THE LAW OF CORPORATIONS

SUPPLEMENTAL READINGS

Class 09

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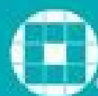
Corporations

and Other Business Entities

Seventh Edition

Steven L. Emanuel



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CORPORATIONS
AND OTHER BUSINESS ENTITIES

SEVENTH EDITION

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This book is intended as a general review of a legal subject. It is not intended as a source of advice for the solution of legal matters or problems. For advice on legal matters, the reader should consult an attorney.

CHAPTER 12

ISSUANCE OF SECURITIES

ChapterScope

This Chapter discusses both state and federal laws that regulate the issuance of securities. Key concepts:

- **Par value:** A corporation may choose to declare a ***"par value"*** for its shares before they are issued. If the corporation does so, then it may not issue the shares for ***less*** than this par value amount.
- **Payment in goods or services:** States put some — though not many — limits on a corporation's right to "sell" stock to insiders in return for ***goods and services*** rather than cash.
- **Preemptive rights:** Corporations sometimes opt to give shareholders ***"preemptive rights."*** A preemptive right permits an existing shareholder to ***maintain his existing percentage of ownership***, by guaranteeing him the right to buy a portion of any newly-issued shares.
  - **Exceptions:** There are some important exceptions to the coverage of preemptive rights, even when those rights exist. For instance, if the corporation issues shares in return for services or property, other shareholders' preemptive rights don't become triggered.
- **Public offerings:** The issuance of shares to "the public" (i.e., to large numbers of buyers simultaneously) is tightly regulated by federal law.
  - **Exemptions:** A large part of our treatment of public offerings consists of rules defining the borderline between offerings that are "public" (and thus tightly federally-regulated) and those that are "private" (subject to less regulation). Federal law has a number of ***"exemptions"*** that transform an offer that would otherwise be public into a private one. For instance, offerings to fewer than 35 affluent people, and offerings aggregating less than $1 million, are generally given an exemption.

I. STATE-LAW RULES ON SHARE ISSUANCE

A. Subscription agreements: Suppose that A, B, C, D, and E all want to form a new business that will operate as XYZ Corporation. Each is willing to put $10,000 into the venture, but each wants to be sure that he will not have to actually come up with the cash unless everybody else also comes up with the cash. One way the five would-be shareholders could do this is by having XYZ enter into a separate ***subscription agreement*** with each of the prospective investors. Each person's agreement might say that he promises to pay $10,000 for 100 shares in XYZ, but that this obligation is contingent upon the corporation's simultaneously selling at least 400 shares for $40,000 to one or more other investors. Once these agreements are signed, XYZ's promoter can begin arranging for workers, facilities, etc., confident that the $50,000 in capital will be available when needed.

1. **Installment plan:** Apart from this "reliance" objective, a second reason why promoters might want to use subscription agreements is that some or all of the stockholders may want to pay for their shares in ***installments***. The subscription agreement could then set out the size and timing of the installments, the remedies for default, etc.

2. **Less used today:** Subscription agreements are less frequently used today than formerly. If the corporation will be formed as part of a public offering, then the SEC's public offering procedures (*infra,* p. 539) will be used instead of the subscription-agreement procedure. If the corporation will begin its operations as a small privately held one, it will often be easier for the investors to simply form a shell and then simultaneously each purchase the shares, instead of having a pre-capitalization period in which the parties' expectations are protected by a subscription agreement.

3. **Law governing:** Nonetheless, subscription agreements are sometimes used, so it's worthwhile to understand the general principles governing them.

   a. **Revocation:** Suppose the subscription agreement is entered

into ***before*** the formation of the corporation that will be issuing the shares. A key question is whether this agreement may be ***revoked*** by the signing shareholder if he attempts to do so before the corporation is formed.

i. **No statute:** In a state where there is no statute on this subject, a court is likely to hold that the subscription agreement is only a ***continuing offer*** to a proposed corporation, and that the investor is ***entitled to revoke*** before the corporation is formed. In fact, some courts allow the investor to revoke even after the corporation is formed, so long as the corporation has not yet indicated that it intends to treat him as bound.

ii. **Statute:** But many states have statutes making the subscription agreement ***irrevocable*** for some stated period. Usually, this period is ***six months***. See, e.g., MBCA §6.20(a) (subscription agreement is irrevocable for six months unless it provides for a longer or shorter period; however, it may be revoked at any time if ***all*** the subscribers agree to revocation). See also Del. GCL §165 (irrevocable for six months unless all other shareholders consent to revocation).

b. **Liability:** Subscription agreements are generally ***enforceable*** by their terms. This means that a subscriber is ***liable*** for the unpaid portion of his subscription price. Clearly the corporation may recover against the recalcitrant subscriber; courts are split about whether the ***creditors*** of an insolvent corporation may recover from the subscriber.

B. **Par value:** You will remember from our discussion of dividends the historical importance of ***par value***. (See *supra*, p. 507.) To recapitulate briefly: traditionally in most states, stock was issued at a particular par value. This par value per share, when multiplied by the number of shares outstanding, constituted the corporation's "stated capital" or "legal capital." As we saw in the treatment of dividends, most states have statutes ostensibly prohibiting the payment of dividends where the payment would be greater than the

corporation's "capital surplus" and would thus impair "stated capital." Now we focus on the other key aspect of the concept of par value: as a ***minimum price at which shares must be issued***.

1. **General rule:** The key rule about par value in connection with share issuance is this: ***the corporation may not sell the shares for less than their par value***. Nutshell, p. 105. If the corporation does sell shares for less than their par value, the shareholder who received them may be ***liable to the corporation*** or to the corporation's ***creditors***, a liability known as ***"watered stock"*** liability (discussed *infra*, p. 531).

    Example: XYZ Corp is authorized to issue 1,000 shares of $100 par value stock. XYZ issues 1,000 of these shares to Promoter for $10 per share. (Assume that Promoter has not given XYZ any past property or services, and that he has not promised to do so in the future as additional payment for the shares.) This issuance of shares to Promoter violates the fundamental rule that the price for shares must be at least equal to their par value. Therefore, Promoter will probably be liable to XYZ Corp (or to XYZ's creditors, if XYZ becomes insolvent) for $90,000 (the difference between the $100,000 aggregate par value of the shares he received, and the $10,000 he actually paid).

    a. **Rationale:** In theory, two different groups of people are protected by this insistence that shares not be issued for less than their par value.

        i. **Creditors:** First, a corporation's ***creditors*** are protected. Thus on the above example, if a creditor of XYZ knew that all 10,000 authorized shares had been issued, and knew (from reading XYZ's articles of incorporation, a public document) that the par value was $100 per share, he could rely on XYZ's shareholders' having contributed, as the corporation's "permanent capital," at least $1,000,000. In theory, this might lead the creditor to lend money to XYZ that he might otherwise not have lent.

        ii. **Other shareholders:** Second, the rule that shares be sold

for at least par value might protect one ***shareholder*** against unfair favors being extended to another. Thus if Able and Baker both bought shares in XYZ, and Able bought at the $100 par value figure, he could know that XYZ could not legally sell shares for less to Baker — Able would therefore be reassured that he was being treated fairly as compared with prior or subsequent purchasers (but only assuming that Able paid par, not some amount greater than par).

b. Significance: The rise of no-par and low-par stock has greatly impaired the ability of the par value scheme to protect either creditors or other shareholders. This is discussed *infra*, p. 533. For now, just understand that there remains on the books of virtually all states that recognize par value, a rule that shares must not be sold at a price less than par value.

2. Amount of consideration (the "watered stock" problem): What, then, happens if the corporation violates this rule against selling shares for less than their par value? The brief answer is that the purchasing stockholder may be liable to the corporation and/or its creditors, a liability known as ***"watered stock"*** liability.

a. Different types: Observe that there are three different ways in which a corporation might sell stock for less than par value.

i. Bonus shares: First, shares having a par value might simply be issued for ***no consideration*** at all (either paid or promised). These are commonly called ***"bonus"*** shares.

ii. Discount shares: Much more commonly, a corporation might sell shares for cash, but a cash amount less than the par value per share. (Our example above in which Promoter buys $100 par value stock for $10 per share is an illustration of this.) These are commonly called ***"discount"*** shares.

iii. Watered shares: Finally, most statutes allow the corporation to issue shares in return for ***property or services***. If the corporation accepts the property or services as being equal to the par value of the shares given in

exchange, but the property or services are in fact ***overvalued***, the shares are referred to as ***"watered"*** stock. (Sometimes, the term "watered" stock refers to discount and bonus shares as well as to the kind of watered stock we are specifically talking about here.) C&E, p. 1328.

b. **Recovery by creditors:** The main issue that arises in connection with watered stock ("watered" here will be used to refer to "bonus" and "discount" shares as well as shares issued for overstated property or services) is: May ***creditors*** of a corporation recover against the stockholder who received the watered stock? This issue usually arises only after the corporation has become ***insolvent***. There are several theories under which the receiving shareholder might be liable to the corporation's creditors.

i. **"Holding out" or "misrepresentation" theory:** A majority of the courts that have recognized any common-law liability to creditors have done so on a ***"holding out"*** or ***"misrepresentation"*** theory. The key concept behind this theory is ***reliance***: only to the extent that the creditor has relied on the corporation's (false) assertion that all shares were issued for at least par value, may the creditor recover. Under this theory, one who becomes a creditor ***before*** the wrongful issuance, and one who becomes a creditor after the wrongful issuance but with ***knowledge*** of it, may not recover, since by definition they have not "relied."

3. **Kind of consideration:** Most of the time, of course, stock is issued to the shareholders in return for cash. But it will often be desirable to award stock in return for something other than cash. This "something other than cash" might be ***property*** held by a would-be shareholder. Or, it might be ***services*** that have been performed by a promoter during the pre-incorporation. Finally, the consideration might be a shareholder's ***promise*** to pay cash, turn over property, perform services, etc., ***in the future***.

a. **Usual rule:** Statutes vary as to which of these forms of consideration are acceptable. One common scheme, however,

is that existing property and past services are valid, but ***promises*** to perform services, donate property in the future, or pay cash in the future, are ***not***. See, e.g., N.Y. BCL §504(a) ("Consideration for the issue of shares shall consist of money or other property, tangible or intangible, or labor or services ***actually received by*** or ***performed for*** the corporation or for its benefit or in its formation or reorganization.…") Similarly, Delaware apparently does not allow a promise to perform future services to be consideration (at least with respect to the par value or "stated capital" part of the payment). See Del. GCL §152.

b. MBCA liberalizes: But the MBCA is much more liberal. Under §6.21(b), virtually ***any kind of consideration*** will be valid, so long as the board of directors acts in good faith and with reasonable care in concluding that the consideration is adequate. Thus ***promissory notes*** and promises to ***perform future services*** would both be valid consideration under the MBCA, whereas they would not be under the New York scheme.

i. Rationale: Preserving the board's ability to give stock in return for promises of future payment or future services makes good economic sense. For instance, suppose that XYZ has just been formed, has no operating business yet, and could benefit enormously from the skills of Peter, an experienced executive who is willing to become president in return for stock. There is little reason why XYZ should not be permitted to give Peter stock in return for his promise to run the company for, say, three years — if XYZ cannot do this, it may be deprived of the ability to lure Peter away from his existing job.

(1) Risk to corporation: Of course, there is a risk that after receiving the stock, Peter will ***not in fact perform*** the services. But the MBCA makes the judgment that this problem can best be solved by requiring the board of directors to fulfill their duty of due care and loyalty (see *supra*, pp. 169 and 197) as they determine that this

promise-for-stock exchange is a good idea, rather than by completely prohibiting all exchanges of stock for promises.

ii. Remedies: If the promised payment or services do not in fact come about, the corporation probably has a ***contract claim*** against the shareholder to pay/perform. Alternatively, MBCA §6.21(e) lets the corporation ***escrow*** the shares until the future services or payments are fulfilled. What is significant about the MBCA's liberalization is that creditors or other shareholders cannot force the shareholder to pay with immediate cash instead of services or future installment payments.

4. **Valuation of consideration:** If the board of directors sells stock to a stockholder in return for past or future services or property, the board's good faith ***computation of the value*** that should be attributed to those services or property will usually ***not be overturned*** by a court. See, e.g., Delaware GCL §152 ("in the absence of actual fraud in the transaction, the judgment of the directors as to the value of such consideration shall be conclusive").

5. **Decline of par value's significance:** Today, both the use of par value stock and the importance of "watered stock liability" are dramatically ***reduced***.

a. Par concept not recognized or not required: Most states today don't even require the par concept at all. As of 2002, only 22 states required the articles of incorporation to state the par value of shares. Hamilton (8th), pp. 392-93. The remaining states have all either eliminated the concept of par value entirely, or have left to the corporation the decision whether to use the concept. The MBCA follows this trend: §2.02(1)(2)(iv) makes par value optional, and §6.21 on "Issuance of Shares" does not even mention the concept.

b. No-par stock allowed: Furthermore, in the minority of states still imposing the concept of par stock, each state allows the corporation to choose ***no-par stock*** (and most also allow ***low-***

par stock). As a consequence, only a very misguided lawyer will normally let his corporate client issue stock having any significant par value.

i. **Effect on watered stock liability:** This increased use of no-par and low-par stock makes the watered stock liability problem almost disappear. Generally, a stockholder is liable only for the difference between the par value of the shares issued to him and the value of what he has contributed. If the stock issued to him has no par value or nominal par value (as it will when low-par stock is used), then the shareholder will have almost always contributed an amount at least equal to this low or nonexistent number.

C. Preemptive rights and related issues: A ***"preemptive right"*** is a right sometimes given to a corporation's existing shareholders that permits them to ***maintain their percentage of ownership*** in the corporation, by enabling them to buy a portion of any newly-issued shares. To understand the dangers that preemptive rights theoretically protect against, consider the following example.

Example: Inventor has invented a marvelous new mousetrap, which is guaranteed to be a commercial success if only he can raise the funds to produce it. Capitalist agrees to put up the money needed to exploit the mousetrap. Together, they form Mousetrap Corporation, with Capitalist receiving 51% of the stock (in return for advancing all of the capital) and Inventor 49% (in return for assigning to the corporation all of his rights to the invention.) A nine-member board of directors is set up, with Capitalist controlling five seats and Inventor four seats. There are 1,000 shares outstanding, held 510 by Capitalist and 490 by Inventor. The business is an overnight success.

Capitalist wants to increase his percentage of ownership, and decrease not only Inventor's percentage of the economic pie but also Inventor's participation in decision making. He therefore causes his five directors to authorize the issuance of an additional 1,000 shares, at $500 per share (a fair price given Mousetrap's current economic prospects). He causes the board to offer these shares to (and only to) Capitalist's own personal

holding corporation, PHC, Inc.; PHC immediately accepts the offer, and buys the shares for $500,000. Now, Capitalist controls three quarters of the company, and Investor has only one quarter. True, Investor now has an equity stake in a company that has $500,000 of extra cash, but Investor's share of any future increases in the company's value is reduced to half of what he thought it was at the time he made the arrangement.

1. **Rationale for preemptive rights:** If Mousetrap Corp, in our example, had preemptive rights, Inventor might have had some protection against the dilution of his interest. Under a typical preemptive rights scheme, Mousetrap would have been required to offer to Inventor 49% of any new issue of shares. Thus had there been preemptive rights, and had Inventor been able to get hold of about $250,000 on short notice, he could have maintained his 49% ownership position.

2. **Common-law rule:** Formerly, most states recognized preemptive rights as a common-law matter. Although the right was subject to many exceptions and varied a lot from state to state, the basic concept was that if the corporation offered newly-authorized stock to anyone, it had to offer to ***each*** existing stockholder the right to buy as many shares as would keep his percentage ownership from decreasing. The shareholder exercising the preemptive right was obligated to pay the same price as was being paid by the other buyers. See, e.g., *Stokes v. Continental Trust Co.*, 78 N.E. 1090 (N.Y. 1906) (holding that the corporation "could not lawfully dispose of [the new] shares without giving [an existing shareholder] a chance to get his proportion at the same price that outsiders got theirs").

3. **Statutes:** Today, every state governs preemptive rights by ***statute***. All modern statutes allow the corporation to ***dispense*** entirely with preemptive rights if it so chooses. Nutshell, p. 148. This choice by the corporation is embodied in the articles of incorporation.

   a. **"Opt out" provision:** Some statutes give the corporation an

"opt out" election — the corporation has preemptive rights unless it expressly specifies, in the articles of incorporation, that it does not want such rights. See, e.g., N.Y. BCL §622(b) and (c).

b. "Opt in" election: But the modern trend is toward an ***"opt in"*** scheme — that is, the corporation does ***not*** have preemptive rights unless it ***expressly elects***, in the ***articles of incorporation***, to have such rights.

i. MBCA: The MBCA follows this "opt in" pattern; see §6.30(a). Section 6.30 also simplifies the job of the drafter of a corporation's articles of incorporation: if the drafter wants preemptive rights, he simply puts in a clause that "the corporation elects to have preemptive rights," and this will cause the corporation to have the fairly detailed preemptive rights scheme set forth in §6.30(b) (including terms of waiver, exceptions for such items as shares issued for property or to satisfy stock options, and other procedural aspects).

4. Exceptions: Both at common law and under the modern statutes, only certain kinds of share issuances are subject to preemptive rights. Thus the following kinds of share issuances are generally ***not*** covered even if the corporation has preemptive rights:

a. Initially authorized shares: Most important, preemptive rights usually do not apply to shares that are part of the amount that is ***initially authorized*** at the time the corporation is first formed. Here, the theory is that a diligent shareholder should understand at the time he makes his initial purchase that the corporation may ultimately be selling to persons other than himself the entire rest of the initially-authorized amount.

i. Time limit: On the other hand, if years go by without any sale of these remaining initially-authorized shares, the statutory scheme may cover the shares. Thus under MBCA §6.30(b)(3)(iii), initially-authorized but unissued shares become covered by the preemptive rights scheme (if the

corporation has elected to have one) once ***six months*** have elapsed from the date of incorporation. N.Y. BCL §622(e)(5) applies a similar rule to initially-authorized shares that are sold more than ***two years*** after incorporation.

b. **Treasury shares:** Under most statutes, ***treasury shares*** (that is, shares that were once outstanding, but that have been repurchased by the corporation) are not covered; see, e.g., N.Y. BCL §622(e)(4). But the MBCA does not exclude such shares.

c. **Property or services:** Shares that are issued in exchange for ***property*** or ***services*** are generally not covered. The theory is that the corporation has to be able to make special deals for hard-to-get property or services, and it would be a logistical nightmare to have to let existing shareholders participate proportionately (since usually the existing shareholders will not have comparable property or services to contribute, and it will be hard to equate their money with the outsider's property or services). Similarly, shares issued to allow the exercise of employee ***stock options*** generally are not covered.

5. **When to use:** As a matter of corporate planning (rather than law), when is it wise for a corporation to adopt preemptive rights? It is important to distinguish between publicly held and closely held corporations.

a. **Publicly held:** It will very rarely be wise for a ***publicly held*** corporation to have preemptive rights. A preemptive rights scheme will cause substantial ***delays*** in financing — before the corporation offers shares to the public, it must make a "rights offering" to each existing shareholder, a complex procedure. Conversely, preemptive rights are rarely necessary to protect an existing shareholder in the public corporation — if he wants to maintain his proportional share of the corporation's equity, he can simply buy additional shares in the open market.

b. **Closely held corporations:** But the reality is quite different in the context of the ***closely held*** corporation. Here, a

stockholder (especially a minority one) is likely to find it very important to make sure that his equity percentage cannot be decreased without his consent. For instance, in our example on p. 534, a preemptive rights scheme would have offered Inventor the chance to maintain his 4/9's control of the board of directors, and thus the chance to preserve his voice in how the company should be managed.

i. **Limited effectiveness:** But preemptive rights are only of limited effectiveness, even in a close corporation. Most significantly, they will only work if the existing shareholder has the ***financial resources*** to participate in the new stock issue. For instance, on the facts of our example on p. 534, even if Inventor got the benefit of preemptive rights, he would still have had to come up with $250,000 immediately to prevent dilution of his equity stake, a sum he might well not have had or been able to borrow. (In theory, Inventor could sell his preemptive rights to a third party, and at least receive some compensation if those rights entitled the holder to buy stock at less than its fair market value. But in the typical close corporation context, an outsider will usually not pay very much for the chance to be a minority stockholder in a company controlled by another — such as Capitalist — where the controlling shareholder does not welcome the new minority investor.)

6. **Emerging "fiduciary duty" theory towards dilution:** Because preemptive rights are often either waived by the corporation or not effective (for the reasons described just above), some modern courts are shifting to a new common-law theory for protecting minority stockholders against dilution. These courts have occasionally articulated a theory of ***"fiduciary obligation"***: the majority stockholder has a fiduciary duty not to cause the issuance of new shares where the purpose is to ***enhance his own control at the expense of the minority.*** Courts that have imposed such a duty do not, of course, block the controlling shareholder from ever causing the issuance of new shares over the objection of the minority; instead, these courts

typically require that there be a valid ***"business purpose"*** for the new shares, so that the shares cannot be issued solely to enhance the majority's control.

a. Unfair price: The court is most likely to impose this fiduciary duty where the new shares are issued at a ***bargain price*** to those who are already in control.

b. Bona fide business purpose required: But ***even if the price is fair***, many courts will not sustain a sale of new stock by the corporation to its controlling shareholders if there is ***no valid business purpose*** behind the sale. For example, if the court becomes convinced that the controlling shareholder has caused the sale to take place solely for the purpose of ***enhancing his own control***, the court is likely to strike the transaction even though the price was fair.

c. Preemptive rights as a defense: As we've just seen, even where preemptive rights do not apply, the court will sometimes recognize a fiduciary obligation on the part of the board to offer all shareholders the opportunity to buy new shares on the same terms. But suppose that preemptive rights *do* apply, the plaintiff declines to participate (perhaps because he doesn't have enough money), and he then attacks the sale of new shares to other existing shareholders on the grounds that the price is ***unfairly low***. In this situation, courts are split:

i. Defense: Some courts hold that the fact that P was offered the shares on the same terms under the preemptive rights plan constitutes a ***complete defense*** (and the court will therefore not inquire into whether the shares were sold at an unfairly low price.)

ii. Not a defense: But other courts have held that the existence of preemptive rights is ***not*** a defense, and that the board must bear the burden of showing that the price was at least within the range of fairness. See, e.g., *Katzowitz v. Sidler*, 249 N.E.2d 359 (N.Y. 1969) (shares offered at one-eighteenth of present book value; P declined to exercise his preemptive rights; *held*, despite the availability of

preemptive rights, board must show that the issuing price fell “within some range which can be justified on the basis of valid business reasons” — the corollary of preemptive rights is “the right not to purchase additional shares without being confronted with dilution of [one’s] existing equity if no valid business justification exists for the dilution”).

Quiz Yourself on
ISSUANCE OF SECURITIES *(STATE-LAW RULES)*

106. Attila the Hun wants to buy 100 shares of newly-issued Pillage & Plunder Construction Equipment Company stock. The stock is worth $10,000. As payment, Attila gives Pillage & Plunder a document signed by him, which says, “In consideration of 100 shares of P&P stock to be issued immediately, I promise to perform for P&P pillaging and plundering services equal in value to at least $10,000. The services shall be performed, on the schedule requested by the company, over the next 2 years.”

(a) May Pillage & Plunder properly issue the 100 shares? (Assume that the company is located in a state that follows the majority approach to issues raised by this question.) ____________________________

(b) Now, assume that the MBCA is in force. May Pillage & Plunder properly issue the 100 shares? ____________________________

107. On April 1, the Old King Coal Company incurs a $10,000 liability to the Keepon Trucking Co., for trucking that Keepon did for Old King Coal. On August 1, Old King Coal issues stock having par value of $25,000 to LaBrea Tarpit, in return for property that is worth (as LaBrea knows) only $10,000. On Sept. 1, Old King Coal becomes insolvent. Keepon Trucking sues LaBrea for $10,000, on the theory that Keepon may, as creditor of Old King, recover against LaBrea on account of LaBrea’s having received $15,000 of “watered” stock. Assume that in the jurisdiction, the issuance of stock to LaBrea was in fact improper. Assume further that the jurisdiction follows the majority view on all relevant matters, and that there is no statute on point. May Keepon recover the $10,000 from LaBrea? ____________________________

108. Torquemada is a fabulously successful TV producer, his most popular program being “Wheel of Torture.” His TV production company, a close corporation called Thumbscrew Productions, Inc., has 2,000 shares of common stock authorized and outstanding. Lucrezia Borgia owns 500 of those shares. Because the company needs more capital, Thumbscrew’s board and shareholders vote to amend its articles to increase the company’s authorized common stock from 2,000 to 3,000 shares. The board offers all 2,000 shares to Torquemada, at a fair price. Lucrezia would like to buy some of these shares for herself (so her percentage interest in the company won’t be reduced). The company’s charter is silent on all relevant issues.

(a) What doctrine or property concept is relevant to whether Lucrezia has the right to buy any of the newly-issued shares?

____

(b) Assume that the MBCA is in force. Does Lucrezia have the right to buy any of the newly-issued shares? ______________________________

109. Same basic facts as prior question. Now, however, assume that the corporation’s charter expressly awards preemptive rights.

(a) For this question, suppose that the events occur at a time when the corporation’s authorized shares still total the originally-authorized 2,000 shares, of which only 1,000 were ever issued (750 to Torquemada and 250 to Lucrezia). Five months after the corporation is formed and the first 1,000 shares were issued, the board votes to sell an additional 500 shares (out of the initially-authorized batch) to Torquemada. Does Lucrezia have a right to buy enough shares to keep her ownership at 25%?

____

(b) Suppose that after the company has raised its authorized shares to 3,000, the board enters into a employment contract with Torquemada, under which Torquemada gets 500 of the newly-authorized shares as compensation, in addition to salary. Does Lucrezia have the right to purchase as many new shares as will keep her percentage of ownership at its prior levels? ______________________________

Answers

106. (a) No. The issue, of course, is whether Attila has supplied adequate consideration for the shares. The majority approach — followed in New York and Delaware, among others — is that existing property and services are valid as consideration, but that promises to supply cash, property or services *in the future* are not valid. See, e.g., N.Y. BCL §504(a) ("Consideration for the issue of shares shall consist of money or other property, tangible or intangible, or labor or services *actually received by or performed for* the corporation …") [532] Since Attila has supplied only his unsecured promise to perform the services, rather than the services themselves, under the prevailing view Attila has not supplied adequate consideration, and Pillage may not validly issue the shares.

(b) Yes. MBCA §6.21(b), unlike the prevailing approach, allows a very broad range of things to suffice as consideration for share issuance. In particular, that section says that if the board so authorizes, consideration may consist of "contracts for services to be performed." [533] Since Attila has bound himself contractually to perform the services, his agreement constitutes valid consideration.

107. No. Not all courts recognize any common-law right on the part of a creditor of an insolvent corporation to recover against a recipient of "watered stock." Of those courts that do recognize such a right, most apply the "holding out" or "misrepresentation" theory. Under this theory, only a creditor who has ***relied*** on the corporation's (false) implied or express assertion that all shares were issued for at least par value may recover. [532] Here, Keepon extended credit to Old King Coal *before* Old King Coal even issued the stock to LaBrea. Therefore, Keepon could not possibly have relied on any express or implied assertion by Old King Coal that no watered stock had been issued. Since Keepon didn't rely on any assertion, it can't recover anything from LaBrea. (But there may be a statute, or case law, letting *Old King Coal* or its trustee in bankruptcy recover from LaBrea for the amount of "water.")

108. (a) The doctrine of preemptive rights. A preemptive right is a right, sometimes given to a corporation's existing shareholders, permitting them to maintain their percentage of ownership in the corporation by enabling them to buy a portion of any newly-issued shares. [534] If preemptive rights applied here, Lucrezia would be guaranteed the right to buy 25% of any newly-authorized batch of shares, at the same price as was offered to

anyone else.

(b) No. The MBCA, like many modern statutes, follows an “opt in” approach to preemptive rights. That is, stockholders don’t have preemptive rights unless the articles of incorporation specifically confer such rights (as opposed to an “opt out” approach, under which holders have such rights unless the charter says that they don’t). See §6.30(a). [535] Since the facts say that Thumbscrew’s charter is silent on all relevant issues, Thumbscrew has not “opted in,” and there are no preemptive rights. Therefore, the board can choose to offer all the new stock to Torquemada. (Where there are no preemptive rights, and the price is fair, courts generally say that the board can offer the stock to whomever it wishes.)

Notice that the facts say that the stock is being issued to raise needed capital. If this had not been true — if the stock was instead being issued solely to increase Torquemada’s control — a court might hold that there was no “valid business purpose” for the issuance, and that Torquemada had used his control in violation of a fiduciary duty to the minority holders. In that event, even without preemptive rights the court might strike down the issuance to Torquemada, or order that Lucrezia be permitted to participate pro rata.

109. (a) No. Preemptive rights generally do not apply to shares that are part of the initially-authorized shares at the time the company is formed. [535] Some states provide that after a certain lapse of time, the initially-authorized-but-unissued shares do become subject to preemptive rights. But virtually no state would make this happen in as little as the five months specified in the facts. (MBCA §6.30(b)(3)(iii) makes it happen 6 months from the date of incorporation; NY BCL §622(e)(5) makes it happen after 2 years.)

(b) No. Shares that are issued in exchange for property or services generally are not deemed to trigger preemptive-rights schemes. [535]

II. PUBLIC OFFERINGS — INTRODUCTION

A. Regulation of public offerings generally: We turn now to a major new topic: federal regulation of the process by which securities are ***sold to the public***.

1. **The Securities Act of 1933:** Federal regulation of securities issuance is principally governed by the Securities Act of 1933 (which we will refer to as the "'33 Act").

   a. **Distinguished from '34 Act:** You must constantly distinguish between the '33 Act and the Securities Exchange Act of 1934 (the "'34 Act"). The '33 Act is virtually limited to the regulation of ***new issues*** of securities to the public. The '34 Act, by contrast, regulates nearly all securities-law aspects of publicly held companies apart from new issues. Thus the proxy regulations (*supra*, p. 97), the main insider trading and other anti-fraud rules promulgated by the SEC (such as Rule 10b-5, *supra*, p. 262), and the requirement of periodic financial disclosure (*supra*, p. 95), are all imposed by the '34 Act. So it may loosely be said that the '33 Act regulates "new issues," and the '34 Act regulates "companies."

2. **Section 5 of the '33 Act:** The key provision of the '33 Act is §5. In brief, §5 makes it unlawful (subject to some exemptions) to ***sell any security*** by use of the mails or other facilities of interstate commerce, ***unless a registration statement is in effect for that security***. This "registration statement" must contain a large amount of information about the security being offered and the company that is offering it (the "issuer"). Additionally, §5 prohibits the sale of any security unless there is delivered to the buyer, before or at the same time as the security, a ***"statutory prospectus,"*** which contains the most important parts of the registration statement. (This way, the investor does not have to go to the SEC to read the registration statement.)

3. **Disclosure:** The '33 Act, like the other securities laws, reflects one key policy determination by Congress: that the best way to regulate securities markets, and to protect against fraud, is by requiring ***extensive disclosure***. The SEC has no power to decide that a particular stock issue should be prohibited on the grounds

that it is too risky, overpriced, or otherwise inappropriate on the merits — so long as full disclosure is made in the registration statement and prospectus, there is no security too worthless to be offered to the public.

4. **What is covered:** The ’33 Act does not apply only to “stocks,” as you might expect. Instead, it applies to all ***“securities,”*** including ***bonds*** and other forms of debt. The meaning of “security” is discussed further *infra*, p. 541.

B. **The distribution process:** Before we can understand how the ’33 Act regulates public offerings, we must first understand something about the system by which securities are distributed to the public. This entire distribution process is usually referred to as the ***“underwriting”*** process.

1. **“Firm commitment” underwriting:** Most securities offerings are handled through what is known as ***“firm commitment”*** underwriting. If the security is viewed as a “good,” the firm commitment process can be viewed as a wholesale-retail distribution channel. The issuer (the company whose stock or bonds is to be sold) is in a sense the “manufacturer.” There is a group of investment banking firms, known as the ***“underwriters”*** or the “underwriting syndicate,” who function in effect as wholesalers — these underwriters contract in advance to ***purchase the entire issue*** at a stated price from the issuer. By means of this contract, the risk of a price decline, or of the unpopularity of the shares, is passed by the issuer onto the underwriters. The underwriters then “wholesale” the securities to a group of retail securities ***dealers***, usually called the ***“selling group.”*** These dealers then sell the securities “at retail” to institutional or individual investors. S,S,B&W, p. 283.

   a. **Compensation:** The underwriters and dealers are compensated by receiving ***discounts*** on the securities. Generally, the total discount on stocks is somewhere between 6 and 15%. For instance, if the stock is being sold to the public for $10, the underwriters might pay the issuer $9, and the dealers might pay the underwriters $9.50. C&E, pp. 1415-16.

2. **"Best efforts" underwritings:** There is a second type of underwriting, known as ***"best efforts"*** underwriting. This method is used only by firms that are smaller and/or less well-established. Here, the underwriters do not give a hard contractual commitment to buy the stock issue and resell it to the public; instead, the underwriter merely commits to use its "best efforts" to sell the stock ***as agent for the issuer***. If the market turns out to be weak or the issue is overpriced, it is the issuer rather than the underwriter who takes the loss; the underwriter and the dealers under him are merely paid a commission for what they do sell. C&E, p. 1415.

C. **What is a "security":** Since the '33 Act applies only to sales of "securities," it becomes vital to know what constitutes a ***"security."*** Section 2(1) gives a definition of the term that is vastly broader than you might expect — the term is defined to include a list of items too long to reprint here, but one that includes any "note," "stock," "bond," "evidence of indebtedness," "certificate of interest or participation in any profit-sharing agreement," "investment contract," "certificate of deposit," or any put, call, or other option on any of the above. Here are some of the key rulings on what constitutes a "security," rulings that have emerged as a result of a substantial body of litigation[1]:

1. **Stock:** A share of ***stock*** will almost always be a security. Thus in the usual case of a for-profit corporation that issues shares of stock to represent an interest in the corporation's assets and future profits, these shares are clearly "securities."

   a. **Sale of all stock in a closely held business:** Suppose that the owners of a ***closely held corporation*** sell ***all of the stock*** in the business to a purchaser who expects to manage the business himself. Does the fact that the ***entire business*** is being sold, rather than just a portion of it, prevent the stock sold from being a "security"? The answer seems to be ***"no"*** — ***even the sale of all the stock of a business will be the sale of a "security," and must therefore comply with the '33 Act***. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), in which the Supreme Court so held — the Court found that the

federal securities laws were intended to apply not only to sales to “passive investors,” but also to “privately negotiated transactions involving the transfer of control to ‘entrepreneurs.’”

2. **Debt instruments:** A ***debt instrument*** may or may not be a “security.” At one end of the scale, we have, say, a “note” given by a small-business owner to a bank, in return for a loan; this is clearly not a “security.” At the other end of the spectrum we have, say, a multimillion dollar set of bonds issued by a large corporation, and held by many institutions or even the general investing public; each of these bonds is almost certainly a “security.” Other debt instruments will fall closer to the dividing line.

   a. **Bank loans:** A note or other debt instrument that is issued to a single, or small number, of ***banks*** will normally ***not*** be a security. This is especially true where the loan is for some specific business purpose (e.g., to correct a seasonal cash flow shortage).

3. **“Investment contract”:** The trickiest aspect of the definition of “security” involves whether a given money-raising scheme involves the sale of an ***“investment contract”*** (listed in §2(1) as one of the types of “securities”). In general, the courts and the SEC have interpreted the phrase “investment contract” very ***broadly*** to reach agreements that a lay person would not think of as being “securities.” The key concept seems to be that if A pays B money as an investment in a venture whose economic success will depend solely on the efforts of B or third persons (and not at all on A’s own efforts), the deal will be held to have involved a security.

   a. **Sale of LLC interest:** What about the sale of an ***interest in an LLC*** — can that be an “investment contract,” so that the ’33 Act applies? Again, the answer is likely to turn on whether the profitability of the LLC after the acquisition will depend in part on the buyer’s efforts (in which case the buyer’s interest is *not* an “investment contract”) or will instead depend solely

on the efforts of persons other than the buyer (in which case the buyer's interest probably *will* be an investment contract).

III. PUBLIC OFFERINGS — MECHANICS

A. How filing works: Recall that under §5 of the '33 Act, no security may be sold in interstate commerce unless a registration statement has been filed for it. In fact, §5 requires that, prior to the sale, the registration statement not only have been filed but also have become ***"effective."*** To understand the impact of this requirement of an effective registration statement prior to the sale of securities, you must understand something about the mechanics of the registration process.

1. **Filing the registration statement:** The process begins when a registration statement is ***filed*** with the SEC. The registration statement must contain considerable disclosure about the issue and the issuer. What goes into the registration statement is discussed more extensively *infra*, p. 545.

2. **20-day waiting period:** The issuer must now wait for the registration statement to become ***"effective,"*** because only when the statement is effective can the issuer actually sell the securities. Normally, the statement becomes effective ***20 days*** after it is filed. '33 Act, §8(a).

    a. **Letters of comment:** During this 20-day waiting period, the SEC staff reviews the registration statement to make sure that all required information is disclosed. If, as is usually the case, there are shortcomings, the staff notifies the issuer's lawyers of the problems in one or more ***"letters of comment,"*** also known as ***"deficiency letters."***

3. **Stop orders and refusal orders:** The registration statement automatically becomes "effective" on the 20th day after filing, regardless of whether the Commission finds it satisfactory. However, the SEC has the power to act affirmatively to delay or suspend the effectiveness of a registration statement. It can issue a "refusal order" (to prevent the statement from becoming

effective) or a "stop order" (to suspend the effectiveness of an already-effective registration statement). In practice, however, it rarely has to use these devices, because issuers usually voluntarily comply with the wishes of the Commission's staff. See Ratner, pp. 39-40.

4. **Price amendment:** For a registration statement to be complete and therefore legal, it must include the ***price*** at which the securities will be offered to the public. But because markets are volatile, no underwriter is willing to commit himself to a fixed price 20 days before the public issue will take place. Therefore, what invariably happens is that the registration statement is initially filed ***without the price***, and the statement is then ***amended*** to include the price term.

5. **No investigation of underlying merits:** It is important to understand that in the registration process, the Commission does not conduct any ***independent investigation*** into the truth of the matters disclosed in the registration statement. True, the Commission staff inspects the documents carefully to see whether they appear to be complete and accurate ***on their face***; also, the staff generally compares the information in the registration statement against other information about the issuer in the Commission's files. But the Commission does not look into other sources of information (e.g., newspaper reports). Therefore, in the event of a later civil suit for a falsehood in the registration statement (see *infra*, p. 558), the issuer may not raise as a defense the fact that the Commission reviewed the statement and found it accurate. In fact, §23 of the '33 Act makes it a crime to tell any prospective buyer that the fact that the Commission has allowed the statement to become effective means that the Commission has found the statement to be truthful.

B. **Rules during the three periods:** We can think of the offering process as having three distinct periods: (1) the ***pre-filing*** period, i.e., the period when the offering is being planned but the registration statement has not yet been filed with the Commission; (2) the period between filing and the effective date of the registration statement, usually called the ***"waiting period"***; and (3)

the period ***after*** the registration statement has become effective. There are important rules about what activities by the issuer, underwriters and dealers are permitted during each of these periods.

1. **Pre-filing period:** During the ***pre-filing*** period, not only sales but also ***offers to sell*** are completely ***forbidden***. ’33 Act, §5(c).
   a. **Exception for preliminary negotiations:** There is one important exception: the issuer may conduct ***preliminary negotiations*** with the underwriter(s) and the underwriters may negotiate among themselves.
   b. **Definition of "offer":** But all other "offers" to sell are forbidden, and the term "offer" is defined quite broadly. For example, the term goes far beyond the usual contract-law meaning of soliciting an expression of willingness to purchase. For instance, any ***publicity*** by the issuer or the underwriter whose purpose or principal effect is to ***stir up interest*** in the planned offering is an "offer" and is thus forbidden.
      i. **Oral offers:** Even an ***oral*** effort to stir up interest is forbidden during the pre-filing period. Thus it is unlawful for a broker at Merrill Lynch to telephone his clients and say, "We'll be underwriting a new issue of XYZ Corp stock next month, would you like me to put you down for 1,000 shares?" Similarly, it is unlawful for the president of XYZ to phone friends or relatives to ask them whether they would like to buy stock at the upcoming offering. Clark, p. 721.
      ii. **Press release:** However, Rule 135 under the ’33 Act does allow an issuer to put out a ***press release*** or other written notice of an offering during the pre-filing period, so long as the notice only lists the name of the issuer, and the purpose and basic terms of the offering (without listing the underwriters).
2. **Waiting period:** During the ***"waiting period"*** (after filing but before effective date of the registration statement), things loosen up a bit. Now, some types of offers to sell and offers to buy are

allowed, but ***sales*** and ***contracts to sell*** are still not allowed.

a. Oral offers: Thus several types of offers are allowed during the waiting period. For instance, virtually any kind of ***oral offer*** is allowed during the waiting period, so long as it is truthful. Thus dealers may call all of their customers to ask whether they would like to enter a tentative order for the securities; similarly, the executives of the issuer may orally solicit their friends or customers to buy.

b. Written offers: On the other hand, ***written*** offers are still tightly regulated. Section 5(b) of the ’33 Act has the effect of barring any type of written offer about the securities unless the offer is of a type that is specifically allowed.

i. Preliminary prospectus or "red herring": The main type of written "offer" that ***is*** allowed during the waiting period is the ***preliminary prospectus***, known in securities industry jargon as a ***"red herring."*** This is the prospectus as the issuer believes it will ultimately become effective, but minus the details about price and underwriters, details that will be supplied as an amendment just before the effective date (see *supra*, p. 543). (The "red herring" gets its name from the fact that there must be printed on the front of the document, in red ink, a statement explaining that the document is preliminary and that sales may not yet take place.)

(1) Must be sent to customers: Rule 15c2-8 under the ’34 Act requires brokers and dealers to ***send*** the red herring to anyone who requests one in writing, and to anyone who is ***expected to receive a confirmation*** of sale.

ii. Tombstone ad: Another writing which the issuer or the underwriters may produce during the waiting period is the ***"tombstone ad,"*** that is, a newspaper ad which contains only certain tightly-specified information about the offer. (The name comes from the fact that the ad is usually enclosed in a black border.) See Rule 134 under the ’33 Act.

iii. **"Free writings" prohibited:** But ***"free writings"*** are prohibited during the waiting period. Thus a brokerage firm that is offering the securities may not send its customers, say, a ***research report*** explaining why the firm's research department thinks that the issue will be a good investment. Clark, p. 722.

c. **No binding offers to buy:** Furthermore, no offer to buy or acceptance occurring during the waiting period will be deemed ***binding***. Thus suppose that Broker asks Customer, "Would you like to buy any shares of XYZ Corp? You won't have to take the shares or pay for them until after the offering becomes effective, which will be on July 1." Even if Customer says, "Yes, I'll take 1,000 shares," and even if Customer puts this acceptance in writing, Customer is ***not bound*** to take the securities or pay for them.

3. **The post-effective period:** Once the registration statement becomes effective, underwriters and dealers may make offers to sell, and actual sales, to anyone. However, the final ***prospectus*** (complete with the final price and underwriter information) must be sent to any purchaser ***before or at the same*** time he receives the securities. '33 Act, §5(b)(2). (Thus the investor does not have to receive the prospectus until he is receiving the securities, a time when his investment decision has already been made. So the final prospectus is not likely to be very helpful in the investment decision-making process. That's why the SEC requires widespread dissemination of the preliminary prospectus, as described above, p. 544.)

C. **What must be in registration statement:** What must be in the registration statement? A great deal of information about the issuer and the particular security must be disclosed, including such items as "Risk Factors," "Use of Proceeds," "Selling Security Holders" (that is, which existing stockholders of the issuer are selling stock, if any), an extensive description of the issuer's business, detailed three-year financial information, etc. These requirements are laid down in the mammoth Regulation S-K, which coordinates all disclosure information under both the '33 and '34 Acts.

1. **Previously-public companies:** Companies that are already public, and that are therefore already making periodic reports to the SEC under the '34 Act (see *supra*, p. 96), can file a simpler registration statement than companies that are going public for the first time. Whereas companies going public must file on the very comprehensive Form S-1, already-public companies can file on the shorter Forms S-2 or S-3, which permit much of the required information to be incorporated by reference to other disclosure documents (e.g., the 10-K annual report) previously filed with the Commission.

IV. PUBLIC OFFERINGS — EXEMPTIONS

A. Importance of exemptions: The ordinary corporate lawyer, assuming that he is not practicing the specialty of securities law, does not need to know the intricacies of how to draft a registration statement or how to supervise a public offering. But because of the exceptional breadth of the securities laws, many more transactions will be held to be "public offerings" (and thus governed by the registration requirement) than a non-lawyer might expect. Therefore, it is exceptionally important that the corporate lawyer have a good sense of the complex scheme of ***exemptions*** from the securities laws — unless a particular issuance of stock falls within one of the exemptions, it is likely to be governed by the '33 Act; if so, the issuer, any financial intermediaries (and perhaps even the lawyer himself) could be found liable for distributing unregistered securities in violation of the '33 Act, something for which the potential penalties are staggering (see *infra*, p. 561). Therefore, we must examine this pattern of exemptions with great care.

B. Broad sweep of §5: Section 5 of the '33 Act appears on its face to cover virtually ***any*** sale of a security. Section 5(a) provides that "unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly — (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise…." When this is combined with other parts of §5, §5 seems to say that ***virtually any***

"sale" of a "security" must be registered as if it were a public offering.

1. **Exemptions:** However, other section of the Act grant important exemptions. Section 3 exempts certain securities, and §4 exempts certain transactions. It is these exempted securities and transactions that we will be focusing on in this section. But the general point remains: ***if something constitutes a "sale" of a "security"*** (and the terms "sale" and "security" are very broadly defined; see, e.g., *supra*, p. 541), ***the registration requirement applies*** — and the sale must be treated as if it involves a public offering — ***unless some specific exemption applies***.

2. **Two key exemptions:** There are two types of exempted transactions that are so basic that we will consider them briefly here, though their intricacies will be explored below.

   a. **Persons other than issuers, underwriters and dealers:** The first of these is the exemption given in §4(1) for ***"transactions by any person other than an issuer, underwriter, or dealer."*** So if a person can show that he is neither an issuer, underwriter or dealer, he doesn't have to worry about the registration requirements. Furthermore, nearly all sales by a "dealer" are exempted under §4(3). Boiling it all down, therefore, registration will generally be required only where the transaction is being carried out by a person who is an ***"issuer"*** or ***"underwriter."*** But these two terms turn out to have broad, and sometimes unexpected, meanings, which are discussed below.

   b. **Non-public offerings:** The second key exemption is given in §4(2): "transactions by an issuer ***not involving any public offering***." So if an issuer can show that its sale of securities was "non-public" rather than "public," it need not comply with the registration requirements.

3. **Organization of our discussion:** Our discussion of exemptions is organized into the following pieces: (1) non-public offerings; (2) "small" offerings, for which special SEC Rules have been enacted; (3) sales by persons other than the issuer (including

sales by "underwriters," sales by controlling persons, and sales by non-controlling persons of shares bought at an earlier non-public offering); (4) mergers; and (5) some miscellaneous other exemptions (including the exemption for intrastate transactions).

4. **Illustration of issues:** Before we get enmeshed in the details of the various exemptions, it is useful to see how transactions that a lay person would never dream might be covered by the securities laws may in fact or at least arguably be covered. Let's consider the following hypothetical scenario:

    Example: Paul, a skilled lawyer and would-be journalist, is tired of practice and wants to go into the law school study aid publishing business. He therefore forms Outline Corp. By telephone and mail, he solicits some prospective investors, including Vickie (a wealthy doctor who likes to back small ventures) and four of Vickie's friends. The various investors put up a total of $1 million of capital in return for 1 million total shares; Paul receives 75% of the shares for $500,000, Vickie receives 15% for $300,000, and Vickie's four friends collectively pay $200,000 for 10% (which they split evenly).

    The first problem is that Outline Corp has "sold" "securities" to Paul, Vickie and the others, and this sale has involved interstate commerce (because the telephone and mail are instruments of interstate communication). Therefore, unless some exemption applies, Outline Corp (and probably Paul, as a promoter) have sold unregistered securities in violation of the '33 Act. (However, either the exemption for private offerings, or the exemption for small offerings, will probably apply, as we shall see later.)

    Now, suppose that one year after the initial stock in Outline Corp is issued, Vickie wants to cash in her chips and go on to the next investment. She is unable to find a buyer for her shares among her circle of existing friends, so she asks her stockbroker to solicit a wider group of potential buyers. Her broker solicits 50 wealthy investors on his client list, and finally turns up Ned, who buys the shares. Assuming that this Vickie-to-Ned transaction does not qualify as a private or

small offering (which it may not, in part because of the large number of buyers solicited), Vickie may have violated the ’33 Act. While Vickie doesn’t sound like an “issuer” or “underwriter,” the broad definition of “underwriter” in the ’33 Act will include Vickie if her purchase and subsequent resale is found to be part of the initial distribution. (This might be the case if a court finds that at the time she initially bought, she was already thinking about reselling within a year or two.) Vickie’s problem is analyzed further *infra*, p. 557.

Finally, five years after the formation of Outline Corp, Paul grows tired of the grind of annual editorial revisions, and wants to sell his 75% interest. He hires Broker to find him a buyer for this controlling position. Broker locates Xavier, who buys Paul’s interest. Because five years have passed since the formation of Outline Corp, the sale by Paul through Broker is unlikely to be found to be part of the original distribution, so the problem faced by Vickie won’t apply here. But because Paul would be an “affiliate” of Outline Corp, he will be treated as an “issuer.” Broker may therefore become an “underwriter,” but will consequently lose the exemption given for ordinary sales by brokers on behalf of their customers. Thus both Paul and Broker may be guilty of selling unregistered securities in violation of the ’33 Act when Broker arranges the sale by Paul to Xavier. See *infra*, p. 554.

C. Private offerings: Probably the most important exemption from the ’33 Act’s registration requirements is for ***non-public*** offerings (usually called “***private*** offerings”). Today, there are two paths by which an offering may qualify as “private” and thus exempt: (1) by means of the general exemption in §4(2) of the ’33 Act; or (2) by means of the special, and much more specific, exemption given in SEC Rule 506.

1. Statutory exemption: As noted, §4(2) of the ’33 Act gives an exemption for “transactions by an issuer ***not involving any public offering.***” The term “public offering” is not defined in the ’33 Act, so defining it has been left to the courts and the SEC. These have recognized a number of basic categories of private-

offering transactions:

a. Sales to institutions: Most important (at least in dollar volume) are sales to ***institutional investors***. If a corporation sells a large block of stock, bonds, or other securities to one or a few large and sophisticated institutions (e.g., insurance companies or pension funds), the transaction will be a private offering for which no registration statement is needed. This makes good sense: such institutions are powerful enough and sophisticated enough that they will insist on appropriate disclosure as a condition to committing their funds, and they therefore do not need the protection of the ’33 Act’s disclosure rules.

b. Sales to key employees: A second important category consists of ***stock sales to key employees***. Thus if a corporation offers stock (or stock options) to, say, its three most senior and important executives, this will almost certainly not constitute a public offering. As in the case of the institutional investor, these key executives presumably have such sophistication and knowledge about the company’s affairs that they do not need the protection of the ’33 Act’s disclosure scheme.

c. Acquisition of closely held corporation: Similarly, suppose that Public Corp, a large company whose shares are publicly traded, wants to acquire Private Corp, a small closely-held outfit. The parties would like to do the transaction as an exchange of stock (see *supra*, p. 361), but Public Corp would like not to have to file a registration statement, since the transaction is small and all of the newly-issued Public Corp stock will go to Prez, the sole stockholder of Private Corp. Assuming that Private Corp’s sole stockholder is reasonably sophisticated, Public’s “sale” of its stock to Prez will probably qualify as a private offering under §4(2).

d. Money-raising offerings to small numbers of people: Finally, the §4(2) exemption may be used in the case of a ***money-raising offering*** to a ***small number*** of offerees. Here, the applicability of the exemption is more questionable

than in the three prior categories, and more likely to depend on the precise facts of the case. In general, the two key factors seem to be:

(1) how many offerees — not buyers — there are (with, obviously, the exemption becoming less applicable the more offerees there are); and

(2) the degree of sophistication and knowledge about the company's affairs possessed by the offerees.

Factor (2) means that even if there are very few offerees, if they do not have a reasonable level of sophistication and a substantial degree of ***knowledge*** about the company's affairs, the offering will not fall within the §4(2) exemption.

Example: Ralston Purina Co. allows any "key employee" to buy unregistered stock in the company. The company defines "key employee" very broadly to include any individual "who is eligible for promotion" or who "especially influences others." "Chow loading foreman," "clerical assistant," "production trainee," and "stenographer" are some of the people who are permitted to buy under the plan. The company claims that since its offering is limited to "key employees," the offering is private under §4(1) (now §4(2)).

Held, this was not a private offering. The fact that an offering is only to a small number of people, or to a tightly-defined class, is not sufficient to make it "private." The availability of the statutory exemption should turn on "whether the particular class of persons affected need the protection of the Act." The offerees here were not shown to have had ***access*** to the kind of information about the company that registration would have disclosed, so they could not fend for themselves and needed the protection of the Act. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

i. Later cases: Cases after *Ralston Purina* seem to establish that an employee can "fend for himself" (so that an offering to him qualifies as private) if it is the case that ***either***: (1) the employee had ***access*** to the kind of data about the

company that a registration statement would have disclosed (which will generally be the case for a ***senior executive***); or (2) the offeror makes actual ***disclosure*** of such information to him (so that if Ralston Purina had given each of the "key employees" a disclosure statement containing information similar to what would be provided in a registration statement, it would probably have won the case). See, e.g., *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

2. Rule 506: Relying on the §4(2) statutory exemption to establish that an offering is "private" is a risky undertaking: there are no firm standards, and the offeror is at the mercy of how a particular court will construe prior case law. Therefore, the SEC has created a "safe harbor" — if a transaction satisfies the requirement of SEC ***Rule 506***, it will be deemed "private" regardless of whether it would meet the requirements of cases (like *Ralston Purina*) decided under the basic §4(2) statutory exemption. Rule 506 is part of the broader SEC Regulation D, which sets forth a number of rules governing both "private" and "small" issues. (The other rules within Regulation D are discussed in our treatment of small offerings, *infra*, p. 550). Rule 506 imposes a somewhat mechanical test based on the number of purchasers.

a. Gist: The gist of Rule 506 is that an issuer may sell an ***unlimited amount*** of securities to: (1) any number of ***"accredited"*** investors; and (2) up to ***35 non-accredited*** purchasers.

i. Meaning of "accredited": The term ***"accredited investor"*** is defined in Rule 501(a). The full definition is too intricate to reproduce here. However, the key concept is that an investor is accredited if he is sufficiently ***rich***. In the case of an individual, he is accredited if either: (1) his ***net worth*** is more than $1 million (not counting his personal residence) (501(a)(5)); or (2) he has had an ***income*** of more than $200,000 in each of the two most recent years ($300,000 when his income is combined with that of his

spouse), and has a "reasonable expectation" of reaching the same income level in the current year (501(a)(6)).

b. **Accredited can be dumb:** If an investor is "accredited," he can be completely dumb about financial matters, and his purchase will not prevent the offering from qualifying under Rule 506. Thus if Promoter can find 100 very gullible millionaires, he can raise unlimited sums from each while still having the transaction be "private" under Rule 506.

c. **Sophistication:** On the other hand, a ***non-accredited*** investor must be ***sophisticated***. More precisely, the issuer must ***"reasonably believe"*** that the non-accredited investor "either alone or with his purchaser representative(s) has ***such knowledge and experience*** in financial and business matters that he is ***capable of evaluating the merits and risks*** of the prospective investment." (A "purchaser representative" is defined in Rule 501(h) to be a person of sophistication in financial and business matters who is helping the investor evaluate the merits of the investment.)

d. **No dollar limit:** There is ***no dollar limit*** on the securities that may be sold under Rule 506.

e. **No advertising:** The issuer may not make any general ***solicitation*** or ***advertising***, if the offering is to qualify under Rule 506 and the issuer wants the right to sell to up to 35 non-accredited investors. However, as the result of the 2012 "JOBS" Act, an issuer that is willing to sell ***only to accredited investors*** may now conduct general solicitations and advertising.[2]

f. **Filing with the commission:** The issuer must file a ***notice*** with the SEC that it will be making a Rule 506 offering. See Rule 503.

g. **Disclosure:** If the offering is ***solely*** to ***accredited*** investors, the SEC does not impose ***any disclosure requirements***. But if even one investor is ***non-accredited***, then ***all*** purchasers (whether accredited or not) must receive specific disclosures,

as set forth in Rule 502(b)(2). The precise information that must be disclosed varies with the size of the offering and with whether the company is already filing SEC reports under the ’34 Act. But even where disclosure is required, complying with Rule 502(b)(2) is much simpler and less expensive than filing a full-fledged registration statement. Clark, p. 731.

h. **Not exclusive:** Observe that Rule 506 is merely a ***"safe harbor,"*** not the exclusive method of demonstrating that the issue is a private offering. Therefore, if the issuer gets tripped up on one or two of the technical requirements of Rule 506, he still has the opportunity to prove that he qualifies as a private offering under the more general §4(2) statutory exemption (discussed above).

Example of Rule 506's use: Rule 506 might have been quite useful in our Outline Corp example on p. 546. So long as Vickie and her four friends were each either "accredited" investors, or persons who (together with their "purchaser representative") had adequate sophistication to evaluate the offering, they would be appropriate investors under Rule 506. (Paul, as the promoter, would presumably have been either a director or officer of Outline Corp prior to the offering; if so, he would be an accredited investor by virtue of this insider status. See Rule 501(a)(4).) So long as Paul and Outline Corp did not conduct a general advertising or solicitation campaign, and gave an adequate disclosure document in the event that Vickie or one of her friends was not accredited, the other substantive requirements of Rule 506 would be met. But remember that if even one of the investors was non-accredited, all investors (accredited or not) would have to be given the appropriate disclosure document.

D. **Small offerings:** Rule 506, although often applicable, will not suffice for every case in which a small business wants to raise financing. The principal problem is that each investor must be either "accredited" or sophisticated (though sophistication can come from the purchaser representative). Suppose that Entrepreneur simply wants to raise a few hundred thousand dollars

of seed money from his friends and relatives, who are neither rich nor sophisticated. Rule 506 will not do. Fortunately, the SEC has adopted two rules, Rules 504 and 505, that give a safe harbor for certain ***small size*** offerings, without reference to the degree of sophistication of the investors.

1. **Rule 504:** Rule ***504*** allows an issuer to sell up to a total of ***$1 million*** of securities. (For purposes of calculating the $1 million limit, all sales in any ***12 month period*** made under Rule 504 or the companion small-offering provision, Rule 505, must be added together.) For these very small offerings that fit under Rule 504, there are practically no significant restrictions:

   a. **Unlimited number:** There is no limit on the ***number*** of investors who may purchase. (Contrast this with Rule 506, where the number cannot be more than 35 nonaccredited plus any number of accredited investors.)

   b. **Disclosure:** No particular ***disclosure*** is required. (However, the issuer must still comply with the general anti-fraud provisions of the federal securities laws, including Rule 10b-5.)

   c. **Advertising:** Generally, the offering may ***not*** be ***publicly advertised*** or accomplished by ***widespread solicitation***. But even here, an exception will sometimes be available: If the offering is made solely in states whose own laws require registration and the delivery of a disclosure document, an offering that is in compliance with the state requirements may be advertised and sold by solicitation.

   d. **No "development stage" companies:** "Development stage" companies — companies that ***don't yet have real business operations*** (including companies set up to ***acquire other not-yet-identified companies***) — ***cannot use*** Rule 504. See R. 504(a)(3).

   e. **Illustration:** The following example shows how Rule 504 might be used.

   Example: Return to our Outline Corp example from p. 546.

Assume that the issuance of stock to Paul was lawful even without reliance on Rule 504 (or its companion small-offering rule, Rule 505, discussed below). If so, the amount of stock being sold to Vickie and her friends aggregates less than $1 million, so the Rule 504 exemption is available. This makes Paul's life much easier: he will not have to make any specific disclosure to Vickie or her friends, and will not have to worry about whether they are all sufficiently sophisticated to understand the nature of the investment. (But Outline Corp will have to file a Notice of Sale with the SEC within 15 days after it makes the first sale to Vickie or her friends. See Rule 503.)

2. **Rule 505:** Rule ***505*** "can be understood as a rule that straddles 504 and 506." Clark, p. 733. It allows a higher dollar amount than Rule 504, yet imposes less stringent requirements on who may invest than does Rule 506.

   a. **Gist:** Under 505, the issuer can sell up to ***$5 million*** of securities in any 12-month period (counting sales not only under 505 but also those under 504). As with Rule 506, the number of investors is limited to 35 non-accredited and any number of accredited investors.

   b. **Disclosure and advertising:** If the issuer is selling to any non-accredited investors, it must make the same ***disclosure*** to all investors as would be required under 506. Similarly, the no-advertising and no-solicitation rules (*supra*, p. 550) that apply to Rule 506 offerings that are sold to non-accredited investors apply equally to Rule 505 offerings.

   c. **Why used:** Given that the number-of-investor limits, disclosure rules, and anti-advertising rules that apply to 506 also apply to 505, and that 505 limits the offering to $5 million whereas 506 has no dollar limits, why would anyone ever use 505? The answer is that there are no requirements concerning the ***type of investor*** — unlike 506, the investor need not be either accredited or sophisticated. "Thus, the lawyer counselling her client about the availability of this exemption

may be able to achieve ***greater certainty*** than if the [Rule 506] private offering exemption were invoked." Clark, p. 733.

Example: Return once again to our Outline Corp example from p. 546. Suppose, however, that Paul wants to have Outline Corp sell $2 million of stock to Vickie and her friends, rather than $500,000. Now, Rule 504 will not apply (because of its $1 million limit). Outline Corp will certainly want to get under 505 rather than 506 if it can, since under 505, Outline Corp and Paul will not have to form a belief about whether Vickie and her friends have "such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment" (as Rule 506(b)(2)(ii) requires).

3. **Table 12-1:** Table 12-1 shows some of the more important aspects of the three main rules of Regulation D, Rules 504-506.

E. **Sales by persons other than the issuer:** We have now seen most exemptions that apply to sales by an "issuer." (Several others are briefly covered below, including mergers, intrastate offers, and Regulation A.) Let us now turn to the rules governing sales by persons ***other than the issuer***.

1. **We only worry about "underwriters":** Remember that §4(1) of the '33 Act exempts from the registration requirements "transactions by any person other than an issuer, underwriter or dealer." Furthermore, virtually all sales by a "dealer" are exempted by §4(3), except for those taking place during the first 40 days of a public offering. Therefore, our discussion of sales by persons who are not issuers is mostly a discussion of who is an "underwriter" — if a person is not an "underwriter" (and does not sell "through" an underwriter — see the problem of sales by controlling shareholders *infra*, p. 554), he probably does not need to worry about the registration requirements.

2. **Resales:** Another way to look at this topic of "sales by persons other than the issuer" is to think of it as a discussion of when ***resales*** are allowed. In terms of our Outline Corp example from p. 546, the kinds of problems we are interested in here are

questions like: (1) May Vickie make her sale to Ned, one year after the original stock issuance, without registering her shares?; and (2) May Paul sell his shares to Xavier, five years after the initial stock issuance, without registration?

Table 12-1
COMPARISON: SEC REG. D EXEMPTIONS FOR "PRIVATE" AND "SMALL" OFFERINGS

	Rule 504	Rule 505	Rule 506
Maximum Amount (in any 12-month period)	$1 million	$5 million	Unlimited
Maximum Number of Investors	Unlimited	35 non-accredited; unlimited accredited	35 non-accredited; unlimited accredited
Investor Qualifications	None	None	Accredited, or sophisticated (alone or with Purchaser Representative)
Disclosure Requirements	None	If 1 or more investors are non-accredited, disclosure required by Rule 502(b)(2). If all investors are accredited, no specific disclosure required	Same as for Rule 505

Adapted from C&E (6th Ed.), p. 1509

3. **Ordinary brokerage transactions:** At the outset, let's consider ordinary ***secondary-market*** trading. If Investor buys registered shares at an initial public offering, and then wants to resell those shares on a stock exchange or in the over-the-counter market sometime later, why doesn't he have to file a registration statement to cover this sale? Assuming that investor has no special affiliation with the issuer, he is protected by the main

exemption of §4(1) (exempting any transaction that is not by an "issuer, underwriter, or dealer") as long as he is not an "underwriter." We will be discussing in detail who is an "underwriter." For now, you can simply assume that if Investor is an ordinary small investor with a small stake in the company, he is not an underwriter and can therefore resell on the open market without registration.

4. **Meaning of "underwriter":** The term ***"underwriter"*** is defined in §2(11) of the '33 Act to mean "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security.…" This definition is a broad one. It doesn't just cover institutions that call themselves "underwriters," and that formally contract to buy a new issue from the issuer and resell it to the public by means of tombstone ads and the like. Instead, ***anyone***, even an individual, who "buys from" or "sells for" the issuer with a "view to … distribution," is potentially an underwriter.

5. **Sales by or for controlling persons:** Because of the very broad definition of "underwriter," sales by or for a person who ***controls*** the issuer will often turn out to ***require separate registration*** (even if the issuer is already a "public" company with properly-registered shares in public hands).

   a. **Broad definition of "issuer":** To see how this can come about, first consider the last sentence of §2(11) of the '33 Act: "As used in this paragraph [defining "underwriter"] the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly ***controlling*** or controlled by the issuer. …" If we couple this broad definition of "issuer" with the definition of "underwriter" as meaning anyone who "sells for an issuer in connection with the distribution of any security," then it follows that ***a broker who sells shares for a controlling stockholder may be acting as an "underwriter"*** (in which case the key exemption given in §4(1) for "transactions by any person other than an issuer, underwriter, or dealer" will not be available).

b. **Liability of controlling shareholder:** As I just noted, a broker can be liable for selling unregistered securities if he makes sales for one who controls the issuer, and the sales are found to constitute a "distribution." But the ***controlling stockholder*** can ***also*** be similarly liable for unregistered sales: since the broker is acting as an "underwriter," the sales are not "transactions by any person other than an issuer, underwriter, or dealer," so the controlling shareholder loses his key §4(1) exemption and is illegally selling unregistered securities unless he can find some other exemption.

c. **Rule 144:** So the key concept is "distribution": if a broker sells for a controlling shareholder in what is found to be a "distribution," then both the controlling shareholder and the broker can be liable for selling unregistered securities. Fortunately for brokers and controlling shareholders, the SEC has adopted a special rule, ***Rule 144***, that provides a ***safe harbor***: if the terms of the rule are complied with, no "distribution" is deemed to occur, so the broker and the controlling shareholder get the §4(1) exemption for "transactions by any person other than an issuer, underwriter, or dealer," and are not required to register the offering. In the case of a sale by or for a ***controlling shareholder*** of the issuer (what the rule defines in 144(a)(1) as an ***"affiliate"*** of the issuer), Rule 144 is available only if all of the following conditions are satisfied:

   i. **Limit on amount of sales:** The sales must be made ***gradually***. More precisely, in ***any three-month period*** the controlling shareholder may not sell more than the greater of: (1) ***1% of the total shares outstanding***; or (2) the ***average weekly trading volume*** for the four prior weeks. These volume limits mean that unless the stock is ***fairly actively*** traded (i.e., with more than 1% of its shares traded in an average week), a controlling shareholder will be likely to have to wait a ***very long time*** to sell a significant chunk of his holdings under Rule 144. For instance, it would take a ***30% holder*** more than ***seven years*** to sell off his holdings if

less than 1% of the company's stock traded in an average week. Therefore, controlling shareholders who want to dispose of their entire holdings will generally find that as a practical matter, they must register their offering rather than rely on Rule 144. Clark, p. 740.

ii. Holding period: The controlling shareholder must normally have held the securities ***for at least two years*** before reselling them. (But the holding period does not apply if he bought the shares in a public offering.)

iii. Disclosure: The issuing corporation must be a "public" company, i.e., one which makes periodic reports to the SEC under the '34 Act (see *supra*, p. 95). Alternatively, there must be equivalent information about the company publicly available. So if the issuer is a typical closely-held corporation about which little financial information is publicly known, Rule 144 is not available to permit the controlling shareholder to sell shares.

iv. Ordinary brokerage transactions: The stock must be sold in ***ordinary brokerage transactions***, or sold directly to a "market maker." The main thrust of this requirement on the manner of sale is that the controlling shareholder's broker may not ***solicit*** orders to buy the stock — the broker must merely respond to unsolicited buy orders or sell on the open market, rather than, say, phoning his customer list to find out whether anybody is interested.

v. Notice: Finally, a ***notice*** of each sale must normally be filed with the SEC at the time the order to sell is placed with the broker. A notice must also be filed with any stock exchange on which the issuer's shares are traded.

Illustration of operation: Let's return to our Outline Corp hypothetical from p. 546 to see how Rule 144 might apply to a sale by a controlling shareholder. Recall that five years after the founding of the company, Paul wants to dispose of his interest, which consists of 750,000 of the 1,000,000 shares outstanding. If Broker simply calls up various

customers and solicits orders for a large portion of Paul’s stake, these sales are likely to be held to be a “distribution,” and both Paul and Broker will be guilty of selling unregistered securities. Rule 144 might furnish Paul and Broker a way to sell off his stake without registration.

The biggest problem is the requirement that the shares be sold either to a market maker or in ordinary brokerage transactions. As a practical matter, this probably means that unless Outline Corp has not only “gone public” at some time in the past five years but is somewhat actively traded, Paul and Broker will simply not be able to use Rule 144 — without a reasonable “float,” or number of shares in public hands, Broker could only move the shares by soliciting orders, and this is precisely what the “ordinary brokerage transaction” requirement prohibits.

Assuming that Outline Corp is already publicly traded, the “company disclosure” requirement will also be satisfied: Outline Corp will be making periodic reports to the SEC under the ’34 Act.

The holding-period rule will not cause any problem: Paul is required to have held his shares (since they were not obtained in a public offering) for at least two years. But he has in fact held them for five.

But the volume limits will be a problem. Paul may not sell in any three month period more than the greater of: (1) 1% of the total outstanding shares of Outline Corp common stock; or (2) the average weekly trading volume for the stock over the prior four weeks. Therefore, unless more than 1% of Outline Corp stock trades in an average week, Paul will be limited to 10,000 shares (1% of the company’s total outstanding stock) in any three-month period; thus for him to sell his 750,000 shares, it will take him 75 three-month periods, or more than 18 years! So unless Paul is content to dribble out his shares over such a long schedule, he will have no choice but to file a registration statement for his shares.

If Paul does proceed by Rule 144, he will have to file

with the SEC a notice of sale at the time each sale order is placed with Broker.

6. **Sales by non-controlling person:** ***Non-controlling persons*** will also sometimes have to worry about being classed as "underwriters" if they sell their unregistered shares. The principal situation in which a non-controlling shareholder needs to worry about being an "underwriter," and would like to be able to use Rule 144, is where the person has previously ***bought stock from the issuer in a private transaction*** and now wishes to resell that stock. Especially where the investor has not held the stock for very long, there is a chance the court will hold that he ***bought with an intent to resell*** rather than to hold for investment; if so, the resale is likely to be deemed part of the original "distribution," the investor will therefore be an "underwriter," and the resale will be an illegal sale of an unregistered security.

   a. **Rule 144 helps:** ***Rule 144*** may help in this situation of a resale by a non-controlling shareholder, just as it may help in the case of sales by controlling shareholders. In fact, the conditions which must be met before Rule 144 applies are actually ***easier*** in the non-controlling shareholder case, as we shall see shortly. Our discussion assumes that the non-controlling shareholder is holding ***"restricted securities,"*** that is, securities bought from the issuer in a non-public offering. (If the shares were bought in a public offering, he will generally not have to worry about his re-sales being considered "distributions," so he does not need the protection of Rule 144.)

      i. **Held less than three years:** If the non-controlling shareholder has held his restricted stock for ***less than three years***, then he may only use Rule 144 if ***all*** the requirements listed above for controlling-shareholder sales are met. That is, he is subject to the sale volume limits and the two-year minimum holding period, the issuer must make periodic SEC reports (or supply equivalent disclosure to the public), the sales must be made in ordinary brokerage transactions, and the SEC notice must be filed, all exactly as if the seller

were a controlling shareholder.

ii. Held for more than three years: But if the non-controlling shareholder has held his restricted stock for ***more than three years***, life gets dramatically easier under Rule 144. The volume limits, company-disclosure rules, "ordinary brokerage transaction" requirement, and SEC filing requirement are all ***removed***. So we have a simple general rule: ***a non-controlling shareholder who buys stock in a private offering and then holds that stock for three years may sell to whomever he wishes, in whatever amounts he wishes, by whatever type of transaction he wishes*** (so long as the resale does not itself involve a brand new public offering), without reference to whether the company ***files SEC reports***, and without any need to file any notice with the SEC.

Illustration: Returning once again to our Outline Corp example from p. 546, let's see how Rule 144 might have helped Vickie dispose of her 15% interest in Outline Corp. The Rule would not have helped Vickie at all with respect to her sale made one year after Outline Corp first distributed stock. Therefore, Vickie could be charged by the SEC with illegally selling unregistered shares — if a court found that she bought with an intent to resell rather than hold for investment, the court might well hold that her resale was a "distribution," thus making her broker an "underwriter" and depriving both Vickie and her broker of the key §4(1) exemption for transactions not involving an underwriter, issuer or dealer.

But if Vickie held her Outline Corp stock for two years, she could then sell it under Rule 144, provided she met all of the stringent requirements of that Rule. For instance, assuming Outline Corp stock was lightly traded, she would be limited to selling 1% of all Outline Corp shares (i.e., 10,000 shares) in any three month period, so it would take her almost four years to dispose of her 15% position. Similarly, Outline Corp would have to be "public," in the

sense that it either filed periodic reports under the ’34 Act or made comparable information available to the public; the sales by broker would have to be “ordinary” ones in which the broker did not solicit for buyers and merely filled orders; and a notice with the SEC would have to be filed each time Vickie told her broker to sell some shares.

Assume, however, that Vickie is willing to wait until ***three years*** have passed since she first got her shares. Now, her life will be much easier: since she is not a controlling stockholder, she can sell all her shares whenever she wishes to whomever she wishes in any kind of transaction (as long as her sales activity doesn’t independently constitute a new public offering), without reference to whether Outline Corp files SEC reports, and with no need on her part to file any notice with the SEC.

F. Other exemptions: Let us now review very briefly two other exemptions to the registration requirements: (1) the exemption for “intrastate” offerings; and (2) the Regulation A exemption.

1. Intrastate offerings: Section 3(a)(11) of the ’33 Act exempts from the registration requirements “[a]ny security which is part of an issue offered and sold ***only to persons resident within a single State*** … where the issuer of such security is a … corporation, ***incorporated by and doing business within, such State***….” This is the ***“intrastate offerings”*** exemption.

a. Stringent requirements: Several stringent requirements make the intrastate exemption very hard to use. One writer says that these requirements render the exemption “virtually useless for making public offerings except in ***isolated areas far from any state border***.” Ratner, pp. 62-63.

2. Regulation A: Regulation A is a set of SEC Rules that gives an exemption for certain issues of up to ***$5 million.***

a. Eligibility: All offerings made under Regulation A during any 12-month period must be added together, and this total must be less than $5 million.

b. Disclosure requirements: Regulation A imposes substantial ***disclosure requirements*** on an issuer. The issuer must file an “offering statement” with the local SEC regional office before beginning the offering. This offering statement must include material that is fairly similar to what would have to be in a registration statement, although in less detail, and without audited financials.

c. Employee benefit plans: Regulation A is rarely used today, because it is not that much simpler to comply with than the true registration process (especially since the registration statement for smaller offerings can now be filed on a simple form that is hardly more burdensome than the Regulation A form). The main use of Regulation A is for offerings made under ***employee stock option*** and stock ***purchase*** plans. C&E, p. 1449.

V. PUBLIC OFFERINGS — CIVIL LIABILITIES

A. Liabilities generally: The ’33 Act contains four ***liability*** provisions:

1. **Section 11:** Section 11 imposes liability for ***false statements in a registration statement***. It is probably the most important of the ’33 Act liability provisions.

2. **Section 12(1):** Section 12(1) imposes liability on anyone who offers or sells a security in violation of §5 of the ’33 Act. Its main use is where stock should be registered but is not, i.e., an ***unregistered public offering***.

3. **Section 12(2):** Section 12(2) is a general ***anti-fraud*** provision. Unlike §§11 and 12(1), it is not keyed into registration. Thus even if the offering is exempt from registration, if the seller tells a lie orally or in writing in connection with the sale, he will be liable.

4. **Section 17(a):** Section 17(a) is an even more general anti-fraud provision. Like §12(2), it applies without reference to whether registration is required, so it can apply to sales of securities that

are exempt from registration. The fraudulent conduct it prohibits is phrased more broadly than the prohibition in §12(2) (since 12(2) applies only to statements or omissions, whereas §17(a) applies to "any device, scheme, or artifice to defraud"). However, unlike §12(2), §17(a) does not explicitly give a civil remedy to the buyer, and courts are in dispute about whether such a remedy should be implied.

B. Liability under §11: Section 11 is the best reason for an issuer or underwriter to make sure that a registration statement is done carefully, for it comes fairly close to imposing ***strict liability*** for errors in registration statements.

1. **Basic provision:** Section 11 provides that if a registration statement, at the time it became effective, "contained an ***untrue statement of a material fact*** or ***omitted to state a material fact*** required to be stated therein or necessary to make the statements therein not misleading," anyone who buys the stock thereafter may sue not only the issuer but a number of other people. Remember that the registration statement includes the prospectus, so any prospectus error will trigger §11.

2. **Who may sue:** A §11 suit may be brought by ***anyone*** who buys the stock covered by the registration statement. Thus the plaintiff does not have to be someone who bought at the initial public offering — he can be a ***secondary*** buyer (one who bought from one who bought at the initial offering).

3. **Reliance:** Even better still for the plaintiff, he does not have to show that he ***relied*** on the registration statement. Even if it is clear that he never read the prospectus, and that he would have bought the stock no matter what the prospectus said, he is still permitted to sue.

   a. **Actual knowledge:** However, the defendant is given an affirmative defense: he will avoid liability if he can bear the burden of showing that the plaintiff purchaser ***knew of the untruth*** or omission at the time he purchased.

   b. **Release of subsequent earnings report:** Also, if the

plaintiff bought the stock after the issuer made public an earnings statement covering the first 12 months of operations following the effective date of the registration, then the plaintiff must prove that he in fact relied on the registration statement. §11(a).

4. **Who may be sued:** A wide range of people may be sued under §11. The categories include:

   (1) everyone who ***signed*** the registration statement (which always includes at least the issuer, the principal officers, and a majority of the directors);

   (2) everyone who was a ***director*** at the time the registration statement was filed (or who was named with his consent in the statement as being about to become a director);

   (3) every ***expert*** who consented to being named as having prepared or certified a part of the registration statement (including accountants, engineers, and appraisers); and

   (4) every ***underwriter***.

   So even if the issuer is bankrupt by the time suit is commenced, the plaintiff typically has a number of other deep-pocketed parties to sue.

5. **Standard of conduct:** The ***issuer's*** liability is ***absolute***; even if the misstatement or omission was inadvertent and in fact non-negligent, the issuer is strictly liable. But all other defendants are given the chance to raise the so-called ***"due diligence"*** defense. That is, a defendant who shows that he exercised due diligence in connection with the registration statement will escape liability. The due diligence test applies differently with respect to portions of the registration statement prepared by experts and those portions not prepared by experts, so we consider each of these situations separately:

   a. **Distinction between "expertised" and "non-expertised" parts:** A portion of the registration statement that makes extensive use of an ***expert***, and that lists the expert as having prepared that portion, is called the ***"expertised"*** portion. All

other parts are referred to as “non-expertised” portions. In general, courts define the “expertised” parts narrowly. For instance, the fact that the entire registration statement is prepared by lawyers does not mean that the entire statement is “expertised” by the lawyers. See *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968), discussed further *infra*. Typically, the expertised portions will be: (1) the ***financial statements***, expertised by the accountants who prepared them; (2) any ***engineering*** reports dealing with such items as structural soundness of properties; and (3) ***appraisals*** of property.

b. **“Non-expertised” portions:** With respect to the ***non-expertised*** parts of the registration statement, the due diligence defense is phrased affirmatively: the defendant must show that: (1) he made a ***reasonable investigation***; and (2) after that investigation, he was left with ***reasonable ground to believe***, and did ***in fact believe***, that there was no material misstatement or omission.

i. **Can’t be delegated:** In general, this duty to make a reasonable investigation ***cannot be delegated***. For instance, suppose that an outside director says to the president of the issuer, or to the representative of the underwriter, “Have you checked out this registration statement completely?” and the insider or underwriter says, “Yes we have, and everything is alright.” This will ***not*** constitute “reasonable investigation” on the director’s part, so he will not succeed with his due diligence defense if this is all that he has done. *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968) (where newly-appointed director relies on assurances of president and chief executive officer that all data in the registration statement is accurate, director has not made a “reasonable investigation” of the non-expertised portions).

c. **“Expertised” portion:** With respect to the ***“expertised”*** part of the registration statement, somewhat different rules apply:

i. **The expert:** The same standard that applies to all defendants concerning the nonexpertised portion is applied to the ***expert*** in connection with the expertised part that he has prepared. In other words, the expert must make the affirmative showing that he conducted a reasonable investigation that left him with reasonable ground to believe (and the actual belief) that the part he prepared was accurate.

ii. **Non-experts:** But all other persons get the benefit of an easier standard for due diligence in connection with the expertised portion: they merely have to prove the ***negative*** proposition, that they ***"had no reasonable ground to believe and did not believe"*** that there was any material misstatement or omission. For instance, an ordinary director can leave to a financial expert (typically, the accounting firm) the preparation of the audited financial statements that are to appear in the registration statement; so long as the director does not have reason to believe, and does not in fact believe, that the financials are inaccurate, he will be protected even though he did not conduct any independent investigation of his own.

6. **Measure of damages:** The ***measure of damages*** in §11 cases is the difference between: (1) the ***price*** the plaintiff ***paid*** for the stock (but not more than the public offering price); and (2) the ***value*** of the stock at the time of the suit (or the price the plaintiff got when he sold the stock). So the measure of damages essentially covers the plaintiff's ***out-of-pocket loss***.

   a. **Affirmative defense:** But the defendant may get the damages reduced by showing that the decline in value was caused by ***factors other than the error*** in the registration statement. For instance, suppose that D shows that the entire stock market declined substantially between the offering and the suit; the court may well reduce the plaintiffs' damages by an amount that approximates the general percentage decline in the market.

C. Section 12(1): Section 12(1) is very brief: it imposes liability on "[a]ny person who … offers or sells a security in violation of Section 5.…" Section 12(1) therefore imposes liability on anyone who sells a security that ***should have been registered*** but was not.

1. **Strict liability:** Liability under §12(1) is ***strict*** — even if the seller made an honest mistake, and indeed a non-negligent mistake, in concluding that the stock did not need to be registered, he is liable.

2. **Liable only to his purchaser:** ***Privity*** is required for a §12(1) suit. In other words, a buyer of stock that should be registered and is not may sue only the person who sold to him, not someone further back in the distribution chain.

3. **Damages:** The plaintiff gets the equivalent of ***rescission***. In other words, he collects damages equal to the difference between what he paid and what the stock was worth at the time of suit (or the amount he received when he re-sold it).

D. Section 12(2): Section 12(2) is somewhat similar to §11, in that it establishes liability for ***untrue statements of material fact*** and for ***omissions of material facts***. But there are some important differences, and some key situations in which suit will be possible only under §12(2), not §11:

1. **Not in registration statement:** Unlike §11, §12(2) is ***not limited to misstatements made in the registration statement***. Section 12(2) imposes liability for misstatements made ***orally***, or in a writing other than the registration statement. It also applies regardless of whether the security is registered or required to be registered. Thus if Promoter falsely tells Investor orally, "I've got a great private placement for you; management is honest and the company is profitable," §12(2) may allow recovery even though §11 does not (because there is no registration statement containing any error) and even though §12(1) is unavailable (assuming that this is indeed a private placement that does not need to be registered).

2. **Negligence standard:** Section 12(2) effectively imposes a

negligence standard. This is because it gives the seller a defense if he can show “that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.” (This is a bit different from the §11 standard for non-expertised parts of the registration statement, where the defendant has the burden of showing that he conducted a reasonable investigation and did not learn of the error.)

3. **Broad class of defendants:** Under §12(2), the buyer may sue anyone who was a ***substantial factor*** in the sale. Thus the class of possible defendants is not limited to the seller. For instance, a broker who merely handles the transaction as the seller’s agent, or a public relations consultant who works for the seller, might each be liable if he makes an untrue statement or a material omission in connection with the sale. Loss, pp. 891, 1017-22. (By contrast, §11 probably applies only to those defendants who fall within the precise classes specified in that section.)

E. **Section 17(a):** Finally, §17(a) is a ***general anti-fraud provision***, which makes it unlawful, in the offer or sale of any security, to: (1) “employ any ***device, scheme, or artifice to defraud***”; (2) “obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact …”; or (3) “engage in any transaction … which operates or would operate as a fraud or deceit upon the purchaser.”

1. **Similarity to Rule 10b-5:** Observe that what is forbidden by §17 is almost identical to what is forbidden by Rule 10b-5 (*supra*, p. 211). However, there is one main reason why a plaintiff might want to bring suit under §17 rather than Rule 10b-5: subsections (a)(2) and (a)(3) (categories (1) and (2) listed above) probably do not require a showing of ***scienter***, i.e., of intentional falsehood, on the part of the defendant, whereas scienter is required under Rule 10b-5. See Loss, p. 979; see also *supra*, p. 277.

2. **Probably no private right of action:** On the other hand, whereas the other three liability provisions we have just discussed (§§11, 12(1), and 12(2)) all explicitly give an injured

buyer the right to bring a private civil action, §17(a) is silent about whether the buyer can sue. Courts are split about whether a private right of action should be implied; "The weight of recent opinions seems to be against a private right of action." Clark, p. 748.

F. **Rule 10b-5:** Apart from these provisions that deal expressly with public issuance of securities, a defrauded buyer may also be able to sue under the much more general Rule 10b-5 (*supra*, p. 262). In other words, even if a particular buyer would have an express right of action under, say, §11 for an error in a registration statement, he may elect instead to proceed under 10b-5 (which he might want to do, for instance, because of 10b-5's longer statute of limitations). See Loss, p. 975.

VI. PUBLIC OFFERINGS — STATE REGULATION

A. **State "Blue Sky" laws generally:** So far, we have assumed that all regulation of securities issuance occurs at the federal level. But this is not true: ***every state*** regulates some aspects of securities transactions as well. Ratner, p. 295. These state securities regulations are collectively known as ***"blue sky"*** laws (perhaps because they were aimed at promoters who "would sell building lots in the blue sky in fee simple;" Loss, p. 8).

B. **'96 Act changes rules:** However, Congress ***took away*** a large portion of the states' Blue Sky powers, in the ***National Securities Market Improvement Act of 1996***. Except for a few small, regional or intrastate securities offerings, ***state regulation of securities issuance is now pre-empted by federal regulation.*** So an issue of securities that either satisfies the registration requirements of the '33 Act, or that falls within some exemption (e.g., Rules 504 or 505) need not comply with any state regulations.

1. **Fraud or deceit:** State regulators are still free to ***combat securities fraud or deceit*** that takes place in their state. But the '96 Act gets them out of the business of regulating the ***issuance*** of securities.

Quiz Yourself on ***ISSUANCE OF SECURITIES*** *(PUBLIC OFFERINGS AND EXEMPTIONS)*

110. Rocky Raccoon is the sole shareholder of Roadkill Family Restaurants, Inc., a restaurant chain that obtains its ingredients mainly by harvesting them from the nation's highways and byways. Rocky would now like to raise about $2.5 million of additional capital for the company, to fund expansion. He tells you that he has two friends who are multi-millionaires that would like to invest around $1 million each. He says he also has an additional 20 or so friends who are "working stiffs," who each earn under $100,000 and don't have many assets; Rocky thinks that these friends might invest an average of about $20,000 each. A public offering (which would require a registration statement and subject the company to all sorts of SEC regulation) is out of the question at this time, so the money will have to be raised without one.

(a) If you are drafting and structuring the offering, what SEC exemption should you rely on? ____________________________

(b) Does the SEC regulate the types of financial and business disclosures you will have to make to the investors, when you rely upon the exemption you chose in (a)? ____________________________

(c) Suppose that Rocky tells you, instead, that he only wants to raise the money from his two very rich friends. You and Rocky both want to be sure that the transaction won't be a public offering, so that you won't have to prepare a registration statement. Do you need to find a particular SEC Rule that gives you an exemption from the public offering requirements (and if so, what Rule applies)?

____

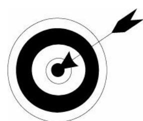
Answers

110. (a) Rule 505 under the '33 Act. SEC Rule 505 allows a company to raise up to $5 MM. [551] There can be any number of "accredited" investors (those having a net worth of more than $1 MM or income of more than $200,000 in each of the past two years), plus up to 35 non-

accredited investors. The 20 "working stiff" friends thus qualify as non-accredited investors.

(b) Yes. You'll have to obey the pretty precise disclosure requirements laid out in SEC Rule 502. Some of the financial information (e.g., the balance sheet) will have to be audited.

(c) No. §4(2) of the '33 Act exempts from the registration requirements any transaction that does not involve a "public offering." Certain SEC Rules give a "safe harbor," by preventing certain transactions from being public offerings; Rule 505, discussed above, is one such. But a transaction can also avoid being a public offering just by complying with judicial decisions that define "public offering." [548] An offer to a very small number of very rich people would almost certainly be held by a court not to be a public offering. Therefore, Rocky can make his offer to his two rich friends, and take their money, without complying with any particular SEC Rule. The advantage of this non-Rule-based approach is that Rocky won't have to comply with any particular SEC-defined disclosure requirements (as he would if he went with SEC Rules 504, 505 or in some instances 506).



Exam Tips *on* ***ISSUANCE OF SECURITIES***

The most common exam topics from this chapter are: (1) subscription agreements; (2) preemptive rights; and (3) watered stock.

- ☛ Concerning ***subscription agreements***, the most frequently-tested issue is whether a subscriber may ***revoke*** a pre-incorporation subscription. Here, recall that there are two principles applicable in most states:
  - ☞ First, most states say that the subscription is ***irrevocable*** for some period, usually 6 months.

    Example: G, and A and B agree to pay $3,000 each for all of the stock of Corp., a corp. to be formed by G. One week later, before

anything further has happened, A and B write to G, stating “We hereby revoke any agreement to buy stock in Corp.” In most states (incl. Del. & under the MBCA), G can form the corp. and have it sue A and B for the purchase price, because the subscription acts like an offer to the corp. that is irrevocable for some time, probably 6 mos.

☞ Second, even states making the subscription irrevocable for some time allow ***all s/h’s, acting together, to rescind*** the agreement. (But if even one subscriber insists, the subscription remains in force.) (*Example:* On the facts of the above example, G, A and B could get together and all agree to rescind, but A and B by themselves can’t.)

☛ Questions on ***preemptive rights*** are surprisingly common. A preemptive-rights issue can pop up even where the question does not use the phrase “preemptive rights” — you should look for such an issue whenever s/h *A* buys shares, then shares are offered to s/h *B* without *A*’s getting a chance to avoid dilution by buying additional shares.

☞ Don’t forget that under most statutes, pre-emptive rights work on an ***“opt in”*** basis: unless the corp. in its charter specifically provides that there will be pre-emptive rights, such rights won’t exist.

☞ Actually, most preemptive-rights issues involve the three main situations in which such rights ***don’t apply***:

❏ ***Previously-authorized, but unissued, shares***. (However, under some statutes the unauthorized-but-unissued shares become covered by the pre-emptive rights scheme after passage of a certain amount of time, e.g. 6 mos., following formation.)

❏ ***Treasury stock*** (i.e., shares that were once outstanding, but that have been repurchased by the corp.).

❏ Most often-tested of all, shares ***exchanged for services or assets.***

Example: Corp. was incorporated 2 years ago with initial authorized capital of 10,000 shares of $100 par value stock. Corp. then issues 5,000 shares, 2,500 each to A and B. Later, Corp. issues 1,000 shares to C in return for C’s transfer of title to Blueacre, which Corp. wants for a future plant site. Even if Corp. has pre-emptive rights, A can’t exercise any rights as the result of the deal with C, because C got his shares as the result of an exchange for assets. (Also, since C’s shares

were part of the originally-authorized amount, this fact, too, may prevent pre-emptive rights from arising in A, though the passage of 2 years might be enough under the statute to cause pre-emptive rights to re-attach to the 5,000 authorized-but-originally-unissued shares.)

- ☛ Issues relating to the ***form*** and ***amount*** of ***consideration*** paid for stock are also common on exams.
  - ☞ The principal issue relating to the ***"form"*** of consideration is the distinction between ***past*** services or property given in exchange for stock, and promises of ***future*** services or property:
    - ☞ If the consideration is ***past services*** to the corp., or ***existing property*** already transferred to the corp., this is clearly ***valid*** consideration (at least if it's got a value that's ***no less than the par value*** of the stock).
    - ☞ But if the consideration is a ***promise*** of ***future*** services, or a promise to ***transfer property in the future***, some statutes make this ***invalid*** consideration. (But most modern statutes, including the MBCA, allow such promises to be consideration.)
  - ☞ As to the "amount" of consideration, you mainly have to worry about the problem of ***"watered stock."*** That is, if the shares are exchanged for money, property or services whose ***value is less than the stated par value of the shares***, in many states the transaction is an illegal issuance of watered stock.

    Example 1: Corp. issues 100 shares, each with par value of $100, to A in exchange for A's promissory note for $7,500. This presents a watered-stock issue, because the value of the thing received by the corp. (the note) is less than the $10,000 aggregate par value of the stock.

    Example 2: Corp. issues 100 shares, again each with par value of $100, to A in exchange for A's promise to work for Corp. for one year at a salary of $100,000. If the market value (and value to Corp.) of A's services for a year is less than $110,000, the issue may be invalid as watered stock.

    But again, it's the ***exceptions*** that are usually tested. Most important:

- ❑ There's a ***"good faith"*** (or ***"business judgment"***) exception to the "no watered stock" rule: as long as the board in its good faith business judgment ***believes*** that the funds, property or services to be received in exchange are worth at least the par value, the court won't second-guess. Thus in Example 2 above, if the board honestly and plausibly believes that A's services for a year are worth $110K, the court won't find the stock to have been watered, even though the court might not agree with the board's assessment of A's value.

- ❑ Also, when stock is exchanged for property, don't be tricked into thinking that the stock is watered just because the recipient ***obtained*** the property for less than the par value of the stock. What's relevant is the value of the property at ***the time the stock is issued***, not how much the recipient originally paid for the property.

Example: Corp. issues 100 shares of $100 par value stock to A in return for office equipment currently appraised at $11,000. A had bought the equipment 6 months earlier at an auction, for $8,000. The stock isn't watered, because the present value (measured by the appraisal) is greater than the par value of the stock; it doesn't matter how much A originally paid for the equipment.

- ❑ Finally, remember that if the corp. has placed the legend ***"fully paid"*** on shares that were sold at a discount, in some states the corp. is ***"estopped"*** from later claiming otherwise — so the corp. or another s/h cannot later have the transaction rescinded, or recover the discounted amount from the issuee.

☞ Sometimes you'll see a question in which the person complaining about watered stock is not another s/h (as in the above examples), but a ***creditor***. This will generally happen only if the corp. is now ***insolvent***.

☞ The most common theory for letting the creditor recover against the s/h who received the watered stock is the ***"holding out"*** or ***"misrepresentation"*** theory. Under this theory, the creditor can recover from a s/h the amount of the "water" (the difference between par value and value of what the s/h paid) if the creditor shows that he extended credit in ***reliance*** on the corp's assertion that all stock previously issued was for par value. (Because of the reliance requirement, creditors usually can't use the holding-out

theory where they lent ***before*** the watered-stock issue, or lent after but with ***knowledge*** of the watering.)

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1. By the way, the definition of “security” is essentially the same in the ’34 Act as in the ’33 Act. K,R&B (5th), p. 405. So if the buyer of, say, corporate stock wants to bring a civil suit against the seller for fraud or misstatement under SEC Rule 10b-5 (promulgated under the ’34 Act — see *supra*, p. 262), the precedents we are exploring here concerning the meaning of “security” under the ’33 Act will apply to that ’34-Act-based claim.

2. The amendment to Rule 506 that’s needed to carry out this JOBS Act provision has been proposed by the SEC, but not yet finally enacted as of this writing (April, 2013).

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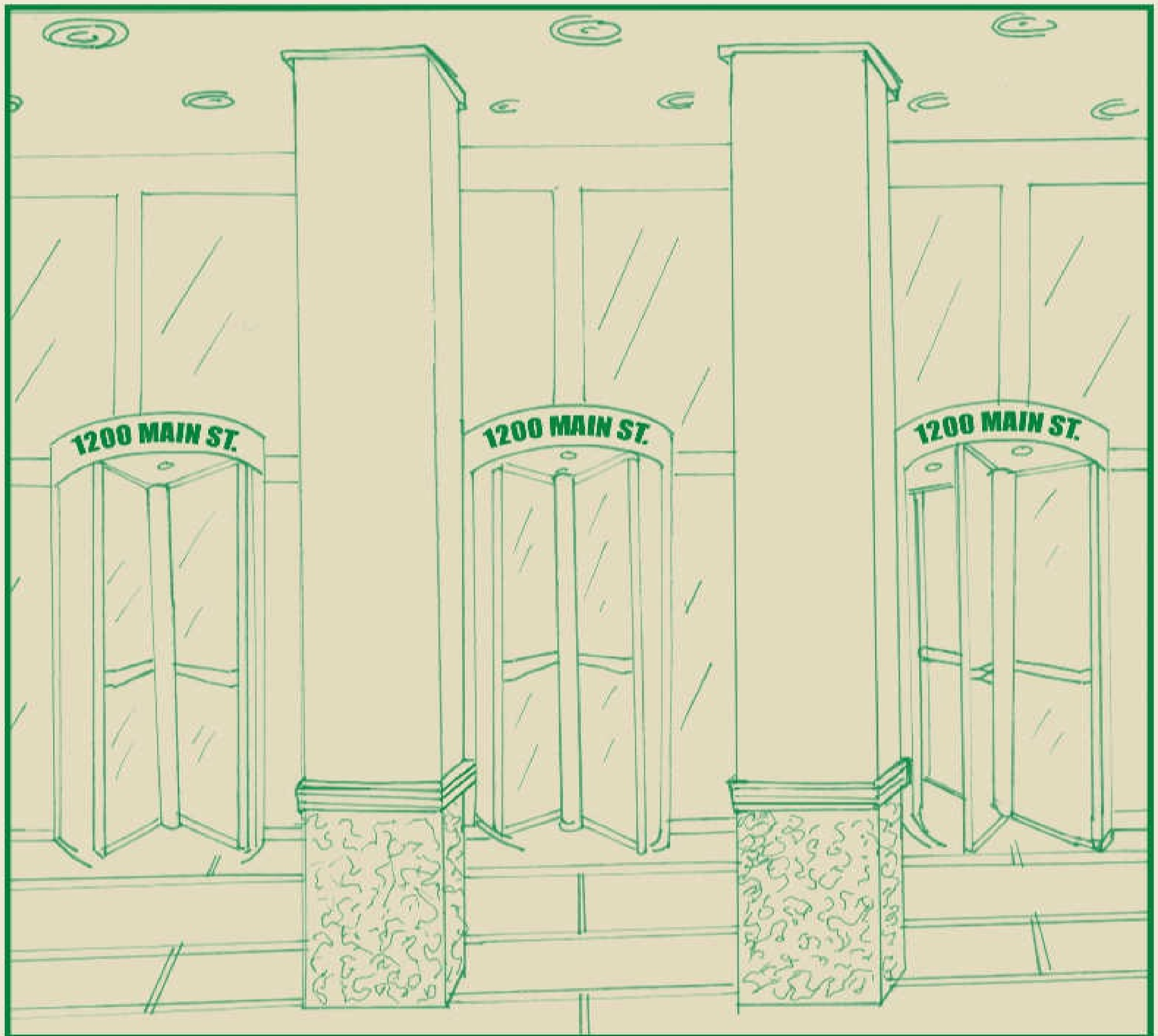

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CHAPTER 5

Federal Regulation of Securities Offerings

When a corporation issues its securities, it "promises" investors that future anticipated payments to the investors by the corporation justify the investment. Investors thus pay cash in the expectation of future financial returns.

How can investors be sure the corporation will keep its promises—that its business plan is solid, that its management is able, that its earnings will cover principal and interest, and that its net earnings will be enough to pay dividends? In 1933 Congress created a complex "truth in securities" scheme for the issuance of securities to the public.

Just as food producers today must label their products and describe ingredients, calories, and fat content, the Securities Act of 1933 requires issuers of securities to provide investors with detailed information about the company, its management, its plans and finances, and the securities offered. The goal of the 1933 Act is disclosure, built on a philosophy that informed investors will not only have the confidence to invest, but will make better investment choices.

This chapter provides an overview of the Securities Act's complex regulatory structure: Securities Act registration and disclosure requirements (§5.1), the principal exemptions from the registration requirements (§5.2), civil liability under the Act for violating the registration requirements and for making false or misleading statements in specified securities sales (§5.3), and the federal securities law's definition of a security—the linchpin for

Securities Act registration, disclosure, and liability (§5.4).

For a fuller treatment of how securities offerings are regulated, as well as other securities regulation topics covered in this book—such as disclosure requirements for public companies in Chapter 21, securities fraud class actions in Chapter 22, and insider trading in Chapters 23 and 24—you may want to turn to other sources. See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* (6th ed., Wolters Kluwer Law & Business 2014).

Note on Difference between Securities Act and Exchange Act

The Securities Act of 1933 has a different focus than the Securities Exchange Act of 1934, which deals primarily with stock *trading*—that is, the buying and selling of securities after their original issuance—as well as the regulation of securities professionals and organized stock markets. Ongoing periodic disclosure is required under the Exchange Act by "public" (or "reporting") companies—namely, companies whose stock is traded on a stock exchange or which have more than 500 shareholders and $10 million in assets (see §21.2.1).

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§5.1 SECURITIES ACT REGULATION OF PUBLIC OFFERINGS

The Securities Act of 1933 was an important part of the New Deal program to address the perceived causes of the Great Depression. Many believed that the stock market crash of 1929 and the ensuing collapse of the U.S. financial markets resulted from rampant speculation during the 1920s in new, financially unsound companies. Believing that state law was inadequate, Congress chose as the antidote a national system of mandatory disclosure to investors. In 1934 Congress created the Securities and Exchange Commission (SEC) to administer the federal securities laws.

§5.1.1 Public Offerings—Issuers, Underwriters, Dealers, and Investors

To understand the Securities Act's operation, you should understand the way securities are generally sold to the public. In a typical "firm commitment" offering, the marketing of securities occurs much as the marketing of other products to the public. The "issuer" (the company that creates the securities) sells the full issue to "underwriters" (wholesalers) who resell them to "dealers" (retailers) who sell them to "investors" (consumers).

The process of getting securities from issuer to the investing public is known as a "public distribution." The issuer can be any person or entity selling an investment interest—usually a corporation raising capital by selling equity or debt securities. Underwriters and dealers are generally securities firms, which specialize in evaluating, recommending, buying, and selling securities. Well-known securities firms involved both in the business of underwriting (known as "investment banking") and the retail business include Merrill Lynch (part of Bank of America) and Goldman Sachs (mostly institutional customers). Investors come in many sizes and varieties. Some are unsophisticated retirees; others are enormous mutual fund groups with sophisticated investment advisers. See §19.2.

§5.1.2 Registration and Mandated Disclosure—Section 5 of the Securities Act

The purpose of the Securities Act is full disclosure to investors in public offerings. The Act accomplishes this principally by requiring the filing and dissemination of disclosure documents. The regulatory centerpiece is §5 of the Securities Act, which broadly prohibits the sale of *any* security using the mails or other interstate means of communication unless (1) the issuer has filed a disclosure document ("registration statement") with the SEC, and (2) the registration statement has become effective.

Section 5 also requires that investors receive a disclosure document known as a "prospectus." The prospectus forms the main part of the registration statement and contains information about the company, its business, and its risks, its management, the securities being offered, the purpose of the offering, the company's capital structure, and its financial performance. The financial statements must be audited and certified by independent accountants. Registration statements are public documents and, once filed with the SEC, are available on the EDGAR database at *www.sec.gov*.

During the registration period, disclosure to investors and securities markets is strictly controlled and sometimes even prohibited. Before the registration statement is filed, marketing of the offering is significantly curtailed. After the registration statement is filed and before it becomes effective (the “waiting period”), marketing is mostly limited to oral communications and dissemination of the preliminary (“red herring”) prospectus. (Recent rule changes give well-known, seasoned issuers greater freedom in their registration-period communications.) A violation of the disclosure rules during the registration period can force the issuer and underwriters to abandon the offering. Once the registration process is complete, the SEC permits the registration statement to become effective, and securities sales can commence. The SEC has no authority to stop an offering simply because of doubts about its merits, such as because the agency believes that the firm’s business plan is flawed or its management is overcompensated. It is enough if these matters were disclosed in the prospectus for evaluation by investors.

SEC registration is time-consuming, expensive, and intrusive. The issuer’s executives must gather information and ensure the accuracy of the prospectus. The issuer must also have its financial statements audited by an independent accounting firm. The issuer must retain legal counsel, typically a large, high-priced law firm. The underwriters, who also retain separate legal counsel, charge commissions or fees. And once an issuer “goes public,” it becomes subject to ongoing SEC disclosure requirements.

§5.1.3 State “Blue Sky” Laws

Originally, the Securities Act contemplated that securities offerings would also be subject to regulation under state securities laws—known as “blue sky” laws. These laws (which vary widely) contain a mix of three basic regulatory devices: (1) antifraud provisions that give state administrators authority to act against false or misleading statements in the sale of securities; (2) licensing of securities professionals to permit state supervision and disciplining; and (3) registration of securities prior to their sale or trading, which in some states requires administrative approval of the *merits* of a particular security.

In 1996, responding to claims that state “blue sky” laws impose more costs than benefits, Congress amended the Securities Act to preempt state

regulation of many securities offerings. Specifically, §18 now prevents states from regulating offerings of "covered" securities, which include securities listed on the New York Stock Exchange or the National Association of Securities Dealers Automated Quotations (NASDAQ) National Market System, or securities exempt from registration under §4(a)(2) (private placements under SEC Rule 506, see §5.2.2 below) or under §4(a)(6) (crowdfunding offerings, see §5.2.3 below).

The preemption, however, is not complete. States still can bring antifraud proceedings when securities are sold fraudulently and, for covered offerings not on an exchange or NASDAQ, states can collect fees and require filing of documents "substantially similar" to those filed with the SEC. States also can require full-blown registration of offerings subject to the intrastate exemption and the small-offering exemptions of Regulation A and Regulation D (see below).

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§5.2 EXEMPTIONS—TEMPERING SECTION 5 OF THE SECURITIES ACT

Broad exemptions temper the sweep of §5's prohibition against offerings of unregistered securities. Exempted from Securities Act registration and mandatory disclosure requirements are

- transactions in trading markets
- nonpublic (or private) offerings
- intrastate offerings by local issuers to local investors
- small offerings, as defined by SEC rules
- crowdfunding offerings, as defined by SEC rules

Because SEC registration is expensive and intrusive, many securities lawyers devote a big part of their practice to helping clients gain an exemption from registration. In fact, most offerings of securities (particularly by smaller companies seeking to raise less than $20 million in capital) are structured as exempt offerings. Bear in mind, however, that none of the exemptions discussed below shields sellers from the antifraud provisions of the Securities Act or the Exchange Act (in particular, Rule 10b-5; see Chapter

22).

§5.2.1 Intrastate Offerings

To permit local offerings that are subject to state jurisdiction, the Securities Act exempts from its registration and disclosure requirements any offering made and sold only to residents within a single state. §3(a)(11). The exemption is narrow and strict, and relying on it is risky.

- **In-state issuer.** The issuer must reside and be doing business in the state of the offering. A corporation "resides" in the state of its incorporation. An issuer "does business" in a state if its revenues, assets, and principal office, as well as use of the proceeds of the offering, are principally in-state.
- **In-state offering.** The offering can be made only to in-state residents—actual residence and domiciliary intent controls. The statutory exemption is lost if any sale *or* offer (even one that does not result in a sale) is made to an out-of-state resident. The exemption is also lost if any in-state purchaser acts as a conduit and resells to out-of-state investors. The issuer cannot rely on representations by in-state purchasers.
- **Part of one issue.** The intrastate offering cannot be part of a larger offering in which there are out-of-state investors. Any other offers or sales that are part of the same offering must comply with the in-state restrictions.

The SEC has clarified and eased some of these requirements in a regulatory "safe harbor" rule. Under Rule 147 an issuer qualifies for the intrastate exemption if at least 80 percent of its revenues, assets, and proceeds are in-state; a purchaser's residence is determined without reference to domiciliary intent; resales to out-of-state investors are permitted beginning nine months after the initial offering; offers by in-state purchasers to out-of-state residents are forgiven so long as there is no actual sale during the nine-month holding period; other offerings conducted six months before or after the intrastate offering are separate. But, as with the statutory exemption, any sale or offer to an out-of-state investor by an issuer destroys the entire exemption.

§5.2.2 Nonpublic (Private) Offerings

The most important Securities Act exemption for issuers seeking to raise capital is the "private placement" exemption. §4(a)(2) (any offering "by an issuer not involving any public offering"). Without it, virtually every effort to raise capital—regardless of who the investors are—would be subject to the expense and burden of the Act's registration and disclosure process.

The private placement exemption exists in two forms: (1) the §4(a)(2) statutory exemption that provides a complete exemption from the disclosure and registration requirements of the Securities Act, and (2) a regulatory exemption (Rule 506 of Regulation D) created by the SEC to provide greater certainty to issuers, but conditioned on disclosure to certain investors.

Statutory Exemption

Courts have interpreted the §4(a)(2) statutory exemption to be available if the offering meets the following criteria:

- **Qualified investors.** Each investor (as well as each person receiving an investment offer, "offeree") must meet a sliding-scale test that factors both her ability to evaluate the investment (given her business and investment sophistication) and the availability of information (based on both her access to it and its actual disclosure). The less sophisticated the investor, the more disclosure required; the more sophisticated, the less disclosure required.

  In *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), the Supreme Court defined the scope of the §4(a)(2) exemption. The case involved Ralston Purina's policy of selling company stock to employees who on their own initiative sought to invest. Hundreds of different employees (including chow loading foremen, stock clerks, and stenographers) had purchased unregistered stock from the company. The Court held that the exemption applies when offerees and investors, regardless of how many there are, are "able to fend for themselves." The Court gave as an example "executive personnel" with access to the same kind of information available in a registration statement. In the case, many of the Ralston Purina employees lacked this access, and the Court held that Securities Act registration was required.

- **Restricted securities.** The §4(a)(2) exemption is lost if qualified investors resell to unqualified investors who cannot "fend for themselves." For this reason securities sold in a private placement are known as "restricted securities," and issuers will often seek to preserve their exemption by placing contractual restrictions on the transfer of the securities. Transfer limits are noted on the security certificates, and the issuer will instruct its transfer agent (usually a bank that keeps records on share ownership) not to record any transfer unless it complies with or is exempt from the Act's registration requirements.
- **Strict compliance.** Private offerings under §4(a)(2) can be made only to investors and offerees with the requisite sophistication and access to information. A sale or offer to just one unqualified investor (or to the public at large) causes the exemption to be lost for all.

There is no maximum either on the dollar size of a private offering or the number of offerees and investors. In fact, it is not uncommon for issuers to use the §4(a)(2) statutory exemption for private placements that raise many millions of dollars and are sold to many institutional investors. Nonetheless, the larger the group to whom offers or sales are made, the more likely some will not be qualified, thus putting the entire offering at risk.

Regulation D—SEC Regulatory Exemption

In response to concerns from small business about the expense of Securities Act registration, the SEC has promulgated a set of rules, known as Reg D, that give detailed guidance on when an offering qualifies for the private placement exemption of §4(a)(2). Rule 506. Reg D also exempts certain "small offerings" as authorized by §3(b) of the Securities Act. Rules 504, 505.

The three Reg D exemptions turn on (1) the dollar amount of the offering, (2) the number and kinds of investors (as opposed to offerees) who participate in the offering, (3) whether the Reg D offering is part of a larger offering, (4) the kind of advertisement used, and (5) the kind of information provided investors. Since their promulgation in 1982 the SEC has modified Reg D a number of times. The description below is as of 2008:

- **Rule 504—small offerings subject to state "blue sky" law.** Nonpublic

companies can sell up to $1 million in securities in any 12-month year. There is no limit on the number or kinds of investors or any disclosure requirement. But general advertising and solicitations are not permitted, and the securities issued under the exemption are "restricted." To avoid these marketing and liquidity restrictions, small issuers can either (1) register the offering under a state blue sky law that requires public filing and delivery to investors of a disclosure document, or (2) limit the offering to "accredited investors" (see below) under any state exemption that allows general solicitations.

- **Rule 505—medium-sized offerings subject to SEC conditions.** Companies (except investment companies and those disqualified under the SEC's "bad boy" criteria) can sell up to $5 million in securities in any 12-month period. No general advertising or solicitations are permitted. The offering can be sold to an unlimited number of "accredited" investors, but there can be no more than 35 "nonaccredited" investors. All nonaccredited investors must receive specified written disclosure and an opportunity to ask questions of the issuer. Securities acquired pursuant to Rule 505 become "restricted securities."
- **Rule 506—private offerings subject to SEC safe-harbor conditions.** Any company (provided it is not disqualified under the SEC's "bad boy" criteria) can sell an unlimited amount of securities under the same conditions as Rule 505, with two provisos. First, broad marketing of Rule 506 offerings is permitted, so long as the issuer ends up selling only to accredited investors. Second, if any sale under Rule 506 is made to nonaccredited investors, each of these investors (alone or with her purchaser representative) must have sufficient knowledge and experience in business and financial matters so she can evaluate the merits and risks of the investment. Rule 506 is a nonexclusive safe harbor—thus, an offering that does not satisfy all the rule's conditions may still be exempt under §4(a)(2).

Accredited Investors

The Reg D exemptions thus depend on whether particular investors are accredited. Rule 501 of Reg D defines various categories of accredited investors, which include:

Accredited Investors	
Institutional investors	banks, savings institutions, brokerage firms, insurance companies, mutual funds, and certain Employee Retirement Income Security Act (ERISA) employee benefit plans
Big organizations	tax-exempt organizations and for-profit corporations with more than $5 million in assets
Key insiders	the directors, executive officers, and general partners of the issuer
Millionaires	individuals who have a net worth (along with spouses) of over $1 million, not counting the value of their primary residence — this amount is to be adjusted by the SEC
Fat cats	individuals who have had for two years, and expect to have, an annual income of at least $200,000 (or $300,000 with their spouse) — these amounts are to be adjusted by the SEC
Venture-capital firms	firms that invest in start-up companies to which they then provide significant managerial assistance
Sophisticated trusts	trusts that have over $5 million in assets and are run by someone with the knowledge and experience to evaluate the merits and risks of the investment

Reg D assumes that investors that fall into these categories either have the sophistication to fend for themselves or the financial resources to seek the help of a sophisticated investment advisor.

SEC Filing and Noncompliance

The issuer must file an informational notice (describing itself and its Reg D offering) with the SEC within 15 days after the first sale. Rule 503(a) (Form D). Even if an issuer fails to comply with Reg D, the exemption is not lost if the issuer shows that the failures were insignificant and noncompliance was immaterial to the particular investor seeking to avoid the exemption. Rule 508(a).

Actual Use of Reg D

Despite the SEC's intention that smaller issuers would use Rule 504, medium-sized issuers Rule 505 or Regulation A (described next), and large issuers Rule 506, experience under the SEC exemptive rules has been quite different. In a study of exempt securities offerings during the period 2008-2010, Professor Rutherford Campbell found that only a handful of issuers used Rule 504 or 505 (or Reg A); instead, most used Rule 506 and then generally only with accredited investors:

Exempt Offerings (2008-2010)			
	Number	Percent	Only AI*
Reg D	27,234		
Rule 504	1,196	4.4%	59.3%
Rule 505	447	1.6%	56.5%
Rule 506	25,591	94.0%	91.2%
Reg A	46		

* Based on sample of 1,000 Reg D offerings

It is perhaps understandable that Rule 506 has been the predominant SEC exemption used by issuers, given its preemption of state "blue sky" laws. Given this advantage, Rule 506 has been the preferred rule regardless of the size of the offering, with Rule 506 used 78.6 percent of the time for Reg D offerings of less than $1 million and 91.9 percent of the time for Reg D offerings of between $1 million and $5 million.

§5.2.3 Small Offerings

Under §3(b)(1) of the Securities Act, the SEC has authority to exempt offerings of less than $5 million. In addition to the Reg D exemptions of Rules 504 and 505 (discussed above), the SEC has adopted Regulation A pursuant to this authority. Reg A exempts offerings by nonreporting companies of up to $5 million provided the issuer follows a simplified "mini-registration" process. See Rules 251—264. The exemption permits the use of a simplified question-and-answer disclosure document, and financial information need not be audited.

In addition, the JOBS Act of 2012 authorized the SEC to exempt offerings of up to $50 million over a 12-month period. See §3(b)(2). As proposed, Regulation A+ would allow issuers to file a streamlined offering statement with the SEC and gauge investor interest before making the offering. Unlike Regulation A, proposed Regulation A+ would make issuers subject to ongoing disclosure requirements, including the filing of annual audited financials. But Regulation A+ offerings sold only to qualified investors (as defined by the SEC) would be preempted from state "blue sky" laws.

§5.2.4 Crowdfunding Offerings

Under still-to-be-finalized SEC rules, small U.S. issuers will be able to raise up to $1 million in any 12-month period from many small investors via the Internet—the so-called crowdfunding exemption. New §4(a)(6) (added by the JOBS Act of 2012). The exemption imposes individual investment caps based on investors' annual income and net worth, and requires the issuer to sell the securities through an intermediary—either an SEC-registered securities firm or a funding portal. Securities sold in a crowdfunding are subject to strict limits on advertising and restrictions on resale.

Financial crowdfunding permitted by SEC rules—as opposed to social or charitable crowdfunding, such as through www.kickstarter.com—is in its infancy. It is unclear whether crowdfunding intermediaries (which become jointly and severally liable for any material misrepresentations in the offering documents) will emerge or whether small investors will invest in untested companies that have limited financial histories. Nonetheless, crowdfunding represents an opportunity for small issuers that want to raise money from nonaccredited investors and avoid both SEC registration and state "blue sky" laws.

§5.2.5 Exemptions for Postdistribution Market Trading

Ordinary trading—such as on stock exchanges or between investors—is exempt from the Securities Act's registration and disclosure requirements. Section 4(1) exempts any transaction by a person *other than* an issuer, an underwriter, or a dealer (during the initial distribution of an offering). The effect of the §4(1) exemption—along with the exemptions for postdistribution market transactions by dealers in §4(3) and for broker transactions in §4(4)—is that only transactions that are part of the *distribution* of securities are subject to the Act's registration and disclosure requirements.

Defining a Distribution

The §4(1) exemption has some hidden catches because of the way the Act defines a statutory "underwriter." An underwriter is defined under §2(a)(11) to include any person (1) who purchases shares from an issuer "with a view to" their further distribution, or (2) who offers or sells shares "for an issuer" in connection with a distribution. In short, an underwriter is any person who

acts as a conduit or agent for an issuer's securities into a public market.

As a result of this definition, the distribution of securities becomes a surprisingly broad concept. For example, a shareholder who owns *restricted securities* cannot resell them into a public trading market unless they are first registered. If the shareholder purchased the securities "with a view" to public distribution, their resale in a public trading market is known as a "secondary distribution," and the selling shareholder is deemed a statutory underwriter. This means that the holder of restricted securities must either have the issuer register the securities or wait until they have "come to rest" with him so their subsequent resale is not viewed as part of a distribution.

In addition, any person who acts as a conduit or agent for a *control person* is also defined to be an underwriter. (A control person is anyone who because of his position or shareholdings has access to confidential corporate information and the power to have the corporation register shares under the Securities Act.) For example, a brokerage firm that assists a control person to sell his shares on a public trading market is subject to the Act's registration requirements, just as if the assistance had been to the issuer. To prevent abuses by control persons, whose unregistered sales pose similar dangers as unregistered sales by an issuer, the §2(a)(11) definition limits the ability of controlling shareholders and corporate executives to sell their shares in a public trading market.

Rule 144—Safe Harbor for Secondary Market Transactions

The SEC permits the resale of restricted shares and resales by control persons into public markets *without registration* under an important safe harbor—Rule 144. Under the rule (as revised in 2008), conditions for reselling securities vary depending on whether the seller is a noncontrol or control person, whether the resale is of restricted or nonrestricted shares, and whether the issuer is a reporting or nonreporting company.

Rule 144 Conditions	
Resales by noncontrol persons of restricted securities	**Holding period:** 6 months for securities of reporting company, and 12 months for securities of nonreporting company **Issuer information:** current public information for reporting company, during 12 months before resale
Resales by control persons (restricted or nonrestricted securities)	**Holding period:** 6 months for securities of reporting company, and 12 months for securities of nonreporting company* **Trickle:** during 3-month period, resales of no more than 1% of outstanding equity securities or average weekly trading; resales of no more than 10% of tranche (class) of debt securities **Sale method:** brokers' transactions (can't solicit buyers) for equity securities **Issuer information:** current public information, whether reporting or nonreporting company **Notice:** must disclose on Form 144 the sale of more than 5,000 securities or more than $50,000

*No holding period for resales by control persons of nonrestricted securities.

Thus, noncontrol persons can resell their restricted shares without limit after a 12-month holding period (and after a 6-month holding period, if the issuer is a reporting company current in its periodic filings). Control persons (whose informational advantages are presumed) must always abide by the various resale conditions, though no holding period applies to their resales of nonrestricted shares.

Examples

1. Adam, Boone, and Carver are friends, ardent outdoorsmen, and weekend chefs. They fix on a new concept in dining—a rustic outdoor restaurant offering a menu of muskrat steaks, squirrel sausage, and hickory ale. They form Outdoor Cafes, incorporated in the state of Mayflower, to operate the business in Mayflower. Each invests $100,000 and receives 100,000 shares of stock. Adam will manage the restaurant; Boone and Carver will be passive investors.
    a. Has Outdoor Cafes violated §5 of the Securities Act by issuing stock to Adam, Boone, and Carver?
    b. Adam and Boone are Mayflower residents; Carver lives in the adjoining state of New Columbia, though he covenants to be subject to Mayflower jurisdiction. Is Outdoor Cafes' issuance of stock

exempted from registration by §3(a)(11)?

   c. After learning that Carver is from New Columbia, Adam and Boone decide that each will buy $150,000 of stock and later resell $50,000 to Carver. Is the intrastate offering exemption available, and does Rule 147 help?
   d. Adam has little wealth, though some experience running an eating establishment. Boone is a well-to-do physician who enjoys hunting and investing in start-up restaurants. Carver is a struggling securities lawyer with a modest investment portfolio. Is the issuance of Outdoor Cafes' stock to them exempted from registration by §4(a)(2)?

2. After five years Outdoor Cafes becomes a success. Adam, Boone, and Carver plan to open new restaurants throughout New England. They will need about $3 million, which they can raise by selling 300,000 new shares at $10 each to personal acquaintances and angel investors who look for these kinds of start-up companies. Many investors will be from outside Mayflower.
   a. Outdoor Cafes expects to raise the $3 million by selling to about 40 investors: Ten have net worth of over $1 million; another ten have incomes of over $200,000; another ten are intimately familiar with the restaurant business; the last ten are relatives of Adam, Boone, and Carver. Can Outdoor Cafes rely on Regulation D?
   b. Zach, who knows Adam because they have gone on hunting trips together, is a cross-country truck driver with minimal investment and business experience. He nonetheless has a net worth of $750,000. Can Outdoor Cafes sell stock to Zach under Rule 506?
3. Outdoor Cafes uses Rule 505 to avoid Securities Act registration.
   a. It places an advertisement in *Outdoor Life*, a national publication, soliciting interest in the company's offering. No sales are made through this advertisement except to accredited investors. Is this permitted?
   b. Adam, Boone, and Carver talk to Jane, who works for an investment firm that advises start-up businesses on how to raise money from angel investors. She agrees to help in the offering, and the investment firm's next mailing to its clients includes a reference to the Outdoor Cafes offering. Is this mailing permitted?

   c. Adam, Boone, and Carver send 60 letters to squirrel sausage-loving friends and acquaintances who have inquired about investing in their business. Of those who receive the letters, 50 do not satisfy the definition of an accredited investor. Is this mailing permitted?
   d. Adam, Boone, and Carver have identified exactly 35 nonaccredited friends and family members who are interested in buying stock. They also consider whether to sell to Michelle, a Hollywood producer, who has a current personal net worth of over $2 million but is squandering her fortune. Can they sell to Michelle?
4. The Outdoor Cafes issue took place under Rule 505 in August last year and was a complete (and legal) success.
   a. In January this year, Michelle, who purchased 10,000 shares, wants to resell 5,000 to her gardener George. Can Michelle sell?
   b. In January this year, Michelle wants to sell all her shares to Adam, who is still the Outdoor Cafes president. Can Michelle sell?
   c. In December this year, Michelle wants to resell all 10,000 shares to George, her still-unsophisticated gardener. Outdoor Cafes is still owned by only 50 shareholders and does not make public reports of its financial condition. Can Michelle sell?
5. In August this year, Outdoor Cafes registers and makes an initial public offering (IPO) of 1 million shares. After the IPO, a trading market in Outdoor Cafes stock develops, and the company becomes subject to and complies with the periodic reporting requirements of the Securities Exchange Act of 1934 (see §21.2.2). Two months after the $20 IPO, the price of Outdoor Cafes stock rises to $28.
   a. Adam, who acquired his stock ten years ago, wants to sell 20,000 of his 100,000 shares through his stockbroker at the current market price. Can he?
   b. Michelle, who purchased 10,000 shares 16 months ago pursuant to Rule 505, wants to immediately sell all her shares through her broker, who will actively solicit buyers. Can she?

Explanations

1. a. Possibly. It depends on (1) whether the mails or other interstate means of communication were used during the issuance, and (2) whether there is an exemption.

It is virtually impossible to avoid using the mails in a securities transaction. If the parties transact a check, which will be cleared through the mails, §5 prohibits the sales to Adam, Boone, and Carver unless Outdoor Cafes registers the stock with the SEC or there is an exemption. To know if an exemption applies, we must know much more.

b. No. The intrastate offering exemption requires that each investor be from the same state as the issuer, in this case Mayflower. Because Carver is a New Columbia resident, regardless of any representation or covenant to the contrary, the entire offering (including the sales to Adam and Boone) fail the intrastate offering exemption.

c. No, under the statute; perhaps, under the safe-harbor rule. The statutory exemption is not available because Adam and Boone purchased their stock "with a view" to reselling to an out-of-state resident. See Securities Act §2(a)(11) (definition of underwriter). They become statutory underwriters, and their resales to Carver—no matter when they occur—would be viewed as part of the original distribution, thus disqualifying the entire offering under the statutory §3(a)(11) exemption.

If, despite their resale intention, Adam and Boone held on to their stock for nine months, Rule 147 would provide a safe harbor for their resales. But there is a twist. If Carver had agreed to this arrangement from the outset, it might be possible to characterize his original agreement as one to purchase from the company through Adam and Boone. If so, it would be an out-of-state sale, occurring during the nine-month holding period.

d. Probably. The nonpublic offering exemption of §4(a)(2) requires that each investor meet a sliding-scale test that factors both their ability to evaluate the investment and the availability of information (both their access to it and its actual disclosure). As manager of the business, Adam would seem to satisfy the test because his business knowledge and access to inside information enable him to fend for himself.

Boone and Carver may also qualify. Their status as "weekend chefs," their personal relationship to Adam (and hence their indirect access to investment information), their investing experience, and their apparent wealth (and hence their ability to bear the risk and to afford

sophisticated representation) indicate they can evaluate (or have someone else evaluate) the investment and its risks. Nonetheless, if either Boone or Carver fails the test, the private offering exemption is lost as to the whole issue.

2. a. Yes, using Rule 505. Rule 505 allows for offerings of up to $5 million each year. Because Outdoor Cafes plans to raise more than $1 million, Rule 504 is unavailable. And, although Rule 506 has no dollar limit, it is not clear that all of the nonaccredited investors (or their investment representatives) meet the experience and sophistication requirement of Rule 506.

   Rule 505 allows for the sale to up to 35 nonaccredited investors. Twenty of the investors (the "millionaires" and $200,000 "fat cats") are accredited under Reg D and do not count against this limit. The other 20, on the facts, are nonaccredited. If any sales are made to these nonaccredited investors, they must be provided specified disclosure—in a Reg D offering typically called an "investment circular." The experience and sophistication test of Rule 506, however, would not apply in a Rule 505 offering.

   Although the offering would seem to meet the conditions of Rule 505, it would still be subject to state "blue sky" laws—and would either have to find a state exemption (unlikely) or be subject to state registration. For this reason, few issuers rely on Rule 505.

   b. Probably not, unless Zach has an investment representative. Zach is nonaccredited and would have to meet (alone or with an investment representative) the sophistication criteria of Rule 506. This presents a significant disadvantage compared to Rule 505. The issuer must reasonably believe that each nonaccredited investor (alone or with his purchaser representative) has knowledge and experience in business and financial matters so he can evaluate the merits and risks of the investment.

   Rule 505 has no such requirement because it derives from the small offering exemption of §3(b) of the Securities Act. On the other hand, Rule 506 is a safe-harbor rule for the private offering exemption of §4(a)(2).

3. a. No. General advertising is not allowed in a Rule 505 offering—though it would be permitted in a Rule 506 offering sold only to accredited

investors. See Rule 502(c). The reason for this prohibition, which has been controversial, is to prevent the promotion of speculative schemes, which generally depend on widespread advertising or solicitations.

b. Yes. Inclusion in a mailing to angel investors *who are clients of the firm* is not a general solicitation. According to the SEC, if the issuer or its representative has a "preexisting relationship" with the solicited investors, it is not a general solicitation. Those who receive the mailing have shown an interest in such investments; Jane is not softening the market or widely touting a speculative scheme, and many of the recipients will probably qualify as accredited investors.

c. Probably. This mailing does not seem to be a general solicitation because it is directed to those who had before expressed an interest in buying the company's stock—a "preexisting relationship." There seems little risk of creating a "speculative mania." Further, Rules 505 and 506, unlike the §4(a)(2) statutory exemption, allow offers to nonaccredited investors as long as the final number of nonaccredited *purchasers* does not exceed 35. Unlike the statutory exemption, offers to nonaccredited investors (even if they have no investment representative when they receive the offer) do not undermine the Reg D exemption.

d. Yes. Rule 505 (like Rule 506) places no limit on the number of *accredited* investors who can purchase under the rule. Michelle satisfies the Reg D criteria for a "millionaire"—a person whose personal net worth exceeds $1 million. Even though she may not be able to appreciate the investment or its risks and would not meet the sophistication requirements of Rule 506 if she were nonaccredited, this makes no difference because she fits one of the "accredited investor" categories. Reg D is a safe harbor.

4. a. Almost certainly no. All securities acquired under Rule 505 are treated as restricted securities and cannot be sold unless their resale is itself registered or an exemption is available. See Rule 502(d). But no exemption seems to be available. The intrastate offering exemption of §3(a)(11) and the private placement exemption of §4(a)(2) are available only to issuers—Michelle would not be selling for the issuer when she resells to George.

The market trading exemption of §4(1), which at first blush seems

it might apply, is unavailable because Michelle is probably a statutory underwriter. The definition of an underwriter includes anyone who buys stock "with a view" to its distribution to the public. Michelle, because of the short time she has held the securities, probably will be seen as having purchased her shares with a view to reselling them. The sale to George is a public "distribution" because George does not appear to be an investor who can fend for himself.

The safe harbor Rule 144 does not apply because Michelle has not held the shares for more than 6 months, the minimum holding period for noncontrol persons who wish to resell restricted shares.

b. Probably. The market trading exemption of §4(1) seems to apply. In her sale to Adam, Michelle fails the definition of a statutory underwriter. Although Michelle's quick resale to Adam might indicate that she purchased her shares with a view to their resale, the sale to Adam is not a *public* "distribution," which the Securities Act is meant to regulate. Adam qualifies as an investor who can fend for himself, and Michelle's sale to Adam would not be a "transaction by an issuer, underwriter, or dealer" and thus would be exempt under §4(1).

c. Perhaps. The market trading exemption of §4(1) depends on Michelle's intentions when she originally bought the stock. If Michelle originally purchased with "a view to" resell them, they remain restricted. Any sale to an unsophisticated investor (or in a public market) would be a prohibited public distribution, no matter how long Michelle holds on to the shares.

Nonetheless, original intentions are rarely clear. Michelle has held the stock for more than a year, negating a resale intention. Under the safe harbor Rule 144, she can resell without limitation because she satisfies the one-year holding period for resales by noncontrol persons of restricted shares. Securities lawyers would say that the stock had "come to rest" with Michelle, and she may now resell without being considered a statutory underwriter.

The resale conditions of Rule 144, such as the requirement that the issuer be a reporting company or that notice be given if more than 5,000 shares are sold, do not apply to resales by noncontrol persons who have held for more than 12 months.

5. a. Yes, but he must comply with the conditions of Rule 144. As a control

person, Adam cannot sell into a public stock market using an intermediary unless he complies with the conditions of Rule 144. He must "trickle" his stock into the market—selling no more during any three-month period than 1 percent of Outdoor Cafes' outstanding shares or its average weekly trading volume. Adam must also provide notice to the SEC because he will sell more than 5,000 shares. Otherwise the conditions of Rule 144 appear to be met: current public information about Outdoor Cafes is available, and Adam has held his "restricted shares" for more than one year.

b. Yes. Rule 144 permits noncontrol holders of "restricted shares" to resell without conditions if they have held their stock for more than one year (before 2008, this was two years). Michelle is not subject to any "trickle," public information, broker sales, or filing requirements.

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§5.3 CIVIL LIABILITY UNDER SECURITIES ACT

Civil liability under the Securities Act is structured along three themes:

- **Statutory rescission for violations of §5.** To protect the integrity of the Act's mandatory disclosure system, investors can rescind their investment if there was any violation of the §5 registration and disclosure requirements. Securities Act §12(a)(1) (numbered §12(1) before 1995).
- **Antifraud liability for false registration statement.** Investors in a *registered* offering can recover any losses from specified participants if there are material misrepresentations or omissions in the registration statement (or prospectus). Securities Act §11.
- **Antifraud liability for falsehoods in public offering.** "Sellers" in public offerings are liable for material misrepresentations made in the prospectus or orally. Securities Act §12(a)(2) (numbered §12(2) before 1995).

Sale of unregistered securities in violation of §5, or generally the

deceptive sale of securities, is also subject to administrative and criminal sanctions.

§5.3.1 Section 12(a)(1)—Rescission for Violations of §5

Section 12(a)(1) is a simple and powerful provision that enforces the registration and prospectus dissemination requirements of §5. Whenever securities are offered or sold in violation of §5, any purchaser may rescind the transaction and get her money back with interest (or recover damages if she has resold the stock). Section 12(a)(1) thus imposes strict liability for violations of §5 and represents a significant private enforcement tool against the sale of unregistered securities for which no exemption applies.

§5.3.2 Section 11—Damages for Deceptive Registration Statements

Section 11 allows any purchaser of a *registered* security to recover damages from the issuer and others involved in the distribution if the registration statement contains any falsehoods or half-truths concerning any material fact—that is, one that a reasonable investor would consider important in deciding to invest.

Section 11 creates a complex liability scheme with

- specifically enumerated defendants
- convoluted nonculpability ("due diligence") defenses
- intricate formulas for computing damages
- allocation of liability among defendants
- tricky limitations period

Plaintiffs (purchasers in the offering) need only identify material untruths or omissions of material facts in the registration statement. Section 11 thus modifies the elements of common law fraud and equitable contract rescission. Plaintiffs need not prove the defendants' culpability, though each defendant (except the issuer) has a defense based on the defendant's diligence in

checking the registration statement. Plaintiffs need not show actual reliance on the claimed untruths or omissions, or even that they read the prospectus—though there is a defense if the investor knew of the claimed untruths or omissions when she bought the securities. Plaintiffs need not prove the claimed misinformation caused their losses, though defendants have a "comparative causation" defense if the plaintiffs' losses were due to factors other than the misinformation.

Section 11 Defendants

As we have seen, a public offering is similar to the distribution of consumer products—from issuer through intermediaries to final purchaser. Just as modern products liability law cuts through old privity requirements, §11 specifies a list of potential defendants, most of whom are not in privity with investors:

- the issuer (who is strictly liable regardless of fault)
- the issuer's directors (whether or not they signed the registration statement)
- the issuer's senior executives who signed the registration statement
- the underwriters of the offering (though each is generally liable only to the extent of its relative participation in the offering)
- any expert whose opinion is used in the registration statement (such as the accounting firm that audits the company's financial statements)

To ensure full and honest disclosure for investors, §11 is purposefully designed to put fear in the hearts of potential defendants and create a diligent group of disclosure watchdogs.

"Due Diligence" Defenses

Very few litigated cases actually impose liability under §11. Instead, most cases are settled. Nonetheless, the section's staggering *potential* liability and its due diligence defenses mold the way in which participants in registered offerings behave.

What is "due diligence"—besides something often assigned to junior securities lawyers. Due diligence is the investigation by potential defendants of the information contained in the registration statement and prospectus—a

task usually delegated to outside law firms and, within those firms, often to junior associates.

The level of diligence due varies according to who prepared (or certified) the information later attacked as false or misleading. It also depends on whether the false or misleading information arose in those portions of the registration statement certified by an expert, such as financial information audited by an accounting firm or legal opinions given by lawyers—the "expertised" portions. All other portions, including most of the registration statement, are nonexpertised.

The due diligence defenses for experts and nonexperts are as follows:

Due Diligence Defenses

	Expertised portion	**Nonexpertised portion**
Expert	Must investigate and believe information is true (ignorance is no excuse)	No liability
Nonexpert	No reasonable ground to believe information is false (ignorance is excuse)	Must investigate and believe information is true (ignorance is no excuse)

Although the statute does not explicitly create different standards for different defendants, courts have used a variable yardstick to judge when each defendant's investigation is sufficient.

Consider the leading case on §11 due diligence, *Escott v. BarChris Construction Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968). The case involved a bowling alley construction company whose registration statement in a debt offering seriously misstated the company's financial position and its exposure to losses. The principal issue in the case was whether the nonissuer defendants had made out their §11 due diligence defenses. The court carefully analyzed each defendant's position with the company, his role in the offering, and his access to critical information. In the process, the court identified a continuum of "reasonable investigation" and "reasonable belief." Company insiders who had responsibilities that gave them broad access to company information were treated as virtual guarantors of the registration statement's accuracy. But nonemployee outsiders who did not have an advisory relationship were required only to read the registration statement and follow up on obvious discrepancies. See Rule 176 ("reasonable investigation" varies according to position and relationship to issuer).

§5.3.3 Section 12(a)(2)—Rescission for

Misrepresentations

Section 12(a)(2) is an antifraud provision that picks up where §11 leaves off. Purchasers in an offering may seek rescission from "statutory sellers" if the offering is carried out "by means of a prospectus or oral communication" that is materially false or misleading. Reliance and causation are not elements of the claim, though sellers have a defense if they show the purchaser knew of the misstatement or if the claimed losses represent "other than the depreciation in value … resulting from" the challenged misstatements. See §12(b). In addition, defendants have a "reasonable care" defense if they show they did not know (and reasonably could not have known) of the misinformation.

Section 12(a)(2) does not require privity, but extends to those who actively solicit purchases and do so for gain—so-called statutory sellers. See *Pinter v. Dahl*, 486 U.S. 622 (1988). This means that collateral participants in a securities offering, such as lawyers and investment advisers, who assist in the selling effort risk becoming liable.

The scope of §12(a)(2) has been significantly, though ambiguously, restricted by the Supreme Court. See *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) (holding that misrepresentations in sales contract to outside investor group were not actionable under §12(a)(2) because the contract was not a "prospectus"). The decision, which surprised the securities community, stated that §12(a)(2) liability is limited to misrepresentations in prospectuses used in registered public offerings. The Court thus abandoned decades of uniform case law that §12(a)(2) also covers written misrepresentations made in exempt private sales, such as private placements under §4(a)(2). Whether §12(a)(2) extends to exempt offerings that use "prospectus-like" offering circulars remains an open question.

Liability in Crowdfunding

As part of the new crowdfunding regime (see §5.2.4 above), the JOBS Act of 2012 creates a liability scheme for issuers and intermediaries participating in an exempt crowdfunding offering similar to that of §12(a)(2).

Under new §4A(c) of the Securities Act, crowdfunding purchasers can bring an action in federal or state court to rescind their investment or seek damages from crowdfunding defendants that make materially false or misleading statements (oral or written) in the offering, provided the purchaser

did not know of the untruth or omission. §4A(c)(1), (2)(A).

Crowdfunding defendants include the issuer, its top managers who participate in the offering (specifically directors or partners, principal executive officers, principal financial officers, and principal accounting officers), intermediaries participating in the offering (including securities brokers and crowdfunding portals), and any other "person who offers or sells" securities in the offering. §4A(c)(3).

There is a "due care" defense for crowdfunding defendants (including the issuer) similar to the defense under §12(a)(2). Thus, defendants can avoid liability by proving that they did not know, and in the exercise of reasonable care could not have known, of the deception. §4A(c)(2)(B).

Finally, a crowdfunding action is subject to the "loss causation" defense and the limitations periods applicable to §12(a)(2) actions. §4A(c)(1)(B). Thus, crowdfunding defendants can avoid liability to the extent that they prove the plaintiff's losses resulted from other than the claimed false or misleading statements. See §12(b). And crowdfunding claims must be brought within one year after the plaintiff discovers (or should have discovered) the alleged misinformation—but in no event more than three years after the purchase. See §13.

Examples

1. Soon after Adam, Boone, and Carver form Outdoor Cafes—each investing $100,000—Carver becomes disenchanted with his investment. Adam (the restaurant manager) had given him an offering memorandum with pro forma income statements before he invested. The statement optimistically forecasted that the restaurant would have monthly revenues of $40,000. In fact, they have averaged only $15,000. Carver has come to you for some litigation advice.
   a. You conclude an exemption from registration was unavailable. Can Carver get his money back without having to litigate the accuracy of the income statement? From whom?
   b. You conclude a private offering exemption applied to the offering and the sale to Carver. Is there another route by which Carver can get his money back?
   c. Adam approaches Carver to purchase his shares. Adam knows that a national restaurant chain is about to offer to buy Outdoor Cafes at a

significant premium, but does not tell Carver. Can Carver sue under the Securities Act?

2. Outdoor Cafes opens new restaurants in other states. To raise capital it sells its stock in a registered offering in compliance with §5. The prospectus states that the concept of a "rustic outdoor restaurant" has been tried successfully in other states besides Mayflower. The statement is false: the only such restaurants are in Mayflower. Michael buys some of the stock a couple months after the public issue. Within a year the price of the stock plummets.
   a. Can Michael sue Outdoor Cafes to recover damages? What must he show?
   b. Joseph, Outdoor Cafes' outside counsel, had drafted the prospectus. Is he liable to Michael?

Explanations

1. a. Yes. Carver can seek rescission under §12(a)(1). If the sale was made using the mails or some means of interstate communication—a virtual certainty—the sale to Carver violated §5 because (1) no exemption was available, and (2) no registration statement was filed or became effective. Section 12(a)(1) provides for strict liability and rescission. He must bring his action within one year after the illegal sale. See Securities Act §13.

   Outdoor Cafes (the issuer) and Adam are both potential defendants under §12(a)(1). Outdoor Cafes was the privity seller, and Adam actively solicited Carver's investment and stood to gain by bringing in another investor. See *Pinter v. Dahl*, 486 U.S. 622 (1988).

   b. Probably not under the Securities Act. Although courts once allowed deceived securities purchasers to seek rescission under §12(a)(2), the Supreme Court has limited the remedy to "public offerings." In addition, there can be no liability under §11 because there was no registration statement.

   Nonetheless, Carver might sue under Rule 10b-5 of the Securities Exchange Act of 1934, though he would have to prove (among other things) that Adam knew projections were false or misleading and that Carver actually and reasonably relied on the projections. See §22.3.

   c. No. The Securities Act only regulates fraud in the *sale* of securities, not

in the purchase of securities—as here. (Michael, however, can sue for this insider trading under Rule 10b-5; see Chapter 23.)

2. a. Perhaps. Michael could seek damages under §11 from Outdoor Cafes, which has no due diligence defense. Although some district courts have read *Gustafson* broadly to exclude Securities Act liability for aftermarket trading, denying §11 standing to plaintiffs who purchased their securities in the aftermarket of a registered offering, most circuit courts accept that §11 standing extends to aftermarket purchases "traceable" to the public offering. See *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

   If Michael has standing, he would need only show the prospectus contained a materially false or misleading statement. The "other states" statement was false, and its materiality depends on whether a reasonable investor would consider it important in deciding whether to invest. Because the offering was meant to raise money to expand to other states, the success of a "rustic outdoor restaurant" outside Mayflower would seem significant to the expansion's success.

   If the falsehood was material, the burden would switch to Outdoor Cafes to show that (1) Michael knew the "other states" statement was false—a reliance defense—or (2) some or all of Michael's loss was caused by factors other than the lack of non-Mayflower experience, such as a general decline in restaurant stocks—a comparative causation defense.

   b. Probably not. Joseph is liable under §11 only if he falls in one of the categories of §11 defendants. As issuer's counsel in the offering, he can be liable under §11 for "other states" falsehood only if he was a company director or a statutory underwriter by actively soliciting investors. (For this reason, lawyers are well advised not to accept positions as directors of corporate clients or to assist in the solicitation of investors.) He cannot be liable as an expert because the "other states" statement did not constitute *expertised* information certified by him.

   In addition, Joseph would be liable under §12(a)(2) for misstatements in the prospectus used in the registered offering only if he were a "statutory seller"—that is, only if he actively promoted the offering.

§5.4 DEFINITION OF SECURITY

All of the registration requirements and liability rules of the Securities Act turn on whether a transaction can be characterized as the sale of a security. What is a security?

§5.4.1 Statutory Definition

Section 2(a)(1) of the Securities Act, like the definitions of the other federal securities laws, contains a long list of financial instruments that qualify as securities: stock, bonds, debentures, notes, and transferable shares. See *Landreth Timber v. Landreth*, 471 U.S. 681 (1985) (holding that sale of a business, structured as a "stock" transaction, constituted sale of security). The section also contains some catch-all terms that qualify as securities: evidences of indebtedness, investment contracts, certificates of interest in profit-sharing agreements, and any instrument commonly known as a security.

In most cases, there is no question about whether a transaction involves the sale of a security. For example, a company's issuance of stock to new investors or the sale of limited partnership interests are unquestionably subject to the Act. The sale of real estate or the assets of a business are not. But many investment schemes fall in between. The borderline case often turns on whether the scheme involves an "investment contract."

§5.4.2 Definition of Investment Contract

The most important catch-all term in the statutory definition of securities is "investment contract." The Supreme Court has defined an *investment contract* as any transaction in which a person (1) invests money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of others. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). The Court's definition has taken on a quasi-statutory quality. Since it was first pronounced, lower courts have clarified the contours of the *Howey* test. Courts have accepted that the investment can take other forms besides money. Courts have also generally required that there be a number of investors in a common, managed pool (horizontal commonality), though some courts have held a single investor who allows another to manage his

investment is enough (vertical commonality). The expected return must come from earnings and not merely additional contributions. Finally, the requirement that profits come “solely from the efforts of others” has been interpreted to mean that someone other than the investor has contributed the *predominant* managerial effort in the common enterprise.

Basically, the *Howey* test attempts to identify transactions in which investors are counting on others to manage an enterprise that will produce returns on their investment. This definition is consistent with the purpose of the Securities Act: to ensure that capital used in the production of goods and services in the U.S. economy goes to those ventures where a well-informed market dictates it should go.

The investment contract definition has been used in surprising ways. Courts have used the definition to hold that each of the following investment schemes involves the sale of a security:

- Visitors to Florida purchased rows of orange trees, and the seller promised to handle the cultivation, harvesting, and marketing of the fruit—the facts in the *Howey* case.
- Homeowners purchased earthworms, and the seller promised to buy back all of the worms (after they reproduced at geometric rates) for a guaranteed price and market them to fishermen.
- Internet users paid for shares in “virtual companies” on a “virtual stock exchange,” and the website host promised price appreciation as other users bought into the pyramid “game.”
- Vacationers bought beachfront condominiums, subject to limited occupancy rights, and the seller managed the condos and pooled rentals from many condo units.

In each case, people put money into a scheme in which the expected returns derived predominantly from the efforts of others. The enticement was not in the property ostensibly sold to the investor, but rather in a return on the investment created by others’ management or marketing efforts.

Whether LLC interests, unknown when the Securities Act was enacted, constitute securities has led to different results under the *Howey* test. When LLC investors are passive and have only tangential involvement in the LLC’s management, courts have found a security—that is, an investment in a

common enterprise where profits arise primarily from the efforts of others. When LLC investors have significant management oversight, courts have refused to find a security. See *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376 (D. Del. 2000) (concluding that sale of 100 percent interest in LLC was not sale of a security because owner had complete authority to remove manager without cause and thus directly affect profits).

Examples

Outdoor Cafes is a smashing success. Adam, the company's president, decides to expand the business by selling "muskrat dogs" from pushcarts in downtown business districts throughout the Northeast.

Adam devises an ingenious way to finance the new pushcart venture. Under his plan, Outdoor Cafes will purchase the pushcarts and then sell them to pushcart owners who must agree to buy muskrat dogs and related supplies exclusively from Outdoor Cafes. The contract will specify that pushcart owners either can operate the carts themselves or enter into an operator's agreement with Outdoor Cafes. Under the operator's agreement, the company selects, trains, and supervises an operator hired by the owner to push the cart and the muskrat dogs. Outdoor Cafes advertises the sale of pushcart ownership interests in area newspapers, and Adam assures prospective purchasers they will earn significant returns.

1. Owen buys a muskrat cart from Outdoor Cafes, along with the services available under the operator's agreement. After a few months, Owen discovers his cart is losing money, and he wants his money back. How might he use the Securities Act?
2. Did Outdoor Cafes sell Owen a security?
3. Portia buys a muskrat cart from Outdoor Cafes, but decides to operate the cart herself. After a few months, Portia is losing money and wants her money back. Can she use the Securities Act?

Explanations

1. Owen can argue the sale of the cart *with the operator's agreement* was the sale of a security. If so, he can seek rescission under §12(a)(1), if the arrangement was an unregistered, nonexempt offering. (Owen could not seek rescission under §12(a)(2), even though Adam may have misrepresented the cart's profitability because the sale was not

accomplished by a prospectus in a public offering.)

2. Most likely. The purchase of a pushcart, accompanied by an operator agreement, appears to satisfy the definition of an investment contract under the *Howey* test:
    - Owen invested money by purchasing the pushcart and agreeing to pay fees under the operator agreement
    - Outdoor Cafes contemplates a number of investors like Owen—horizontal commonality
    - Owen is led to expect profits from the sale of muskrat dogs
    - the return from Owen's investment comes predominantly (if not exclusively) from the efforts of Outdoor Cafes, which is responsible for selecting, training, and supervising the cart operator and producing the muskrat dogs

    Although Outdoor Cafes might argue Owen manages the investment by hiring the operator, this is only technically true. The Operator Agreement leaves to Outdoor Cafes all management decisions relating to running the business. Adam's promise of significant returns depends on Outdoor Cafes running the business successfully. Owen is counting on putting money into an arrangement (the pushcart purchase and Operator Agreement) in which others will manage an enterprise (the pushcart business) that will produce a return on his investment. The arrangement operates as though Outdoor Cafes had set up Pushcart Dogs, Inc. (which purchased carts and services from Outdoor Cafes) and Owen invested as a shareholder in this new corporation. In the end, disclosure about Outdoor Cafes and its management history and plans will be highly relevant to Owen's investment decision. Securities regulation is appropriate. See *SEC v. Edwards*, 540 U.S. 389 (2004) (finding sale-leaseback of pay phones to be a security, where investors were offered phones with a five-year arrangement for leaseback, management, and buyback by management company that selected sites for phones, installed equipment, arranged connections, collected coins, and maintained phones).

3. Standing alone, probably not. This is much more like a typical franchise arrangement, which generally has been held not to involve the sale of a security. Although the first three *Howey* factors are satisfied (Portia has invested money, others have invested money, and they expect a profit

from their investment), the critical element that these profits be derived solely or predominantly from the efforts of others is not met. Portia is not relying on Outdoor Cafes' management of her investment, and disclosure concerning Outdoor Cafes' history, performance, and plans as a supervisor of pushcart operators would have been largely irrelevant to her decision whether to buy the cart. Although Portia is expecting Outdoor Cafes' products will sell, her own efforts predominate in determining the cart's success or failure.

But if Portia had also been *offered* an Operator Agreement when she purchased the cart, the offer would have involved a security—as discussed above. As such, Portia might be able to seek rescission under §12(a)(1) of a transaction that included the unregistered, nonexempt *offering* of a security.

CHAPTER 9

Federal Regulation of Proxy Voting

As we have seen, shareholders in public corporations vote primarily by proxy. But proxy voting creates opportunities for management abuse. If management obtains open-ended proxies from shareholders, management gets a "rubber stamp." If management does not inform shareholders how their proxies will be voted, management escapes accountability. And if management prevents shareholders from seeking proxies for their own initiatives, management's control becomes virtually airtight.

State law authorizes proxy voting, but does not significantly regulate its potential for abuse. To protect shareholders from management overreaching —common before federal regulation—federal rules promulgated under the Securities Exchange Act of 1934 ("Exchange Act") regulate proxy voting in public corporations.

This chapter describes federal proxy regulation of the content and process of proxy voting. It describes the nature and source of federal proxy regulation (§9.1), the scope of the federal proxy rules (§9.2), their formal requirements (§9.3), and the rules permitting shareholder-initiated proposals (§9.4). Chapter 10 describes the state and federal regimes that govern proxy fraud.

Note on Terminology

Technically, a "proxy" is the agency relationship that arises when a

shareholder grants the authority to vote her shares to another person—namely, the "proxy holder." Sometimes the word "proxy" is used (ambiguously) to describe the signed writing by which this agency is created and that describes the powers of the proxy holder. See MBCA §7.22 (requiring that proxy be in writing and limiting duration to 11 months, unless otherwise specified); cf. Del. GCL §212(b) (limited to three years). For clarity's sake, the SEC rules refer to the signed writing as the "proxy card" and the disclosure document as the "proxy statement."

§9.1 FEDERAL PROXY REGULATION—AN OVERVIEW

Federal proxy regulation by the Securities and Exchange Commission (SEC) promotes fair corporate suffrage with a multipronged attack against proxy abuse:

- **SEC-mandated disclosure.** Rules of the SEC require that anyone (including the board of directors) soliciting proxies from public shareholders must file with the SEC and distribute to shareholders specified information in a stylized "proxy statement."
- **No open-ended proxies.** The SEC proxy rules, beyond disclosure, prescribe the form of the proxy card and the scope of the proxy holder's power.
- **Shareholder access.** The SEC proxy rules equalize access to the proxy process in public companies by requiring management (1) to mail shareholders' material and bill for the cost or to provide a shareholder list and (2) to include "proper" shareholder proposals with company-paid proxy materials, subject to a number of conditions.
- **Private remedies.** Federal courts have inferred a private cause of action for shareholders to seek relief for violations of the SEC proxy rules, particularly the rule prohibiting false or misleading proxy solicitations.

Congress did not directly regulate shareholder voting. Instead, it

delegated the task to the SEC, whose proxy rules derive from §14(a) of the Exchange Act.

> It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title. (emphasis added)

Let's parse. First, the jurisdictional reach of §14(a) is effectively unlimited—the "or otherwise" language means Congress has gone as far as the Constitution permits. Second, §14(a)'s prohibition applies to proxy solicitations involving securities registered under §12 of the Exchange Act—this means publicly traded corporations (see §9.2.1 below). Third, the prohibition applies to "proxy solicitations"—a broad concept (see §9.2.2 below). Fourth, the proxy solicitation must comply with SEC rules on filing, disclosure, and distribution of proxy materials (see §9.2.3 below).

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§9.2 REACH OF THE SEC PROXY RULES

§9.2.1 Public Corporations—Registration under the Exchange Act

The SEC proxy rules apply to companies whose securities are registered under §12 of the Exchange Act. Registration also compels the company to file periodic reports of business and financial information with the SEC. See §21.2. (Registration under the Exchange Act, which allows a company's securities to be publicly traded, is different from registration under the Securities Act of 1933, which allows securities to be sold to public investors.)

Registered (or *reporting*) companies fall into two categories:

- **Listed companies.** Companies whose securities (whether debt or equity) are listed on a national stock exchange. Exchange Act §12(a). Listing is voluntary. The New York Stock Exchange, for example, permits listing of companies with at least 2,200 U.S. shareholders and pretax earnings

of at least $10 million for the previous three years.

- **OTC companies.** Companies whose equity securities are traded on the over-the-counter (OTC, see §19.2) markets—specifically, any company with more than $10 million in assets *and* at least 2,000 shareholders (or 500 nonaccredited shareholders) of record at year's end. Exchange Act §12(g) (revised by JOBS Act of 2012, with different thresholds for banks and bank holding companies); SEC Rule 12g-1 (asset threshold increased to $10 million in 1996). Once *both* the asset and shareholder thresholds are surpassed, the company must register with the SEC within 120 days.

Once registered, a company may deregister only under specified circumstances. A company registered because its securities are listed on a stock exchange is no longer subject to the registration requirements once its securities are delisted. Exchange Act §12(d). Deregistration of an OTC company is more difficult. Deregistration is possible only when: (1) there are fewer than 300 shareholders of record; or (2) there are fewer than 500 shareholders of record and the company's total assets have not exceeded $10 million for its last three fiscal years. Rule 12g-4. The SEC takes the view that once an OTC company is registered, thus triggering the full range of federal protections for its shareholders, deregistration should not come easily.

§9.2.2 Definition of Proxy Solicitation

The federal proxy rules apply only to *proxy solicitations.* Although you might imagine a proxy solicitation refers to the formal document that accompanies management's request for shareholders to return a proxy card, the proxy rules are much broader. SEC Rule 14a-1(l) defines a "solicitation" to include: (1) *the obvious*—the informational document accompanying the proxy card; (2) *request to sign*—any request for a proxy even if a proxy card does not accompany it; (3) *request not to sign*—any request to not sign or to revoke a proxy; and (4) *the sly*—any other communication "under circumstances reasonably calculated to result in" shareholders signing, not signing, or revoking a proxy. The SEC also defines "proxy" broadly to include any action that gives or withholds authority concerning issues on which shareholders may decide—for example, when shareholders give written consents to an action taken without a shareholders' meeting (see

§7.2.6). Rule 14a-1(f).

Federal courts construed these definitions liberally, leading to protests that the SEC was overregulating communications among shareholders. In 1992, the SEC responded to this criticism and amended its proxy rules to exempt a variety of shareholder communications from its filing and distribution requirements. We consider how the amended rules affect some leading cases.

Part of Solicitation Plan

In *Studebaker Corp. v. Gittlin,* 360 F.2d 692 (2d Cir. 1966), a shareholder who planned a proxy contest to elect a new board sought the company's shareholders' list under a state law that gave inspection rights only to shareholders holding at least 5 percent of the company's shares. When the dissident shareholder obtained authorizations to inspect the list from 42 other shareholders whose holdings totaled more than 5 percent, management sued to block the inspection on the theory the dissident's request for authorizations constituted an illegal proxy solicitation. The court agreed, holding that a proxy solicitation includes any communication to shareholders that asks for action that is *part of a "continuous plan" leading to the formal solicitation of proxies*—a broad notion, indeed. The court pointed out that the definition of proxy includes "authorizations" and the dissident group's effort to obtain authorizations for an inspection was part of a "continuous plan" intended to end in a formal proxy solicitation. To ensure that shareholders are informed even in the preliminary stages of a voting contest, the court required the dissident group to start again with a proper proxy filing, distributed to all solicited shareholders.

The 1992 amendments to the SEC proxy rules explicitly reject the implications of this broad notion of solicitation when nonmanagement shareholders communicate with other shareholders. The shareholder communication rules permit shareholders to communicate so long as they do not seek to act as a proxy and do not furnish or ask for a proxy card. Rule 14a-2(b). Otherwise, such communications are not subject to the filing, disclosure, and distribution requirements of the proxy rules. The exemption, however, does not apply to communications by management, director nominees, or those already in a proxy fight with management. And exempt communications remain subject to Rule 14a-9, the rule that prohibits proxy

fraud, if they qualify as a “solicitation” under the “continuous plan” test.

Under the current proxy rules, even though the dissident group in *Studebaker* would not be subject to the filing, disclosure, and distribution requirements—because the gathering of authorizations did not involve seeking proxies—the group might nonetheless be forced to disclose their intentions. The SEC rules applicable to control transactions require the filing of an SEC disclosure document (Schedule 13D) by any 5 percent group of shareholders who intend to act together to vote their shares. See Rule 13d-5(b) (see §38.1).

Public Criticism of Management

In *Long Island Lighting Co. v. Barbash*, 779 F.2d 793 (2d Cir. 1985), the court applied a “chain of communications” theory to hold that a newspaper ad could be a proxy solicitation if motivated to advance a pending shareholder insurgency. In the case, a public interest group had paid for a newspaper ad urging that LILCO be sold to a public power authority and accusing LILCO of mismanagement in raising rates to build an unnecessary nuclear power plant. Without mentioning him, the ad tended to support the position of a local political candidate (and LILCO shareholder) who had succeeded in having a special shareholders’ meeting called to consider a sale of the company. The court held that a fact finder could conclude that the ad was “reasonably calculated” to influence shareholders’ votes and was thus a “solicitation” under the proxy rules even though it did not mention proxies and purportedly addressed matters of “public interest” in a general publication.

To some, this result borders on a violation of First Amendment free speech rights. Read literally, the court’s holding could turn every expression of opinion about a public corporation into a regulated proxy solicitation. If so, any person stating an opinion would be required to prepare a proxy statement and mail it to every shareholder being “solicited”—if a public opinion, this would mean all shareholders.

The current SEC rules, as amended in 1992, would exempt this kind of communication if the speaker neither seeks authority to act as a proxy nor requests a proxy card. See Rule 14a-2(b). Thus, a public interest group commenting on a shareholder vote—provided the group is not aligned with management or acting on behalf of a director nominee or someone seeking

control—is under no filing, disclosure, or distribution obligations. The "solicitation," however, remains subject to the SEC proxy fraud rule. In addition, the amended rules go one step further to exclude from the definition of "solicitation" (and thus from the proxy fraud rule) a public announcement by an unaffiliated shareholder on how she intends to vote and her reasons. Rule 14a-1(l)(2).

§9.2.3 Mandatory Disclosure When Proxies Not Solicited

In some circumstances, as when a majority of a public corporation's shares are held by a parent company, it may be unnecessary for approval of a corporate transaction to solicit proxies from minority shareholders. Nonetheless, the proxy rules require the company to file with the SEC and send shareholders, at least 20 days before the meeting, information similar to that required for a proxy solicitation. Exchange Act §14(c); Reg. 14C and Schedule 14C. These filings can become the basis for shareholder challenges to the transaction, such as a suit asserting breach of fiduciary duty, even though the solicitation of proxies is unnecessary.

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§9.3 FORMAL REQUIREMENTS OF SEC PROXY RULES

To enable shareholders to make an informed voting decision, the SEC proxy rules (1) specify the disclosure that must accompany (or precede) every proxy solicitation, (2) specify the form of the proxy card, (3) require the preliminary filing of the proxy statement and proxy cards for SEC staff review, and (4) prohibit false or misleading proxy solicitations.

§9.3.1 Mandatory Disclosure in Proxy Statement

Any time a shareholder's proxy is solicited, a "proxy statement" must accompany or precede every solicitation. Rule 14a-3(a). The proxy statement must contain information specified in Schedule 14A—a set of itemized instructions specifying the disclosures required in the proxy statement. The

disclosure required depends on who is soliciting the proxy.

- **Management solicitation.** If management (or technically, the board of directors) solicits proxies, Schedule 14A requires information about the corporation, the background of all director nominees, the compensation of the company's CEO and four highest-paid employees and their stock holdings, and any other matters being voted on. It must also include a report by the board's compensation committee. If the solicitation is for the annual election of directors, management also must send to shareholders the corporation's annual report. Rule 14a-3(b). For many companies, this is the only requirement (state or federal) of periodic corporate communications to shareholders. Cf. MBCA §16.20 (requiring that shareholders be provided annual financial statements).
- **Nonmanagement solicitation.** If the solicitation is by someone other than management, such as a dissident shareholder or outside insurgent group, Schedule 14A requires that they tell about themselves, the background of their nominees, and any other matters on which they seek a proxy.

§9.3.2 Form of Proxy Card

So that shareholders do not give management (or anyone else) a carte blanche, the federal proxy rules specify the form of the proxy card. Rule 14a-4. The proxy card must state who is soliciting it and the matters to be acted on, and must leave a space for it to be dated. For the election of directors, the card must allow a shareholder to withhold a vote on directors as a group or individually. A nominee cannot be elected if he is not named in the proxy card. Rule 14a-4(d)(1). For other matters, shareholders must have a chance to vote for or against each matter to be acted on. A shareholder can give her proxy holder discretionary voting power if the proxy card states in **boldface** type how the proxy holder intends to vote. The proxy holder must then vote in accordance with the instructions.

Management can retain the authority to vote in its discretion on matters that it does not know, before the solicitation, are to be presented at the meeting. See Rule 14c-4(c)(1). Thus, the proxy statement need only mention

those proposals that are reasonably likely to be submitted. Once a shareholder undertakes an independent solicitation for a proposal, however, the company must send shareholders a supplemental statement explaining clearly how it will exercise its discretionary authority, subject to contrary instructions from shareholders. *Union of Needletrades, Industrial and Textile Employees v. May Department Stores Co.,* 1997 WL 714886 (S.D.N.Y).

§9.3.3 Filing and Distribution of Proxy Statement

If proxies are solicited, each shareholder must be sent a copy of the proxy statement. Since 2007, the SEC has specified procedures for companies to send shareholders a notice of an online proxy statement and instructions on how to vote their proxies online, something that has saved companies more than $140 million annually in printing and mailing expenses. Exchange Act Rel. No. 55,146 (2007) (permitting shareholders to always request printed materials); Exchange Act Rel. No. 61,560 (2010).

Any person soliciting proxies must file *preliminary* copies of the proxy statement and the proxy card with the SEC at least ten days before they are sent to shareholders. Rule 14a-6. The SEC staff reviews and comments on these preliminary materials, giving filers a chance to make changes that conform to the staff's views on disclosure adequacy. Management need not make a preliminary filing if the solicitation is routine and relates to nothing more than the election of directors, selection of auditors, or shareholder proposals at an annual meeting.

All *final* proxy materials, whether or not filed preliminarily, must be filed with the SEC at or before the time they are sent to shareholders. (Like other SEC filings, proxy statements are available through EDGAR on the SEC's website *www.sec.gov* and can also be found on company websites under "investor relations" or "SEC filings.")

Shareholders whose solicitations are exempt from the distribution and disclosure requirements because they do not seek proxy authority and do not have a substantial interest in the matter must nonetheless file a notice with the SEC that attaches all of their written soliciting materials. Such notice is required only of shareholders who own more than $5 million of the company's shares and is not required for oral solicitations, public speeches, press releases, or published or broadcast opinions. Rule 14a-6(g).

§9.3.4 Prohibition against Proxy Fraud

At the heart of the proxy rules is the prohibition against any solicitation (written or oral) that is false or misleading with respect to any material fact or that omits a material fact necessary to make statements in the solicitation not false or misleading. Rule 14a-9. In addition to supplying the information required by Schedule 14A, the proxy statement must also fully disclose all material information about the matters on which the shareholders will vote.

Rule 14a-9 does not specifically authorize shareholders to sue for false or misleading proxy solicitations. Yet federal courts have inferred a private cause of action, which we discuss in Chapter 10.

§9.3.5 Exemptions from Proxy Rules

The proxy rules exempt some "proxy solicitations" from the filing, disclosure, and distribution requirements. Some solicitations are exempted, but remain subject to Rule 14a-9, the proxy fraud rule: solicitations by those not seeking proxy authority and without a substantial interest in the matter; nonmanagement solicitations to less than 10 persons; and advice by financial advisors in their ordinary course of business. Rule 14a-2(b)(1-2).

Other solicitations are completely exempt from the proxy rules, including the proxy fraud provisions: communications by brokers to beneficial owners seeking instructions on how to vote the owners' shares, Rule 14a-2(a)(1); requests by beneficial owners to obtain proxy cards and other information from brokers that hold their shares, Rule 14a-2(a)(2): and newspaper advertisements that identify the proposal and tell shareholders how to obtain proxy documents, Rule 14a-2(a)(6).

Examples

1. Video Palace, Inc. (VPI), owns and operates a video rental chain. VPI's management has solicited proxies for its slate of directors at the next annual shareholders' meeting. An insurgent, Garth, solicits proxies for his alternate slate of directors.
   a. Wayne, a VPI shareholder, first returns management's proxy card but then changes his mind and sends Garth's card. Who has Wayne's proxy?

b. VPI management gives notice of the annual meeting but does not disclose that company earnings fell 60 percent last year. Is this information required under state law?

c. The VPI board plans to issue already authorized stock to Jessica. The issue would bring her holdings to 35 percent, and VPI management would own 20 percent. Must VPI solicit proxies at the upcoming meeting?

2. The board does not issue shares to Jessica, and Garth's insurgency fails. As next year's annual meeting approaches, VPI management begins to plan its proxy solicitation. Consider whether VPI is subject to Exchange Act registration.

   a. At the end of its last fiscal year, VPI had assets of $11 million and 650 shareholders of record, of whom 550 are nonaccredited investors and 100 are company employees who had received stock compensation. The non-employee shareholders acquired their shares in a public offering exempt from registration under §3(a)(11) of the Securities Act of 1933—the intrastate offering exemption.

   b. At the end of its last fiscal year, VPI had assets of $11 million and 400 shareholders of record, though 650 beneficial owners of its shares. Also, last year VPI made a public offering of debt securities registered under the Securities Act.

3. VPI registers under the Exchange Act. Two years later, VPI struggles financially, and its assets fall below $8 million.

   a. VPI management does not want to bother with periodic disclosure and the SEC proxy rules. The company has 700 shareholders of record. Can it terminate its Exchange Act registration?

   b. VPI repurchases some of its stock, reducing the number of record shareholders to 450. Can VPI terminate its Exchange Act registration?

   c. VPI repurchases more stock, reducing the number of record shareholders to 100. Can VPI terminate its Exchange Act registration and avoid registration indefinitely?

   d. A few years after going private, VPI makes a large public offering. The company specifies that new stock must be held in street name with a specified list of qualified nominees. This keeps the number of record shareholders below 2,000. Can VPI avoid Exchange Act

registration in this way?

4. The FBI is investigating several VPI directors and executives for conspiring to distribute “pirate” videos through local VPI outlets.
   a. Garth sends letters to 15 other shareholders suggesting they begin a derivative suit challenging the directors’ actions as a breach of fiduciary duty. Are these letters a proxy solicitation?
   b. Garth appears on a financial talk show and says the directors should step down while the FBI concludes its investigation. Garth mentions he is thinking of running his own slate of directors at the next annual meeting. Are these statements proxy solicitations?
   c. Garth sends letters to 15 large VPI shareholders and suggests they discuss a special shareholders’ meeting to remove the offending directors “for cause.” Garth has enough shares under state law to call the meeting himself but will need the votes of the other shareholders in any proxy fight. Are these letters a proxy solicitation?
5. When VPI’s management learns of Garth’s activities, the company takes out newspaper ads claiming that “VPI only rents properly licensed videos” and suggests that “competitors jealous of VPI’s success” have planted false accusations. The ads do not mention Garth or possible shareholder action.
   a. Are the ads proxy solicitations?
   b. The ads are true. Can Garth seek to enjoin them?
   c. Before placing the ads, the company had already distributed copies of its proxy statement to all shareholders. Do the ads violate the proxy rules?
   d. After filing and distributing its proxy statement, management sends letters to its shareholders stating that Garth’s accusations are false and Garth is “trying to tear down the company.” Do these letters violate the proxy rules?

Explanations

1. a. Garth does. If the writing naming Garth bears a later date, the later-signed appointment revokes the earlier proxy. See §7.2.4. The election inspector will accept Garth’s authority if the writing by Wayne on its face revokes his prior proxy to management. The only issue under state

law would be whether Wayne granted management a proxy "coupled with an interest," thus making it irrevocable. This is unlikely unless his proxy related to a pledge, purchase, loan, employment, or voting agreement. See MBCA §7.22; Del. GCL §212(e) ("interest in stock" or "interest in corporation generally").

b. Generally, no. Most state statutes do not require more than notice of an annual meeting's location, time, and date. See MBCA §7.05; Del. GCL §222. If VPI is a public corporation, however, the "complete candor" duty of *Vickers v. Lynch* (see §10.3) may require management to disclose material adverse information with its notice and proxy statement.

c. No proxy solicitation is necessary. Whether directors are elected by majority or plurality voting, management's slate will be elected if Jessica and management combined their votes.

If VPI is a public corporation, even when proxies are not solicited, the federal proxy rules require management to file an information statement with the SEC and to distribute it to shareholders entitled to vote. Reg. 14C. This gives shareholders notice of any state rights they may have to challenge the election.

2. a. VPI must register under the Exchange Act and thus is subject to the proxy rules. VPI meets the conjunctive test of §12(g) of the Exchange Act: at year-end its assets exceeded $10 million, and it had at least 500 non-employee, nonaccredited shareholders of record. See Exchange Act §12(g) (as revised by JOBS Act of 2012, setting threshold at 2,000 shareholders or 500 nonaccredited shareholders, but excluding persons who received their shares pursuant to an employee compensation plan); see also SEC, *Jumpstart Our Business Startups: Frequently Asked Questions* (Apr. 11, 2012) (providing guidance on exclusion of employee-issued shares). Here, because the company has 550 non-employee, nonaccredited shareholders, it satisfies the shareholder threshold of §12(g).

The Securities Act exemption is irrelevant to the question of registration under the Exchange Act. The Exchange Act mandates periodic disclosure about reporting companies to facilitate trading in the stock of publicly traded companies; the Securities Act seeks to provide public investors information when they invest in a company's

securities offerings.

b. VPI is not subject to the proxy rules. A company is subject to the proxy rules only if its securities are registered under §12 of the Exchange Act. Unless VPI's debt or equity securities are listed on a stock exchange, it is not subject to §12 registration because it has fewer than 500 *record* shareholders (whether or not accredited) at year's end. Exchange Act §12(g). Beneficial shareholders are not counted for these purposes.

Although VPI's public offering of debt securities makes it subject to the reporting requirements of the Exchange Act under §15(d) of the Exchange Act, it is not subject to the proxy rules except by registering under §12. Not all reporting companies are subject to the proxy rules.

3. a. No. Although the value of VPI's assets has fallen below the $10 million threshold for initial registration, SEC rules do not permit termination of registration if the number of shareholders of record exceeds 500, regardless of asset value. Rule 12g-4. The SEC takes the view that public shareholders come to rely on periodic disclosure and SEC proxy regulation, and its rules make "deregistration" difficult.

b. Perhaps. It depends on how long VPI's assets have remained below the $10 million mark. If the number of record shareholders falls below 500 (though remains above 300), SEC rules permit termination of registration only if year-end assets have not exceeded $10 million for the each of the last three fiscal years.

c. Yes. If VPI "goes private"—whether by repurchasing its own stock, engaging in an issuer self-tender, or structuring a squeeze-out merger—it can deregister. Once deregistered, the company is no longer subject to the periodic disclosure and proxy rules of federal securities law.

d. No. Under the literal terms of §12(g), it would seem an OTC company could avoid Exchange Act registration by using street-name registration to keep the number of record shareholders below 2,000 (or 500 nonaccredited shareholders). This ruse circumvents the purposes of the Exchange Act. Periodic disclosure and fair proxy voting are as important to beneficial owners as record shareholders. The SEC rules define record shareholders to include beneficial owners if the company has reason to know that the form in which securities are held is "used primarily to circumvent" the registration provisions of the Exchange Act. Rule 12g5-1(b)(3).

4. a. Probably not. It is difficult to characterize the letters as being part of a "continuous plan" leading to the formal solicitation of proxies. See *Studebaker Corp. v. Gittlin* (§9.2.2). A derivative suit, brought by a shareholder on behalf of the corporation to vindicate a corporate right, will not necessarily lead to a proxy contest.

   Unless Garth's motives are to use the suit as part of a strategy leading to a proxy solicitation—for example, because the suit will provide free and damaging publicity about the directors—it is unlikely the letters will be deemed proxy solicitations. To do so would significantly hamper shareholder oversight of management abuse, undercutting the very purpose of the federal proxy rules.

   b. Yes, but they are probably exempt solicitations. Garth's comments seem to be part of a plan leading to a proxy solicitation, and the proxy rules define them to be a proxy solicitation.

   Nonetheless, the 1992 amendments to the proxy rules exempt solicitations by those who do not seek power to act as a proxy *and* do not furnish or ask for a proxy card. Rule 14a-2(b). At this point, Garth is just testing the waters for an insurgency and is not asking for proxies. This exemption would not apply, however, if Garth is already a board candidate (or is paid by someone who is a candidate) or is a 5 percent shareholder who has declared a control intention.

   c. Yes, but they may be exempt. Garth's letters to his 15 fellow shareholders seem to be part of a "continuous plan" leading to the formal solicitation of proxies, fitting the judicial definition of "proxy solicitation." These early communications, without an accompanying proxy statement, may "poison the well" and lead shareholders to join Garth's cause without full information. On the other hand, regulating preliminary steps to organize a proxy fight may discourage shareholders such as Garth from taking the first steps in exercising their control rights. Some courts have refused to treat preliminary organizational contacts as falling within the proxy rules. See *Calumet Industries, Inc. v. MacClure*, 464 F. Supp. 19 (N.D. Ill. 1978) (discussions among shareholders to organize a proxy fight not a "solicitation" because of the impracticality of preparing a preorganization proxy statement).

   Even if the letters are technically "proxy solicitations," the

exemption for nonmanagement shareholder communications would apply unless Garth is "seeking the power to act as a proxy." See Rule 14a-2(b). If Garth is asking for shareholder "authorizations" to call a special meeting, the letters might constitute a nonexempt solicitation. But if he is simply asking for preliminary showings of interest—because he already holds enough shares to call the meeting himself—the letters may not even be proxy solicitations or are at most exempt solicitations. (Notice the exemption for communications to no more than ten shareholders does not apply.)

5. a. Probably, yes. Under a "chain of communications" theory, the ads seem "reasonably calculated" to influence shareholder voting on the removal of the accused directors. The decision to place the ads seems to have been related to Garth's threatened insurgency. No exemptions apply to these management communications.

   Nonetheless, a court might conclude the ads were primarily meant to answer pirating rumors that might have hurt business and to protect the reputations of the directors rather than to influence shareholder voting. After all, no shareholders' meeting involving the charges has yet been called. In the end, management's motives behind the ads are determinative. See *Long Island Lighting Co. v. Barbash* (§9.2.2).

   b. Yes, if they are proxy solicitations. If management did not file a proxy statement and disseminate the statement to shareholders before placing the ads, they can be enjoined for failing to comply with the rule's filing and disclosure requirements. It makes no difference that the ads are absolutely truthful and well-meaning. As we will see, they can be enjoined either by the SEC or by a shareholder in a private action. See §10.1.

   c. No, unless the ads were materially false or misleading. The proxy rules do not prohibit communications that affect shareholder voting, but mandate only that such communications be made after filing and distributing a proxy statement. This gets the essential information on the table.

   d. Perhaps. The personal attack on Garth may violate Rule 14a-9's prohibition of false or misleading proxy solicitations. To prevent heated and not terribly informative shouting matches, the SEC treats as misleading under the rule "material which … impugns character,

integrity or personal reputation."

§9.4 SHAREHOLDER INITIATIVES

In a public corporation, shareholder voting initiatives face large obstacles. A shareholder who identifies a value-producing idea generally must commit financial resources for a proxy campaign—something rarely justified given the usual shareholder's relatively small holding. Even when a shareholder is willing to make the effort, the shareholder must overcome management's domination of the corporate-funded proxy mechanism.

The SEC proxy rules attempt to overcome these impediments in two ways. First, management can be compelled to help a shareholder communicate with fellow shareholders—but at the shareholder's expense. Second, in specified circumstances, management must include "proper" shareholder proposals in the company's proxy mailings to shareholders—at *corporate* expense.

§9.4.1 "Common Carrier" Obligation under Rule 14a-7

The federal proxy rules aid shareholders willing to pay for soliciting other shareholders. Rule 14a-7 requires management to mail, either separately or together with the corporation's proxy materials, any shareholder's soliciting materials if the shareholder agrees to pay the corporation's reasonable expenses. There is no limit on the length of the materials, nor does the SEC rule allow management to refuse if it objects to their contents.

Management can avoid this "common carrier" obligation by providing a list of shareholders, including intermediaries. This significantly expands the shareholder's rights under state law, which generally allows the shareholder only a list of shareholders upon the showing of a "proper purpose" (see §7.1.4). As a practical matter, however, management is often reluctant to provide the shareholders' list because it can be used for personal solicitations or beyond a shareholder proxy solicitation—such as in a takeover contest.

§9.4.2 Shareholder Proposals under Rule 14a-8

The SEC shareholder proposal rule seeks to promote shareholder democracy by allowing shareholders to propose their own resolutions using the company-financed proxy machinery.

The shareholder proposal rule has gone through three stages. During its early history in the 1940s and 1950s, proponents used the rule to seek changes in corporate governance—proposing such things as mergers and more liberal dividend policies. In the 1970s and 1980s, many proponents used the rule to focus public attention on corporate social responsibility—proposing such actions as divestment from South Africa, environmental protection, and increases to (or reductions of) affirmative action plans. Since the mid-1980s, with the advent of institutional shareholder activism, many proponents have again focused on corporate governance issues—proposing such things as greater board answerability, increased shareholder voting powers, and elimination of antitakeover devices. At the same time, many proposals continue to deal with social policy issues (such as climate change and sustainability). Today approximately 300 to 400 public companies receive a total of about 900 shareholder proposals each year.

During the rule's first 40 years, shareholder proposals were markedly unsuccessful. Of the thousands submitted for shareholder vote before 1985, only two were approved. Since 1985, however, proposals on corporate governance issues have fared better, regularly obtaining majority approval and increasingly leading management to make changes. Remarkably, labor unions have emerged as the most aggressive of all shareholder proponents, making proposals aimed at maximizing investment returns through such reforms as declassification of boards, caps on executive pay, and shareholder access to the director nomination process.

The following tables illustrate the changing nature of the rule during four representative periods. The first table shows the kinds of proposals excluded by management, which the rule requires be submitted for SEC review. The second table shows the kinds of proposals that the SEC upon review found to be includable under its always-changing interpretation of Rule 14a-8.

Proposals Excluded by Management

*Type of Proposal**	*1981–1982*	*1991–1992*	*2001–2002*	*2011-2012*
Governance	26.5%	35.4%	47.3%	43.5%
Operational	44.6%	30.2%	33.1%	30.1%
Social/Political	28.9%	34.4%	19.6%	26.4%
Total	100.0%	100.0%	100.0%	100%

Proposals Found Includable by SEC

*Type of Proposal**	*1981–1982*	*1991–1992*	*2001–2002*	*2011-2012*
Governance	18.2%	41.2%	55.7%	23.7%
Operational	18.9%	3.4%	49.0%	20.0%
Social/Political	37.5%	18.2%	41.4%	30.4%
Total	24.1%	21.9%	48.7%	24.1%

*Categories:

Governance proposals: structure and composition of board, poison pills, shareholder voting
Operational: executive compensation, production/business matters, company communications
Social/political: environmental, sustainability, political, consumer, labor

Notice that "governance" proposals over time have become more frequent and generally have been treated more favorably by the SEC than other proposals. Notice also that "social/political" proposals, though never the mainstay of shareholder proposal activity, have lately been favored by the SEC even more than "governance" or "operational" proposals. (By the way, the reason for the very low inclusion rate for "operational" proposals in 1991—1992 is that the SEC then viewed any proposal dealing with executive compensation to be excludable as "ordinary business;" in the late 1990s the agency changed its view.)

Current SEC Rule

In 1998 the SEC responded to a congressional call to reappraise the shareholder proposal process. Exchange Act Rel. No. 40,018 (1998). While leaving the rule's structure largely intact, the SEC adopted some important policy changes and redrafted (and renumbered) the rule using a "Plain English" question-and-answer format. The revamped SEC rule begins as follows:

> Question 1: What is a proposal? A shareholder proposal is your recommendation or requirement that the company and/or its board of directors take action, which you intend to present at a

> meeting of the company's shareholders. Your proposal should state as clearly as possible the course of action that you believe the company should follow. [Rule 14a-8(a)].

Rule 14a-8 Procedures

Any shareholder who has owned (beneficially or of record) 1 percent or $2,000 worth of a public company's shares for at least one year may submit a proposal. Rule 14a-8(b)(1) (Question 2; dollar amount increased in 1998). The proposal must be in the form of a resolution (only one) that the shareholder intends to introduce at the shareholders' meeting. Rule 14a-8(c) (Question 3).

Shareholders must submit their proposals in a timely fashion. For an annual meeting, this will generally be at least 120 calendar days before the date proxy materials were sent for the last year's meeting. Rule 14a-8(e) (Question 5; information on submissions and deadlines can be found in last year's proxy statement). If the proposal is proper (see below), management must include it in the company's proxy mailing to shareholders. The proposal, along with a supporting statement, can be up to 500 words. Rule 14a-8(d) (Question 4). Management's proxy card must give shareholders a chance to vote for or against the proposal. Rule 14a-8(a) (Question 1).

If management decides to exclude a submitted proposal, it must give the submitting shareholder a chance to correct any deficiencies. Rule 14a-8(f) (Question 6; requiring management to give notice within 14 days of submission, and shareholder to respond within 14 days). If management intends to exclude the proposal, management must file its reasons (and a copy of the proposal) with the SEC for review. Rule 14a-8(j) (Question 10; reasons must include opinion of counsel if based on state or foreign law). The SEC staff issues a "no-action" letter if the staff agrees with management. Over time this procedure has created a body of SEC "common law" on the meaning of the rule.

Proper Proposals

Rule 14a-8 contains a dizzying list of 13 reasons for management to exclude a shareholder proposal. Rule 14a-8(i) (Question 9; formerly Rule 14a-8(c)). The list has undergone periodic changes, and the SEC's interpretation of its terms has ebbed and flowed. Management can exclude a proposal if it fits *any* of the categories specified in the rule. The SEC-created exclusions serve three central purposes.

(1) Proposals inconsistent with centralized management. Four of the exclusions aim at proposals that interfere with the traditional structure of corporate governance:

- **Not "proper subject."** Management can exclude proposals that are not a "proper subject" for shareholder action under state law. Rule 14a-8(i)(1). In *SEC v. Transamerica Corp.,* 163 F.2d 511 (3d Cir. 1947), the court upheld the propriety of proposals for shareholder election of independent public auditors, for changing procedures to amend the company's bylaws, and for requiring that a report of the annual meeting be sent to shareholders. Phrasing proposals to be *precatory*—that is, as advisory suggestions rather than as mandates—further assures their propriety under state law. See Note to Rule 14a-8(i)(1) (noting that "recommendations or requests" to the board are usually proper under state law); see also *Auer v. Dressel,* 118 N.E.2d 590 (N.Y. 1954) (see §7.1.3). Frequently, proposals will ask for management to conduct a study or issue a report, without compelling specific action.

  Recently, an important question has been whether bylaw amendments that require specific action are proper subjects under state law. See §§3.14, 7.1.3.
- **Not "significantly related."** Management can exclude proposals that are not "significantly related" to the company's business. Rule 14a-8(i)(5). To be significant, the proposal must relate to operations that account for at least 5 percent of total assets, net earnings, or gross sales. Or the proposal must be "otherwise significantly related" to the company's business. Beginning in the 1970s, the SEC has adopted a broad view of what is "otherwise significantly related." According to the SEC, matters relating to ethical issues, such as complying with the Arab boycott of Israel or carrying on business in South Africa, could be significant even though not from a purely financial standpoint. See also *Lovenheim v. Iroquois Brands, Ltd.,* 618 F. Supp. 554 (D.D.C. 1985) (holding to be "significantly related" a resolution calling for a report to shareholders on forced geese feeding even though the company lost money on goose pate sales, which accounted for less than .05 percent of revenues).
- **"Ordinary business operations."** Management can exclude proposals that relate to the company's "ordinary business operations." Rule 14a-

8(i)(7). The SEC's interpretation of this exclusion has been checkered. In the 1970s and 1980s, the SEC accepted proposals dealing with such things as construction of nuclear power plants and employment discrimination on the theory they do not relate to "ordinary business" because of their economic, safety, and social impact. In 1992 the SEC reversed course and decided that proposals concerning employment policies (such as equal employment or affirmative action plans) can be excluded as "ordinary business." See *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter (October 13, 1992). The Second Circuit ultimately agreed that the SEC could reinterpret the rule without a formal rulemaking proceeding. *New York City Employees' Retirement System v. SEC*, 45 F.3d 7 (2d Cir. 1995). But after widespread criticism the SEC announced in its 1998 rule revision a return to its pre—*Cracker Barrel* approach of case-by-case review into whether employee-related shareholder proposals raise significant social policy issues.

- **Related to dividend amount.** Management can exclude proposals that relate to the specific amount of dividends. Rule 14a-8(i)(13). This recognizes a fundamental feature of U.S. corporate law that the board has discretion to declare dividends, without shareholder initiative or approval.

(2) Proposals that interfere with management's proxy solicitation. The rule has four exclusions for proposals that threaten to interfere with orderly proxy voting:

- **Related to nomination or election to office.** Management can exclude proposals that relate to a specific nominee (seeking his disqualification or removal, questioning his character, or seeking to have him included in the proxy materials). Rule 14a-8(i)(8) (amended in 2010). This exclusion prevents dissidents from "clogging" the company's proxy statement with their own candidates or views on management's nominees. An earlier version of this aspect of the rule had been interpreted by the SEC to prevent shareholders from adopting procedures to nominate their own candidates to the board. The 2010 rule change made clear that shareholders can propose bylaw amendments that create procedures for shareholders to nominate directors to the

board—so-called proxy access. Exchange Act Rel. No. 62, 674 (2010).

- **Conflicts with management proposal.** Management can exclude proposals that "directly conflict" with management proposals. Rule 14a-8(i)(9) (amending previous exclusion of proposals "counter" to management submissions). Otherwise, the rule would create an open forum in which every shareholder could offer a proposal to undermine any management initiative subject to shareholder vote.
- **Duplicative.** Management can exclude proposals that duplicate another shareholder proposal for being included in the management's proxy materials. Rule 14a-8(i)(11).
- **"Recidivist."** Management can exclude "recidivist" proposals that had failed in the past. Rule 14a-8(i)(12). This exclusion covers any proposal dealing "with substantially the same subject matter" as a proposal submitted in the last five years that failed to get 3 percent support on its first try, 6 percent on its second try, or 10 percent after three tries.

(3) Proposals that are illegal, deceptive, or confused. Five of the exclusions are meant to prevent spurious or scandalous proposals:

- **Violation of law.** Management can exclude proposals that would require the company to violate any law, including the SEC's proxy rules and in particular Rule 14a-9's proxy fraud prohibition. Rule 14a-8(i)(2), (i)(3). This allows management to exclude proposals it considers to be materially false or misleading.
- **Personal grievances.** Management can exclude proposals that relate to any personal grievance. Rule 14a-8(i)(4). This category covers the frequent phenomenon of proposals by disgruntled employees who seek to have the body of shareholders recognize their talents and tribulations.
- **Beyond power.** Management can exclude proposals that deal with matters beyond the corporation's power to effectuate. Rule 14a-8(i)(6).
- **Moot.** Management can exclude proposals that are moot because the company is already doing what the shareholder proposes. Rule 14a-8(i)(10).

If a shareholder proposal dances through this minefield of procedural requirements and substantive exclusions, management must include it in the

company's proxy statement and permit shareholders to vote in the proxy card—though management has a chance to recommend that shareholders vote against the proposal and give its reasons. Rule 14a-8(m) (Question 13).

If management fails to include a proposal that is not properly excludable, the proponent can seek an SEC determination that the proxy rules are being violated. Rule 14a-8(k) (Question 11). Alternatively, the shareholder can bring a private action in federal court to compel inclusion or enjoin management's proxy solicitation as a violation of the proxy rules. Shareholders who prevail in court may recover their attorneys' fees on the theory that "the litigation conferred a substantial benefit" on the body of shareholders. *Amalgamated Clothing and Textile Workers v. Wal-Mart Stores*, 54 F.3d 69 (2d Cir. 1995) (finding substantial benefit in proposal's communication to shareholders, even though proposal was defeated).

§9.4.3 Proxy Access

Over the last decade corporate governance has grappled with whether to open the board nomination process in U.S. public companies so shareholders can include their nominees in the company's proxy materials *at company expense*. The history of "proxy access" has been convoluted and interesting. Nearly all the actors in modern corporate governance have played a role: activist and institutional shareholders, corporate management, the SEC, the federal courts, the U.S. Congress, the Delaware legislature, the Delaware courts, and even corporate law professors.

Proxy access began in 2003 when the SEC proposed a new Rule 14a-11 that would have permitted shareholders (or a group of shareholders) holding five percent of a company's voting shares to nominate one to three directors to the company's board—provided a majority of shareholders had authorized such a vote in the previous election cycle or 35 percent had withheld their vote from a particular board nominee. See Exchange Act Rel. No. 48,626 (2003) (proposing release). The proposal met a firestorm of opposition from corporate management. At first the SEC dithered and then eventually decided not to pursue the rulemaking.

In response to the SEC's inaction, activist shareholders (supported by corporate law professors) began a company-by-company movement proposing amendments to company bylaws to create a process for shareholders to use the company's proxy mechanism to nominate a "short

slate" constituting fewer than a majority of directors. Eventually, the SEC took the position that such proposals were excludable as "related to an election" under the then-applicable Rule 14a-8 exclusion, but the Second Circuit held that the exclusion did not cover shareholder proposals seeking to create proxy access. See *AFSCME v. AIG, Inc.*, 462 F.3d 121 (2d. Cir. 2006). In response, the SEC amended Rule 14a-8 to overrule the court's decision, allowing companies to exclude such shareholder proposals. Exchange Act Rel. No. 56,914 (2007).

Without a proxy access rule and faced with a revised Rule 14a-8 that limited shareholder-initiated proxy access, institutional shareholders turned to Congress. In 2010 Congress put proxy access back on the corporate governance agenda when it passed the Dodd-Frank Act and specifically authorized the SEC to promulgate a proxy access rule. Dodd-Frank §971. Within months, the SEC accepted the Dodd-Frank invitation and re-promulgated Rule 14a-11 in even stronger form than before. Exchange Act Rel. No. 62,674 (2010) (permitting nomination of directors constituting at most one-fourth of the board by shareholders, or groups of shareholders, that had held 1, 3, or 5 percent of company's voting shares for at least three years, the percentage varying with company size).

The plot thickened, however, when corporate management (through the Business Roundtable and U.S. Chamber of Commerce) challenged the reincarnated Rule 14a-11 in federal court for failing to adequately consider the costs and benefits of the new governance rights granted to shareholders. The D.C. Circuit agreed and held that the SEC had failed to consider the rule's effect on "efficiency, competition and capital formation." *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating rule). Even though Dodd-Frank seemed to have authorized the SEC to make this cost-benefit determination, the SEC decided not to appeal the decision to the Supreme Court and not to propose the rule again, apparently worried it could not meet the (unusually) high standard of review set by the D.C. Circuit.

Despite the failure of proxy access to become an SEC rule, many shareholder activists decided to take matters into their own hands and returned to the company-by-company approach. The SEC had reopened this door in 2010 when it revised Rule 14a-8 (as part of its Rule 14a-11 rulemaking) to permit shareholders to propose bylaw changes to establish procedures for nominating directors in the company's proxy materials. Shareholder activists were further emboldened by changes to the Delaware

corporate statute, added by the Delaware legislature in 2009, which made clear that shareholders can amend company bylaws to provide for proxy access as well as mandatory reimbursement of proxy expenses incurred by shareholders in director elections. See Del. GCL §§112, 113; see also MBCA §2.06(c).

You might wonder what all the fuss is about. At most, proxy access gives shareholders a chance to use the company's proxy materials to nominate and place a handful, but not a majority, of directors on the board. Why has corporate management fought this? For one, it's been argued that shareholder-nominated directors might make boards less collegial and more antagonistic. For another, proxy access by SEC rule would create a one-size-fits-all approach, away from the flexible private ordering permitted by state law. In the end, proxy access raises in stark relief the question of who defines shareholder voting rights—the SEC or Delaware. For now, it looks like Delaware retains its preeminence, with the SEC providing support on the sidelines.

Examples

1. Two years ago Reba bought $2,000 worth of Video Palace, Inc. (VPI) stock. She recently calculated that VPI's liquidation value exceeds its current stock price. Reba wants to bring this to the attention of other shareholders and to propose the company be liquidated—its assets sold for cash—and the cash distributed to shareholders.
    a. Reba plans to solicit proxies for a resolution she plans to present at the upcoming annual shareholders' meeting. The resolution will ask the board to take steps to liquidate VPI. Will the company reimburse her for her solicitation expenses?
    b. Reba notices that the company bylaws require that she give notice that she plans to submit her proposal at least 120 days before the next annual shareholders' meeting. She gives this notice. Must VPI provide information about the proposal in its proxy statement so the statement is not misleading?
    c. Reba wants management to include her proposal with the company's proxy mailing. When must Reba make this request?
    d. Reba plans to submit a four-page attachment to her resolution that explains the advantage of liquidation and gives financial details. In

her attachment she blames VPI management for "destroying market confidence as reflected in the company's below-asset market price." Any problems?

e. Reba corrects these problems and submits a resolution that calls for the board to liquidate the business, dissolve the corporation, and distribute the proceeds to shareholders. Management objects. On what basis can management exclude this proposal from the company's proxy materials?

2. Reba's liquidation proposal is submitted for a shareholder vote and soundly defeated at the shareholders' annual meeting. Reba is relentless. Anticipating next year's shareholders' meeting, she wants to shake up the way VPI does business. Which of the following would be includable under the shareholder proposal rule?
   a. A proposal that shareholders elect Reba to the board.
   b. A resolution stating the shareholders' desire that management nominate at least two women as directors on the board.
   c. A resolution requiring the VPI board to prepare a report on affirmative action in the company's management training program.
   d. A proposal to amend the bylaws to permit shareholders holding more than 5 percent of the company's shares for two years to nominate up to two directors to the company's nine-person board.
   e. A proposal to amend the bylaws to require the corporation to reimburse the reasonable expenses of any shareholder that successfully nominates fewer than 50 percent of the directors to the board.
3. Management excludes Reba's proposal against "adult" videos, and the SEC issues a no-action letter accepting the proposal's exclusion. So Reba contacts some of VPI's larger individual shareholders, who say they agree with her proposal. She attends the shareholders' meeting and makes her proposal from the floor. VPI has no advance notice requirements for shareholder proposals.
   a. At the meeting Reba says her proposal is a proper subject for shareholders under the corporation's constitutive documents and state corporate law. If not, she explains, the shareholders can simply vote it down. Is the proposal proper?

b. Reba's proposal is approved not counting the votes for which management has proxies. Management's proxy card gives management complete authority to vote in its discretion on "any other matters that might arise at the shareholders' meeting." The proxy materials, however, do not mention the possibility of shareholder proposals at the meeting. Does management have discretionary authority to vote its proxies against Reba's floor proposal?

4. VPI's management is tired of shareholder proposals. So are many VPI shareholders, who have never cast more than 20 percent of their votes for any shareholder proposal. The board proposes, and the shareholders approve, an amendment to the company's charter banning all nonmanagement shareholder proposals unless by a shareholder (or group of shareholders) holding more than 20 percent of VPI's voting shares.
   a. At the next shareholders' meeting, Reba proposes a resolution urging that no executive receive a salary greater than $1 million. Her ownership qualifies her to make the proposal under Rule 14a-8, but not the charter provision. Must management include the proposal?
   b. Reba asks management to supply her with a list of shareholders or to send her proxy materials so she can solicit support for her executive pay proposal. Must management comply with her request under Rule 14a-7?
   c. Why don't companies "opt out" of the shareholder proposal rule?

Explanations

1. a. Almost certainly no. Under state law, the board has no obligation to reimburse shareholders' solicitation expenses—and rarely does it happen. Only if a shareholder gains control of the board and gets other shareholders to ratify the reimbursement can the shareholder hope to be repaid. See §8.1.2.

Neither Rule 14a-7 nor Rule 14a-8 of the federal proxy rules change this. Rule 14a-7 merely requires that management provide Reba with a shareholders' list or send her solicitation materials to other shareholders at her expense. Rule 14a-8 does not provide for reimbursement, only inclusion of proper proposals in the company-funded proxy statement by qualifying shareholders who comply with

the rule's procedures.

The only hope for a shareholder who undertakes her own proxy solicitation to be reimbursed is a shareholder-approved bylaw providing for corporate reimbursement of reasonable election-related expenses. See *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (finding such a bylaw to be proper under Delaware law, provided it includes a "fiduciary out" that allows the board to fulfill its fiduciary duties) (see §7.1.3).

b. No. A shareholder who announces an intention to make a proposal at an upcoming shareholders' meeting, but does not independently solicit proxies, cannot claim it would be false and misleading under Rule 14a-9 if the company omits mention of the proposal. *Union of Needletrades, Industrial and Textile Employees v. May Department Stores Co.*, 1997 WL 714886 (S.D.N.Y.) (requiring inclusion in the proxy statement would allow shareholders to "back door" their proposals "past the detailed requirements of Rule 14a-8"). This means that shareholders seeking to communicate with other shareholders using the company-financed proxy machinery must use Rule 14a-8.

If Reba were to begin an independent solicitation seeking proxies for her proposal, however, the company would be required to provide shareholders specific disclosure of the proposal and management's intentions on how it would exercise its discretionary authority in voting proxies. See Rule 14a-4(c)(1) (disclosure in company's proxy statement or supplement).

c. Under Rule 14a-8, to qualify for inclusion in management's proxy statement, Reba must mail her proposal so that management receives it at least 120 calendar days before the date on which proxy materials were sent out for last year's annual shareholders' meeting. This assumes this year's meeting is scheduled to fall within 30 days of the date of last year's meeting. Question 5, Rule 14a-8(e).

d. Reba's proposal is in trouble. First, her proposal probably exceeds the word limit for shareholder proposals. The rule limits proposals and supporting statements to 500 words—approximately two double-spaced, typewritten pages. See Question 4, Rule 14a-8(d). If so, management is obligated to point out this deficiency and give her 14 days to reduce the proposal's length. Rule 14a-8(f)(1).

Second, her statement impugning management's integrity may make the proposal excludable. Rule 14a-8(b)(1). Management can exclude proposals that are contrary to SEC rules, including the rule prohibiting proxy fraud. The SEC has said that fraud includes "material which impugns character, integrity or personal reputation." In the no-action process, SEC staff sometimes permits the proponent of an otherwise includable proposal to salvage the proposal by deleting any offending language.

e. A number of exclusions may apply. First, the proposal may not be a "proper subject" for action by shareholders under state law. Rule 14a-8(i)(1). Most state statutes require that sale of substantially all assets and voluntary corporate dissolution be initiated by directors (see §§36.1.2, 36.2.2). Although shareholder approval of the sale and dissolution may be necessary, the board generally has exclusive power to initiate these changes. Second, the proposal would require the company to violate state law regarding the process for approving a sale of all the company's assets and corporate dissolution. Rule 14a-8(i)(2). Third, the proposal may be seen as relating to "specific amounts of cash … dividends." Rule 14a-8(i)(13).

Reba should phrase the resolution to be precatory—a suggestion that the board consider a liquidation or dissolution. The resolution might also call on the board to prepare a report to shareholders on its decision. To make her proposal proper, Reba may have to make it toothless.

2. a. Excludable. The proposal improperly relates to an election to office. Rule 14a-8(i)(8). Although the election of directors is a proper subject for shareholder action, the rule prevents shareholders from interfering with management's orderly operation of the proxy mechanism. If Reba or most other shareholders could propose their own nominees, management's proxy statement and proxy card would become unmanageable, jeopardizing proxy voting.

b. Probably excludable. This resolution is precatory and is a "proper subject" for shareholder action. Under current SEC interpretation, shareholders may make proposals under Rule 14a-8 that urge the board be composed of "outside" directors or "employee" directors. SEC staff has taken the view that such proposals do not relate to a particular

election or nominee and do not “relate to an election” under the Rule 14a-8(i)(8) exclusion.

Nonetheless, the proposal to nominate a specified number of women may be excludable on the ground it urges the company to run afoul of antidiscrimination laws. See Rule 14a-8(i)(2). Reba should have urged the board to consider women nominees to the board, without specifying a quota.

c. Includable. The resolution does not require specific board action, only a report. Further, it deals with a matter of substantial public importance, thus removing it from the “ordinary business” exclusion. Rule 14a-8(i)(7). The SEC once took the position that proposals dealing with a company’s employment practices are within the company’s “ordinary business,” even when they raise “social policy” concerns. *Cracker Barrel Old Country Stores, Inc.*, SEC No-Action Letter (Oct. 13, 1992). The SEC, however, reversed this position in 1998.

d. Includable. Under the current Rule 14a-8, such “proxy access” proposals are permitted. See §9.4.3. The SEC staff once took the position that such proposals were not includable under the prior wording of the Rule 14a-8(i)(8) exclusion for proposals that “relate to an election.” *Walt Disney Co.*, SEC No-Action Letter (Dec. 14, 2004) (reconsideration). But the SEC revised the rule in 2010 to permit such shareholder proposals as part of its rulemaking to create proxy access. As revised, Rule 14a-8(i)(8) now allows exclusion of proposals only if the proposal (i) would disqualify a director standing for election; (ii) remove a director from office; (iii) question the competence, judgment, or character of a director; (iv) seek to exclude a specific individual from being nominated; or (v) otherwise possibly affect the outcome of a board election.

Furthermore, state law (including in Delaware) now permits shareholders to amend the bylaws to provide for a process of shareholder nomination of directors. See Del. GCL §112; see also MBCA §2.06(c).

e. Includable, though it might need to contain a “fiduciary out.” The proposal dealing with a board election is permitted under revised Rule 14a-8(i)(8) (see previous explanation). The only real question is whether it is excludable as invalid under state law. See Rule 14a-8(i)

(1). This question turns on a recent Delaware case and subsequent statute.

In the case—which involved a similar proposal submitted by the SEC to the Delaware Supreme Court for the court's opinion—the Delaware court gave a mixed answer. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (see §7.1.3). The court first opined that the proposed bylaw related to the process of director elections and was a proper subject for shareholder action under Delaware law. The court then opined that the bylaw would unlawfully prevent directors from exercising their full management powers if their fiduciary duties required them to deny reimbursement for a dissident slate. The court explained that while bylaws may "define the process and procedures by which those decisions are made," they may not "mandate how the board should decide specific substantive business decisions."

Is a "fiduciary out" necessary so the board could deny reimbursement to a shareholder if required by the directors' fiduciary duties? Although the *CA* case seems to require such a "fiduciary out," a subsequent Delaware statute specifically permits bylaws that provide for reimbursement of shareholder proxy-related expenses without mentioning the need for a "fiduciary out." See Del. GCL §113; see also MBCA §2.06(c). The statute raises the interesting question of whether the legislature can remove the judicial power to decide when director fiduciary duties arise.

3. a. Perhaps. State corporate statutes do not specify what shareholder proposals are proper, which often presents a problem because Rule 14a-8(i)(1) excludes proposals that are "not proper" under the corporate law of the company's state of incorporation. State judicial decisions suggest that shareholders have broad powers to make nonbinding precatory proposals. See *Matter of Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954) (see §7.1.3). This broad authority is supported by judicial interpretation in other contexts. For example, courts have permitted shareholders to inspect the shareholders' list (and other corporate documents) if the requesting shareholder articulates a purpose related to the financial interests of the company. See §7.1.4. In this case, the propriety of the proposal depends on what state law and state courts say, not on the independent views of the SEC.

b. Perhaps. It depends on when management knew of Reba's proposal and how management phrased its proxy materials. In the 1990s many shareholders in public companies, to avoid the strictures of the Rule 14a-8 exclusions, made proposals from the floor of the shareholders' meeting. These shareholders then asserted that management lacked discretionary authority at the meeting to vote its proxies against the proposal on the theory that management's proxy card did not create this authority.

In 1998 the SEC amended its proxy rules to permit management to create discretionary authority in the proxy card with respect to shareholder proposals at an annual meeting. The proxy card can create this discretionary authority if the proxy materials state either (1) management had not received timely notice of a shareholder proposal, or (2) management had received notice and stated how it planned to vote. Rule 14a-4(c). In general, notice is timely if received 45 days before the date of the prior year's proxy mailing. No discretionary authority arises, however, if the shareholder proponent is making his own proxy solicitation (and sending proxy materials to shareholders). The proponent's solicitation floats or sinks on its own.

In our example, management's failure to mention the possibility of a shareholder proposal—whether or not Reba's was received in a timely fashion under the rule—negates any discretionary authority. Although the grant of discretionary authority is valid under state law, the federal proxy rules deny management voting power when shareholders have not been informed how their proxies are likely to be voted.

4. a. Perhaps. It depends on whether the SEC proxy rules can be seen to create federal substantive rights or merely provide procedures to exercise rights under state law. Reba's proposal on executive compensation is includable under Rule 14a-8, but not under the company's amended articles.

Many courts have justified Rule 14a-8 on a procedural theory. Without the rule it would be misleading for management not to disclose the shareholder proposals it expects shareholders will raise at an upcoming meeting. The rule provides a procedure for that disclosure. If a shareholder has no right to make a proposal, then presumably the rule

does not require management to disclose it or include it on the proxy card. On the other hand, Rule 14a-8 has over time assumed a life of its own. Many of the exclusion categories—such as for proposals that have failed in the past or are counter to a management proposal or are not significantly related to the company's business—do not find any basis in state law. The SEC, arguably, has created a new substantive right, subject to the agency's list of exclusions. Under this view, companies cannot "opt out" of shareholder access pursuant to Rule 14a-8 any more than they could opt out of the other federal proxy rules.

b. Perhaps not. Even if Reba were willing to pay for the solicitation under Rule 14a-7, management might argue that it need not act as a "common carrier" for proposals that are improper under state law. Unlike Rule 14a-8, however, the "common carrier" requirements of Rule 14a-7 do not offer management any explicit grounds for exclusion or for refusing to provide a shareholders' list. On its face, federal law supersedes state law.

c. Management may not be interested in opting out of the shareholder proposal rule for a number of reasons. First, opting out might be bad for investor confidence (and thus stock prices) if management tried to insulate itself from shareholder input.

Second, shareholder proposals have become an effective way for shareholders to express their views on a broad range of corporate matters (such as majority voting in director elections, shareholder access to the nomination process, and shareholder say on executive pay). Increasingly, management has chosen to adopt shareholder-approved resolutions, even when precatory. Without shareholder proposals, shareholders might turn to other protective devices, such as takeovers and litigation, which could be even more intrusive.

Third, opting out might not be valid under state law. Just as shareholders have a basic right to amend the bylaws, courts could well hold that shareholders have an inviolable right to make proper proposals at shareholders' meetings.

Finally, the shareholder proposal rule may provide a relatively painless way for activist shareholders to express their governance, economic, social, and political views short of seeking governmental intervention through the political process.

CHAPTER 20

Limitations on Control Sales

Corporate control is a valuable commodity. A shareholder that holds a controlling interest can direct management of the business. But with control comes responsibility to other corporate constituents.

This chapter considers the prohibition against the sale of a corporate office (§20.1) and the limitations on the transferability of control shares (§20.2).

§20.1 SALE OF OFFICE

Directors and officers are strictly prohibited from selling their offices for personal gain. *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971). Corporate offices do not belong to the incumbents—officers are accountable to the board, and directors are accountable to the shareholders. As fiduciaries, corporate managers are bound to perform their functions under the terms of their appointment.

§20.2 LIMITATIONS ON SALE OF CONTROLLING SHARES

§20.2.1 Control Premium

The trading price of corporate shares does not always reflect fully their latent power (when combined with other shares) to exercise control. Normally, individual shares cannot alone affect control. But when a buyer accumulates enough shares for a voting majority, control value attaches to the shares. The difference between the value of latent control rights and the value of voting control is referred to as a "control premium."

What is a control premium? It is the additional value, above the financial value of a passive corporate investment, that comes with controlling the corporation's business. Suppose GenSys has 10 million shares outstanding and individual shares trade publicly at $50. Barbara, the largest shareholder, has 3 million shares. What is the value of her holding? Probably more than $50 per share because a 30 percent shareholder of a public company generally has effective control. If Kendall wants to buy Barbara's shares, Barbara will demand extra for her control block. Kendall will pay this premium because of the increased value to him of being able to extract greater returns from GenSys than if he owned a noncontrolling interest. Suppose Kendall pays $240 million, or $80 per share, for Barbara's shares. Her control premium is the $90 million difference between the sale price and the prevailing market price of her shares—a difference equal to $30 per share.

Note on What Constitutes a Controlling Interest?

Generally, a controlling interest is one in which a shareholder, whether an individual or a parent corporation, has sufficient voting power to determine the outcome of a shareholder vote—whether to elect a board majority or decide a matter presented to shareholders. See §17.1. In close corporations, this may require a shareholding of more than 50 percent—a majority shareholder. In a public corporation with widely dispersed shareholders, it may be enough to control as little as 20 percent of the voting shares and have the support of the incumbent board—a dominating shareholder. ALI §1.10(b) (presumption of control with 25 percent shareholding); but see *Williamson v. Cox Communications, Inc.*, 32 Del. J. Corp. L. 307 (Del. Ch. 2006) (concluding that

shareholder with less than 50 percent interest not controlling, unless shareholder actually exercises control over corporation, beyond installing directors or exercising veto).

§20.2.2 No-Sharing Rule

Generally, shareholders can sell their shares at whatever price they can get—including at a premium not available to other shareholders. Controlling shareholders need not share the premium their control block commands. *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979).

Some commentators have criticized this no-sharing rule. They have urged an "equal opportunity" rule under which all shareholders would share pro rata in any control premium. They argue that control should be viewed as a corporate "asset" in which each shareholder should share equally. See Berle, *The Price of Power: Sale of Corporate Control*, 50 Cornell L.Q. 628 (1965). Thus, a buyer willing to pay a premium for control (because the corporation's assets are more valuable in her hands) should be willing to pay the same premium for all the shares. See Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965).

Opponents of an equal opportunity rule argue that it would result in fewer (beneficial) control transfers and leave inefficient management entrenched. A rule that would force a buyer to pay all shareholders a control premium would make the acquisition more expensive. Further, the buyer might be unable or unwilling to buy all the shares. Moreover, the rule would dilute the value of control held by existing controlling shareholders, for which they may have already paid a premium. These commentators argue that minority shareholders, on balance, would prefer a rule that resulted in efficient new management, even at the expense of not sharing in any control premium. Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 737 (1982). Studies indicate that prices of minority shares in public corporations rise after the sale of control, even when the control buyer does not purchase minority shares. See ALI Principles §5.16, note 1.

Nearly all courts have rejected the equal opportunity rule—primarily because equal sharing would effectively require all control purchases to be by tender offer open to all shareholders and would discourage beneficial changes

in control. Nonetheless, an equal opportunity rule of sorts now exists for acquiring control in *public corporations*. Under federal rules, *tender offers* in public corporations must be open to all shareholders—the "all holders" rule. Exchange Act Rule 14d-10(a)(1). In addition, each shareholder must be offered the highest price paid any other tendering shareholder—the "best price" rule. Exchange Act Rule 14d-10(a)(2). For tender offers in public corporations, these SEC rules preempt the state no-sharing rule. See §38.2.

Nonetheless, when the controlling shareholder is a parent corporation that seeks to sell a partially-owned subsidiary, the subsidiary's board need not accept whatever terms the parent negotiates with the third-party buyer. Instead, the subsidiary's directors have duties to protect the interests of the minority shareholders—even though the shareholders have no ability to vote down the transaction or right to share in a control premium. See *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (requiring directors of subsidiary to reach "informed and deliberate judgment" that minority shareholders are receiving maximum value for their shares in merger with third-party acquirer, whether by tendering their shares in merger or seeking judicial appraisal based on subsidiary's going-concern value).

§20.2.3 Exceptions to No-Sharing Rule

To discourage harmful transfers of control, state courts recognize exceptions to the general rule of free transferability. See Elhauge, *Triggering Function of Sale of Control Doctrine*, 59 U. Chi. L. Rev. 1465 (1992). Controlling shareholders cannot sell their control block in three situations:

1. The sale is conditioned on the controlling shareholder improperly selling corporate offices to the buyer.
2. The buyer had proposed to acquire the whole company, and the controlling shareholder recast the transaction as a control block sale.
3. The controlling shareholder has reason to believe the seller will "loot" the corporation after acquiring control.

Sale of Office

Often the seller of a control block will promise, as part of the sale, to give the buyer working control of the board. This is accomplished by the seriatim resignation of the seller's directors, with each vacancy filled by the buyer's

directors. Without such a promise, the buyer would have to conduct a special shareholders' meeting to elect his new board, or wait to buy until the next annual shareholders' meeting, or risk his investment until his board is seated.

Courts treat "board succession" promises as a prohibited sale of office if the challenger shows either: (1) the buyer did not acquire working control and could *not* have elected his own slate, *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), or (2) the sales price exceeds the premium the control block alone commands, suggesting the price included a prohibited sale of office, *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955) (Swan, J., dissenting).

Usurpation of Corporate Opportunities

Some cases hold that a controlling shareholder cannot convert an offer made to the corporation into one to the shareholder alone. If the control buyer offers to deal with all shareholders on an equal basis, such as by proposing a merger or the purchase of all the corporation's assets, some courts hold that the controlling shareholder cannot divert this "corporate opportunity" to himself. But many courts permit controlling shareholders to sell their shares as they choose, regardless of whether the buyer might have been willing to deal with the corporation or all the shareholders. See *Tryon v. Smith*, 229 P.2d 251 (Or. 1951) (upholding sale by 70-percent shareholder for twice that paid minority shareholders, even though buyer had first offered to deal with all shareholders equally).

Sale to "Looters"

A controlling shareholder may not sell control if the seller has reason to suspect the buyer will use control to "loot"—that is, steal corporate assets or engage in unfair self-dealing transactions—the corporation and the shareholders (and other constituents) left behind. If the control seller has reason to suspect the buyer will loot the corporation, the seller becomes liable for any damages caused by the buyer, including any damage to the corporation's earnings power. Corporate recovery is not limited to the control premium the seller received.

When does a controlling shareholder have a reason to suspect a looter? Courts accept that too strict a duty discourages control transfers. The seller is not a guarantor of the probity of the buyer. Instead, the seller must investigate the buyer's intentions only when circumstances raise a *reasonable suspicion*

that looting will follow the sale. See *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941); *DeBaun v. First Western Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. App. 1975). If circumstances surrounding the sale are suspicious and the seller fails to investigate or his investigation confirms the suspicions, the seller becomes liable for any losses to the corporation.

What factual circumstances create danger signals?

- **When price is too good.** Although a high price may merely reflect the buyer's view that the corporation is worth more in his hands than with the incumbents, an excessive premium should cause suspicion—particularly if the corporation has readily marketable assets. But courts give sellers a good deal of leeway. See *Clagett v. Hutchinson*, 583 F.2d 1259 (4th Cir. 1978) (holding that price of $43.75 per share, for shares that usually ranged from $7.50 to $10.00 per share, did not place the seller on notice of potential fraud on the corporation).
- **When buyer is dishonest or hurried.** If there is reason to believe the buyer is dishonest, the seller must make further inquiries. See *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990) (even if the sellers themselves relied on misrepresentations by the buyer). In addition, if the buyer shows little interest in the company's business and urges that the transaction be closed quickly, the seller may be required to investigate the buyer's motives.
- **When buyer has bad business reputation.** If the seller knows the buyer has significant debts, outstanding liens against his other businesses, and fraud judgments against him, the seller should suspect that the buyer does not worry about how he makes his money. *DeBaun v. First Western Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. App. 1975).

§20.2.4 Meaning of *Perlman v. Feldmann*

The overlapping sale-of-control limitations are illustrated by the famous, much-studied case of *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955). Feldmann, who controlled 37 percent of the shares of Newport Steel, sold his shares for $20 per share—a two-thirds premium over the thenmarket price of $12. A minority shareholder brought a derivative suit on behalf of the

corporation, claiming Feldmann had sold a corporate asset, namely Newport's steel supplies, during the Korean War's steel shortage when steel prices were controlled and access to steel commanded a premium. Feldmann had invented a way to skirt the price controls (known in the industry as the "Feldmann Plan") by having buyers make interest-free advances to obtain supply commitments. The buyer (Wilport), a syndicate of steel end-users, wanted Newport's steel supplies free of the Feldmann Plan.

The court held that Feldmann had breached a fiduciary duty to the corporation because his sale of control sacrificed the favorable cash flow to the corporation generated by the Feldmann Plan. The court held Feldmann accountable to the minority shareholders to share his premium.

What did Feldmann do wrong?

- **Sale of office?** After Wilport bought Feldmann's control shares, Feldmann and the rest of the board resigned and installed Wilport's nominees. The court agreed that the price paid for Feldmann's shares was a fair one, negating any inference that Wilport had paid Feldmann to sell his office.
- **Denial of "equal opportunity" to share the control premium?** Although the Second Circuit's opinion contains broad statements about the duties of fiduciaries, the court's focus on the loss to the corporation from discontinuing the Feldmann Plan undermines this broad reading of the case. Other courts, including state courts in Indiana whose law the Second Circuit was purporting to interpret, have rejected an equal opportunity rule.
- **Sale to looter?** Wilport wanted a supply of steel free of the Feldmann Plan prepayment terms—that is, it planned to engage in self-dealing at controlled (below-market) prices. Feldmann no doubt knew this. The Second Circuit rejected arguments that gray market pricing under the Feldmann Plan was unethical and concluded that Wilport had taken a corporate asset by discontinuing Newport's gray market profits. Nonetheless, Newport's minority shareholders on balance benefited from the sale, as measured by post-sale increases in their share prices. That is, the loss of gray market profits was offset by the vertical integration with Wilport or its more efficient management. Wilport was on balance a beneficent new owner, not a looter.

- **Taking of a corporate control opportunity?** There was evidence that another purchaser had originally approached Feldmann to merge with Newport, a transaction through which all of the shareholders would have shared in any control premium. Feldmann rejected this offer and soon after sold his shares to Wilport.

Although the minority shareholders sued derivatively on behalf of the corporation, the Second Circuit allowed them to recover in their own right. Recovery by the corporation of Feldmann's premium would have allowed Wilport to recoup part of the premium it paid Feldmann for control (see §18.1.2).

Why is *Perlman v. Feldmann* relevant? The case has not been followed by other courts; the Second Circuit's holding is obscure; and its conclusion that the corporation suffered harm is belied by the remedy ordered. Nonetheless, the case offers a chance to think about corporate control, who owns it, and the role of fiduciary duties in the corporation. Some law professors believe the case offers enough to teach a whole Corporations course—perhaps they're right, but it would be a stretch.

§20.2.5 Disclosure Duties

Sales of control in public corporations must be disclosed under SEC rules. The corporation must disclose any sale of control within four days after it happens. See Item 5.01, Form 8-K (if known to the company's board) (see §21.2). And any acquirer of more than 5 percent of the company's shares must disclose the size of its holdings, along with information about itself, the sources of its funding, and its plans with respect to the corporation. See Schedule 13D (must be filed within 10 days after acquirer passes 5 percent threshold) (see §38.1).

In addition, controlling shareholders may have disclosure duties to minority shareholders. Controlling shareholders who know of an impending control offer and buy shares from minority shareholders cannot misrepresent their reasons for buying. See §23.2.1. What if they say nothing? Under the "special facts" doctrine, controlling shareholders may have a fiduciary duty to reveal material information when they purchase shares from minority shareholders in a face-to-face transaction. See §23.2.2.

Rule 10b-5 (the famous federal rule prohibiting securities fraud) also

imposes a disclose-or-abstain duty on controlling shareholders when trading on nonpublic confidential information in public and private markets. See §23.3.1. But a controlling shareholder who fails to tell minority shareholders that he is selling for a premium is not liable to them because they neither bought nor sold and thus lack standing to sue. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952) (same facts as *Perlman v. Feldmann* above).

Examples

1. Foamex Corp. makes foam for use in furniture. Stella, the firm's founder, owns 400,000 shares, representing 40 percent of Foamex's outstanding stock. Stella is getting on in years and has left management to her son-in-law Carl, the company's CEO and a 5-percent owner. There are 700 other shareholders for whom there exists a thin public trading market. Foamex stock has been trading at $20 a share.
    a. Boyer Inc., a large furniture manufacturer and Foamex's largest customer, wants to buy the company. Boyer offers to buy Carl's stock at $50 per share if he and the rest of the board resign and install Boyer's directors. Is this legal?
    b. Carl rebuffs Boyer, which then approaches Stella to buy her 40-percent block for $30 a share. What must Stella do before selling?
2. Boyer had originally approached Carl with a proposal that Boyer acquire Foamex in a $25 million merger—$25 per share. Carl told Stella about the offer, and she said the price was too low. Carl rejected Boyer's offer.
    a. Soon afterward, Stella suggested to Boyer that she would sell her 40-percent block for $12 million—$30 per share. Stella points out that this would be less expensive than Boyer acquiring control in a $25 million merger. Do you see any problems?
    b. Suppose Carl had informed the board of Boyer's merger offer, and the board had turned it down because the price was too low. Does this change things?
    c. A court holds Stella liable for selling her shares after Boyer's merger offer. Stella sold her shares for $12 million, at a time their aggregate market price was $8 million. In the merger she would have received $10 million. What is the appropriate remedy?

3. Soon after buying Stella's 40-percent block, Boyer buys Carl's 5-percent holding for $30 per share. Boyer bought on the condition that Carl use his best efforts to have the other board members resign and install Boyer's slate of directors.
   a. On what theory could Shawn, a Foamex shareholder, challenge Carl's sale.
   b. Evaluate the merits of Shawn's challenge.
4. After installing its own board, Boyer increases its foam purchases from Foamex and takes significant volume discounts not available to other Foamex customers or in the industry. This pattern is not new. Boyer has bought control positions in other suppliers to obtain supply discounts. Stella knew about Boyer's past practices.
   a. Shawn sues Stella. On what theory?
   b. Does Shawn have recourse against anyone else?
   c. A court finds Stella liable. To whom and for how much?

Explanations

1. a. No. Carl has sold his corporate office. Carl's 5-percent shareholding alone is insufficient to carry any meaningful control, particularly since Stella owns a controlling 40-percent block. The premium over market that Boyer is willing to pay can only be explained as consideration for Carl's promise to help install Boyer's slate of directors. A shareholder could challenge the validity of the board's filling of vacancies.

   b. Nothing, unless she suspects Boyer will loot the company. Shareholders have significant autonomy to decide whether or not to sell their shares, and a controlling shareholder's duty to investigate is triggered only when there is reason to be suspicious.

   Are there any apparent danger signals here? The 50-percent control premium hardly triggers suspicion—courts have approved control sales with premiums of up to 300 percent. Boyer's status as a Foamex customer does not necessarily imply future supply arrangements will be unfair. Unless Stella had some reason to suspect Boyer planned below-market arrangements—for example, because she knew Boyer needed to cut its foam costs significantly to stay competitive—Stella would be under no obligation to investigate or to refrain from selling her shares.

2. a. Perhaps. Stella's sale could be viewed as the usurpation of a corporate control opportunity. A merger would have meant equal sharing of any control premium. When the buyer (as here) is willing to deal with all the shareholders, a sharing rule would not prevent this control transaction from going forward.

Nonetheless, an "equal opportunity" rule reallocates part of the control premium to the other shareholders and dilutes the value of the controlling shareholder's control block. The rule would put Stella in the untenable position of either rejecting the transaction or putting the merger to a shareholder vote and voting against it herself. Modern courts are not inclined to force sharing just because the buyer originally suggested a sharing transaction. Only if the seller fraudulently buys minority shares (a kind of insider trading) to resell them to the buyer do the courts impose a sharing obligation.

b. Perhaps. Arguably, the board's rejection of the merger freed Stella to take the opportunity herself. But the board's rejection of the merger, like the rejection of a corporate opportunity in which a director has an interest, should be reviewed as a conflict-of-interest transaction under a fairness standard if Stella anticipated selling her control block. Was the board sufficiently disinterested, independent, and informed? See §16.3.1.

c. Sharing of her control premium with the minority, even though the normal remedy for a fiduciary breach is recovery by the corporation. Requiring Stella to pay her control premium (or a portion of it) to the corporation would produce a windfall for Boyer—indirectly refunding it a portion of the control premium it had paid for Stella's shares.

Here, the failure to share breached a duty to the minority shareholders, and it would seem that any remedy should be tailored to address the theory of liability. There are two possible theories, leading to different damage calculations:

- Under an "equal sharing" theory—Stella improperly took a control premium—Stella would be liable for 60 percent of the premium to the other (60 percent) shareholders. This was the remedial approach in *Perlman v. Feldmann*. See §20.2.3. Stella's control premium was arguably \$4 million (the difference between her \$12 million sales price and her shares' \$8 million aggregate market price), suggesting

a $2.4 million recovery for the other shareholders, who hold 600,000 shares—$4 per share.

- Under an "improper rejection" theory—Stella improperly blocked the merger—Stella is liable for the loss she caused minority shareholders. This is the difference between the proposed merger price ($25 per share) and the market price ($20 per share) —$5 per share.

3. a. Sale of office. Carl's sale is prohibited if Shawn can show Carl's premium ($10 per share over market) included a payment to relinquish his office. If so, Shawn can seek to have Carl share his premium.

   b. Shawn has a difficult challenge. Although a 5-percent block could not alone command a control premium, a 5-percent *incremental* block might have been of particular importance to Boyer, a 40-percent shareholder. The additional 5 percent would make it virtually impossible for the public shareholders to form an effective dissident block because it would take 91 percent of the public shareholders to outvote a 45-percent Boyer. On the other hand, the most significant impediment to Boyer exercising effective control is not Carl's 5-percent share ownership, but Carl's incumbency and the board's control of Foamex's proxy machinery. Nonetheless, courts are reluctant to accept the obvious: A "board succession" promise has value to a control buyer and forms part of the bargain. Only if there is some suggestion Boyer has bought the board's replacement to abuse its control should a court intervene.

4. a. Sale to a looter. There are two issues: (1) Did Boyer's self-dealing transactions constitute looting? (2) If so, did Stella have reason to suspect that Boyer would engage in them?

   Boyer's self-dealing purchasing appears to be on terms unfair to Foamex—the purchases do not fall into a range of what would be expected in arm's-length transactions (see §13.3.2). Yet overall Boyer's ownership may not cause losses to Foamex. Looting liability is limited to the losses the new owner causes the company.

   Even if Boyer is a looter, Stella is liable only if circumstances suggested Boyer planned to engage in unfair self-dealing. Although Stella should have known Boyer planned to increase its purchases from Foamex, Stella had no apparent reason to suspect the purchases would

be on unfair terms. Stella was under no duty to investigate whether purchases from other Boyer-controlled companies were on unfair terms unless circumstances raised this suspicion.

b. Yes. He can also sue Boyer, as controlling shareholder, on a self-dealing theory (see §17.2).

c. Stella will be liable directly to the minority shareholders on a pro rata basis for their losses, not limited by the control premium she received. (Recovery in a derivative suit would indirectly reimburse Boyer.) These losses could well exceed (and, if the looter does what it intended, should exceed) any control premium. Stella would be liable not only for the actual losses from the self-dealing (here $2 million a year) but also any losses to Foamex's earning power (consequential damages).

CHAPTER 21

Disclosure in Securities Trading Markets

Information is the lifeblood of securities trading markets—and thus shareholders' transfer rights. State corporate law imposes minimal disclosure obligations on the corporation. Instead, shareholders' informational rights arise largely under federal securities law. The Securities Exchange Act of 1934 (Exchange Act) builds on the regulation of public securities offerings under the Securities Act of 1933 (Securities Act, see Chapter 5). While the Securities Act reflects a "truth in securities" philosophy, the Exchange Act reaches ambitiously for "integrity in stock markets."

This chapter describes the rules on corporate disclosure by publicly traded companies under state corporate law (§21.1) and under federal securities law (§21.2).

§21.1 STATE DISCLOSURE DUTIES

Statutory Disclosure

State corporate law imposes minimal disclosure duties on corporations. Besides requiring basic information in the articles of incorporation and barebones notice to shareholders when they vote, state corporate statutes generally have not required regular information to shareholders. An exception, adopted in some states, is a requirement that shareholders receive

an annual financial report. See MBCA §16.20.

Duty of Honesty

In 1998, the Delaware Supreme Court created a stir when it held that corporate managers have a state-based fiduciary duty not to knowingly disseminate false information to shareholders. *Malone v. Brincat,* 722 A.2d 5 (Del. 1998). The duty, the court held, arises whether or not the corporation is requesting shareholder action, and can be enforced by shareholders claiming individual losses or in a derivative action on behalf of the corporation. In *Malone*, shareholders alleged that company directors (aided by the firm's outside accountants) had knowingly overstated the firm's financial position in SEC filings and public reports over a four-year period—causing a loss of virtually all of the company's value.

The chancery court dismissed the claim because the misinformation had not come in a "request for shareholder action," the usual context for Delaware's "duty of complete candor." See §10.3. Worried about duplicating or usurping federal securities law, the chancery court concluded that release of inaccurate information was not a "corporate governance issue." The Supreme Court rejected this formalistic line-drawing. The court held the alleged facts, if properly pleaded, could support a claim (either direct or derivative) that the directors had knowingly misinformed shareholders, a violation of their fiduciary duties.

Although some commentators have labeled *Malone v. Brincat* a "duty of disclosure" case, the label is misleading. The court created no general duty to disclose information, but simply held that *whenever* managers communicate they must be honest. This "duty of honesty" is triggered whether the communication involves a request for shareholder action, compliance with federal disclosure requirements, or a voluntary press release. Honest communications ensure that shareholders can exercise their voting and transfer rights, as well as their fiduciary rights to discipline management indolence or disloyalty.

What is the relationship of *Malone v. Brincat* to federal securities law? Under the Securities Litigation Uniform Standards Act of 1998 (SLUSA), any class action alleging fraud in publicly traded securities must be brought in federal court under federal law; state claims are preempted. Securities Act §16(c); Exchange Act §28(f)(2). The Delaware court interpreted SLUSA, passed after the case had commenced, to not apply. But as to future cases, the

court pointed out that the federal legislation would not prevent "duty of honesty" litigation in state court. SLUSA excludes from its coverage derivative suits and state-based claims based on breaches of fiduciary disclosure obligations—the so-called Delaware carve-out. See §22.1.2. Nonetheless, a "duty of honesty" claim presented as a class action alleging merely management deception might not fit these exclusions.

Is a "duty of honesty" action more advantageous than a federal securities fraud action under Rule 10b-5? See Chapter 22. According to the Delaware court, a "duty of honesty" action (unlike a 10b-5 action) can be brought by shareholders who do not claim to have purchased or sold because of the false disclosure. But a "duty of honesty" action claiming loss in share value would require a showing of individual reliance on the alleged falsehoods—essentially foreclosing class actions using a "fraud on the market" theory permitted under Rule 10b-5. See §23.3.3.

A full comparison, however, is difficult because *Malone v. Brincat* left a number of questions unresolved.

- **Culpability.** Although the *Malone* court said directors cannot "knowingly" disseminate false information, it is unclear what level of culpability must be pled and proved. Must the plaintiff show actual knowledge of the falsehood or is it enough that the directors were negligent?
- **Breach of care or loyalty.** Whether a breach of the "duty of honesty" constitutes a breach of the duty of care or of loyalty affects whether directors can be exculpated from personal liability (see §12.5). What "corporate damages," if any, must be shown in a derivative action? This might be problematic if corrective disclosure returns stock prices to "true value."
- **Remedy.** *Malone* does not identify the remedy when the corporation deceives shareholders. Damages that assume shareholders had bought or sold prior to the deception (rescissionary damages) might be greater than the usual out-of-pocket damages under Rule 10b-5, which are based on the loss in market value caused by the dishonesty (see §22.3.4).

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§21.2 FEDERAL DISCLOSURE REQUIREMENTS

The federal regime of ex ante *mandatory disclosure* applies to companies whose securities are traded in public stock markets. These companies become subject to a panoply of regulation, some of which are described in other chapters:

- **Periodic reporting.** Registered companies must file *periodic disclosure* documents with the Securities and Exchange Commission (SEC). These companies (including those that have made a public offering under the Securities Act) are known as "reporting companies." See §21.2.2 below.
- **Recordkeeping.** To carry out their periodic reporting obligations, registered companies must *keep records* and maintain a system of internal accounting controls. See §21.2.3 below.
- **Proxy disclosure.** Shareholders of registered companies must receive information under the SEC proxy rules when management (or others) *solicits proxies* on matters requiring shareholder voting. See §9.2. For annual shareholder meetings, shareholders must receive the company's annual report.
- **Takeover disclosure.** Any person or group that acquires more than 5 percent of a registered company's equity securities must disclose its plans. See §38.1. Any person that makes a *tender offer* for the equity securities of a registered company is subject to substantive requirements and disclosure rules. See §38.2.
- **Insider trading disclosure and disgorgement.** Directors, officers, and 10-percent shareholders of registered companies must *disclose their trading* in the company's publicly traded *equity* securities and are liable to the company if they make profits (or avoid losses) from purchases and sales within any six-month window. See Chapter 24.

§21.2.1 SEC Registration

Companies must register with the SEC under the Exchange Act in two circumstances:

- **Exchange "listed" companies.** Companies whose *debt* or *equity* securities are listed on a stock exchange must register with the exchange, with copies to the SEC. Exchange Act §12(a) (prohibiting trading by broker-dealers on stock exchange in securities not registered). Stock exchange rules specify qualifications that issuers must satisfy to have their securities "listed" for trading on the exchange. The "listing" rules assure traders on the exchange that these companies meet certain sales, assets, and net worth thresholds.
- **OTC companies.** In 1964 Congress amended the Exchange Act to require registration of companies whose *equity* securities are publicly traded on the over-the-counter (OTC) markets. A company must register if it has a class of equity securities held of record by more than 500 shareholders and has total assets exceeding $10 million. Exchange Act §12(g); Rule 12g-1 (asset threshold increased to $10 million in 1996).

Once registered, a company may deregister only under specified conditions. For a fuller treatment of this topic, see §9.2.1 (proxy regulation).

§21.2.2 Periodic Disclosure

Registered companies become "reporting companies" and must file annual, quarterly, and special reports with the SEC. Exchange Act §13(a). This ongoing stream of information is used extensively in securities trading markets. There are three important Exchange Act filings:

- **Annual report.** Reporting companies must file annually, within 60 to 90 days of the close of their fiscal year, an extensive disclosure document that contains much the same information as a Securities Act registration statement when a company goes public—including description of company's business, management's discussion of risks, and audited financial statements. Form 10-K (for smaller businesses, Form 10-KSB).
- **Quarterly report.** Reporting companies must file quarterly, within 35 to 45 days of the close of each of the company's first three fiscal quarters, a report that consists mostly of updated (and unaudited)

financial information. Form 10-Q.

- **Special report.** Reporting companies must file a special report on specified, material developments. See Form 8-K. Significantly expanded by the SEC in response to post-Enron concerns (see Sarbanes-Oxley §409), Form 8-K has moved closer to a continuous disclosure system. Exchange Act Rel. No. 49,424 (2004).

In theory, these mandatory disclosures represent a “public good” available to all securities market participants. Without a system of mandatory disclosure, management might not be inclined to provide *for free* such fulsome information, and traders would be reluctant to pay for it if others could observe trading patterns to “pirate” their information. To assure an adequate supply of company-specific information, the reporting system is mandatory and the information it produces is available to all.

Reporting by “Public Issuers”

In addition to companies that must register their securities for trading under the Exchange Act, companies that have made a registered securities offering (*debt or equity*) under the Securities Act are also subject to the Exchange Act reporting requirements. See Exchange Act §15(d); Rules 15d-1 to 15d-17. These companies must commence reporting once their Securities Act registration is effective, even if their securities are not listed on a stock exchange and the company does not satisfy the size thresholds of OTC registration. Companies subject to reporting only by virtue of §15(d), however, escape other Exchange Act regulation applicable to other registered companies with respect to proxy solicitations, tender offers, insiders’ short-swing profits, and takeover bids.

Certification of SEC Filings

As commanded by the Sarbanes-Oxley Act, the SEC has adopted rules requiring corporate officers of reporting companies to certify the annual and quarterly reports filed with the SEC. Sarbanes-Oxley §302. The CEO and CFO must each certify that he reviewed the report and, based on his knowledge, that it (1) does not contain any material statements that are false or misleading, and (2) “fairly presents” the financial condition and results of operation of the company—regardless of formal compliance with accounting principles. Exchange Act Rules 13a-14, 15d-14 (certification not applicable

to Form 8-K reports).

In addition, the CEO and CFO must certify they are responsible for establishing and maintaining “disclosure controls and procedures” that ensure material information is made known to them, and these internal controls must be evaluated before making their report. See §12.3.5.

Real-Time Disclosure

There is no requirement that reporting companies disclose all material information on a real-time basis. But there is a move in that direction. As revised in 2004, Form 8-K (special reports) requires filing and disclosure within four business days of the following events:

- **Operational events.** Entry into (or termination of) definitive material agreements, loss of significant customer, bankruptcy, or receivership
- **Financial events.** Acquisition or disposition of assets, results of operations and financial condition (such as interim earnings statements), direct financial obligations or obligations under off-balance sheet arrangements (or events triggering such obligations), restructuring charges, material impairments under existing agreements
- **Securities-related events.** Delisting or transfer of listing, unregistered sales of equity securities, changes in debt rating, material modifications to rights of securities holders
- **Financial-integrity events.** Changes in registrant’s certifying accountant, nonreliability of previously issued financial statements or audit report
- **Governance events.** Changes in corporate control, changes affecting directors or principal officers (departure, resignation, removal, election, appointment), amendments to articles or bylaws, waivers of code of ethics
- **Executive pay.** Compensation agreements (attached to filing), compensation arrangements outside ordinary course of business

In addition, any voluntary company disclosure to some investors must be disclosed simultaneously to all investors, typically by simulcast or posting on the company’s website. See Regulation FD (§23.3.4). Voluntary disclosures of interim financial data and press releases must also be “furnished” to the

SEC on Form 8-K (by being furnished and not filed, the report does not trigger statutory fraud liability).

EDGAR

In the mid 1990s, the SEC computerized its filing and disclosure system. Today all disclosure documents must be filed electronically using the EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. EDGAR filings are available on the Internet, going back to 1994 for most companies. Securities markets, as well as corporate and securities lawyers, have found EDGAR to be invaluable. You can find and play with it on the SEC's website at *www.sec.gov.*

§21.2.3 Recordkeeping and Foreign Bribes

In response to revelations in the 1970s of U.S. companies doctoring their books and setting up slush funds to bribe highly placed foreign government officials, Congress passed the Foreign Corrupt Practices Act (FCPA) of 1978. Cracking down on lax internal controls by publicly held corporations, the FCPA amended the Exchange Act to require reporting companies to (1) maintain financial records in "reasonable detail" to reflect company transactions accurately and (2) put into place internal accounting controls sufficient to provide "reasonable assurances" of internal accountability and proper accounting. Exchange Act §13(b)(2).

The FCPA also prohibits reporting companies (or their officials) from paying bribes to foreign government officials to influence their official actions or decisions for the purpose of obtaining or retaining business. Exchange Act §30A(a). In recognition of the way the world works, however, the FCPA excludes from its coverage "routine" payola to lower-level government officials to facilitate their performing their duties. Exchange Act §30A(b). Violations can result in civil penalties and criminal prosecution—both of companies and individuals. Exchange Act §30A(g) (specifying fines and civil penalties, with caps ranging from $10,000 to $2,000,000, and prison sentences up to 5 years for "willful" violations by corporate officials; prohibiting corporations from paying fines imposed on corporate officials).

In 2002, responding to a wave of corporate and accounting scandals, the SEC adopted new rules that require reporting companies to establish and maintain an overall system of disclosure controls and procedures adequate to

meet the company’s Exchange Act reporting obligations. Exchange Act Rules 13a-15 and 15d-15.

CHAPTER 22 Securities Fraud — Rule 10b-5

Rule 10b-5, the securities antifraud rule promulgated under the Securities Exchange Act of 1934, is a bedrock of U.S. securities regulation. Every securities transaction lives under its protective shade and in its menacing shadow. For those who enter into securities transactions, the rule assures that relevant securities information is not purposefully false or misleading. For purveyors of securities information, it imposes standards of complete honesty that carry risks of heavy liability.

This chapter begins with an overview of Rule 10b-5 (§22.1) and then describes the nature of a private 10b-5 action: the persons and activities to which the rule applies (§22.2); the fraud elements that must be shown to establish liability (§22.3); the defenses that apply in a Rule 10b-5 action (§22.4); a comparison with other antifraud remedies (§22.5).

The next chapter covers the use of Rule 10b-5 as the principal regulatory tool against insider trading. Then Chapter 24 looks at the federal disclosure rules and short-swing disgorgement liability for market trading by specified insiders.

§22.1 OVERVIEW OF RULE 10B-5

§22.1.1 History of Rule 10b-5

Rule 10b-5 has been aptly described as "the judicial oak which has grown from little more than a legislative acorn." The rule's origins were humble. In 1942, faced with reports that a company president was making unduly pessimistic statements about company earnings while at the same time buying his company's stock, the SEC filled a regulatory gap. The antifraud provisions of the Securities Act of 1933 prohibited fraudulent *sales* of securities, but there was no specific prohibition against fraudulent *purchases*.

Using its authority to promulgate rules that prohibit "manipulative or deceptive devices or contrivances … in connection with the purchase or sale of any security" under §10(b) of the Securities Exchange Act of 1934, the SEC filled the "purchase" gap with Rule 10b-5, which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

The SEC approved the rule without debate, with one SEC commissioner asking rhetorically: "Well, we are against fraud, aren't we?"

The regulatory acorn sprouted in 1946 when a federal district court in Pennsylvania first inferred a private cause of action under Rule 10b-5. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The implied 10b-5 action then grew and branched in the 1960s as federal courts used it aggressively to regulate not only securities fraud, but also negligent securities practices and corporate mismanagement. In the 1970s the Supreme Court pruned back this judicial activism and effectively limited the private 10b-5 action to securities deception. This pruning continued, though less dramatically, in the 1980s and 1990s as the Court dealt with issues of 10b-5 coverage and procedure.

Through all of this judicial shaping, the 10b-5 action has shown remarkable resiliency and has become a centerpiece of U.S. securities regulation. Its procedural advantages are many: nationwide service of process, liberal venue rules, and broad discovery tools. In 1995, however,

Congress enacted the Private Securities Litigation Reform Act (PSLRA) to limit perceived abuses in federal securities litigation, particularly 10b-5 class actions. While the number of securities class actions has remained stable (about 150—200 per year, see http://securities.stanford.edu) since the PSLRA was enacted, the substantive and procedural rules introduced by the legislation have discouraged the filing of 10b-5 class actions. In 2002, responding to Enron and other accounting scandals, Congress enacted the Sarbanes-Oxley Act and signaled a renewed commitment to securities fraud liability. See §11.5.1. Then in 2010, responding to the financial crisis of 2008, Congress enacted the Dodd-Frank Act, expanding the SEC's enforcement powers, including in actions arising under Rule 10b-5. See §11.5.2.

§22.1.2 Private 10b-5 Actions and SEC Enforcement

Section 10(b), unlike other antimanipulation and antifraud sections of the Exchange Act, does not specify a private remedy for violations of its rules. Despite the absence of a statutory mandate, it is now beyond question that Rule 10b-5 implies a private cause of action. See *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (first case to impose 10b-5 liability, holding corporate insider liable for misrepresenting that business would not be sold when in fact insider planned to sell it at substantial profit). See also *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (confirming existence of private action). Such claims may be brought only in federal district courts, which have exclusive jurisdiction over actions arising under the Exchange Act. See Exchange Act §27.

Rule 10b-5 is also a potent tool in SEC enforcement. Section 21 of the Exchange Act gives the SEC broad enforcement powers to sue in federal court to enjoin violations of its rules, including Rule 10b-5. Using this authority, the SEC has sought injunctions and other equitable remedies. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (judicial order establishing a fund from which contemporaneous investors could recover lost profits from illegal insider trading). The SEC can also recommend that the U.S. Justice Department institute a 10b-5 criminal action, a common occurrence in insider trading cases. See §23.3.

Madoff Scandal

One of the most high-profile securities frauds—a Ponzi scheme orchestrated by Bernie Madoff in which he used new investor money to pay returns to old investors—illustrates the reach and limits of Rule 10b-5. Madoff was a stockbroker who promised his clients, mostly wealthy individuals and large charities, steady returns using sophisticated hedging techniques. The scheme lasted for nearly 20 years. All told, about $65 billion (including fabricated gains) was missing from client accounts when the fraud was revealed in 2008. Although the SEC had received complaints that Madoff's investment model was "too good to be true," the agency failed to unearth the fraud. Instead, it came to light only when Madoff himself told his sons that his investment funds were "one big lie."

Here is a *partial* list of the more than 250 cases spawned by the Madoff fraud (many as reported by "The D&O Diary" blog):

- Federal prosecutors brought a criminal case against Madoff, charging him with securities fraud (including under Rule 10b-5); Madoff pled guilty in 2009 and is serving a prison term of 150 years.
- Investors in the Madoff funds sued in federal court (including under Rule 10b-5), claiming fraud in their investments in the Madoff funds and seeking to recover a portion of their losses from the bankrupt funds.
- Investors in "feeder funds" that invested in the Madoff funds brought various federal class suits (including under Rule 10b-5) against the feeder funds, their advisers, and their accounting firms.
- Investors in the Madoff funds sued the SEC (under the Federal Tort Claims Act) for "sheer incompetence" in failing to investigate the Madoff scheme.
- The Massachusetts secretary of state brought similar suits (under Massachusetts law) against different feeder funds, which had recorded phone calls from Madoff that began "This conversation never took place, okay?"
- A divorced man sued his former wife (under state law) to recover payments he made in their divorce to buy out her portion of their Madoff investments, now worthless.
- A pro se plaintiff, on behalf of Madoff, sued Britney Spears and Kevin Federline, alleging (under who knows what law) that Spears had "secret

affairs with Madoff in return for Saks Fifth Avenue gift certificates."

Interestingly, although many of the claims involve fraud in connection with investments that ended up with Madoff, the claims often avoid Rule 10b-5. Why is this? You will discover that claims based on Rule 10b-5 face a number of hurdles. Class actions under Rule 10b-5 are subject to discovery stays, as well as limits on who can represent the class; and 10b-5 plaintiffs must prove the defendant's knowledge of the fraud and the victim's reliance on false information. In short, although Rule 10b-5 casts a large shadow, there are numerous ways to get at securities fraud.

§22.1.3 Some 10b-5 Pointers

In your study of Rule 10b-5, some preliminary pointers are in order.

Pointer	Elaboration
Look to the language of the statute, not the rule.	You will notice that the operative language of §10(b) is different from that of the rule. Over time, courts have interpreted the enabling statute and its phrase "manipulative or deceptive device or contrivance" as being narrower than the rule. The statute controls, and the phrasing of the rule's prohibitions has become largely irrelevant. The Supreme Court has repeatedly turned to the statutory language to fashion the 10b-5 action.
Identify a securities purchase or sale.	Both §10(b) and Rule 10b-5 apply to "the purchase or sale of any security." Thus, 10b-5 actions protect both investors who purchase and shareholders who sell. Rule 10b-5 also applies whether the securities are publicly traded or closely held and whether they are subject to registration or exempt. Securities exempt from registration under the Securities Act and the Exchange Act — significantly federal, state, and local government securities — are subject to the antifraud coverage of Rule 10b-5. See Exchange Act §3(a)(12) (definition of exempted securities).
Identify deception "in connection with" the securities transaction.	Both §10(b) and Rule 10b-5 apply to "any person" who engages in prohibited behavior "in connection with" a securities transaction. There is no requirement of privity. Rule 10b-5 applies to persons (such as companies that issue false or misleading press releases) even if they are not parties to securities transactions so long as their behavior affects the transactions.
Check (quickly) for the use of jurisdictional means.	Both §10(b) and Rule 10b-5 hinge on specified jurisdictional means: use of an instrumentality of interstate commerce, the mails, or a national securities exchange. In most situations, this raises essentially a nonissue. Almost always a securities transaction will involve the mails or interstate facilities at some point. If a check must clear or a letter confirms a transaction, the mail will be used. Further, the Exchange Act explicitly treats intrastate phone calls as involving the use of an instrumentality of interstate commerce. Exchange Act §3(a)(17). It is difficult to imagine, outside of a law school exam (such as a face-to-face transaction for cash), a securities purchase or sale not involving jurisdictional means at some point in its initiation, negotiation, or performance. *(continued)*

Pointer	Elaboration
Check (with care) for procedural limitations imposed by the PSLRA.	Class actions claiming securities fraud under federal law (including Rule 10b-5) are a disfavored genre after the Private Securities Litigation Reform Act of 1995. The PSLRA seeks to discourage frivolous securities litigation. Among other things, it requires in a 10b-5 class action that the lead plaintiff be the "most adequate plaintiff," presumably the shareholder or investor with the largest financial stake in the class relief. The PSLRA imposes significant new burdens on lead plaintiffs and their counsel: heightened pleading requirements, stay of discovery while any dismissal motion is pending, shifting of attorneys' fees if the complaint lacks substantial legal or factual support, payment of a bond to cover any fees that may eventually be shifted, full and detailed disclosure of any settlement, and limits on the awarding of attorney fees.
Check whether the action is brought in federal or state court.	Actions claiming 10b-5 violations must be brought in federal district court. Exchange Act §27 (exclusive jurisdiction of "violations of this Act or the rules and regulations thereunder"). In addition, class actions alleging fraud involving publicly traded securities — whether under federal or state law — must be brought in federal court. Securities Act §16(c); Exchange Act §28(f)(2). This jurisdictional mandate was added by the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which responded to a perceived loophole that allowed plaintiffs to avoid the PSLRA rules by bringing securities fraud class actions in state court, where state procedures and substantive law are less demanding. See §21.1. Under SLUSA, however, class actions that allege fiduciary breaches under state corporate law may still be brought in state court — the "Delaware carve-out." Securities Act §16(d); Exchange Act §28(f)(3)(A); Gibson v. PS Group Holdings Inc., Fed. Sec. L. Rep. ¶90,921 (S.D. Cal. 2000) (permitting securities fraud class action that alleges state fiduciary breaches to be brought in state court, not limited to the company's state of incorporation).

§22.2 SCOPE OF PRIVATE 10B-5 ACTION

Although grounded in the elements and terminology of the law of deceit, the judge-made 10b-5 action varies from a garden-variety fraud action. Courts have interpreted §10(b) to impose limits on who can sue, who can be sued, and what counts as securities fraud—the subjects of this subsection. Moreover, courts have conservatively honed the elements of a private 10b-5 action to resemble a decidedly old-fashioned action for deceit, except to relax significantly the normal requirement of reliance (see §22.3). Finally, courts have fashioned defenses to a private 10b-5 action that go beyond those of a typical fraud action (see §22.4).

Layered on this court-created 10b-5 profile are the provisions of the

Private Securities Litigation Reform Act of 1995. Among other things, the PSLRA revamped 10b-5 class action procedures, called for the shifting of attorney fees as a sanction for baseless complaints, largely replaced joint and several liability with proportionate liability, and confirmed the elimination of aiding and abetting liability in private actions.

§22.2.1 Purchasers and Sellers: 10b-5 Standing

Birnbaum Doctrine

Only actual purchasers or sellers may recover damages in a private 10b-5 action. This standing requirement, often called the *Birnbaum* doctrine, avoids speculation about whether and how much a plaintiff might have traded. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). Even if a false or misleading statement leads a person not to buy or sell, with results as damaging as actual trading, there is no 10b-5 liability.

In 1975 the Supreme Court affirmed the purchaser-seller requirement. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The case—famous for the Court's virulent doubts about 10b-5 litigation and a precursor to the PSLRA restrictions on securities fraud actions—involved the unusual allegation that a corporate issuer had made overly pessimistic statements to discourage potential purchasers. Under an antitrust consent decree, the issuer (a trading stamp company) was required to offer its shares at a discount to retailers harmed by its prior anticompetitive activities. One of the retailers that did not buy sued to recover damages on the theory the prospectus offering the stock was pessimistic intentionally to discourage retailers from purchasing.

Speaking for the Court, Justice Rehnquist said the language of §10(b) and the Exchange Act's definitions did not cover offers to sell but only *actual sales or purchases*. He pointed out that for nearly 25 years Congress had let the *Birnbaum* rule stand. Justice Rehnquist then launched into a diatribe against potential abuse of 10b-5 litigation. He speculated that an indeterminate class of nonpurchasers would bring vexatious litigation to extract settlements, in the process disrupting business and abusing civil discovery. In addition, he argued liability would be staggering if nonpurchasers could base a claim on the speculative assertion they *would have purchased* had disclosure been less discouraging.

Securities Fraud Actions by “Holders” in State Court

The 10b-5 purchaser-seller requirement has led “holders” of securities to bring securities fraud class actions in state court alleging that false or misleading statements led them *not to sell* their shares. These “holder” cases ran into SLUSA, which requires that all class actions alleging fraud “in connection with the purchase or sale” of securities be brought in federal court. See §22.1.2.

In 2006 the Supreme Court held that “holder” class actions brought in state court are preempted by SLUSA, even though they are also barred in federal court under the *Birnbaum* doctrine. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006). The principal issue was whether “holder” claims were “in connection with the purchase or sale” of securities. The Court, resolving a split in the circuits, decided they were. Noting that the *Blue Chip Stamps* policy against “vexatious” litigation also motivated the PSLRA restrictions on securities class actions, the Court concluded that SLUSA was intended to funnel such actions into federal court—and squelch them. The Court pointed out that “holder” claims (whether in federal or state court) raise factual issues of whether and how much the holders would have sold, the precise speculation *Blue Chip Stamps* had sought to avoid.

Lead Plaintiff (and Counsel) in 10b-5 Class Actions

The PSLRA, a successor to the *Blue Chip Stamps* antagonism toward private 10b-5 actions, sought to constrain 10b-5 class actions instituted by “professional plaintiffs” who own a nominal number of shares in many public companies and lend their names (for a bounty) to securities lawyers who sue whenever there are unexpected price swings in a company’s stock. The PSLRA establishes procedures for the appointment of the lead plaintiff (and thus lead counsel) in securities fraud actions. After the filing of a securities fraud class action, the plaintiff must give public notice to potential class members inviting them to serve as lead plaintiff. The court then is to appoint as lead plaintiff the “most adequate plaintiff,” which the statute presumes would be the investor with the largest financial interest in the action. Exchange Act §21D(a)(3).

These new provisions envision a prominent role for institutional shareholders, which typically will have the largest financial interest in securities litigation involving public companies. The provisions specifically

exempt institutional shareholders from limits on the frequency a particular investor can serve as lead counsel. See Weiss & Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053 (1995) (cited prominently in PSLRA's legislative history).

§22.2.2 Primary Violators: 10b-5 Defendants

There is no privity requirement under Rule 10b-5. Any person who makes false or misleading statements and induces others to trade to their detriment can become liable—a *primary violator*. See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Significantly, corporate officials who make statements about the corporation or its securities expose the corporation to 10b-5 liability, even though the corporation does not trade.

Control Persons

The Exchange Act imposes joint and several liability on any person who controls a primary violator—such as the parent corporation of a subsidiary that engages in illegal activity—unless the control person shows it "acted in good faith and did not … induce … the violation." Exchange Act §20(a). Courts have interpreted the "good faith" defense as requiring the showing of an affirmative effort by a control person to prevent subordinates from committing securities fraud.

Courts have wrestled with whether, aside from the control person liability of §20(a), the general rule of *respondeat superior* applies to a corporate defendant when an employee of the corporation commits securities fraud in the regular scope of her employment. See *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008) (holding no *respondeat superior* liability under Rule 10b-5 when employee who gave false newspaper circulation figures was not executive officer and false figures were meant to deceive advertisers, not shareholders). The Exchange Act imposes liability on "persons," defined to include a corporation—an entity that can only become liable through its agents. Thus, as some courts have persuasively pointed out, the Act already makes corporate principals liable under traditional agency principles, regardless of the corporate defendant's "good faith" efforts to supervise its employees. Viewed in this light, §20(a) is an additional grounds for vicarious liability beyond traditional agency principles.

Aiders and Abettors

Until 1994 lower courts had uniformly upheld aiding and abetting liability in private Rule 10b-5 cases against secondary participants, such as accountants who certified a company's false financial statements or lawyers who advised and gave "substantial assistance" to securities swindlers. In *Central Bank of Denver*, 511 U.S. 164 (1994), the Court read the "manipulative or deceptive device or contrivance" language of §10(b) to require that 10b-5 defendants engage in actual fraudulent behavior, not merely provide collateral assistance —thus *disallowing* private actions based on a theory of aiding and abetting. The Court pointed out that none of the other express private causes of action under the Exchange Act impose aiding and abetting liability and that, in any event, such liability has never been widely accepted under tort law.

Even though lower courts had uniformly assumed the existence of 10b-5 aiding and abetting liability before *Central Bank*, the Court concluded Congress had never approved these cases and suggested Congress could remedy the problem if the Court's reading were in error. Congress accepted the Court's invitation in a limited way, permitting aiding and abetting liability in SEC enforcement actions. The PSLRA expressly authorizes the SEC to seek injunctive relief or money damages against those who aid and abet a 10b-5 violation by knowingly giving "substantial assistance" to the primary violator. Exchange Act §20(e).

The Dodd-Frank Act gives the SEC additional authority to challenge aiding and abetting. Responding to lower court decisions requiring a showing of "actual knowledge" for such liability, Dodd-Frank adopts a "recklessness" standard in SEC aiding and abetting actions. Dodd-Frank §929M. Thus, securities professionals (such as attorneys, investment banks, accountants, financial analysts, and credit rating agencies) that may not meet the definition of "primary violator" in a private action may be subject to liability in an SEC enforcement action. See §12.3.

Primary Violators (and "Scheme Liability")

Central Bank holds that peripheral actors who engage in fraudulent (or deceptive) conduct on which a purchaser or seller of securities relies may be liable as a primary violator. A recurring question has been whether the "primary violator" standard extends to those who facilitate the fraud. Some lower courts since *Central Bank* have held secondary participants (such as

lawyers, accountants, and underwriters) could be liable as primary violators for their role in drafting and editing documents that contain misrepresentations, even though the participants were not mentioned and the documents were disseminated to investors by others. See *In re Software Toolworks, Inc. Securities Litigation,* 50 F.3d 615 (9th Cir. 1994). Other courts have held that primary violators must actually make the misstatement to investors or have it attributed to them. See *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998) (refusing to hold liable an auditor that privately approved false press report because report stated financials were unaudited and did not mention auditor).

And what about 10b-5 liability for those who participate in fraudulent schemes by, for example, entering into sham transactions used to generate false financial results—so-called scheme liability? In 2008 the Supreme Court rejected scheme liability in private 10b-5 litigation. *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008). The Court held that the suppliers and customers who allegedly helped a cable TV company artificially inflate its earnings could not be liable as primary violators in a 10b-5 action brought by the company's investors. Even though the suppliers/customers had misled the issuer's auditors by documenting sham transactions with the issuer, their misdeeds were held not to be actionable in a private 10b-5 action.

The Court pointed out that the supplier/customers owed no duty to the company's investors, and the sham transactions were not disclosed to the public—and thus investors could not have relied on the deception, a prerequisite for 10b-5 liability. Furthermore, the Court concluded that the suppliers'/customers' deception of the auditors was "too remote" from the issuer's fraudulent financial statements to support primary liability. In short, liability for the investors' full trading losses would have been disproportionate to their attenuated involvement in the company's fraud.

The *Stoneridge* Court noted that Congress, in the PSLRA, had placed various limits on private 10b-5 actions, including limiting aiding and abetting liability to SEC enforcement actions. Although the Court did not address whether private 10b-5 liability extends to "behind the scenes" lawyers and accountants who engineer securities deception without an attribution of their role, the case reflects the Court's misgivings about expanding the implied private 10b-5 action to cover additional parties and situations. Instead, *Stoneridge* puts pressure on the SEC and state regulators to investigate and

bring enforcement actions against secondary participants.

Lower courts have followed the *Stoneridge* lead, denying secondary liability for lawyers and other professionals who created or facilitated fraudulent transactions—provided they were unknown to the victims of the fraud. See *Affco Investments 2001 LLC v. Proskauer Rose LLP*, 625 F.3d 185 (5th Cir. 2010) (refusing to hold law firm liable in disallowed tax avoidance scheme because investors did not allege investors' awareness of or reliance on firm); *Pac. Inv. Mgmt. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) ("behind the scenes" law firm not liable for facilitating fraudulent loan transactions and drafting false offering documents, where false statements were not attributed to firm). In short, lawyers can orchestrate a securities fraud and escape 10b-5 liability—so long as they hide themselves from view.

Securities Fraud in Mutual Funds

In a recent decision with potentially significant ramifications for 10b-5 actions, the Supreme Court held in a 5-4 decision that only those whoactually "make" false or misleading statements can be liable under Rule 10b-5. *Janus Capital Group, Inc. v. First Derivative Traders,* 564 U.S.131(2011). In the case, the Court held that a mutual fund adviser was not liable under Rule 10b-5 for false statements in a fund prospectus because the fund, not the adviser, had made the false statements. The Court said that only those with "ultimate control" over the statements in the prospectus (the mutual fund itself) could be liable.

Somewhat unusual under its 10b-5 jurisprudence, the *Janus Capital* Court focused on the language of Rule 10b-5, which makes it unlawful for "any person … to *make* any untrue statement of material fact" in connection with securities trading. The Court determined that the investment adviser had not "made" the untrue statements in the prospectus, even though it was "substantially involved" in its preparation. The Court said it was bound to interpret Rule 10b-5 with "narrow dimensions," likening the relationship of the fund and fund adviser to that of speaker and speechwriter.

The decision seemed not to understand that mutual funds themselves have no staff or employees, but outsource all of their operations to the fund adviser. It is the fund adviser, in turn, that makes all investment decisions for the fund and prepares all fund disclosures, including prospectuses. Nonetheless, the court concluded that "corporate formalities were observed" and that the investment adviser had a corporate board different from the

board of trustees of the mutual fund, thus making them "separate legal entities." The Court stated that redistributing liability in securities cases based on a "close relationship" between investment advisers and the mutual funds they advise was not the responsibility of the courts, but rather Congress.

Despite what to many seemed a misguided result, the outcome might well have been different had the plaintiffs in the case alleged that the fund adviser was the "control person" of the fund. Under Exchange Act §20(a) (described above), control persons assume the Exchange Act liability of the entities they control, which is the case in a typical mutual fund structure where the fund adviser controls all aspects of the fund's operations, including its drafting of disclosure documents. Any 10b-5 liability of the fund thus becomes the liability of the fund adviser, where the "good faith" defense would be unavailable if the fund adviser's actions satisfy the 10b-5 culpability standard.

§22.2.3 Fraud "in Connection with" Securities Transaction

Section 10(b) and Rule 10b-5 prohibit deception "in connection with" the sale or purchase of securities. How close must the deception be to the securities transaction?

No Privity Requirement

Courts have not required privity in 10b-5 actions. Thus, corporate misstatements in situations when the corporation itself is not trading are actionable—provided it is foreseeable that the misstatements will affect securities transactions.

Beyond Privity

Courts have had some difficulty interpreting the "in connection with" requirement when securities transactions are part of a scheme of corporate misdeeds or professional malpractice. If the securities transactions are tangential to the fraudulent scheme, some courts have assumed the matter is better left to traditional state fiduciary, corporate, agency, and contract law—a federalism concern. Nonetheless, on the three occasions that the Supreme Court has addressed the 10b-5 "in connection" requirement, it has construed

it broadly and flexibly to further investor protection.

- **Stockbroker embezzlement.** Misstatements have been held to be actionable both as a breach of fiduciary duty and as a fraud “in connection with” securities transactions. *SEC v. Zandford,* 535 U.S. 813 (2002). In the case, the SEC brought an enforcement action against a stockbroker who had sold his customer’s securities and pocketed the proceeds without the customer’s knowledge or consent. The stockbroker argued that any deception of the customer was not in connection with the sales of securities from the customer’s account because he had never misrepresented the value of the securities in the account. The Court rejected the sophistry and concluded the securities sales and the stockbroker’s fraudulent practices coincided—with each sale furthering the stockbroker’s fraudulent scheme.
- **Misappropriation of confidential information.** The fraudulent misappropriation of material, nonpublic information has been held to be “in connection with” securities trading based on that information. *United States v. O’Hagan*, 521 U.S. 642 (1997). In the case (discussed more fully in §23.3.1 and §23.3.3 below), a lawyer used information about a client’s planned takeover bid and purchased stock in the target before the bid was announced. The Court concluded that the lawyer’s unauthorized use of client confidences was deceptive and “in connection with” his securities trading. The fraud was consummated, according to the Court, when the lawyer traded on the information entrusted to him—thus, the securities transaction and the breach of duty coincided. Significantly, the Court commented that its interpretation furthered “an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”
- **Fraudulent takeover scheme.** A complex scheme to acquire an insurance subsidiary by using the subsidiary’s assets to finance the acquisition was held to state a 10b-5 claim. *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6 (1971). In the case, the purchasers acquired the subsidiary’s shares and then, to pay for them, had the subsidiary’s board authorize the sale of approximately $5 million of U.S. Treasury bonds owned by the subsidiary. To cover their tracks, the purchasers used the subsidiary’s Treasury bonds to finance

> their acquisition and left a mortgaged CD on the subsidiary's books. The Court held the scheme, which effectively misappropriated reserves meant to cover the subsidiary's insurance obligations, to be "in connection with" a securities transaction—namely the sale of the Treasury bonds. Part of the fraudulent scheme, according to the Court, was the deception practiced on the subsidiary's board when it authorized the sale of the bonds without the subsidiary receiving fair consideration. The subsidiary "suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor."

Sale of Business

The Supreme Court has held that Rule 10b-5 applies to stock transactions in the sale of a business even though the purchaser is not investing as a shareholder but buying the business outright. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). The Court rejected a "sale of business" doctrine, adopted by some lower courts, that a securities transaction is not involved when a company is sold in a 100 percent stock sale. The Court read Rule 10b-5 literally to apply to any purchase or sale of securities, including the sale of a business structured as a stock sale.

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§22.3 FRAUD ELEMENTS OF PRIVATE 10B-5 ACTION

Neither §10(b) nor Rule 10b-5 specifies the elements a plaintiff must show to be entitled to relief. Nonetheless, the Supreme Court has looked to the statutory language of §10(b) and insisted that Congress meant "fraud" when it said "any manipulative or deceptive device or contrivance." The plaintiff has the burden of showing the following elements, each of which tests whether the supplier of misinformation should bear another's investment losses:

10b-5 Elements	
Material misinformation	The defendant affirmatively misrepresented a material fact, omitted a material fact that made his statement misleading, or remained silent in the face of a fiduciary duty to disclose a material fact.
Scienter	The defendant knew (or was reckless in not knowing) the true state of affairs and recognized that the plaintiff might rely on the misinformation.
Reliance	The plaintiff relied on the misrepresentation. In 10b-5 cases involving a duty to speak, courts dispense with reliance if the undisclosed information was material. In 10b-5 cases involving transactions on impersonal trading markets, courts infer reliance from the dissemination of misinformation in the trading market.
Causation	The plaintiff suffered actual losses proximately caused by the misrepresentation.
Damages	The plaintiff suffered damages. Courts use a variety of theories to measure damages under Rule 10b-5. Punitive damages, though, are not available under Rule 10b-5.

The PSLRA modifies the court-made rule of joint and several liability in 10b-5 actions and specifies proportionate liability in some circumstances. Exchange Act §21D(g). Although "knowing" defendants remain jointly and severally liable for the plaintiff's full losses, "unknowing" (reckless) defendants are generally liable only for that portion of damages attributable to their share of responsibility.

§22.3.1 Material Deception

Rule 10b-5 prohibits false or misleading statements of material fact. Not only are outright lies prohibited, so are half-truths. This means a true, but incomplete, statement can be actionable if it omits material information that renders the statement misleading. Under the PSLRA, a 10b-5 complaint that alleges half-truths must specify which statements are misleading and why they are misleading. Exchange Act §21D(b)(1).

Deception in securities markets comes in many packages, encompassing far more than false or misleading statements. It includes securities trading that creates false impressions, as well as silence in the face of a duty to speak. Deception can also occur when a statement, though true when made, is superseded by new information that triggers a duty to update. Confirming the

breadth of Rule 10b-5, the Supreme Court recently held that Rule 10b-5 covers deception in an oral contract for the sale of securities, despite the difficulties of proof. *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001). In the case, the seller of a securities option who secretly intended not to honor the option argued that there had been no deception as to the option's value. The Court brushed aside the argument and held the seller's secret reservation was misleading because "the option was, unbeknownst to [the buyer], valueless."

Materiality

Not all deception is actionable. To prevent allegations of bad information from being used as a pretext for shifting trading losses, courts require that the misinformation be material. The Supreme Court has held that a fact is material for purposes of Rule 10b-5 if there is a substantial likelihood that a reasonable investor "would" (not "might") consider it as altering the "total mix" of information in deciding whether to buy or sell. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (adopting a "probability plus magnitude" test for disclosures pertaining to possible future events, such as merger negotiations, by considering both probability that event might occur and the magnitude of its effect on stock price). In general, if disclosure of the information would affect the price of the company's stock, the information is material.

The PSLRA creates a safe harbor for forward-looking information (such as future plans, predictions, or projections) if they are identified as forward-looking and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement." Exchange Act §21E. The PSLRA safe harbor is in addition to the judicially created doctrine that disclosure that "bespeaks caution" (beyond boilerplate warnings) can negate the materiality of unduly optimistic predictions. See *Kaufman v. Trump's Castle Funding*, 7 F.3d 357 (3d Cir. 1993).

To obtain class certification in 10b-5 actions, plaintiffs need only allege (but need not prove) the materiality of the alleged misrepresentations. See *Amgen Inc. v. Connecticut Retirement Plans & Trust Fund*, 568 U.S. ___ (2013) (despite class plaintiff's burden to show efficient market in "fraud on market" case, see §22.3.3 below, materiality is "question on the merits" to be decided on summary judgment or at trial).

Duty to Speak

Normally, silence is not actionable under Rule 10b-5. Nonetheless, courts have imposed a duty to speak when defendants have a relationship of trust and confidence with the plaintiff. See *Chiarella v. United States*, 445 U.S. 222 (1980) (duty to disclose is predicate to 10b-5 insider trading liability). For example, bank employees who failed to tell shareholders that they could sell their shares for higher prices in a resale market, instead of the primary market offered through the bank, breached their duty to disclose. The bank, as transfer agent for the shareholders' corporation, had a relationship of trust that compelled it to speak fully about the shareholders' selling options. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). A duty to speak also arises when a closely held corporation deals with its shareholder-employees. See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987) (holding securities firm liable for remaining silent when the firm repurchased the shares of an employee who resigned on the eve of a lucrative merger offer).

Silence is also actionable in connection with corporate activities in a limited number of circumstances: when the company itself is trading its own securities, when the company fails to correct misinformation it begot and that is actively circulating in the market, or when the company knows that insiders are trading based on information not available to the public. This means, for example, that a company need not comment on analysts' forecasts unless the company has become entangled with the analysts. See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (no duty to disclose projections by investment analysts if the company had not in some way created or validated them).

Duty to Update

In some situations, statements accurate when made become inaccurate or misleading because of subsequent events. Most federal circuits have held that there is a duty to update when forward-looking statements still "alive" in the market have become inaccurate. The notion is that a projection carries an ongoing assurance of validity and thus an implicit duty to supply new information as it becomes available.

For example, the Second Circuit has held that the public announcement of a plan to find a financial partner to mend an over-leveraged capital structure

triggered a duty to update when the company began to consider a dilutive stock offering as an alternative financing plan. *In re Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993). In a similar vein, the Third Circuit has held that a company that had stated its policy to maintain a stable debt-equity ratio came under a duty to disclose negotiations of a merger that would have added significant new debt. *Weiner v. Quaker Oats Co.*, 129 F.3d 310 (3d Cir. 1997). But there is no duty to update periodic SEC filings, which speak only as of the date when made. See *Gallagher v. Abbott Laboratories*, 269 F.3d 806 (7th Cir. 2001) (no duty to update Form 10-K, which failed to mention FDA letter threatening compliance action when letter was dated eight days after filing of 10-K).

Corporate Mismanagement

Mismanagement by corporate officials can violate Rule 10b-5 if the mismanagement involves fraudulent securities transactions that can be said to injure the corporation. For example, when corporate insiders buy stock from the corporation and deceive those with whom they deal, a derivative suit can be used to enforce the corporation's 10b-5 rights.

But not every corporate fiduciary breach involving a securities transaction gives rise to a 10b-5 action. The Supreme Court has held that Rule 10b-5 only regulates deception, not unfair corporate transactions or breaches of fiduciary duties. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). In the case, a parent company merged with its majority-owned subsidiary after giving minority shareholders notice of the merger and an information statement that explained their rights to a state appraisal remedy. The parent stated that a valuation of the subsidiary's assets indicated a $640 per share value, even though the parent was offering only $125 per share (which was slightly higher than a valuation of the subsidiary by the parent's investment banker). The Court held that unless the disclosure had been misleading, which plaintiffs did not claim was the case, no liability could result. An unfairly low price does not amount to fraud.

§22.3.2 Scienter—"Manipulative or Deceptive Device or Contrivance"

A plaintiff in a 10b-5 action must plead and prove the defendant's *scienter*, a

"mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In *Hochfelder*, an accounting firm negligently failed to audit a company's accounting practices, which would have revealed that the company president had induced investors to put money into nonexistent escrow accounts and pocketed the money himself. Defrauded investors claimed the accounting firm's negligence enabled the fraud. The Supreme Court rejected the argument, previously accepted by several lower courts, that negligence is actionable under Rule 10b-5. It based its holding not on the language of Rule 10b-5, which actually supports such a construction, but instead on the enabling "manipulative or deceptive device or contrivance" language of §10(b).

This culpability standard is the same whether the suit is brought by the SEC or a private plaintiff and whether the suit seeks injunctive relief or damages. *Aaron v. SEC*, 446 U.S. 680 (1980) (scienter required in SEC injunctive actions).

Meaning of Scienter

What is scienter in a securities fraud action? Scienter means the defendant was aware of the true state of affairs and appreciated the propensity of his misstatement or omission to mislead. See *Sundstand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977) (defining scienter as involving "not simple negligence," but extreme departure from ordinary care). Showing scienter, which requires evidence of the defendant's state of mind and intent to mislead, is often difficult.

The Supreme Court in *Hochfelder* left open the question whether a showing of recklessness can satisfy the 10b-5 culpability standard. Lower courts have uniformly concluded that recklessness is sufficient to establish scienter under Rule 10b-5, when misrepresentations were so obvious that the defendant must have been aware of them. See *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999) (summarizing approaches in various circuits). Under this view, recklessness exists when circumstantial evidence strongly suggests actual knowledge. Some courts have even said the plaintiff must show "deliberate recklessness." See *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 979 (9th Cir. 1999) (interpreting the PSLRA to compel 10b-5 plaintiffs to plead "facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct").

The existence of liability for recklessness was implicitly acknowledged in

the PSLRA, which creates different levels of liability for 10b-5 defendants. "Knowing" defendants are subject to joint and several liability, while "unknowing" defendants (presumably those who were only reckless) are subject to proportionate liability. Exchange Act §21D(g)(10) (see §22.3.5 below).

Pleading Scienter

Most 10b-5 actions are dismissed or settled. Frequently, dismissal turns on whether the plaintiff has adequately alleged scienter. In general, allegations of fraud must be pleaded "with particularity." Fed. R. Civ. P. 9(b). More specifically, the PSLRA requires a complaint alleging securities fraud to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Exchange Act §21D(b)(2).

The Supreme Court has interpreted "strong inference" to mean "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007). In the process the Court rejected a "middle ground" approach that looked at all the allegations collectively, without comparing them. The Court said that a comparison of "plausible inferences" (of both innocent misrepresentation and intentional fraud) was necessary, and the inference of scienter must be "at least as likely as" any plausible opposing inference.

The Supreme Court thus concluded that the PSLRA pleading standard can be satisfied by pleading facts that create "cogent and compelling" inferences of scienter, provided these inferences are at least as strong as inferences of nonculpability. Significantly, the Court added that, as in any dismissal motion, the court must accept "all factual allegations in the complaint as true" and the complaint must be read as a whole. The Court majority also rejected the approach of two concurring justices who argued that the inference of culpability must be "more plausible" than the inference of innocence, or "more likely correct than not correct." That is, the Court decided that a tie goes to the plaintiff!

§22.3.3 Reliance and Causation

Reliance and causation, elements of traditional common-law deceit, are also elements of a private 10b-5 action—though not an SEC enforcement action.

See *SEC v. Rana Research*, 8 F.3d 1358 (9th Cir. 1993). The reliance requirement tests the link between the alleged misinformation and the plaintiff's buy-sell decision—it weeds out claims where the misinformation had little or no impact on the plaintiff's decision to enter the transaction. The causation requirement, like proximate cause in tort law, tests the link between the misrepresentation and the plaintiff's loss—it weeds out claims where the securities fraud was not "responsible" for the investor's loss.

Reliance and causation are related. Each serves as a filter to ensure that the misrepresentations or omissions alleged by the plaintiff are causally linked to the plaintiff's actions and losses.

Reliance

Courts treat reliance as an element in all private 10b-5 cases, but relax the requirements of proof in a number of circumstances:

(1) Nondisclosure. When the defendant fails in a duty to speak—whether in a face-to-face transaction or an anonymous trading market—courts dispense with proof of reliance if the undisclosed facts were material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (no reliance need be shown in face-to-face transactions when bank employees violated position of trust by failing to make material disclosures). The materiality of the undisclosed information indicates a reasonable investor would have considered it important, suggesting the plaintiff may have acted differently had he known the information. To require proof of reliance in a case of nondisclosure would impose a nearly insuperable burden on a plaintiff to prove reliance on something not said.

(2) Omitted Information. In cases of half-truths—omitted information that makes a statement misleading—courts are divided on whether reliance must be shown. The PSLRA, however, makes reasonable reliance an explicit condition for "knowing" securities violations and thus joint and several liability, whether the claim is based on a misrepresentation or an omission. Exchange Act §21D(g)(10)(A).

(3) Fraud on the Market. In cases of false or misleading representations on a public trading market—so-called fraud on the market—courts have created a rebuttable presumption of reliance. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (plurality decision). The theory is that those who trade on public trading markets rely on the integrity of the stock's market price. In an open and developed stock market, the efficient capital market hypothesis (§19.2.2)

posits that market prices reflect all publicly available information about a company's stock. On the assumption that material misinformation artificially distorts the market price, courts infer that investors have relied on the misinformation. This "fraud on the market" theory assumes that if the truth had been disclosed, investors would not have traded at the prevailing nondisclosure price.

To obtain class certification in a case based on "fraud on the market," the plaintiff must show that the market in which the class traded was efficient and that the alleged misstatements were made to the public. See *Erica P. John Fund, Inc. v. Halliburton Co.*, 563___U.S. (2011) (interpreting FRCP Rule 23, which requires in damages class actions that common legal/factual issues "predominate" over individual issues). The showing of an efficient market has turned on a variety of factors, such as trading volume, number of analyst reports, presence of market makers and arbitrageurs, whether company is an S-3 filer, and historic movement of stock prices in reaction to unexpected events.

After the plaintiff has made this showing, a defendant can rebut the presumption of reliance and avoid the "fraud on the market" theory by showing either (1) the trading market was not efficient, such as by showing that the challenged misrepresentation did not in fact affect the stock's price, or (2) the particular plaintiff would have traded regardless of the misrepresentation. *Basic Inc. v. Levinson*.

The "fraud on the market" theory, which makes possible the 150-200 securities fraud class actions filed each year, has been a bane for the corporate community. Do investors actually rely on market efficiency? From a policy perspective, are class actions a viable way to deter and remedy corporate misinformation in stock markets? In 2014 the Supreme Court revisited the "fraud on the market" theory and upheld the presumption of reliance where corporate statements are made in public stock markets. *Halliburton Co. v. Erica P. John Fund, Inc.*, 573___U.S. (2014) (*Halliburton II*). The Court held that when a plaintiff seeks class certification based on allegedly false corporate statements made in a public stock market, the defendants may *before class certification* "defeat the presumption of through evidence that an alleged misrepresentation did not actually affect the market price of the stock."

Whether *Halliburton II* affects securities fraud class litigation remains to be seen. Dismissal at the certification stage may well turn on what "event

studies" lower courts come to view as sufficient to satisfy the defendant's burden. (Event studies, typically prepared by an expert, provide statistical analysis of whether and how particular events affected stock prices—such as the effect on stock prices when a company issues corrective disclosure.) It is unclear whether defendants will have to show that corrective disclosure did not produce a market-adjusted *negative* effect or whether defendants satisfy their burden by showing that plaintiffs cannot prove such a negative effect.

Causation

Courts have required that 10b-5 plaintiffs show two kinds of causation to recover:

(1) Transaction causation. The plaintiff must show that "but for" the defendant's fraud, the plaintiff would not have entered the transaction or would have entered under different terms—a restated reliance requirement. Many courts equate transaction causation with reliance.

(2) Loss causation. The plaintiff must also show that the fraud produced the claimed losses to the plaintiff—a foreseeability or a proximate cause requirement. See *Bastian v. Petren Resources, Inc.*, 892 F.2d 680 (7th Cir. 1990) (no loss causation when losses happened because of market crash, not fraud). Normally, plaintiffs can establish loss causation by showing a change in stock prices when the misrepresentations were made and then an opposite change when disclosure corrects the false or misleading information. What if there is no price change when the corrective disclosure happens—is it enough to allege and prove that the purchase price was inflated? The Supreme Court has held that the plaintiff cannot simply allege losses caused by an artificially inflated price due to "fraud on the market," but must allege and prove actual economic loss proximately caused by the alleged misrepresentations. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). In the usual case, this will be done by showing a drop in price at the time of corrective disclosure, creating a logical link between the misrepresentation and the loss. If there is no price drop or the shareholder has sold before the corrective disclosure, the plaintiff may be out of luck!

Despite the plaintiff's burden to prove loss causation at trial, the Supreme Court has held that 10b-5 plaintiffs need not establish loss causation to obtain class certification. Instead, a showing of materiality—which creates a presumption of reliance under the "fraud on the market" theory—justifies a finding under FRCP Rule 23 that common legal issues "predominate" over

individual issues. Thus, for purposes of class certification, it is enough that the plaintiffs have pled their investment losses were the result of the alleged fraud. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S.___(2011) (*Halliburton I*) (finding sufficient plaintiff's pleading that losses resulted from falsified earnings reports, understatements of asbestos-liability risk, and overstatements of benefits of merger).

§22.3.4 Damages

Proof of damages is also an element of a private 10b-5 action. The Supreme Court has held, however, that a 10b-5 plaintiff need not establish a price impact to show commonality in a class certification. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S.___(2011) (*Halliburton I*).

Private 10b-5 plaintiffs have a full range of equitable and legal remedies. The Exchange Act imposes only two limitations. Under §28 the plaintiff's recovery cannot exceed actual damages, implying that the goal of liability is compensation and effectively precluding punitive damages. Under §21D(e), added by the PSLRA, damages are capped according to a formula meant to disregard post-transaction price volatility unrelated to any misinformation.

Damages Formulas

Courts have adopted various damages formulas, though with no clear guidelines as to when each applies. Assume that a company issued a false press release at a time its stock was trading at $18. After the false statement, the stock rose to $25. When the company later corrected the false statement, the stock price fell to $15 and then continued to fall to $12. Consider how the following theories of damages might be used by a purchaser in the market at $25 who sells when the market price falls to $12.

- **Rescission.** Rescission allows the defrauded plaintiff to cancel the transaction. If the plaintiff sold, he gets his stock back; if he purchased, he returns the stock and the seller refunds the purchase price. Rescission is suited only to face-to-face transactions where the parties can be identified; this theory would not be applicable in our example.
- **Rescissionary (disgorgement) damages.** If rescission is not possible because the stock has been resold, rescissionary damages replicate a

cancellation of the transaction. A defrauded seller recovers the purchaser's profits—the difference between the purchase and resale price. A defrauded purchaser recovers his losses—again, the difference between the purchase and resale price. Under this theory, the purchaser in our example would seek $13 in damages.

- **Cover (conversion) damages.** Cover damages, like those in a tort conversion action, assume the plaintiff mitigates her losses by selling or reinvesting. They are the difference between the price at which the plaintiff transacted and the price at which the plaintiff could have transacted once the fraud was revealed. Under this theory, the purchaser in our example would seek $10 in damages.
- **Out-of-pocket damages.** This is the most common measure of damages in 10b-5 cases. The plaintiff recovers the difference between the purchase price and the true "value" of the stock at the time of purchase. This measure does not take into account any post-transaction price changes. Valuing stock in the abstract is often speculative, and many courts (including the Supreme Court in *Dura Pharmaceuticals*, above, §22.3.3) look to the price at the time of corrective disclosure as a measure of the "but for" price. In our example, the purchaser might argue that the "true value" of the stock when he purchased was $12, with damages of $13; the defendant might argue the "true value" was $18, with damages of only $7.
- **Contract damages.** Contract damages compensate the plaintiff for the loss of the benefit of the bargain. They are the difference between the value received and the value promised. This theory would not be applicable in our example.

Courts have not developed a unified theory of 10b-5 damages except to say that the theory of damages should fit the facts of the case. In cases involving claims by customers against securities firms, courts often impose rescissory damages on the theory the customers would not have transacted had they known of the fraud. But in cases involving false corporate reports that affect trading in the company's shares, courts have been reluctant to use rescissory damages because it overpunishes the corporate defendant in a falling market. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976) (Sneed, J., concurring in denial of class action certification). Moreover, even though out-of-pocket damages exclude the effects of extraneous price changes,

aggregating such damages may result in a significant recovery that penalizes nontrading defendants and exceeds that necessary for deterrence.

Damages Cap

When recovery is based on the market price of the security—as with out-of-pocket and cover damages—the PSLRA imposes a damages cap. Congress created the cap on the assumption that damages are typically computed as the difference between the transaction price and the market price on the date of corrective disclosure—a rough out-of-pocket computation. Concerned that this “crash price” might substantially overstate plaintiffs’ losses for a company with highly volatile stock, Congress required that courts consider a longer, 90-day window for determining the market price. In theory, prices during this longer window will more accurately impound the corrected disclosure. Under new §21D(e), damages are capped at the difference between the transacted price and the average of the daily prices during the 90-day period after corrective disclosure.

Circularity of Corporate Liability

When a corporation is made liable for damages in a 10b-5 class action, the effect will often be the subsidization of one group of shareholders (or investors) by current shareholders. For example, if the class action involves falsely optimistic statements by management, class members induced to purchase over-priced stock will receive compensation from the corporation. Rarely do managers themselves contribute significant amounts to the settlement of 10b-5 class action claims.

The result is that one group of investors (current shareholders) subsidizes another group of investors (purchasing shareholders)—net of the litigation expenses paid to class counsel and defense counsel. For investors who are diversified, as most individual and institutional investors are, 10b-5 class action litigation imposes costs, but no *net* financial gains for shareholders. Only to the extent that corporate managers (specifically and generally) respond to 10b-5 litigation by improving disclosure and corporate governance might the system be seen as cost-effective. Although studies indicate that companies that settle 10b-5 class actions subsequently undertake corporate governance reforms and then financially outperform their peers, it is unclear whether the benefits of class litigation are worth the costs. Each year approximately 150—200 securities fraud class actions are filed in the United

States, most of them "classic" cases alleging corporate misrepresentations that resulted in dramatic stock price declines. See Stanford Securities Class Action Clearinghouse, available at *securities.stanford.edu* (includes pleadings, court filings, dismissals, and settlement data in all post-PSLRA securities fraud class actions).

§22.3.5 Nature of 10b-5 Liability

Courts in 10b-5 cases have traditionally imposed liability on a joint and several basis—each culpable defendant becomes liable for all of the damages awarded. Joint and several liability serves to deter securities fraud and assures compensation for its victims. Potentially liable persons, facing the risk of full liability, feel compelled to guard against securities fraud. And plaintiffs are assured full recovery if they can identify at least one deep-pocket defendant.

The PSLRA, however, eliminates joint and several liability for defendants who do not "knowingly" commit violations of the securities laws. Exchange Act §21D(f)(2)(A). Instead, the Act creates a system of proportionate liability based on each "unknowing" defendant's proportion of responsibility. Exchange Act §21D(f)(2)(B). This liability scheme responds to concerns that tangential defendants in securities fraud cases (such as outside directors, lawyers, and accountants) with little or no responsibility for the fraud might be coerced by joint and several liability into settling out of fear that they might be found liable and forced to bear all the damages awarded the plaintiffs.

According to the PSLRA, a person commits "knowing" securities fraud when he makes an untrue statement or factual omission, on which others are likely to reasonably rely, with "actual knowledge" of the falsehood. Exchange Act §21D(g)(10)(A). Reckless conduct, by definition, does not constitute a knowing violation. Exchange Act §21D(g)(10)(B). In 10b-5 actions, the PSLRA liability system thus places significant importance on whether a defendant's scienter was knowing or merely reckless.

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§22.4 DEFENSES IN PRIVATE 10B-5 ACTION

Not only do the procedures and elements of private 10b-5 actions reflect a judicial and legislative caution about permitting investors to shift their trading

losses on the basis of claimed misinformation, but additional defenses (some of recent vintage) further limit the advantages of 10b-5 litigation.

§22.4.1 Limitations and Repose Periods

In 2002, Congress established a new statute of limitations for private 10b-5 actions. Sarbanes-Oxley §804. Under the new provision, "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws" must be brought within two years after the discovery of facts constituting the violation (the limitations period), but no later than five years after such violation (the repose period). 28 U.S.C. §1658(b).

The statute extended the prior judicially-imposed statute of limitations in 10b-5 actions—which had been one year after discovery of facts constituting the violation, but no later than three years after the violation. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (announcing a uniform federal limitations period for 10b-5 actions, which before had borrowed applicable state statutes of limitations).

So when is a plaintiff deemed to have discovered facts constituting the 10b-5 violation—thus beginning the §1658 two-year limitations period? At first, lower courts were divided. Some started the clock when the plaintiff became "constructively aware" of possible fraud, others only when the plaintiff had specific evidence establishing the elements of a 10b-5 claim. The Supreme Court resolved the split in *Merck & Co. v. Reynolds*, 559 U.S.663 (2010). In the case, the Court permitted Merck shareholders to pursue a 10b-5 claim against the company for misrepresenting the safety and commercial viability of Vioxx, a pain reliever that the company ultimately withdrew from the market. The Court concluded that the two-year limitations period of §1658 accrues either (1) when the plaintiff actually discovers the 10b-5 violation or (2) when a reasonably diligent plaintiff would have discovered the facts constituting the violation—including the facts indicating scienter. The Court rejected the argument that the limitations period begins to run when the plaintiff was put on notice that something was amiss, requiring further inquiry. Thus, the limitation period did not start with information indicating concerns about Vioxx's safety—but only when there was information indicating that Merck's statements were false *and* made with an intent to deceive.

§22.4.2 Contribution and Indemnification

Securities fraud often implicates a number of actors. Contribution permits a defendant who becomes liable for more than his share to compel other responsible persons (whether or not they were sued) to pay their share of the total liability. Indemnification permits a defendant who has become liable to compel another person bound by contract to assume some or all of the defendant's liability. Both sharing mechanisms have the effect to encourage settlements with 10b-5 plaintiffs because they assure defendants there will be a later mechanism for them to "settle up," and thus expedite compensation to fraud victims.

Contribution

The PSLRA expressly authorizes contribution actions by parties jointly and severally liable under Rule 10b-5—typically "knowing" defendants. Contribution shares, like proportionate liability, are computed according to the percentage of responsibility. Exchange Act §21D(g)(8). The PSLRA also authorizes contribution by "unknowing" defendants who become subject to proportionate liability, but are forced to pay other parties' uncollectible shares. Exchange Act §21D(g)(5). Contribution may be sought from any person, whether or not joined in the original action, who would have been liable for the same damages. These statutory rights clarify a contribution right earlier recognized by the Supreme Court. *Musick, Peler, and Garrett v. Employers Insurance of Wausau*, 508 U.S. 286 (1993).

Under the PSLRA, contribution claims must be brought within six months after a final nonappealable judgment, though "unknowing" defendants who make additional payments beyond their proportionate share have six months after payment to seek contribution. Exchange Act §21D(g)(9).

Indemnification

Courts have implied a right to indemnification for "passive" or "secondary" 10b-5 defendants against more culpable participants. Such indemnification, courts have pointed out, increases deterrence by shifting liability to deliberately deceptive participants.

§22.5 COMPARISON TO STATE LAW REMEDIES

State law provides several alternatives to a federal 10b-5 action. Shareholders can sue corporate managers for violating their "duty of honesty" if they knowingly disseminate false information that results in corporate injury or damage to individual shareholders. See *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (see §21.1). Although the Delaware courts have yet to clarify the elements of a "duty of honesty" action, one apparent advantage is the absence of a "purchaser or seller" standing requirement.

In addition, many state "blue sky" laws (named after scams where farmers who were promised rain got nothing but blue skies) contain civil liability provisions modeled after §12(a)(2) of the Securities Act. See Uniform Securities Act §§410, 605 (see §5.1.3). For example, the civil liability scheme of §410 provides for rescission of both securities sales *and* securities offers made by means of false or misleading communications, whether written or oral, subject to a "due care" defense. Thus, the standing requirement and traditional 10b-5 elements of scienter, specific reliance, and causation are all relaxed. Moreover, state blue sky laws generally provide for recovery of attorney fees.

State common-law deceit, though its elements are similar to a 10b-5 action, offers some advantages over its federal counterpart. State statutes of limitations may be longer (particularly under the "inquiry notice" standard applied by federal courts); many states have relaxed scienter requirements; most states permit punitive damages in egregious cases; and none imposes the pleading and class action barriers of the PSLRA.

Although the Securities Litigation Uniform Standards Act of 1998 requires that any class action alleging fraud in publicly traded securities must be brought in federal court under federal law (see Securities Act §16(c); Exchange Act §28(f)(2)), not all state claims are preempted. Securities fraud in close corporations involving privately held securities can be brought under state law; "duty of honesty" claims may be brought as derivative actions; and state "blue sky" claims can be brought by individual investors.

Examples

1. Last year ITM Corp. (whose common stock is publicly traded) issued

preferred stock to a group of institutional investors in a private placement exempt from registration under the Securities Act of 1933 (see §5.1.2). ITM is now experiencing financial problems—its annual revenues have dropped 25 percent, and it has discontinued paying dividends on the preferred. One of the investors, Lucre Life Insurance Company, thinks the offering circular accompanying the preferred issuance was misleading.

   a. Does Lucre Life have standing to bring an action under Rule 10b-5?
   b. Lucre Life is worried about delays in federal court. Can it sue in state court?

2. The offering circular stated: "ITM is committed to energy storage research and has spent over $200 million on this research in the last two years." Last year, ITM's total revenues were $25 billion.
   a. In fact, ITM had only spent $150 million on electrolysis research. Is there 10b-5 liability?
   b. The offering circular failed to mention that ITM's electrolysis research is a long shot and there is no assurance it will produce results having any commercial value. Is there 10b-5 liability?
   c. The offering circular also states that "the company anticipates that sales of our energy storage technology in the next fiscal year will exceed research expenses." Senior management, however, has doubts whether this will happen. Is there 10b-5 liability?
3. ITM's offering circular falsely stated the company had been awarded a large military contract to create solar-powered electrolysis systems that would separate water into hydrogen and oxygen (a highly efficient method to produce and store energy). In fact, the company was hoping to receive the contract, but its bid lost. Jane, ITM's outside attorney who prepared the offering circular, had been told by Daniela (ITM's president) that it was a "done deal," though Jane had an inkling that ITM had not been awarded the contract.
   a. Assuming the offering circular was materially false, can Lucre Life sue Jane under Rule 10b-5?
   b. Lucre Life alleges that Jane, though she did not actually know about the status of the contract award, suspected the contract had not been awarded and was in a position to know. Is this sufficient?

c. Nobody at Lucre Life actually read the portion of the offering circular mentioning the contract award. There is no organized market in ITM's preferred shares. Can Lucre Life recover against ITM under Rule 10b-5?

d. Lucre Life bought its preferred shares at $100. After it learned ITM had lost the bid, it sold the shares to another institutional buyer at $85. Assuming liability, how much can Lucre Life recover?

4. Lucre Life settles its lawsuit. Soon afterward, ITM research scientists conduct preliminary tests on a cobalt/phosphate film that has efficient electrolytic properties at room temperatures. If the tests can be confirmed, the discovery would be an enormous breakthrough with great commercial value. It would mean that solar energy could be efficiently stored, potentially making every house or building its own power plant and filling station.

   a. Must ITM issue a press release disclosing the tests?

   b. In the week after the tests, there is an unusual amount of trading activity in ITM's common stock, which rises in price from $50 to $70. A *Wall Street Journal* reporter calls Daniela, ITM's president, and asks if she can explain the recent price rise. Daniela does not believe there has been insider trading, and doesn't want to say anything. What should she do?

   c. ITM's management wants to put an end to media speculation and issues a press release stating, "There are no corporate developments that would explain the unusual recent market activity in ITM's stock." Would this violate Rule 10b-5?

   d. How should the press release have been drafted?

5. Sharon sells her ITM stock when the price falls after the false press release. More than two years later, after many further tests by ITM scientists and much speculation among securities analysts, ITM files a report with the SEC announcing its invention of a low-cost, efficient electrolysis process using a cobalt/phosphate film. The company's stock price soars. But Sharon no longer owns ITM stock. What a disappointment!

   a. ITM never purchased or sold its stock in connection with the original false press release. Can Sharon sue ITM under Rule 10b-5?

   b. Sharon was not aware of the original false press release, and ITM

argues her decision to sell was unrelated to it. Must Sharon show she acted in reliance on the press release?

c. Sharon sold her ITM stock more than two years ago. Would a 10b-5 action now be timely?

Explanations

1. a. Yes. Lucre Life has standing as a purchaser of securities even though they are not traded on a public trading market. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("purchaser" or "seller" standing requirement) (see §22.2.1).

   b. Not under Rule 10b-5. Jurisdiction over 10b-5 claims is exclusively in federal court. If the action were brought in federal court, any state fraud or blue sky claims could be brought as pendent claims. Many securities lawyers perceive federal judges to be more sophisticated in securities matters.

   Nonetheless, Lucre Life could sue in state court on a theory of common-law fraud or under state blue sky provisions whose elements are not as burdensome as those of Rule 10b-5. The preemption of the Securities Litigation Uniform Standards Act of 1998 does not apply because Lucre Life is not bringing a class action. See Exchange Act §28(f)(1) (preemption of "covered class actions").

2. a. Probably not. It is unlikely that the discrepancy was material. The $50 million difference between stated and actual research expenditures seems immaterial for a company with $25 billion in revenues. Lucre Life would have to show a substantial likelihood a reasonable investor would have considered the $50 million discrepancy important in its decision to invest at the offering price. For example, if the company's research activities were perceived to drive its stock value or if the company's stock price fell significantly when the discrepancy was revealed, materiality would be easier to argue.

   b. Probably not. It is unlikely that there was reliance. It seems unlikely a reasonable investor, particularly an institutional investor like Lucre Life, would have understood ITM's statement that it was "committed to energy storage research" to suggest the company was sure of commercial success. The "no assurance" caveat would not have added to the overall mix of information available to the investors.

c. Perhaps. Scienter is an element of a 10b-5 action. A mere misstatement is not actionable, unless it was made with scienter. Even though it may be difficult to establish corporate awareness that the prediction of future revenues was not likely to occur, scienter can also be established by showing "recklessness." Here the lack of a basis for believing that energy-storage revenues would cover research expenses suggests that the falsity of the statement was "so obvious that the defendant must have been aware of them." See §22.3.1.

3. a. Perhaps. Even though she was not a party to the stock sale, privity is not required under Rule 10b-5. Jane may be liable as a "primary violator" if she made false or misleading statements on which investors relied. (She cannot be liable in a private action on an aiding or abetting theory.) Some lower courts have held collateral participants liable as primary violators for their role in drafting documents that contained misrepresentations, even though others disseminated the documents to investors.

The Supreme Court's decision in *Stoneridge* (see §22.2.2) rejecting "scheme liability" under Rule 10b-5 suggests that investors must be aware of the alleged participant's role in the fraud. That is, merely preparing the disclosure documents—although necessary to carry out a fraudulent scheme—is not enough to establish private 10b-5 liability. This conclusion is reinforced in *Janus Capital* (see §22.2.2), which held that merely drafting a false disclosure document did not subject a mutual fund adviser to liability where the statements in the document technically were "made" by the fund itself. Thus, even if Lucre Life knew that Jane (and her law firm) had prepared the disclosure documents, it would seem Lucre Life cannot look to Jane, but only to ITM, for 10b-5 liability. And given that Jane (and her law firm) did not control their client, they would not be exposed to the client's 10b-5 violation as control persons.

This, however, is not the end of the story for Jane. Although probably absolved of direct 10b-5 liability, Jane (and her law firm) might be subject to liability *to ITM* for professional malpractice arising from her knowing assistance in a securities fraud. She might also face liability in an SEC enforcement action for "aiding and abetting" ITM's 10b-5 violation, potentially resulting in an injunction and fines that could be as devastating as direct 10b-5 liability. See Exchange Act

§20(e) (see §22.2.2).

b. Probably not. Even if Jane may be considered a "primary violator" (see previous explanation), Lucre Life must establish her culpability. She must have known or been reckless in not knowing the true status of the contract award. Negligence is not enough.

Are Lucre Life's allegations sufficient? The Supreme Court's decision in *Tellabs* (see §22.3.2) clarifies the PSLRA pleading standard for alleging scienter in a private 10b-5 action. The Court requires that the "plausible inferences" of nonculpability and fraudulent intent be compared, and the inference of scienter must be "at least as likely as" any plausible opposing inference. In this case, because Lucre Life is not alleging actual knowledge, it would have to show Jane's alleged *recklessness* is at least as likely as not.

Lucre Life's allegation that Jane suspected the disclosure was not true and was in a position to know the truth would seem to make out a claim of recklessness, at least as defined by the lower courts. Her suspicions would seem to create a "cogent and compelling" inference that the misrepresentations were so obvious she must have been aware of them. That is, circumstantial evidence strongly suggests Jane knew something was amiss and should have investigated, even if she did not actually know the true state of affairs. In a dismissal motion, the court must accept "all factual allegations in the complaint as true" and the complaint must be read as a whole.

The *Tellabs* approach effectively rejects the prior focus on the "motive and opportunity" of the defendant. Cf. *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (accepting pre-PSLRA pleading standard that strong inference of fraudulent intent can be established by alleging facts that show the defendant had both motive and opportunity to commit fraud). Thus, Lucre Life would not have to allege that Jane had a motive to deceive.

c. Perhaps. Reliance is an element of a 10b-5 action, and Lucre Life must show it acted on the basis of the circular's false statements concerning a government contract. This will be difficult because the plaintiff never read this part of the circular. Nor is there an open, developed, efficient market that sets the price for the preferred stock—undermining for the plaintiff a traditional "fraud on the market" theory of reliance.

Nonetheless, Lucre Life might argue that it relied on the private placement market. Some courts have accepted the argument that a plaintiff establishes reliance if it can show a new offering would not have been marketed *at all* if the investors had known the true facts. That is, Lucre Life could argue it relied on the other institutional investors' decision to buy. This theory nearly excuses reliance in any issuance of stock, and some courts have limited the theory to fraud that was "so pervasive that it goes to the very existence" of the securities on the market. *Ross v. Bank South, N.A.*, 885 F.2d 723 (11th Cir. 1989).

d. Lucre Life has a number of remedial theories to choose from, depending on which defendant it seeks recovery from. If the plaintiff seeks recovery from ITM for selling its securities through a false selling document, a rescissory theory avoids issues of valuation and post-transaction losses. It prevents unfair enrichment by ITM and compensates Lucre Life for losses it would not have incurred but for the fraud—which matches its theory of liability. Lucre Life can support a rescission theory by pointing to §29(b) of the Exchange Act, which states that any "contract made in violation" of any rule under the statute is void. Rescissory damages in this case would be the difference between $100 (the purchase price) and $85 (the price at which Lucre Life later sold)—$15 per share.

A rescission theory does not fit as well for Jane, the arguably complicit attorney. Jane was not the seller and was not unjustly enriched; heavy damages might overdeter her conduct. A cover theory—which assumes the plaintiff sells once the fraud is revealed—does not fit the facts because there was no market into which the plaintiff could sell or to measure the effect on price when the fraud was revealed. An out-of-pocket theory, the traditional theory for fraud damages, would allow Lucre Life to recover the difference between the purchase price and what the price would have been had the disclosure been adequate. This will require Lucre Life to prove the "true" value of the preferred stock as of the time of its purchase. Recovery will probably be less than $15 per share, given that it might be difficult for Lucre Life to show the price drop was due entirely to the misinformation about the contract award.

According to the Supreme Court in *Dura Pharmaceuticals* (see §22.3.3) a plaintiff alleging "fraud on the market" (against a nonprivity

defendant) must prove actual economic loss proximately caused by the alleged misrepresentations. Here the price drop is not clearly tied to misinformation in the offering circular. The burden is on the plaintiff to show proximate cause (loss causation).

In addition, damages will be capped by the difference between the $100 purchase price and the "average of the daily prices during the 90-day period after corrective disclosure." See Exchange Act §21D(e) (see §22.3.4—Damages Cap).

4. a. No. Rule 10b-5 does not require disclosure of all material information. Only if ITM has a duty to speak is silence actionable. A duty might arise in a few ways:

   1. ITM was buying or selling its own shares.
   2. ITM was aware of insider trading by others.
   3. ITM had a duty to update an earlier statement that had become inaccurate and that was still "alive" in the trading market.
   4. ITM had a fiduciary duty to its shareholders that required disclosure.

   None seems to apply here. There was no trading, and there was no "current" information about electrolysis research that the new tests contradicted. Finally, ITM's decision not to disclose the breakthrough is protected by the business judgment rule. Cf. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (imposing a "duty of honesty" whenever corporate managers communicate with shareholders) (see §21.1). ITM's management could decide secrecy is in the corporation's best interests for competitive or any other business-related reason. An evaluation of ITM's disclosure duties turns on general, rather than individual, shareholder wealth maximization.

   b. "No comment." The Supreme Court in *Basic, Inc. v. Levinson* (see §22.3.1) took the view that such a response is tantamount to silence. Absent a duty to speak, silence is not actionable under Rule 10b-5—even when the company has highly material information.

   Although some might view a "no comment" answer to be tacit confirmation of undisclosed material information, the Supreme Court suggests companies can create a reputation for discretion, whether or not there are material developments. The president might well say, "We have a corporate policy not to comment on market trends or rumors."

c. Yes, if the preliminary tests were material. Whenever a company makes a statement about material information, it cannot be false or misleading. ITM's management might argue the press release is essentially true because management thinks the tests have been kept secret and does not know why there has been unusual trading activity. On similar facts, the Supreme Court in *Basic, Inc. v. Levinson* (see §22.3.1) rejected this sophistic argument. A "no developments" statement suggests management does not know of information that would be of interest to the market, which is misleading if the tests are material.

   To judge the materiality of the tests requires balancing the probability of an energy-storage breakthrough (which may be low because the tests were preliminary) and the breakthrough's significance to the corporation (which is extremely high). See *Basic, Inc. v. Levinson* (§22.3.1). The "probability plus magnitude" test suggests it is substantially likely that reasonable shareholders would consider the tests relevant to their buy-sell decisions. This conclusion is bolstered if the recent price increases were related to rumors about energy-storage research. They would indicate that energy-storage information is relevant to trading and pricing of ITM's stock.

d. The release should have made clear the tests are preliminary, have not been confirmed, and might never be confirmed:

   ITM's research scientists have conducted tests using a cobalt/phosphate film that results in high rates of electrolysis at room temperatures. The tests have not been confirmed by the company or by independent researchers. It is possible that they cannot be duplicated.

   The release must walk a fine line. If it is overly pessimistic, some shareholders may sell, be disappointed, and sue. If it is overly optimistic, some investors may buy, be disappointed, and sue.

5. a. Yes. A private purchaser (or seller) of securities has an implied right of action under Rule 10b-5. Further, there is no privity requirement if the challenged misstatements were made "in connection with" stock trading. ITM (even though it never transacted) should have known that shareholders and investors would rely on its press release.

   b. Yes, reliance is an element of a 10b-5 action. In a face-to-face transaction, Sharon would have to show that she actually knew of the press release and that she sold because of its bad news. When trading

occurs in an impersonal stock market, courts relax the reliance requirement and accept a "fraud on the market" theory. *Basic, Inc. v. Levinson* (see §22.3.1). Under this theory, a public company's stock price is set by available public information and those who trade rely on the integrity of the market. If there is fraud, the stock price impounds the misinformation and those who trade rely on the misinformation as though they had known of it.

Once Sharon had shown a developed trading market in ITM stock, ITM would have the burden to rebut the presumption of reliance by showing a break between the misinformation and Sharon's trading: (1) ITM's stock is not widely followed and misinformation is not necessarily reflected in its stock price; (2) securities traders already knew of the preliminary tests, the press release notwithstanding; (3) Sharon would have traded even if the price had been different or she had known the press release was false.

c. Probably. Even though Sharon has sued more than two years after her purchase or sale of securities, the statute of limitations for federal securities fraud action permits a 10b-5 action to be brought within two years after "discovery of the facts constituting the violation," so long as the action is brought within five years after the violation. 28 U.S.C. §1658(b). Here the violation occurred when Sharon sold on the basis of the company's false press release. When should she have discovered the press release was false and the company had acted with scienter? See *Merck & Co. v. Reynolds* (see §9.4.1) (interpreting the two-year limitations period of §1658 to accrue either (1) when the plaintiff actually discovers the violation or (2) when a reasonably diligent plaintiff would have discovered the facts constituting the elements of the violation). Although there was much speculation about ITM's electrolysis research, the market seemed not to know for sure until the company's SEC filing, which also would have alerted Sharon to look into whether company officials knew that prior statements had been false. To expect Sharon to be more prescient than the market would seem inconsistent with Congress's purpose in lengthening the statute of limitations to protect defrauded investors against concealment.

CHAPTER 23

Insider Trading

Insider trading has captured the popular imagination. From press accounts, it would seem the most contemptible of corporate behaviors. Remarkably, state corporate law mostly accepts the principle of unfettered share liquidity and only narrowly regulates the trading of company stock by insiders. The real law of insider trading is federal—an offshoot of Rule 10b-5 under the Securities Exchange Act of 1934. See Chapter 22.

This chapter describes the nature of insider trading (§23.1), state corporate law of insider trading (§23.2), the federal "abstain or disclose" duties and enforcement under Rule 10b-5 (§23.3), and new rules on insider trading added by the Sarbanes-Oxley Act of 2002 and revised in the Dodd-Frank Act of 2010 (§23.4). Chapter 24 considers §16 of the Exchange Act—a remedial scheme applicable to short-swing trading profits by designated insiders.

§23.1 Insider Trading—A Primer

§23.1.1 Classic Insider Trading

The paradigm case of insider trading arises when a corporate insider trades (buys or sells) shares of his corporation using material, nonpublic information

obtained through the insider's corporate position. The insider exploits his informational advantage (a corporate asset) at the expense of the corporation's shareholders or others who deal in the corporation's stock.

The insider can exploit his advantage whether undisclosed information is good or bad. If *good news*, the insider can profit by buying stock from shareholders before the price rises on the favorable public disclosure. (An insider can garner an even greater profit on a smaller investment by purchasing "call options" on an options market that give him a right to buy the shares at a fixed price in the future.) If *bad news*, the insider can profit by selling to unknowing investors before the price falls on unfavorable disclosure. (An insider who does not own shares can also profit by borrowing shares and selling them for delivery in a few days when the price falls, known as "selling short," or by purchasing "put options," which give him the right to sell the shares at a fixed price in the future.)

§23.1.2 Misappropriation of Information—Outsider Trading

An insider can also exploit an informational advantage by trading in *other* companies' stock—"outsider trading." If the insider learns that his company will do something that affects the value of another company's stock, trading on this material, nonpublic information can also be profitable. The insider "misappropriates" this information at the expense of his firm. Although he trades with shareholders of the other company, he violates a confidence of his firm.

Many cases reported in the media as "insider trading" are actually cases of outsider trading on misappropriated information. Although classic insider trading and misappropriation often are grouped together under the rubric of "insider trading," it is useful to distinguish the two. The justifications for regulating each differ.

§23.1.3 Theories for Regulating Insider Trading

There are a number of theories for regulating trading by those with material, nonpublic information—whether insiders or outsiders.

Enhance Fairness

Insider trading is unfair to those who trade without access to the same information available to insiders and others “in the know”—a *fairness* rationale. The legislative history of the Exchange Act, for example, is replete with congressional concern about “abuses” in trading by insiders. This fairness notion, however, has not been generally accepted by state corporate law, which has steadfastly refused to infer a duty of candor by corporate insiders to shareholders in anonymous trading markets. See *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (rejecting duty of insiders to shareholders except in face-to-face dealings). Moreover, a fiduciary-fairness rationale cannot explain regulation of outsider trading based on misappropriated information.

Preserve Market Integrity

Insider trading undermines the integrity of stock trading markets, making investors leery of putting their money into a market in which they can be exploited—a *market integrity* rationale. A fair and informed securities trading market, essential to raising capital, was the purpose of the Exchange Act. Moreover, market intermediaries (such as stock exchange specialists or over-the-counter market makers) may increase the spread between their bid and ask prices if they fear being victimized by insider traders. Greater spreads increase trading costs and undermine market confidence. Yet a market integrity explanation may overstate the case for insider trading regulation. Many professional participants in the securities markets already trade on superior information; the efficient capital market hypothesis posits that stock prices will reflect this better-informed trading. See §1.2.

Reduce Cost of Capital

Insider trading leads investors to discount the stock prices of companies (individually or generally) where insider trading is permitted, thus making it more expensive for these companies to raise capital—a *cost of capital* rationale. In stock markets outside the United States, studies show that cost of equity decreases when the market introduces and enforces insider trading prohibitions. For this reason, most U.S. public companies have insider trading policies that permit insiders to buy or sell company stock only during “trading windows”—usually 7 to 30 days after important company announcements.

Protect Property Rights

Insider trading exploits confidential information of great value to its holder—a *business property* rationale. Those who trade on confidential information reap profits without paying for their gain and undermine incentives to engage in commercial activities that depend on confidentiality. Although in the information age a property rationale makes sense, theories of liability, enforcement, and private damages have grown in the United States out of the rhetoric of fiduciary fairness and market integrity

§23.1.4 Policing Insider Trading

Insider trading, cloaked as it is in secrecy, is difficult to track down. The stock exchanges have elaborate, much-used surveillance systems to alert officials if trading in a company's stock moves outside of preset ranges. When unusual trading patterns show up or trading occurs before major corporate announcements, exchange officials can ask brokerage firms to turn over records of who traded at any given time. The exchanges conduct computer cross-checks to spot "clusters" of trading—such as from a particular city or brokerage firm. An Automated Search and Match system, with data on thousands of companies and executives on such things as social affiliations and even college ties, assists the exchanges. If the exchanges see something suspicious, they turn the data over to the SEC for a formal investigation. The SEC can subpoena phone records and take depositions, and promise immunity to informants.

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§23.2 STATE LAW ON INSIDER TRADING

In a relatively narrow range of cases, state law limits insiders' liquidity rights when they trade on material, nonpublic corporate information.

§23.2.1 Fraud or Deceit—Limited Tort Liability

The traditional law of deceit applies when

- The insider affirmatively misrepresents a material fact or omits a material fact that makes his statement misleading. (There is a duty to speak only in a relationship of trust and confidence.)
- The insider knows the statement is false or misleading or, under evolving notions, recklessly disregards its truthfulness.
- The other party actually and justifiably relies on the statement.
- The other party is harmed as a result.

Restatement (Second) of Torts, §§525, 526, 537, 538. Absent a duty to speak, the insider can avoid tort liability by remaining silent. In a public corporation, this is easy. For example, a company insider who knows of an impending special dividend can buy stock on an impersonal trading market. Even if subject to a special duty to speak, the absence of privity dissolves any causal link between the insider's purchases and particular shareholders' sales.

Early state courts, on the premise that corporate fiduciaries owe duties to the corporation and not to individual shareholders, regulated insider trading only on a showing of actual deceit. This is *caveat emptor*—the insider has no more duty than a used car salesperson owes her customers.

§23.2.2 State Fiduciary Rules

State corporate law has taken three approaches to insider trading: (1) a duty on insiders not to trade with corporate shareholders in face-to-face transactions while in the possession of highly material, nonpublic corporate information—the "special facts" rule (the majority rule); (2) a duty on insiders not to trade with corporate insiders in face-to-face transactions, regardless of the existence of special facts—the Kansas rule (the minority rule); (3) a duty on insiders *to the corporation* not to advance their own pecuniary position using corporate information, regardless of the harm to the corporation— the rule in New York.

Special Facts Doctrine

The traditional fraud rule fails to recognize an insider's fiduciary status. In recognition of this, state courts impose a diluted duty on individual shareholders to disclose their inside information or abstain from trading. In face-to-face transactions—as distinguished from transactions on stock trading markets between anonymous traders—courts have developed a *special facts*

rule under which neither affirmative misrepresentations nor actual reliance need be established.

The special facts doctrine is limited as follows:

- The insider (an officer or director) must have purchased from an existing shareholder—in some jurisdictions, sales by insiders to nonshareholder investors in the case of “bad news” are not covered.
- The insider must be in privity with the selling shareholder—there must be a face-to-face transaction or something approximating it (such as an insider using an agent to hide the insider’s identity).
- The corporate information that the insider knows must be highly material, such as the impending sale of significant corporate assets or the declaration of a special dividend.
- Secrecy is critically important to the sale—it must be clear the shareholder would not have traded had she known the information.

See *Lank v. Steiner*, 224 A.2d 242 (Del. 1966) (when corporate fiduciary buys from or sells directly to existing stockholder, fiduciary must disclose in such private transaction only when fiduciary “possesses special knowledge of future plans from secret sources and deliberately misleads a stockholder who is ignorant of them”). Special facts cases have often involved concealment of the insider’s identity and sympathetic plaintiffs, such as widows.

The special facts rule arose in *Strong v. Repide*, 213 U.S. 419 (1909). The Supreme Court, applying general federal common law before *Erie Railroad v. Tompkins,* held a dominant insider could not trade surreptitiously with an unsuspecting shareholder when the insider possessed highly material, confidential corporate information. Repide (the company’s majority shareholder and general manager) had finished negotiating the sale of a significant corporate property and sought to buy more corporate shares from a fellow shareholder. To hide his identity, Repide used an intermediary who bought the shares from the shareholder’s agent. The Court agreed the agent would not have sold had he known Repide was the buyer. When the contract was finalized, the company’s stock value increased tenfold. The Court held that Repide’s position, along with his active concealment of highly material information, were “special facts” that supported rescission of the stock sale.

Strict (Kansas) Rule

A handful of state courts have expanded the special facts rule to impose a duty to disclose material nonpublic information in any face-to-face transaction. "Special facts" need not be present. This stricter approach, which originated in a Kansas case, is known as the "Kansas rule." In *Hotchkiss v. Fischer,* 16 P.2d 531 (Kan. 1932), the court said that in direct-negotiated purchases there is a "relation of scrupulous trust and confidence." A corporate president had told a widow, undecided whether to sell her shares or wait for a dividend, that he was unsure whether a dividend would be declared. The president bought the widow's shares for $1.25 per share, and a week later the board declared a $1.00 dividend—a possibility of which the president was aware. The court held the president liable. Although the case's facts fall in the "special facts" mainstream, the "scrupulous trust and confidence" rationale imposes a higher disclose-or-abstain duty. The "Kansas rule" has been rejected in some jurisdictions.

Limitations of Special Facts and Kansas Rules

The special facts and Kansas rules have two significant shortcomings. First, the rules assume purchases from existing shareholders on the basis of undisclosed "good news." A number of courts have refused to impose liability when an insider dumps stock on *nonshareholder investors* using inside "bad news." Second, the rules require privity. When insider trading occurs on an anonymous stock trading market, state courts have shown great reluctance to impose a disclose-or-abstain duty.

Consider *Goodwin v. Agassiz,* 186 N.E. 659 (Mass. 1933), where the court held that insiders who purchased their company's stock on the Boston Stock Exchange could not be held liable under a special facts test. The insiders had access to a geologist's theory that, if valid, indicated the possibility of valuable copper deposits on property owned by the company. The court found two problems with imposing liability. First, the insiders had a fiduciary duty to the corporation, not to individual shareholders. Assuming the insider trading did not harm the company, the insiders were not liable as fiduciaries. Second, privity between buyer and seller does not exist in anonymous trading on a stock exchange. There would be insurmountable practical problems of making disclosure to other traders, deciding when information (such as a geologist's theory) becomes material, and aligning sale and purchase transactions to determine which shareholders are entitled to recover and how much.

§23.2.3 Liability to Corporation

In an attempt to overcome these gaps in the common law, the New York Court of Appeals held more than 30 years ago that insider trading creates liability *to the corporation,* which liability can be enforced in a derivative suit. *Diamond v. Oreamuno,* 248 N.E.2d 910 (N.Y. 1969). The case involved insiders who had dumped their stock after learning nonpublic bad news about the company's earnings. To the objection that the corporation had not been harmed, the court had two responses. First, it held no harm need be shown. As between the insiders and the corporation—just as when an agent receives confidential information on behalf of his principal—the corporation "has a higher claim to the proceeds derived from the exploitation of the information." The insider cannot unjustly enrich himself. Second, the court inferred that the insider trading might have damaged the corporation's reputation and thus the marketability of its stock—though this need not be proved.

The *Diamond v. Oreamuno* court analogized its novel approach to §16(b) of the Exchange Act, which allows the corporation in a direct or derivative suit to recover short-swing trading profits from designated insiders (see §24.3). The court, however, pointed out the inadequacy of federal remedies. In the case, §16(b) offered no relief because trading had occurred outside the provision's six-month window. According to the court, Rule 10b-5 raised unresolved issues on the class entitled to recover, the measure of damages, and the allocation of recovery. (As we will see, these 10b-5 issues are today somewhat clearer. See §23.3 below.)

The *Diamond v. Oreamuno* approach has not fared well outside New York. Some courts have rejected the approach outright. *Schein v. Chasen,* 313 So. 2d 739 (Fla. 1975). Other courts have said that corporate recovery for insider trading requires that the corporation "could have used the information to its own profit." *Freeman v. Decio,* 584 F.2d 186 (7th Cir. 1978). For example, if the corporation was about to repurchase its own stock in the market, insider purchases would directly compete and raise the price to the corporation. See *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. 1949).

In recent years, the Delaware courts have recognized the ability of shareholders to bring derivative claims on behalf of the corporation (so-called "*Brophy* claims") when an insider uses material, nonpublic information to trade in the company's securities. See *In re Oracle Corp. Deriv. Litig.*, 867

A.2d 904 (Del. Ch. 2004). It is not necessary that the corporation suffered an actual harm; it is enough that the insider was unjustly enriched. The remedy in such cases is disgorgement of the insider's profits to the corporation. See *Kahn v. Kohlberg Kravis Roberts & Co*., 23 A.3d 831 (Del. 2011) (holding that special litigation committee could not dismiss *Brophy* claim against insider who acquired company's preferred shares while in possession of material, nonpublic information).

Although liability to the corporation offers a practical solution to the limits of the traditional insider trading rules, it has some troubling and strange implications. First, shareholders who hold their shares during the insider trading receive a windfall in a corporate recovery. If the insider trading is on good news, the losers are the shareholders who sold their shares at deflated prices. They do not share in the corporate recovery at all. If the insider trading is on bad news, the losers are the investors who bought the stock at inflated prices. They recover only to the extent the corporate recovery increases the value of their stock—at most a partial recovery. Second, corporate recovery also creates the possibility of double liability. Besides being liable to the corporation, the insiders may be liable under Rule 10b-5 to contemporaneous traders (see §23.3.4). Although the *Diamond v. Oreamuno* court suggested this problem could be handled by interpleader, there will be jurisdictional, notification, and class certification difficulties.

Despite these deficiencies, the ALI Corporate Governance Principles adopted an unjust-enrichment approach similar to *Diamond v. Oreamuno* and the Delaware cases accepting *Brophy* claims, with the additional gloss that the corporation (or the shareholders as a group) can authorize or ratify insider trading if in the corporation's interest. ALI Principles §5.04 (prohibiting insiders from using material nonpublic information concerning the corporation to advance their pecuniary interests, whether or not this use harms the corporation). The ALI Principles views a rule of corporate recovery as better than no rule at all.

Outsider Trading under State Law

You may have noticed that, until now, we have talked only about insiders trading *in their company's shares*—classic insider trading. Very few state cases involve allegations of trading *in other companies' shares* using "misappropriated" information—outsider trading. At most, outsider trading may violate state trade secret laws and the antifraud provisions of state "blue

sky" laws. See §5.1.3.

Examples

1. Elbert, a chemist of ITM Corp., has conducted tests on a cost-effective electrolysis process (separation of water into hydrogen and oxygen) using a cobalt/phosphate film at room temperatures. The results are a huge scientific breakthrough with enormous commercial potential. Daniela, ITM's president, learns of the tests and sends a memo to all who know of them urging complete secrecy. ITM's stock, which is publicly traded, doubles when ITM eventually confirms the tests and discloses the discovery. Assume the following happen before public disclosure:
   a. After Elbert's tests are confirmed, ITM's board offers Daniela options on the company's stock. Daniela accepts the options without telling the board of Elbert's tests. Is Daniela liable to the corporation under state law?
   b. Before Elbert's tests are confirmed, Daniela purchases ITM stock from Columbia Employees Pension Trust, one of ITM's major institutional shareholders. Daniela buys the stock from CEPT using a stockbroker, who does not disclose for whom the purchases are made. Is Daniela liable to CEPT?
   c. Daniela purchases ITM stock through her broker, who fills the order on a stock exchange. Shareholders who sold at about the time of Daniela's purchases seek to recover from her the profits they would have made if they had not sold. Can they under state common law?
   d. Elbert (who is neither a director nor officer of ITM) purchases ITM stock from fellow employees who do not know of the discovery. He says nothing to them, and they do not ask. Is Elbert liable to these shareholders under state common law?
2. Let's turn the tables. Assume ITM publicly announces Elbert's tests before they are confirmed. The price of ITM's stock rises dramatically. Elbert then tells Daniela the announcement was premature. The tests appear to have been a fluke and cannot be reproduced. When ITM issues a public disclaimer, the price of its stock plummets to preannouncement levels. Assume the following happen before ITM disavows the original announcement:
   a. Daniela sells her stock under a corporate stock repurchase program at

current market prices. She does not tell the board or anyone else that the announcement has become misleading. Is Daniela liable to the corporation under state law?

b. Daniela sells her entire shareholding to Mutual of Columbia, a major insurance company, through various brokers who do not disclose for whom they were selling. Is Daniela liable to MOC under state common law?

c. Elbert (who is neither a director nor officer of ITM) buys put options as soon as he realizes the original tests are flukes. Can any of those on the other side of these transactions recover under state common law?

d. Elbert prepares the original announcement about the cobalt/phosphate electrolysis process, knowing that his preliminary tests are flukes. Elbert buys options, as above. Is he liable to the parties on the other side of these transactions under state common law?

Explanations

1. a. Probably, under both state fraud law and common law of insider trading. As the company's CEO, Daniela has a fiduciary duty *to the corporation* not to use her position to harm the corporation. Although she did not misrepresent anything, deceit law imposes a duty to speak on those in a relationship of trust and confidence. Further, her silence in the *face-to-face* negotiations fits the "special facts" test. The discovery had enormous potential value, and it is likely the board would have reconsidered its decision to approve the options.

b. Perhaps under the strict Kansas rule. CEPT probably will be unable to show all the elements of fraud—there were no affirmative misrepresentations and CEPT did not actually rely on Daniela's silence. CEPT did not know it was buying from Daniela and thought it was selling at a good price. Although evolving fraud standards impose a duty to disclose in a confidential relationship—requiring disclosure to an employer or a client—state fraud law has not yet expanded to cover a corporate insider's relationship *to shareholders*.

Both the strict Kansas rule and the more limited "special facts" doctrine cover insiders' trading outside of impersonal trading markets.

Nonetheless, the "materiality" requirements under the tests are different. Under the "special facts" doctrine, Elbert's preliminary tests must have constituted unusual or extraordinary information that, if disclosed, would have caused a reasonable shareholder to have acted differently. This may be hard to show because the tests had to be confirmed, and a reasonable shareholder might have viewed the preliminary tests as flukes. The strict Kansas rule is less deferential. It is enough that the information would have been important to the shareholder's decision to sell. In view of the enormous potential revealed by the preliminary tests, Daniela's duty of "scrupulous trust and confidence" probably would have required her not to trade without first disclosing the tests and their potential implications.

c. No. State fraud law requires some misrepresentation, absent in this case of impersonal market trading. Moreover, identifiable privity is required under the "special facts" doctrine and the strict Kansas rule. The absence of face-to-face dealings will preclude these shareholders from recovering from Daniela. Notice that the *Diamond v. Oreamuno* corporate recovery approach also leaves them in the cold because any recovery goes only to the corporation.

d. No. Although state fraud law prohibits silence by those in a confidential relationship, it is unlikely that Elbert's coworker relationship would be enough. Courts have applied the special facts and strict Kansas rules only to officers and directors. Thus, even though Elbert as an employee has a fiduciary relationship to the corporation, he may not have a corporate fiduciary relationship to fellow coworkers or shareholders under state law.

2. a. Probably. Just as a fiduciary cannot buy from the corporation on the basis of undisclosed "good news," the fiduciary cannot sell to the corporation on the basis of undisclosed "bad news." Elbert's inability to confirm the original tests would seem to be material under both a special facts and Kansas rule.

b. No. There was no affirmative misrepresentation or confidential relationship, and hence no fraud under state law. Further, liability under a special facts or strict Kansas rule is premised on the fiduciary's relationship to existing shareholders. Daniela's sale to a nonshareholder investor leaves MOC unprotected under traditional state law. Even if

corporate recovery were available under a *Diamond v. Oreamuno* theory, ITM's recovery would only indirectly and partially compensate MOC to the extent the recovery increased the value of MOC's shares.

c. Probably not. Under a put option, Elbert receives a contractual right to sell ITM stock to the option sellers in the future at a predetermined price (the *strike price*). If the strike price is higher than the market price on the strike date—which will certainly be the case once the "bad news" is announced—Elbert will profit either by selling cheap stock or (as is more common) by simply having the other party buy back the commitment at the difference between the lower market price and the higher strike price. There are options markets on which these arrangements can be made.

   There are a number of impediments for options sellers to recover. Fraud law requires some affirmative misrepresentation—there was none. Corporate fiduciary rules require that there have been some semblance of privity—there was none. Further, because options traders are not shareholders of the corporation, even *Diamond v. Oreamuno* recovery may be unavailable since the disappointed traders were not past or present shareholders.

d. Yes, under a fraud theory. Fraud law does not require privity; it is enough that Elbert knowingly made an affirmative misrepresentation intending that others rely, that the options sellers actually and justifiably relied, and that they were damaged as a result. Assuming the options sellers knew of the ITM announcement—which is likely—they have a good chance to recover. State corporate law, however, provides little help. None of the options sellers was trading in the capacity of an ITM shareholder.

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§23.3 APPLICATION OF RULE 10B-5 TO INSIDER TRADING

Federal securities regulation of insider trading has developed in stages. It began with the novel scheme in the Exchange Act for the disgorgement of insider trading profits, a scheme aimed at discouraging stock price manipulation by corporate insiders (see Chapter 24). Later in the 1960s the

SEC and federal courts used Rule 10b-5 to build an awkward "abstain or disclose" jurisprudence applicable to insiders who trade on material, nonpublic, confidential information. See *In re Cady, Roberts & Co.*, 40 SEC 907 (1961) (first case suggesting that trading on inside information might violate Rule 10b-5).

In the 1980s Congress entered the fray and increased the penalties for insider trading, clarified the scope and mechanisms for private enforcement, and imposed additional surveillance duties on firms with access to inside information. In 2000 the SEC promulgated rules clarifying the state of mind that triggers liability and the persons who become subject to the "abstain or disclose" duty. In 2002 Congress sought to discourage insider trading by executives that came at the expense of employees or was based on falsified company financials. In 2010 Congress strengthened corporate "clawback" devices to discourage corporate executives from manipulating company financials to increase their stock-based pay.

The development of 10b-5 insider trading duties is a fascinating story of judicial activism and ingenuity in the face of a statutory lacuna. It also offers an insight into the operation of corporate federalism. Perceiving a failure by state corporate law to regulate insider trading, federal courts have used Rule 10b-5 to develop a theory of disclosure-based regulation that assumes the existence of fiduciary duties of confidentiality that state courts have been unwilling to infer.

§23.3.1 Federal Duty to "Abstain or Disclose"

Federal courts have interpreted Rule 10b-5 to prohibit securities fraud. See §22.1. No person may misrepresent material facts that are likely to affect others' trading decisions. This duty is meaningless to insider trading, which happens not by means of misrepresentations but rather silence. Over time, federal courts have developed rules against insider trading based on implied fiduciary duties of confidentiality.

Parity of Information

Early federal courts held that just as every securities trader is duty-bound not to lie about material facts, anyone "in possession of material, nonpublic information" must either abstain from trading or disclose to the investing public—a duty to *abstain* or *disclose.* See *SEC v. Texas Gulf Sulphur,* 401

F.2d 833 (2d Cir. 1968). But even the proponents of a “parity of information” (or “equal access”) approach recognized that an absolute rule against trading when one has an informational advantage goes too far. Strategic silence is different from outright lying. To impose an abstain-or-disclose duty on everyone with material, nonpublic information—however obtained—would significantly dampen the enthusiasm for trading in the stock market. Capital formation might dry up if investors in trading markets were prohibited from exploiting their hard work, superior skill, acumen, or even their hunches. Investors would have little incentive to buy securities if they could not resell them using perceived informational advantages.

Fiduciary Duty of Confidentiality

In the early 1980s the Supreme Court provided a framework for the abstain-or-disclose duty. *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983). A decade later the Court brought “outsider trading” within this framework. *United States v. O’Hagan*, 521 U.S. 642 (1997). Reading Rule 10b-5 as an antifraud rule, the Court has held that any person in the possession of material, nonpublic information has a duty to disclose the information, or abstain from trading, if the person obtains the information in a relation of trust and confidence—a fiduciary relation. The Supreme Court thus anchors federal regulation of classic insider trading on a presumed fiduciary duty of corporate insiders to the corporation’s shareholders—even though state corporate law has largely refused to infer such a duty in impersonal trading markets. See §23.2.2. Thus, the federal regulation of insider trading began largely as a judicial invention! The Court has extended this fiduciary-based regulation to cover trading by outsiders who breach fiduciary duty of confidentiality to persons or entities unrelated to the corporation in whose securities they trade.

Classic insider trading liability: Chiarella v. United States *(1980)*

Chiarella was employed in the composing room of a financial printer. Using his access to confidential takeover documents that his firm printed for corporate raiders, he figured out the identity of certain takeover targets. Chiarella then bought stock in the targets, contrary to explicit advisories by his employer. He later sold at a profit when the raiders announced their bids. The Supreme Court reversed Chiarella’s criminal conviction under Rule 10b-5 and held that Rule 10b-5 did not impose a “parity of information”

requirement. Merely trading on the basis of nonpublic material information, the Court held, could not trigger a duty to disclose or abstain. Chiarella had no duty to the shareholders with whom he traded because he had no fiduciary relationship to the *target companies or their shareholders.* (The Court decided that Chiarella could not be convicted for trading on information misappropriated from his employer since the theory was not presented to the jury.)

Tipper-tippee liability: Dirks v. SEC *(1983)*

Dirks was a securities analyst whose job was to follow the insurance industry. When he learned of an insurance company's massive fraud and imminent financial collapse from Secrist, a former company insider, Dirks passed on the information to his firm's clients. They dumped their holdings before the scandal became public. On appeal from SEC disciplinary sanctions for Dirks's tipping of confidential information, the Supreme Court held that Dirks did not violate Rule 10b-5 because Secrist's reasons for revealing the scandal to Dirks were not to obtain an advantage for himself. For Secrist to have tipped improperly "in connection with" the trading by Dirks's clients, the Court held, there had to have been a fiduciary breach. The Court took the view that a breach occurs when the insider gains some direct or indirect personal gain or a reputational benefit that can be cashed in later. In the case, Secrist had exposed the fraud with no expectation of personal benefit, and Dirks (whose liability depended on Secrist violating a fiduciary duty) could not be liable for passing on the information to his firm's clients.

Misappropriation liability: United States v. O'Hagan *(1997)*

O'Hagan was a partner in a law firm retained by a company planning to make a tender offer for a target company. He purchased common stock and call options on the target's stock before the bid. Both the bidder and law firm had taken precautions to protect the bid's secrecy. When the bid was announced, O'Hagan sold for a profit of more than $4.3 million. After an SEC investigation, the Justice Department brought an indictment against O'Hagan alleging securities fraud, mail fraud, and money laundering. He was convicted on all counts and sentenced to prison. The Eighth Circuit, however, reversed his conviction on the ground that misappropriation did not violate Rule 10b-5. (The Eighth Circuit also held the SEC exceeded its authority in promulgating Rule 14e-3. See §23.3.3 below.) The Supreme Court reversed

and validated the misappropriation theory. The Court concluded that the unauthorized use of confidential information is (1) the use of a "deceptive device" under §10(b) and (2) "in connection with" securities trading. First, the misappropriator "deceives" the source that entrusted to him the material, nonpublic information by not disclosing his evil intentions—a violation of fiduciary duty. Second, the "fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when … he uses the information to purchase or sell securities." Citing to the legislative history of the Exchange Act and to SEC releases, the Court concluded that misappropriation liability would "insure the maintenance of fair and honest markets [and] thereby promote investor confidence." O'Hagan's trading operated as a *fraud on the source* in connection with securities trading—a violation of Rule 10b-5.

Satisfying the Disclosure Duty

According to the logic of the 10b-5 "abstain or disclose" construct, a fiduciary may trade on confidential information by first disclosing the information to the person to whom she owes the fiduciary duty. See *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968) (suggesting that insiders wait 24 to 48 hours after information is publicly disclosed to give it time to be disseminated through wire services or publication in the financial press). In a similar vein, some companies have internal policies that permit corporate insiders to trade only during a one- or two-week period after the company files quarterly and annual reports. As a practical matter, the abstain-or-disclose duty is really a prohibition against trading, since any disclosure must be effective in eliminating any informational advantage to the person who has material, nonpublic information—thus eliminating any incentive to trade.

State of Mind

An unsettled issue in the cases has been the state of mind that triggers insider trading liability when a person purchases or sells securities. In *O'Hagan* the Supreme Court said that insider trading must be "on the basis" of material, nonpublic information. Lower courts split on whether the trader must be in "knowing possession" of inside information or must actually consciously "use" the information in trading. Compare *United States v. Teicher,* 987 F.2d 112 (2d Cir. 1993) (accepting "knowing possession" standard, as simpler to apply and consistent with the expansive nature of Rule 10b-5, where a young

attorney tipped inside information about transactions involving clients of his law firm); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998) (requiring showing of "use" of inside information, particularly when a defendant's state of mind is at issue in criminal case).

In 2000 the SEC adopted a rule to clarify this aspect of insider trading liability. Rule 10b5-1. Under the rule, a person trades "on the basis" of material, nonpublic information if the trader is "aware" of the information when making the purchase or sale. Rule 10b5-1(b). In its release accompanying the rule, the SEC explained that "aware" is a commonly used English word, implying "conscious knowledge," with clearer meaning than "knowing possession." Does the SEC have rulemaking authority to define the elements of insider trading, which (until now) has been governed exclusively by judge-made rules? Arguably the agency that begot Rule 10b-5 can also change and define its contours.

Preexisting Trading Plans

The SEC has also sought to clarify when corporate insiders and others can trade in company stock even when aware of inside information. Individuals and entities who set up specific securities trading plans when unaware of inside information can avoid liability even if trading under the plan occurs later when they are aware of inside information. Rule 10b5-1(c). The person must demonstrate the following:

- She had entered in "good faith" into a binding contract to trade the security, instructed another person to execute the trade for her account, or adopted a written plan for trading securities—when unaware of inside information.
- This preexisting trading strategy either (1) expressly specified the amount, price, and date of the trade; (2) included a written formula for determining these inputs; or (3) disabled the person from influencing the trades, providing the actual trader was unaware of the inside information.
- The trade accorded with this preexisting strategy.

An entity (nonindividual) has an additional affirmative defense if the actual individual trading for the entity was unaware of inside information and the

entity had policies and procedures to ensure its individual traders would not violate insider trading laws. Rule 10b5-1(c)(2).

In 2009 the SEC provided some interpretive guidance when Rule 10b5-2 plans are revised. First, although termination of a trading plan does not automatically trigger 10b-5 liability, a termination that "coincides" with insider trading may violate Rule 10b-5. Second, canceling and then replacing an existing plan may also run into problems if the actions are part of a "scheme to evade" the rule; such liability can be minimized with a "waiting period" between the cancellation and replacement.

§23.3.2 Insider Trading 10b-5 Primer

The linchpin of 10b-5 insider trading liability is the knowing misuse of material, nonpublic information entrusted to a person with duties of confidentiality. Attempting to provide a general definition, the SEC's Rule 10b5-1 offers a restatement of federal insider trading law:

> The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material, nonpublic information about that security or issuer, in breach of a duty of trust and confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material, nonpublic information.

Although the Supreme Court has glossed over the provenance of these duties, its opinions give clear guidance to persons who have material, nonpublic information:

Insiders	Insiders who obtain material, nonpublic information because of their corporate position — directors, officers, employees, and controlling shareholders — have the clearest 10b-5 duty not to trade in the securities of their company. See *Chiarella.*
Constructive (temporary) insiders	Constructive insiders who are retained temporarily by the company in whose securities they trade — such as accountants, lawyers, and investment bankers — are viewed as having the same 10b-5 duties as corporate insiders. See *Dirks* (dictum). Lower courts have also inferred status as constructive insider in family settings where there are expectations of confidentiality.
Outsiders (with duty to source of information)	Outsiders with no relationship to the company in whose securities they trade also have an abstain-or-disclose duty when aware of material, nonpublic information obtained in a relationship or trust and confidence with the company (or source) of that information. See *O'Hagan.* The outsider's breach of confidence to the information source is deemed a deception that occurs "in connection with" his securities trading. *(continued)*

Tippers	Those with a confidentiality duty — whether an insider or an outsider — who knowingly make improper tips are liable as participants in illegal insider trading. See *Dirks*. The tip is improper if the tipper expects the tippee will trade and anticipates reciprocal benefits — such as when she sells the tip, gives it to family or friends, or expects the tippee to return the favor. This liability extends to subtippers who know (or should know) a tip is confidential and came from someone who tipped improperly. The tipper or subtipper can be held liable even though she does not trade, so long as a tippee or subtippee down the line eventually does.
Tippees	Those without a confidentiality duty inherit a 10b-5 abstain-or-disclose duty if they knowingly trade on improper tips. *Dirks*. A tippee is liable for trading after obtaining material, nonpublic information that he knows (or has reason to know) came from a person who breached a confidentiality duty — whether an insider or an outsider. In addition, subtippees tipped by a tippee assume a duty not to trade if they know (or should know) the information came from a breach of duty.
Traders in derivative securities	The 10b-5 duty extends to trading with nonshareholders — such as options traders. *O'Hagan* (call options). The Insider Trading Sanctions Act of 1984 makes it unlawful to trade in any derivative instruments while in possession of material, nonpublic information if trading in the underlying securities is illegal. Exchange Act §20(d).
Strangers	A stranger with no relationship to the source of material, nonpublic information — whether from an insider or outsider — has no 10b-5 duty to disclose or abstain. *Chiarella*. Strangers who overhear the information or develop it on their own have no 10b-5 duties.

It is important to notice that corporate insiders (directors, officers, employees, and agents) often own stock in their companies. This is not illegal — in fact, it is sometimes highly desirable for corporate executives to have some "skin in the game." Nor is it illegal for these insiders to buy and sell their company stock. There is a problem only when these insiders are aware of nonpublic, material information when they trade in their company's stock or the stock of another company—or improperly tip this information to others.

§23.3.3 Outsider Trading—Misappropriation Theory

The misappropriation theory is a bit tricky. Under the theory, 10b-5 liability arises when a person trades on confidential information in breach of a *duty owed to the source of the information*, even if the source is a complete

stranger to the traded securities. *United States v. O'Hagan,* 521 U.S. 642 (1997). In effect, the deception is on the source and the trading with another party. This "fraud on the source" construct raises a number of issues: the basis for misappropriation liability, the scope of the duty of confidentiality, and the validity of the SEC's rule creating misappropriation liability for tender offer information.

Notice the difference between an *outsider* who misappropriates information from a source unrelated to the company in whose securities the outsider trades and a *tippee* who receives information from a fiduciary inside a company in whose securities the tippee (or subtippee) trades. The outsider's duty is to the "outside" source of the information; the tippee's duty is derived from the duty to the "insider" who tips improperly.

Misappropriation Theory

The *O'Hagan* decision was an important victory for the SEC, which ten years before had failed to convince the Supreme Court that Rule 10b-5 encompasses a misappropriation theory. *Carpenter v. United States,* 484 U.S. 19 (1987) (split 4-4 decision).

Although the ruling in *O'Hagan* removed any uncertainty about whether Rule 10b-5 regulates securities trading using misappropriated information, it exposed doctrinal rifts in the Court's 10b-5 jurisprudence. First, *O'Hagan* suggests that there can be no 10b-5 insider trading liability if there is no breach of trust and confidence. Thus, a person who gains access to material, nonpublic information by other wrongful means—such as outright theft—would seemingly not face 10b-5 sanctions. Moreover, a fiduciary who discloses his trading intentions or receives permission to trade from the information source would escape 10b-5 liability since there would arguably be no breach of his abstain-or-disclose duty. Cf. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006) (upholding misappropriation claim against wife who "tricked" husband into revealing confidential company information and then tipped her brother who traded on the information, even though husband asked wife not to tip when she revealed her plans).

Second, *O'Hagan* leaves largely unanswered the question of who has duties of trust and confidence and when a duty of confidentiality attaches. For lawyer O'Hagan, it was easy to identify his duties to his law firm and thus to the bidder, but the inquiry becomes more difficult when a person overhears a conversation or has only a superficial relationship with the information

source. See *SEC v. Switzer,* 590 F. Supp. 756 (W.D. Okla. 1984) (holding that eavesdropper is not liable for trading after overhearing CEO tell his wife company might be liquidated). Nonetheless, when information has been obtained deceptively, the breach of duty is not "cleansed" by later revealing to the source an intention to trade on the deceptively obtained information. See *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006) (holding that wife who deceptively obtained information from her CEO husband was liable for tipping this information to her brother, even though she informed husband of tip).

Duty of Confidentiality in Misappropriation Cases

The duty of trust and confidence in misappropriation cases is clearest when confidential information is misappropriated in breach of an established business relationship, such as investment banker—client or employer-employee. The duty is less clear in other business and personal settings.

In an attempt to provide clarity, the SEC promulgated a rule that specifies —for purposes of misappropriation liability—when a recipient of material, nonpublic information is deemed to owe a duty of trust and confidence to the source for purposes of misappropriation liability. Rule 10b5-2(b):

- The recipient agreed to maintain the information in confidence.
- The persons involved in the communication have a history, pattern, or practice of sharing confidences (both business and nonbusiness confidences) so the recipient had reason to know the communicator expected the recipient to maintain the information's confidentiality.
- The communicator of the information was a spouse, parent, child, or sibling of the recipient, unless the recipient could show (based on the facts and circumstances of that family relationship) that there was no reasonable expectation of confidentiality.

Confidentiality Expectations outside the Family

By their terms, the rule's first two categories clarify when confidentiality expectations—and thus a duty of trust or confidence—arise in nonbusiness and business settings outside the family. Thus, a contractual relationship (though not necessarily creating a fiduciary relationship) could give rise to a duty not to use confidential information, if that is what the parties had agreed

to or mutually understood. In addition, as the SEC stated in its preliminary note to the rule, the list is not exclusive, and a relationship of trust and confidence among family members or others can be established in other ways, as well.

Are confidentiality expectations, without a legal relationship of trust and confidence, enough to trigger a 10b-5 duty to "disclose or abstain"? That is, did the SEC overstep its rulemaking authority in Rule 10b5-2 by identifying duties of "trust and confidence" in the absence of a fiduciary relationship? Consider the SEC's case against Mark Cuban, of Audionet and Dallas Mavericks fame. In 2004 Cuban had a phone conversation with the CEO of Mamma.com, a company in which Cuban was a 6.3 percent shareholder. The Mamma CEO told Cuban confidentially that Mamma was planning to accept a new investor and thus dilute existing shareholders. According to the SEC, Cuban said to the CEO he would keep the information confidential, but then he sold his Mamma shares and avoided losses of $750,000 in the process. When the SEC brought an insider case against him, Cuban argued that his relationship with the Mamma CEO and any confidentiality promise he made did not create a cognizable §10(b) duty. The trial court disagreed with Cuban, but dismissed the SEC's case on the theory that Cuban's oral promise of confidentiality encompassed only keeping the information confidential, but did not bar trading. On appeal, the Fifth Circuit did not address the lower court's novel parsing of the parties' understanding, but instead held that the SEC's complaint laid out a "more than a plausible" case of insider trading, and remanded for further proceedings. *SEC v. Cuban*, 634 F. Supp.2d 713 (N.D. Tex. 2009), *vacated and remanded,* 620 F.3d 551 (5th Cir. 2010). At trial, the jury found that Cuban had not entered into a confidentiality agreement and, in any event, the information about Mamma's new investor was already public knowledge, given an earlier spike in trading volume in the company's stock. The SEC licked its wounds and said it would continue to bring cases where it believed there had been insider trading. As for the Mavericks, there's always next season!

Confidentiality Expectations inside the Family

Rule 10b5-2 was adopted largely in response to the anomaly in the case law that a family member who trades on material, nonpublic information obtained from a another family member violates Rule 10b-5 if the trading breached an *express promise* of confidentiality, even when there was a

reasonable expectation of confidentiality. The SEC rule treats insider trading by family members on the basis of inside information as undermining market and investor confidence, whether the expectation of confidentiality was express or implied. As the SEC explained, the trader's informational advantage in either case stems from "contrivance, not luck." Additionally, the SEC said its brighter-line approach was less intrusive than a case-by-case analysis into the nature of family relationships, as required by existing case law. See *United States v. Chestman*, 947 F.2d 551 (2d Cir.1991) (en banc) (holding that son-in-law owed no duty to in-laws who planned to sell their supermarket chain, when he and his broker traded on confidential information about impending sale).

Some courts have used this "expectation" analysis in cases of classic insider trading on the question whether family members qualify as "constructive insiders." In *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003), a husband told his wife during divorce discussions that his stock options should be re-valued at a lower price because of a soon-to-be-made announcement of a drop in company earnings. The wife then told office mates about this impending news, who traded on the tip. The court held that spousal communications implicated a fiduciary duty when the communicating spouse has a "reasonable expectation of confidentiality"—given their history or practice of sharing business confidences. The court commented that Rule 10b5-2, which creates a presumption of spousal confidentiality in misappropriation cases, bolstered the conclusion that spouses should be understood to have expectations of confidentiality in cases of classic insider trading.

Confidentiality Expectations in Congress

Do members of Congress and their staff have duties of trust or confidence to the American public? Until 2012, the question was open. But in that year, Congress passed the Stop Trading on Congressional Knowledge (STOCK) Act to extend insider-trading restrictions to members of Congress and legislative employees by specifying that such persons owe duties to the United States (as well as Congress and U.S. citizens) with respect to material nonpublic information derived from their position or gained from performing their official responsibilities. See Exchange Act §21A(g). Thus, members of Congress and their aides—as well as any recipients who trade on congressionally sourced information—can be liable for insider trading under

Rule 10b-5.

Before the STOCK Act, there were doubts about whether members of Congress and their aides were subject to duties not to engage in stock trading on the basis of confidential information gleaned through their public service. Nonetheless, the Act does not resolve how regulators will enforce the prohibition—given the evidentiary barriers created by the Constitution's "Speech or Debate" clause that immunizes lawmakers in their official legislative activities. Nor does the STOCK Act prevent members of Congress and their aides from owning company stock in industries that they have the power to impact.

But just as corporate insiders must report their trading in their corporation's stock (see §24.2 below), members of Congress and their aides must report their stock trades above $1,000 within 30 to 45 days of the trade. See Ethics in Government Act of 1978 §103 (along with other specified members of executive and judicial branches). Not only does such reporting allow the public to compare congressional stock trading with congressional activities, it also can serve as the basis for public and private insider-trading actions.

In particular, the STOCK Act affects Wall Street "data miners" that gather political intelligence from congressional sources to predict legislative outcomes that might affect stock prices. These firms, as well as law firms and lobbyists, now face "tippee" liability for passing on nonpublic congressional information that they received in breach of the source's duties. Although members of Congress may have immunity, private parties that trade on illegally tipped congressional information do not.

Tipping of Misappropriated Information

Just as it is illegal to trade on a tip from an insider, it is illegal to trade on a tip from an outsider who passes misappropriated information to obtain a personal benefit. That is, 10b-5 tipping liability described in *Dirks* applies to tips both from insiders and from outsiders. See *United States v. Falcone*, 257 F.3d 226 (2d. Cir. 2001) (finding 10b-5 liability when distributor of *Business Week*, before magazine went on sale to general public, passed on copies to neighbor/broker who traded on nonpublic information in magazine).

Consider a recent case involving tipped misappropriated information. One Strickland, a financial analyst at GE Capital, learned that a client, Allied Capital, was planning to acquire SunSource. Strickland mentioned this to one

Black (a former college roommate) who then "to curry favor" told his boss, one Obus at Wynnefield Capital. Obus had Wynnefield buy 50,000 shares of SunSource—resulting in a $1.3 million profit. The SEC sued Strickland (as tipper), Black (as tippee and sub-tipper) and Obus (as sub-tippee). The Second Circuit agreed that there was sufficient evidence that Strickland breached a duty to his employer, GE Capital, by tipping Black, knowing that the information was confidential. The court held Black could be liable for tipping the information because he knew it was confidential and his "close friendship" with Strickland constituted a sufficient personal benefit. And Obus could be liable for "consciously avoiding" any further inquiry in the face of a "credible" tip. *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012) (finding evidence sufficient to overcome defendants' motions for summary judgment).

The case has created a stir. First, the court's conclusion that Strickland may have committed a fiduciary breach was contradicted by an internal GE Capital investigation that concluded he had not—rendering "waiver" of duty by the source insufficient to avoid tipping liability. Second, the court concluded that "personal benefit" could be as ephemeral as the *quid pro quo* of a personal friendship—almost gutting the element. Third, the court accepted that a sophisticated sub-tippee could not easily claim ignorance about the tip's source under the "know or should know" element of the *Dirks* test—making circumstantial evidence sufficient to show a sub-tippee should have known of a tip's tainted origin.

Rule 14e-3—Misappropriation of Tender Offer Information

The SEC has used the misappropriation theory to adopt rules prohibiting trading based on material, nonpublic information about *unannounced tender offers.* Using its rulemaking authority under §14(e) of the Exchange Act—which allows rules aimed at "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer"—the SEC prohibited trading by those with inside information about a tender offer. Exchange Act Rule 14e-3. The rule prohibits, during the course of a tender offer, trading by anybody (other than the bidder) who has material, nonpublic information about the offer that he knows (or has reason to know) was obtained from either the bidder or the target. Notice that there is no need under Rule 14e-3 to prove that a tipper breached a fiduciary duty for personal benefit. See *United States v. O'Hagan*, 521 U.S. 642 (1997) (upholding SEC's rulemaking authority to "define and prescribe means reasonably designed to

prevent [fraudulent] acts" under §14(e) of the Exchange Act).

The Second Circuit has considered the difference between 10b-5 and 14e-3 liability. *United States v. Chestman,* 947 F.2d 551 (2d Cir. 1991) (en banc). In the case Chestman, a stock broker, learned of an impending tender offer from the husband of the niece of the company's controlling shareholder. The controlling shareholder had agreed to sell his control block as a prelude to the purchaser's tender offer. When Chestman traded on this information for himself and his clients, the government prosecuted him under Rules 10b-5 and 14e-3. The Second Circuit affirmed Chestman's 14e-3 conviction, for which no showing of duty was necessary. But the court held he could not be convicted under a 10b-5 misappropriation theory because the family tipper had no duty to his family to guard confidential information.

Mail and Wire Fraud—Criminal Liability for Misappropriation

Misappropriation of confidential information can also be the basis of nonsecurities criminal liability. In *Carpenter v. United States,* 484 U.S. 19 (1987), the Supreme Court had sidestepped the 10b-5 quagmire by affirming in an 8-0 decision a *Wall Street Journal* reporter's conviction under federal mail and wire fraud criminal statutes for misappropriating and tipping information before it appeared in a column he wrote. (The SEC cannot enforce the mail and wire fraud statutes, which can only be enforced by the Justice Department in a criminal prosecution.) The Court held that the newspaper had a "property" interest in keeping the column confidential prior to publication, and that the reporter's breach of his confidentiality obligation defrauded the newspaper. Although the Court's decision raises disquieting issues about criminal liability for breaching an employment stipulation, the case makes clear that trading on misappropriated securities-related information is subject to criminal penalties.

§23.3.4 Remedies for Insider Trading

Insider traders are subject to an imposing host of sanctions and liabilities. As the following list makes clear, it is no wonder that law firms tell new lawyers not to trade on clients' confidential information.

Civil Liability to Contemporaneous Traders

In an impersonal trading market, it is unclear who is hurt by insider trading and how much. Shareholders and investors who trade at the same time as an insider presumably would have traded even had the insider fulfilled his duty and abstained. If, however, the theory is that insider trading is unfair to traders, recovery should be equal to the traders' contemporaneous trading "losses"—typically significantly greater than the insider's gains. If the theory is that insider trading undermines the integrity of trading markets, recovery should be disgorgement of the insider's trading gains to the market as a whole. If the theory is that those who engage in insider trading pilfer valuable commercial information, recovery should be based on the losses to the owner of the confidential information.

Congress has addressed the issue and adopted a recovery scheme that borrows from both the unfairness and disgorgement rationales. The Insider Trading and Securities Fraud Enforcement Act of 1988 limits recovery to traders (shareholders or investors) whose trades were contemporaneous with the insider's. Recovery is based on the disgorgement of the insider's actual profits realized or losses avoided, reduced by any disgorgement obtained by the SEC under its broad authority to seek injunctive relief (see below). Exchange Act §20A.

Civil Recovery by "Defrauded" Source of Confidential Information

Owners of confidential information who purchase or sell securities can bring a private action under Rule 10b-5 against insider traders and tippees who adversely affect their trading prices. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (actual purchaser or seller standing requirement). A "defrauded" company may recover if it suffered trading losses or was forced to pay a higher price in a transaction because the insiders' trading artificially raised the stock price. *FMC Corp. v. Boesky*, 673 F.2d 272 (N.D. Ill. 1987), *remanded*, 852 F.2d 981 (7th Cir. 1988) (holding tippee not liable for trading on misappropriated information concerning company's impending recapitalization plan because company lost nothing in the recapitalization). Although some commentators proposed corporate recovery *on behalf of shareholders*, courts have insisted on a corporate (not shareholder) injury for there to be corporate recovery.

SEC Enforcement Action

The SEC can bring a judicial enforcement action seeking a court order that enjoins the inside trader or tippee from further insider trading (if likely to recur) and that compels the disgorgement of any trading profits. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (ordering establishment of fund from which shareholders and other contemporaneous traders could recover from insider traders and tippers).

Civil Penalties

To add deterrence, the SEC can also seek a judicially imposed civil penalty against those who violate Rule 10b-5 or Rule 14e-3 of up to three times the profits realized (or losses avoided) by their insider trading. Exchange Act §21A (added by the Insider Trading Sanctions Act of 1984). For example, in 2006, Martha Stewart was ordered to pay $195,000, or three times the trading losses she avoided, for her insider trading of ImClone stock. The penalty, paid into the federal treasury, is in addition to other remedies. Thus, it is possible for an insider or tippee to disgorge her profits (in a private or SEC action) *and* pay the treble-damage penalty.

"Watchdog Penalties"

To create even more deterrence, the SEC can seek civil penalties against employers and others who "control" insider traders and tippers. Exchange Act §21A (added by Insider Trading and Securities Fraud Enforcement Act of 1988). Controlling persons are subject to additional penalties up to $1 million or three times the insider's profits (whichever is greater) if the controlling person knowingly or recklessly disregards the likelihood of insider trading by persons under its control. Broker-dealers that fail to maintain procedures protecting against such abuses may also be subject to these penalties if their laxity substantially contributed to the insider trading.

"Bounty Rewards"

To encourage informants, the SEC can pay bounties to anyone who provides information leading to civil penalties. The bounty can be up to 10 percent of the civil penalty collected. Exchange Act §21A(e) (added by Insider Trading and Securities Fraud Enforcement Act of 1988). This bounty program is in addition to the "whistleblower" bounty program created by Dodd-Frank. See Exchange Act §21F (see §12.3.5).

Criminal Sanctions

To punish those who engage in "willful" insider trading—that is, insider trading where the defendant knows that it is wrongful—the SEC can (and often does) refer cases to the U.S. Department of Justice for criminal prosecution. Exchange Act §32(a). Congress has twice increased the criminal penalties for violations of the Exchange Act and its rules. In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress increased the maximum criminal fines from $100,000 to $1,000,000 ($2,500,000 for nonindividuals) and jail sentences from five years to ten years. Then in the Sarbanes-Oxley Act of 2002, Congress upped the maximum fines to $5,000,000 ($25,000,000 for nonindividuals) and jail sentences to 20 years. Sarbanes-Oxley §1106, Exchange Act §32(a).

The Exchange Act's criminal provisions provide a curious defense against incarceration for violating an SEC rule if the defendant "proves he had no knowledge of such rule." Exchange Act §32(a). Courts have denied the defense if the defendant recognized he was engaged in deception.

§23.3.5 Regulation FD and Selective Disclosure

Inside information does not stay bottled up in companies forever. Sooner or later, companies communicate to securities markets. Formal disclosure in SEC filings is the soul of federal securities regulation. Informal disclosure, particularly by means of selective discussions with securities analysts and large investors, has been controversial—criticized as systematic tipping of valuable inside information and praised as an efficient way to reveal information to securities markets.

In 2000 the SEC took to heart the criticisms and adopted Regulation FD (Fair Disclosure) to forbid public companies from selectively disclosing material, nonpublic information. Exchange Act Rel. No. 43,154 (2000). The detailed rules on how companies may respond to analyst inquiries and engage in investor relations have altered how company information reaches securities markets. Disclosure practices once widespread, such as giving detailed financial projections to selected securities analysts or reviewing analyst reports before public release, are now regulated.

Regulation FD applies to issuer disclosures of material, nonpublic information to specified market professionals, as well as security holders who

it is “reasonably foreseeable” will trade on the basis of the information. Rule 100(b)(1). When the disclosure is “intentional,” issuers must disclose inside information to the investing public *simultaneously* with any disclosure to selected analysts or investors. Rule 100(a)(1). If the issuer discovers it has made an “unintentional” selective disclosure, the issuer must disclose the information to the public *promptly* (generally within 24 hours). Rule 100(a)(2). The information must be disseminated by methods “reasonably designed to achieve broad non-exclusionary distribution to the public”—such as through Internet postings or simulcasts, or by furnishing a Form 8-K to the SEC. Rule 101(e) (defining “public disclosure”). The restrictions apply to the issuer’s senior officials and those who regularly communicate with analysts and investors, such as investor relations or public relations officers. Rule 101(f).

The “equal access” rules of Regulation FD have some important exclusions [Rule 100(b)]:

Context	Disclosure Allowed
Normal course of business	Disclosure may be made in the normal course of business, such as to professional advisers (attorneys, investment bankers, or accountants) or business partners in contract negotiations. Dodd-Frank calls on the SEC to eliminate the exclusion for credit rating agencies, unless the credit rating agency receives the information pursuant to a confidentiality or nondisclosure agreement. Dodd-Frank §939B.
Public disclosures	Disclosure may be made to media or government officials, such as by responding to newspaper inquiries or complying with regulatory investigations.
Public offerings	Disclosures may be made in securities offerings registered under the Securities Act, such as to analysts and institutional investors in going-public “road shows.”
Foreign private issuers	Disclosure may be made by foreign private issuers (which, if they meet the jurisdictional requirements, remain subject to the securities antifraud provisions).

To take some of the sting out of these rules, Regulation FD is enforceable only through SEC enforcement actions and does not give rise to 10b-5 liability or private enforcement. Rule 102.

Regulation FD is an important step toward a systematic regulation of

inside information. Rather than dealing with each selective disclosure as a possible instance of "tipping," the regime encourages wide dissemination of information—whenever the issuer decides to disclose. The rules encourage the release of information, not its suppression—consistent with the philosophy of securities regulation that all investors have access to the same company-provided information at the same time. The rules also avoid the potential conflicts that analysts once felt to report favorably on companies to protect the flow of selective disclosures and that company executives felt to delay public disclosure so as to curry favor with preferred analysts or institutional investors.

In 2002 the SEC brought its first enforcement actions under Regulation FD. In one case, a company CFO called a handful of analysts to explain that their reports had failed to note that company earnings usually were higher in the second half of the year. The SEC issued an administrative cease-and-desist order, pointing out the company should have publicly disclosed the seasonality of its earnings before calling the analysts. When the company balked and the agency brought a judicial enforcement action, however, the court concluded that the CFO's statements had already been disclosed (or were available) to the public, in the process chiding the SEC for being too linguistic and for chilling company disclosures. *SEC v. Seibel Systems*, 384 F.Supp.2d 694 (SDNY 2005). The court, however, did not address the fact that investors privy to the CFO's statements bought the company's shares, causing the stock price to surge. In short, the market's reaction to the private information suggested its materiality, even though the court's parsing of words led to a different conclusion.

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§23.4 REGULATION OF INSIDER TRADING UNDER SARBANES-OXLEY (AND DODD-FRANK)

In response to the corporate scandals of the early 2000s, the Sarbanes-Oxley Act of 2002 regulates insider trading by company executives in two new situations: during pension fund blackouts and during the year before financials are restated. The Dodd-Frank Act of 2010 adds new "clawback" requirements for public companies.

§23.4.1 Insider Trading during Pension Plan Trading Blackout

Sarbanes-Oxley seeks to prevent insiders from "abandoning a sinking ship" while other employees are prevented from selling their stock. Sarbanes-Oxley §306(a). Directors and officers are prohibited from trading in their company's stock during any "trading blackout" in the company's pension plan—that is, when for more than three consecutive business days a majority of plan participants cannot obtain distributions or trade company stock held in the plan. ERISA §101, 29 U.S.C. §1021(h). The prohibition applies to any stock obtained by the director or officer in connection with his service or employment, whether or not held in the plan. The prohibition is meant to prevent company management from freezing trading in the company's pension plan for ordinary employees while dumping their own stock during a decline in the company's stock prices. Not only must the pension plan administrator notify plan participants (and the SEC) of the blackout, but the company must also notify directors and officers of the prohibition against trading in company stock. See Regulation BTR, Rule 104 (specifying contents and timing of notice).

Any trading profits realized by the director or officer during a trading blackout are recoverable by the company, regardless of intent—much like the strict liability scheme for short-swing profits under §16(b). See §24.3. The action to recover trading profits may be brought as a direct suit by the company or as a derivative suit by a shareholder after making demand on the company's board. The suit must be brought within two years after the profits are realized. See Regulation BTR, Rule 103 (specifying "profit recoverable" to be difference between the transaction price and the average market price after the end of the blackout).

Unlike short-swing trading, which only triggers reporting requirements and the possibility of disgorgement in private litigation, trading during a pension plan blackout is *prohibited*. Thus, directors or officers who trade during such a blackout may also be subject to SEC enforcement actions and even criminal sanctions.

§23.4.2 Reimbursement ("Clawback") of Incentive Pay When Financials Misstated

Sarbanes-Oxley "Clawback" Regime

Sarbanes-Oxley created a regime calling on corporate executives in public companies to reimburse the company for incentive pay when the company must restate its financials because of "misconduct." Sarbanes-Oxley §304 (adding 15 U.S.C. §7243). Specifically, the CEO and CFO are required to reimburse the company for any incentive pay (such as bonuses or equity-based compensation) received from the company during the 12-month period after the misstated financials were issued or filed. This "reimbursement" duty also applies to any profits on the sale of company stock by the CEO or CFO during the same period.

The Sarbanes-Oxley reimbursement provisions sought to prevent a company's top officers from profiting from false financials. The provisions, for which legislative history was scant, introduced numerous uncertainties: (1) Do voluntary restatements trigger a reimbursement duty? (2) What individuals are covered? (3) Are private actions (including derivative suits) available or only SEC enforcement? (4) Are negligent misstatements or only intentional ones considered misconduct? (5) How are trading profits calculated? (6) Can a company create its own definitions of misconduct and trading profits? (7) What is the statute of limitations?

There have been some answers to these questions, but only a few. Courts have uniformly interpreted §304 not to create a private cause of action, but only a basis for an SEC enforcement action. See *Neer v. Pelino*, 389 F. Supp.2d 648 (E.D. Pa. 2005) (plain language of Sarbanes-Oxley, buttressed by legislative history, precludes private right of action). The SEC, however, has brought few enforcement actions.

Dodd-Frank "Clawback" Regime

In response to the many weaknesses and unanswered questions of the §304 clawback regime, Dodd-Frank created a new one. Dodd-Frank §954. Under new §10D to the Exchange Act, the SEC is required to impose rules on the national stock exchanges that would compel listed companies to adopt "clawback" policies for the recovery of any incentive-based compensation (including stock options) from current or former executive officers for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. The amount to be recovered is set at the difference between the amount

of incentive-based compensation received and the amount that should have been received under the restated financial results.

The §954 regime of Dodd-Frank is different from the §304 regime of Sarbanes-Oxley. First, the new clawback right is enforceable, not just by the SEC, but also in derivative actions whenever companies fail to seek such relief. Further, private plaintiffs may initiate litigation even when restatements did not occur, but should have occurred were it not for a conflict of interest by management. Second, while the §304 regime only allowed disgorgement from the company's CEO and CFO, the §954 regime covers the company's current and former "executive officers," which presumably includes all officers subject to §16 reporting. Third, the §954 regime lowers the trigger for clawbacks to instances of "material noncompliance with applicable accounting principles," while the §304 regime was limited to restatements resulting from "misconduct." Fourth, the §954 regime extends the look-back period from one year to three years.

Despite adding greater clarity—and increasing the likelihood of enforcement—the §954 regime leaves some important questions unanswered. First, if an executive and the company's board fight the clawback, it is unclear whether the usual corporate law rules on board demand and dismissal of derivative litigation would apply. In particular, it is unclear whether the board (or a special litigation committee) could argue that the benefits of any clawback are outweighed by the disadvantages. Second, it is unclear whether the SEC and stock exchanges would have any leeway in defining such terms as "executive officers" and "material noncompliance." Finally, Dodd-Frank imposes no deadline for the SEC to issue rules to the stock exchanges or for the exchanges to pass the new clawback standards.

Examples

1. ITM Corp. is a publicly traded company with an active research and development department. Elbert, an ITM chemist, has conducted preliminary tests on a cobalt/phosphate film that electrolyzes (separates water into hydrogen and oxygen) at room temperatures. If the test results can be confirmed, it would be a huge scientific breakthrough with enormous commercial potential in storing energy generated by solar panels. Daniela, ITM's president, learns of the tests and sends an intraoffice memo to all concerned urging complete secrecy.
    a. ITM's board grants ITM stock to Daniela, who accepts. She does not

tell the board of Elbert's tests. Is Daniela liable to the corporation under Rule 10b-5?

b. Daniela purchases "call" options (allowing her to buy ITM stock) on the options market. She does not trade with ITM shareholders. Is Daniela liable under Rule 10b-5?

c. Elbert purchases ITM stock through a stockbroker under a written investment plan that calls for fixed, monthly purchases of ITM stock. Under the plan Elbert can choose to purchase more or fewer shares in any month, but he does not exercise this option. Is Elbert, who is neither a director nor officer of ITM, liable under Rule 10b-5?

2. After the test results are confirmed, but before public disclosure of the tests, Elbert tells Elsa (a fellow physicist who works for another research company) of the low-cost electrolysis breakthrough.

   a. Elsa buys ITM stock. Is she liable under Rule 10b-5?

   b. Elbert does not trade himself, but reveals the ITM test results to Elsa hoping to receive similar market-sensitive scoops from her. Assuming Elsa never reciprocates with information of her own, is Elbert liable under Rule 10b-5?

   c. Elbert and Elsa discuss the future of electrolysis and its impact on energy policy while riding in a limousine on their way to a scientific conference. Mickey, the limo driver, overhears their conversation and the next day purchases ITM stock. Is Mickey liable under Rule 10b-5?

3. Still before the electrolysis breakthrough is disclosed publicly, Daniela tells her husband Donald (from whom she is separated) that he should reconsider divorcing her since she stands to become wealthy because of a "top secret breakthrough" at ITM. She asks him to keep the information confidential.

   a. Instead, Donald buys ITM call options. Has he violated Rule 10b-5?

   b. Donald also tells a colleague at his office that "Daniela tells me there's a breakthrough at ITM—you should buy." The colleague does. Has the colleague violated Rule 10b-5?

   c. Donald and his good friend Martha have the same stockbroker, Merton. When Donald tells Merton to purchase ITM stock options,

Merton assumes Donald knows from Daniela that something good is afoot at ITM. He calls Martha and says simply, “Donald’s buying.” Martha buys ITM stock. Has she violated Rule 10b-5?

4. Meanwhile, at company headquarters Daniela receives a phone call from Raymond, a securities analyst who follows high-tech companies. Daniela tells Raymond, “There have been significant developments in our energy-storage research.” Daniela hopes to signal to the market the impending good news.
    a. Raymond tells his clients that ITM should be viewed as a “strong buy.” Has Daniela violated any duties?
    b. Daniela calls you, the company’s lawyer, and asks for your advice on how to handle disclosures about ITM’s electrolysis research and results to securities analysts. Can she talk with you, and what would you advise?
5. Before public disclosure of the electrolysis breakthrough, Daniela discloses it to Wilbur (the president of Third Federal Bank) to obtain a loan for ITM to build a new manufacturing plant. Daniela asks Wilbur to keep the information secret.
    a. Wilbur calls his stockbroker and buys ITM stock. Is Wilbur liable under Rule 10b-5?
    b. Wilbur tells his wife Wanda over dinner that ITM’s stock price is “probably going to go through the ceiling.” Wanda asks no more but buys ITM stock. Is Wilbur or Wanda liable under Rule 10b-5?
    c. Tina, a corporate spy, breaks into Third Federal’s offices and rifles the files to find the ITM loan application. She buys ITM stock. Is Tina liable under Rule 10b-5?
6. ITM’s board decides it should be prepared to add manufacturing capacity to produce electrolysis machines using the company’s cobalt/phosphate process. It decides to acquire Ovid Corporation, a publicly traded industrial builder, to build new manufacturing plants. ITM secretly negotiates an acquisition of Ovid.
    a. Before announcing the acquisition, ITM purchases a significant block of Ovid stock. Is ITM liable to Ovid shareholders under Rule 10b-5? Rule 14e-3?
    b. ITM decides to proceed with a tender offer, but before announcing

its bid the ITM board authorizes Daniela to purchase a limited amount of Ovid stock on the market. Is Daniela liable under Rule 10b-5? Rule 14e-3?

c. Ovid shareholders who sold during the period between Daniela's trading and eventual disclosure of the merger sue Daniela to recover the gains they would have made if they had not sold. Is Daniela liable to these shareholders under Rule 10b-5?

d. Daniela makes $100,000 in trading profits by buying Ovid stock. What is her maximum monetary exposure?

e. Daniela attends a stock analysts' meeting, which is simulcast on the company's website. She announces that ITM will manufacture its new electrolysis machines, but does not mention new manufacturing plants or the pending acquisition of Ovid. One of the analysts, Tom, figures out that ITM is likely to acquire Ovid. Tom tells his clients, who buy Ovid stock. Is Tom liable under Rule 10b-5?

7. Legislation pending in Congress would create tax incentives for upgrades to the U.S. power grid, but does not extend the proposed incentives to utilities that switch their power transmission systems to new superconductive high-tension wires. A team of ITM executives meet privately with congressional leaders on the House and Senate committees considering the legislation. The executives receive assurances that Congress will include tax incentives for superconductive transmission systems.

   a. Senator Bills, who attended the meetings with the ITM executives, realizes that ITM's stock will go through the roof once the tax incentives kick in. He buys ITM stock. Is the Senator liable under Rule 10b-5?

   b. Senator Bills also realizes that it would be great if ITM's new manufacturing plants were built in his state. He calls the state governor and asks what kinds of incentives the state might offer to ITM to locate its plants in the state. After their chat, the governor realizes the potential for ITM and buys call options on ITM stock. Is the governor liable under Rule 10b-5?

   c. Legislative aide Sandro, who also attended the ITM meetings, receives a (regular) phone call from Mega-Data, a company that collects data of all sorts and sells the data to hedge funds for use in

their stock trading. Sandro reveals the basics of the meetings with ITM about adding tax incentives for superconductivity in the U.S. power grid. The hedge funds trade on this information. Are the hedge funds liable under Rule 10b-5? What about Mega-Data and Sandro?

Explanations

1. a. Yes, probably. Insider trading duties also apply to trading with one's corporation. As a corporate insider, Daniela has a fiduciary relationship to ITM and, under Rule 10b-5, a duty to abstain or disclose when trading *with the corporation* on the basis of material, nonpublic information. *Chiarella* (§23.3.1). An insider trading case under Rule 10b-5 must also satisfy the fraud elements of materiality and scienter:

   - *Materiality.* The information about the preliminary tests is material if a reasonable investor would consider it important to a buy-sell decision. Under the "probability plus magnitude" test of *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (§22.3.1), the magnitude of discovering a low-cost electrolysis process would be demonstrated by a post-disclosure jump in ITM's stock price. The probability that the preliminary tests would confirm the process's effectiveness seem high.
   - *Scienter.* Daniela knew of the tests when she accepted the options and should have been aware of their propensity to affect the value of the company's stock. See §22.3.2. It is not necessary that she actually used this information, but that she was aware of it. Rule 10b5-1.

   When trading involves nondisclosure, the Supreme Court has presumed reliance upon a showing that the undisclosed information was material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (§22.3.3). In this face-to-face transaction, Daniela might nonetheless rebut the assumption of reliance by showing that the corporation (acting through an independent board) would have offered the options anyway, even had it known of the inside information.

   b. Yes, almost certainly. Daniela's abstain-or-disclose duty extends to shareholders and other investors in ITM's stock. *Chiarella* (§23.3.1). Does it extend to nonshareholder investors? Before 1984, some courts had held that option traders were owed no duty of disclosure. The

Insider Trading Sanctions Act of 1984, however, closed this judge-made loophole by explicitly prohibiting trading in any derivative instrument if trading in the underlying securities would violate insider trading rules. See Exchange Act §20(d).

Although materiality would seem an issue, it rarely is in insider trading cases. If the insider considered the information important to her buy-sell decision, it is almost certain that a court will conclude that a "reasonable shareholder" would also consider the information important—and thus material.

c. Probably, because the trading plan left some discretion to Elbert. The 10b-5 insider trading rules apply to any corporate insider with a fiduciary (or agency) relationship to the corporation. Elbert, an employee-agent of ITM, is subject to the same duties as Daniela. His awareness of the test results would establish a culpable state of mind, subject to an affirmative defense that the trading plan was such that the stock purchases would have happened regardless of his inside knowledge. Elbert would have to show he entered into the written plan before he was aware of the low-cost electrolysis breakthrough and the plan specified the terms of purchases, contained a formula for these terms, or disabled him from influencing the broker. Rule 10b5-1(c). That Elbert retained the option to increase or decrease the purchases each month means the plan was not fixed, as required by the SEC safe harbor rule for plan purchases.

2. a. Perhaps, depending on Elbert's motives and expectations. If Elsa knows (or has reason to know) that the information was confidential and came from an insider who tipped for some personal or reputational benefit, Elsa is liable as a tippee. *Dirks.* A significant issue is whether Elbert disclosed the breakthrough for personal gain or for some nonpersonal corporate reason. If he expected reciprocal stock-trading tips or personal reputational gain, the tip violated Rule 10b-5 if Elsa had reason to know those were his motives. If, however, Elbert revealed the breakthrough for business reasons, such as to discuss the scientific aspects of the discovery, Elsa is under no confidentiality obligation. Elsa's liability thus hinges on Elbert's motives—a deficiency of the *Dirks* approach, but part of federal insider trading law.

In addition to his motives, Elbert's expectations of confidentiality

might also be relevant. If Elsa and Elbert have exchanged confidential information in the past so that Elsa had reason to know that Elbert expected confidentiality, it might be argued she became a "temporary insider." In its recent Rule 10b5-2, the SEC has inferred a duty of trust and confidence in such circumstances. Although the rule by its terms applies only to misappropriation liability, its logic extends to identifying temporary insiders in cases of classic insider trading.

b. Yes. Elbert is liable as a tipper because he gave the tip in breach of his fiduciary duty for an improper personal benefit—the expectation of future reciprocal tips. Even though Elbert did not trade himself, a tipping insider is liable for placing confidential nonpublic material information in peril of abuse. *SEC v. Texas Gulf Sulphur* (see §23.2.1). Under this aiding and abetting theory, nontrading tippers are jointly and severally liable to the same extent as their trading tippees. See Exchange Act §20A(c).

c. Perhaps, though not as a tippee. If Elbert did not anticipate a personal gain from his discussion or there was an expectation of confidentiality, there was no breach of Elbert's duty and a tippee (or an eavesdropper) could not be liable on that basis.

Nonetheless, Mickey might be liable on a misappropriation theory. If Mickey worked for a limousine company that expected complete discretion of its employees, he could be liable for misappropriating the information in breach of *his employer's* expectation of confidentiality. See *United States v. O'Hagan* (§23.3.3). His trading would constitute a breach of duty owed to his employer if the employer expected that he would not divulge or use for personal purposes any information obtained on the job. The SEC confirmed this analysis by defining a relationship of "trust or confidence" to include a contractual relationship (though not necessarily creating a fiduciary relationship) in which there was an agreement of confidentiality. Rule 10b5-2(b).

One sticking point might be whether Mickey had the requisite state of mind. Although his awareness of the importance of the electrolysis breakthrough would appear to satisfy the general "awareness" standard for civil liability, see Rule 10b5-1(b), it may not be enough to establish the "willfulness" required for criminal liability. The *O'Hagan* court pointed out that under Exchange Act §32(a) a criminal 10b-5 defendant

cannot be imprisoned if he "has no knowledge of the rule."

3. a. Probably. The question is whether Donald is a "constructive insider" who has a duty of confidentiality because of his relationship to Daniela. Although earlier courts held that within a family duties not to trade on material, nonpublic information arise only if there were *express* understandings of confidentiality, recent courts have followed the lead of the SEC (see Rule 10b5-2) and treated spousal communications as carrying a duty of confidentiality if the spouses had an *express* or *implied* understanding of confidentiality. See *SEC v. Yun* (§23.3.3). By asking Donald to keep the information confidential, Daniela expected he would not use the information. Only if Donald could show her expectation was unfounded, perhaps because of his past indiscretions, would the presumption of spousal confidentiality be rebutted.

   Notice that this is not a case of tipping. When Daniela told Donald of the breakthrough it was not in the belief he would trade on it—in fact, she asked him to keep it confidential. Much like the spouse in *SEC v. Yun*, who told his wife during divorce discussions about an impending drop in the company's stock, Daniela's revelation was meant to preserve the marriage, not facilitate advantageous stock trading. Spousal communications about work do not constitute a fiduciary breach if the communications are not intended as a stock tip.

   b. Probably. The question here is whether the colleague is liable as a tippee. If Donald was a "constructive insider" (see previous answer), the issue becomes whether the colleague knew or had reason to know that Donald's tip violated his duty of confidentiality, which requires that Donald expected a personal benefit from the tip. See *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988) (holding two New York City police officers liable as tippees for receiving information from another officer, who had received it from an employee of a Wall Street law firm, on the grounds they "should have known" the original tip was a breach of fiduciary duty). Since the colleague knew that Donald had received the tip from Daniela, he should have (at the least) inquired whether Donald was expected to keep it secret. If the colleague had reason to know that Donald was not supposed to reveal the information, a personal benefit is virtually presumed—for example, it would be enough that Donald hoped for a good relationship with a workplace colleague. See *SEC v. Yun* (see §23.3.3). Courts have used the same

broad analysis as to what constitutes a "personal benefit" in cases of classic insider trading and misappropriation. If the tipper wrongfully tips the information and anticipates the tip will result in some financial or reputational gain (however slight)—and the tippee should know this—liability is established.

c. Perhaps not. This is much like the trading in which Martha Stewart was said to have engaged. Merely knowing that an insider is trading does not establish that he is trading on material, nonpublic information. That is, in the normal case there is no reason to believe that the trading breached a fiduciary duty. Unless the tipper—here, the broker Merton—told Martha that Donald was trading on the basis of specific inside information, it may be difficult to establish the tippee's requisite state of mind. Under Rule 10b-5, trading must be with scienter to be actionable in an administrative or private lawsuit (§22.3.2), and must be "willful" to be criminal. Exchange Act §32(a). Perhaps for this reason, the SEC only brought an administrative action against Stewart seeking fines and disgorgement of her insider trading profits. In 2006, she settled these charges without admitting or denying any wrongdoing for $195,000, representing a trebling of the losses avoided plus interest. The criminal case against her was based not on her trading, but on false statements she made to SEC investigators about her reasons for selling her stock.

4. a. Probably. Daniela has clearly violated Regulation FD if her disclosure of the electrolysis breakthrough was to only one securities analyst. Senior officials of publicly traded companies are obligated to disclose material information *simultaneously* to the market when the disclosure is intentional. Here Daniela had already warned others in the company to keep the electrolysis test results secret—suggesting she understood the information was material and nonpublic. Rule 101(a) (definition of intentional). There does not appear to be any effort to disclose the information to other analysts or investors. Nor does any exception apply since Raymond was under no duty to maintain the information in confidence.

Whether Daniela has violated the 10b-5 insider trading rules is not as clear. A violation of Regulation FD does not automatically create 10b-5 liability. Rule 102. And an argument can be made that Daniela is not liable under Rule 10b-5 since she was not a tipper under *Dirks.* She

disclosed the information not for any personal gain but to inform the securities markets. Nonetheless, one must wonder why she told only Raymond. If it was because he has given favorable reports on ITM in the past (boosting the value of Daniela's stock options) and Daniela expects similar favors from him in the future, her disclosure might have violated her *Dirks* duties. At the least, Daniela risks being the target of an SEC investigation.

b. Regulation FD forces companies to institute policies and procedures for dealing with market inquiries. Although conversations are permitted with company advisors, such as lawyers who have a duty of trust and confidence to the company client, senior company officials must be careful in disclosing material, nonpublic information to market professionals and investors who are likely to trade on the information.

- *Materiality determinations.* Companies should have policies for determining what information is nonpublic and material—such as earnings information, important product or contract developments, and important acquisitions or extraordinary transactions. There should also be procedures for consulting with inside counsel and, when appropriate, outside counsel.
- *Identify authorized officials.* Companies should limit analyst and investor contacts to specific company spokespersons—such as the CEO, the vice president of finance, and the head of investor relations. Private meetings or phone calls between senior officials and securities professionals should be discouraged, particularly if material information may be discussed.
- *Coordinated disclosure.* Companies should have procedures for responding to both informal and formal contacts. There should be internal communications channels so that questions are directed to the right persons and responses are consistent. For example, responses to common queries could be posted on a company intranet, and scripts for analyst conferences should be prepared and reviewed in advance. There should be policies for prompt "debriefing" of informal contacts to cure unauthorized disclosures.
- *Wide dissemination.* Material disclosures should be disseminated by press release and accompanied by the filing of a Form 8-K. Any press conference or analyst calls should be conducted on the Internet

to allow full media and investor access. These materials should also be archived for a set period, such as seven days. It may be useful to file a *procedural* Form 8-K to announce generally how the company will disseminate material, nonpublic information.

- *Forward-looking disclaimers.* Since many queries will ask for management's predictions and views about the future, the company should have policies for giving forward-looking statements that fit within the safe harbor rules. The speaker should identify the statement as predictive and refer the audience to risk disclosure in a readily available SEC filing. Exchange Act §21E(c)(2). These risk disclosures should be updated periodically.

5. a. Yes, under a misappropriation theory. Daniela provided Wilbur information on the electrolysis tests on the condition that the bank keep it confidential. Wilbur, in effect, misappropriated this information *from the bank.* If the bank had a policy against employees using confidential customer information—which seems nearly certain—he would be liable on a misappropriation theory. The theory protects confidential business information and assures stock trading markets that trading with information purloined in a relationship of trust and confidence is prohibited.

Even if the bank did not have this policy, the new SEC rule defining the relationships that trigger misappropriation liability specifies that if there was a pattern of sharing confidences so Wilbur had reason to know Daniela expected confidential treatment, Wilbur would have a duty not to trade. Rule 10b5-2(b)(2). Although the bank was not an agent of ITM, since commercial lenders typically deal with borrowers on an arm's-length basis, the SEC rule stretches the notion of trust and confidence beyond that of state agency law. Compare *United States v. Chestman* (see §23.3.3).

Notice, however, that Wilbur was not a tippee of ITM, since Daniela expected no personal gain from the disclosure and breached no duty when she provided it. She supplied the information so her company could get a loan, something permissible under the selective disclosure rules of Regulation FD. Rule 100(b)(2)(i).

b. Both are liable. Tipper and tippee liability work the same in an outsider misappropriation case as in an insider trading case. See *United States v.*

Falcone, 257 F.3d 226 (2d. Cir. 2001) (see §23.3.3—Tipping of Misappropriated Information). If, as discussed in the prior answer, Wilbur is under an abstain-or-disclose duty because of his position at the bank or his taking of confidential information, he cannot tip the information. Wanda is liable as a tippee if she knew (or had reason to know) that Wilbur received the information in confidence and that Wilbur gained some personal benefit (such as a share of her trading profits) by disclosing it to her. She is liable as tippee, and he as tipper, for any trading gains.

c. Perhaps not. Rule 10b-5 liability hinges on a relationship of trust and confidence, and there is none here. See *O'Hagan.* Tina does not have a relationship with and is not a fiduciary to either ITM or to Third Federal Bank. Nor has Tina agreed to maintain the information in confidence, nor is there any practice of sharing confidences with Tina from which an expectation of confidentiality might arise. See Rule 10b5-2(b). Although insider-trading prohibitions may be meant to protect confidential business information, it can be argued that 10b-5 liability is not so broad. Compare *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) (liability of *former employee* who used magnetic identification card to gain access to secret information on pending takeovers).

Nonetheless, the Second Circuit has held that a computer hacker who illegally acquires a company's nonpublic information and trades on it for his own profit can be liable for insider trading, even though the hacker had no fiduciary relationship with the company or its shareholders. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (holding that, despite lack of fiduciary relationship, "act of hacking" could satisfy 10b-5 deception requirement).

In any event, Tina can be liable for mail and wire fraud. See §23.3.3—Mail and Wire Fraud. In addition, if any of the information she stole and traded on related to a tender offer, she would also be liable under Rule 14e-3. See § 23.3.3—Rule 14e-3. Neither of these "information protection" rules requires a relationship of trust and confidence.

6. a. No. The trading does not breach any duty of trust and confidence. *Chiarella* and *O'Hagan* (§23.3.1). ITM has not misappropriated any information, since any proprietary interest in the information concerning the Ovid acquisition belonged to ITM. The company is merely

exploiting its informational advantage, based on its own plans, and has no abstain-or-disclose duty.

This analysis is the same under Rule 14e-3, which applies to material, nonpublic information about a pending tender offer. Even if the Ovid acquisition were structured as a tender offer, the rule applies only to persons other than the "offering person." Rule 14e-3(a).

b. Probably not under Rule 10b-5, though perhaps under Rule 14e-3. Because Daniela had permission to trade on information about ITM's undisclosed plans, she did not misappropriate any information when she traded in Ovid's shares. See *O'Hagan.* In these circumstances, there was no deception *aimed at the source of the information*, a necessary element for liability under the Supreme Court's theory for liability in *O'Hagan.* Just as ITM's trading on its own information would not violate Rule 10b-5 (see previous answer), Daniela's trading could be seen as a form of additional, indirect trading by ITM itself. There might, however, be problems for ITM under federal line-item disclosure rules (or state corporate fiduciary law) if the company fails to disclose this implicit executive compensation, but not under Rule 10b-5.

Whatever Daniela's authorization, she violated the terms of Rule 14e-3, which regulates trading on confidential information about a *tender offer*. See §23.3.3. The rule prohibits trading by "any other person" (besides the bidder) who possesses material, nonpublic information she knows is nonpublic and came from the bidder. Rule 14e-3. By its terms, Rule 14e-3 is violated even if there is no breach of a duty of trust and confidence. Does the SEC have the rulemaking power to regulate trading not in breach of a duty? Although the Supreme Court in *O'Hagan* upheld Rule 14e-3 as applied to a lawyer who had breached his duties by trading on confidential client information, the Court reserved "for another day" the legitimacy of Rule 14e-3 as applied to "warehousing," the practice by bidders of leaking advance information of tender offers to allies and encouraging them to purchase target stock before the bid is announced. Like warehousing, Daniela's authorized trading breaches no duty. As applied to Daniela, Rule 14e-3 may go beyond the SEC's rulemaking power.

c. No, even if Daniela violated Rule 10b-5, only shareholders who traded "contemporaneously" with Daniela can recover. The Insider Trading and Securities Fraud Enforcement Act of 1988 provides an explicit private right of action to contemporaneous traders against misappropriators. Exchange Act §20A. At one time courts saw the misappropriation theory as protecting the confidences of the outside company, here ITM, and held that Rule 10b-5 did not protect trading shareholders, such as Ovid's. The 1988 Act rejects this view. Liability, however, is not tied to the period during which the misappropriator failed to disclose, but rather the period of the misappropriator's trading.

d. There is no cap, if she violated Rule 10b-5 or 14e-3. Daniela can be liable for her trading profits in a disgorgement proceeding by the SEC or in a restitution suit by contemporaneous traders—maximum $100,000. See Exchange Act §20A. In addition, she can be liable for additional civil penalties of up to three times her trading profits—maximum $300,000. Exchange Act §21A. She can also be subject to criminal fines—now up to $5 million. Exchange Act §32(a). Finally, she can be liable for any losses to ITM if it had to pay more for the merger because of the signaling inherent in her trading—no maximum. All for a $100,000 trading gain!

e. No. Although Tom revealed nonpublic, confidential information to his clients (namely the likely ITM acquisition of Ovid), he ascertained it from public information and thus breached no duty. Nor did Tom have any duty to ITM (the source of the information) or Ovid (the company whose shares were traded).

But didn't Tom misappropriate information about ITM's likely merger with Ovid from his own brokerage firm? Although the brokerage firm could have used this information to its advantage, it is unlikely the firm has a policy against analysts disclosing their analysis to clients. In fact, Tom's job is probably to do precisely what he did. The Supreme Court in *Dirks* recognized the crucial role securities analysts play in disseminating information to the market.

7. a. Yes. Senator Bills violated his duty under the STOCK Act not to trade on material nonpublic information that he derived from his congressional position. See §22.2.3—Insider Trading by Members of Congress. Although there might be some difficulties for the SEC or

private plaintiffs to demand information about the meeting given the prerogative of members of Congress to conduct their business in privacy, there is nothing in the Constitution to suggest that Congress cannot regulate corrupt behavior by its members and staff.

b. Maybe. The state governor is not subject to the duties of the STOCK Act, but might be liable under Rule 10b-5 on four theories: (1) the governor violated his duties to his state by trading on information that he gained from performing his official responsibilities; (2) the governor had an understanding not to use confidential information from a federal congressional colleague; (3) the governor is a "temporary insider" with respect to the information from his federal colleague; and (4) the governor was a "tippee" who knew or should have known that Senator Bills violated his duties by disclosing this information for "personal gain."

   The first theory depends on state law, which a federal court in a 10b-5 case might infer, just as federal courts have inferred the existence of fiduciary duties of trust and confidence in business corporations, even when state fiduciary law may not recognize such duties. For example, a state statute that mandates the confidentiality of state information would suggest that the governor violated a duty by trading on the basis of information he gained in his official capacity.

   The second theory arises from Rule 10b5-2 and its creation of duties of trust and confidence in misappropriation cases when a person (here the governor) trades on the basis of information he agreed to keep confidential, or Senator Bills and the governor have an understanding that they expect their communications will be kept confidential. This expansion of Rule 10b-5 liability beyond fiduciary duties to the source (here the United States) has not been challenged, but would seem to be within the authority of the SEC under §10(b) to define the contours of a "manipulative or deceptive device or contrivance."

   The third theory depends on a federal court using the logic of *Dirks* (see §22.2.1) to create "temporary insider" status for persons who have an agency-like relationship with the source of the information. Here it might be argued that the governor had become part of a "team" looking for ways to bring manufacturing to a state—and thus was duty bound to maintain the confidences of the group. That is, the governor assumed

the same duties as Senator Bills by acting as part of an initiative led by a federal legislator. That the STOCK Act creates only duties in federal legislators and their aides suggests that Congress did not go as far as *Dirks* did.

The fourth theory depends on Senator Bills having violated his duties by disclosing information about the ITM meeting. This theory seems less likely to succeed, given that Senator Bills was conducting legitimate official business when he talked with the governor about how his state might get ITM to build its manufacturing plants in the state. That is, it would not appear that Senator Bills derived a “personal benefit” when he shared this information. Although helping bring ITM manufacturing plants to the state might benefit him politically, Senator Bills seems to have shared the information with the governor to advance the state’s interests, not his own. His actions would seem to be comparable to those of a company executive who legally discloses confidential information to advance a corporate interest, even while he might also benefit from any corporate success.

c. Each has probably violated Rule 10b-5. In this tipping case, liability for each person in the chain depends on Sandro having violated his duties of trust and confidence by “tipping” Mega-Data. There is no indication that part of his legislative duties includes disclosing information about private meetings between legislators and constituents. And although Sandro received no explicit personal benefit from Mega-Data, courts have accepted implicit benefits such as “personal friendship” and “professional connections.” Here, if there was any possibility that Mega-Data would later offer Sandro employment (a “revolving door”) or would give him any other favor, then Sandro would have received an improper personal benefit. Although in some situations congressional aides might be under instructions to “leak” confidential information for political purposes, there is no indication that the “owner” of the information (the Congress) asked Sandro to do this.

If Sandro breached his duties, then the next question becomes whether Mega-Data knew or should have known about this breach. Certainly, if Mega-Data had made direct promises to Sandro to obtain the information, it would be aware that Sandro’s disclosure breached his duties. Even if Mega-Data did not make such promises, its recognition that the disclosure was about private meetings suggests that

it was not receiving the information as a member of the public—but as a special favor.

Finally, it seems likely that Mega-Data's hedge fund clients should have known that the information about private congressional meetings came from a source that violated his duties by disclosing the information. If Mega-Data told the hedge funds that Sandro was the source of the information, the funds should have known—particularly after the STOCK Act—that Sandro owed duties of trust and confidence as to market-sensitive information. Even if Mega-Data had not disclosed its source, the hedge funds should have expected that the information came from an inside congressional source and would have been under a duty to inquire further.

CHAPTER 24

Section 16(b)—Disgorgement of Short-Swing Profits

The prohibitions of Rule 10b-5 are not the only federal limitations on share liquidity. To deter price manipulation by insiders in public corporations and encourage insiders to acquire long-term interests in their corporations, Section 16 of the Securities Exchange Act of 1934 requires specified insiders to report their trading in their company's securities, and authorizes the corporation to recover from these insiders any profits made on stock purchases and sales in a narrow six-month period—so-called short-swing trading profits.

This chapter describes the companies, trading, and persons subject to §16 (§24.1), the trading reports required of specified insiders (§24.2), and the rules on disgorgement of short-swing profits (§24.3). The previous chapter dealt with the state and federal rules against insider trading.

§24.1 COVERAGE OF §16

Section 16 only applies to trading in the *equity securities* of a corporation that has a class of equity stock registered under §12 of the Exchange Act —*registered* companies (see §21.2.1). Thus, §16 applies to trading in any equity securities of registered companies, whether or not the particular securities are subject to §12 registration. For example, if a company's common stock is subject to Exchange Act registration, but its preferred stock

is not—because it is not listed on a stock exchange and is held by fewer than 500 shareholders (see §8.3.1)—trading by insiders in the unregistered preferred is subject to §16's reporting and disgorgement rules.

The SEC has broadened §16 coverage to include options, convertible securities, and other equity derivatives within the definition of "equity securities." Rule 16a-1(c), (d). Thus, insiders must also report their option trading and are subject to disgorgement of any profits on their short-swing option trading. The §16 short-swing trading provisions apply only to qualifying officers, directors, and shareholders who own (of record or beneficially) more than 10 percent of any class of the company's equity securities.

Exemptions for Executive Compensation

The SEC has created a complex set of rules that permit company executives to acquire and sell shares under company compensation plans. Recognizing the value of stock ownership in executive compensation plans, the SEC has exempted "tax conditioned" plans from the reporting rules and short-swing profit liability. These plans include those that are "qualified employee benefit plans" under the Internal Revenue Code (which allows tax deductions for the company and tax-deferral for the executive) and those that meet the requirements of a "qualified stock purchase plan" under the Internal Revenue Code. Rule 16b-3. This means that company executives need not worry about the short-swing trading rules when they (1) use plan contributions to acquire company stock or derivative securities, (2) purchase company stock in an employee stock ownership plan (ESOP), (3) dispose of company stock pursuant to domestic relation orders, or (4) receive distributions in company stock on death, disability, retirement, or termination. Company executives can even elect to transfer in and out of company stock funds, or receive cash withdrawals, if the election is made only once every six months.

Note on § 16(b) Effect on Corporate Governance

One effect of the §16(b) short-swing trading rules is to discourage shareholder activism—particularly by institutional shareholders. Taking a significant position in a company (more than 10 percent) or placing directors on the company's board limits the ability of activist

shareholders to buy and sell company shares during any six-month window. Section 16(b) is regularly cited as one of the reasons that U.S. institutional shareholders do not take a more activist role in their portfolio companies.

§24.2 REPORTS

To facilitate the policing of insiders' short-swing trading, §16(a) requires reports by qualifying officers, directors, and 10-percent shareholders. Form 3 (initial reporting once insider status achieved); Form 4 (reporting of subsequent changes in beneficial ownership); Form 5 (annual report).

The reports, which must be filed electronically with the SEC and posted on the company's website, disclose the amount of securities *beneficially owned* by the insider and the price paid in any purchase or sale. Initial reports must be filed within ten days after a person becomes an insider, and updating reports must be filed within two business days after any change in the insider's holdings. Rule 16a-3; Securities Act Rel. No. 8230 (2003). Failure to file subjects the insider to penalties.

§24.3 DISGORGING SHORT-SWING PROFITS — MECHANICAL TEST

Section 16(b) imposes automatic, strict liability on qualifying officers, directors, and 10-percent shareholders who make a profit (as defined) in short-swing transactions within a six-month period. No proof of intent or scienter is required. Recovery is to the corporation, and suit may be brought either by the corporation or by a shareholder in a derivative suit.

The mechanical short-swing profit rules are both overly broad and overly narrow. They broadly cover innocent short-swing trading that occurs without the use of inside information or any wrongful intent, yet they fail to cover abusive insider trading that occurs outside the six-month window or by those who are not insiders specified under §16.

Short-Swing Algorithm

A two-part algorithm determines whether disgorgement is available (the examples at the end of this chapter reveal the many permutations involved in determining §16(b) liability):

Identify a qualifying insider (whom the statute deems to have access to insider information and the power to manipulate the company's stock price).

- *Officer or director at either sale or purchase.* For qualifying officers or directors (but not 10-percent shareholders), official status at the time of either purchase or sale is sufficient—not necessarily both. The theory is that by trading when he was an officer or director, the insider had access to nonpublic information and was in a position to manipulate the price of the stock. Under Rule 16a-2, transactions occurring within six months before becoming a director or officer are not counted, though transactions occurring within six months of ceasing to be a director or officer are counted.
- *Shareholder (10 percent) "immediately before" both transactions.* For 10-percent shareholders, it is necessary that the person have held more than 10 percent *immediately before* both the purchase and sale to be matched. *Reliance Electric Co. v. Emerson Electric Co.,* 404 U.S. 418 (1972) (holding that shareholder must hold 10 percent or more before matching *sale*); *Foremost McKesson Inc. v. Provident Securities Co.,* 423 U.S. 232 (1976) (holding that shareholder must hold 10 percent or more before matching *purchase*). The different treatment of 10-percent shareholders comes from an exclusion in §16(b) of "any transaction where [the] beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved." The rationale is that 10-percent shareholders are less likely to have access to inside information or to corporate control mechanisms than officers or directors. Thus, their insider status must exist at both ends of the matching transactions.

Match any stock transactions by the insider that produce a profit. Section 16(b) liability is predicated on matching any *purchase* with any *sale* by a qualifying insider, regardless of order, that occurred during any six-month period in which the sale price was higher than the purchase price. There is no tracing of shares, and recovery is frequently measured by matching later lowest-cost purchases with earlier highest-cost sales. See *Smolowe v. Delendo Corp.,* 136 F.2d 231 (2d Cir. 1943) (establishing the "lowest price in, highest price out" method of calculating short-swing profits). There is no need to offset any losses—that is, any purchases and sales in which the sales price is *lower* than the purchase price need not be matched and can be disregarded.

Comparisons to Rule 10b-5

Section 16(b) is broader and narrower than the insider trading prohibitions of Rule 10b-5. Limited to trading in securities of registered companies during a six-month window, it is narrower than Rule 10b-5—which applies to all companies and regardless of holding periods. Yet, by covering any trading during a six-month period, whether or not based on inside information, §16(b) is also broader than Rule 10b-5—which requires a showing that

trading was based on material, nonpublic information.

§24.3.1 Special Interpretive Issues

The literal terms of §16(b) are inflexible, sometimes too harsh, and other times too lenient. To accomplish the rule's purpose to discourage manipulative insider trading, courts have interpreted the section's significant terms—*officer* and *director, beneficial ownership,* and *purchase* and *sale*—to introduce policy analysis into the otherwise mechanical disgorgement rules.

Officer and Directors

Courts have interpreted §16(b) to reach persons and entities who do not fall within the literal definition of *officer* or *director,* but who are functionally equivalent for purposes of insider access:

- **Functional officers.** For purposes of §16(b), a qualifying officer is any employee who has a position in the corporation that gives her access to confidential inside information that is not freely circulated. An official title may help identify these persons, but is not determinative. *Merrill, Lynch Pierce Fenner & Smith, Inc. v. Livingston,* 566 F.2d 1119 (9th Cir. 1978) (holding that a brokerage firm's "vice president" was not an officer for §16(b) purposes, because his title was merely honorary in recognition of sales accomplishments and did not reflect access to inside information). In 1991, as part of a comprehensive update of §16, the SEC defined "officer" to include those persons who perform policy-making functions. See Rule 16a-1(f) (definition based on title and policy-making functions).
- **Deputization.** Courts have developed a *deputization theory* for entities that hold stock in a corporation and are also represented on the corporation's board of directors. *Feder v. Martin Marietta Corp.,* 406 F.2d 260 (2d Cir. 1969). For example, suppose that Henrietta is a managing partner of Trout Brothers, an investment bank with a securities trading department, and that she also sits on the board of Bullseye Corporation, the subject of takeover speculation. If Trout Brothers purchases 5 percent of Bullseye's stock, §16(b) by its terms does not impose any short-swing trading liability: Trout Brothers is

neither a 10-percent shareholder nor a director, and Henrietta is not the beneficial owner of Bullseye stock held by Trout Brothers. Nonetheless, there should be concern that Trout Brothers will use Henrietta as its conduit of inside information.

Under the deputization theory, Henrietta is treated as Trout Brothers' "deputy" and any Trout Brothers transactions in Bullseye stock are subject to the short-swing profit rules. The scope of the deputization theory is unclear. Under one view, Trout Brothers is treated under §16(b) as a "director" if Henrietta (1) represents its interests on the Bullseye board and (2) actually passes along inside information to Trout Brothers. See *Blau v. Lehman*, 368 U.S. 403 (1962) (entire partnership not liable as an insider merely because one member was a director in a corporation in whose stock the partnership traded based on public information).

Beneficial Ownership

An important issue in many §16(b) cases is whether a person subject to the disgorgement rules beneficially owns securities that have been transacted. For example, if the spouse of an officer of Company X owns shares in the company, can transactions by the spouse be attributed to the officer? In 1991, the SEC promulgated a rule that defines beneficial ownership differently for 10-percent shareholders and officer/directors.

- **Ten-percent shareholders.** In general, beneficial ownership of securities under the Exchange Act depends on whether a shareholder has the power either to vote the securities or to dispose of them. Rule 13d-3(a). The SEC has adopted this definition for purposes of determining ownership by 10-percent shareholders. Rule 16a-1(a)(1). Under the SEC definition, this means that spouses and other family members (even if they share pecuniary benefits) are not the beneficial owners of each other's stock for §16(b) purposes unless they can control its voting or disposition.
- **Officers and directors.** Officers and directors are subject to a different rule of beneficial ownership that focuses on whether they have (or share) a "pecuniary interest" in the shares. Rule 16a-1(a)(2). The pecuniary interest can be direct or indirect, and does not depend on whether the

officer or director has any voting or disposition power over the shares. It is enough if the officer or director stands to profit directly or indirectly from the transaction. This means that if the spouse of an officer of a company sells her shares and the officer stands to profit indirectly, the sale is attributed to the officer.

Unorthodox Transactions (Purchases and Sales)

Usually whether a stock transaction constitutes a matchable purchase or sale under §16(b) is not an issue. But when the stock transaction is *unorthodox*—such as when shares are acquired in a merger or in an option transaction— the courts have been willing to inquire into whether the transaction should be treated as a matchable "sale" or "purchase" for purposes of §16(b). The SEC also has promulgated extensive (and very technical) rules that exempt certain transactions—such as redemptions, conversions, and transactions involving employee benefit plans—where the risk of insider abuse is minimal. Rules 16b-1 through 16b-11.

The Supreme Court has held that an unorthodox transaction by a hostile bidder (which became a 10-percent shareholder) in a takeover contest is not a matchable "sale" if there is no evidence of abuse of inside information. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973). In the case, Occidental successfully bid for 20 percent of Kern County's stock—a §16(b) "purchase." Concerned about Occidental's intentions, Kern County management found a white knight (Tenneco) that agreed to buy Kern County in a merger. Under the merger terms, "Old Kern" merged into a wholly owned Tenneco subsidiary and became "New Kern." Old Kern shareholders received Tenneco preferred stock in exchange for their stock. To buy Occidental's good will, Tenneco granted Occidental an option to sell its Tenneco preferred stock (after the merger) at a premium. Occidental agreed not to oppose or vote on the merger, and the remaining Old Kern shareholders approved. Occidental, along with the other Old Kern shareholders, then received Tenneco preferred stock for their Old Kern stock.

Was there a "sale" that could be matched with the tender offer "purchases"? The plaintiff argued there were two: (1) the option granted to Occidental—granted within six months of the original purchases, though exercisable after the six-month period; and (2) Occidental's exchange of New Kern stock for Tenneco preferred stock in the merger—which occurred within

the six-month period. In other contexts, the receipt of consideration in a merger has been treated as a sale under the federal securities laws. See Securities Act Rule 145 (requiring prospectus disclosure for securities issued in a merger). Nonetheless, the Supreme Court decided that Occidental had not "sold" its Old Kern stock in the merger because the transaction was involuntary and the relationship between Occidental and Kern County's management was hostile. Likewise, there was no evidence of abuse of inside information in the granting of the option, which was granted to buy Occidental's acquiescence in the merger.

But when it is possible inside information has been abused, the granting of an option has been treated as a "sale." In *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), McDonough and his wife had purchased more than 10 percent of Cudahy's stock, and McDonough became a director. Within six months of these purchases, the McDonoughs granted another company, Smelting Refining, an option to purchase the bulk of their Cudahy stock. McDonough then resigned from Cudahy's board, and Smelting Refining placed its representatives on the board. Under the option agreement, the McDonoughs placed their Cudahy shares in escrow. Smelting Refining exercised the option more than six months after their original purchase. The court held that the granting of the option was a matchable "sale" because it could lend itself to inside speculation.

§24.3.2 Section 16(b) Litigation

Compared to the factual and legal issues that surround 10b-5 insider trading litigation, §16(b) short-swing disgorgement litigation is a cinch. The statute specifies the elements of a disgorgement action:

- realization of profit
- by an officer, director, or 10-percent shareholders
- from matching purchases and sales during any six-month period
- of equity securities of a public company

Suit by the corporation or by a shareholder in a derivative suit must be brought within two years of the date the profit was realized.

The information to establish a §16(b) disgorgement case is available in

public filings with the SEC. There is no requirement that the §16(b) plaintiff establish any of the elements normally required in a private 10b-5 insider-trading private action—namely that the trading was based on material, nonpublic information, that the defendant acted with a culpable state of mind, that those who traded relied in some way, that the trading caused any losses, or even that there were losses.

The only significant procedural issue in §16(b) disgorgement actions is whether the plaintiff has standing. Congress created a scheme of corporate enforcement and recovery. Under the statutes, if the corporation fails to sue within 60 days of a demand, an "owner of any security of the issuer" may bring a derivative suit on behalf of the corporation. The statute does not specify any standing requirements for a derivative suit plaintiff, and courts have interpreted the statute broadly to be consistent with its remedial purposes. Thus, some of the standing requirements in a normal derivative suit, such as contemporaneous ownership (see §18.3.2), do not apply in a §16(b) suit. See *Gollust v. Mendell,* 501 U.S. 115 (1991) (holding that shareholder of corporation acquired in a merger had standing to continue a §16(b) action against former 10-percent shareholder, even though corporation was merged into a new entity).

Why would a shareholder or bondholder bring a §16(b) disgorgement suit if any recovery goes to the corporation? The holder's interest in the suit is limited to the increase in value (if any) of the holder's securities. This diluted incentive, it would seem, will rarely justify investigating a §16(b) violation and initiating the litigation. The real incentive for §16(b) litigation is that the attorneys' fees of a successful derivative-suit plaintiff are recoverable from the corporation. It is no defense that the §16(b) litigation was brought primarily to obtain attorneys' fees. See *Magida v. Continental Can Co.,* 231 F.2d 843 (2d Cir. 1956).

Statute of Limitations

Section 16(b) suits—whether by the corporation or as a derivative suit—must be brought within two years of the date when the insider's profit was realized. §16(b). In 2012, the Supreme Court held that this period is not tolled if insiders have failed to file their §16(a) disclosures, though the Court did decide that traditional equitable tolling might apply. *Credit Suisse Securities (USA) LLC v. Simmonds*, 566 U.S. ___ (2012) (remanding §16(b) case, which had been brought in 2007 alleging short-swing profits arising during

dot-com boom of late 1990s, for a determination of when plaintiff, with due diligence, could have known or did know of trading at issue).

Examples

1. ITM Corp. has one class of common stock, which is registered under §12 of the Exchange Act. Dorothy is a director of ITM. For each of the following situations, what is Dorothy's disgorgement liability under §16(b)? Hint: you'll find it helpful to create a timeline for each sequence.
    a. Dorothy purchases 100 shares of ITM stock on February 1 at $10 per share, and sells on August 2 at $15 per share. ITM's stock price rose because it was awarded a large government contract on April 1, which Dorothy knew about when she bought.
    b. Dorothy buys 200 shares on July 1 at $5 per share, sells 200 shares on February 1 of the next year at $15 per share, and then purchases 300 shares on May 1 at $10 per share.
    c. Dorothy buys 100 shares at $10 per share on February 1, buys another 100 shares at $20 per share on March 1, sells 100 shares at $12 per share on April 1, and sells another 100 shares at $15 per share on May 1.
    d. Dorothy adds to her portfolio and buys 180 shares on February 1 at $10 per share, sells 150 shares on May 1 at $15 per share, and then sells another 100 shares at $18 per share on June 1.
    e. Dorothy became a director on March 1. Prior to this, on February 1, she had purchased 100 shares at $10 per share. She purchases 100 shares at $12 per share on April 1, and sells 100 shares at $15 per share on June 1.
    f. Dorothy purchases 100 shares at $10 per share on February 1. She becomes a director on March 1 and resigns as director on May 1. She sells 100 shares at $15 per share on May 2. Dorothy purchased in February at $10 per share knowing of confidential, nonpublic developments that would raise the price in May.
2. Cheryl is an investor with a keen interest in ITM. She is neither an officer nor a director of ITM.
    a. Over four years, Cheryl accumulates 9 million shares (9 percent) of ITM stock. On February 1 she buys 5 million additional shares at $15 per share, bringing her holdings to 14 percent. On May 1 she

sells all of her 14 million shares at $20 per share. What is Cheryl's §16(b) liability?

b. After selling all of her ITM stock last year, Cheryl decides to acquire control of the company by making open-market purchases and a tender offer. She is prepared, however, to sell her holdings if another bidder offers a good price. Advise Cheryl on how to purchase and, if the opportunity presents itself, sell her stock without becoming subject to §16(b) liability.

3. Cheryl does not take your advice. Instead, she buys 11 percent of ITM's stock in December and then buys an additional 9 percent on March 1, bringing her holdings to 20 percent. She then enters into negotiations with ITM's management and, on July 20, agrees to have the corporation repurchase all of her stock.
   a. The repurchase agreement calls for closing on the repurchase to occur on October 1, outside the six-month window that opened on March 1. Under §16(b), can Cheryl's March purchases be matched with her July agreement?
   b. If the closing had occurred on August 1—at a slightly lower price than the one negotiated for the October 1 closing—does your answer change?
4. After selling back her shares, Cheryl and her husband Charles each begin buying ITM stock. By November, each owns 6 percent of ITM's stock.
   a. In January, Charles purchases additional shares at $40 per share, bringing his holdings to 9 percent. In March of the same year, Cheryl sells some of her shares at $45 per share, bringing her holdings to 3 percent. Is either liable under §16(b)?
   b. In August, after Cheryl and Charles sell all of their remaining ITM stock, Cheryl joins the ITM board of directors. She purchases ITM stock as trustee for her child's college fund. In November of the same year, Cheryl sells all of this stock at a profit. Is she liable under §16(b)?
5. MACO Corp. decides to "greenmail" ITM. To do this, it will first buy a large stake in ITM on the open market, then threaten a hostile tender offer, and finally negotiate a sale of its stake to ITM at a premium.
   a. Otto, an officer of MACO, sits on ITM's board. Is there a possibility of §16(b) liability in MACO's plans?

b. MACO has Otto resign from the ITM board. MACO then becomes a 10-percent shareholder in January and in February purchases 200,000 more shares. ITM management reacts by offering its shareholders a capital restructuring in which they will receive for their shares a package of cash and preferred stock. This will require an amendment to ITM's charter. MACO supports the restructuring, and its votes for the charter amendment prove decisive. After the June restructuring, MACO receives cash and preferred stock, producing a significant profit. Is MACO liable under §16(b)?

Explanations

1.a. No disgorgement liability. None of Dorothy's trades occurred within six months of each other. Under §16(b) it is irrelevant whether Dorothy had any material, nonpublic information about the government contract when she bought and sold. She may be liable, however, under Rule 10b-5 for insider trading (see §23.3).

Date	Transaction
February 1	Buy: 100 @ $10
April 1	Government contract
August 2	Sell: 100 @ $15

b. $1,000. Lower-priced purchases are matched with higher-priced sales occurring within six months. Only the February sale and May purchase can be matched; the July purchase is outside the six-month window. The disgorgement formula operates regardless of the order of the transactions as long as the sale price is higher than the purchase price. In this case, only 200 shares match, and Dorothy is liable to disgorge $1,000 in profits (200 shares times $5).

Date	Transaction
February 1	Sell: 200 @ $15
May 1	Buy: 300 @ $10

c. $500. Matching the February purchase and the May sale produces the highest gain—$500 (100 shares times $5). There is no need to offset any losses, so the $800 loss generated by matching the March purchase and the lower April sale can be disregarded. Even though Dorothy lost

a net $300 during the six-month trading period—she purchased 200 shares for $3,000 and sold 200 shares for $2,700—she is subject to disgorgement liability. This crude rule of thumb assumes that her February and May transactions were based on inside information or short-swing market manipulations.

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Buy: 100 @ $20
April 1	Sell: 100 @ $12
May 1	Sell: 100 @ $15

d. $1,200. First match the transactions that produce the greatest gains (100 shares—February and June) and then any other transactions that produce gains (80 shares—February and May). The combined recoverable profits are thus $1,200 (100 times $8 profits, matching the $18 June sale and the $10 February purchase, *plus* 80 times $5 profits, matching the $15 May sale and the $10 February purchase).

Date	Transaction
February 1	Buy: 180 @ $10
May 1	Sell: 150 @ $15
June 1	Sell: 100 @ $18

e. $300. Although the February-June match produces a larger gain than the April-June gain, the February-June match is not available under §16(b) because Dorothy was not a director at the first point in the match—the February transaction. Under Rule 16a-2(a), transactions *prior* to a person becoming director are exempt from §16(b) liability. The idea is that she likely did not have had inside information when she bought in February. Matching the April and June transactions, Dorothy's liability is $300 (100 shares times $3).

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Becomes director
April 1	Buy: 100 @ $12
June 1	Sell: 100 @ $15

f. No disgorgement liability. There is no sale and purchase to match because Dorothy was not a director at the time of either trade. Nonetheless, Dorothy may be liable under Rule 10b-5 for trading on

material, nonpublic information she received in her capacity as a director (see §23.3).

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Becomes director
May 1	Resigns as director
May 2	Sell: 100 @ $15

2 .a. Cheryl is not liable under §16(b). The February purchase cannot be matched because Cheryl was not a 10-percent shareholder *immediately prior* to it. (In fact, Cheryl would not have disclosed her February purchase on Form 3 because at the time of the purchase she was not a 10-percent shareholder.) Shareholders must have "inside" status—that is, hold more than 10 percent of the shares—immediately before each transaction to be matched. This differs from the rule for officers and directors and is based on an assumption that shareholders are less likely to have access to inside information or the ability to manipulate prices.

Date	Transaction
February 1	Buy: 5MM @ $15
May 1	Sell: 14 MM @ $20

b. Cheryl should buy only 9.9 percent of ITM's outstanding shares on the open market. The purchase that brings her above 10 percent should be in one fell swoop—such as in a tender offer. In this way, none of her purchases will occur when she is a 10-percent shareholder, and none will be matchable. Cheryl can later sell without incurring any §16(b) liability. The assumption in *Kern County* (see §243.3), decided by the Supreme Court in 1973, that tender offer purchases that bring a shareholder's holdings above 10 percent are matchable was explicitly rejected by the Supreme Court in *Foremost McKesson* in 1976 (see §24.3).

If Cheryl makes any matchable purchases while a 10-percent shareholder, she should sell her stock in chunks, not all at once. In this way, only those sales that she makes while she is a 10-percent shareholder are matchable. Once her holdings fall to 10 percent or less, any further sales are not matchable. This limits her §16(b) exposure.

3.a. Probably not. Can the July 20 agreement be characterized as a "sale" for

purposes of §16(b)? Management's apparent hostility to Cheryl suggests she had no access to corporate information or control, and there would be little purpose in imposing short-swing liability. Such liability would effectively allow the corporation to renegotiate the repurchase price.

b. Probably. There would then be a traditional purchase and sale within six months. Nothing in the language of §16(b) suggests that there are exceptions to the disgorgement rules if the evidence strongly suggests the absence of inside abuse. Although the August closing would seem for financial purposes to be equivalent to an October closing, §16(b) may elevate the form of the transaction over its substance.

4. a. Probably not. The critical issue is whether Cheryl and Charles are treated as a single beneficial owner. If so, their individual 6 percent holdings would be combined. As beneficial owners of more than 10 percent, the January purchases by Charles would be matched with the March sales by Cheryl to produce a recoverable profit. In each case, they beneficially owned more than 10 percent immediately before the transaction. If, however, they are not the beneficial owner of the other's shares, neither can be liable because neither individually surpassed the 10-percent threshold.

According to the SEC, holdings of shareholders' percents must be aggregated if one shareholder has voting or disposition control over the other's shares. Rule 16a-1(a)(1) (for purposes of determining whether shareholders own more than 10 percent, look to investment/voting control rule). In this case, unless Charles or Cheryl had control over the other's shares, there would be no beneficial ownership. This is an unusual result, which essentially permits family members to hold and trade outside the strictures of §16 so long as no family member holds more than 10 percent of the company's stock and they do not enter into any arrangement to vote or dispose of the others' stock. Rule 13d-3(a). This means that even if Cheryl and Charles share the financial benefits of ownership, they are not deemed to be beneficial owners of each other's shares, making their January and March transactions unmatchable.

b. Probably. The question of beneficial ownership also arises for a director whose family members trade in the company's stock. See Exchange Act §16(a) (requiring reports of "all shares of which [the

officer/director] is a beneficial owner"). Normally, a director is subject to §16 for any trading by members of his immediate family. See Rule 16a-1(a)(2)(ii)(A) (defining "indirect pecuniary interest" in equity securities to include securities held by officer/director's "immediate family" sharing the same household). In §16(b) disgorgement actions, courts have attributed trading by a director's spouse to the director, treating profits realized as a result of the spouse's transactions as "profits realized by [the director]." See *Whiting v. Dow Chemical Co.,* 523 F.2d 680 (2d Cir. 1975).

In the case of securities held in trust for a family member, the SEC rules recognize the risk that a director may abuse her insider status in connection with the trading of securities as to which the director acts as trustee. See Rules 16a-1(a)(2), 16a-8(b)(2)(ii) (director who acts as a trustee is deemed to have "beneficial ownership" in trust securities if at least one beneficiary of the trust is a member of the director's immediate family). Nonetheless, some courts in §16(b) disgorgement cases have used a narrower understanding of beneficial interest than the SEC test. *CBI Industries, Inc. v. Horton*, 682 F.2d 643 (7th Cir. 1982) (Posner, J.) (director, acting as trustee for adult children, is subject to §16(b) liability for trading in trust only if director is able to use income or assets of trust).

This different treatment, apparently in sympathy for the trading limitations otherwise placed on family members of a director, seems questionable in light of the §16(b) purpose to discourage insiders from manipulating company stock prices to benefit their own trading. A director, it would seem, would have as much incentive to manipulate her company's stock prices whether profits flow directly to her or whether they flow to her children's trust fund. That is, consistent with the statute's broad remedial purposes, there are "profits realized [by the director]" when her trading decisions enhance her (and her family's) overall financial position.

5. a. Yes. MACO might be treated as a Bullseye director under a "deputization" theory because Otto, an officer of MACO, sits on Bullseye's board. If MACO is "deputized," any gains in its short-swing trading would be subject to §16(b) disgorgement.

To show deputization, Otto must have represented MACO on the

board. In addition, it might be necessary to show some (or all) of the following: Otto was “controlled” by MACO; Otto was ultimately responsible for deciding about MACO’s acquisitions of Bullseye stock; Otto had access to inside Bullseye information; and Otto actually passed such information on to MACO. Although requiring a showing of actual access or actual passing of inside information might seem inconsistent with §16(b) strict liability, deputization is meant to achieve the underlying §16(b) purposes of deterring and compensating for the abuse of inside information. A deputization test requires a showing of actual or probable abuse.

b. Perhaps, though it is hard to say. Although the February and June transactions are matchable because MACO was a 10-percent shareholder before each one, it could be argued that the June transaction was not a “sale” for purposes of §16(b). Arguably, the June restructuring was involuntary—that is, its timing was not of MACO’s making—and MACO’s relationship to ITM was such that it is unlikely any confidential information was passed to MACO. See *Kern County* (§24.3.1).

There are, however, two significant differences between this case and the situation in *Kern County*. First, MACO supported the restructuring. This should not make a difference if MACO was not involved in ITM’s restructuring decision and there was no passing of inside information. Second, ITM’s management may have had reasons to pass inside information to MACO. It is possible that the restructuring was negotiated with MACO—just as was the option in *Kern County*. If so, ITM’s management might have found it useful to pass inside information to MACO to ensure the success of the restructuring. Nonetheless, even if ITM passed inside information, it may well have been “good news” to encourage MACO’s support. Because all the MACO shareholders shared in the restructuring premium, the abuse would not have harmed them.

CHAPTER 38

Federal Regulation of Tender Offers

Federal securities law adds informational rights to the mix of shareholder protections in fundamental corporate changes. The federal proxy rules mandate disclosure in any corporate combination (such as a merger) that requires approval by public shareholders. See Chapter 9. The federal prospectus disclosure rules apply to any exchange tender offer in which public shareholders receive securities for their shares. See Chapter 5. But until 1968 no federal disclosure rules applied to acquisition of a *control block for cash*, whether through open-market purchases or a tender offer.

To plug this regulatory gap, Congress passed the Williams Act in 1968—a set of amendments to the Securities Exchange Act of 1934—to regulate stock purchases that affect corporate control. The Williams Act applies to public corporations whose securities are registered under §12 of the Exchange Act (see §9.2.1). This chapter describes how the Williams Act mandates disclosure for stock accumulations of more than 5 percent of a target's equity securities (§38.1), mandates disclosure by anyone who makes a tender offer for a target's equity securities, as well as the terms of such tender offers (§38.2), and provides for enforcement of its rules (§38.3).

Note on Effect of Williams Act

Despite protestations by the Williams Act drafters that the legislation was meant to be neutral—protecting shareholders without favoring

management or bidders in takeover fights—some commentators have criticized the Act as having a pro-target bias. In fact, studies indicate that in the years immediately after the Act's passage in 1968 takeover premiums increased from 32 percent to 53 percent, while the frequency of takeovers declined. By imposing disclosure and timing impediments on bidders, without limiting the defensive arsenal of the target, some have argued the Act actually tilts the playing field in favor of target management. While a tender offer is pending, management can mount defenses whose substantive terms are not regulated by the Williams Act's principle of neutrality. See Chapter 39.

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§38.1 DISCLOSURE OF FOOTHOLD POSITION

Any person (or group) that acquires *beneficial ownership* of more than 5 percent of a public corporation's equity securities must file a disclosure document with the SEC. Exchange Act §13(d). The disclosure alerts the stock market (and the target's management) of a possible change in control.

§38.1.1 Schedule 13D Disclosure

The filing, known as a Schedule 13D, must disclose

- the acquirer's (and any group member's) identity and background
- the source and the amount of funds for making the purchases
- the number of the target's shares held by the acquirer
- any arrangements that the acquirer has with others concerning shares of the target
- the acquirer's purposes for the acquisition and his intentions with respect to the target

A Schedule 13D must be filed within ten days after the 5 percent threshold is passed. This gives an acquirer a ten-day window during which to buy stock on the open market before having to signal that the company may be in play.

§38.1.2 Beneficial Ownership and Shareholder Groups

According to the SEC rules, beneficial ownership turns on whether the person (or group) has "voting power and/or investment power." Rule 13d-3(a). Thus, the shareholding of a father with the ability to control how his children vote their shares would be combined with the shareholdings of the children. Courts have looked at substance over form to determine whether there is a contract, arrangement, understanding, or relationship that suggests one person has voting or investment authority over another person's voting securities.

If persons who collectively hold more than 5 percent agree to act together for the purpose of affecting control, they (as a group) become subject to the §13(d) reporting requirement. Even if the group does not acquire more shares, their *agreement* triggers the reporting obligation. Rule 13d-5(b)(1); *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971).

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§38.2 FEDERAL TENDER OFFER RULES

Seeking control through open-market purchases is problematic—rarely will enough shareholders sell at market for a bidder to acquire a control block. A tender offer forces the question. The bidder greatly increases its chances by publicly offering to buy a specified number of tendered shares during a specified period at a premium over prevailing market prices. A tender offer operates much like a retailer's "Saturday night special at never-again prices."

Any tender offer for a public corporation's *equity securities* that would result in the bidder holding more than 5 percent of the target's equity securities is subject to both disclosure requirements and substantive rules governing the offer terms. Exchange Act §14(d). Federal tender offer regulation is meant to ensure that shareholders have sufficient information about the offer and adequate time to evaluate it, so they are not unfairly pressured into tendering their shares.

§38.2.1 Tender Offer Disclosure

The bidder must file a disclosure document with the SEC on the day it commences the tender offer. The document (Schedule TO) must include the same information as Schedule 13D, along with

- information about the tender offer
- past negotiations between the bidder and the target
- the bidder's financial statements (if material)
- any regulatory requirements that may be applicable to the bid
- any other material information

The target must cooperate in distributing the bidder's tender offer materials to shareholders, by either mailing them to shareholders (at bidder expense) or furnishing the bidder a current shareholders' list. Rule 14d-5.

Under rules promulgated by the SEC in 1999, a bidder can file a registration statement for securities to be issued in a stock-for-stock tender offer at the same time it files its Schedule TO and commences the offer. Securities Act Rel. No. 7760 (1999) (calling for expedited SEC review of exchange offers). This equalizes the treatment of exchange tender offers and cash tender offers. Before the new rules, securities issued in an exchange offer had to be registered with the SEC before the offer could be commenced; cash offers faced no such delay or uncertainty.

§38.2.2 Substantive Terms of Offer

Besides requiring disclosure, the Williams Act regulation prescribes how a third-party tender offer must be carried out—a departure from the general disclosure-only philosophy of federal securities regulation. SEC rules expand the minimum levels specified in the statute. The current rules require the following:

- **Minimum open period.** The tender offer must be left open a minimum of 20 business days. Rule 14e-1. If any change is made in the offered price or the percentage of shares being sought, the offer must be left open for an additional ten days after the change.
- **Withdrawal rights.** Shareholders can withdraw their shares (revoke

their tenders) at any time while the tender offer is open. Rule 14d-7.

- **All holders.** The tender offer must be open to all shareholders of the same class and not exclude any shareholders from tendering. Rule 14d-10(a)(1).
- **Best price.** Each shareholder must be paid the best price paid to any other shareholder. Rule 14d-10(a)(2). If consideration alternatives are provided (such as a choice of cash or debentures), each shareholder can choose. Rule 14d-10(c)(1).
- **Pro rata purchases.** When the bidder seeks only a portion of all the shares (a partial tender offer) and shareholders tender more than the bidder seeks, the bidder must purchase the tendered shares on a pro rata basis. Exchange Act §14(d)(6). For example, assume the bidder seeks 50 percent of the target's stock and 75 percent is tendered. The bidder must purchase two-thirds (50/75) of each shareholder's tendered shares (disregarding fractions) and then return the unpurchased shares. Rule 14d-8.
- **No outside purchases.** The bidder cannot purchase outside the tender offer while it is pending. Rule 10b-13.

To make sure shareholders hear the other side of the story, target management must make a statement responding to the offer within ten business days after the tender offer commences. Rule 14e-2. The management statement (Schedule 14D-9) can either oppose or support the bid, take a neutral position, or take no position at all. Whatever its response, management must give its reasons.

§38.2.3 Regulation of Issuer Self-Tenders

Sometimes issuers defend against hostile tender offers by buying back their own stock. This increases the proportion of friendly shareholders or burdens the target with new debt, or both.

The Williams Act authorizes the SEC to promulgate rules regulating tender offers by targets—*issuer self-tenders*. Exchange Act §13(e). In general, the SEC rules regulate self-tenders much as third-party tender offers. Rule 13e-4. Self-tender regulation differs from third-party regulation in only two significant respects:

- **Outside purchases.** The issuer may purchase stock outside its self-tender. Open-market purchases, whether part of an ongoing corporate repurchase program or a defensive strategy, are not subject to the prohibition applicable to third-party tender offers. If made while another tender offer is pending, SEC rules require only disclosure. Rules 13e-1.
- **Cooling-off period.** For ten days after a self-tender terminates, the issuer is prohibited from making any purchases. Rule 13e-4(f)(6). This prevents an issuer from starting a tender offer, withdrawing it, and then purchasing stock in the resulting depressed market.

§38.2.4 Regulation of Deception (but Not Unfairness)

The Williams Act also contains a broadly-worded antifraud provision. Section 14(e) prohibits any false or misleading statement—as well as any fraudulent, deceptive, or manipulative act—in connection with any tender offer or any solicitation for or against tenders. Although modeled on Rule 10b-5, §14(e) does not contain the 10b-5 “sale or purchase” language. This suggests that even those who did not enter into a securities transaction—namely, shareholders who did not tender and investors who did not purchase—may be protected by §14(e) even though they would lack standing under Rule 10b-5.

In *Schreiber v. Burlington Northern, Inc*., 472 U.S. 1 (1985), the Supreme Court held that §14(e)’s prohibition against “manipulative acts” regulates only deception in connection with a tender offer and cannot be the basis to challenge a tender offer’s substantive fairness. In the case, Burlington Northern withdrew a hostile tender offer and substituted a friendly offer with terms less favorable to shareholders. Target shareholders claimed target management had been bought off, making the second tender offer unfair and “manipulative.” As it had with respect to Rule 10b-5 (*Santa Fe Industries v. Green*; see §9.3.1), the Court held that the sole objective of §14(e) is full disclosure, not regulation of corporate mismanagement. In effect, the Court left target shareholders to their state-based fiduciary claims.

Insider Trading during a Tender Offer

Using its §14(e) authority, the SEC has prohibited trading by those with inside information about a tender offer—whether the shares are publicly traded or not. Rule 14e-3 (see §23.3.3). The rule prohibits trading during the course of a tender offer by anybody (other than the bidder) who has material, nonpublic information about the offer that he knows (or has reason to know) was obtained from either the bidder or the target. There is no need under Rule 14e-3, unlike Rule 10b-5, to prove that a tipper breached a fiduciary duty for personal benefit. Thus, trading on material information about a tender offer before the information is made public (or tipping such information) is prohibited—whether or not there is a fiduciary breach—and can result in civil and criminal liability. See §23.3.4.

Reminder: Rule 10b-5

Disclosure in connection with stock trading during a takeover is regulated under Rule 10b-5's broad antifraud prohibitions. See §22.2. In the takeover context, Rule 10b-5 has two significant effects. First, it regulates the issuer's disclosure of merger negotiations, such as when an unsolicited acquirer privately proposes a merger (a "bear hug") or during a target's discussions with a white knight or a management LBO group. See §34.2. Second, it regulates insider trading on the basis of material, nonpublic, confidential information about takeover plans, whether or not relating to a tender offer. See §23.3.

§38.2.5 Unorthodox Tender Offers

The term *tender offer* is not defined in the Williams Act or SEC rules. Usually, this is no problem. An orthodox tender offer is easy to recognize: A bidder publicly announces an offer to buy a specified number of shares at a premium within a specified period, subject to specified terms. But sometimes stock purchase programs, though not presented as a tender offer, involve the kinds of high-pressure tactics that led to the Williams Act. Are these programs *unorthodox tender offers*?

Consider a purchaser who announces a deadline to a select group of shareholders or a purchaser who publicly announces an open-market purchase program for a specified number of shares. If these purchase programs are tender offers, they are illegal. By their nature, they cannot comply with the SEC tender offer rules—such as the "all holders" rule and

the minimum 20-day open period.

The cases have taken different tacks. Some courts have held that a tender offer occurs only when solicited shareholders lack information and are subjected to coercive pressure akin to that of an unregulated tender offer. In *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985), on the same day a bidder terminated a public tender offer, the bidder purchased 25 percent of the target's stock in a series of five privately negotiated transactions and one open-market purchase. The Second Circuit, focusing (perhaps incompletely) on the negotiated purchases from institutional investors and arbitragers, held the purchases were not pursuant to a tender offer. The sellers had not been publicly solicited; they were securities professionals aware of the essential facts concerning the target; and they were not coerced to sell because the bidder bought at the market price without imposing any percentage contingency or time limits.

Other courts, and the SEC, have articulated an eight-factor "taste" test that describes the ingredients of an orthodox tender offer. Under the test, a "tender offer" exists if the offer to public shareholders is active and widespread, for a substantial percentage of the target's shares, at a premium price above market, firm and nonnegotiable, contingent on a fixed number of shares being tendered, and open for a limited time. As a result, offerees are subject to pressure to sell their shares, and there is a rapid, large accumulation of shares. *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985).

Courts have been reluctant to subject open-market purchases to the tender offer rules, unless the purchaser publicizes its purchase plans or makes a general solicitation that coerces shareholders to sell. Even without such coercion, it is possible to buy a large block of stock after arbitragers have begun to acquire stock in reaction to a tender offer. Known as a "street sweep," this technique can be used to buy an effective control block (30 percent to 40 percent) virtually overnight. Although the SEC in 1987 proposed to prohibit unregulated purchases of 10 percent or more of a target's stock after a tender offer is made for the stock, the proposed rules proved unnecessary as state antitakeover statutes made it infeasible for a purchaser to acquire control in a street sweep. Delaware's statute, for example, imposes a three-year moratorium on any back-end transaction (such as a squeeze-out merger) unless the acquirer buys 85 percent of the target's shares—a virtual impossibility in a street sweep. See §34.2.

§38.3 WILLIAMS ACT ENFORCEMENT

Although §21 of the Exchange Act explicitly authorizes the SEC to enforce the Williams Act in federal court, none of the Act's provisions expressly creates a private cause of action. Nonetheless, lower courts have inferred implied private actions under the Williams Act, although there have been two main sticking points: (1) Do bidders and targets have standing? (2) What remedies are appropriate—damages or injunctive relief?

§38.3.1 Standing to Represent Target Shareholders

Courts have held that target shareholders, for whom the Williams Act was passed, have standing to challenge violations of the Act. Commentators have pointed out that §14(e) does not mention "sale or purchase" and have suggested that standing extends to nontendering shareholders and nonpurchasing investors, subject only to the usual requirement that they show materiality, reliance, causation, and damage. See §22.3.

The question of standing for the combatants—the bidder and the target—has been more difficult. Courts have been ambivalent about standing for bidders and targets because their interests will often be at odds with shareholder interests. Nonetheless, courts have accepted standing for bidders and targets to the extent they purport to represent shareholder interests.

§38.3.2 Remedies

Damages

Lower courts, buttressed by approving Supreme Court dictum, have awarded damages to shareholders injured by Williams Act violations. See *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981) (approving shareholder recovery under a benefit-of-the-bargain theory). The Supreme Court, however, has held that a *frustrated bidder* cannot sue under §14(e) for damages arising from fraudulent statements made by the target in opposing the bidder's tender offer. *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977).

Injunctive Relief

The Supreme Court has held that a target cannot sue to enjoin a bidder from exercising its voting rights—whether to elect a new board or to effectuate a back-end merger—unless the traditional showing for injunctive relief(irreparable injury)has been made. *Rondeau v. Mosinee Paper Corp*., 422 U.S. 49 (1975). Some lower courts have denied standing to targets seeking to disenfranchise bidders or to force them to divest their holdings. Most lower courts, however, have allowed bidders and targets to seek less burdensome relief, such as corrective disclosure and interim standstill injunctions.

Examples

1. Raider Partners is an investment firm engaged in the leveraged buyout of companies. Its dominant partner, Ernest Krass, has identified a target: Bullseye Industries, a consumer products manufacturer with widely respected brand names whose stock price has been in the doldrums at $40—$45. Bullseye has one class of common stock, which is traded on the New York Stock Exchange.
   a. Raider begins purchasing Bullseye stock surreptitiously on the NYSE through a number of brokers, without disclosing its identity or intentions. If Bullseye shareholders knew of Raider's plans, Krass acknowledges, they would not sell at prevailing prices. Must Raider disclose these purchases?
   b. After acquiring 4.9 percent of Bullseye, Krass tests the waters for a $65 takeover of Bullseye. He asks First Philly Investments (FPI), a leading investment banking firm, whether FPI would be willing to sell into a $65 tender offer for Bullseye. FPI's arbitrage department has been following Bullseye with great interest and already holds 2 percent of its stock. FPI says that $65 would be acceptable and FPI probably would sell. Does Raider have to report this contact?
2. Raider acquires 11 percent of Bullseye and discloses in its Schedule 13D that "Raider is considering its options, including gaining control of Bullseye." Soon after, trading in Bullseye stock increases dramatically and the price rises to $55. Arbitragers come to hold most of Bullseye's stock. Krass plans to push Raider's holdings above 50 percent. Here's his plan:

- FPI (acting as broker for Raider) will have its reps call 30—40 arbs and institutional investors to ask if they would be willing to sell privately;
- the reps will call on a Friday afternoon at 2:00 p.m. without revealing for whom they are calling, saying only they are soliciting others in the same way; and
- the reps will ask each investor to sell at $60 per share and will require an answer by 5:00 p.m., after the NYSE closes.

  Is this market sweep legal?

3. Krass decides against a market sweep and instead considers a tender offer. He outlines his tender offer proposal and asks you to point out any problems:
   a. Any shareholder will be allowed to tender, though Raider will buy only 75 percent of Bullseye's stock (bringing its total holdings to 86 percent).
   b. The offer will be open on a first-tendered, first-purchased basis until the 75 percent threshold is reached.
   c. Consideration will be $65 cash or $70 in subordinated notes of Bullseye, at the option of each tendering shareholder, provided that no more than 50 percent of those tendering choose cash.
   d. The offer will be open for 20 business days, and tendering shareholders can withdraw their shares during the first seven business days after the offer is announced.
   e. Raider will announce that its offer will be followed by a back-end squeeze-out merger (see §34.2) in which the remaining shares will be acquired for $65 in subordinated notes of Bullseye—less than that offered in the tender offer.
   f. Raider will disclose its plans as follows: "If the offeror succeeds in gaining control of Bullseye, it will study Bullseye's business operations and prospects and after such examination may implement an alternative plan of operations."
   g. Raider will disclose that both during and after the tender offer it may purchase shares on the open market, at prevailing prices.
   h. Raider will condition its purchase of shares pursuant to the tender offer on the Bullseye board redeeming its poison pill and Raider

obtaining a satisfactory commitment from an investment bank to sell junk (high-yield) bonds to finance the deal.

4. Raider makes a properly structured $65 tender offer for 40 percent of Bullseye's stock. Bullseye management thinks that the price is too low and that Raider is trying to coerce Bullseye to buy out Raider's foothold interest at a premium (greenmail). Management proposes a restructuring in which the corporation will take on new debt and repurchase 50 percent of its shares for $75 cash per share. To frustrate Raider's greenmail plans, the issuer self-tender excludes Raider from tendering.
   a. Raider wants to have the issuer self-tender enjoined for violating the federal tender offer rules. Does the exclusionary tender offer violate the rules?
   b. Does Raider have standing to challenge the self-tender as a violation of the rules?

Explanations

1. a. No, as long as Raider's holdings do not exceed 5 percent of Bullseye's common stock. The Williams Act requires disclosure of open-market purchases only when a person (or group) acquires beneficial ownership of more than 5 percent of a class of registered equity securities. Exchange Act §13(d). Further, no disclosure is required under Rule 10b-5 because Raider has no fiduciary relationship with Bullseye or its shareholders and developed its purchase plan on its own. See §23.3.1.

   b. Perhaps. If Raider and FPI are members of a group for purposes of §13(d), their holdings must be aggregated. Under §13(d), as interpreted, a group arises even though its members make no additional stock purchases. If Raider and FPI agreed to "hold, acquire, or dispose" of their Bullseye stock for purposes of affecting control in Bullseye, §13(d) would require them to report their identity, their holdings, their intentions, and their arrangement within ten days after their agreement.

   Was FPI's statement that it probably would sell at $65 such an agreement? On the one hand, it could be argued that FPI did not commit to sell to Raider or to otherwise further Raider's takeover plans—there was no agreement to affect control. On the other hand, FPI's implicit commitment to sell its 2 percent into a $65 tender offer effectively meant that Krass could count on acquiring a total of 6.9

percent of Bullseye's stock—the 5-percent trigger had been reached and the Williams Act entitled Bullseye's shareholders to information about the possibility of a takeover. Much depends on how firm FPI's commitment was.

2. Perhaps not. If a tender offer, the purchasing program violates a number of the federal tender offer requirements—namely, the filing and distribution of a Schedule TO, the minimum 20-day open period, withdrawal rights for tendering shareholders, and equal treatment of all shareholders.

At first blush, the plan seems to be an unorthodox tender offer. It contemplates stoking precisely the kind of "stampede mentality" that led to §14(d). The plan's goal is to coerce the investor-solicitees to sell quickly, without detailed information about the bid or about who is making it. They will be led to believe they must sell or lose any chance for a control premium. The solicitees will not have a 20-day period to evaluate the company, Raider's offer, and management's response. A very similar open-market pressure tactic was held to be a tender offer. See *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

Other cases, however, suggest a different result. If sophisticated professional investors did not actually feel pressured to sell, Krass's plan might not be a tender offer. For example, perhaps they had evaluated Bullseye and believed the price would remain high even if Raider succeeded in buying a significant block. Applying the manipulable eight-factor test could lead to the same conclusion: (1) there was no public solicitation; (2) there was no premium over market; (3) the offer was not contingent on a specified tender; (4) the sophisticated offerees may not have been subjected to significant pressure. In the end, do the sophisticated investors solicited by Raider need the protection of the tender offer rules? There is some question whether the orthodoxy (and mandated egalitarianism) of a regulated tender offer should be imposed on all hostile takeovers.

3. a. No problem. Partial tender offers are possible under the tender offer rules. The "all holders" rule only requires that the tender offer be open to all shareholders. Exchange Act §14(d)(6); Rule 14d-8. If the offer is oversubscribed, the pro rata rules require the bidder to buy from each shareholder in proportion to the ratio of the number of shares sought and

the number of shares tendered.

b. Problem. The “pro rata” rule specifies how shares are to be purchased if the tender offer is oversubscribed. Buying shares on a first-come, first-served basis pressures shareholders to make ill-considered, rushed decisions—the main evil addressed by the tender offer rules. Although the open withdrawal rights provided for by the SEC rules ameliorate the problem of a first-come, first-served tender offer, the statute nonetheless requires pro rata purchases. Exchange Act §14(d)(6); Rule 14d-8.

c. No problem. The bidder can offer alternative forms of consideration and condition the tender offer in any way that does not violate the tender offer rules. Rule 14d-10. The 50-percent cash condition does not create a “stampede” problem and acts much like a financing condition. If the tender offer will be too expensive, Raider need not accept the tendered shares.

d. Problem. The withdrawal period must be as long as the tendering period —here the minimum 20 business days. To prevent fraudulent, deceptive, or manipulative tender offers, the SEC has required that the tendering period be at least 20 business days. Rule 14e-1. Although the statute contemplates that shareholders may withdraw tendered shares (in the normal case) only for the first seven business days of the offer, SEC rules expand withdrawal rights to extend through the entire period the offer is open.

e. No problem. Even though a two-tier bid is coercive and “stampedes” shareholders into tendering, the Williams Act does not require that all the shares be acquired pursuant to a tender offer. In fact, there will always be some shareholders who will fail to tender into even the most generous tender offer because of stubbornness, lack of initiative, loyalty to management, or ignorance. If Raider acquires control (usually a condition of the tender offer) and wants 100-percent ownership (particularly if it contemplates self-dealing transactions to pay off the takeover debt), it can accomplish this in a back-end merger. As far as the federal tender offer rules are concerned, nontendered shares (as well as shares returned if the partial tender offer is oversubscribed) can be squeezed out in a merger for whatever consideration Raider decides to pay. The “best price” rule does not

apply to the merger, nor does §14(e) require that the price or other terms of the merger be fair. The only Williams Act requirement is that the bidder not misrepresent its intentions, or say anything false or misleading about the merger during the tender offer. See Exchange Act §14(e). Stringent fiduciary rules under state law, however, apply to controlling shareholders in a squeeze-out merger—and a back-end merger in which the price were set below the front-end price would raise serious questions about the merger's "entire fairness." See §17.3.

f. No problem. If this is true and not misleading, the tender offer rules do not require full plans. In fact, recent courts have held that it is not even necessary for the bidder to have its financing for the offer lined up when it commences a tender offer as long as this is disclosed.

g. Problem. Third-party bidders cannot make purchases during the tender offer. Rule 13d-10. This keeps a bidder from starting a low-priced tender offer that artificially depresses the stock price and then buying at the manipulated price.

Under current rules, third-party bidders are not prohibited from making purchases after the tender offer ends. If this possibility was disclosed and the tender offer unequivocally withdrawn, post-bid purchases are not a continuation of the original tender offer. See *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985). Unlike issuers that are subject to a ten-day cooling-off period after a self-tender, third-party bidders are required only to disclose the possibility of such purchases if they would be material to shareholders deciding whether to tender.

h. No problem. A tender offer, like any other contractual offer, can be conditioned on particular events occurring. So long as Raider does not make an illusory offer because (for example) it knows it cannot obtain financing, it may attach whatever conditions it chooses, subject to the federal tender offer rules. See *Gilbert v. El Paso Co.*, 575 F.2d 1131 (Del. 1990). The bidder does not breach its implied covenant of good faith under contract law unless it deliberately causes a condition precedent not to occur.

4. a. Technically, yes. Bullseye's exclusion of Raider violates the "all holders" rule, which requires that every tender offer (including a self-tender) be made to all shareholders. Rule 14d-10(a)(1); 13e-4(f)(8)(i).

The SEC has justified the rule on two grounds. First, it comports with the equal treatment philosophy of §14(d), which assumes that equality means fairness. Second, without the rule, bidders could pressure the excluded group to sell to the included group, while avoiding the disclosure and substantive requirements of the tender offer rules. Excluded shareholders wishing to participate indirectly in the premium would not receive disclosure, would sell on a first-come, first-served basis, and would have no withdrawal rights.

These justifications for the rule, however, may not be as persuasive when the excluded shareholder group (Raider) is itself a bidder. The "all holders" rule effectively undercuts Bullseye's ability to respond to a perceived greenmailer with a self-tender. The rule would allow Raider to extract a premium at the expense of Bullseye's other shareholders, who would be forced to share their premium under the "pro rata" rules. Although excluding Raider may pressure it to give up the fight and sell to included shareholders, the Williams Act's pro-shareholder philosophy may not be concerned with the bidder's plight.

b. Perhaps not. Raider's exclusion benefits tendering shareholders, who need not share their self-tender premium with Raider. Because only Raider is excluded, it can be argued that Raider's challenge would not further the shareholder-protection purpose of the Williams Act. In *Piper v. Chris-Craft* (see §38.3.2), the Supreme Court held that a *bidder* could not recover damages for a violation of the tender offer rules. In the case, recovery to the bidder would have come indirectly at the expense of the shareholders who allegedly had been deceived.

Nonetheless, Raider might assert standing in its capacity as a shareholder. If denied the ability to challenge the exclusionary self-tender, Raider could not recoup its bidding expenses by tendering its shares at a premium, thus removing one of the important cushions that soften the financial risk of launching a takeover bid. As a result, shareholders in general would be hurt if takeover bids became more expensive—a tilting of the playing field against bidders. The Williams Act regime, arguably, was intended to avoid such favoritism.

NEW YORK'S
MARTIN ACT

New York General Business Law Article 23-A

§352 Investigation by attorney-general

1. Whenever it shall appear to the attorney-general, either upon complaint or otherwise, that in the advertisement, investment advice, purchase or sale within this state of any commodity dealt in on any exchange within the United States of America or the delivery of which is contemplated by transfer of negotiable documents of title all of which are hereinafter called commodities, or that in the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or from this state, of any stocks, bonds, notes, evidences of interest or indebtedness or other securities, including oil and mineral deeds or leases and any interest therein, sold or transferred in whole or in part to the purchaser where the same do not effect a transfer of the title in fee simple to the land, or negotiable documents of title, or foreign currency orders, calls or options therefor hereinafter called security or securities, any person, partnership, corporation, company, trust or association, or any agent or employee thereof, shall have employed, or employs, or is about to employ any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, or that any person, partnership, corporation, company, trust or association, or any agent or employee thereof, shall have made, makes or attempts to make within or from this state fictitious or pretended purchases or sales of securities or commodities or that any person, partnership, corporation, company, trust or association, or agent or employee thereof shall have employed, or employs, or is about to employ, any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser, or that any broker, dealer, or salesman, as defined by section three hundred fifty-nine-e of this article, or any agent or employee thereof, has sold or offered for sale or is attempting to sell or is offering for sale any security or securities in violation of the provisions of said section or section three hundred fifty-nine-ee, or that any other section of this article has been violated, any one or all of which devices, schemes, artifices, fictitious or pretended purchases or sales of securities or commodities, deceptions, misrepresentations, concealments, suppressions, frauds, false pretenses, false promises, practices, transactions and courses of business are hereby declared to be and are hereinafter referred to as a fraudulent practice or fraudulent practices or he believes it to be in the public interest that an investigation be made, he may in his discretion either require or permit such person, partnership, corporation, company, trust or association, or any agent or employee thereof, to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate, and for that purpose may prescribe forms upon which such statements shall be made. The attorney-general may also require such other data and information as he may deem relevant and may make such special and independent investigations as he may deem necessary in connection with the matter.

2. The attorney-general, his deputy or other officer designated by him is empowered to subpoena witnesses, compel their attendance, examine them under oath before him or a magistrate, a court of record or a judge or justice thereof and require the production of any books or papers which he deems relevant or material to the inquiry. Such power of subpoena and examination shall not abate or terminate by reason of any action or proceeding brought by the attorney-general under this article.

3. No person shall be excused from attending such inquiry in pursuance to the mandates of a subpoena, or from producing a paper or book, or from being examined or required to answer a question on the ground of failure of tender or payment of a witness fee and/or mileage, unless at the time of such appearance or production, as the case may be, such witness makes demand for such payment as a condition precedent to the offering of testimony or production required by the subpoena and unless such payment is not thereupon made. The provisions for payment of witness fee and/or mileage do not apply to any officer, director or person in the employ of any person, partnership, corporation, company, trust or association whose conduct or practices are being investigated.

4. If a person subpoenaed to attend such inquiry fails to obey the command of a subpoena without reasonable cause, or if a person in attendance upon such inquiry shall without reasonable cause refuse to be sworn or to be examined or to answer a question or to produce a book or paper when ordered so to do by the officer conducting such inquiry, or if a person, partnership, corporation, company, trust or association fails to perform any act required hereunder to be performed, he shall be guilty of a misdemeanor.

5. It shall be the duty of all public officers, their deputies, assistants, subordinates, clerks or employees and all other persons to render and furnish to the attorney-general, his deputy or other designated officer when requested all information and assistance in their possession or within their power. Any officer participating in such inquiry and any person examined as a witness upon such inquiry who shall disclose to any person other than the attorney-general the name of any witness examined or any other information obtained upon such inquiry except as directed by the attorney-general shall be guilty of a misdemeanor.

§ 352-a. Foreign corporation to make designation

1. If the stocks, bonds or other securities of a foreign corporation, association, common law trust or similar organization are offered or advertised for sale within the state of New York and such corporation, association, common law trust or other organization has not filed pursuant to laws heretofore or hereafter existing the designation of a person upon whom process against it may be served or the designation of the secretary of state as such person pursuant to section thirteen hundred four of the business corporation law or other laws heretofore or hereafter existing or, in lieu thereof, an instrument in writing duly acknowledged and filed in the office of the secretary of state designating the secretary of state as the person upon whom may be served any subpoena, subpoena duces tecum or other process directed to such foreign corporation, association, common law trust or

similar organization and issued in any investigation, examination or proceeding pending or about to be instituted under and pursuant to the provisions of this article, the attorney-general may serve a notice upon such corporation, association, common law trust or similar organization, or upon any nonresident officer thereof, by mailing the same in a securely sealed postpaid wrapper addressed to such corporation, association, common law trust or similar organization or officer thereof at its or his last known place of business or residence, and may in such notice require that such corporation, association, common law trust or similar organization or such officer furnish a written statement, verified as required in said notice, giving the information therein specified relating to the stocks, bonds or other securities of such corporation, association, common law trust or similar organization or, in the alternative, that such corporation, association, common law trust or other organization, by its proper officer or officers, or such officer, shall appear within a reasonable time from the date of mailing of such notice at a designated place within this state for examination and shall produce at the time and place of such examination such books and papers of such corporation, association, common law trust or similar organization as may be designated in such notice.

2. If such corporation, association, common law trust or similar organization or such officer thereof shall fail to furnish the statement called for by such notice, or shall fail to appear pursuant thereto or to produce the books and papers required thereby to be produced, or refuse to submit to examination or to answer any proper question, the proof of such failure or refusal shall constitute prima facie evidence that the sale or offering for sale or advertisement of the stocks, bonds or other securities of such corporation, association, common law trust or similar organization constitutes a fraudulent practice within the meaning of this article and may in the discretion of the court be treated as a sufficient basis for a permanent injunction against the continuance of such fraudulent practice.

3. The department of state shall keep a record of each process served upon the secretary of state under this chapter, including the date of service. It shall, upon request made within ten years of such service, issue a certificate under its seal certifying as to the receipt of the process by an authorized person, the date and place of such service and the receipt of the statutory fee. Process served upon the secretary of state under this chapter shall be destroyed by him after a period of ten years from such service.

§ 352-b. Non-resident brokers, dealers, salesmen and investment advisors; designation of secretary of state as agent for service of process; service of process

1. Any person, partnership, corporation, company, trust or association resident or having his or its principal place of business without the state or organized under and by virtue of the laws of a foreign state, who or which shall do business in this state as a broker, dealer, salesman or investment advisor, as defined in section three hundred fifty-nine-e or three hundred fifty-nine-eee of this article, or any partner, principal, officer or director of such broker, dealer or investment advisor shall be deemed to have irrevocably appointed the secretary of state as his or its agent upon whom may be served any summons, complaint, subpoena, subpoena duces tecum, notice, order, judgment or other process directed to

such person, partnership, corporation, company, trust or association, or any partner, principal, officer or director thereof, in any action, investigation or proceeding brought or conducted by the attorney general under the provisions of this article arising out of or in connection with any transaction, matter or thing relating to the practices, affairs, management or business of such person, partnership, corporation, company, trust or association, or any partner, principal, officer or director thereof. Any such person, partnership, corporation, company, trust or association, or any partner, principal, officer or director thereof, may file with the secretary of state a designation, in terms complying herewith, duly acknowledged, irrevocably appointing the secretary of state as his or its agent upon whom may be served any such process; provided, however, that a designation filed with the secretary of state pursuant to section three hundred fifty-two-a of this article or section thirteen hundred four of the business corporation law shall serve also as such designation.

2. Service of such process upon the secretary of state shall be made by personally delivering to and leaving with him or a deputy secretary of state a copy thereof at the office of the department of state in the city of Albany, and such service shall be sufficient service provided that notice of such service and a copy of such process are forthwith sent by the attorney general to such person, partnership, corporation, company, trust or association, by registered or certified mail with return receipt requested, at his or its office as set forth in the “broker-dealer's statement”, “salesman's statement” or “investment advisor's statement” filed in the department of law pursuant to section three hundred fifty-nine-e or section three hundred fifty-nine-eee of this article, or in default of the filing of such statement, at the last address known to the attorney general. Service of such process shall be complete on receipt by the attorney general of a return receipt purporting to be signed by the addressee or a person qualified to receive his or its registered or certified mail, in accordance with the rules and customs of the post office department, or, if acceptance was refused by the addressee or his or its agent, on return to the attorney general of the original envelope bearing a notation by the postal authorities that receipt thereof was refused.

3. The department of state shall keep a record of each process served upon the secretary of state under this chapter, including the date of service. It shall, upon request made within ten years of such service, issue a certificate under its seal certifying as to the receipt of the process by an authorized person, the date and place of such service and the receipt of the statutory fee. Process served upon the secretary of state under this chapter shall be destroyed by him after a period of ten years from such service.

§ 352-c. Prohibited acts constituting misdemeanor; felony

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;

(b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;

(c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made;

where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

2. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to engage in any artifice, agreement, device or scheme to obtain money, profit or property by any of the means prohibited by this section.

3. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, engaged in the sale of any securities or commodities, as defined in section three hundred fifty-two of this article, within or from the state of New York to represent that they are an “exchange” or use the word “exchange,” or any abbreviation or derivative thereof, in its name or assumed name unless it is registered with the Securities and Exchange Commission as a national securities exchange, pursuant to section six of the Securities and Exchange Act of 1934, or unless it has been designated as a contract market by the Commodity Futures Trading Commission, pursuant to section five of the Commodity Exchange Act.

4. Except as provided in subdivision five or six, a person, partnership, corporation, company, trust or association, or any agent or employee thereof, using or employing any act or practice declared to be illegal and prohibited by this section, shall be guilty of a misdemeanor.

5. Any person, partnership, corporation, company, trust or association, or any agent or employee thereof who intentionally engages in any scheme constituting a systematic ongoing course of conduct with intent to defraud ten or more persons or to obtain property from ten or more persons by false or fraudulent pretenses, representations or promises, and so obtains property from one or more of such persons while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation or purchase of any securities or commodities, as defined in this article, shall be guilty of a class E felony.

6. Any person, partnership, corporation, company, trust or association, or any agent or employee thereof who intentionally engages in fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale, or who makes any

material false representation or statement with intent to deceive or defraud, while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of any securities or commodities, as defined in this article, and thereby wrongfully obtains property of a value in excess of two hundred fifty dollars, shall be guilty of a class E felony.

§ 352-d. Effect of prosecution under previous section

A person, partnership, corporation, company, trust or association or any agent or employee thereof that, having engaged in any act or practice constituting a violation of section three hundred fifty-two-c of this article, commits additional acts under such circumstances as to constitute a felony, the crime of conspiracy, petit larceny, or more than one of the aforesaid, is punishable therefor, as well as for the violation of that section, and may be prosecuted for each crime, separately or in the same information or indictment, notwithstanding any other provision of law.

§ 352-e. Real estate syndication offerings

1. (a) It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to make or take part in a public offering or sale in or from the state of New York of securities constituted of participation interests or investments in real estate, mortgages or leases, including stocks, bonds, debentures, evidences of interest or indebtedness, limited partnership interests or other security or securities as defined in section three hundred fifty-two of this article, when such securities consist primarily of participation interests or investments in one or more real estate ventures, including cooperative interests in realty, unless and until there shall have been filed with the department of law, prior to such offering, a written statement or statements, to be known as an “offering statement” or “prospectus” concerning the contemplated offering which shall contain the information and representations required by paragraph (b) of this subdivision unless the security offering is exempted hereunder or under section three hundred fifty-nine-f, subdivision two, of this article by rule or action of the attorney general. The term “real estate” as used in the paragraph shall not include mineral, oil or timber leases or properties, or buildings, structures, land or other realty housing or containing business offices or industry, owned or leased by the issuer, where the issuer is not primarily engaged in the business of buying and selling such building or other realty or leases or interests therein. The circulation or dissemination of a non-firm offer (including circulation or dissemination of a preliminary prospectus pursuant to section ten (b) of the securities act of nineteen hundred thirty-three, and the rules thereto appertaining) shall not constitute making or taking part in a public offering within the meaning of this section.

(b) The detailed terms of the transaction; a description of the property, the nature of the interest, and how title thereto is to be held; the gross and net income for a reasonable period preceding the offering where applicable and available; the current gross and net

income where applicable and available; the basis, rate and method of computing depreciation; a description of major current leases; the essential terms of all mortgages; the names, addresses and business background of the principals involved, the nature of their fiduciary relationship and their financial relationship, past, present and future, to the property offered to the syndicate and to those who are to participate in its management; the interests and profits of the promoters, offerors, syndicate organizers, officers, directors, trustees or general partners, direct and indirect, in the promotion and management of the venture; all restrictions, if any, on transfer of participants' interests; a statement as to what stock or other security involved in the transaction, if any, is non-voting; a statement as to what disposition will be made of the funds received and of the transaction if not consummated, which statement shall represent that all moneys received from the sale of such securities until actually employed in connection with the consummation of the transaction as therein described, shall be kept in trust and that in the event insufficient funds are raised through the offering or otherwise to effectuate the purchase or purchases or other consummation of the contemplated transaction, or that the intended acquisition shall not be completed for any other reason or reasons, then such moneys, less such amounts actually employed in connection with the consummation of the transaction, shall be fully returned to the investor; which of the securities offered are unsecured; clearly distinguish between leasehold and fee ownership, between fact and opinion; a commitment to submit annual reports to all participants, including an annual balance sheet and profit and loss statement certified by an independent certified public accountant; clearly distinguish between those portions of promised distributions which are income and those which are a return of principal or capital; in the case of qualified leasehold condominiums, as defined in section three hundred thirty-nine-e of the real property law, a disclosure of the unique requirements imposed on the unit owners of such condominiums by the provisions of sections three hundred thirty-nine-bb and three hundred thirty-nine-cc of such law; and such additional information as the attorney general may prescribe in rules and regulations promulgated under subdivision six hereof as will afford potential investors, purchasers and participants an adequate basis upon which to found their judgment and shall not omit any material fact or contain any untrue statement of a material fact.

(c) All advertising in connection with an offering of securities described in this subdivision shall be consistent with the representations and information required to be set forth as hereinbefore in this subdivision provided.

2. Unless otherwise provided by regulation issued by the attorney general, the offering statement or statements or prospectus required in subdivision one of this section shall be filed with the department of law at its office in the city of New York, prior to the public offering of the security involved. No offer, advertisement or sale of such securities shall be made in or from the state of New York until the attorney general has issued to the issuer or other offerer a letter stating that the offering has been filed. The attorney general, not later than thirty days after the submission of such filing, shall issue such a letter or, in the alternative, a notification in writing indicating deficiencies in the offering statement, statements or prospectus; provided, however, that in the case of a building or group of buildings to be converted to cooperative or condominium ownership which is

occupied in whole or in part for residential purposes, such letter or notification shall be issued in not sooner than four months and not later than six months from the date of submission of such filing. The attorney general may also refuse to issue a letter stating that the offering statement or statements or prospectus has been filed whenever it appears that the offering statement or statements or prospectus does not clearly set forth the specific property or properties to be purchased, leased, mortgaged, or otherwise to be acquired, financed or the subject of specific investment with a substantial portion of the offering proceeds.

2-a. (a) For the purposes of this subdivision the following words shall have the following meanings:

(i) “Plan”. Every offering statement or prospectus submitted to the department of law for the conversion of a building or group of buildings or development from residential rental status to cooperative or condominium ownership, other than a plan governed by the provisions of either section three hundred fifty-two-eee or three hundred fifty-two-eeee of this chapter, or a plan for such conversion pursuant to article two, eight or eleven of the private housing finance law.

(ii) “Non-purchasing tenant”. A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date. A person who sublets a dwelling unit from a purchaser under the plan shall not be deemed a non-purchasing tenant.

(iii) “Eligible senior citizens”. Non-purchasing tenants who are sixty-two years of age or older on the date the attorney general has accepted the plan for filing, and the spouses of any such tenants on such date, and who have elected, within sixty days of the date the attorney general has accepted the plan for filing, on forms promulgated by the attorney general and presented to such tenants by the offeror, to become non-purchasing tenants under the provisions of this subdivision; provided that such election shall not preclude any such tenant from subsequently purchasing the dwelling unit on the terms then offered to tenants in occupancy.

(iv) “Eligible disabled persons”. Non-purchasing tenants who have an impairment which results from anatomical, physiological or psychological conditions, other than addiction to alcohol, gambling, or any controlled substance, which are demonstrable by medically acceptable clinical and laboratory diagnostic techniques, and which are expected to be permanent and which prevent the tenant from engaging in any substantial gainful employment on the date the attorney general has accepted the plan for filing, and the spouses of any such tenants on such date, and who have elected, within sixty days of the date the attorney general has accepted the plan for filing, on forms promulgated by the attorney general and presented to such tenants by the offeror, to become non-purchasing tenants under the provisions of this subdivision; provided, however, that if the disability first occurs after acceptance of the plan for filing, then such election may be made within sixty days following the onset of such disability unless during the period subsequent to

sixty days following the acceptance of the plan for filing but prior to such election, the offeror accepts a written agreement to purchase the apartment from a bona fide purchaser; and provided further that such election shall not preclude any such tenant from subsequently purchasing the dwelling unit or the shares allocated thereto on the terms then offered to tenants in occupancy.

(b) The attorney general shall refuse to issue a letter stating that the offering statement or prospectus required in subdivision one of this section has been filed whenever it appears that the offering statement or prospectus offers for sale residential cooperative apartments or condominium units pursuant to a plan unless the plan provides that:

(i) No eviction proceedings will be commenced, except as hereinafter provided, at any time against either eligible senior citizens or eligible disabled persons. The rentals of eligible senior citizens and eligible disabled persons who reside in dwelling units not subject to government regulation as to rentals and continued occupancy and eligible senior citizens and eligible disabled persons who reside in dwelling units with respect to which government regulation as to rentals and continued occupancy is eliminated or becomes inapplicable after the plan has been accepted for filing shall not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of their occupancy considering, in determining comparability, such factors as building services, level of maintenance and operating expenses; provided that such proceedings may be commenced against such tenants for non-payment of rent, illegal use or occupancy of the premises, refusal of reasonable access to the owner or a similar breach by the tenant of his obligations to the owner of the dwelling unit or the shares allocated thereto and provided further that an owner of a unit or of the shares allocated thereto may not commence an action to recover possession of a dwelling unit from a non-purchasing tenant on the grounds that he seeks the dwelling unit for the use and occupancy of himself or his family.

(ii) Eligible senior citizens and eligible disabled persons who reside in dwelling units subject to government regulation as to rentals and continued occupancy shall continue to be subject thereto.

(iii) The rights granted under the plan to eligible senior citizens and eligible disabled persons may not be abrogated or reduced notwithstanding any expiration of, or amendment to, this section.

(iv) Any offeror who disputes the election by a person to be an eligible senior citizen or an eligible disabled person must apply to the attorney general within thirty days of the receipt of the election forms for a determination by the attorney general of such person's eligibility. The attorney general shall, within thirty days thereafter, issue his determination of eligibility. The foregoing shall, in the absence of fraud, be the sole method for determining a dispute as to whether a person is an eligible senior citizen or an eligible disabled person. The determination of the attorney general shall be reviewable only through a proceeding under article seventy-eight of the civil practice law and rules,

which proceeding must be commenced within thirty days after such determination by the attorney general becomes final.

(c) The provisions of this subdivision shall be applicable in any city, town or village not covered by the provisions of section three hundred fifty-two-eeee of this chapter, or which has not elected to be covered by section three hundred fifty-two-eee of this chapter, provided the local legislative body elects, by majority vote to adopt by resolution, coverage provided by this section. A certified copy of such resolution shall be filed in the office of the attorney general at Albany and shall become effective on the date of such filing.

2-b. In the case of offerings of cooperatives, condominiums, interest in homeowners association and other cooperative interests in realty, including homes subject to deed or covenant or agreements requiring investment therein, the attorney general may refuse to issue a letter of acceptance unless the offering statement, prospectus or plan shall provide that all deposits, down-payments or advances made by purchasers of residential units shall be held in a special escrow account pending delivery of the completed apartment or unit and a deed or lease whichever is applicable, unless insurance of such funds in a form satisfactory to the attorney general has been obtained prior thereto. In addition to the general regulatory authority provided in this section, the attorney general is hereby authorized to adopt, promulgate, amend and rescind suitable rules and regulations to carry out the provisions of this subdivision, including, but not limited to, determining when escrow funds may be released, the nature of escrowees, and other terms and conditions relating thereto deemed necessary in the public interest.

2-c. Payment of legal fees for representation of a tenant or tenant's association in a residential building undergoing conversion to cooperative or condominium ownership shall not be made from any reserve fund, working capital fund, or other fund established to cover expenses, repairs and capital improvements of buildings converted to cooperative or condominium ownership, unless made pursuant to a retainer agreement entered into before this subdivision shall have become a law. Payment of legal fees may be made, however, from another fund specifically designated for such purpose.

2-d. (a) For the purposes of this subdivision the term “self-dealing contract” shall be defined as any contract or portion thereof which is entered into after October eighth, nineteen hundred eighty, and which:

(i) provides for operation, maintenance, or management of a condominium or cooperative association in a conversion project, or of property serving the condominium or cooperative unit owners in such projects;

(ii) is between such unit owners or such association and the developer or an affiliate of the developer;

(iii) was entered into while such association was controlled by the developer through special developer control or because the developer held a majority of the votes in such association;

(iv) is for a period of more than three years, including any automatic renewal provisions which are exercisable at the sole option of the developer or an affiliate of the developer; and

(v) may not be terminated without penalty by such unit owners or such association.

(b) In the case of offerings of cooperatives, condominiums or other interests in realty covered by the provisions of section six hundred eight of the Condominium and Cooperative Abuse Relief Act of 1980, 15 U.S.C. 3607, the attorney general shall refuse to issue a letter of acceptance unless the offering statement, prospectus or plan provides that the tenant shareholders or owners entitled to vote to terminate a self-dealing contract pursuant to such section twice be notified of such right in writing (i) once within thirty days of the date that the right to terminate pursuant to subsection (b) of such section commences and (ii) secondly at least six months prior to the date that such right to terminate will expire.

3. No offering literature shall be employed in the offering of securities as defined in subdivision one of this section except by the offering statement or statements filed in the department of law pursuant to the provisions of this section. All advertising in whatever form, including periodicals or on radio or television shall contain a statement that no offer of such securities is made except by such offering statement or statements.

4. In all literature employed in the offer and sale of securities defined in subdivision one of this section and in all advertising in connection therewith there shall be contained, in easily readable print on the face thereof, a statement that the filing of an offering statement or statements or prospectus as required by subdivision one of this section with the department of law does not constitute approval of the issue or the sale thereof by the department of law or the attorney general of this state.

5. No offering or sale whatever of securities described in subdivision one of this section shall be made except on the basis of information, statements, literature, or representations constituting the offering statement or statements or prospectus described in such subdivision, and no information, statements, literature, or representations shall be used in the offering or sale of securities described in such subdivision unless it is first so filed and the prospective purchaser furnished with true copies thereof.

6. (a) The attorney general is hereby authorized and empowered to adopt, promulgate, amend and rescind suitable rules and regulations to carry out the provisions of this section, including regulations for the method, contents and filing procedures with respect to the statements required by subdivision one and the making of amendments thereto.

(b) The attorney general is hereby authorized and empowered to adopt, promulgate, amend and rescind suitable rules and regulations relating to the information furnished to investors of the sources of any distribution or distributions made by any issuer in connection with the sale of realty securities since January first, nineteen hundred sixty-one within the provisions of section three hundred fifty-two-e and section three hundred fifty-two-g of this article.

7. (a) The department of law shall collect the following fees for the filing of each offering statement or prospectus as described in subdivision one of this section: seven hundred fifty dollars for every offering not in excess of two hundred fifty thousand dollars; for every offering in excess of two hundred fifty thousand dollars, four-tenths of one percent of the total amount of the offering but not in excess of thirty thousand dollars of which one-half of said amount shall be a nonrefundable deposit paid at the time of submitting the offering statement to the department of law for review and the balance payable upon the issuance of a letter of acceptance for filing said offering statement. The department of law shall, in addition, collect a fee of two hundred twenty-five dollars for each amendment to an offering statement. For each application granted by the department of law which permits the applicant to solicit public interest or public funds preliminary to the filing of an offering statement or for the issuance of a “no-filing required” letter, the department of law shall collect a fee of two hundred twenty-five dollars. In the event the sponsor thereafter files an offering statement, the fee paid for the preliminary application shall be credited against the balance of the fee due and payable on filing. For each application granted pursuant to section three hundred fifty-two-g of this article, the department of law shall collect a fee of two-tenths of one percent of the amount of the offering of securities; however, the minimum fee shall be seven hundred fifty dollars and the maximum fee shall be thirty thousand dollars. All revenue from that portion of any fee imposed pursuant to this paragraph, which exceeds twenty thousand dollars shall be paid by the department of law to the state comptroller to be deposited in and credited to the real estate finance bureau fund, established pursuant to section eighty of the state finance law.

(b) The attorney general may, in his discretion, require an inspection to be made by the department of law in connection with a real estate syndication, cooperative, or condominium offering, of lands and property thereon, situated outside of the state of New York, involved in such offering. In such case, prior to the acceptance of such filing, there shall be remitted to the department of law an amount equivalent to the cost of travel from New York to the location of the property involved in the offering and return, as estimated by the department of law, and a further reasonable amount estimated to be necessary to cover the additional expenses of such inspection. The department of law shall return to the person making the remittance any amount advanced in excess of the actual expenses incurred, and where there is a deficiency, the department of law shall be empowered to collect the difference between the actual expenses and the amount advanced.

(c) Notwithstanding the provisions of paragraph (a) of this subdivision, the department of law shall not collect any fees for the filing of an offering statement or prospectus or any amended filings thereto as described in subdivision one of this section whenever a

conversion of a mobile home park, building or group of buildings or development from residential rental status to cooperative or condominium ownership is being made pursuant to article eighteen, nineteen or twenty of the private housing finance law.

8. Within four months after the end of its fiscal year, every syndicate which shall have been required to file an offering statement or statements or prospectus under subdivision one of this section shall file with the department of law at its office in the city of New York an annual report of the syndicate operation, including an annual balance sheet and profit and loss statement certified by an independent certified public accountant. The department of law shall collect a fee of five dollars for the filing of each such annual report.

9. Each offering statement or prospectus as described in subdivision one of this section, and all exhibits or documents referred to therein shall be available for inspection by any person who shall have purchased a security described in this section or shall have participated in the offering of such security.

§ 352-ee. Conversion of non-residential property to residential cooperative or condominium ownership

1. The attorney general shall refuse to issue a letter stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this article has been filed whenever it appears that the offering statement or prospectus offers for sale residential cooperative apartments or condominium units located in a city of over one million in population pursuant to a plan for the alteration or conversion of the building to residential use under cooperative or condominium ownership, other than a plan relating to a building already in compliance with section three hundred one of the multiple dwelling law, unless the offering statement or prospectus contains the following:

(i) a statement that a copy of plans for such alteration or conversion, approved in accordance with section three hundred of the multiple dwelling law, has been submitted to the attorney general prior to the issuance by the attorney general of a letter stating that the offering statement or prospectus has been filed;

(ii) a report prepared by an architect or engineer licensed by the state which sets forth such alterations to the public portions and common areas of the building and such alterations to individual spaces or dwelling units as may be necessary to obtain a permanent certificate of occupancy for permanent residential use of the premises;

(iii) a statement, satisfactory to the attorney general, that it is the obligation of the sponsor to complete all alterations and improvements to the public portions and common areas of the building in compliance with such approved plans within the time specified in the plan;

(iv) a statement, satisfactory to the attorney general, that it is the obligation of the sponsor to complete all alterations and improvements to individual spaces or dwelling units in

compliance with such approved plans within the time specified in the plan or, if the sponsor does not undertake such obligation, that it is the obligation of the individual owners of shares in the cooperative corporation or of condominium units, under the supervision of the cooperative corporation or, in the case of a condominium, under the supervision of the board of managers, to complete such alterations and improvements within the time specified in the plan; and

(v) a statement that a permanent certificate of occupancy is required for permanent residential use of the premises, that a temporary certificate of occupancy may only be renewed for a total period of two years from the date of its original issuance and that, if the temporary certificate of occupancy shall have expired prior to obtaining a permanent certificate of occupancy, residential occupancy of the premises will be in violation of the multiple dwelling law, subjecting the occupants and the cooperative corporation and its board of directors or, in the case of a condominium, the unit owners and board of managers, to penalties under the multiple dwelling law including eviction of residential occupants.

2. “Residential use” shall mean, for the purposes of this section, space to be used for either living or joint living-work and shall be presumed if the offering statement or prospectus sets forth items which relate to residential use of the space, including but not limited to, income tax benefits under section two hundred sixteen of the internal revenue code, real property tax benefits available to residential property or alterations required for the issuance of a permanent certificate of occupancy for permanent residential use of the premises.

§ 352-eee. Conversions to cooperative or condominium ownership in certain cities, towns and villages located in the counties of Nassau, Westchester and Rockland

<[Eff. until and including June 15, 2015, pursuant to L.1983, c. 402, § 4.]>

1. As used in this section, the following words and terms shall have the following meanings:

(a) “Plan”. Every offering statement or prospectus submitted to the department of law pursuant to section three hundred fifty-two-e of this article for the conversion of a building or group of buildings or development from residential rental status to cooperative or condominium ownership or other form of cooperative interest in realty, other than an offering statement or prospectus for such conversion pursuant to article two, eight or eleven of the private housing finance law.

(b) “Non-eviction plan”. A plan which may not be declared effective until at least fifteen percent of those bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the plan is declared effective shall have executed and delivered written agreements to purchase under the plan. As to tenants who were in occupancy on the date a letter was issued by the attorney general accepting the

plan for filing, the purchase agreement shall be executed and delivered pursuant to an offering made in good faith without fraud and discriminatory repurchase agreements or other discriminatory inducements.

(c) “Eviction plan”. A plan which, pursuant to the provisions of this section, can result in the eviction of a non-purchasing tenant by reason of the tenant failing to purchase pursuant thereto, and which may not be declared effective until written agreements to purchase under the plan pursuant to an offering made in good faith without fraud and with no discriminatory repurchase agreements or other discriminatory inducements shall have been executed and delivered by: (i) at least fifty-one percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general excluding, for the purposes of determining the number of bona fide tenants in occupancy on such date, eligible senior citizens and eligible disabled persons; and (ii) at least thirty-five percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general including, for the purposes of determining the number of bona fide tenants in occupancy on such date eligible senior citizens and eligible disabled persons.

(d) “Purchaser under the plan”. A person who owns the shares allocated to a dwelling unit or who owns such dwelling unit itself.

(e) “Non-purchasing tenant”. A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date. A person who sublets a dwelling unit from a purchaser under the plan shall not be deemed a non-purchasing tenant.

(f) “Eligible senior citizens”. Non-purchasing tenants who are sixty-two years of age or older on the date the plan is declared effective and the spouses of any such tenants on such date; provided that such tenant shall not be precluded from subsequently purchasing the dwelling unit on the terms then offered to tenants in occupancy.

(g) “Eligible disabled persons”. Non-purchasing tenants who have an impairment which results from anatomical, physiological or psychological conditions, other than addiction to alcohol, gambling, or any controlled substance, which are demonstrable by medically acceptable clinical and laboratory diagnostic techniques, and which are expected to be permanent and which prevent the tenant from engaging in any substantial gainful employment on the date the attorney general has accepted the plan for filing, and the spouses of any such tenants on such date, and who have elected, within sixty days of the date the attorney general has accepted the plan for filing, on forms promulgated by the attorney general and presented to such tenants by the offeror, to become non-purchasing tenants under the provisions of this section; provided, however, that if the disability first occurs after acceptance of the plan for filing, then such election may be made within sixty days following the onset of such disability unless during the period subsequent to sixty

days following the acceptance of the plan for filing but prior to such election, the offeror accepts a written agreement to purchase the apartment from a bona fide purchaser; and provided further that such election shall not preclude any such tenant from subsequently purchasing the dwelling unit or the shares allocated thereto on the terms then offered to tenants in occupancy.

2. The attorney general shall refuse to issue a letter stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this chapter has been filed whenever it appears that the offering statement or prospectus offers for sale residential cooperative apartments or condominium units pursuant to a plan unless:

(a) The plan provides that it will be deemed abandoned, void and of no effect if it does not become effective within twelve months from the date of issue of the letter of the attorney general stating that the offering statement or prospectus has been accepted for filing and, in the event of such abandonment, no new plan for the conversion of such building or group of buildings or development shall be submitted to the attorney general for at least fifteen months after such abandonment.

(b) The plan provides either that it is an eviction plan or that it is a non-eviction plan.

(c) The plan provides, if it is a non-eviction plan, as follows:

(i) The plan may not be declared effective until at least fifteen percent of those bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the plan is declared effective shall have executed and delivered written agreements to purchase under the plan. As to tenants who were in occupancy on the date a letter was issued by the attorney general accepting the plan for filing, the purchase agreement shall be executed and delivered pursuant to an offering made in good faith without fraud and discriminatory repurchase agreements or other discriminatory inducements.

(ii) No eviction proceedings will be commenced at any time against non-purchasing tenants for failure to purchase or any other reason applicable to expiration of tenancy; provided that such proceedings may be commenced for non-payment of rent, illegal use or occupancy of the premises, refusal of reasonable access to the owner or a similar breach by the non-purchasing tenant of his obligations to the owner of the dwelling unit or the shares allocated thereto; and provided further that an owner of a unit or of the shares allocated thereto may not commence an action to recover possession of a dwelling unit from a non-purchasing tenant on the grounds that he seeks the dwelling unit for the use and occupancy of himself or his family.

(iii) Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to the conversion of the building or group of buildings or development to cooperative or condominium ownership shall continue to be subject thereto.

(iv) The rentals of non-purchasing tenants who reside in dwelling units not subject to government regulation as to rentals and continued occupancy and non-purchasing tenants who reside in dwelling units with respect to which government regulation as to rentals and continued occupancy is eliminated or becomes inapplicable after the plan has been accepted for filing by the attorney general shall not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of their occupancy. In determining comparability, consideration shall be given to such factors as building services, level of maintenance and operating expenses.

(v) The plan may not be amended at any time to provide that it shall be an eviction plan.

(vi) The rights granted under the plan to purchasers under the plan and to non-purchasing tenants may not be abrogated or reduced notwithstanding any expiration of, or amendment to, this section.

(vii) After the issuance of the letter from the attorney general stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this article has been filed, the offeror shall, on the thirtieth, sixtieth, eighty-eighth and ninetieth day after such date and at least once every thirty days until the plan is declared effective or is abandoned, as the case may be, and on the second day before the expiration of any exclusive purchase period provided in a substantial amendment to the plan, (1) file with the attorney general a written statement, under oath, setting forth the percentage of bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development who have executed and delivered written agreements to purchase under the plan as of the date of such statement, (2) before noon on the day such statement is filed post a copy of such statement in a prominent place accessible to all tenants in each building covered by the plan.

(d) The plan provides, if it is an eviction plan, as follows:

(i) The plan may not be declared effective unless: (1) at least fifty-one percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general excluding, for the purposes of determining the number of bona fide tenants in occupancy on such date, eligible senior citizens and eligible disabled persons; and (2) at least thirty-five percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general including, for the purposes of determining the number of bona fide tenants in occupancy on such date eligible senior citizens and eligible disabled persons; shall have executed and delivered written agreements to purchase under the plan pursuant to an offering made in good faith without fraud and with no discriminatory repurchase agreements or other discriminatory inducements.

(ii) No eviction proceedings will be commenced against a non-purchasing tenant for failure to purchase or any other reason applicable to expiration of tenancy until the later

to occur of (1) the date which is the expiration date provided in such non-purchasing tenant's lease or rental agreement, and (2) the date which is three years after the date on which the plan is declared effective. Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to conversion shall continue to be subject thereto during the period of occupancy provided in this paragraph. Thereafter, if a tenant has not purchased, he may be removed by the owner of the dwelling unit or the shares allocated to such dwelling unit.

(iii) No eviction proceedings will be commenced, except as hereinafter provided, at any time against either eligible senior citizens or eligible disabled persons. The rentals of eligible senior citizens and eligible disabled persons who reside in dwelling units not subject to government regulation as to rentals and continued occupancy and eligible senior citizens and eligible disabled persons who reside in dwelling units with respect to which government regulation as to rentals and continued occupancy is eliminated or becomes inapplicable after the plan has been accepted for filing shall not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of their occupancy considering, in determining comparability, such factors as building services, level of maintenance and operating expenses; provided that such proceedings may be commenced against such tenants for non-payment of rent, illegal use or occupancy of the premises, refusal of reasonable access to the owner or a similar breach by the tenant of his obligations to the owner of the dwelling unit or the shares allocated thereto; and provided further that an owner of a unit or of the shares allocated thereto may not commence an action to recover possession of a dwelling unit from a non-purchasing tenant on the grounds that he seeks the dwelling unit for the use and occupancy of himself or his family.

(iv) Eligible senior citizens and eligible disabled persons who reside in dwelling units subject to government regulation as to rentals and continued occupancy shall continue to be subject thereto.

(v) The rights granted under the plan to eligible senior citizens and eligible disabled persons may not be abrogated or reduced notwithstanding any expiration of, or amendment to, this section.

(vi) Any offeror who disputes the election by a person to be an eligible senior citizen or an eligible disabled person must apply to the attorney general within thirty days of the receipt of the election forms for a determination by the attorney general of such person's eligibility. The attorney general shall, within thirty days thereafter, issue his determination of eligibility. The foregoing shall, in the absence of fraud, be the sole method for determining a dispute as to whether a person is an eligible senior citizen or an eligible disabled person. The determination of the attorney general shall be reviewable only through a proceeding under article seventy-eight of the civil practice law and rules, which proceeding must be commenced within thirty days after such determination by the attorney general becomes final.

(vii) After the issuance of the letter from the attorney general stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this article has been accepted for filing, the offeror shall, on the thirtieth, sixtieth, eighty-eighth and ninetieth days after such date and at least once every thirty days until the plan is declared effective or abandoned, as the case may be, and on the second day before the expiration of any exclusive purchase period provided in a substantial amendment to the plan, (1) file with the attorney general a written statement, under oath, setting forth the percentage of bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general who have executed and delivered written agreements to purchase under the plan as of the date of such statement, and (2) before noon on the day such statement is filed post a copy of such statement in a prominent place accessible to all tenants in each building covered by the plan.

(viii) If the plan is amended before it is declared effective to provide that it shall be a non-eviction plan, any person who has agreed to purchase under the plan prior to such amendment shall have a period of thirty days after receiving written notice of such amendment to revoke his agreement to purchase under the plan.

(ix) The tenants in occupancy on the date the attorney general accepts the plan for filing shall have the exclusive right to purchase their dwelling units or the shares allocated thereto for ninety days after the plan is accepted for filing by the attorney general, during which time a tenant's dwelling unit shall not be shown to a third party unless he has, in writing, waived his right to purchase; subsequent to the expiration of such ninety day period, a tenant in occupancy of a dwelling unit who has not purchased shall be given the exclusive right for an additional period of six months from said expiration date to purchase said dwelling unit or the shares allocated thereto on the same terms and conditions as are contained in an executed contract to purchase said dwelling unit or shares entered into by a bona fide purchaser, such exclusive right to be exercisable within fifteen days from the date of mailing by registered mail of notice of the execution of a contract of sale together with a copy of said executed contract to said tenant.

(e) The attorney general finds that an excessive number of long-term vacancies did not exist on the date that the offering statement or prospectus was first submitted to the department of law. “Long-term vacancies” shall mean dwelling units not leased or occupied by bona fide tenants for more than five months prior to the date of such submission to the department of law. “Excessive” shall mean a vacancy rate in excess of the greater of (i) ten percent and (ii) a percentage that is double the normal average vacancy rate for the building or group of buildings or development for two years prior to the January preceding the date the offering statement or prospectus was first submitted to the department of law.

(f) The attorney general finds that, following the submission of the offering statement or prospectus to the department of law, each tenant in the building or group of buildings or development was provided with a written notice stating that such offering statement or prospectus has been submitted to the department of law for filing. Such notice shall be

accompanied by a copy of the offering statement or prospectus and a statement that the statements submitted pursuant to subparagraph (vii) of paragraph (c) or subparagraph (vii) of paragraph (d) of this subdivision, whichever is applicable, will be available for inspection and copying at the office of the department of law where the submission was made and at the office of the offeror or a selling agent of the offeror. Such notice shall also be accompanied by a statement that tenants or their representatives may physically inspect the premises at any time subsequent to the submission of the plan to the department of law, during normal business hours, upon written request made by them to the offeror, provided such representatives are registered architects or professional engineers licensed to practice in the state of New York. Such notice shall be sent to each tenant in occupancy on the date the plan is first submitted to the department of law and to the clerk of the municipality wherein such building or group of buildings or development is located.

3. All dwelling units occupied by non-purchasing tenants shall be managed by the same managing agent who manages all other dwelling units in the building or group of buildings or development. Such managing agent shall provide to non-purchasing tenants all services and facilities required by law on a non-discriminatory basis. The offeror shall guarantee the obligation of the managing agent to provide all such services and facilities until such time as the offeror surrenders control to the board of directors or board of managers, at which time the cooperative corporation or the condominium association shall assume responsibility for the provision of all services and facilities required by law on a non-discriminatory basis.

4. It shall be unlawful for any person to engage in any course of conduct, including, but not limited to, interruption or discontinuance of essential services, which substantially interferes with or disturbs the comfort, repose, peace or quiet of any tenant in his use or occupancy of his dwelling unit or the facilities related thereto. The attorney general may apply to a court of competent jurisdiction for an order restraining such conduct and, if he deems it appropriate, an order restraining the owner from selling the shares allocated to the dwelling unit or the dwelling unit itself or from proceeding with the plan of conversion; provided that nothing contained herein shall be deemed to preclude the tenant from applying on his own behalf for similar relief.

5. Any local legislative body may adopt local laws and any agency, officer or public body may prescribe rules and regulations with respect to the continued occupancy by tenants of dwelling units which are subject to regulation as to rentals and continued occupancy pursuant to law, provided that in the event that any such local law, rule or regulation shall be inconsistent with the provisions of this section, the provisions of this section shall control.

6. Any provision of a lease or other rental agreement which purports to waive a tenant's rights under this section or rules and regulations promulgated pursuant hereto shall be void as contrary to public policy.

7. The provisions of this section shall only be applicable in the cities, towns and villages located in the counties of Nassau, Westchester and Rockland which by resolution adopted by the respective local legislative body of such city, town or village, elect that the provisions hereof shall be applicable therein. A certified copy of such resolution shall be filed in the office of the attorney general at Albany and shall become effective on the date of such filing.

§ 352-eeee. Conversions to cooperative or condominium ownership in the city of New York

<[Eff. until and including June 15, 2015, pursuant to L.1982, c. 555, § 10.]>

1. As used in this section, the following words and terms shall have the following meanings:

(a) “Plan”. Every offering statement or prospectus submitted to the department of law pursuant to section three hundred fifty-two-e of this article for the conversion of a building or group of buildings or development from residential rental status to cooperative or condominium ownership or other form of cooperative interest in realty, other than an offering statement or prospectus for such conversion pursuant to article two, eight or eleven of the private housing finance law.

(b) “Non-eviction plan”. A plan which may not be declared effective until written purchase agreements have been executed and delivered for at least fifteen percent of all dwelling units in the building or group of buildings or development by bona fide tenants in occupancy or bona fide purchasers who represent that they intend that they or one or more members of their immediate family intend to occupy the unit when it becomes vacant. As to tenants who were in occupancy on the date a letter was issued by the attorney general accepting the plan for filing, the purchase agreement shall be executed and delivered pursuant to an offering made in good faith without fraud and discriminatory repurchase agreements or other discriminatory inducements.

(c) “Eviction plan”. A plan which, pursuant to the provisions of this section, can result in the eviction of a non-purchasing tenant by reason of the tenant failing to purchase pursuant thereto, and which may not be declared effective until at least fifty-one percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general (excluding, for the purposes of determining the number of bona fide tenants in occupancy on such date, eligible senior citizens and eligible disabled persons) shall have executed and delivered written agreements to purchase under the plan pursuant to an offering made in good faith without fraud and with no discriminatory repurchase agreements or other discriminatory inducements.

(d) “Purchaser under the plan”. A person who owns the shares allocated to a dwelling unit or who owns such dwelling unit itself.

(e) “Non-purchasing tenant”. A person who has not purchased under the plan and who is a tenant entitled to possession at the time the plan is declared effective or a person to whom a dwelling unit is rented subsequent to the effective date. A person who sublets a dwelling unit from a purchaser under the plan shall not be deemed a non-purchasing tenant.

(f) “Eligible senior citizens”. Non-purchasing tenants who are sixty-two years of age or older on the date the attorney general has accepted the plan for filing, and the spouses of any such tenants on such date, and who have elected, within sixty days of the date the attorney general has accepted the plan for filing, on forms promulgated by the attorney general and presented to such tenants by the offeror, to become non-purchasing tenants under the provisions of this section; provided that such election shall not preclude any such tenant from subsequently purchasing the dwelling unit on the terms then offered to tenants in occupancy.

(g) “Eligible disabled persons”. Non-purchasing tenants who have an impairment which results from anatomical, physiological or psychological conditions, other than addiction to alcohol, gambling, or any controlled substance, which are demonstrable by medically acceptable clinical and laboratory diagnostic techniques, and which are expected to be permanent and which prevent the tenant from engaging in any substantial gainful employment on the date the attorney general has accepted the plan for filing, and the spouses of any such tenants on such date, and who have elected, within sixty days of the date the attorney general has accepted the plan for filing, on forms promulgated by the attorney general and presented to such tenants by the offeror, to become non-purchasing tenants under the provisions of this section; provided, however, that if the disability first occurs after acceptance of the plan for filing, then such election may be made within sixty days following the onset of such disability unless during the period subsequent to sixty days following the acceptance of the plan for filing but prior to such election, the offeror accepts a written agreement to purchase the apartment from a bona fide purchaser; and provided further that such election shall not preclude any such tenant from subsequently purchasing the dwelling unit or the shares allocated thereto on the terms then offered to tenants in occupancy.

2. The attorney general shall refuse to issue a letter stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this chapter has been filed whenever it appears that the offering statement or prospectus offers for sale residential cooperative apartments or condominium units pursuant to a plan unless:

(a) The plan provides that it will be deemed abandoned, void and of no effect if it does not become effective within fifteen months from the date of issue of the letter of the attorney general stating that the offering statement or prospectus has been accepted for filing and, in the event of such abandonment, no new plan for the conversion of such building or group of buildings or development shall be submitted to the attorney general for at least twelve months after such abandonment.

(b) The plan provides either that it is an eviction plan or that it is a non-eviction plan.

(c) The plan provides, if it is a non-eviction plan, as follows:

(i) The plan may not be declared effective until written purchase agreements have been executed and delivered for at least fifteen percent of all dwelling units in the building or group of buildings or development subscribed for by bona fide tenants in occupancy or bona fide purchasers who represent that they intend that they or one or more members of their immediate family occupy the dwelling unit when it becomes vacant. As to tenants who were in occupancy on the date a letter was issued by the attorney general accepting the plan for filing, the purchase agreement shall be executed and delivered pursuant to an offering made without discriminatory repurchase agreements or other discriminatory inducements.

(ii) No eviction proceedings will be commenced at any time against non-purchasing tenants for failure to purchase or any other reason applicable to expiration of tenancy; provided that such proceedings may be commenced for non-payment of rent, illegal use or occupancy of the premises, refusal of reasonable access to the owner or a similar breach by the non-purchasing tenant of his obligations to the owner of the dwelling unit or the shares allocated thereto; and provided further that an owner of a unit or of the shares allocated thereto may not commence an action to recover possession of a dwelling unit from a non-purchasing tenant on the grounds that he seeks the dwelling unit for the use and occupancy of himself or his family.

(iii) Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to the conversion of the building or group of buildings or development to cooperative or condominium ownership shall continue to be subject thereto.

(iv) The rentals of non-purchasing tenants who reside in dwelling units not subject to government regulation as to rentals and continued occupancy and non-purchasing tenants who reside in dwelling units with respect to which government regulation as to rentals and continued occupancy is eliminated or becomes inapplicable after the plan has been accepted for filing by the attorney general shall not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of their occupancy. In determining comparability, consideration shall be given to such factors as building services, level of maintenance and operating expenses.

(v) The plan may not be amended at any time to provide that it shall be an eviction plan.

(vi) The rights granted under the plan to purchasers under the plan and to non-purchasing tenants may not be abrogated or reduced notwithstanding any expiration of, or amendment to, this section.

(vii) After the issuance of the letter from the attorney general stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this article has been filed, the offeror shall, on the thirtieth, sixtieth, eighty-eighth and

ninetieth day after such date and at least once every thirty days until the plan is declared effective or is abandoned, as the case may be, and on the second day before the expiration of any exclusive purchase period provided in a substantial amendment to the plan, (1) file with the attorney general a written statement, under oath, setting forth the percentage of the dwelling units in the building or group of buildings or development subscribed for by bona fide tenants in occupancy or bona fide purchasers who represent that they intend that they or one or more members of their immediate family occupy the dwelling unit when it becomes vacant as of the date of such statement and, (2) before noon on the day such statement is filed post a copy of such statement in a prominent place accessible to all tenants in each building covered by the plan.

(d) The plan provides, if it is an eviction plan, as follows:

(i) The plan may not be declared effective unless at least fifty-one percent of the bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general (excluding, for the purposes of determining the number of bona fide tenants in occupancy on such date, eligible senior citizens and eligible disabled persons) shall have executed and delivered written agreements to purchase under the plan pursuant to an offering made in good faith without fraud and with no discriminatory repurchase agreements or other discriminatory inducements.

(ii) No eviction proceedings will be commenced against a non-purchasing tenant for failure to purchase or any other reason applicable to expiration of tenancy until the later to occur of (1) the date which is the expiration date provided in such non-purchasing tenant's lease or rental agreement, and (2) the date which is three years after the date on which the plan is declared effective. Non-purchasing tenants who reside in dwelling units subject to government regulation as to rentals and continued occupancy prior to conversion shall continue to be subject thereto during the period of occupancy provided in this paragraph. Thereafter, if a tenant has not purchased, he may be removed by the owner of the dwelling unit or the shares allocated to such dwelling unit.

(iii) No eviction proceedings will be commenced, except as hereinafter provided, at any time against either eligible senior citizens or eligible disabled persons. The rentals of eligible senior citizens and eligible disabled persons who reside in dwelling units not subject to government regulation as to rentals and continued occupancy and eligible senior citizens and eligible disabled persons who reside in dwelling units with respect to which government regulation as to rentals and continued occupancy is eliminated or becomes inapplicable after the plan has been accepted for filing shall not be subject to unconscionable increases beyond ordinary rentals for comparable apartments during the period of their occupancy considering, in determining comparability, such factors as building services, level of maintenance and operating expenses; provided that such proceedings may be commenced against such tenants for non-payment of rent, illegal use or occupancy of the premises, refusal of reasonable access to the owner or a similar breach by the tenant of his obligations to the owner of the dwelling unit or the shares allocated thereto.

(iv) Eligible senior citizens and eligible disabled persons who reside in dwelling units subject to government regulation as to rentals and continued occupancy shall continue to be subject thereto.

(v) The rights granted under the plan to eligible senior citizens and eligible disabled persons may not be abrogated or reduced notwithstanding any expiration of, or amendment to, this section.

(vi) Any offeror who disputes the election by a person to be an eligible senior citizen or an eligible disabled person must apply to the attorney general within thirty days of the receipt of the election forms for a determination by the attorney general of such person's eligibility. The attorney general shall, within thirty days thereafter, issue his determination of eligibility. The foregoing shall, in the absence of fraud, be the sole method for determining a dispute as to whether a person is an eligible senior citizen or an eligible disabled person. The determination of the attorney general shall be reviewable only through a proceeding under article seventy-eight of the civil practice law and rules, which proceeding must be commenced within thirty days after such determination by the attorney general becomes final.

(vii) After the issuance of the letter from the attorney general stating that the offering statement or prospectus required in subdivision one of section three hundred fifty-two-e of this article has been accepted for filing, the offeror shall, on the thirtieth, sixtieth, eighty-eighth and ninetieth days after such date and at least once every thirty days until the plan is declared effective or abandoned, as the case may be, and on the second day before the expiration of any exclusive purchase period provided in a substantial amendment to the plan, (1) file with the attorney general a written statement, under oath, setting forth the percentage of bona fide tenants in occupancy of all dwelling units in the building or group of buildings or development on the date the offering statement or prospectus was accepted for filing by the attorney general who have executed and delivered written agreements to purchase under the plan as of the date of such statement, and (2) before noon on the day such statement is filed post a copy of such statement in a prominent place accessible to all tenants in each building covered by the plan.

(viii) If the plan is amended before it is declared effective to provide that it shall be a non-eviction plan, any person who has agreed to purchase under the plan prior to such amendment shall have a period of thirty days after receiving written notice of such amendment to revoke his agreement to purchase under the plan.

(ix) The tenants in occupancy on the date the attorney general accepts the plan for filing shall have the exclusive right to purchase their dwelling units or the shares allocated thereto for ninety days after the plan is accepted for filing by the attorney general, during which time a tenant's dwelling unit shall not be shown to a third party unless he has, in writing, waived his right to purchase; subsequent to the expiration of such ninety day period, a tenant in occupancy of a dwelling unit who has not purchased shall be given the exclusive right for an additional period of six months from said expiration date to

purchase said dwelling unit or the shares allocated thereto on the same terms and conditions as are contained in an executed contract to purchase said dwelling unit or shares entered into by a bona fide purchaser, such exclusive right to be exercisable within fifteen days from the date of mailing by registered mail of notice of the execution of a contract of sale together with a copy of said executed contract to said tenant.

(e) The attorney general finds that an excessive number of long-term vacancies did not exist on the date that the offering statement or prospectus was first submitted to the department of law. “Long-term vacancies” shall mean dwelling units not leased or occupied by bona fide tenants for more than five months prior to the date of such submission to the department of law. “Excessive” shall mean a vacancy rate in excess of the greater of (i) ten percent and (ii) a percentage that is double the normal average vacancy rate for the building or group of buildings or development for two years prior to the January preceding the date the offering statement or prospectus was first submitted to the department of law.

(f) The attorney general finds that, following the submission of the offering statement or prospectus to the department of law, each tenant in the building or group of buildings or development was provided with a written notice stating that such offering statement or prospectus has been submitted to the department of law for filing. Such notice shall be accompanied by a copy of the offering statement or prospectus and a statement that the statements submitted pursuant to subparagraph (vii) of paragraph (c) or subparagraph (vii) of paragraph (d) of this subdivision, whichever is applicable, will be available for inspection and copying at the office of the department of law where the submission was made and at the office of the offeror or a selling agent of the offeror. Such notice shall also be accompanied by a statement that tenants or their representatives may physically inspect the premises at any time subsequent to the submission of the plan to the department of law, during normal business hours, upon written request made by them to the offeror, provided such representatives are registered architects or professional engineers licensed to practice in the state of New York. Such notice shall be sent to each tenant in occupancy on the date the plan is first submitted to the department of law.

3. All dwelling units occupied by non-purchasing tenants shall be managed by the same managing agent who manages all other dwelling units in the building or group of buildings or development. Such managing agent shall provide to non-purchasing tenants all services and facilities required by law on a non-discriminatory basis. The offeror shall guarantee the obligation of the managing agent to provide all such services and facilities until such time as the offeror surrenders control to the board of directors or board of managers, at which time the cooperative corporation or the condominium association shall assume responsibility for the provision of all services and facilities required by law on a non-discriminatory basis.

4. It shall be unlawful for any person to engage in any course of conduct, including, but not limited to, interruption or discontinuance of essential services, which substantially interferes with or disturbs the comfort, repose, peace or quiet of any tenant in his use or occupancy of his dwelling unit or the facilities related thereto. The attorney general may

apply to a court of competent jurisdiction for an order restraining such conduct and, if he deems it appropriate, an order restraining the owner from selling the shares allocated to the dwelling unit or the dwelling unit itself or from proceeding with the plan of conversion; provided that nothing contained herein shall be deemed to preclude the tenant from applying on his own behalf for similar relief.

5. Any local legislative body may adopt local laws and any agency, officer or public body may prescribe rules and regulations with respect to the continued occupancy by tenants of dwelling units which are subject to regulation as to rentals and continued occupancy pursuant to law, provided that in the event that any such local law, rule or regulation shall be inconsistent with the provisions of this section, the provisions of this section shall control.

6. Any provision of a lease or other rental agreement which purports to waive a tenant's rights under this section or rules and regulations promulgated pursuant hereto shall be void as contrary to public policy.

7. The provisions of this section shall only be applicable in the city of New York.

§ 352-f. Description of realty bonds

Whenever hereafter any person, partnership, corporation, company, trust or association, or any agent or employee thereof, makes or takes part in an offering or sale of securities described in subdivision one of section three hundred fifty-two-e of this article, and such securities consist of bonds or other evidence of indebtedness, there shall be included in numeral form, in bold print on the first page of all offering literature employed in the solicitation and sale of such securities, the actual interest rate payable on such securities. Such rate shall not include any return of principal.

§ 352-g. Exemptions

The attorney general, upon application, may exempt from the provisions of sections three hundred fifty-two-e, three hundred fifty-two-f and three hundred fifty-two-h any offerings of securities (1) made to persons not exceeding forty in number or (2) which securities have been fully registered with the securities and exchange commission of the United States of America or have received an exemption therefrom for reasons other than said offering is an intrastate offering to residents of the state of New York only.

§ 352-h. Trust funds

Whenever hereafter any person, partnership, corporation, company, trust or association, offers or sells securities described in subdivision one of section three hundred fifty-two-e of this article to the public in or from the state of New York, then all moneys received in connection therewith, including deposits or advances therefor, shall continue to be the

money of the person making such purchase, deposit or advance, and shall be held in trust by the person, partnership, corporation, company, trust or association offering or selling such securities and shall not be commingled with the personal moneys or become an asset of the person, partnership, corporation, company, trust or association receiving the same, and shall not be subject to attachment, levy or other encumbrance in any action by a third party against such person, partnership, corporation, company, trust or association; and said funds shall remain in trust until actually employed in connection with the consummation of the transaction; and in the event insufficient funds are raised to effectuate the consummation of the transaction, or if the transaction does not result in the acquisition of the real estate, mortgage or lease involved for any reason or reasons, then all moneys so collected less such amounts actually employed in connection with the consummation of the transaction shall be fully returned to the investors. Any provision of any contract or agreement or understanding, whether oral or in writing, whereby a person who so purchases such securities waives any provision of this section is absolutely void. Nothing herein contained shall be deemed to preclude an action against a defaulting investor.

§ 352-i. Injunctive relief

Any person, partnership, corporation, company, trust or association, or any agent or employee thereof, who violates any of the provisions of sections three hundred fifty-two-e, three hundred fifty-two-ee, three hundred fifty-two-f, three hundred fifty-two-g, three hundred fifty-two-h or three hundred fifty-nine-ff of this article or of any regulations issued by the attorney general pursuant thereto shall be deemed to have committed a fraudulent practice, upon which the supreme court may issue a permanent injunction, as provided in section three hundred fifty-three of this article, upon application by the attorney general.

§ 352-j. Application of article

All the provisions of this article shall be fully applicable to real estate syndication offerings and security transactions described in subdivision one of section three hundred fifty-two-e of this article, with the exception that the additional provisions contained in sections three hundred fifty-two-e, three hundred fifty-two-ee, three hundred fifty-two-f, three hundred fifty-two-g, three hundred fifty-two-h and three hundred fifty-two-i shall also be applicable to such transactions.

§ 352-k. Broker dealer minimum capital requirements

1. Every broker-dealer registered or required to be registered in this state shall have and maintain a net capital of not less than five thousand dollars. The term net capital shall be deemed to mean the net worth of a broker or dealer (that is, the excess of total assets over total liabilities), adjusted by

(a) adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer and, if such broker or dealer is a partnership, adding equities (or deducting deficits) in accounts of partners, as hereinafter defined;

(b) deducting fixed assets and assets which cannot be readily converted into cash (less any indebtedness secured thereby) including, among other things, real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and expenses; good will; organization expenses; all unsecured advances and loans; customers' unsecured notes and accounts; and deficits in customers' accounts, except in bona fide cash accounts within the meaning of section 4(c) of regulation T of the board of governors of the federal reserve system;

(c) deducting the percentages specified below of the market value of all securities, long and short (except exempted securities) in the capital, proprietary and other accounts of the broker or dealer, including securities loaned to the broker or dealer pursuant to a satisfactory subordination agreement, as hereinafter defined, and if such broker or dealer is a partnership, in the accounts of partners, as hereinafter defined:

(1) in the case of non-convertible debt securities having a fixed interest rate and a fixed maturity date which are not in default, if the market value is not more than five per cent below the face value, the deduction shall be five per cent of such market value; if the market value is more than five per cent but not more than thirty per cent below the face value, the deduction shall be a percentage of market value, equal to the percentage by which the market value is below the face value; and if the market value is thirty per cent or more below the face value, such deduction shall be thirty per cent;

(2) in the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which is not in arrears as to dividends, the deduction shall be twenty per cent;

(3) on all other securities, the deduction shall be thirty per cent; provided, however, that such deduction need not be made in the case of (1) a security which is convertible into or exchangeable for other securities within a period of thirty days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible, or for which it is exchangeable, are short in the accounts of such broker or dealer or partner, or (2) a security which has been called for redemption and which is redeemable within ninety days.

(d) deducting thirty per cent of the market value of all “long” and all “short” future commodity contracts (other than those contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any “spot” commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer and, if such broker or dealer is a partnership, in the accounts of partners as hereinafter defined;

(e) deducting, in the case of a broker or dealer who has open contractual commitments, the respective percentages specified in subparagraph (c) above of the value (which shall

be the market value whenever there is a market) of each net long and each net short position contemplated by any existing contractual commitment in the capital, proprietary and other accounts of the broker or dealer and, if such broker or dealer is a partnership, in accounts of partners, as hereinafter defined; provided, however, that this deduction shall not apply to exempted securities, and that the deduction with respect to any individual commitment shall be reduced by the unrealized profit, in an amount not greater than the percentage deduction provided for in subparagraph (c), (or increased by the unrealized loss) in such commitment; and that in no event shall an unrealized profit on any closed transactions operate to increase net capital;

(f) excluding liabilities of the broker or dealer which are subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement as herein defined; and

(g) deducting, in the case of a broker or dealer who is a sole proprietor, the excess of (1) liabilities which have not been incurred in the course of business as a broker or dealer over (2) assets not used in the business.

(h) For the purposes of this section only the term “exempted securities” shall mean:

(1) obligations issued or guaranteed by the United States, a state, territory or any political subdivision thereof, or of any instrumentality, authority, commission, or agency, of the United States, a state, territory, or any political subdivision thereof, and

(2) any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not more than nine months, exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and which is such as is sold in the open market in the usual course of business of broker-dealers.

(i) the term “accounts of partners”, where the broker or dealer is a partnership, which shall mean accounts of partners who have agreed in writing that the equity in such accounts maintained with such partnership shall be included as partnership property;

(j) the term “contractual commitments” shall include underwriting, when-issued, when-distributed and delayed delivery contracts, endorsement of puts and calls, commitments in foreign currencies, and spot (cash) commodities contracts, but shall not include uncleared regular way purchases and sales of securities and contracts in commodities futures; a series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment;

(k) the term “satisfactory subordination agreement” shall mean a written agreement between the broker or dealer and a lender, which agreement is binding and enforceable in accordance with its terms upon the lender, his creditors, heirs, executors, administrators, and assigns, and which agreement satisfies all of the following conditions:

(1) it effectively subordinates any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future general creditors of the broker or dealer;

(2) it is not subject to cancellation at the will of either party and is for a term of not less than one year;

(3) it provides that it shall not be terminated, rescinded or modified by mutual consent or otherwise, if the effect thereof would be to make the agreement inconsistent with the conditions of this rule, or to reduce the net capital of the broker or dealer below the amount required by this section;

(4) it provides that no default in the payment of interest or in the performance of any other covenant or condition by the broker or dealer shall have the effect of accelerating the maturity of the indebtedness;

(5) it provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference;

(6) it provides that any securities or other property loaned to the broker or dealer pursuant to its provisions may be used and dealt with by the broker or dealer as part of his capital and shall be subject to the risks of the business;

(7) the term “customer” shall mean every person except the broker or dealer; provided, however, that partners who maintain “accounts of partners” as herein defined shall not be deemed to be customers insofar as such accounts are concerned.

2. Every broker-dealer shall file, as required by the attorney-general, a financial statement setting forth its assets, liabilities and net worth as computed in subdivision one above.

3. The provisions of this section shall not be applicable to issuers of their own securities who are deemed to be broker-dealers solely for such reason or to banks, private banks, trust companies or other organizations engaged in a banking business and in the conduct of such banking business are subject to examination, supervision and control of the banking authorities of any state or of the United States or any insular possession thereof.

4. Upon a showing by the attorney-general that a broker-dealer has failed to maintain a net capital as hereinbefore prescribed, the supreme court after a hearing may issue an injunction in the form and manner provided for in subdivision one of section three hundred fifty-three of this article in the case of one who actually has or is engaged in any fraudulent practice, for such period of time during which such broker-dealer shall not have and maintain such minimum net capital. The failure, without reasonable cause therefor, of a broker-dealer to file financial statements as may be required by the

attorney-general, shall be prima facie proof that such broker-dealer has failed to maintain the minimum net capital required hereunder and an injunction may issue from the supreme court as hereinbefore set forth without any further showing by the attorney-general.

5. The attorney-general may from time to time in the public interest make, amend and rescind such rules, regulations and forms as are necessary to carry out the provisions of this section, including rules, regulations and forms governing financial statements and filings thereof. For the purpose of such rules, regulations and forms, the attorney-general may classify securities, persons and matters within his jurisdiction and may prescribe different forms and requirements for different classes.

6. Any false statement of a material fact contained in any such financial statement, in any certificate attached thereto or any papers submitted in connection therewith shall constitute a violation of this section within the meaning of section three hundred fifty-nine-g of this article.

§ 352-*l*. Cooperative corporations

1. For the purposes of this section, "non-occupying owner" shall mean the owner of shares in a cooperative corporation who does not occupy the dwelling units to which his or her shares are allocated.

2. If a non-occupying owner rents any dwelling unit to a tenant and then fails to make payments due for maintenance, assessments or late fees for such unit within sixty days of the expiration of any grace period after they are due, upon notice in accordance with subdivision three of this section, all rental payments from the tenant shall be directly payable to the cooperative corporation.

3. If the maintenance, assessments or late fees due for any unit have not been paid in full within sixty days after the expiration of any grace period of the earliest due date, the board of directors shall provide written notice to the rental tenant and the non-occupying owner providing that, commencing immediately and until such time as all payments for maintenance, assessments or late fees are made current, all rental payments due subsequent to the issuance of such notice are to be made payable to the cooperative corporation at the address listed on the notice. Where a majority of the board of directors has been elected by and from among the owners who are in occupancy, the board may elect not to require that rental payments be made payable to the cooperative corporation. At such time as payments for maintenance, assessments and late fees from the non-occupying owner are once again current, notice of such fact shall be given within three business days to the rental tenant and non-occupying owner. Thereafter all rental payments for such unit shall be made payable to the non-occupying owner or to a designated agent. A non-occupying owner who disputes the cooperative corporation's claim to rental payments pursuant to this section shall be entitled to present facts supporting such owner's position at the next scheduled meeting of the board of directors,

which must be held within thirty days of the date that such board receives notice that such owner seeks to dispute such claim.

4. Nothing in this section shall limit any rights of shareholders or of the board of directors existing under any other law or agreement.

5. Payment by a rental tenant to the cooperative corporation made in connection with this section shall relieve that rental tenant from the obligation to pay such rent to the non-occupying owner and shall be an absolute defense in any non-payment proceeding commenced by such non-occupying owner against such tenant for such rent.

§ 353. Action by attorney-general

1. Whenever the attorney-general shall believe from evidence satisfactory to him that any person, partnership, corporation, company, trust or association has engaged in, is engaged or is about to engage in any of the practices or transactions heretofore referred to as and declared to be fraudulent practices, he may bring an action in the name and on behalf of the people of the state of New York against such person, partnership, corporation, company, trust or association, and any other person or persons theretofore concerned in or in any way participating in or about to participate in such fraudulent practices, to enjoin such person, partnership, corporation, company, trust or association and such other person or persons from continuing such fraudulent practices or engaging therein or doing any act or acts in furtherance thereof or, if the attorney-general should believe from such evidence that such person, partnership, corporation, company, trust or association actually has or is engaged in any such fraudulent practice, he may include in such action an application to enjoin permanently such person, partnership, corporation, company, trust or association, and such other person or persons as may have been or may be concerned with or in any way participating in such fraudulent practice, from selling or offering for sale to the public within this state, as principal, broker or agent, or otherwise, any securities issued or to be issued. In said action an order or a judgment may be entered awarding the relief applied for or so much thereof as the court may deem proper. Upon a showing by the attorney-general in his application for a permanent injunction hereunder that the defendant named in the action or an officer thereof has refused to be sworn or to be examined or to answer a material question or to produce a book or paper relevant to the inquiry when duly ordered so to do by the officer or judge duly conducting an inquiry into the subject matter forming the basis of the application for such injunction, such refusal shall be prima facie proof that such defendant is or has been engaged in fraudulent practices as set forth in such application and a permanent injunction may issue from the supreme court without any further showing by the attorney-general. In such an action, the court may award to the plaintiff a sum not in excess of two thousand dollars as an additional allowance.

2. Upon a showing by the attorney-general in an application for an injunction that any person engaged in the purchase, sale, offer to purchase or sell, issuance, exchange, promotion, negotiation, advertisement or distribution within this state of any security or securities, either as principal, partner, officer, agent, employee or otherwise, has ever

been convicted by a court of competent jurisdiction in any state or country of any felony; or of any other criminal offense by any such court, whether or not constituting a felony, involving securities, the supreme court after a hearing may issue a permanent injunction awarding the relief applied for, or so much thereof as the court may deem proper, against such person shown to have been so convicted, in the form and manner provided for in subdivision one of this section in case of one who actually has or is engaged in any fraudulent practice.

3. Upon a showing by the attorney general that a fraudulent practice as defined by this article has occurred, he may include in an action under this article an application to direct restitution of any moneys or property obtained directly or indirectly by any such fraudulent practice.

§ 353-a. Receivers

In any action brought by the attorney-general as provided in this article, the court at any stage of the proceedings may appoint a receiver of any and all property derived by the defendant or defendants or any of them by means of any such fraudulent practices, including also all property with which such property has been mingled if such property can not be identified in kind because of such commingling, together with any or all books of account and papers relating to the same. The judgment entered in such action may provide that such receiver shall take title to any or all such property and books of account and papers relating to the same and liquidate such property or any part thereof for the benefit of all persons intervening in the said action and establishing an interest in such property. The judgment may also provide that all such property, the title to or interest in which has not been established in such action by intervenors or otherwise by due process to be in a person or persons other than defendant or defendants, shall be returned to the defendant or defendants as their interest may appear. Such receiver shall be subject to all the duties of receivers appointed in a civil action as far as practicable except that such provisions relating to commissions or compensation of receivers shall not be applicable to receivers appointed pursuant to this section, but such commissions or compensation shall be fixed by the court in any amount which it may determine to be just and equitable. In any action brought by the attorney-general as provided in this article the court may grant such other and further relief as may be proper.

§ 354. Examination of witnesses and preliminary injunction

Whenever the attorney-general has determined to commence an action under this article, he may present to any justice of the supreme court, before beginning such action, an application in writing for an order directing the person or persons mentioned in the application to appear before the justice of the supreme court or referee designated in such order and answer such questions as may be put to them or to any of them, or to produce such papers, documents and books concerning the alleged fraudulent practices to which the action which he has determined to bring relates, and it shall be the duty of the justice of the supreme court to whom such application for the order is made to grant such

application. The application for such order made by the attorney-general may simply show upon his information and belief that the testimony of such person or persons is material and necessary. The provisions of the civil practice law and rules, relating to an application for an order for the examination of witnesses before the commencement of an action and the method of proceeding on such examination, shall not apply except as herein prescribed. The order shall be granted by the justice of the supreme court to whom the application has been made with such preliminary injunction or stay as may appear to such justice to be proper and expedient and shall specify the time when and place where the witnesses are required to appear. The justice or referee may adjourn such examination from time to time and witnesses must attend accordingly. The testimony of each witness must be subscribed by him and all must be filed in the office of the clerk of the county in which such order for examination is filed.

§ 355. Procedure on hearing

The order for such examination must be signed by the justice making it and service of a copy thereof with an endorsement by the attorney-general signed by him or his deputy, to the effect that the person named therein is required to appear and be examined at the time and place and before the justice or referee specified in such endorsement, shall be sufficient notice for the attendance of witnesses. Such endorsement may contain a clause requiring such person to produce at such examination all books, papers and documents in his possession or under his control relating to the subject of such examination. The order shall be served upon the person named in the endorsement aforesaid by delivering to and leaving with him a certified copy thereof, endorsed as above provided, subject to the payment of witness fees and mileage as and when provided to be paid by section three hundred fifty-two, subdivision three of this article in connection with attendance pursuant to subpoenas authorized to be issued under said action. Service of an order pursuant to section three hundred fifty-four of this article may be made under section three hundred fifty-two-b of this article in cases falling thereunder.

§ 356. Powers of referee

The referee appointed as provided in this article possesses all the powers and is subject to all the duties of a referee appointed in a civil action, so far as practicable, and may punish for contempt a witness duly served with the papers as prescribed in this article for non-attendance or refusal to be sworn or to testify or to produce books, papers and documents according to the direction of the endorsement aforesaid, in the same manner and to the same extent as a referee to hear, try and determine an issue of fact or of law.

§ 357. Application of provisions of civil practice law and rules

The provisions of the civil practice law and rules shall apply to all actions brought under this article except as herein otherwise provided.

§ 358. Criminal prosecution

The attorney-general may prosecute every person charged with the commission of a criminal offense in violation of the laws of this state, applicable to or in respect of the practices or transactions which in this article are referred to as fraudulent practices. In all such proceedings, the attorney-general may appear in person or by his deputy before any court of record or any grand jury and exercise all the powers and perform all the duties in respect of such actions or proceedings which the district attorney would otherwise be authorized or required to exercise or perform; or the attorney-general may in his discretion transmit evidence, proof and information as to such offense to the district attorney of the county or counties in which the alleged violation has occurred, and every district attorney to whom such evidence, proof and information is so transmitted shall forthwith proceed to prosecute any corporation, company, association, or officer, manager or agent thereof, or any firm or person charged with such violation. In any such proceeding, wherein the attorney-general has appeared either in person or by deputy, the district attorney shall only exercise such powers and perform such duties as are required of him by the attorney-general or the deputy attorney-general so appearing.

§ 359. Immunity

Upon any investigation before the attorney-general or his deputy or other officer designated by him, or in any criminal proceeding before any court or grand jury, pursuant to or for a violation of any of the provisions of this article, the attorney-general, his deputy or other officer designated by him, or the court or grand jury, may confer immunity in accordance with the provisions of section 50.20 or 190.40 of the criminal procedure law.

§ 359-a. Appointment of deputies

For the purposes of this article, the attorney-general may in his discretion, and without civil service examination, appoint and employ, and at pleasure remove, such deputies, officers and other persons as he deems necessary, and determine their duties and fix their compensation.

§ 359-b. Effect of unconstitutionality of part of article

Should any section or provision of this article be declared unconstitutional, by the decision of any court, such decision shall affect the section or provision so declared unconstitutional and shall not affect any other section or provision of the article.

§ 359-c. Publication of state notices

1. Every state notice filed in the department of state pursuant to this article shall be published by such department in the next issue of the state bulletin following the receipt thereof, except that a notice received by the department less than five days before the next issue may be published either in such next issue or the next issue but one, at the convenience and in the discretion of such department.

2. The department of state shall collect a fee of seventy-five dollars for filing and publishing each state notice and each further state notice.

[§ 359-d. Repealed. L.1928, c. 710, § 2, eff. July 15, 1928]

§ 359-e. Definitions. Registration requirements

1. The following terms, whenever used or referred to in this article, shall have the following meaning unless a different meaning clearly appears from the context:

(a) A "dealer" shall mean and include any person, firm, association or corporation engaged in the business of buying and selling securities from or to the public within or from this state for his or its own account, through a broker or otherwise, except a bank unless such bank is considered a dealer under the federal securities exchange act of 1934, but does not include any person, firm, association or corporation in so far as he or it buys or sells securities for his or its bona fide investment account, either individually or in some fiduciary capacity. The term "dealer" shall, except as otherwise provided in this article, also include a person, firm, association or corporation selling or offering for sale from or to the public within or from this state securities issued by it. No person shall be deemed to be a "dealer", as defined in this subdivision, or a broker, as defined in subdivision (b) of this section, solely by reason of the fact that he is engaged in the business of (i) selling, offering for sale, purchasing or offering to purchase any security or securities to, from or through any bank, dealer or broker, or to or from any syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups, or (ii) any offer, sale or distribution by an issuer of stock dividends, nontransferable warrants or transferable warrants exercisable within ninety days of their issuance to existing stockholders, securities issued upon conversion of convertible securities and exercise of warrants and securities issued as part of a recapitalization or reclassification to existing stockholders of the same issuer, or (iii) selling, offering for sale, purchasing or offering to purchase any security or securities on the floor of any securities exchange registered as a national securities exchange under the securities exchange act of nineteen hundred thirty-four. No person, firm, association or corporation shall be deemed to be a "dealer", as defined in this subdivision, solely by reason of selling or offering for sale any security or securities to any bank, corporation, savings institution, trust company, insurance company, investment company, as defined in the federal investment company act of nineteen hundred forty, pension or profit-sharing trust, or other financial institution or institutional buyer, whether the purchaser is acting for himself or itself or in some fiduciary capacity, as part of a private placement of securities.

(b) A “broker” shall mean and include any person, firm, association or corporation, other than a dealer, engaged in the business of effecting transactions in securities for the account of others within or from this state, but does not include a bank unless such bank is considered a broker under the federal securities exchange act of 1934.

(c) A “salesman” shall mean and include every person employed by a broker or dealer as said terms are defined in this section, for the purpose of representing such broker or dealer in the sale or purchase of securities to or from the public within or from this state.

(d) A “principal” shall mean and include every person or firm directly or indirectly controlling any broker or dealer.

(e) A “bank” shall mean and include a state or national bank, trust company or savings institution incorporated under the laws and subject to the examination, supervision and control of any state or of the United States or of any insular possession thereof.

2. No dealer or broker shall sell or offer for sale to or purchase or offer to purchase from the public within or from this state, as principal, or broker, any securities issued or to be issued unless and until a notice, to be known as the “state notice,” containing the name, business or post office address of such dealer or broker and if a corporation the state or country of incorporation thereof, and if a partnership the names of the partners, shall have been filed in the department of state. Such notice shall be in the following form:

STATE NOTICE

Name(s) of dealer(s), broker(s)
....

Business address(es) or post office address(es) (state which)

....
....

If a corporation, the state or country in which incorporated.

....
....

If a partnership, the names of the partners
....

3. It shall be unlawful for any dealer, broker or salesman to sell or offer for sale to or purchase or offer to purchase from the public within or from this state, any securities issued or to be issued, unless and until such dealer, broker or salesman shall have filed with the department of law a registration statement as provided herein. A real estate

broker or salesman licensed under article twelve-A of the real property law who is not acting as a dealer shall be deemed to be in compliance with such registration statement filing requirements with respect to the sale of securities constituting cooperative interests in real estate, including shares of cooperative apartment corporations, commercial cooperative corporations, condominiums, and interests in homeowners associations.

(a) The registration statement relating to dealers and brokers, to be known as the “broker-dealer statement” shall contain such information pertaining to the business history for the last preceding five years, criminal record, and educational background of the applicant and his or its partners, officers, directors or other principals thereof deemed pertinent by the attorney-general. The attorney-general may prescribe forms for the use of such applicants.

(b) The registration statement relating to salesmen, to be known as the “salesman's statement,” shall contain such information pertaining to the business history for the last preceding five years, criminal record and educational background of the applicant deemed pertinent by the attorney-general. The attorney-general may prescribe forms for use of such applicants and, as a condition of registration, shall require that prior to the filing of such a registration statement any such applicant shall undertake and successfully complete the uniform securities agent state law examination (“series 63”) or the uniform combined state law examination (“series 66”) as administered by or on behalf of the North American Securities Administrators Association, Inc. (NASAA) by any national securities association or national securities exchange; provided that, if an applicant registers with the attorney-general solely for the purpose of selling condominiums, shares of cooperative apartment corporations or commercial cooperative corporations, interests in homeowners associations or interests in timeshare projects, such applicant shall not be required to undertake the aforementioned examination as a condition of registration.

(c) The registration of brokers, dealers and salesmen shall be for periods of four years commencing on January fifth, nineteen hundred sixty. Such statements for brokers, dealers or salesmen shall be filed every four years within sixty days prior to the expiration of the four year period, provided that previously filed statements shall continue to be effective for a period of ninety days following the end of the four year period. Initial statements for those having no previous filing may be made at any time and shall be effective from the date of filing for a period of four years. All statements filed pursuant to prior provisions of law shall remain in effect until January fifth, nineteen hundred sixty.

4. The attorney-general may by rule or order provide for the filing of supplemental statements prescribed by him which shall contain such information as the attorney-general may deem necessary to keep reasonably current the information on file.

5. The department of law shall collect the following fees: (a) twelve hundred dollars for each broker-dealer's statement; (b) twelve hundred dollars for each broker-dealer's statement filed by a person, firm, association or corporation selling or offering for sale from or to the public within or from this state securities issued by it for any amount in excess of five hundred thousand dollars; (c) three hundred dollars for each broker-dealer's

statement filed by a person, firm, association or corporation selling or offering for sale from or to the public within or from this state securities issued by it for any amount of five hundred thousand dollars or less; (d) three hundred dollars for each broker-dealer's statement filed by a person, firm, association or corporation solely for the purpose of selling or offering for sale from or to the public within or from this state securities consisting of condominiums, shares of cooperative apartment corporations or commercial cooperative corporations, interests in homeowners associations or interests in timeshare projects, plus fifteen dollars for each partner, officer, director or principal of any such firm, association or corporation; (e) one hundred fifty dollars for each salesman's statement; (f) thirty dollars for each supplemental statement; (g) three hundred dollars for each application granted pursuant to subdivision two of section three hundred fifty-nine-f of this article; and (h) two hundred twenty-five dollars for the issuance of a “no filing required letter”; these fees shall obtain for both original statements and their renewals. No fee, however, shall be collected for filing a supplemental statement by a salesman cancelling his prior registration as such salesman.

Any partner, officer, director or principal who is named as such in a broker-dealer statement and who shall act as a salesman for such broker or dealer, shall not be required to register as a salesman.

6. Any false statement of a material fact contained in any such broker-dealer or salesman's statement or supplemental statement or in any certificate attached thereto shall constitute a violation of this section within the meaning of section three hundred fifty-nine-g of this article.

7. Any person, partnership, corporation, company, trust or association representing in any manner that the state, the department of law or any officer thereof has recommended the purchase of any stocks, bonds, or other securities, in advertising or offering such stocks, bonds or other securities for sale shall be guilty of a misdemeanor punishable as provided in subdivision two of section three hundred fifty-nine-g of this article.

8. After this subdivision as hereby amended takes effect no dealer shall sell or offer for sale to the public within this state as principal or agent, any securities issued or to be issued which are not exempted from the provisions of this subdivision by section three hundred and fifty-nine-f hereof unless and until such dealer shall cause to be filed a “further state notice” containing the information, other than the names of partners, required to be published by subdivision two of this section, but opposite the heading “name of dealer”, if the person or persons causing such notice to be filed are acting pursuant to the provisions of this subdivision, there shall be added either the words “syndicate manager” or “syndicate managers” as the case may be; and in addition thereto and as part of each such further state notice the name of the security or securities, name, post office address and state or country of incorporation or organization of the corporation, association, common law trust or similar organization issuing or to issue the security or securities to be sold or offered for sale, in the following form:

FURTHER STATE NOTICE

Name of security or securities
....

Name of issuer of securities
....

Post Office address of issuer of securities
....

....
....

The state or country in which organized
....

....
....

Two or more dealers may jointly file such further state notice required by this subdivision, and a dealer or exchange must file a further state notice for each issue about to be offered which has not heretofore been published by the issuer. A syndicate manager or co-manager with an office in this state may file on behalf of an entire syndicate.

9. A broker-dealer or salesman registration statement or any other document is filed when it is received in the New York city office of the attorney-general.

10. The attorney-general may from time to time in the public interest make, amend, and rescind such forms as are necessary to carry out the provisions of this act, including forms governing registration statements and applications. For the purpose of forms, the attorney-general may classify securities, persons and matters within his jurisdiction, and may prescribe different forms and requirements for different classes.

11. It is unlawful for any broker or dealer to employ a salesman unless the salesman is registered. The registration of a salesman is suspended during any period when he is not associated with a particular broker or dealer registered under this act or a particular issuer. When a salesman begins or terminates a connection with a broker or dealer, or begins or terminates those activities which make him a salesman, the salesman as well as the broker or dealer shall promptly notify the attorney-general.

12. All persons, including partners, officers, directors and salesmen employed by a member or a member organization of a national securities exchange, a national securities association, or any other broker-dealer, registered with the federal securities exchange commission or any broker or dealer required to be registered with the department of law pursuant to this article except those dealers required to be registered solely by reason of the fact that they are engaged in selling or offering for sale securities issued by

themselves, and any employee of a clearing corporation affiliated with any such registered national securities exchange or with any national securities association registered with the federal securities exchange commission, employed on or after September first, nineteen hundred sixty-nine, who are regularly employed within the state of New York shall, as a condition of employment, be fingerprinted. Every set of fingerprints taken pursuant to this subdivision shall be promptly submitted to the attorney general for appropriate processing, except that individuals fingerprinted in compliance with the rules of the securities and exchange commission need not file with the attorney general so long as records of those fingerprints, as well as information received in response to their filing, are available to the attorney general for inspection. The department of law shall collect from a member or member organization of a national securities exchange, a national securities association, or any registered broker-dealer as described above or a clearing corporation affiliated with any such registered national securities exchange or with any such registered national securities association submitting fingerprints to the attorney general for processing a fee in the amount prescribed therefor by the division of criminal justice services for each set of fingerprints submitted. Failure to comply with this section shall be deemed a violation of and a fraudulent practice within the meaning of this article.

12-a. Any employee of a national securities exchange or national securities association registered with the federal securities and exchange commission, and any employee of a clearing corporation or securities information processor affiliated with any such registered national securities exchange or national securities association, and who are regularly employed within the state of New York, shall, as a condition of employment, be fingerprinted. Every national securities exchange, national securities association, clearing corporation or securities information processor that is required to submit fingerprints pursuant to this section shall also obtain fingerprints from any individual not employed by such organization who provides services to such organization within the state of New York provided that the individual has access to records including electronic records, as defined by section three hundred two of the state technology law, or other material or secure buildings or secure property, which place the security of such organization at risk.

Every set of fingerprints taken pursuant to this subdivision shall be promptly submitted to the federal bureau of investigation for the purpose of a nationwide criminal history check. Such reports received from the federal bureau of investigation shall be kept confidential, although the contents of any such report may be disclosed to exchange officials involved in personnel and security matters, to the attorney general, to law enforcement authorities and to the securities and exchange commission. Unless inconsistent with federal law, fingerprints supplied by such employee or employment applicant shall be returned to such person upon termination or denial of such employment. Fingerprints supplied by such other individuals providing services shall be returned upon completion of such services.

12-b. Any employee of a designated contract market, as that term is defined in the Commodity Exchange Act, under the authority of the federal Commodity Futures Trading Commission, and any employee of a derivatives clearing organization, as that

term is defined under the Commodity Exchange Act, that is affiliated with any such designated contract market, and who are regularly employed within the state of New York, shall, as a condition of employment, be fingerprinted. Every designated contract market and derivatives clearing organization that is required to submit fingerprints pursuant to this section shall also obtain fingerprints from any individual not employed by such organization who provides services to such organization within the state of New York provided that the individual has access to records including electronic records, as defined by section three hundred two of the state technology law, or other material or secure buildings or secure property, which place the security of such organization at risk.

Every set of fingerprints taken pursuant to this subdivision shall be promptly submitted to the federal bureau of investigation for the purpose of a nationwide criminal history check. Such reports received from the federal bureau of investigation shall be kept confidential, although the contents of any such report may be disclosed to designated contract market or derivatives clearing organization officials involved in personnel and security matters, to the attorney general, to law enforcement authorities and to the Commodity Futures Trading Commission. Unless inconsistent with federal law, fingerprints supplied by such employee or employment applicant shall be returned to such person upon termination or denial of such employment. Fingerprints supplied by such other individuals providing services shall be returned upon completion of such services.

13. (a) The attorney general may by regulation, rule or order provide an alternative method of registration by which any dealer, broker or salesman acting as such or as principal in more than one state or who engages in multi-state securities offerings may supply the information otherwise required to be furnished in the state notice, registration statement, supplemental statements and further state notice mandated by subdivisions two, three, four and eight of this section. Such alternative method, when complied with, shall be deemed to fulfill the filing requirements of subdivisions two, eight and nine of this section, and shall be in lieu thereof. The regulation, rule or order of the attorney general may also provide for alternative filing periods and expiration dates and an alternate method for the payment of fees, to be known as “in lieu filing fees”, which shall be collected pursuant to such regulation, rule or order of the attorney general in the same amounts as, and for the same information otherwise required to be collected for statements filed as specified by subdivision five of this section.

(b) No alternative method may be provided by the attorney general which does not have, as its purpose, the facilitation of a central registration depository whereby brokers, dealers or salesmen can centrally or simultaneously register and pay fees for all states in which they plan to transact business which requires registration. The attorney general is hereby authorized to enter into an agreement or otherwise facilitate such alternative method with any national securities association, national securities exchange, national association of state securities administrators or similar association or agents thereof to effectuate the provisions of this subdivision.

(c) Any false statement of a material fact contained in any substitute for a broker-dealer statement or salesman's statement or supplemental statement which is provided pursuant

to the attorney general's regulation, rule or order specified in paragraph (a) of this subdivision, shall constitute a violation of this section within the meaning of section three hundred fifty-nine-g of this article.

(d) It shall be unlawful for any dealer, broker or salesman to sell or offer for sale to or purchase or offer to purchase from the public within or from this state, any securities issued or to be issued, unless and until such dealer, broker or salesman shall have complied with the requirements of either: (i) the regulation, rule or order of the attorney general specified in paragraph (a) of this subdivision; or (ii) the filing of a state notice and registration statement and supplemental statements and further state notice as applicable to said dealer, broker or salesman, in accordance with subdivisions two, three, four and eight of this section.

(e) To the extent inconsistent therewith, the provisions of this subdivision shall supersede the provisions of any other subdivision of this section.

14. (a) Definitions. For purposes of this subdivision the following definitions shall apply:

(i) “Commodity” means, except as otherwise specified by the attorney general by rule, regulation or order, any agricultural, grain, animal, chemical, metal or mineral product or byproduct, any gem or gemstone (whether characterized as precious, semi-precious or otherwise), any fuel (whether liquid, gaseous or otherwise), any foreign currency, and any other good, article, or material.

(ii) “Commodity contract” means any account, agreement or contract for the purchase or sale of, or any option or right to purchase or sell, primarily for speculation or investment purposes and not for use or consumption by the offeree or purchaser, one or more commodities, whether for immediate or subsequent delivery or for storage and whether or not delivery is intended by the parties, and whether characterized as a cash contract, deferred shipment or deferred delivery contract, forward contract, futures contract, installment or margin contract, leverage contract, option, privilege, indemnity, bid, offer, put, call, advance guaranty, decline guaranty or otherwise. Any commodity contract offered for sale or sold to a person other than a producer, processor, merchant, handler, commercial user or ultimate consumer of the commodity shall, in the absence of evidence to the contrary, be presumed to be offered for sale or sold for speculation or investment purposes.

(iii) “Commodity broker-dealer” means any person engaged in the business of selling or offering to sell commodities through commodity contracts to the public within or from the state of New York.

(iv) “Commodity salesperson” means any person employed by or representing a commodity broker-dealer in selling or offering for sale commodities through commodity contracts to the public within or from the state of New York.

(v) “Commodity investment advisor” means any person who, for compensation, within or from the state of New York, engages in the business of advising members of the public, either directly or through publications or writings, as to the advisability of investing in, purchasing, selling or holding commodity contracts.

(b) Any person acting as a commodity broker-dealer, commodity salesperson or commodity investment advisor and any person who manages or supervises any such broker-dealer, salesperson or investment advisor shall file a registration statement with the attorney general as a commodity broker-dealer, commodity salesperson, or commodity investment advisor relating to the activity actually engaged in.

(c) The attorney general may adopt rules and regulations governing the form and content of such registration statements for each such activity which may include information pertaining to the business history for the last preceding five years, record of criminal convictions, litigation history, and educational background of the registrant and the registrant's partners, officers, directors or other principals deemed pertinent by the attorney general and the names of persons employed as commodity salespersons or commodity investment advisors by the registrant.

(d) The registration statement shall be effective for a period of one year from the date of filing.

(e) The attorney general shall by rule or regulation provide for the method of renewing such registration statements and may require the filing of supplemental statements which shall contain such information as the attorney general may deem necessary to keep reasonably current the information on file.

(f) The attorney general shall collect the following annual fees: one hundred dollars for each commodity broker-dealer registration statement or commodity investment advisor registration statement; twenty-five dollars for each commodity salesperson registration statement; and ten dollars for each supplemental statement.

(g) The provisions of this subdivision shall not apply to (i) any person who is a member or member firm of a national securities exchange, board of trade designated as a contract market by the Commodity Futures Trading Commission pursuant to the commodity exchange act, as amended, the National Association of Securities Dealers, Inc., or the National Futures Association, Inc., or is an affiliate of such a member or member firm, or employed by such a member or member firm or by an affiliate of such a member or member firm; (ii) any board of trade designated as a contract market as aforesaid; (iii) any other person registered, temporarily licensed, or exempt from registration under the commodity exchange act, as amended, or the rules and regulations promulgated thereunder where such registration, license or exemption relates directly to the activity engaged in; and (iv) any bank or trust company as defined in this article or any person acting as an employee of any bank or trust company or any licensed money transmitter or employee thereof.

(h) In addition to those persons exempt under paragraph (g) of this subdivision, no person shall be required to register as a commodity investment advisor pursuant to paragraph (b) of this subdivision who is (i) a lawyer, accountant, engineer, or teacher who renders investment advice solely incidental to the practice of his or her profession; (ii) a broker or dealer in securities or a commodity broker-dealer or a commodity salesperson who renders investment advice solely incidental to the conduct of his or her business as a broker or dealer in securities or a commodity broker-dealer or a commodity salesperson respectively, and who receives no special compensation for such advice; (iii) a publisher of, editor of, or writer for a bona fide newspaper or news magazine, whether published in print or by electronic means; or (iv) a person who during the course of the preceding twelve months has not advised more than fifteen persons as to the advisability of investing in, purchasing, selling or holding commodity contracts and who does not hold himself out generally to the public as engaging in any of the activities set forth in subparagraph (iii), (iv) or (v) of paragraph (a) of this subdivision.

(i) The provisions of this subdivision shall not apply to any contract or transaction involving the sale of commodities by the owner or lessee of real property upon which such commodities are grown or raised, the sale of items by art dealers or licensed auctioneers at public auction or the sale or resale by a distributor or wholesaler of goods for consumption by the public.

(j) Any person required to be registered by this subdivision who is not registered shall be guilty of a misdemeanor punishable as provided in the penal law.

(k) Any person who engages in a business requiring registration under this article and who knowingly employs two or more persons for the purpose of engaging in conduct requiring registration as a commodity broker-dealer, commodity salesperson or commodity investment advisor under this article with the knowledge that they are not so registered shall be guilty of a class E felony.

(*l*) A violation of this subdivision shall constitute a fraudulent practice as that term is used in this article.

(m) If any provision of this subdivision or the application thereof to any persons or circumstances is held invalid, the validity of the remainder of this subdivision or of the application of such provision to other persons and circumstances shall not be affected thereby.

§ 359-ee. Report of existence

1. Every person, partnership, corporation, company, trust or association which caused to be filed in the department of law a “dealer's statement” on or before June thirtieth, nineteen hundred fifty-three, shall on or before February first, nineteen hundred fifty-nine, file in the department of law a certificate which shall be entitled and endorsed, “Certificate of Report of Existence of ...... (state name of dealer), pursuant to section

three hundred fifty-nine-ee, of the general business law” and shall state: (a) The name of the dealer, and if it was changed, the name under which last registered. (b) The date of the last filing of the dealer's statement in the department of law. (c) That its existence is hereby continued. Such certificate shall be signed and certified by the dealer or any principal officer thereof.

2. On or before January first, nineteen hundred fifty-nine, notice of the enactment of this section shall be given by the attorney-general to each dealer to which this section applies by mailing a copy of such notice to said dealer directed to said dealer at the address stated in the “dealer's statement” filed by said dealer in the department of law and then on file there. A copy of this section shall be endorsed or annexed to each such notice.

3. On March fifteenth, nineteen hundred fifty-nine, the attorney-general shall make a list containing the names of all such dealers, who have not filed the certificate of report of existence required by subdivision one of this section.

4. The attorney-general shall make a proclamation under his hand and seal of office as to the dealers whose names are included in such list, declaring the “dealers' statements” theretofore filed by such dealers as void pursuant to the provisions of this section. He shall file the original proclamation in his office and shall publish a copy thereof in the April or May issue of the state bulletin in the year nineteen hundred fifty-nine.

5. Upon the publication of such proclamation in the manner aforesaid, the “dealer's statement” of each dealer named therein shall be deemed void as of May thirty-first, nineteen hundred fifty-nine, without further proceedings, except as otherwise provided in subdivision six of this section.

6. After this section takes effect, no dealer whose statement has been voided by subdivision five of this section shall sell or offer for sale to the public within this state, as principal, broker or agent, or otherwise, any securities issued or to be issued, unless and until such dealer shall have caused to be filed in the department of law a new “dealer's statement” as required by section three hundred fifty-nine-e of this article.

7. After this section takes effect, no dealer whose statement has been voided by subdivision five of this section shall sell or offer for sale to the public within this state, as principal, broker or agent, or otherwise, any securities issued or to be issued, unless and until such dealer shall have caused to be filed in the department of state a new “state notice” as required by section three hundred fifty-nine-e of this article, and, as to any securities which are not exempted from the provisions of subdivision eight of section three hundred fifty-nine-e of this article by section three hundred fifty-nine-f hereof, until and unless such dealer shall have caused to be filed in the department of state a further “state notice” as required by such section three hundred fifty-nine-e.

8. The fee of the attorney-general for filing a certificate under subdivisions one or six of this section shall be five dollars, and the fee of the department of state for filing any notice under subdivision seven of this section shall be two dollars.