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ABSTRACTS OF INSIGHTFUL CURRENT ARTICLES FROM LEGAL PERIODICALS

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SECURITIES REGULATION & DISCLOSURE

Follow Rule 83 Carefully, Lest FOIA Trump Confidentiality At The SEC

ABSTRACTED FROM: *Keeping Your Comments Private: The SEC, The Freedom Of Information Act, And You*
BY: Julie Bell, SEC Division of Corporation Finance, Office of Rulemaking, Washington, DC
Business Law Today, Vol. 13, No. 2, Pgs. 35-39

Overview: *Cautions that failing to follow precise rules and procedures may thwart issuers trying to secure confidential treatment for data disclosed in response to SEC comment letters. Lays out the requirements, briefly contrasts them with rules applicable to material actually filed with the SEC, and traces the review and appeals process.*

Through many toils and snares. Though nothing requires them to do so, issuers and registrants hoping to facilitate a quicker review often disclose confidential business information to the SEC in response to the staff's comments on filings. Although Regulation S-T Item 101(a) classifies these responses as "nonpublic" for purposes of the EDGAR filing system, Julie Bell warns that they are not necessarily exempt from disclosure under the Freedom of Information Act. In fact, the SEC will release these items unless the company follows the precise, somewhat complex procedures outlined in FOIA Rule 83. Another snare comes if the company fails to request that supplementary matter, such as board materials, be returned after the staff review. Without a request for return or for confidential treatment, the items must be filed electronically—and publicly—on EDGAR.

Making the request. Rule 83 under the FOIA sets out detailed requirements to request confidential treatment for comment responses or supplemental matter. Preliminarily, the author suggests, the issuer should redact the material from its electronic transmission. The segregated paper data sent to the Commission should be clearly labeled as confidential, along with a letter to the staff examiner and the SEC's FOIA office that details what information the company seeks to protect. At the same time, file a paper copy of the complete response letter with the staff examiner. Compliance with these procedural steps does not insure that identified information will actually receive confidential treatment if and when someone requests it; that determination awaits the actual request. (Note that this is not the case when confidentiality is sought for filed material within registration statements and reports; the SEC will rule immediately on that confidentiality request.) The reservation of confidential treatment lasts

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10 years and can be renewed in 10-year increments. The company need not substantiate its eligibility until a disclosure request.

Securing confidentiality. The second phase of the FOIA exemption process arises when a third party requests the release of the data under FOIA. The SEC will then notify the issuer, which has 10 days to document why the data deserves protection. The SEC requires the issuer to submit a statement describing the reasons for confidential treatment, the harm that disclosure would cause, the company's own confidentiality procedures, the ease of a competitor's obtaining the information otherwise, and whether and how disclosure would affect the company's future SEC disclosures. If its preliminary determination is negative after it reviews the submission, the SEC will allow the issuer 10 additional days to marshal more arguments. Following this, either the issuer or the requester may appeal to the SEC's general counsel.

Common blunders and practical advice. The author notes the frequency with which companies and their counsel either fail to request confidentiality or do so improperly (for example, by requesting it for entire response letters rather than for narrowly selected parts). In the current period, which has been characterized by a dramatic increase in the volume of FOIA requests, SEC staff cannot do the company's work for it, ferreting out negligent mistakes or chasing after parties who do not update contact information. Companies are well advised to take maximum advantage of the ability to request the return of supplemental matter and to follow Rule 83 scrupulously.

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Voluntary Delisting A Cost-Efficient Alternative To Going Private

ABSTRACTED FROM: *Delisting/Deregistration Of Securities Under The Securities Exchange Act Of 1934*
BY: David Alan Miller and Marci Frankenthaler, Graubard Miller, New York, NY
Insights: Corporate & Securities Law Advisor, Vol. 17, No. 10, Pgs. 7-12

Overview: *Points out considerations for companies contemplating withdrawal from the burdens of exchange listing and SEC registration. Outlines the substantive and procedural steps to follow, and mentions post-deregistration options.*

Making a quick exit. For many small public companies, the Sarbanes-Oxley Act of 2002 represented the last straw in their ability to maintain public status. Many now want release from the burdens of SEC reporting requirements and exchange listing. David Alan Miller and Marci Frankenthaler advise that deregistration is a less-cumbersome alternative to going private, since it does not require a fundamental alteration of capital structure. If the company has fewer than 300 record holders of the registered security (or fewer than 500 if its assets have been below $10 million for the last three years) and has not registered a security under the 1933 Act within the year, it can deregister with the SEC. It can also withdraw its exchange listing or its Nasdaq or OTC Bulletin Board quotation, whether or not it deregisters, but delisting automatically deregisters the company under 1934 Act Sections 12(b) and 12(g). Residual registration and the duty to file reports will remain under Section 15(d). Unless the charter documents provide otherwise (and they rarely do), the company can deregister without shareholder approval. Before taking this step, however, the board should carefully consider and explicitly weigh the costs and benefits of SEC registration, including the prestige factor, greater liquidity, greater access to capital markets, and greater ability to use stock options or similar compensation schemes.

Cease and delist. Since a company listed on a national exchange or quoted on Nasdaq or OTCBB must perforce file SEC reports under the 1934 Act, the first step in deregistration is to delist. Nasdaq and the American, Boston, and Pacific exchanges have simplified procedures for delisting, requiring only notice and copies of the board resolution approving the delisting. The New York Stock Exchange requires that both the board and the audit committee approve the delisting, that the company issue a press release, and that it notify its 35 largest shareholders, with a copy to the NYSE. The exchange will then issue an approval, no-action, or similar letter, whereupon the company must request SEC delisting approval under 1934 Act Rule 12d2-2. The SEC publishes notice of the request and solicits public comment for about three weeks. If no significant opposition materializes, the SEC approves the delisting, which automatically deregisters the company under 1934 Act Sections 12(b) (for exchange listers) or 12(g) (for Nasdaq listers), as the case may be.

Next stop, deregistration. Having delisted from an exchange or quotation system, or never having been listed or quoted, an issuer may deregister entirely under 1934 Act Section 15(d) by filing Form 15 with the SEC. It can do so, the author reminds, only if it has for the prior three years (or since registration, if shorter) filed all its required periodic reports, even if not on time. Form 15 requires certification that the company meets the stockholder and asset requirements for deregistration. Filing the form suspends the company's reporting requirements, although the SEC has 90 days in which to investigate the facts and approve or deny the application. Upon approval, the reporting requirements end; in the interim, however, the executives must still file Forms 3, 4, and 5, and the company remains liable under the short-swing-profit sections and rules.

Other considerations. The authors suggest several post-deregistration steps for companies to consider. Before delisting from Nasdaq or the OTCBB, issue a press release sufficiently in advance to let holders sell their shares. Notify the marketmakers, who might wish to get ongoing information on the delistee from the so-called pink sheets, which is an information service for brokers. After deregistration, the company may have continuing obligations under state corporation law to hold annual meetings and file financial statements. It may wish to continue to issue press releases and to produce information that permits quotation on the pink sheets. If the company later wishes to resume SEC registration, it may do so by filing Form 10, which the SEC reviews as if it were a new registration.

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Conflict Between The Promptness Of Disclosures And The Quality

ABSTRACTED FROM: *Getting It Right Versus Getting It Quick: The Quality-Timeliness Tradeoff In Corporate Disclosure*
BY: Wally Suphap
Columbia Business Law Review, Vol. 2003, No. 2, Pgs. 661-714

Overview: *Discusses the tradeoff between providing disclosure rapidly and providing it in a high-quality, well-crafted form. Considers the additional tension the SEC has created by accelerating several filing deadlines.*

New rules accelerate disclosure. Although the SEC sees them as compatible goals, the dual objectives of the securities laws—well-crafted information/prompt disclosure—are often at odds with one another, reports Wally Suphap. If an issuer is late in filing a periodic report, it faces severe consequences, such as losing its ability to use the S-3 short-form registration process. Generally, issuers can control the timing of their disclosures. For example, public companies are under no affirmative duty to disclose material nonpublic information during the interval between periodic reports, unless an event occurs that prompts an 8-K filing. However, SEC rules would accelerate the filing deadlines for Forms 10-K, 8-K, and 10-Q. Phased in over three years, the deadline for filing annual reports would change to 60 days from the end of the company's fiscal year. The deadline for filing Forms 10-Q would become 35 days after the end of the quarter. The deadline for filing Forms 8-K would change to two days from the triggering event, and the list of events requiring an 8-K would broaden.

Time-consuming and burdensome calls. This new disclosure regime may create unworkable disclosure duties, the author speculates. With regard to an 8-K event, an issuer has to determine that the event occurred, gather information about it, analyze the data to prepare proper disclosures, and format everything for filing by EDGAR. Just assessing the need for an 8-K filing takes time, since it requires considerable judgment calls on the part of management. Many of the events that require a filing are defined by subjective terms such as “material” or “awareness.” For example, Item 1.03 requires disclosure when the company “becomes aware” that the termination or reduction of a business relationship meeting the 10% threshold has occurred.

Reduced quality. Even if issuers meet the new deadlines, they may significantly compromise the quality of their disclosures to do so. Among the consequences outlined by the author are the possibilities that companies will provide expansive disclosure of immaterial events or may not report events in a consistent, uniform fashion. In addition, some events may compel the company to prepare a mini-MD&A analysis of the reportable event. Two days seems insufficient to draft, review, and file a meaningful, well-crafted mini-MD&A section. Foreign issuers and small businesses face an additional set of issues in meeting the deadlines in a thoughtful fashion, such as time-zone conflicts or the lack of in-house counsel. Even the EDGARization process could take considerable time, particularly if the company has to include lengthy exhibits.

Addressing the tension. The SEC recognizes the tension between quality and timeliness and, the author notes, has made some effort to accommodate both. Among the most important of these efforts, according to the author, are the phasing-in of many regulations, the elimination of duplicative reporting requirements, the ability to obtain extensions from some original deadlines, and the establishment of a safe harbor. The accelerated filing deadlines for periodic reports are being phased in over a three-year period. Rule 12b-25 under the 1934 Act allows companies to extend the filing deadline for quarterly reports by up to five days, and the deadline for annual reports by 15, if it files Form 12b-25 within one day after the original due date. Unfortunately, filing the form may alarm the market by signaling that the company will be disclosing important information.

Late filings still a problem. The SEC has also proposed a new safe harbor from liability for filing a late 8-K, under 1934 Act Sections 13(a) and 15(d). The company would qualify only if: on the due date, it had procedures in place to assure its ability to collect, process, and disclose the information that should have been on Form 8-K; no corporate officer knew that an 8-K should be filed; and once an officer became aware of the failure to file, the company promptly filed a Form 8-K with the required information. Unfortunately, the provisions are ambiguous, so they may not be effective. In addition, despite the safe harbor, a company that fails to file a timely 8-K is also ineligible to use the S-3 registration form for a year.

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Practical Reminders For Complying With Blackout Rules

ABSTRACTED FROM: *Sarbanes-Oxley Produces Complex Blackout Notice Requirements And Imposes Personal Civil Liability For Plan Administrators*
BY: James Hickmon, Williams Mullen, Richmond, VA
Tax Management Financial Planning Journal, Vol. 19, No. 9, Pgs. 227-234

Overview*: Examines the ERISA regulations requiring retirement-plan administrators to give notice of blackout periods. Explains the timing and content of notices, exceptions, and penalties.*

Scandal provokes reforms. Enron's 2001 blackout scandal crippled its 401(k) plan, which was top-heavy with company stock. The resultant public outcry led to the Sarbanes-Oxley Act of 2002, which mandates that the Department of Labor issue regulations requiring administrators establish blackout periods in ERISA-governed, employer-sponsored retirement plans. James Hickmon explains that blackout requirements forbid retirement-plan participants from trading in their accounts when the plan administrators change the investment options or outside managers or when M&A activity occurs. The stringent final DOL regulations cover all plans (except single-participant) with individual account balances: employee-stock-ownership, profit-sharing, 401(k), and money-purchase-pension plans.

Timing and content of notices. The plan administrator must give notice to participants and beneficiaries 30 to 60 days before the last day on which they can exercise the rights being suspended, e.g., directing investments or receiving loans and distributions. The plan's procedure for processing participants' requests might, however, necessitate a longer advance notice, the author notes. An administrator who cannot precisely calculate the blackout's first and last days in advance may instead give the calendar weeks during which those days are expected to fall, provided participants get a toll-free phone number or free website through which to learn whether the blackout has started or concluded. The notice must specify the blackout's length, the reasons behind it, and the rights that it impacts.

Exceptions and additional notice. The administrator may give less than 30 days' notice if waiting that long would violate another ERISA rule, if unforeseeable or uncontrollable events would necessitate a shorter notice, or if an outside manager's computers have broken down. Individuals who join or leave the plan due to M&A activity may also receive shorter notice. The blackout rules do not cover a suspension of participants' rights due to the operation of securities laws or a plan amendment that regularly suspends rights, if the administrator discloses the amendment by any of several authorized methods. The rules do not apply to restrictions on one participant resulting from that person's acts or omissions (e.g., the failure to obtain a PIN.) Under Sarbanes-Oxley, blackouts apply to directors and officers' trading of an issuer's equity securities obtained in connection with their employment. Accordingly, the plan administrator must also give a blackout notice to the issuer of any employer stock that the plan holds. If the blackout will last four straight business days and affect over half of the plan's participants, the issuer must notify the directors, executive officers, and SEC.

Harsh penalties. The DOL can impose a civil penalty for failure to give timely notice. The maximum daily fine is $100 per participant and beneficiary, tallied from the day on which notice was required through the blackout's last day. A late notice does not eliminate the violation. The administrator is personally liable, the author warns, not the plan itself or even an outside manager that contractually assumes liability for late notices. People serving collectively as the administrator are jointly and severally liable. The DOL cannot impose a penalty before giving the administrator written notice and the opportunity to show compliance or mitigation. After the DOL serves a penalty notice, the administrator has 30 days to request a decrease or waiver. If DOL rejects the request, the administrator may exhaust administrative remedies and then sue in federal court.

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MERGERS & ACQUISITIONS

Saving The Deal, Post-*Omnicare,* With Creative Agreement Drafting

ABSTRACTED FROM: *Deal Protection After Omnicare*
BY: Jeff Gordon, Scott Davis, and Mark Uhrynuk
Mayer Brown Rowe & Maw, London, England (JG and MU); Chicago, IL (SD)
International Company & Commercial Law Review*,* Vol. 14, No. 10, Pgs. 311-318

Overview*: Examines Omnicare v. NCS Healthcare, in which the Delaware Supreme Court struck down merger protection provisions in a deal approved by the target board and supported by its majority shareholders. Explores ways to structure deal-protection provisions to withstand scrutiny.*

Protecting the deal. Delaware courts carefully balance the rights of bidders to lock up their deal against the duty of target boards to maximize shareholder value. The more preclusive the lockup, the more likely it is to be struck down. The Delaware Supreme Court's decision in *Omnicare v. NCS Healthcare* (2003) dramatically changes the landscape, tilting the scale to favor the seller, write Jeff Gordon, Scott Davis, and Mark Uhrynuk. Once a bidder obtains an agreement on an acquisition, its next focus is to protect the deal against competing bidders. Over the years, lawyers and bankers have invented numerous devices to protect a signed transaction, buffered by the target board's obligations under *Unocal* and *Revlon*. The bidder usually seeks a commitment from the target's board that it will not solicit competing bids or negotiate with competing bidders unless it has a fiduciary duty to do so. Should the board invoke this fiduciary-out, the bidder often gets a 2% to 4% termination fee. Bidders also want the target board to submit the transaction to shareholders for approval, even if the board cannot recommend the deal. When the target has a majority shareholder, the bidder may insist that the shareholder agree to vote in favor, or it can even seek an option over the majority shares. The target can protect minority shareholders by insisting that they receive the same consideration as the majority or by demanding a fiduciary-out provision. Bidders resist, arguing that since the majority of shareholders have approved the deal, the board has no fiduciary duty to seek a superior bid.

Omnicare tips the balance. NCS Healthcare shopped itself for over 20 months and entertained competing bids before accepting a buyout offer from Genesis Healthcare. NCS signed an acquisition agreement without a fiduciary-out clause. The board could withdraw its recommendation if a superior bid came along, but it still had to submit the transaction for a shareholder vote. The results of that vote seemed a foregone conclusion, because Genesis had a agreement from NCS's 65% majority shareholder to vote in favor of the deal. The next day, Omnicare made a much more favorable offer and sued to enjoin the Genesis transaction. The Delaware Supreme Court, in a split decision, concluded that this lockup was preclusive and a disproportionate response to the threat posed by the Omnicare offer. It held that the merger and voting agreements were unenforceable. As the dissent pointed out, this decision effectively voids a merger freely negotiated and approved by the board and supported by a majority of the shareholders. The dissent expressed its hope that *Omnicare* will be interpreted narrowly and that future parties can negotiate around it.

Negotiating around Omnicare. From the dissent's opinion, the authors distill several ways in which the parties in *Omnicare* could have changed the outcome, which may serve as negotiating tactics for future lockups. At the end of the day, if the majority shareholders want to sell their shares to a potential bidder, the parties should be able to agree on a transaction that will withstand judicial challenge. If, for example, the agreement had contained a standard fiduciary-out, the original bidder would have received significant protection. It would have been able to option the majority shareholder's shares, at the original deal price, in the event that the board exercised its fiduciary-out, making Genesis the majority shareholder. It could then have accepted Omnicare's offer and enjoyed the profits from the deal, or it could have attempted to maintain its original transaction. It might have been hindered by

Delaware General Corporate Law Section 203, which prohibits it from executing a back-end merger for three years unless it received the target board's approval or approval by a majority of the minority shareholders. Of course, this would significantly delay its ability to consummate a back-end merger and force it to pay a higher price to buy out the minority. The initial bidder would also encounter problems if the target had a poison pill in place. However, it could increase the pressure by starting a tender offer for the minority shares or by replacing the incumbent board as soon as possible.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Issues To Consider When Buying D&O Liability Insurance

ABSTRACTED FROM: *The Continuing Crisis In D&O Insurance: How Can Directors And Officers Be Sure Their Personal Assets Are Protected?*
BY: William Cotter, National Union Fire Insurance Company of Pittsburgh, PA
D&O Advisor, Vol. 1, No. 2, Pgs. 48-55

Overview: *Describes the risk factors affecting the availability and adequacy of D&O liability insurance, and considers the impact of recent court decisions. Addresses pension fund issues, suits brought against smaller companies, and ambiguities in Sarbanes-Oxley.*

Scandals make for bad law, higher liability risk. Recent court decisions, many arising out of the major corporate governance scandals of the last few years, may lower the risk bar for corporate officers, directors, and their insurers. The standard of required scienter may fall as well. One court's holding that private companies' directors owe the same fiduciary duties as public directors will also encourage suits. William Cotter warns D&O insurance carriers to take heed of the implications. For example, corporate indemnification is generally not available in derivative actions. In fact, the SEC has suggested that indemnification undermines the punitive impact of a settlement with an individual defendant. It may begin to condition its settlements on the defendant agreeing to forgo corporate indemnification of the cost. If directors cannot rely on indemnification, they must look to their D&O insurance coverage.

Targeting smaller companies. Another risk factor likely to impact D&O insurance, according to the author, is the probability that the plaintiffs' bar will go after smaller companies in the future. Restated financial statements frequently indicate a problem that results in securities litigation. Almost half of the recent restatements have been made by companies with less than $100 million in revenue. Because these smaller companies generally have fewer shareholders, plaintiffs are better able to control the litigation and to push for quick settlements. Some smaller companies may also find prohibitive the cost of complying with all the new requirements under the Sarbanes-Oxley Act of 2002. Thus, a small company's litigation defenses may be weaker. The lesson for insurers? They may be underpricing the cost of D&O insurance for these riskier companies.

Pension fund issues. Directors and officers may face increased liability arising from the company's pension fund. If a 401(k) plan offers the company's stock and if corporate fraud is discovered, plaintiffs may claim that the fiduciaries should have divested the plan of the company stock. For this purpose, fiduciaries may include both plan fiduciaries and other directors and officers of the company. The author also notes that some defined benefit plans are underfunded. Because of the earlier strong investment climate, firms underestimated the amount that needed to be invested. To compensate, companies must now make significant additional contributions to these funds, causing a charge to earnings. Lawsuits may also allege that the company's prior earnings were inflated because the defined benefit plans were underfunded.

Sarbanes-Oxley's impact on insurance costs. Over the next few years, Sarbanes-Oxley is likely to increase the risk to officers and directors, and therefore to D&O insurers, cautions the author. Adequate D&O insurance is necessary so that directors feel confident even when making risky-but-innovative decisions for their companies. The new statute and the regulations are ambiguous and require clarification in many areas. Plaintiffs' attorneys will use those ambiguities to bring suits seeking favorable interpretations of the law, and insureds will call on their D&O policies for defense costs. Some companies may not focus on good governance practices, assuming that their governance practices are appropriate because the practices comply with Sarbanes-Oxley or because the directors are independent, yet history has proven that D&O insurers should not be so complacent.

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Review D&O Liability Insurance Before Bankruptcy To Ensure Its Adequacy

ABSTRACTED FROM: *Director/Officer Liability In Event Of Bankruptcy: Can You Count On Your D&O Policy?*
BY: David Sunkin and Kirk Pasich
Earl Scheib Inc., Sherman Oaks, CA (DS); Pasich & Kornfeld, Los Angeles, CA (KP)
ACC Docket, Vol. 21, No. 10, Pgs. 114-130

Overview: *Outlines what types of D&O coverage are available, and analyzes how the insured company's bankruptcy affects coverage. Suggests ways to maintain coverage in the wake of a bankruptcy.*

Relying on D&O insurance. In the event of a company's bankruptcy, the automatic-stay provision of the Bankruptcy Code protects the company from lawsuits, but actions against the directors and officers are not stayed. They must therefore rely on their D&O insurance. David Sunkin and Kirk Pasich explain how corporate bankruptcy affects the coverage. Directors' and officers' liability insurance generally provides coverage for the directors and officers but also for the company if it must indemnify those individuals. The D&O portion of the policy usually requires the insurer to cover all losses resulting from wrongful acts for which the directors and officers are not indemnified, while the company portion covers losses incurred by the company as a result of its obligation to indemnify. Losses generally include damages, judgments, settlements, and legal defense costs. D&O policies may also be written with entity coverage, which would cover losses the company faces as a result of securities litigation or employment practice claims.

Policy's fate during bankruptcy. Courts have generally held that the insurance policy itself is the property of the bankrupt's estate but that the proceeds are not. However, if the policy provides coverage for the debtor as well as the directors and officers and if it is subject to an aggregate limit, the value of the policy to the debtor will be diminished if the directors' and officers' claims are paid. This, the authors point out, would effectively violate the automatic stay. Deductibles and self-insured retentions ("SIRs") may also give rise to coverage issues. Insurers have argued that, when multiple policies are in place, the SIRs and deductibles must be paid on all the policies before the insurance proceeds from any one policy are due. Courts have rejected that argument, distinguishing the usual rule of horizontal exhaustion (which requires exhaustion of all primary policies) by noting that SIRs and deductibles are not primary insurance but contractual terms. The policy may explicitly require that the debtor pay the deductible or SIR from its own funds, but for a bankrupt company, this can be an insurmountable hurdle. At least one court has held that the debtor can satisfy the SIR requirements of one insurance policy by using the proceeds from another.

Common defenses. When the claim against the insureds alleges fraud, the insurer may attempt to rescind the policy, arguing that the application failed to disclose the fraud. This argument is gaining steam, note the authors, in the light of the notorious corporate accounting scandals of the last few years. The insured will argue that its knowledge of a potential risk does not mean that it purposely made a material misstatement in its application. At least one court has agreed that fearing a potential lawsuit, while troubling with the benefit of hindsight, is not material misrepresentation. Another area of conflict arises because D&O policies generally exclude coverage for insured-versus-insured lawsuits. In bankruptcy cases, the trustee often brings a claim against the former directors and officers. Some courts have held that the trustees' claims are made on behalf of the estate and not the company, so the insured-versus-insured exclusion is inapplicable.

Practical steps. The authors suggest several steps that corporate counsel can take to ensure D&O coverage remains despite the company's declaration of bankruptcy. Review all D&O policies to evaluate the level of coverage and to make sure that the policy requirements are being met. Insurers attempt to exclude coverage of claims resulting from fraudulent financial statements; however, under most policies, coverage will be provided if the insured gives adequate notice of the potential claim. If possible, purchase separate policies, one for entity coverage and the other for directors' and officers' liability. When double polices are not practical, the sole policy should have separate limits for the entity insurance and the D&O coverage. Negotiate the terms to ensure that bankruptcy will not be a termination event and to include a waiver of the automatic stay.

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Delaware Courts Chip Away At The Duty Of Loyalty

ABSTRACTED FROM: *Speaking With Complete Candor: Shareholder Ratification And The Elimination Of The Duty Of Loyalty*
BY: Prof. J. Robert Brown Jr., University of Denver College of Law
Hastings Law Journal, Vol. 54, No. 3, Pgs. 641-694

Overview: *Critiques the Delaware courts' replacement of the fairness criterion for approving interested-director transactions with a shareholder-ratification procedure. Argues that ratification is ineffective where interested directors control the information flow. Reviews the duties of loyalty and care, traces how the duty of candor evolved from the other duties, and observes that ratification has supplanted other substantive and procedural safeguards against abuse.*

Tempered fi. Although the fiduciary duty of loyalty has retained a strong substantive element, the duty of care has been transformed by the business-judgment rule and corporate charter provisions into a mere set of procedural safeguards, argues J. Robert Brown Jr. This leaves an action for waste—a virtually impossible action to prosecute successfully—as the disgruntled shareholder's only remedy. In interested-director transactions, courts assess not only the process by which a deal was approved but also the fairness from the corporation's standpoint, yet several developments have attenuated the fairness review in duty-of-loyalty cases. For example, under Delaware General Corporation Law Section 144, a transaction between a corporation and a director is not void (or voidable, the former standard) by virtue of a conflict of interest, provided one of three conditions applies: approval by a majority of disinterested directors following full disclosure by the interested director; good-faith approval by the shareholders following full disclosure; or inherent fairness of the transaction, plus approval or ratification by the directors, a board committee, or the shareholders. Many transactions fall outside the scope of Section 144, including transactions that benefit but do not officially involve a director (e.g., a merger) or that involve controlling shareholders.

Bit of an (incoherent) stretch. Delaware courts have, in the author's assessment, extended Section 144's ratification concept far beyond its intended narrow compass. This has transformed duty-of-loyalty law dramatically, applying ratification to cases not within Section 144's ambit and extending the law's impact from mere voidability to presumptively valid under the business-judgment rule, leaving an action for waste as the only available remedy. In *In re Walt Disney Co. Derivative Litigation* (1998), the chancery court concluded that if an interested-party transaction is approved by a majority of disinterested shareholders (a constituency never mentioned in Section 144), the business-judgment rule applies to the transaction. In other situations, where neither Section 144 nor disinterested-shareholder approval applies, courts theoretically apply a fairness review. Sometimes, as in *Cinerama v. Technicolor* (1995), the court interprets the facts generously to apply the statute, but the author finds the rationale for either doing or not doing the fairness review is often incoherent.

Disclosure lite. The major prerequisite for shareholder ratification, whether under Section 144 or case law on disinterested-shareholder ratification, is "full and fair" disclosure of all material facts surrounding the transaction. Delaware courts ostensibly apply the same definition of materiality as do the federal courts in securities cases, using the *Basic v. Levinson* concept of what a reasonable investor would want to know. Yet several glosses on the concept have resulted in the board being able to conceal a great deal of material information that federal courts would require it to disclose. One example the author gives is from Delaware cases dealing with mergers. Three key elements are not subject to disclosure: the structure and results of alternative valuation methodologies that the board might have used instead of the one they ultimately adopted; offers for the company other than the one the board recommends for shareholder approval; and facts that would tend to suggest an improper motivation, such as a conflict of interest, behind the directors' recommendations. In each of these situations, federal courts have held such information to be material under the securities laws, and Delaware courts have held them immaterial as a matter of state corporation law.

High on purity, low on protection. To obtain what Delaware, but not the federal courts, would consider informed ratification, interested directors could skew the information flow to the shareholders. This would effectively abolish the fairness review, even in duty-of-loyalty cases. Delaware adopts a categorical analytical approach. The courts do not weigh the probability of the harm against the magnitude but rather the benefits of disclosure against the harm to the corporation from disclosing certain categories of information. "Harm" includes the inundation of shareholders with immaterial material information such as alternative valuations (even though such valuations may be quite reliable under particular circumstances); the detrimental effect on the business of publicly disclosing alternative valuations and other suitors; and the seemingly demeaning effect of the directors being required to describe facts outside the scope of the particular transaction. Therefore, according to the author, the focus of Delaware disclosure analysis is the very specific proposal before the shareholders, not the potential alternatives.

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SECURITIES ENFORCEMENT & FRAUD

Securities Lawyers Facing Fraud Class Actions Need Adequate Insurance

ABSTRACTED FROM: *Transactional Lawyers Under Fire: A Look At Coverage Questions Arising In The Context Of Securities Class Action Suits Against Legal Professionals*
BY: Donald McMinn, Spriggs & Hollingsworth, Washington, DC
Tort Trial & Insurance Practice Law Journal, Vol. 38, No. 4, Pgs. 999-1017

Overview: *Warns attorneys of the post-Enron danger of becoming a defendant in a securities-fraud class action. Identifies escape clauses for the insurer in a professional liability policy.*

Enron as omen. Plaintiffs in securities-fraud class actions are likely to emulate the Enron plaintiffs by suing the lawyers who worked on a transaction gone awry, Donald McMinn surmises. The law firm representing public companies should therefore know which provisions and exclusions in its professional liability policy might be cited by the insurance company seeking to avoid or decrease its coverage obligations. Professional liability policies usually exclude coverage for intentional harm and for actions or omissions that are illegal, dishonest, or malicious. When establishing a law firm's liability, plaintiffs often show that a lawyer's actions come within the exclusion. This is especially likely in suits under 1934 Act Section 10(b), which (unlike 1933 Act Section 11) requires proof of scienter.

Definitions affect coverage. Policies commonly cover the insured law firm's "loss" or "damages" paid, but insurance companies try to restrict coverage by arguing that these terms exclude fines, taxes, and penalties; equitable remedies, including restitution and disgorgement; matters that are legally uninsurable; and punitive and exemplary damages. Some policies make these exclusions explicit. Insurers sometimes attempt to restrict coverage to liability for the insured's technical legal mistakes, even though the typical policy language covers the performance of all "professional services." The policy might not define this term, so the author suggests that the parties use a commonsense definition. Courts define the term as services routinely rendered by lawyers (even if nonlawyers could render them), but they sometimes mistakenly exclude service based on the mere allegation that it was fraudulently rendered.

Making claims. For claims to be covered, the insured law firm must either receive them within the policy period or, under some policies, both receive and report them to the insurance company within the period. Most policies also cover claims that occur subsequent to the policy period, provided the insured gives written notice during the period of the precipitating circumstances. Insurers might deny coverage for post-period claims by arguing that the notice, designed to maximize coverage, was a speculative and vague laundry list. Most policies exclude claims whose precipitating circumstances the insured knew before the starting date. Absent such an exclusion, the author points out, insurers can avoid coverage by asking an insured to specify in its application any claims made and circumstances that might lead to claims. Then it will argue that the insured hid material information. Many policies also exclude coverage of claims based on acts or omissions that occurred before the starting date or a specified, earlier date.

Defense counsel, innocents, and firm switchers. Standard contracts give the insurer the right to choose defense counsel, the author mentions. The insured should verify the chosen counsel is appropriate and sufficiently experienced. An insured could purchase this right, although the insurer might retain the right to consent to the insured's choice or limit the choice to a designated list of approved names. The insurer's obligation to defend extends to an appeal for which there are reasonable grounds. Standard contracts generally include an innocent-insured clause, preserving coverage for those attorneys in the firm who did not commit any wrongful acts, who did not know about those being committed by others, and who acted as whistleblowers upon finding out. Absent an express innocents' clause, the courts might imply one. When an attorney switches firms after performing legal services but before those services give rise to a claim, the former firm's current policy is apt to provide coverage. The new firm's policy might cover all liabilities of the firm's current attorneys or only liabilities for services performed on that firm's behalf.

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