many attorneys.

If the three requisite elements of aiding and abetting are present, and if there is a securities law violation, an attorney may be held jointly and severally liable with the principal violator. The three elements are: a securities law has been violated, the aider and abetter either knew or had a general awareness that the law was being violated, and the aider and abetter gave substantial assistance in effecting the wrong.

Numerous cases enunciate this three-pronged test.²⁹ The principal area of disagreement among the courts is the level of scienter required to establish aiding and abetting liability under rule 10b-5. According to *Hochfelder*, something akin to conscious intent must be demonstrated. The court in *Hochfelder* reserved judgment as to whether recklessness would satisfy the scienter standard under certain circumstances. The lower courts have not been consistent on the issue whether recklessness itself will satisfy the scienter requirement in cases of aiding and abetting liability, or whether the high conscious intent standard is necessary. According to some courts, the level of culpability required depends on whether there is a fiduciary obligation owed to the plaintiff by the alleged aider and abettor. If there is such a fiduciary obligation, the level of culpability decreases to ordinary recklessness.³⁰

Since *Hochfelder*, when dealing with a primary violator or a primary defendant, the circuits have generally held that recklessness suffices for rule 10b-5 liability.³¹ What constitutes recklessness is a very murky and troublesome question. The Court's formulation in *Lanza v. Drexel & Co.*³² is helpful:

In determining what constitutes 'willful or reckless disregard of the truth' the inquiry normally will be to determine whether the defend-

²⁹ See, e.g., *SEC v. Washington County Utility District*, 676 F.2d 218, 224 (6th Cir. 1982); *IIT, an Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 483 n.5 (2d Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1973); *Landy v. Federal Deposit Insurance Corp.*, 486 F.2d 139, 162 (3d Cir. 1973).

³⁰ See, e.g., *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir. 1982) (accountant/client relationship); *Edwards*, 602 F.2d at 484 (securities clearing house/broker-dealer relationship); *Woodward*, 522 F.2d at 84 (bank lender/cosigner of bank loan relationship).

³¹ See, e.g., *IIT*, 619 F.2d at 923; *Rolf*, 570 F.2d at 44, 46; *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), cert. denied, 439 U.S. 970 (1978); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir.), cert. denied, 434 U.S. 875 (1977). The courts in these cases have concluded that there is no indication in *Hochfelder* that the Supreme Court intended a radical departure from the common law analog of fraud which imposes liability for recklessness.

³² 479 F.2d 1277 (2d Cir. 1973).

ants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure to apprise themselves of the facts where they could have done so without any extraordinary effort.³³

This formulation is the one that is likely to be applied to lawyers. Thus, it is important to remember the admonition to ask the right questions, listen carefully to the answers, and slow the process if the answers do not sound right.

In *Aaron v. SEC*³⁴ the Supreme Court determined that the scienter requirement applies under Rule 10b-5 in SEC enforcement actions. One of the interesting questions that remains unresolved is whether this will result in a different outcome in SEC enforcement cases or whether the courts will speak in the language of recklessness rather than in the language of negligence when dealing with the same facts.

Section 11 of the Securities Act of 1933³⁵ is a very limited area of exposure for attorneys. I do not know of a single case decided against a lawyer for providing purely legal services, under section 11.³⁶

An important area of attorney exposure that is developing is liability under section 12(2) of the 1933 Act.³⁷ This is a general antifraud provision, which applies to a seller of securities whether or not the securities are registered. A lawyer functioning as an advisor for a client in the securities transaction might not seem to be a seller, but the Fifth Circuit has determined otherwise. In *Croy v. Campbell*³⁸

³³ *Id.* at 1306.

³⁴ 446 U.S. 680 (1980). In *Aaron* a manager of two employees who had made false and misleading statements to induce the public to purchase stock in a corporation, was sued under section 10(b) of the 1934 Act as an aider and abettor. The Supreme Court remanded the case to determine whether the manager had scienter—whether he knew or had reason to know that the employees under his supervision were engaged in fraudulent practices.

³⁵ 15 U.S.C. § 77k (1982). Section 11 creates an express right of action for securities purchasers against sellers when registration materials contain certain untrue statements or omissions of material fact.

³⁶ Sellers are defined under Section 11 to include issuers, officers, directors, and signers of registration statements, as well as certain professionals whose opinions are included in the registration statement. Merely acting as an attorney is not sufficient to impose liability.

³⁷ 15 U.S.C. § 77l(2) (1982). Section 12(2) provides:

Any person who offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, or such truth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Id.

³⁸ 624 F.2d 709 (5th Cir. 1980).

the lawyer involved was actually a tax lawyer who had become involved with plaintiffs by recommendation. He read the material provided by the syndicator of the particular project and told the client that it was "one of the best deals I have ever seen." The lawyer's fee was paid by the syndicator. The court held that the attorney's participation in the deal was not a sufficiently important cause of plaintiffs' buying the securities to place the attorney in the position of a seller under section 12(2) of the 1933 Act. Therefore, he was held not to be liable.

In *Junker v. Crory*³⁹ the level of the lawyer's activity was greater. *Junker* involved a freeze-out merger where the complaint was a breach of the corporate fiduciary duty because the merger terms were unfair. The controlling stockholders caused the corporation to acquire a sister corporation that had a third-party minority stockholder. The majority forced through a disproportionate exchange ratio that undervalued the properties of the acquired company, which consisted mainly of land and buildings. The lawyer had participated throughout by structuring and orchestrating the merger, participating in stockholder meetings, making representations, and urging the shareholders of the acquired company to proceed with the deal. The *Junker* court held that the level of the attorney's participation was such that he was a seller for purposes of section 12(2).

While there must be scienter to establish liability under rule 10b-5, there need only be negligence under section 12(2) and the burden of proving lack of negligence is on the defendant. Section 12(2) is thus a handy alternative for plaintiffs who cannot prove that the attorney's conduct was intentional or reckless to satisfy the standards of rule 10b-5 liability. Since *Hochfelder*, section 12(2) has become a fertile area of pursuit.

The Fourth Circuit has accepted the notion that a lawyer participating in a transaction can be a seller within the definition of section 12(2). In *Wassell v. Eglowski*⁴⁰ the Fourth Circuit affirmed the district court decision that the lawyer was a participant because of the level of his participation in the deal. In other words, he was a substantial cause in bringing about the sale, and therefore, was jointly and severally liable with the principals in the transaction.⁴¹

Another emerging area of attorney exposure is controlling personal liability, something that would not occur to most attorneys. Section 20 of the 1934 Act⁴² and section 15 of the 1933 Act⁴³ pro-

³⁹ 650 F.2d 1349 (5th Cir. 1981).

⁴⁰ 399 F. Supp. 1330 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976).

⁴¹ The attorney represented the corporation in a sale of control to an outsider. To facilitate the takeover, the attorney solicited a proxy from the principal shareholders, voted their stock to approve the takeover, and removed restrictions from the stock. *Id.*

⁴² 15 U.S.C. § 78t (1982).

⁴³ *Id.* § 77t.

vide that "controlling persons are liable, joint or severally with the primary violator," if it appears that they acted without good faith. Where the burden of proof of good faith lies is not clear because some courts place it on the plaintiff and others on the controlling person. In any event, an attorney participating in the affairs of a client in a significant way can be held to be a control person, and therefore jointly and severally liable with the client for its own securities law violations, even in a situation in which the attorney is neither a seller under Section 12(2), nor an aider and abettor under rule 10b-5.

In *West Lake v. Abrams*⁴⁴ the court refused to grant summary judgment on the issue whether outside counsel of a broker-dealer was a control person of the firm, which was a primary violator. The lawyer unquestionably was not a primary violator, but it was claimed that he was a control person. He had been outside general counsel for the company and had consulted frequently with management on major decisions. The staff counsel for the company testified in an affidavit that he never took any action without calling this lawyer and consulting with him. The court held that there was a genuine issue of fact as to whether this lawyer was a control person under section 20 of the 1934 Act, and therefore, jointly and severally liable with the brokerage firm.

I will return to what I mentioned at the beginning: when functioning as a lawyer in a securities transaction, remember that it is a risky task and sometimes a lonely one. Protect yourself and your client by asking the right questions, and if you do not get satisfactory answers, slow the process.

⁴⁴ 565 F. Supp. 1330 (N.D. Ga. 1983).

